

New carbon borders change the game for high carbon products and exports

Introduction

KPMG IMPACT is a platform to support and empower KPMG professionals to assist clients in fulfilling their purpose and helping deliver on the UN Sustainable Development Goals (SDG).

One focus of KPMG IMPACT is on the latest global climate policy developments and their possible impact on international business. To assist with these issues, we have decided to produce a newsletter (on an occasional basis) for those who are alert to the latest climate and decarbonization developments.

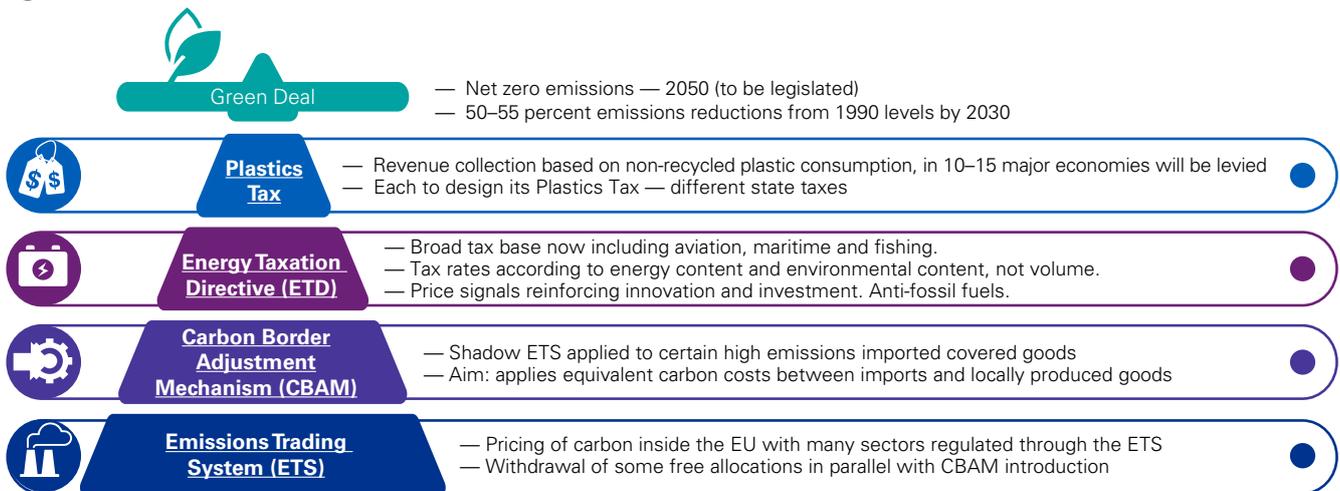
Background

On Wednesday 14 July the European Commission (EC) tabled a series of significant carbon reforms¹ as part of its 'Fit for 55 package' to meet its 2030 emission goals. Tighter emissions caps, greater Emissions Trading System (ETS) coverage and a new Carbon Border Adjustment Mechanism (CBAM) are at the centre of the reforms. The reforms could significantly impact EU industry and global export markets.

Ahead of COP 26 in Glasgow later this year, the EC has released a package of reforms to ensure the EU meets

its emissions reduction goal of a 55 percent reduction of 1990 emissions levels by 2030. These reforms, dubbed the EU Green Deal, represent some of the most substantial reforms to the European Emissions Trading System and EU carbon policy 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.

Figure 1: Tax measures in EU Green Deal

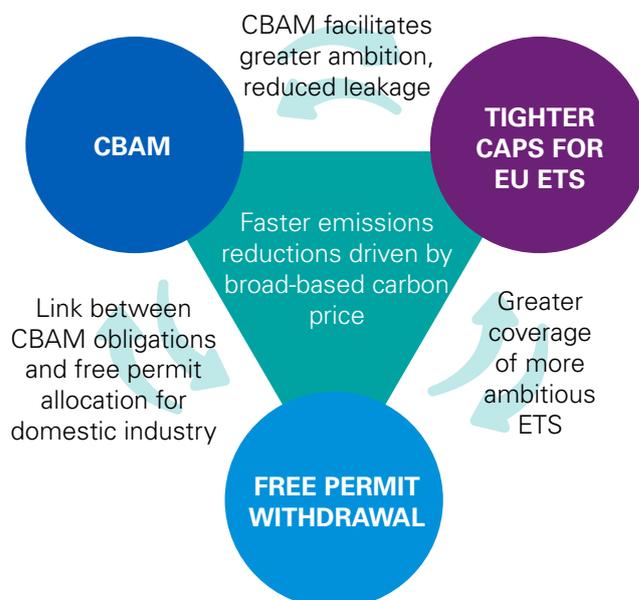


¹ Delivering the European Green Deal, European Commission, 14/07/2021, https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal/delivering-european-green-deal_en

Reforming carbon pricing

There are four key pillars to the reforms that represent a game changer for carbon pricing:

- A step change tightening of emissions cap under the EU ETS to align the ETS ambitions with the EU's carbon reduction targets.
- Expanding the sector coverage of the existing ETS to cover maritime transport, and introducing a separate but adjacent ETS covering buildings and road transport.
- The progressive withdrawal of free permits for emission-intensive trade-exposed (EITE) sectors under the EU ETS.
- The introduction of a CBAM, which establishes a 'shadow ETS' for certain goods being imported into the EU to avoid further carbon leakage from these more ambitious reforms.



Source: KPMG, 2021

Summary of key changes	Proposed changes
Sharp tightening in EU ETS emissions cap to 2030	Annual reduction of emissions cap increased from the <u>planned 2.2%</u> to the now tabled 4.2%
New sectors covered by EU ETS	Maritime transport
New ETS introduced	Buildings and road transport
Introduction of CBAM	Impacting imports of electricity, cement, fertilizer, iron and steel, and aluminium
Withdrawal of free permits	Sectors previously receiving free permits covering a substantial portion of their exposure will have these withdrawn, with CBAM to address leakage and competitiveness

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 Emissions Units or European Union Allowances (EUAs) for their emissions, or avoid emissions via carbon reduction. Until now, the EU ETS has covered 40 percent of the EU's emissions, with power generation, heavy industry and aviation covered by the scheme.

Key changes proposed to the EU ETS:

- **The cap on EUA supply:** The proposed changes will reduce the cap on supply in the market, bringing the EU ETS trajectory into line with the EU's wider 55 percent carbon reduction target.

Absent carbon leakage, this cap will force greater investment in decarbonization activities as the 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.

- **The availability of free EITE EUAs:** Auctioning has 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'. The proposed reforms seek to reduce free allocations, using the CBAM to protect against carbon leakage and therein, exposing emitters to the full cost of carbon for their emissions. For many heavy emitters such as steel producers, this will impact the marginal costs of both EU and international producers through the CBAM.

Key changes proposed to the EU ETS (continued):

- **Scope of the EU ETS:** Introducing a new ETS for the road transport and buildings sectors and including maritime transport in the existing ETS helps ensure the emissions reductions pathway from these sectors are aligned with the EU's decarbonization target of 55 percent by 2030.

What is the CBAM and how will it work?

The CBAM is a tool to address the risk of carbon leakage, where goods produced in a high ambition region — like the EU — are substituted with imports from a region with a lower carbon price or the 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 emissions 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 emissions 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, fertilizer, 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 electricity should calculate their embedded emissions on default values as standard. These are determined based on specific default values for a specific country or region, or where that information is not available, be based on EU default values.
- Importers of covered goods (except electricity) will 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 emissions will be determined using default values.
- The default values shall be based on the average emission intensity of the worst 10 percent performing EU producers or, where reliable data is available the default values can be adapted to reflect region specific features (e.g. geography, energy mix or industrial production) which result in more targeted default values.

- Importers of covered goods will be liable for their direct emissions released in their production process. However, these parties will need to report on both direct and indirect emissions. Indirect emissions include emissions from the energy which is purchased in the production process. At the end of the transition period in 2025, the EC will consider whether CBAM liabilities should include both direct and indirect emissions.
- Where goods are imported from countries that have mandatory carbon prices, the number of CBAM certificates required to be surrendered may be reduced in line with carbon costs already paid.
- CBAM certificates will 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 will 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, are exempt from the CBAM. If any other countries join the EU ETS or link their ETS they may also be exempt.
- To facilitate the swift implementation of the CBAM, a simplified transitional period has been proposed under 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.

What are the likely impacts of the changes to the EU ETS and CBAM?

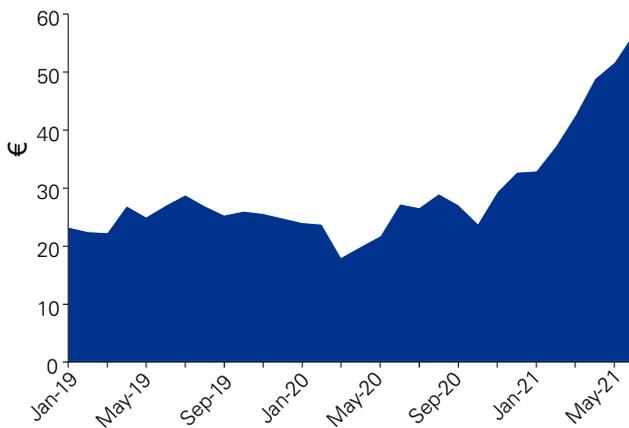
Higher EUA prices

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

Indeed, the price of EUAs appears to have been rising in the last 12 months in anticipation (see figure on the following page). The EC impact assessment projects the price of EUAs will range between €50 to €85 by 2030 if the Green Deal policies are implemented. This increase impacts the cost of all products covered by the EU ETS, and the road transport and buildings sectors covered by a new ETS.

The EC recognizes this inclusion of new sectors will adversely impact vulnerable consumers with the costs for lower income households increasing by up to 1.4 percent of consumption expenditures. However, the EC is proposing the introduction of a comprehensive social climate fund to assist households through this transition.

Figure 2: Historic EUA future prices 2019–2021²



Increased cost of high emission goods

EU consumers and users of goods covered by the EU ETS and CBAM will likely face an increase in final retail costs. This will flow from higher EUA prices, the 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 will likely lead to greater structural changes across the European 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 Energy Taxation Directive, should have profound impacts on supply chain costs for many manufacturers, retailers and wholesale businesses.

Potential to set international precedent

The introduction of the CBAM could risk a challenge from the World Trade Organization 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 emissions 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 emissions reporting requirements. To avoid EU default settings, the CBAM requires an 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 the 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, in the future they may 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 the 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 will 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.

² Graph compiled by the VCOE using Intercontinental Exchange Inc, accessed on 9/07/2021, <https://www.theice.com/products/197/EUA-Futures/data?marketId=6665364>

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KPMG IMPACT includes a *Virtual Center of Excellence (VCOE) for Excise and Environmental Taxes*, comprising more than 130 excise and environmental specialists globally.

This newsletter is one in a series on the EU Green Deal, including editions on the CBAM (pre-14 July regulations), the ETD and the Plastics Tax.

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