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The European Union Carbon Border Adjustment Mechanism

1. Introduction

This report provides an update on the status of the European Union's (EU) Carbon Border Adjustment Mechanism (CBAM), as of February 2024.

2. CBAM Overview

What is the CBAM? It is border measure that places a tax or carbon price on emissions-intensive imports from non-EU countries/jurisdictions. The tax is relative to the carbon emitted during the production of these goods. This is meant to level the playing field with the equivalent carbon price already placed on EU producers under the EU's Emissions Trading System (ETS) or carbon trading market. If EU did not do this, EU producers would possibly relocate to non-EU locations to avoid these EU carbon taxes.

In other words, the EU seeks to steadily reduce the amount of carbon utilised to produce goods in an identified set of sectors. Manufacturers must account for the carbon emissions they generate and buy allowances or credits to cover their emissions. There is also a cap on what you can emit. Anything over the cap is fined. Over time the cap decreases, to encourage greener production methods. Allowances can also be traded between companies. The fines go mostly to EU member state national budgets. The revenue is used to support investments in renewable energy, energy efficiency improvements and low-carbon technologies that help reduce emissions further. But what happens if a company gets fed up with this system or cannot handle the fines? They may seek to relocate their operations to a country outside the EU with less stringent carbon rules, and then sell their products back into the EU. This is called carbon leakage by the EU designers of the ETS. The solution – place a carbon tax at the border to level the playing field. Thus, the CBAM, which taxes imports based on their carbon intensity, and is linked to the ETS.

The EU states that it seeks through the ETS and CBAM to start decarbonising the EU economy, prevent carbon leakage, and encourage cleaner industry in non-EU countries.

3. CBAM processes

- The CBAM is also located within European Green Deal. It is in line with the 'Fit for 55 Package' - to meet the objective of a climate-neutral EU by 2050 in line with the Paris Agreement. The reference to "55" is that as a first milestone, the EU aims to reduce net emissions by at least 55% by 2030 compared to 1990 (this has now been tightened in 2023 to 62%)

- Sectors to be affected first: iron and steel, cement, fertilisers, aluminium, electricity and hydrogen sectors. Expansion envisaged: likely organic chemicals, plastics, hydrogen and ammonia, and by 2030 to all ETS sectors such as: energy-intensive industry sectors, including oil refineries, steel works, and production of iron, aluminium, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids and bulk organic chemicals, maritime and aviation. Under the most recent revision of the ETS, the scope has already in 2023 been expanded to include maritime transport.

- Agriculture in NOT included at present! But the European Parliament has called for the European Commission to assess the possibilities for an extension of CBAM to include imported agricultural products by 2030. This is likely because alignment will be needed between the Green Deal programmes (which includes Farm to Fork), policies and the CBAM.

- A transitional period will apply for from 1 October 2023 to 31 December 2025. Exporters will not be charged the tax during the trial phase but will face penalties if they do not comply with the quarterly reporting requirements. From 1 January 2026 onward, purchasing CBAM certificates will be required for exporters to the EU in the affected sectors.

- Can the CBAM 'tax' be offset? Yes, if an exporter's country imposes a domestic carbon tax, then the exporter will only pay the difference. However, SA's carbon tax is insufficient to match the EU CBAM price, providing an estimated maximum 10% discount only. In reality probably closer to 5%.

- How it will work:
    - Exporters to the EU in sectors covered by the CBAM will need to buy CBAM Certificates.
    - The price of such Certificates will be calculated depending on the weekly average auction price of EU ETS allowances (€ / tonne of CO2 emitted).
    - The exporter must declare by 31 May each year the quantity of goods and the embedded emissions in those goods imported into the EU in the preceding year.
    - If firms can prove that a carbon price has already been paid during production this amount can be deducted from their final bill.
    - How is the carbon intensity of a firm's production calculated? Ideally based on actual data; second source would be estimated country average; or failing that, the EU will look at the average emission intensity of the 10% worst-performing EU equivalent type of goods.

4. Where are we now?

- Agriculture remains excluded from the CBAM.

- On 1 January 2024, the EU extended ETS coverage to include the maritime sector, as part of a broader EU ETS reform that came into force in June 2023.

- In addition, a new, separate ETS 2 will cover emissions from fuel combustion in buildings, road transport and additional sectors (mainly small industry not covered by the existing EU ETS). ETS 2 will become operational from 2027 or possibly 2028.

- Carbon taxes and Emissions Trading Schemes (ETS) are being considered or developed globally, covering around 23% of global GHG emissions, e.g. Australia, Japan, UK, US and Canada.
- A number of developing countries, including South Africa are firmly opposed to the CBAM and the underlying concept, believing it will significantly reduce the competitiveness of their exports to the EU and increase the cost of exporting to the EU. Such objections will be raised at the February 2024 WTO MC13. They note that climate related negotiations should not be occurring under trade measures. and Trade and Environment issues have their own place within WTO processes, and should not be incorporated into unilateral trade measures. The BASIC group (Brazil, South Africa, India and China), are further raising objections that the CBAM is a unilateral trade measure.
- The EU will provide support for CBAM participants in the form of E-learning (general and sector-specific); Webinars (general and sector-specific); and tailored guidance documents for producers in third countries and reporting declarants.

5. Implications

- Interestingly, CBAM's impact on global carbon emissions could be less than 0,1% according to a recent UN study. It may therefore be unable to significantly addressing the underlying issues driving carbon emissions.
- If SA's manufacturing exports were too be fully included, it is estimated the CBAM will have a severe impact on the export value of relevant products. Overall, affected SA exports could decline by 8% or income by $1.3bln at current carbon prices of $88/ton. There is also the indirect impact of a rebalancing of global markets as a result of the CBAM. e.g. SA may lose other market shares in its other non-EU markets to displaced parties, thereby increasing competition faced by SA firms in Africa and possibly in SA.
- Inclusion of maritime transport from 1 January 2024 raises the concern that the cost of shipping to the EU will increase[1]:
  - 50% of emissions on voyages into or out of the EU/EEA, are to be subject to the EU ETS. A rule for transshipment ports is included. It only applies to offshore ships above 5000 GT from 2027, but they will be required to start reporting from 2025.
  - Shipping companies with ships sailing to or from ports in the EU or European Economic Area will need to have enough CBAM allowances annually to cover GHG emissions from their ships.
  - The cost of emission allowances and related admin under the EU ETS will have implications for pricing and other terms of contractual agreements between parties across the value chain, including charterers and cargo owners.
- SA is a highly carbon-intensive producer. This applies to agriculture as well: with an estimated intensity of more than 1,100 tons of carbon dioxide equivalent (tCO2e) per $1m of exports. Next largest is Poland, at a

[1] For maritime shipping, a three-year phase-in period, increasing in scope from 40% of emissions in 2024 to 70% in 2025 and 100% in 2026 has been announced. It applies to cargo and passenger ships above 5000 GT from 2024 and offshore ships above 5000 GT from 2027. The ETS inclusion will cover carbon dioxide emissions at first and then will be expanded to methane and nitrous oxide from 2026. Offshore ship and general cargo ships between 400 and 5000 GT will also be required to report emissions and may be included in the EU ETS at a later stage. See https://www.dnv.com/maritime/insights/topics/eu-emissions-trading-system/index.html and https://www.dnv.com/maritime/insights/topics/eu-emissions-trading-system/eu-ets-compliance.html for more detail.

650 tCO2e per $1m. Most countries have intensity of between 100 and 500 tCO2e per $1m. This means that any expansion of CBAM to include agriculture would be a direct risk for SA agricultural exports to the EU.

- Exporters to the EU of currently affected products need systems to measure and track the carbon intensity of their production processes. This is necessary for reporting. Agriculture may need to consider the same data collection depending the evolution of the EU legislation; i.e. when it becomes apparent that agriculture is to be included. This is not a given outcome at present, but it is a risk factor to monitor.
- Trade Agreements: The CBAM may allegedly be a technical contravention of provisions the EU-SADC-EPA. E.g. carbon pricing linked to place of production clashes with Rules of Origin clauses. South Africa, together with other developing countries, plans to challenge the validity of CBAM via WTO processes and platforms, as it allegedly contravenes a number of WTO principles. Approximately 180 countries export the affected products to the EU, and SA is in the top most impacted exporters. It is expected to hit SMMEs hardest. It is being described as a discriminatory measure. E.g. production of fertilizer is not covered by the EU ETS but is under CBAM; CBAM verification is stated presently as physical, yet ETS is virtual; ETS application is allowed to differ across Member States as it is a Directive, but CBAM as an EU Regulation has a common penalty; and CBAM currently lacks use of carbon credits from the Clean Development Mechanism (CDM), but the ETS text says affected firms can utilise CDM2.
- EU ETS prices will also ironically make EU exports more expensive, thus less competitive when exporting to SA. The EU cannot just waive the tax for exports, as would create a WTO incompatible export subsidy. The EU is therefore studying options to address this.
- Demand for low-carbon products presents an opportunity for early-movers. E.g. agri exporters who promote the low carbon intensity of their products may win greater consumer and importer favour, given the focus within developed markets consumer and retail culture on reduction of carbon emissions.

By Agbiz Fruit General Manager Wolfe Braude

[2] The Clean Development Mechanism (CDM) is part of the United Nations Framework Convention on Climate Change (UNFCCC). The CDM offers the public and private sector in high-income nations the opportunity to purchase carbon credits from offset projects in low or middle-income nations. The CDM allows countries to partly meet their Kyoto targets by financing carbon emission reduction projects in low and middle-income countries. https://www.offsetguide.org/understanding-carbon-offsets/carbon-offset-programs/united-nations-offset-mechanisms/clean-development-mechanism-cdm/