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EU carbon pricing goes global
Preparing for the Carbon Border Adjustment Mechanism (CBAM)

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Carbon border adjustments
An idea whose time has come?

Plugging a gap in action on climate change

Climate change is a global problem, but binding global agreement on tough GHG emission reductions is almost certainly unattainable

Solution? "Nationally Determined Contributions" regime (Paris Agreement)

Countries can set (and meet) demanding NDCs, yet still cause high GHG emissions

Carbon border adjustment is a way for unilateral measures to have global impact

Why economists advocate carbon border adjustments (BCA / CBAM)

Greenhouse gas (GHG) emissions

Economic activity ➔ climate change

- Extractive industries
- Energy consumption in production of goods and services
- Transportation

Carbon pricing

Most effective way to tackle GHG emissions

- Tradeable permits or carbon tax?
- Which emissions should be in scope?
- How best to set / adjust price?
- Need to avoid regressive impacts

Global carbon pricing regime?

Ideal approach, but probably impracticable

- Will not reach agreement on an effective scheme
- ➔ Separate national and regional regimes
- But these may redistribute, rather than reduce, overall emissions

Carbon border adjustment (BCA / CBAM)?

Could be a pragmatic way forward

- Same CO_2 price for imports and domestic goods
- Avoid negative impacts of territorial regimes
- May ➔ wider adoption of effective CO_2 pricing globally
- But each country can develop CO_2 pricing at its own pace

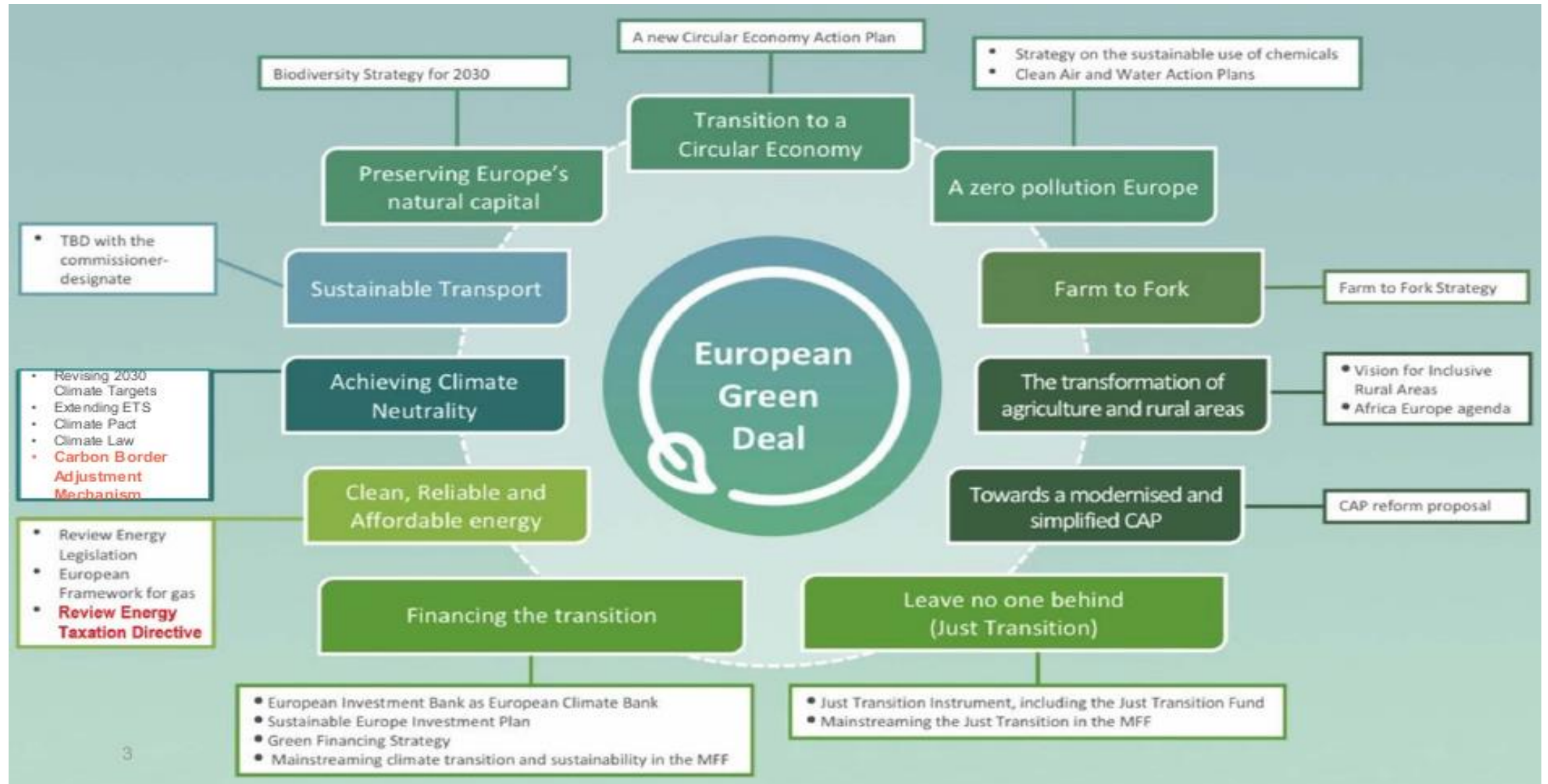**Implementing a BCA / CBAM**

Some significant challenges

- International trade law controversies
- Other potential legal obstacles
- Practicality of monitoring and enforcement
- Avoiding incentivising unhelpful behaviour on the part of exporters
- Shares (and magnifies) difficulties of national or regional regimes

CBAM in context: overview of the EU Green Deal

A new Circular Economy Action Plan

Biodiversity Strategy for 2030

- Strategy on the sustainable use of chemicals
- Clean Air and Water Action Plans

Transition to a Circular Economy

Preserving Europe's natural capital

A zero pollution Europe

- TBD with the commissioner-designate

Sustainable Transport

Farm to Fork

Farm to Fork Strategy

- Revising 2030 Climate Targets
- Extending ETS
- Climate Pact
- Climate Law
- Carbon Border Adjustment Mechanism

Achieving Climate Neutrality

European Green Deal

The transformation of agriculture and rural areas

- Vision for Inclusive Rural Areas
- Africa Europe agenda

- Review Energy Legislation
- European Framework for gas
- Review Energy Taxation Directive

Clean, Reliable and Affordable energy

Towards a modernised and simplified CAP

CAP reform proposal

Financing the transition

Leave no one behind (Just Transition)

- European Investment Bank as European Climate Bank
- Sustainable Europe Investment Plan
- Green Financing Strategy
- Mainstreaming climate transition and sustainability in the MFF

- Just Transition Instrument, including the Just Transition Fund
- Mainstreaming the Just Transition in the MFF

3

Key relevant policies and legislative initiatives

High-level Green Deal climate policy objectives

- EU to be a fair and prosperous society with a modern, resource-efficient and competitive economy
- By 2050: Europe to be the first climate-neutral continent
- By 2030: reduce EU CO_2 emissions by 55% (from 1990 level)

Key EU decarbonisation priorities

- EU energy intensive industry needs to make substantial investments in new plant in order to reduce emissions
- Impacts of (successful) EU policies: risk of carbon leakage
- Green recovery / just transition

Relevant legislative initiatives

- "EU Climate Law": sets EU emissions targets
- EU ETS (carbon pricing regime): proposed expansion / reform
- Energy Taxation Directive: proposed reform
- Carbon Border Adjustment Mechanism (CBAM)

EU Emissions Trading System: some key features

Covers all of EEA (EU + Norway, Iceland, Liechtenstein); mostly CO_2, some N_2O and perfluorocarbons

Applies to c.11,000 installations in specified "heavy" industries + 600 aircraft operators flying to / from EEA

A "cap and trade" scheme: cap set at EU level and reduces annually at steady rate

Surrender 1 EU allowance per tCO_2e emitted or face heavy financial penalty

EU-wide auction process to purchase allowances (revenues ➜ Member States: c. € 14 billion)

Free allocation of allowances for emitters in some sectors

EU Emissions Trading System: evolution to date

Phase 1: 2005-2007
Phase 2: 2008-2012
Phase 3: 2013-2020
Phase 4: 2021-2030

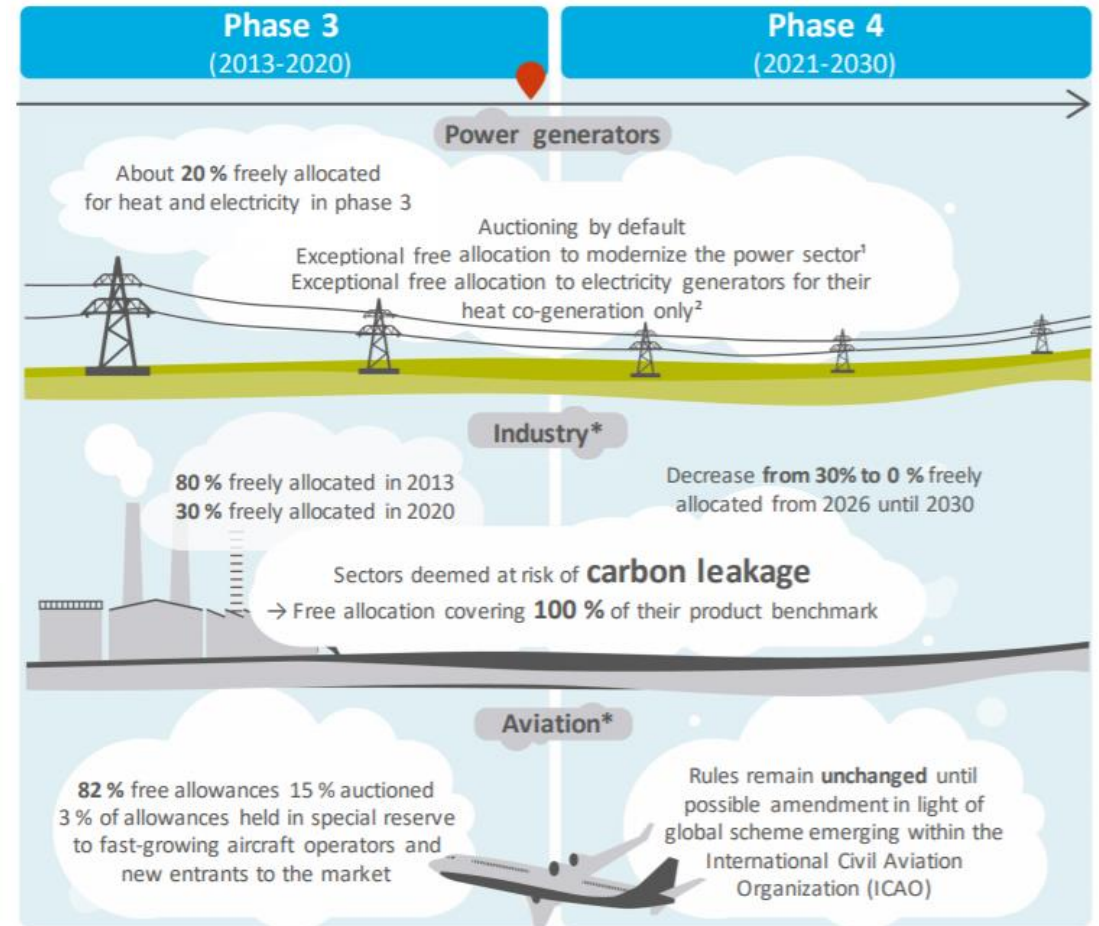Fewer allowances allocated free, on a more targeted basis, and subject to benchmarking

Market Stability Reserve (and "shelf life" for allowances) introduced to deal with problem of "surplus" allowances

Phase 4: Member States can include additional sectors and exclude small emitters

Key question now: how to adapt EU ETS to hit revised 2030 GHG emissions reduction target (increased from 40% to 55% on 1990 levels)

EU Emissions Trading System: some developments

Chart (top left): EUA price 2008–2019
- 30.52 – 30 June 2008
- ETS Phase 2
- ETS Phase 3
- 24.67 – 30 Dec. 2019
- 2.97 – 22 April 2013

Chart (bottom left): EUA FUTURES (DEC 2021) · 1D · ICEEUR — 52.17 +2.91 (+5.91%), Vol 51.14K

Phase 3 (2013-2020) | **Phase 4 (2021-2030)**

Power generators
- About **20 %** freely allocated for heat and electricity in phase 3
- Auctioning by default
- Exceptional free allocation to modernize the power sector[1]
- Exceptional free allocation to electricity generators for their heat co-generation only[2]

Industry*
- **80 %** freely allocated in 2013
- **30 %** freely allocated in 2020
- Decrease **from 30% to 0 %** freely allocated from 2026 until 2030
- Sectors deemed at risk of **carbon leakage** → Free allocation covering **100 %** of their product benchmark

Aviation*
- **82 %** free allowances 15 % auctioned 3 % of allowances held in special reserve to fast-growing aircraft operators and new entrants to the market
- Rules remain **unchanged** until possible amendment in light of global scheme emerging within the International Civil Aviation Organization (ICAO)

* Categories of activities as defined by Annex I of Directive 2003/87/EC
[1] Article 10c of the ETS Directive
[2] Article 10a(4) of the ETS Directive

ECA report

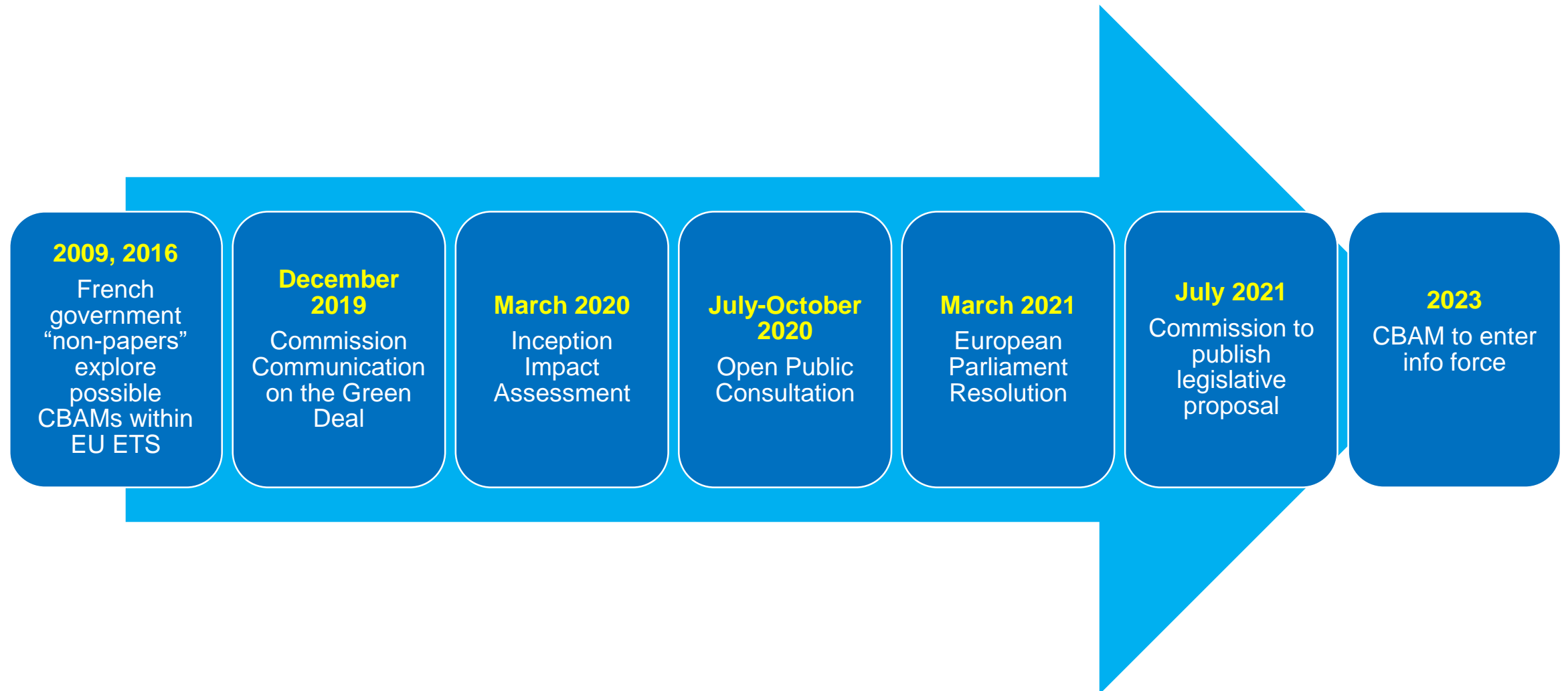*Sources: European Court of Auditors, Ember, Sandbag, Carbon Tracker*

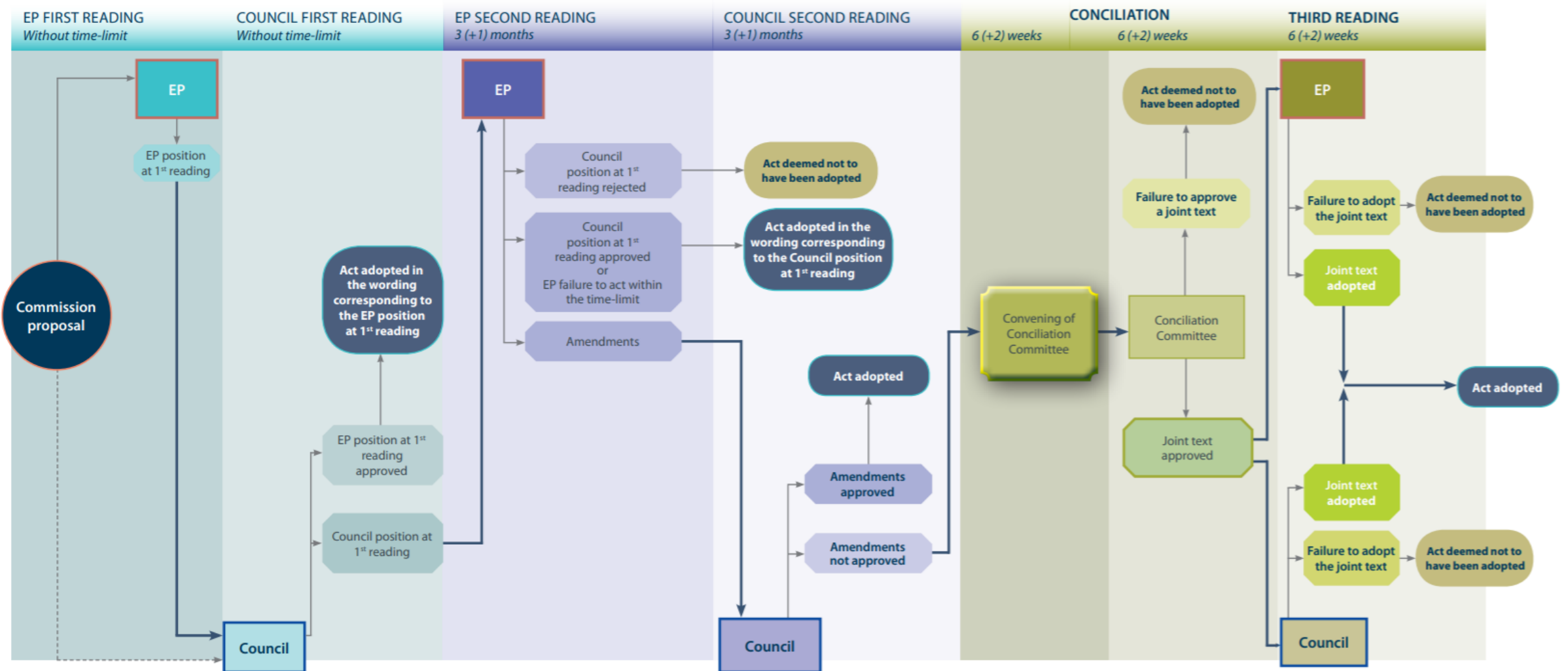**Key question now: how to adapt EU ETS to hit EU's revised 2050 GHG emissions reductions target (40% ➔ 55%)?**

Development of EU CBAM policy: key milestones

2009, 2016
French government "non-papers" explore possible CBAMs within EU ETS

December 2019
Commission Communication on the Green Deal

March 2020
Inception Impact Assessment

July-October 2020
Open Public Consultation

March 2021
European Parliament Resolution

July 2021
Commission to publish legislative proposal

2023
CBAM to enter info force

Summary of EU "ordinary legislative procedure"

EP FIRST READING	COUNCIL FIRST READING	EP SECOND READING	COUNCIL SECOND READING	CONCILIATION		THIRD READING
Without time-limit	*Without time-limit*	*3 (+1) months*	*3 (+1) months*	*6 (+2) weeks*	*6 (+2) weeks*	*6 (+2) weeks*

EP

EP position at 1st reading

Commission proposal

Council

Act adopted in the wording corresponding to the EP position at 1st reading

EP position at 1st reading approved

Council position at 1st reading

EP

Council position at 1st reading rejected

Council position at 1st reading approved or EP failure to act within the time-limit

Amendments

Act deemed not to have been adopted

Act adopted in the wording corresponding to the Council position at 1st reading

Council

Act adopted

Amendments approved

Amendments not approved

Convening of Conciliation Committee

Act deemed not to have been adopted

Failure to approve a joint text

Conciliation Committee

Joint text approved

EP

Failure to adopt the joint text

Act deemed not to have been adopted

Joint text adopted

Act adopted

Joint text adopted

Failure to adopt the joint text

Act deemed not to have been adopted

Council

Open public consultation: feedback on CBAM design options and coverage

Design Options

a) Import tax — 1.30 (462)

b) Extension of ETS — 0.98 (464)

c) Notional ETS — 1.05 (461)

d) Consumption tax (excise or VAT type) — 1.10 (459)
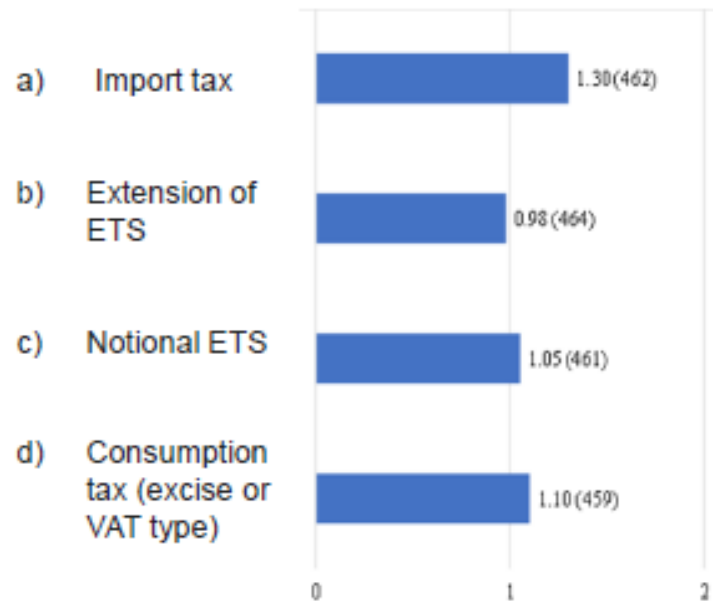
Legend: 0 = Not relevant   1 = Somewhat relevant   2 = Highly relevant

Scope of Emissions

a) Direct and Indirect emissions (production) — 2.42 (485)

b) Complete Value chain — 2.33 (486)

c) Differentiate between finished/intermediary and basic products — 1.29 (476)

d) Cover international transport of goods — 2.12 (483)
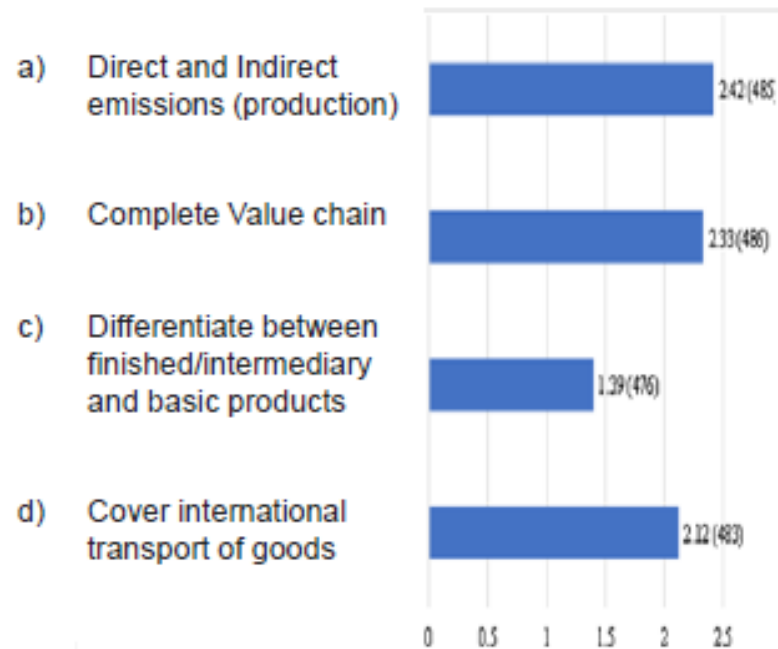
Legend: 1 = Strongly disagree 1 = Somewhat disagree 1.5 = Neither agree nor disagree 2 = Somewhat agree 3 = Strongly agree

Top 10 Sectors

Electricity — 103

Cement, lime and plaster — 101

Iron, Steel and ferro-alloys — 94

Chemicals, fertilisers, plastics — 85

Extraction of crude petroleum — 61

Precious and non-ferrous metals — 47

Animal production — 46

Mining hard coal — 45

Pulp, paper and paperboard — 42

Extraction of natural gas — 42
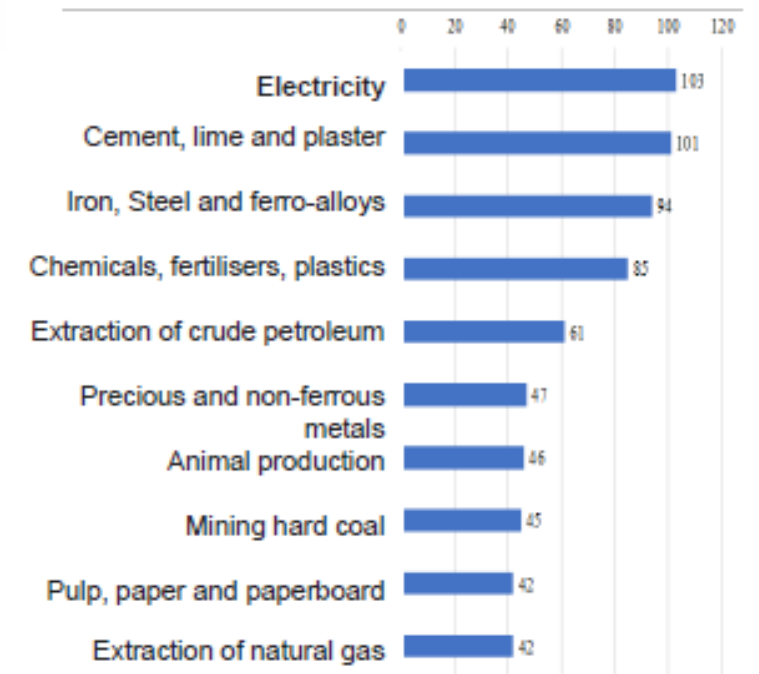
European Parliament resolution (March 2021): Key points (1)

Justification for an EU CBAM

- EU's increased climate ambition should not lead to carbon leakage
- Importance of taking full-lifecycle approach to CO_2 emissions
- Net imports into EU represent 20% of EU's domestic CO_2 emissions
- Trade as tool of sustainable development, EU as global standard setter
- Expectation of positive response from US

Climate change mitigation, not protectionism

- Designed exclusively to advance climate objectives
- Should not enhance protectionism, unjustifiable discrimination or restrictions
- Not a substitute for other policies (e.g. low carbon subsidies & standards)
- Minimise risk of circumvention (re-routing, exporting semi-finished goods)

CBAM to be based on reformed EU ETS

- Separate pool of EU allowances for importers; pricing to reflect EU ETS price
- Cover all products / commodities in EU ETS (including when embedded)
- Start with power sector and energy intensive sectors (cement, steel, aluminium, refineries, paper, glass, chemicals, fertilisers (94% of EU industrial emissions)
- Carbon embedded in logged wood and depleted soil should have a price

European Parliament resolution (March 2021): Key points (2)

"Trade-related aspects"	• EU trade policy to be consistent with Paris Agreement / help to achieve its goals • CBAM can be GATT-compliant if it only pursues environmental aims • Global action should make CBAM redundant • Commission to initiate WTO / G20 negotiations: update GATT for climate crisis • Export rebates: only if WTO compatible and have positive climate impact
Use of proceeds	• Revenues from CBAM (? €5-14 billion): a new "own resource" for Commission • CBAM should not be treated as a cash-machine • Revenues should support Green Deal (just transition, EU decarbonisation) • Increased finance for Least Developed Countries and Small Island States • Reduce some pressure on Member States to fund EU programmes
Implementation	• Commission should design CBAM with a clear and ambitious timeline • Need to evaluate impact on SMEs and possibly provide support for them • Most climate-friendly materials should not suffer competitive disadvantages

CBAM design and implementation challenges (1): calculating how much importers should pay

Potential volatility of market-based EU carbon price

Complexity of the EU carbon price: free allocation of allowances

Comparison with exporter jurisdiction: explicit carbon prices

Comparison with exporter jurisdiction: effective / implicit carbon prices

Individual adjustment mechanism (IAM) for exporters who "beat the average" for their jurisdiction?

Supply chain traceability (carbon content); robustness of data and verification processes

CBAM design and implementation challenges (2): avoiding unintended consequences

Differentiation
- Take account of actual emissions to encourage greener exporters (IAM)
- Green output ➔ EU; "dirty" plants' ➔ rest of world: no climate gain?
- Even with IAM, selling to non-EU importers is more profitable
- ➔ A form of carbon leakage (if those other markets have no CBAM)?

Scope
- Practicability ➔ (initial) narrow / shallow scope
- But (1) choice of narrow scope likely to be arbitrary; (2) less impact
- So go for wider / deeper scope?
- Impact should be greater, but complexity increases more?

Impact on EU industry
- EU exports become more expensive / may be shunned by some buyers
- ➔ More emissions globally
- Export rebate? ➔ Trade law difficulties
- Free allocation? ➔ Weakens carbon price, distorts market