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IMPACT OF THE CBAM AND THE RED III DIRECTIVE ON THE COMPETITIVENESS OF THE INDUSTRIAL SECTOR

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Jorge Fernández Gómez
Jaime Menéndez Sánchez

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Executive summary

The complex global economic and geopolitical current situation poses significant risks for the Basque and European industry. This paper analyses the potential impact on the competitiveness of the industrial sector of two recent regulations in the European Union (EU) aimed at protecting the competitiveness of industrial companies and, at the same time, promoting the decarbonisation of their activities: (a) the update of the Renewable Energy Directive, known as RED III; and (b) the carbon border adjustment mechanism (CBAM).

PART I: IMPACT OF THE RENEWABLE ENERGY DIRECTIVE (RED III) ON INDUSTRIAL COMPETITIVENESS

The RED III promotes the development of renewable and low-emission energy sources (including renewable hydrogen and others) and the adoption of new clean technologies.

In particular, the RED III sets a target share of renewable energy in the EU's total energy consumption of at least 42.5% by 2030 (aiming for 45%) and establishes penetration targets for other renewable energies (including renewable hydrogen, other renewable gases and renewable fuels of non-biological origin, RFNBOs) in different sectors (transport, industry, buildings, district heating and cooling systems, etc.).

The potential impact on the European industry of this updated regulatory framework to promote the growth of renewable energies in the European energy mix is significant.

Industrial companies will have to increase the share of renewable energy in their energy consumption, use RNFBOs and reduce greenhouse gas emissions associated with energy consumption by at least 70% compared to a specific benchmark. In addition, it establishes various requirements related to regulatory compliance and the submission of non-financial information. Industrial companies are responsible for ensuring and demonstrating that they comply with the set targets and must monitor and report on the share of renewable energy they achieve and the measures they are taking to reach the indicative targets.

On the other hand, the Delegated Regulations of previous directive on renewable energies (RED II Directive or Directive (EU) 2018/2001) establish a methodology with detailed rules for the production of renewable liquid and gaseous fuels of non-biological origin, including, in the case of renewable hydrogen, requirements for additionality in the use of renewable electricity as an input and temporal and geographical correlation between the production of renewable energy and the production of renewable hydrogen. They also specify a methodology for assessing the greenhouse gas emissions reduction from non-biological renewable liquid and gaseous fuels and synthetic fuels.

To adapt to the new RED III standards, energy-intensive industrial companies will have to undertake a profound transformation of their business models and operational processes.

Potentially significant potential impacts for industrial companies include (a) increased energy supply costs; (b) limited availability of renewable hydrogen and other renewable fuels; (c) the need to make significant investments and find adequate financing channels; (d) the costs associated with regulatory obligations; (e) the uncertainty associated with the evolution of the regulatory framework (not yet completed); and (f) the need to adapt organisational structures.

The RED III generates multiple opportunities for Basque industrial companies.

In the Basque Country, the development of conventional renewable energies (wind and photovoltaic) and the promotion of renewable hydrogen, other RFNBOs and innovative decarbonisation technologies promoted by RED III makes strategic sense, given the weight of energy- and emission-intensive industry and associated services in the generation of economic added value, and can enable the enhancement and capitalization of industrial knowledge and expertise, business and industrial capabilities in the energy sectors and other value chains, and human capital in energy-intensive industries.

In addition to promoting value chains associated with renewable (electric) energy, smart electricity grids, power electronics, etc., the regulatory framework on hydrogen and other renewable gases offers a great opportunity for the Basque Country to pursue a "smart regional decarbonisation strategy". This strategy would allow to simultaneously reduce emissions and improve industrial competitiveness, by focusing on the development of key value chains and activities related to the development, production, use and marketing of energy products for energy-intensive industries. Critical value chains include : (1) renewable electricity; (2) renewable and low-carbon fuels (second-generation biofuels, renewable and low-carbon hydrogen and derived products such as ammonia, methanol and synthetic fuels); and (3) CCUS (carbon capture, use and storage).

Strong support from public administrations for the industrial transformation will facilitate the generation of value associated with the implementation of the RED III.

Materialising these opportunities through the deployment of competitive business models around clean technologies and energies by industrial companies will require an appropriate economic and regulatory context, where public administrations will play an important role, helping to drive innovation, facilitate investment financing, and ensure a stable and appropriate economic, business, legal/regulatory and institutional environment that facilitates investment decisions and the financing of innovative projects, the generation of new capacities and cooperation between public, private and other relevant third sector actors (e.g. foundations and philanthropic institutions with investment capacity).

PART II: IMPACT OF THE CARBON BORDER ADJUSTMENT MECHANISM (CBAM) ON INDUSTRIAL COMPETITIVENESS

The CBAM aims to protect European industry and prevent carbon leakage.

The CBAM is a tool that aims to reconcile the major objectives of the EU's energy-industrial-environmental strategy: (1) to protect energy-intensive domestic industry from unfairly priced imports from countries with lower environmental ambitions; (2) to generate incentives for industrial decarbonisation; and (3) to expand the EU's environmental objectives globally.

In essence, the CBAM is a mechanism for adjusting the prices of imports into the EU of a set of basic or *upstream* goods and commodities (products related to cement, electricity, fertilisers, smelting, iron and steel, aluminium and chemical products such as hydrogen) whenever these prices do not incorporate the cost of CO_2 emissions implicit in their production and transport to the EU border. By doing so, the EU hopes to avoid a potential competitive disadvantage for EU producers of the same products, subject to the Emissions Trading System (ETS).

The adjustment of the import price of each good is carried out through the purchase and delivery of "CBAM certificates" by importers. In practice, this instrument functions in a similar way to a "border tax" compatible with World Trade Organisation (WTO) rules, although it is technically neither a tax nor a regulated fee or charge.

Full implementation of the CBAM will commence on January 1st, 2026.

During a transition period, which ends at the end of 2025, its application has been limited. However, from 1 January 2026, all importers into the EU of goods and products subject to the CBAM scheme are required to surrender CBAM certificates for the value of the implicit CO_2 emissions in their imports that have been not priced into their goods and products.

The obligation to surrender CBAM credits will increase gradually in 2026-2034, in line with the planned gradual reduction in the free allocation of CO_2 emission allowances under the emissions trading scheme. In 2034, importers of products subject to the CBAM will bear 100% of the cost of 'CBAM certificates', while industrial companies (that are currently entitled to CO_2 discounts) will receive 0% of the emission allowances that were allocated free of charge.

Risks associated with the implementation of the CBAM.

A priori, the CBAM will tend to improve the domestic competitiveness of energy- and emissions-intensive European industries in the short term and generate incentives for industrial decarbonisation. However, its complex design, the lack of precedents of similar mechanisms and the current geopolitical context generate great uncertainty about the potential impacts on industrial companies, among which the following can be highlighted:

- The possibility that exporters in third countries will avoid the application of the CBAM, both upstream in value chains (e.g., by diverting emission-intensive commodities to less environmentally demanding markets or by exporting secondary material to the EU) and downstream (by exporting final products).
- The focus on imports, without specific solutions for exports from the EU, may mean that the increase in production costs in the EU could deteriorate the position of European industrial manufacturing companies in international markets.
- The cost of compliance with the regulatory standards for companies is significant, due to limited (and costly) data availability, the complexity of value chains and the procedures required, the administrative burden, legal loopholes and changes or uncertainties in the standard, etc.
- The gradual reduction in free emission allowances may jeopardise the viability of industrial companies if they do not make the necessary investments to decarbonise their activities, which in many cases may involve very significant capital outlays.

The CBAM mechanism will be evaluated and reviewed in 2026.

The review of the CBAM in 2026, in addition to seeking regulatory and bureaucratic simplification of the mechanism (in line with the February 2025 "omnibus package" of the EU), should prioritise (a) extending the scheme to other energy goods and products beyond the initial six products; (b) extending it downstream in value chains and, in particular, to manufacturing sectors; (c) the inclusion of indirect emissions; (d) the protection of exporting companies (e.g., through the recycling of CBAM revenues); (e) mitigating potential situations of evasion and fraud; and (f) establishing flexibility mechanisms in the application of the CBAM so that it can be adapted to different contexts in

international markets depending on the commercial situation (e.g., tariffs) and geopolitics (e.g., armed conflicts, energy prices, etc.).

The CBAM may have a significant impact on the Basque industry.

Industry in the Basque Country (and, in particular, sectors with strong international exposure, such as the automotive components sector) could be affected gravely in terms of loss of economic activity and employment, exports and investment. Almost 30% of the added value in the Basque Country is created by the manufacturing industry, energy and construction sectors. Import tariffs on steel, iron, aluminium, copper and scrap from third countries (outside the EU), which are below 25% in all cases, limit the risks of the CBAM for Basque industry in the short term.

The Basque Country's position on changes to the CBAM should focus on its extension to *downstream* industries and products, the inclusion of export support measures, the implementation of flexibility measures for the most affected industries, and the deployment of wide-ranging and far-reaching industrial decarbonisation financing schemes, including CBAM revenues.

Part III: RECOMMENDATIONS FOR PUBLIC ADMINISTRATIONS AND INDUSTRIAL COMPANIES

Recommendations for public administrations

1. Continue to work on the implementation of a "smart Basque industrial strategy." Based on the framework provided by the Basque Energy Transition and Climate Change Act and the recently approved Euskadi 2030 Industry Plan, economic growth, innovation, industrial policy, and environmental policy must be aligned with the dual objectives of competitive decarbonization and reindustrialization around clean energy, decarbonization technologies, and new materials.

2. Plan energy sectors in an integrated manner. A key element of the industrial decarbonisation strategy must be to achieve synergies and efficiencies from energy and decarbonisation strategies that take into account the integration between different energy and industrial sectors and different energy sources and energy vectors.

3. Continued support for Basque industrial companies. Public administrations must promote ecosystems that support investment and financing for projects and *start-ups* focused on innovative clean technologies, with effective and intelligent investment incentive schemes and financing mechanisms for investments in clean technologies (i.e., efficient and results-oriented, aimed at a real transformation of the economy). In this regard, the Basque Financial Alliance and the Industry Aid Plan 2025, within the Basque Country Industry Plan 2030, will facilitate the competitive decarbonization of Basque industry. The use and optimisation of state aid exemption mechanisms enabled by the EU and updated in the context of *the Clean Industrial Deal* should also be encouraged. Support for companies can also take the form of relevant initiatives to foster digitalisation, the provision of technical, financial and regulatory support, the generation of information and knowledge on industrial decarbonisation, the development of new capabilities and business models, etc.

4. Develop strategic infrastructure. It is essential to identify optimal areas for renewables and plan hydrogen and other RFNBO infrastructure integrated with other sectors. In addition, innovative financing schemes, such as intertemporal cost allocation models that facilitate affordable tariffs and the recovery of investments should be supported. Transformative Projects within the Basque Country Industry Plan 2030, such as the creation of a "Sovereign Data Hub" or an "Advanced Robotics Solutions Center," the "Grid4Industry" and "Decarbonization Valley" projects, and the creation of a

"Renewable Fuels Hub," will underpin the infrastructure networks that are required for the competitive decarbonization of the Basque Country.

5. Support an adequate development of the regulatory framework. Regulatory consistency must be ensured between various key legislative pieces (e.g., RED III, CBAM, EU-ETS, etc.), avoiding excessive burdens that reduce industrial competitiveness. With regard to the CBAM, aspects such as increasing its scope by including *downstream* products, export protection measures, reviewing the timetable for phasing out free emission allowances and ensuring coordination with the financing of new investments and other industry support schemes must be clarified. In relation to the RED III, it is essential to correctly define exemptions for hydrogen as a co-product, or input for decarbonising hard-to-abate activities, and to make the criteria for additionality and temporal/geographical correlation more flexible.

6. Foster social support for industrial transition. Public administrations must effectively communicate the benefits of sustainable transformation and promote social acceptance of infrastructure development (renewables, hydrogen, etc.), as well as encourage the demand for low-carbon products.

7. Develop RFNBO value chains. Support for new fuels should focus on sectors where renewable hydrogen and others have the greatest impact and where there are fewer decarbonisation alternatives for industrial companies. Favourable conditions can be created by reducing barriers such as (a) high costs compared to fossil fuels; (b) high electricity prices; (c) scarcity of PPAs and supply contracts; (d) access to dedicated renewable generation; (e) lack of infrastructure; and (f) low firm demand from the industry. Several of the Transformative Projects mentioned above in the Basque Country Industry Plan 2030 will facilitate the development of RFNBO value chains.

Recommendations for industrial companies.

Industrial companies that depend on fossil fuels must redesign their strategies to comply with the RED III, CBAM and the renewable gases package, while maintaining their competitiveness under the new regulatory framework. This requires:

1. Strengthening business intelligence. The new regulations require developing internal knowledge about the scope, implementation timeline and obligations of standards such as CBAM and RED III, and anticipating the impact on materials, products and regulatory reporting obligations.

2. Deploy an efficient decarbonisation strategy. Each company must draw up a roadmap to transform its energy mix in line with RED III and the reduction in free CO_2 allowances implied by the CBAM. This involves (a) conducting regular emissions audits; (b) collaborating with their supply chains; (c) evaluating alternatives for renewable or low-emission energy, energy and material efficiency, clean technologies and process optimisation; (d) reviewing procurement strategies (e.g. seeking closer and more transparent suppliers); (e) analysing the potential positive impact of establishing internal incentive mechanisms, such as internal CO_2 prices.

3. Optimise energy and materials management. Energy contracts (e.g., renewable PPAs, products with guarantees of origin) and material supply contracts need to be adapted. In addition, companies that produce their own hydrogen will need to adjust their logistic and production activities.

4. Improve regulatory information. Companies must allocate resources to capture, process and report data required by the CBAM and RED III and monitor CO_2 emissions and energy, product and material consumption, which implies new technical, analytical, legal and regulatory capabilities.

5. Ensure financing for the required investments. The transformation of *the* energy *mix* will involve significant investments in infrastructure and equipment, which must be financed through appropriate mechanisms.

6. Implement a regulatory strategy. Large companies must define strategies to influence regulation, promoting regulatory simplification, a clear definition of the goods and products affected by the new regulatory framework, support for the financing of pilot projects, flexibility in the application of standards, the establishment of incentives for companies pioneering the transformation, and taxation schemes that are favourable to new fuels, among other measures.

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