

Just the FAQs

China and the European Union's Carbon Border Adjustment (CBAM)

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For more information

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In October 2023, the EU formally kicked off its Carbon Border Adjustment Mechanism (CBAM). When it is implemented fully, the CBAM will represent a considerable financial challenge for producers seeking to sell goods into the EU, especially goods with high levels of embedded carbon emissions. The impact on some Chinese producers will be considerable, but many questions remain as this policy is still in the phase-in period. In this edition of Just the FAQs, we examine the main features of CBAM and the likely impact on producers in China.

What is the Carbon Border Adjustment Mechanism (CBAM)?

ANSWER: The Carbon Border Adjustment Mechanism (CBAM) is a carbon taxation tool currently being implemented by the European Union (EU). CBAM was first proposed under the European Green Deal in 2019 and finally adopted in April of 2023 after four years of internal negotiations. When it comes into full effect in 2026, CBAM will establish the world's first cross-border levy on imported carbon, targeting sectors with high levels of embedded emissions such as steel, aluminium, cement, fertilisers and hydrogen.

What is the point of CBAM?

ANSWER: CBAM intends to create a mechanism for account for carbon emissions associated with goods produced outside the EU, closing a loophole in the current EU carbon trading scheme. Currently, any imports from regions such as Africa (which has no carbon scheme) or China (where carbon prices are much lower than in the EU) will have lower prices than EU-produced goods. The expected outcome of taxing carbon at the border is to close the associated carbon price gap between imported goods and EU-produced goods, called Carbon Leakage or the Carbon Gap. This gap will be particularly pronounced when looking at steel or aluminium produced in regions where a high portion of the power consumed comes from fossil fuels, so these segments will be most heavily affected in the initial phase.

Who will be affected by CBAM?

ANSWER: Any producer importing goods with high levels of embedded emissions into the EU will be affected by CBAM. The industries most likely to see a material effect in the short term will be steel and aluminium, with other high-polluting industries to follow. The tax on embedded carbon will be assessed on products entering the EU, regardless of whether the producer is a foreign entity or the overseas factory of an EU-headquartered entity. Eventually, other imported goods that are not themselves high-emitting products will also be affected (to a lesser extent) via a carbon tax levied on their transportation, such as shipping.

When will this start having a financial impact on producers?

ANSWER: CBAM is a multi-phase scheme, with the first (transitional) phase having already kicked off in October 2023, emissions reporting beginning this year, and taxation implementation expected from January 2026 onwards. For now, the key concern for producers should be how they report their emissions. Until the end of this year, producers will have three reporting options, but starting from January 2025, only the EU method will be considered valid, so it is advisable for mandated entities to prioritise familiarising themselves with the EU approach from the outset.

Between October 2023 and 31 December 2025, CBAM importers will report a set of data, including emissions embedded in their goods, without paying a financial adjustment for the embedded emissions. However, penalties such as failing to submit the required quarterly CBAM reports may be imposed. From 1 January 2026, importers to the EU will begin to pay tax covering the embedded emissions associated with the goods in question. The embedded emissions cost will be linked to the weekly EU ETS price on the market, with producers outside the EU surrendering their CBAM certificates upon arrival. In addition, under new EU ETS rules, shippers will be required to report associated emissions incurred during voyages to and from the EU for 2024 and 2025. By 2026, all ships of 5000+ tons will be required to pay the prevailing EU carbon rate for either 50% of their emissions (if moving goods between the EU and a third party) or 100% of emissions (if moving goods between two ports).

Will maintaining CBAM compliance be expensive for producers?

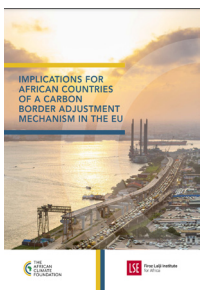
ANSWER: It depends, but potentially yes. The key factors are whether you are in an exposed industry and exporting regularly to the EU. If so, it's advisable to follow developments in this space closely. Since the carbon price in the EU constantly changes, the carbon tax cost will also be continually evolving, updated weekly according to the average prices in the EU carbon markets.

According to the European Commission, the EU is expected to enjoy additional revenue of up to 9.1 billion euros annually by 2030 via CBAM levies. On the Chinese side, the China Iron and Steel Association expects CBAM will raise the cost of Chinese steel products exported to the EU by 4-6% per ton.

What has been the international response to CBAM?

ANSWER: CBAM has not been received well by some of the EU's trading partners. China and South Africa, for instance, have voiced opposition, with China saying the scheme is "regrettable" and in violation of WTO policies regarding non-discrimination against similar products from different trading partners. Additionally, questions of environmental fairness have arisen with CBAM, which is likely to have a strong negative effect on the competitiveness of African exports, especially Sub-Saharan African nations. Joint studies between LSE and the African Climate Foundation have suggested implementation of CBAM will lead to lower exports of African steel and aluminium to the EU by 8.2% & 13.9%, respectively, even before considering other sectors covered by CBAM. These studies show the implementation of a border tax under CBAM at a rate of 87 EUR per tonne could lead to an overall 5.7% drop in exports from Africa to the EU, leading to a corresponding 1.1% drop in GDP for the African continent.

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www.lse.ac.uk/africa/assets/Documents/AFC-and-LSE-Report-Implications-for-Africa-of-a-CBAM-in-the-EU.pdf

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Are there other options to maintain compliance besides paying the EU carbon tax?

ANSWER: Exposed producers worldwide are now searching for ways to maintain compliance under CBAM without paying the tax to the EU, for instance by paying for carbon in another jurisdiction. This could be a relevant approach for China, which has already launched its own emissions trading scheme. Currently, Chinese carbon prices are still much lower than those in the EU's ETS, so even if activities in the Chinese ETS are recognised by the EU, (which is certainly not guaranteed) a tax could still be levied on the price difference. If the price of carbon in the Chinese ETS draws closer to the price of carbon in the EU's ETS, producers should theoretically be able to trade carbon in China and thereby avoid having to pay a carbon tax in the EU.

Another option for producers in China is to explore and report a linkage between their green electricity consumption and carbon emissions. With an appropriately robust and well-documented approach, producers may be able to demonstrate their consumption of low- or zero-carbon electricity in China is equivalent to a certain level of carbon emissions reduction, thereby reducing the carbon tax burden at the EU border. Again, this approach will rely on the EU's recognition of the producer's green power consumption in China.

What should exposed producers do right now?

ANSWER: The border tax under CBAM will not be implemented until 2026, so CBAM does not yet pose a tax burden for affected enterprises, only a reporting burden. Exposed producers should start now to assess and quantify emissions within their production and supply chains. This is especially important for steel producers in China, where average emissions per tonne of steel produced from a typical Chinese blast furnace can be as much as 30% lower than the default value that would be used in the EU. Without robust documentation, Chinese producers would be forced to use the default EU value and subject themselves to a needlessly high carbon tax burden.

After quantifying actual emissions, producers should also identify potential areas of carbon inefficiency with a carbon audit. After identifying any inefficiencies associated with carbon-intensive production processes, the producer can conduct a cost-benefit analysis to assess the cost of inaction (i.e. simply paying the carbon border tax) vs. the cost of implementing mitigating measures to eliminate the inefficiency. According to current carbon prices in the EU ETS, any mitigating measures on the production end that cost less than 80 euros to reduce 1 tonne of CO₂ annually should be cost-effective.

In addition to raising efficiency, carbon-intensive producers may now also wish to conduct a further cost-benefit analysis on the consumption of renewable energy (for instance, green electricity) at their production facilities to reduce embedded emissions and their exposure to the carbon tax under CBAM.

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