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Euro Tax Flash from KPMG's EU Tax Centre

European Commission proposes a series of carbon pricing reforms as part of its 'Fit for 55 package'

Green taxation – CBAM – EU ETS – Energy Taxation Directive – EU Green Deal

On July 14, 2021, the European Commission (EC) released a package of reforms aimed at ensuring the EU meets its emission reduction goal of a 55 percent reduction of 1990 emission levels by 2030. These reforms, dubbed 'the EU Green Deal', represent some of the most substantial reforms the European Emissions Trading System (ETS) and EU carbon policy have experienced in over a decade. These changes to carbon pricing sit alongside extensive fiscal programs, reforms to the Energy Taxation Directive (ETD) to make energy excise arrangements greener, and the introduction of a plastics tax.

There are four key pillars to the reforms, all being phased in over four years:

1. A step change tightening of emission caps under the EU ETS to align the ETS ambitions with the EU's carbon reduction targets;
2. Expanding the sector coverage of the ETS to a broader scope of sectors;
3. The progressive withdrawal of free permits for emission intensive, trade exposed (EITE) sectors under the EU ETS;
4. The introduction of a carbon border adjustment mechanism (CBAM), which establishes a 'shadow ETS' for certain goods being imported into the EU to avoid further carbon leakage from these more ambitious reforms.

What is the EU ETS and how does it work?

The EU ETS has been central to the EU's efforts to reduce CO2 emissions since its inception in 2005. Operating as a cap and trade scheme, the EU ETS allows the EU to set a cap on emissions in each year going forward, requiring obligated emitters to purchase and retire Emission Units / European Union Allowances (EUAs) for their emissions, or avoid emissions via carbon reduction. Until now, the EU ETS has covered around 40% of the EU's emissions, with power generation, heavy industry and aviation covered by the scheme with the emissions cap reducing at a rate of 2.2% per year.

The July 14 announcement has three major implications for the functioning of the EU ETS going forward:

1. The cap on EUA supply
2. The availability of free EITE EUAs
3. Scope of the EU ETS

1) The cap on EUA supply: The annual emissions cap reduction was recently increased to 2.2% with the launch of Phase 4 of the EUETS in 2021 and these announcements increase this annual decline to 4.2%. This cap will force greater investment in decarbonisation activities as supply of units continues to decline in excess of the obligated emissions in the economy. Such a reduction also provides a clear market signal to enable investors in these decarbonisation activities to price the future carbon outlook and make long term investment decisions.

2) The availability of free EITE EUAs: Auctioning has always been the primary allocation mechanism for releasing the supply of EUAs to market, however some participants have been eligible for free EUAs if they are judged as exposed to 'carbon leakage' (offshoring of carbon intensive manufacturing). However, the proposed reforms seek to reduce these free allocations as the Carbon Border Adjustment Mechanism (CBAM) is introduced from 2023, using CBAM to protect against carbon leakage and therein, exposing emitters to the full cost of carbon for their emissions

3) Scope of the EU ETS: Introducing a new ETS for the road transport and buildings sectors and including maritime transport in the existing ETS ensures the emissions reductions pathway from these sectors are aligned with the EU's decarbonisation target of 55% by 2030.

What is the CBAM and how will it work?

The CBAM is a tool to address the risk of "carbon leakage", that is where goods produced in a high ambition region – like the EU – are substituted with imports from a region with a lower carbon price or production of goods is moved from the high ambition area to a lower one. The CBAM does this by placing a requirement that certain covered goods imported into the EU will need to surrender CBAM emission certificates for the embedded emissions in the imported good – mirroring the existing EU ETS for such goods produced in the EU.

This measure is designed to complement the withdrawal of free permits for the covered goods being produced within the EU. According to the EC, this is intended to provide an ongoing even playing field between EU and non-EU high emission products, while ensuring emissions are priced consistently across the economy.

Key design elements and compliance requirements of the CBAM are outlined below:

- Covered goods currently include cement, electricity, fertiliser, aluminium, iron and steel (although it should be noted that there are some exceptions and it is necessary to check the tariff items in the Customs Tariff carefully to ascertain if a specific product is covered).
- Importers of covered goods would need to have the embedded emissions of their products calculated according to the established EU methodologies and independently verified.
- Where such verification is not possible, embedded emission would be determined using default values set a level corresponding to the emissions of the worst 10% of sites in the EU.
- Emissions which need to be measured are both Scope 1 (direct emissions released in the production process) and Scope 2 (indirect emissions which have been released in the generation of energy which is purchased for use in the production process). Scope 2 emissions are based on the emissions intensity of the grid in the exporting country.
- Where goods are imported from countries that have a mandatory carbon price the number of CBAM certificates required to be surrendered may be reduced in line with carbon costs already paid
- CBAM certificates would be surrendered annually on 31 May in respect of embedded emissions in imports in the previous calendar year but can be purchased at any time.
- The price of CBAM certificates would be set each week as the average closing price of all auctions of EU ETS allowances from the week prior
- Countries with linked systems to the EU ETS including Iceland, Liechtenstein, Norway, Switzerland and EU territories would be exempt from the CBAM. If any other countries join the EU ETS or link their ETS they may also be exempt.
- Importers of covered goods will need to calculate their emissions, however default values for embedded emissions would be available if that is not possible.

To facilitate the swift implementation of the CBAM a simplified transitional period has been proposed which, for the first two years of the CBAM, the importer will still be required to calculate and report on embedded emissions. However, there will be no financial adjustment required.

EU Tax Centre Comment

What are the likely impacts of the changes?

A significant impact of the changes will be an increase in the price of EUAs, resulting from the one-off emission cap reduction, and the withdrawal of some free permits and the increase in covered sectors.

The EC impact assessment projects the price of EUAs will range from EUR 50 to EUR 85 by 2030 if the Green Deal policies are implemented. This increase impacts the cost of all products covered by the EU ETS, including the newly covered sectors of road transport and buildings. The EC recognises this inclusion of new sectors will adversely impact vulnerable consumers with the costs for lower income households estimated to increase by 0.7 to 1.4 percent of consumption.

EU consumers and users of goods covered by the EU ETS and CBAM may face an increase in final retail costs. This will flow from higher EUA prices, requirements of EUA pegged CBAM certificates and the withdrawal of free permits to some sectors. Depending on the availability of low-carbon substitutes which can be identified, the costs of construction and manufacturing may increase. The additional compliance burden of the CBAM may also affect imports of these covered sectors as importers adjust to new system requirements.

Structural changes away from covered goods

In the medium to longer term, the higher EUA costs and CBAM requirements may lead to greater structural changes across the EU economy as there is a move away from high carbon products and fuels. Equally, this change will represent a growth opportunity for low carbon materials and fuels. This, along with changes flowing from the ETD, are expected to have profound impacts on supply chain costs for many manufacturers, retail, and wholesale businesses.

Potential to set international precedent

The introduction of the CBAM could risk challenge from the World Trade Organisation depending on the design details and implementation – for example if, in practice, the CBAM results in a higher carbon price for importers than domestic producers due to artificial difficulties in verifying the embedded carbon content of imports. The parallel removal of free permits somewhat reduces the risk of challenge, though this may depend on detailed implementation. If the CBAM does become established and succeeds in underpinning greater ambition while reducing carbon leakage, it could create a norm-setting precedent for other countries to adopt similar policies. Countries with a high trade exposure to the EU may seek to align their emissions verification methodologies to align their emission accounting approaches. Additionally, over the longer run this may create greater impetus for other ETS or equivalent carbon measures around the world to directly link and address carbon leakage issues in a more efficient manner.

What do these changes mean for exporters to the EU?

CBAM compliance

Businesses that export CBAM covered goods to the EU customs territory will need to ensure they comply with the emission reporting requirements. To avoid EU default settings, the CBAM requires independently verified assessment of embedded emissions of covered goods. This will require firms to understand the carbon footprint of their products, even if they have a good understanding of this at facility level. For example, if an Asia-Pacific company wanted to export steel to the EU and avoid the default EU settings (say because they consider their emissions profile to be lower), they would need to undertake verified product level accounting. More generally, border measures will add to existing pressure to understand and verify carbon through supply chains, both from direct compliance risk and norm setting effects.

CBAM strategy

With the introduction of the CBAM which operates as a shadow ETS pegged to the EU ETS, exporters of CBAM covered goods may need to engage in a hedging strategy that guides their approach to CBAM certificates. This may include the strategic purchase, banking, and possible re-selling of CBAM certificates.

Competitive advantage

The introduction of the CBAM, alongside the withdrawal of free permits, may impact the competitive position of different exporters of covered goods differently. For example, a relatively carbon efficient iron and steel exporter may improve its competitiveness versus low efficiency EU plants, though this depends on its ability to verify actual emissions and avoid the default settings (which are based on benchmarks for poorly performing EU competitors). Alternatively, if an exporter is located on a grid with a high emissions intensity, they would be disadvantaged from the introduction of the CBAM requirements and may opt to export to non-EU markets (unless provision is made to be able to avoid this by verifying purchase of power from low emissions sources). Each exporter will need to assess the impact of the final details of the various components of the package on their own products and available choices, and those of competitors.

Other exporters

The combined impact of the range of measures will have impacts beyond exporters directly affected by the CBAM, and indeed beyond trade with the EU. Higher and more consistently applied carbon charges within the EU will affect final demand for goods, depending on their carbon content. It is expected to produce fuel switching and demand substitution from high to low carbon fuels and products. Given the EU is a significant consumer, this will impact global commodity markets and opportunities.

Over time these impacts could become more profound if this package of approaches is adopted by other significant markets.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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