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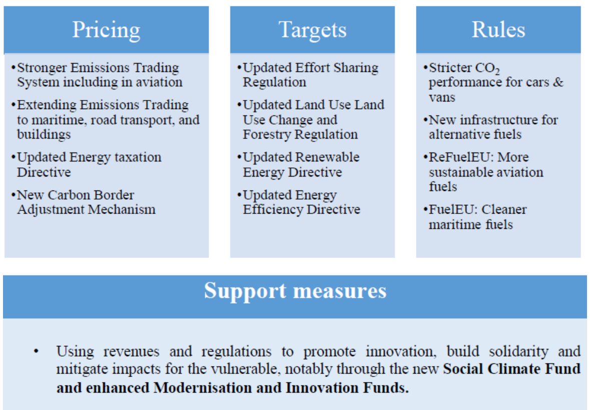
The EC green deal proposal is a further step towards greening the EU economy

- **On July 14, the EC proposed detailed measures to implement its green deal plan. It contains concrete and also ambitious targets for accelerating the reduction of carbon emission, incl. broader carbon pricing and tougher emission standards for cars. It includes the phasing out of domestic carbon credits over 10 years.**
- **In order to limit carbon leakage to third countries the EC proposes an adequate cross border adjustment mechanism (CBAM) that effectively introduces carbon taxes on imports.**
- **While resistance against the plan is likely, we ultimately expect a sensible compromise, not least due to support of affected regions from the EU budget and additional tailwind from the ECB's new strategy giving additional incentives for firms to become greener.**
- **Regarding markets the near-term impact of the recently announced measures is rather neutral in rebalancing the cards between winners and losers. Among sectors, building and materials are the main beneficiaries while Utilities and Autos will have to adapt.**
- **Forthcoming sizeable green issuance in the EU will help growing and greening European finance in a more balanced and standardised way.**

The European Commission (EC) already announced last year to go green and made green deal proposals. The target on which the EU27 member states committed themselves is to reduce green house emissions by 55% relative to the 1990 level by 2030 and to achieve **climate neutrality until 2050**. Hence, economic growth shall be decoupled from resource use while no place and no person shall be left behind. This target implies a significant change in the European economic structure.

Key features of the EC green deal proposal



Source: https://ec.europa.eu/info/sites/default/files/chapeau_communication.pdf

In order to realize it, the EC now made more concrete proposals containing ambitious measures. They comprise higher prices for energy consumption but also stricter rules for instance for the emissions of cars but also ships. Regarding the politically sensitive emissions from vehicles the plan targets a 55% reduction for cars by 2030 and a 50% reduction for vans by then. By 2035, there shall be zero emissions from new cars. To transform the European economy **carbon pricing is of essence**. A key role plays tradable carbon credits. Under the Emissions Trading System (ETS) large industrial polluters have to buy carbon credits in order to cover their emissions. The EC suggests to also include the shipping industry under this scheme for the first time. Also transport and building shall be included. The proposal is also to phase out free credits for many sectors, including inner-EU flights. The phaseout is proposed to end in 2036.

In order to avoid a shift of production to environmentally less ambitious regions and to not damage the external competitiveness of European firms the EC had proposed a **cross border adjustment mechanism (CBAM)** as part of the ETS. However, the details of the CBAM still need to be determined. The EC suggests six variants which it deems appropriate to fulfil the target and to be also consistent with WTO rules (see box below). However, the EC also finds that to minimise carbon leakage the options 4,3 and 5 are best suited. Regarding compliance costs the options 1, 2, 3, 4 and 5 are preferable as emissions are declared at default value so that monitoring of the emissions from the production process is not necessary and therefore also limited costs are incurred. The EC has a lot of sympathy for option 4. It contains carbon leakage as the carbon price is based on the production in the third country but has a smooth 10-year phasing-in period starting in 2026. Which option will in the end to chosen is critical for the impact on the business of carbon importing firms and sectors and hence for their capital market performance.

EC proposals on Cross Border Adjustment Tax

Source: European Commission

1. In the **first option**, CBAM is an import carbon tax, paid by the importer when products enter the EU. The tax would be collected by customs at the border based on a tax reflecting the price of carbon in the Union combined with a default carbon intensity of the products. Importers would have the opportunity to claim a reduction of the CBAM based on their individual carbon footprint and any carbon price paid in the country of production.
2. The **second option** involves the application on imports of a system that replicates the EU ETS regime applicable to domestic production.
3. The **third option** operates in the same way as option 2, however the carbon price of imports is based on actual emissions from third country producers rather than on a default value based on EU producers' averages.
4. **Option 4** would apply in the same way as option 3. It consists of surrendering CBAM certificates on imported products. However, this option considers also a 10 years phasing in period starting in 2026 during which the free allocations of allowances under the EU ETS would be gradually phased out by 10 percentage points each year and the CBAM would be phased in.
5. **Option 5** is a variant of Option 3 with a scope extended further down in the value chain. Carbon-intensive materials that are part of semi-finished and finished products would be covered along the value chain. For imports, the CBAM would again be based on the actual emissions from third country producers.
6. **Option 6** consists of an excise duty on carbon-intensive materials covering consumption in the Union of both domestic and imported products, besides the continuation of the EU ETS including the free allocation of allowances covering production in the EU.

Generally, we view the EC proposals as an important further step for greening the economy but also **look for cumbersome political discussion on the European level** in order to balance environmental progress and political willingness of the member countries to adopt this new regime. The more concrete the plans become the clearer it will become which sectors or firms suffer, probably resulting in aggressive lobbying. That said, it also needs to be kept in mind that the EU's approach towards greening the economy is broad-based. One third of the € 1.8 tr investments from the NextGenerationEU Recovery Plan, and the EU's seven-year budget will finance the European Green Deal. It also contains the so called Just in Transition Mechanism which provides targeted support to help mobilise at least €65-75 billion over the period 2021-2027 in the most affected regions, to alleviate the socio-economic impact of the green transition. There is also support for the greening of the economy by the ECB. In its updated strategy it foresees a climate action providing incentives for firms to become greener. Among other things it foresees more favourable haircuts for green firms in repo operations and a departure from the principle of market neutrality regarding asset purchases. All in all, we are confident that the European Council will eventually agree after some arm twisting and horse trading on the implementation of the green deal.

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Regarding markets, the **near-term impact of the announced measures is rather neutral** but impact will be important at sector-level, in rebalancing the cards between winners and losers. The most affected ones will be **building and materials** which **will be the main beneficiaries** through the objective of building and renovating in an energy and resource-efficient way, while on Utilities and Autos the impact will be sector neutral but winners and losers will emerge within sectors. Among Utilities there will be even a greater rotation between conventional energy producers versus renewable specialists, while in the Auto sector the green deal is providing the sector with subsidies to cope with the very ambitious carbon issuance reduction plan.

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