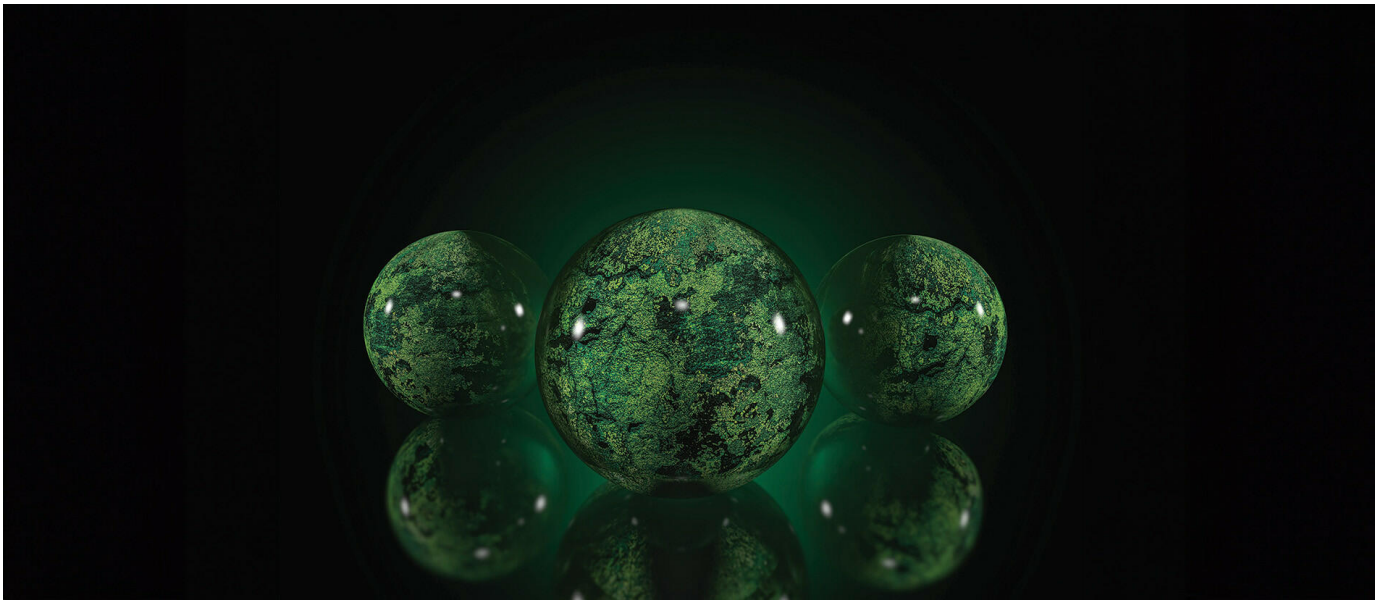
The EU's Carbon Border Adjustment Mechanism: preparing for the next phase

Environmental International Tax



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As the EU’s Carbon Border Adjustment Mechanism enters its next phase from 1 July 2024, and with a proposed UK mechanism on the horizon, we ask what this will mean for UK businesses.

Key Points

What is the issue?

From 1 July 2024, the EU’s Carbon Border Adjustment Mechanism (CBAM) will enter its next phase, requiring exporters to EU member states to use actual embedded emissions data for the quarter from July to September 2024. Businesses must also prepare for a similar, but not identical, UK CBAM regime.

What does it mean for me?
Statistics from member states suggest that there have been far fewer registrations than had been expected from their own customs data, suggesting that many businesses remain unaware of the need to comply.

What can I take away?
Nearly all businesses that have submitted declarations to date have been relying on default emissions values. They will need to engage suppliers to ensure they can file actual emissions values and remain compliant for imports into the EU from July 2024.

From 1 July 2024, the EU's Carbon Border Adjustment Mechanism (CBAM) will enter its next phase, requiring exporters to EU member states to use actual embedded emissions data for the quarter from July to September 2024. This will require businesses to actively engage with their suppliers to collect the necessary data. We look at how they are getting on, as well as providing an overview of the proposed UK CBAM due to start in 2027.

A previous article in this series, 'The EU's Carbon Border Adjustment Mechanism: the practical implications' (October 2023) looked at the practical implications for businesses as they prepared to register and submit their first EU CBAM declarations in January 2024. With businesses now needing to prepare for the next phase of requirements and submit actual embedded emissions data for imports into the EU from 1 July 2024, they are likely to need to engage intensively with their suppliers.

A (very brief) recap of the EU CBAM

The EU CBAM entered into force on 1 October 2023 as part of a 'transition period' which will run until 31 December 2025. Importers into the EU now have to track all imports of iron and steel, aluminium, fertiliser, concrete, hydrogen and electricity on a quarterly basis. The regime applies to any importer of covered goods with a consignment value of over €150.

These reporting requirements require a mix of product data, customs-related data and calculated embedded carbon emissions data.

From 2026, when the ‘transition period’ ends, businesses will need to buy CBAM certificates to offset the cost of the embedded carbon and other greenhouse gas emissions based on the weekly price of the EU’s Emissions Trading Scheme. Credit will be given (within certain parameters) for carbon prices and taxes already paid in the country of origin. In addition, the CBAM reports will need to be independently verified by an accredited verification body.

Calculating actual embedded emissions

For the first three EU CBAM declarations (due in January, April and July 2024, each covering the quarter that finished the month prior) businesses that were required to submit a declaration were able to rely on the use of ‘default embedded emissions values’. These were provided by the European Commission as a proxy for the level of carbon dioxide and other greenhouse gas emissions that have been produced during the production process of different products falling under the EU CBAM.

From our work across businesses in a variety of different sectors, it is clear that to date the vast majority have taken advantage of the use of default values when submitting their CBAM declarations. The reasons for doing so have been understandable, with technical issues facing first-time declarants as they overcame challenges relating to registering as EU CBAM declarants across different EU member states and IT errors when uploading declarations.

Often, businesses filing for the first time didn’t know if the filing errors were due to problems at their end or, as was the case for some member states, the portal simply wasn’t working. These challenges were often exacerbated in businesses that used indirect representatives who were responsible for conducting customs formalities across the EU on behalf of the businesses. Consequently, the EU extended the deadline for the first declaration to the end of February, and some businesses simply made incomplete declarations in the knowledge that they still had the extra weeks to amend their returns to complete them. The second filing date passed less eventfully at the end of April. The third and final filing based on default values is due on 31 July.

The CBAM transitional phase from 1 July 2024

Attention now turns to the next part of the EU CBAM transitional phase, for products imported into the EU from 1 July 2024. Businesses will be required to collect and submit actual embedded emissions data on 31 October 2024 for all imports entering the EU in the quarter running from 1 July to 30 September 2024.

The EU has set out how this is to be done through the development of a new EU methodology for calculating embedded emissions. This broadly falls into two categories which must be captured in each CBAM declaration:

- **Calculation approach:** This determines the emissions of EU CBAM products on the basis of source streams and activity data through measurement systems at the site of production combined with laboratory analysis or standard values. This combines combustion emissions together with process emissions.
- **Measurement-based approach:** This determines the emissions of EU CBAM products based on the emission source through continuous measurement of greenhouse gases at the installation using specified disaggregation formulae aligned with international ISO standards on source emissions.

Certain derogations from the EU's prescribed methodology are permitted for the two declarations due on 31 October 2024 and 31 January 2025. These derogations include the possibility to utilise embedded emissions data if it is captured as part of an existing carbon pricing or emissions monitoring scheme in the country where the product is produced. However, from 1 January 2025 onwards, only the EU's methodology may be used.

Collecting actual embedded emissions data

These derogations highlight that many businesses are not used to collecting emissions data in line with the EU's methodology as the parameters used in that methodology are wider in some instances than existing emissions trading schemes. For example, there is the need for certain 'complex' CBAM products to include emissions contained in precursor products which are incorporated into the final product.

It is also the case that there are differences in these approaches from the Greenhouse Gas Protocol that underpins much of Scope 1, 2 and 3 emissions reporting; therefore, the existing reporting processes may not provide the necessary

answer for the EU CBAM reporting without further work.

For the next phase of the EU CBAM, prioritising the identification of any data gaps should be a priority.

Engaging with suppliers

Where businesses are not themselves the producer of CBAM products, they will need to engage with their suppliers in order to obtain the necessary emissions data. The EU has provided standard data requests for installation operators. However, depending on how far down the supply chain a business is, this could require several steps to find the original installation operator and obtain the necessary data.

CBAM declarants have also identified challenges with using the EU's standard data request as they seek to overcome language barriers, missing data fields relating to specifics of types of electricity used in the production of certain products, the use of product-specific production processes and instances of suppliers refusing to provide the necessary information.

Businesses should be looking to actively engage with their suppliers to understand the data collection requirements and address any existing data gaps. In some instances, this will require the upskilling of suppliers, as many businesses outside the EU are still unfamiliar with the requirements of the EU CBAM regime.

We have worked with businesses to help them create their own simplified data requests in order to streamline the data collection process when engaging with suppliers. Where multiple suppliers are used across supply chains, keeping track of different emissions intensities embedded in CBAM products will be needed.

Modelling the cost impact of EU CBAM

Once businesses have several quarters of EU CBAM declarations and collect actual embedded emissions data, they will be in a much better position to model the eventual cost of the EU's CBAM certificates which they will be required to buy and surrender from 2026 onwards once the EU CBAM transition phase ends.

This will drive important conversations between the business's procurement and finance functions as the eventual liabilities for the EU CBAM become clear. It may also start to influence product design.

In some cases, we understand that businesses have identified substantial risks to their business model in some carbon price scenarios as a result of the prospective CBAM impact. In these cases the issue has been elevated to the C-suite.

The next CBAM to look out for: a UK CBAM

The UK government has announced that it will be introducing its own CBAM from 2027 onwards after completing a carbon leakage consultation during the summer of 2023. In preparation for the UK CBAM, the government has been consulting on the scope and design of the future regime. The consultation will close on 13 June 2024.

Whilst there are many similarities between the proposed UK and EU regimes, there are also differences. Such differences will mean that businesses will not simply be able to 'cut and paste' their approach to EU CBAM in order to comply with the UK CBAM.

The largest difference between the EU and UK CBAMs, as currently set out, is that the UK CBAM is being much more clearly identified as a tax and integrated into existing HMRC processes and the UK's VAT machinery.

The proposed scope of the UK CBAM covers largely the same products as the EU CBAM, with certain differences – including glass and ceramic products, while excluding electricity imports. The consultation envisions that only goods within the scope of the UK Emissions Trading Scheme, if produced domestically and at risk of carbon leakage, will be considered for potential inclusion within the scope of a UK CBAM.

Regarding the calculation of embedded emissions, the consultation sets out a dual approach for the determination of emissions embodied within imported goods:

- using default values; or
- using data on the actual emissions embodied within CBAM goods.

The current thinking of the UK government is that the default values would be valid for at least an initial period of 2027 to 2030.

On the administration, payment and compliance of the UK CBAM regime, the main points of consideration include a higher threshold to register under the UK CBAM regime than the €150 consignment value in the EU CBAM:

- £10,000 of imports within the relevant customs codes on a rolling 12 month basis for each given importer of record; or
- the intention to import more than £10,000 of covered products in the next 30 days.

The first UK CBAM reporting period would run for the 2027 calendar year and the first UK CBAM declaration and payment due in May 2028, but would then revert to a quarterly declaration schedule.

The UK government will be considering consultation responses before setting out primary and secondary legislation in the coming months. The exact timing of these announcements may be impacted by the UK general election, which is due to take place before January 2025.

Other countries continue to consider whether to introduce their own CBAM.

Other issues with suppliers

CBAM isn’t the only thing businesses need to engage with their suppliers about. Legislative developments in the EU and UK continue apace, with several new requirements entering into force which will require increased visibility of supply chains from businesses, including the recently finalised EU Forced Labour regulation and EU Supply Chain Due Diligence Directive.

More immediately, new due diligence requirements are being introduced for several commodities being imported, exported or traded within the EU from coffee and leather to rubber, requiring businesses to prove that they are free of products contributing to deforestation from 1 January 2025. Meanwhile, we expect updates on the proposed UK Forest Risk Commodities regime to tackle deforestation in the near future.

Where possible, businesses should be looking to take a holistic approach to understanding their supply chain and working across business functions to ensure that the appropriate steps are being taken to source appropriate suppliers, collect the necessary data and complete any related compliance procedures. See our previous article ‘Sustainability regulations and tax: taking a cross-functional approach’ (January 2024).

Failure to do so will reduce the resilience of the supply chain, and in some cases might mean it breaks and stops completely.

Final thoughts

The increase in green taxes, pseudo-taxes and broader sustainability reporting requirements will no doubt feel like considerable new compliance processes and costs are being placed on businesses. However, authorities appear convinced that they have an important strategic role in helping to shape businesses’ broader sustainability response and accelerate opportunities to decarbonise the supply chain and meet other environmental objectives.

Given the commitment to increased reporting and taxes, businesses need to be preparing now to meet the upcoming requirements and, in particular, establish processes that allow reliable access to the required data.

The authors’ views are their own and not necessarily representative of those of EY.

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