



CBAM for the EU – Policy proposal

22 April 2021

Andrei Marcu, ERCST
Aaron Cosbey, ERCST
Michael Mehling, ERCST

ERCST

Roundtable on
Climate Change and
Sustainable Transition

22 April
2021

 15:00-16:30 (CEST, Brussels time)

ERCST

European Roundtable on
Climate Change and
Sustainable Transition

ERCST Proposal Launch

Carbon Border Adjustment Mechanism in the EU

Presentation of
proposal:



A. Marcu
ERCST Director



M. Mehling
MIT



A. Cosbey
IISD/ ERCST

During this meeting ERCST will present
a CBAM proposal with optimized
options for general CBAM design.

Reactions:



T. Kachka, Ukraine
Deputy Minister



K. Coppenholle
CEMBUREAU



O. Haanperä
SITRA



S. Droege
SWP



R. Baron
ECF



V. Hurtado-Roa
DG TAXUD

CBAM Proposal 22 April

Table of Contents

1. Introduction	4
2. Approach	5
2.1. Methodology	5
2.2. Guiding Principles and General Assumptions	6
2.2.1. Objectives of a CBAM	6
2.2.2. WTO Compliance	7
2.2.3. No Double Protection	8
2.2.4. Compliance	8
2.2.5. Operationalization	8
2.2.6. CBAM and EU ETS	8
2.2.7. Pilot Phase	8
2.2.8. Scope of Analysis	9
3. Proposed Design	9
3.1. Step-by-Step Design	9
3.1.1. Coverage of Trade Flows	9
3.1.2. Policy Instrument	10
3.1.3. Geographic scope	11
3.1.4. Sectoral Scope	13
3.1.5. Emissions Scope	14
3.1.6. Determination of Embedded Emissions	16
3.1.7. Calculation of the Charge	17
3.1.8. Use of Revenue	20
3.2. Cross-Cutting Issues	21
3.2.1. Treatment of Free Allocation	21
3.2.2. Treatment of Indirect Costs	22
3.2.3. Timeline and Sequence	23
3.2.4. Review Processes	24

ERCST

Roundtable on
Climate Change and
Sustainable Transition

2021

ERCST

Roundtable on
Climate Change and
Sustainable Transition

CBAM for the EU: A Policy Proposal



Andrei Marcu Michael Mehling Aaron Cosbey

ERCST CBAM Project Part II

- **Report I: A sectoral assessment** analyzing the suitability of a CBAM in addressing carbon leakage and the competitiveness of individual industrial sectors, as well as its impacts.
- **Report II: A CBAM proposal** outlining what the ERCST team would see as a combination of the nine BCA dimensions (*identified and assessed during Part I*), providing a balanced and ‘best outcome’ in their view for a CBAM on its own. It will include all instruments that are part of the EC’s Public Consultation document.
- **Report III: An analysis of the EC’s CBAM proposal** after it is put forward, which is expected by June 2021.
- **Report IV: A proposal** for a framework and pathway for introducing different policy measures to address carbon leakage and competitiveness.

Introduction: Our Approach

- Our previous work has **unpacked CBAM design elements** and implementation options, highlighting the **complexity** of this instrument and the **trade-offs** of alternative designs.
- The **political debate** on CBAM – as an integral part of the “Fit for 55” package under the European Green Deal – has revealed **heterogeneous preferences** among key stakeholders.
- Building on a **multi-criteria analysis** (see next slide) and extensive **consultations** with stakeholders in the EU and abroad, the latest ERCST report proposes a **CBAM design** that **balances tradeoffs** and remains **technically, legally** and **politically viable**.

- Previous **studies**:



“Issues and Options”:

Unpacking CBAM design options and evaluating these based on a multi-criteria approach



“Sectoral Deep Dive”:

Sector-by-sector analysis of sectoral features relevant for CBAM design, e.g. market structure, trade flows, and decarbonization pathways

Methodology

Eight design elements:

- Coverage of trade flows
- Policy mechanism
- Geographic scope
- Sector/product scope
- Emissions scope
- Determination of embedded emissions
- Calculation of adjustment
- Use of revenue

Five evaluative criteria

- Environmental benefit
- Competitiveness benefit
- Technical and administrative feasibility
- Legal feasibility
- Political and diplomatic feasibility

Guiding Principles & General Assumptions (I)

- **Objectives: A menu**
 - Avoid carbon leakage
 - Address competitive concerns
 - Allow for increase EU level of ambition
 - Motivate trade partners
 - Eliminate free allocation
 - Generate revenue
 - **ERCST:** address risk of carbon leakage by addressing competitive concerns resulting from the costs of climate action, in domestic and international markets
- **WTO compliance**
 - Interpretations of what is and what is not aligned with WTO may change in the future.
- **Compliance**
 - Compliance obligation will be on importers

Guiding Principles & General Assumptions (II)

- **No double protection**
 - Domestic producers cannot end up being better off than foreign producers
 - Application should not be driven by ideology.
- **Operationalization**
 - CBAM will require a significant level of administrative effort
 - EU and/or international institutional changes, new structures may need to be created.
- **CBAM & EU ETS**
 - It is thus a companion policy to the EU ETS
 - CBAM will impact the functioning of the EU ETS
- **Pilot phase**
 - May differ from what the final design of a CBAM may be.
 - Allows for gradual and cautious introduction of approaches that need to be tested.
 - Covers 2023-2027, takes into account the Paris Agreement stocktake

Coverage of Trade Flows

During the pilot phase, the proposed CBAM covers imports, with leakage related to exports addressed separately through continued, but declining free allocation to European producers for both domestically consumed and exported products.

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
Relatively greatest benefit due to maximum emissions coverage (no rebates)	Levels the playing field in the domestic market; free allocation addresses exports	Levels the playing field in the domestic market; free allocation addresses exports	Strong case under Article XX GATT for CBAM, but ASCM risk for free allocation	Diplomatically controversial as a unilateral measure with extraterritorial effects, combined with free allocation

- **Rationale:**
 - Coverage of imports is environmentally beneficial as it extends the coverage of European carbon pricing to additional products
 - Leakage can also occur through the export channel, but addressing that through the CBAM itself (e.g. with an export rebate at the border) incurs a high risk of challenge under the WTO Agreement on Subsidies and Countervailing Measures
 - Free allocation, irrespective of destination, retains the benchmark-induced incentive to improve environmental performance without the risky conditionality on export

Policy Mechanism

Options:

- It could extend the ETS to imports;
- It could extend the ETS to imports, but have imports dealing in a virtual pool of allowances;
- It could levy a border carbon tax on carbon-intensive imports; or
- It could establish an EU carbon tax for carbon-intensive goods (VAT or excise duty) that would also apply at the border.

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
No major differences from an environmental benefit perspective	Unlikely that an ETS-linked CBAM could cover exports, hence reliance on continued free allocation in the pilot phase	Much more feasible than switching from existing ETS to a tax	Under EU law, easier to elaborate than a tax. More straightforward to grant WTO-compliant treatment under a tax	No major differences from an international perspective

• Rationale:

- EU ETS is an evolved existing scheme, in 4th phase; related legislation requires only qualified majority
- Use of actual EUAs would involve adjusting the ETS cap – complex undertaking
- Virtual pool uncapped; importers feel the incentives of cap lowering through price equivalence
- Need review of experience

Geographic Scope

The only national exemptions from the coverage of the proposed CBAM are for least developed countries, small island developing states, and states with whom the EU has linked emissions trading systems.

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
Very slight risk of leakage to LDCs and SIDS; none to countries with linked ETS	Very slight risk of loss of competitiveness to LDCs and SIDS; none to countries with linked ETS	The exemptions themselves would be straightforward. Monitoring against the risk of trans-shipment would be more difficult, but would use existing institutions	Country-based exemptions are a violation of GATT Art. I. Very likely saved by either GATT Art XX or the Enabling Clause	Should not cause major controversy

- **Rationale:**

- LDCs, SIDS: defined list & existing principles of special treatment in UNFCCC and WTO
- Countries with linked ETS: no risk of leakage
- No other national exemptions:
 - Would involve unilateral determination of adequacy – controversial, counter to Paris Agreement
 - National sectoral crediting, facility-level *crediting* instead

Sectoral Scope

- Cover any sectors, sub-sectors identified at risk of leakage under ETS
- As well: Any sectors at risk of leakage due to carbon costs in input goods (Scope 3)

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
High environmental benefit from preventing leakage in downstream sectors	High competitiveness benefit from preventing low-cost competition in downstream sectors	Difficult to devise and administer a revised definition of leakage along these lines, but not more so than other aspects of the existing ETS	Would be a violation of GATT's national treatment provisions – would need saving as an environmental measure under GATT Article XX	Should not cause major controversy

- **Rationale:**
 - CBAM is designed to prevent leakage, so including ETS leakage list is obvious
 - But that list is based only on direct and Scope 2 emissions. Downstream sectors at risk because of costs embedded in input goods.
 - Discriminatory under GATT rules, but has environmental motivation – Art. XX defence
 - Needs a sector-by-sector assessment of leakage. Risk is diminished as we go downstream:
 - Lower carbon cost per unit of value added
 - Goods become more differentiated – compete on more than just price

Emissions Scope

During the pilot phase, the proposed CBAM covers direct (Scope 1) emissions and indirect (Scope 3) emissions embedded in raw material inputs that are themselves covered products.

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
Intermediate environmental benefit due to coverage of Scope 1 and some Scope 3 emissions	In combination with continued compensation of indirect carbon costs, this levels the playing field with regard to cost of Scope 1 and 2 emissions, as well as some upstream Scope 3 emissions	Relatively more complex due to additional data needs	Art. XX GATT: more complex than only Scope 1 emissions, but also greater environmental benefit	Relatively more controversial than only Scope 1 emissions due to additional burden

- **Rationale:**

- Inclusion of Scope 2 emissions would increase resource shuffling concerns and fail to address the carbon cost passed through electricity prices, which is determined in EU competitive wholesale markets by the carbon intensity of the generator on the margin
- Existing methodology to compensate for indirect carbon cost is more accurate and already well-established, but its application should be reviewed
- Scope 3 emissions related to raw material inputs (see previous slide) should be included for downstream products; transport-related emissions pending review

Determination of Embedded Emissions

- Default emissions intensity for importers: global sectoral average
- Possibility for more than one sectoral benchmark, based on production method
- Importers can challenge the default with third-party verified data

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
Achieves some leakage prevention. Effectiveness moderated by assuming high-carbon imports produced at global average	Achieves some prevention of competitiveness. Effectiveness moderated by assuming high-carbon imports produced at global average	Assuming defaults is more feasible than demanding actual data. Calculating global average emission intensity would be somewhat difficult	Allowing the default to be challenged is a positive feature from a WTO legal perspective. Assuming global average is discriminatory, but environmentally motivated	Use of global average as default might be seen as punitive

- **Rationale:**
 - Demanding actual data would be punitive – not collected in most places.
 - Global average is discriminatory if that figure is worse than EU average. Justified as better protection against leakage, esp. as EU decarbonizes and EU average drops.
 - Allowing individual challenges incentivizes clean production, respects WTO law, though it also creates risk of resource shuffling.

Calculation of the Charge

- Product of:
 - Global average intensity
 - Difference between the price of EUAs and an explicit carbon price in the exporting jurisdiction
 - Factor that reflects the amount of free allocation received by EU producers
 - Where no explicit price of carbon in exporting jurisdiction: cost of carbon based on a negotiated agreement between the EU and the country of origin

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
Crediting of foreign policy efforts strengthens the incentive for foreign p to increase their climate policy ambition	Crediting foreign policy efforts and adjusting for free allocation reduces the compliance obligation imposed on imports	Crediting foreign policy efforts, especially for implicit carbon costs, and adjusting for free allocation adds to the administrative burden	Crediting foreign policy efforts and adjusting for free allocation helps avoid discriminatory treatment, and strengthens the case under Art. XX GATT	Crediting foreign policy efforts and adjusting for free allocation less likely to elicit diplomatic pushback than not doing so

- **Rationale:**
 - Pay the whole amount at the border
 - Pay only the difference from EU free allocation

Use of Revenue

- Revenue directed to:
 - Administrative cost
 - Defraying certification costs for importers
 - Funding mitigation actions in trade partner countries affected by the CBAM;
 - Contributing to the EU budget (“Own Resources”).

Environmental Benefit	Competitiveness Benefit	Technical & Administrative Feasibility	Legal Feasibility	Political & Diplomatic Feasibility
Allocating part of the revenue to mitigation actions offers a “double dividend” of the CBAM and strengthens its environmental benefit	Covering certification costs and mitigation projects of foreign producers weakens the competitiveness benefit	Allocating revenue to multiple uses and carrying out a process to award funding for mitigation projects adds to the administrative burden	Allocating a share of revenue to minimize the transaction cost of foreign producers and promote mitigation efforts is likely to strengthen the case under Article XX GATT	Allocating a share of revenue to minimize the transaction cost of foreign producers and promote foreign mitigation efforts is likely to reduce diplomatic pushback

- **Rationale:**
 - WTO considerations
 - Political reactions of international trading partners
 - Domestic reactions

Cross-Cutting Issues: Free Allocation

- Free allocation maintained in pilot phase, but transitioning
- Free allocation & CBAM: only charge at the border for the difference from the benchmark
- “Fit for 55” should ensure that there is free allocation to the end of the pilot phase
- Review of free allocation & CBAM in 2028

Rationale:

- CBAM is untested
- Too many objectives
- Choice between free allocation and CBAM may be a false one
- No double protection
- Allows export protection and avoids carbon leakage from international markets
- Possibly susceptible to international pressure e.g. prices of VEUAs

Cross-cutting Issues: Indirect Costs

- Maintain indirect cost compensation in the pilot phase
- Possibly reform it to have a more harmonized, EU-wide approach

Rationale:

- Increasing importance of indirect costs
 - Increasing electrification
 - Structure of the EU electricity market
 - Increase in carbon prices
 - Inability to address indirect carbon costs through adjustment at the border

Cross-cutting Issues: Timeline and Sequence

- First five year after launch: opt-in pilot phase as a learning period with gradual transition from existing leakage safeguards
- **Rationale:**
 - Allows proof of concept for subsequent expansion and elaboration
 - Reduces initial impact and uncertainty for EU and foreign stakeholders, and provides more time to prepare, consult and align policy frameworks
 - Opt-in approach affords flexibility and stronger initial leakage protection with opportunity to adjust to necessary system changes
 - Periodic reviews (see next slide) and a timeline the is aligned with the Paris Agreement ambition cycle maximize synergies

Cross-cutting Issues: Review Processes

- Scheduled, periodic review processes assessing CBAM performance, need for modifications, and continued leakage threat
 - Impacts/interactions of CBAM on EUA market dynamics (e.g. hedging)
 - Scope of covered products and value chain coverage threshold
 - Scope of covered emissions (e.g. raw material inputs and transport)
 - Emissions intensity default values
 - Free allocation of emission allowances
 - Resource shuffling and avoidance strategies
- **Rationale:**
 - CBAM is highly complex, and (as with the EU ETS) the initial design will reveal flaws and ways to improve its functioning; context will continue to rapidly evolve, as will international reactions; review process improves knowledge base

Thank you

ERCST

Roundtable on
Climate Change and
Sustainable Transition