FIT FOR 55 PACKAGE: EU REVISES THE EU EMISSIONS TRADING SYSTEM AND ESTABLISHES A NEW CARBON BORDER ADJUSTMENT MECHANISM

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In the last couple of years, the European Union has announced and adopted a wave of sustainability initiatives that will have significant implications for European and global companies across all industries. Among other measures, the EU institutions have stepped up their legislative activity aiming to achieve climate neutrality in 2050 through promoting sustainable and responsible environmental behaviors, not only by EU member states and European businesses, but also by non-EU countries and companies.

In this context, on 18 and 25 April 2023, the European co-legislators (European Parliament and Council of the European Union) adopted the directive revising the EU Emissions Trading System (the EU ETS) and the regulation establishing a Carbon Border Adjustment Mechanism (CBAM) that is designed to reflect and complement the EU ETS on imported goods. These are key elements of the so-called “Fit for 55” legislative package, initially proposed by the European Commission (the Commission) in July 2021, which aims to reduce EU greenhouse gas emissions by at least 55% by 2030 (compared to 1990 levels) and achieve climate neutrality in 2050 in line with the European Green Deal. In the context of the “Fit for 55” package, the co-legislators have also approved revisions to the ETS Aviation Directive, the amendment of the Monitoring, Reporting, and Verification (MRV) Shipping Regulation and the regulation establishing a Social Climate Fund. These laws have far-reaching implications for global climate and energy interests in general, and in particular for global companies that need to implement changes in order to offset potential impacts on their business operations.

REVISIONS TO THE EU ETS

The EU ETS is a carbon market based on a system of cap-and-trade of emission allowances for energy-intensive industries and the power generation sector.[1]

The new EU ETS directive aims to accelerate the pace at which sectors covered by the EU ETS are required to decarbonize, increasing the EU emissions reductions target to 62% by 2030, up from the 41% achieved since it was first introduced in 2005. The revision of the EU ETS provides for the decrease of the overall quantity of emission allowances and for the increase of the cap's annual reduction rate per year.

Implications for Aviation Sector

In relation to emissions from the aviation sector, the EU ETS applies to intra-European flights, whereas the Carbon Offsetting and Reduction Scheme for International Aviation reduction scheme continues to apply to international aviation. Free emission allowances will be gradually phased out and full auctioning from 2026 will be implemented.

New Rules for Maritime Transport Sector

The scope of the EU ETS has been broadened, including for the first time to encompass emissions from maritime transport. Shipping companies must surrender 40% of allowances for verified emissions from 2024, 70% from 2025, and 100% from 2026. At this stage, most large vessels will be included in the scope of the EU ETS, whereas remaining large vessels (i.e., offshore vessels) will be included in the MRV regulation on the MRV of CO2 emissions from maritime transport and only at a later stage included in the EU ETS.

Additional Scheme for Other Sectors

In addition, a new separate emissions trading system for greenhouse gas emissions derived from fuels used in buildings, road transport, and in certain additional sectors[2] will apply as of 2027, unless the oil and gas prices rise to exceptional levels in the years preceding 2027. In this case, a safeguard provides that the application of the emissions trading system could be pushed to 2028.

Support for Vulnerable Households, Micro-Enterprises, and Transport Users

In an effort to address social impacts deriving from this specific system, the regulation establishing the Social Climate Fund provides that member states will be able to use the Social Climate Fund to finance temporary direct income support for vulnerable households and to support measures and investments that reduce emissions in road transport and the buildings sector, thereby benefitting vulnerable households, micro-enterprises, and transport users.

CBAM

Objectives of the CBAM

The CBAM aims to ensure that the carbon price for imported goods is equivalent to the carbon price paid for EU products operating under the EU ETS, in order to reduce the risk of carbon leakage and to promote a level playing field. The CBAM is designed to reflect and complement the EU ETS on imported goods.

For production outside of the European Union, EU importers will have to purchase CBAM certificates for the difference between the carbon price in the country of production and the price of carbon allowances in the EU ETS. The CBAM will therefore essentially impose a tax on imported energy-intensive goods that correlates to the price of emissions allowances on comparable domestic industries under the EU ETS. In-scope importers must become authorized CBAM declarants, obliged to purchase and surrender CBAM certificates.

Sectors in Scope of the CBAM

The energy-intensive goods that will initially fall under the scope of the CBAM include: (i) iron and steel, (ii) cement, (iii) fertilizers, (iv) aluminum, (v) electricity, and (vi) hydrogen, as well as certain precursors and downstream products. The Commission will adopt implementing acts to further specify the scope of the CBAM. In this context, the Commission could decide to broaden the CBAM's scope to include products further down the value chain. Moreover, the CBAM will also cover indirect emissions (carbon emissions linked to the consumption of fossil electricity) under certain conditions. Overall, in-scope sectors represent between 50% and 60% of the European Union's industrial carbon footprint.

Companies in Scope of the CBAM's Obligations

Under the CBAM, undertakings in scope will have to purchase and surrender CBAM certificates to cover the embedded carbon content in the products, unless they can prove that such carbon emissions have already been covered by the relevant legislation in the producer's country. Prior to that, they will have to become authorized CBAM declarants and set up a CBAM account in each member state where they import goods under the levy's scope, and on a yearly basis, they must provide each member state with the number of certificates corresponding to the level of carbon emissions embedded in the products imported.

Application Timeline

The CBAM will apply as of 1 October 2023, with a transitional period until the end of 2025, where importers will only have to comply with reporting obligations. As of 2026, the CBAM will be phased in, while the EU ETS will be simultaneously phased out for sectors now covered by the CBAM. By 2034, the EU ETS will no longer apply to the sectors covered by the CBAM.

HOW K&L GATES CAN ASSIST

K&L Gates is carefully monitoring the upcoming requirements and reporting obligations regarding the EU ETS, the CBAM, the Corporate Sustainability Due Diligence Directive, and the Corporate Sustainability Reporting Directive. K&L Gates' Antitrust, Competition, and Trade Regulation practice group and Public Policy and Law practice group include experienced lawyers and policy professionals across the European Union, the United Kingdom, the United States, and beyond who are able to provide assistance in regulatory and policy matters relating to corporate sustainability, taxonomy, and supply chain. Our lawyers are ready to put their experience at the service of clients in order to scrutinize the incoming measures and evaluate their impact on businesses. K&L Gates remain available to provide updates and to answer any doubts or questions.

FOOTNOTES

[1] The EU ETS covers approximately 10,000 companies, including electricity and heat generation, energy-intensive industry sectors (e.g., oil refineries, steel industry, cement, glass, and paper production), and commercial aviation (flights within the European Economic Area).

[2] Additional sectors that correspond to industrial activities not covered by Annex I to Directive 2003/87/EC, such as the heating of industrial facilities.

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