#WhyESGMatters

Special Edition - The European Green Deal

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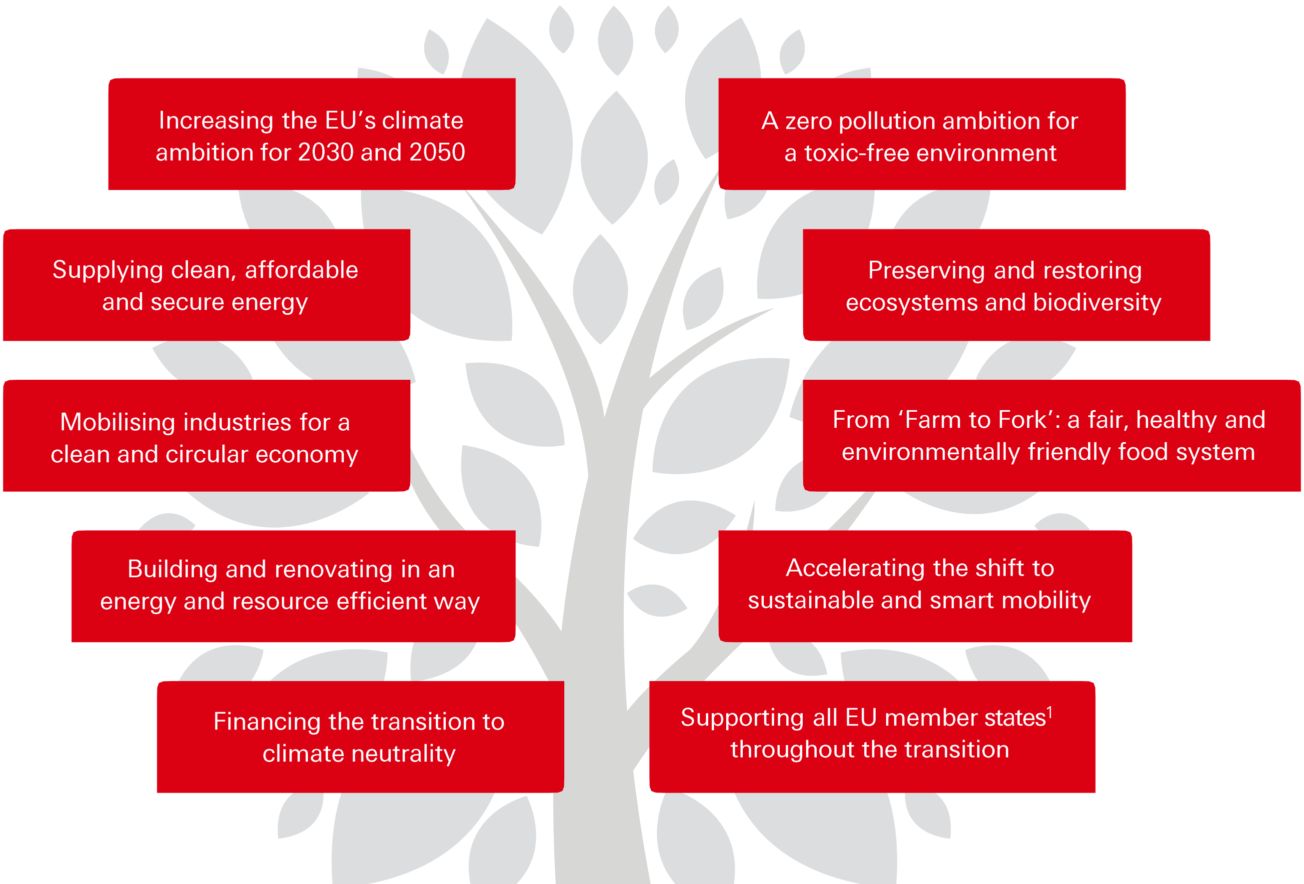
The European Green Deal was first unveiled in 2019 by the European Commission (EC), with the primary objective for the EU to be the "first climate-neutral continent" by 2050. Since then, the EC have formally proposed a Climate Neutrality Law and announced elevated targets to achieve 55% net reduction in greenhouse gas (GHG) emissions by 2030, compared to 1990 levels. This year, the EU formalised these targets as a renewed pledge ahead of the Leaders' Summit on Climate on Earth Day, with new details released in mid-July.

In this special edition of #WhyESGMatters, we discuss these recent developments on the European Green Deal and their significance towards achieving climate neutrality. We also delve into the Carbon Border Adjustment Mechanism, a world-first carbon tariff policy and why this could potentially be a strong catalyst for decarbonisation within and outside of the EU.

1. The European Green Deal

The Deal is a multi-year project which aims to revise existing regulation and propose new policies. There are essentially "fifty actions for 2050" which touch upon climate, industry, agriculture, taxation, financing, and investing - as highlighted in Figure 1.

Figure 1: The Framework of the European Green Deal



Source: HSBC
[1] Applicable to the 27 nations currently part of the European Union

Specific to climate neutrality, there are two parts:

- Reducing emissions by decarbonising in all parts of the economy
- For residual emissions, maximising the potential of natural carbon sinks and carbon capture & storage

The EC announced its Climate Neutrality Law in 2020, which is designed to "enshrine" the 2050 climate neutral objective into legislation and provide a long-term direction of travel for EU climate polices. The targets will be an EU-wide collective objective, which implies that not all member states have to achieve individual neutrality.

Significant developments were made recently in July, when the EC announced a work programme aligned with the EU Green Deal and Climate Neutrality Law. The programme includes revisions to existing legislation and new proposals under the "Fit for 55" package, designed to place the EU on course to reach the 55% net reduction in GHG emissions by 2030. These revisions and proposals can be categorised under three areas – see Figure 2:

Figure 2: Summary of updates to the "Fit for 55" package

Carbon pricing[2]	Climate targets	Emissions rules
REVISION **EU Emissions Trading System:** to lower the annual GHG emissions cap from certain sectors as well as extend to transport and buildings	REVISION **Effort Sharing Regulation:** strengthen GHG emissions target assigned to each EU member state	REVISION **EU clean car standard:** require average emissions of new cars to reduce by 55% (from 2030) and 100% (from 2035) compared with 2021 levels
REVISION **Energy Taxation Directive:** align taxation of energy products with EU energy and climate objectives	REVISION **Regulation on Land Use, Forestry and Agriculture:** strengthen overall EU target for carbon removals via natural sinks by 2030	REVISION **Alternative Fuels Infrastructure Regulation:** require EU Member States to expand charging capacity in line with zero-emission car sales; build new infrastructure
NEW **Carbon Border Adjustment Mechanism:** taxation on emissions for imports	REVISION **Renewable Energy and Energy Efficiency Directive:** increased target to produce 40% of energy from renewable sources by 2030	NEW **ReFuelEU Aviation Initiative:** suppliers to blend increasing levels of sustainable aviation fuels
	REVISION **Energy Efficiency Directive:** more ambitious binding annual target for reducing energy use at EU level	NEW **FuelEU Maritime Initiative:** more sustainable maritime fuels and zero-emission technologies

Source: EU, HSBC

[2] Denotes cost of greenhouse gas emissions borne by the EU public

With Europe as the third highest CO_2 emitting region in the world, the European Green Deal is an illustration of extensive government initiatives, that provides a wide range of support to sustainable investments. These top-down government measures will also be increasingly important for companies to be forward-looking and ride on the sustainability trend, and similarly for investors to look for opportunities in companies with sound ESG practices and/or innovative green solutions.

2. The Carbon Border Adjustment Mechanism

A significant recent proposal is the Carbon Border Adjustment Mechanism (CBAM), a world-first tariff policy on carbon emissions embedded in imported goods based on the EU carbon price. In its transition phase to be soft-launched from 2023, the CBAM will be imposed on five carbon-heavy sectors: iron & steel, aluminum, cement, fertilisers and electricity (more in Figure 3).

Other sectors could also be extended into CBAM's scope after full implementation in 2026. The EC expects to raise about EUR10 billion a year as tax revenue for the EU's budget and own resources. We believe that the CBAM will also accelerate multilateral decarbonisation and initiate the global race on climate ambitions.

Figure 3: Highlights of the EU Carbon Border Adjustment Mechanism

When?
A transition phase will start in 2023. Importers will start paying a financial adjustment after full implementation in 2026.

What sectors?
Iron & steel, Aluminum, Cement, Fertilisers and Electricity.

Which country?
All non-EU countries except members of the European Economic Area and Switzerland.

How does it work?
Importers have to purchase and surrender CBAM certificates to cover emissions embedded in goods.

How much?
The CBAM certificates link to the price of the EU ETS allowance. The EU expects to raise EUR 10bn a year from the CBAM.

Source: EU, HSBC

The EC's proposal on CBAM is expected to kick-start a series of domestic and international discussions and debates over the next year. With the complexity and controversy that it brings, implementation of the CBAM will require extensive dialogue between EU member states and their trading partners. This could influence the target launch timelines, even for the transition phase planned for 2023.

And while approval is likely within the EU, pressure from trading partners such as China, Russia and the US will likely arise given their much publicised criticism on the CBAM. The proposal could also face headwinds from the World Trade Organisation, the global body is responsible for the rules of trade between nations.

There could also be cost impact applied to sectors heavily reliant on imported goods, such as construction and automotive. EU importers may face the scenario of foreign suppliers passing the carbon cost onto them, which will increase costs down the value chain eventually. However, the CBAM proposal could also see importers receiving some level of compensation for the carbon price paid to their origin's regulators, thereby alleviating this cost impact.

Aside from these potential headwinds, the CBAM could be one of the most effective and strongest instruments to promote multilateral decarbonisation and climate ambitions. It could also be effective in reducing carbon leakage in the EU's Emission Trading System, or the risk of carbon-intensive companies moving to other developing countries to avoid being subject to climate rules, and also protect selected European industries from foreign competitors that are not subject to stringent climate policies.

It also incentivises countries that have bold climate rules or credible carbon pricing schemes. We expect that more countries to tighten their climate policies and consider similar initiatives to protect their domestic industries in response to the CBAM and carbon leakage. In tandem with the release of the proposal, Canada, Japan, UK and US are also examining the feasibility of introducing a carbon border tax.

3. Conclusion

As the EU continues to unveil the next proposals of its European Green Deal, major economies such as China and the US have also made further announcements in 2021 to accelerate their climate ambitions. In addition to the CO_2 emissions reduction targets in their 14th Five Year Plan, China has launched its national emissions trading scheme in July. The scheme will initially focus on the power sector and subsequently expand to others in working towards lower carbon developments. Meanwhile, the US has returned to climate leadership with its rejoining of the Paris Agreement and introduced a series of net-zero pledges, including an Infrastructure Framework announced in June to invest in green infrastructure.

In the race to combat climate change, we believe that not only will this momentum be carried by other global economies in the coming year, but also infiltrate into the corporate sector. We believe that companies who adapt with foresight to the risks and opportunities are better placed to outperform their competitors in the longer run. Investors should prepare for an accelerated transition to a lower carbon economy as more pledges around the world are made, more solutions are developed to achieve these goals, more controls on ESG disclosures are enforced and more likelihood for net-zero emissions to become the norm.

Disclosure appendix

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