



# CBAM – how the EU’s new carbon border tax will impact non-EU businesses

On 17 May 2023, the EU Regulation establishing a carbon border adjustment mechanism (the **CBAM Regulation**) came into force. The CBAM Regulation will become applicable in phases, with provisions applying from 1 October 2023, 31 December 2024 and 1 January 2026.

The CBAM is relevant to EU and non-EU businesses that sell or import in-scope goods from third countries into the EU. In this bulletin, we explore the impact of the CBAM on non-EU businesses, and provide recommendations for getting ‘CBAM ready’.

## Background

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Introduced as part of the ‘Fit for 55 package’, the CBAM aims to reduce the risk of so-called ‘carbon leakage’, which arises through the relocation of carbon-intensive production from the EU to other countries with less stringent carbon policies, or through the increased importation of carbon-intensive products in place of equivalent domestic products that are less carbon-intensive.

The CBAM is expected to help the EU attain carbon neutrality by 2050 and encourage cleaner industrial production in non-EU countries, while also ‘levelling the playing field’ by ensuring equivalent carbon pricing for certain domestic products and equivalent imports from non-EU countries with less stringent emissions regulations. Specifically, the CBAM will put a price on

the carbon emitted during the production of those imports which is roughly equivalent to what domestic EU producers pay for allowances under the EU’s Emissions Trading System (**EU ETS**).

There is currently no similar ‘protection’ for EU exporters who will be exposed to the higher costs of the EU ETS compared to their competitors in export markets which do not apply similar carbon pricing mechanisms. The Commission has been tasked to monitor and assess the impact of CBAM in relation to exports, and to report on this particular risk every two years. It may, where appropriate, present a legislative proposal after 31 December 2027 to address this carbon leakage risk in a World Trade Organization (WTO)-compliant manner.

## In-scope goods

The CBAM's coverage of goods is ultimately intended to reflect the activities covered by the EU ETS, to ensure that imported products are treated no less favourably than equivalent domestic products. Whereas the EU ETS applies to 'installations' in the EU, the CBAM applies to in-scope goods imported into the customs territory. While the ultimate objective of the CBAM is broad product coverage, its initial focus is on a select number of sectors where there is a risk of carbon leakage, namely iron and steel, cement, certain fertilisers (including some types of ammonia), aluminium, hydrogen, and electricity.

The Commission's aim is to include goods for all sectors caught within the EU ETS by 2030, and it will likely present further legislative proposals extending the scope of the CBAM in

coming years. For example, the Commission will be expected to report on the possibility of extending the scope to products further down the value chain of the goods that are presently in-scope, as well as extending the scope to other goods at risk of carbon leakage (such as organic chemicals and polymers), by the end of 2024 and 2025 respectively.

Designing the CBAM to apply universally to any imports, so long as the products are within scope, was in part to ensure compatibility with WTO rules. Nevertheless, there remains a risk that the CBAM will be challenged before the WTO, particularly if free allowances are retained for exporters alongside the carbon border tax, as these would effectively amount to an export rebate.

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## Anti-circumvention

The CBAM defines the practice of circumvention as a change in the pattern of trade in goods where there is *“insufficient due cause or economic justification other than to avoid, wholly or partially, any of the obligations laid down in this Regulation”*. Practices of circumvention may include making slight product modifications to bring goods out of scope, and artificially splitting shipments into consignments to avoid exceeding applicable thresholds.

The Commission will take action to address practices of circumvention of the CBAM Regulation through continuous market surveillance, engaging with reports from interested parties (e.g. civil society organisations, environmental organisations and non-governmental organisations), and investigating suspected circumvention practices. Businesses should ensure that they do not fall foul of the anti-circumvention provisions, which will apply from 1 January 2026.

## Transitional phase: 1 October 2023 - 31 December 2025

During the transitional phase from 1 October 2023 until 31 December 2025, the obligations of importers and their indirect customs representatives will be limited to reporting under the CBAM Regulation.

More specifically, importers or their indirect customs representatives must submit quarterly CBAM reports containing information on the goods imported during each quarter, no later than one month after the end of that quarter.

The first CBAM report (Q4 2023) should be submitted by 31 January 2024, and the last CBAM report (Q4 2025) by 31 January 2026.

Businesses may face *“effective, proportionate and dissuasive”* penalties for submitting incomplete or incorrect CBAM reports, or for otherwise failing to comply with their reporting obligations. In due course, the Commission will adopt implementing acts concerning the indicative range of penalties to be imposed, as well as further rules regarding the means and format for complying with the reporting obligation.

Information to be contained in CBAM reports should include:



the quantity of the goods imported during that quarter;



the total embedded emissions which are divided between:

- direct (i.e. from the production process itself) emissions; and
- indirect (i.e. for the electricity used to power the industrial process) emissions. However, information as regards indirect emissions are not initially required for aluminium, hydrogen, and most iron and steel within scope; and



the carbon price due in the country of origin for the embedded emissions.

# Full compliance phase: 1 January 2026 and beyond



## Authorisation to import in-scope goods

From 1 January 2026, in-scope goods can only be imported into the customs territory of the EU by those who are authorised CBAM declarants. As discussed below, businesses that are not authorised will face penalties for importing in-scope goods.

Importers or their representatives can apply to become authorised CBAM declarants by submitting the required information via the CBAM registry from 31 December 2024 onwards. Provided that the applicable criteria are met, the authorisation will be granted by the competent authority in the Member State where the applicant is established, although the authorisation will be recognised in all Member States.



## Annual CBAM declaration

Commencing in 2027, each authorised CBAM declarant will be required to submit an annual CBAM declaration (by 31 May each year for the preceding calendar year) which will include the following:

- the total quantity of each type of goods imported during the preceding calendar year;
- the total embedded emissions in those goods;
- the total number of CBAM certificates to be surrendered, corresponding to the total embedded emissions, after a reduction on account of the carbon price effectively paid in the country of origin, and after an adjustment has been made to reflect free emission allowances under the EU ETS; and
- a copy of the verification report of the embedded emissions issued by an independent, accredited verifier.

Where actual emissions data cannot be adequately determined by the authorised CBAM declarant, default emission data will be used. This data could disadvantage non-EU importers, particularly as the default value will be set in accordance with the average emission intensity of each exporting country for each of the in-scope goods (other than electricity), increased by a mark-up (to be determined in implementing acts). Moreover, if reliable data for the exporting country is not available, the default values will be based on the average emission intensity of the 'X%' worst performing EU ETS installations for that type of good. The exact 'X%' is to be determined in implementing acts.



## CBAM certificates

Commencing in 2027, each authorised CBAM declarant must surrender a number of CBAM certificates that corresponds to the embedded emissions set out in its CBAM declaration (by 31 May each year for the preceding calendar year). CBAM certificates will be sold by each Member State to authorised CBAM declarants on a common central platform. The price of CBAM certificates will reflect the average weekly carbon price under the EU ETS, thereby pegging CBAM certificates to the EU ETS. Nevertheless, unlike EU ETS allowances, there is no cap on the number of CBAM certificates that can be issued.

The shift from the current system of free allowances to the CBAM will take place gradually: the requirement to purchase and surrender CBAM certificates will be phased in during 2026-2034, in parallel with the phasing-out of free allocation under the EU ETS. This means that the CBAM will apply only to the proportion of emissions that does not benefit from free allowances under the EU ETS in the same industry in a specific year.

The Commission is due to provide further details of the timing, administration, and other information related to the management of the sale and repurchase of CBAM certificates. In the meantime, the CBAM Regulation already outlines rules around the number of CBAM certificates that should be on account at the end of each quarter, the number of excess CBAM certificates that can be repurchased by Member States, and the circumstances in which remaining CBAM certificates shall be cancelled without compensation.

There are robust penalties for those who fail to surrender the requisite number of CBAM certificates by 31 May each year. For authorised CBAM declarants, the penalties for a shortfall in surrendered CBAM certificates will be identical to the excess emissions penalty under the EU ETS (i.e. EUR 100 for each tonne of carbon dioxide). For non-compliant businesses who are not authorised CBAM declarants, penalties may be three to five times higher.



# Exemptions

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The CBAM Regulation provides for a number of exemptions. Notably, the CBAM will not apply to goods originating in third countries that participate in the EU ETS (e.g. Iceland, Liechtenstein, Norway), or have an emissions trading system linked to that of the EU (e.g. Switzerland). Moreover, there are exemptions for goods originating in Büsingen, Heligoland, Livigno, Ceuta and Melilla, as well as for consignments of goods which do not exceed certain value thresholds.

The Commission will continue to explore cooperation and solutions with third countries regarding the implementation of specific elements of the CBAM. In particular, the Commission may conclude bilateral agreements with third countries such that producers who pay a carbon tax in their home jurisdiction 'equivalent' to EU standards would be exempt from paying the CBAM cost. The process for equivalence has not been laid out and it is therefore unclear how this important mechanism will be relied on in practice.

# Global initiatives to combat carbon leakage

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The CBAM is being introduced at a time when geopolitical tensions are high, with the US Inflation Reduction Act adding to concerns about the drift of low carbon investment away from the EU and other markets. Furthermore, since the announcement of the CBAM, China has introduced a carbon trading system, while Canada, the US and the UK are considering implementing their own CBAMs. The CBAM directly affects the geopolitical landscape for the UK carbon border approach given that, pursuant to the Northern Ireland Protocol, electricity generators in Northern Ireland fall under the EU ETS. If Northern Ireland is therefore subject to an EU CBAM, this could increase regulatory hurdles for trade, especially with the Republic of Ireland.

The Commission has indicated its intention to work with third countries to promote the implementation of ambitious climate policies and pave the way for a global carbon pricing framework. This may be achieved through the efforts of the Climate Club, which is proposed to be established as a forum of countries with carbon pricing instruments or other comparable instruments, to facilitate the comparison and coordination of relevant measures where appropriate.

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# Next steps

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The CBAM could have consequences for your business, no matter where you are located. If you have operations in the EU or supply goods into the EU that are subject to the CBAM, you will be impacted by the mechanism.

Businesses should take steps towards getting CBAM-ready where possible, including:

- 1. remaining abreast of developments in the EU** – the Commission is expected to adopt implementing acts to provide further details in respect of, for example, the granting of 'authorised CBAM declarant' status, the means and format for complying with the transitional CBAM reporting requirements, the calculation of embedded emissions and adjustments to reflect EU ETS free allowances, and the sale and repurchase of CBAM certificates. We also expect that changes will be made on a rolling basis to the regulatory scope in future, in terms of exempted third countries/territories and in-scope products;
- 2. implementing data processes to ensure compliance with all elements of CBAM as and when they begin to apply** (for example, to apply for 'authorised CBAM declarant' status from 31 December 2024 onwards, to submit the first CBAM report by 31 January 2024, and to submit the first CBAM declaration by 31 May 2027); and

- 3. implementing a process to ensure that an appropriate number of CBAM certificates will be on account.**

This process should involve documenting the emissions embedded in the products that you sell into the EU (particularly the products that are currently in-scope) and documenting whether you pay a carbon price in your production outside the EU.

Businesses that sell or import in-scope goods into the EU will be evaluating their supply chains to ensure that profit margins and competitiveness are maintained, and that any exposure to the CBAM is mitigated where possible. For example, considering that the total number of CBAM certificates to be surrendered will be reduced on account of the carbon price effectively paid in the country of origin, imports from countries with lower carbon prices or weaker climate policies may lose some of their competitive advantage.

Similarly, for energy transition projects currently developed outside the EU and looking to export some of the production there (e.g. green ammonia, green hydrogen), assessing the financial impact of the CBAM on the project's economics will be a major focus. Offtakers acting as EU-based importers will indeed integrate any CBAM administrative and financial costs in their business models.

# Thoughts

The CBAM breaks new ground in seeking to address carbon leakage risks. However, there are obvious cost implications for businesses and consumers. With the phasing-out of free allocation of allowances under the EU ETS, we expect that the CBAM will increase demand for these allowances and, in parallel, the cost of the CBAM certificates. At the same time, carbon-intensive goods caught by the CBAM may become more expensive, in order to account for the adjustment. Accordingly, the carbon price will likely rise, whether that be for production or inputs, and we expect those costs to be passed onto EU consumers. In addition, importers caught by the CBAM will likely face increased compliance costs associated with tracking and reporting their carbon emissions.

The CBAM is anticipated to prompt businesses to assess their supply chains and to identify whether lower carbon-intensive suppliers can be used. The CBAM may also motivate businesses who see the EU as a key market to invest in cleaner industrial production and utilise lower-carbon fuels, making their exports more competitive in carbon-constrained markets. Businesses should kickstart efforts to comply with the CBAM Regulation while staying tuned for developments which will unfold through the implementing acts to be adopted by the Commission.

Should you have any questions on the matters discussed in this article, please contact the authors or your usual contact at Allen & Overy LLP.

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