

Addressing “Crunch Issues” in the EU CBAM: A Review of the ENVI Committee Rapporteur’s Draft Report

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Overview

With the availability of the Draft Report (Report)¹ of Mohammed Chahim, European Parliament (EP) Committee on the Environment, Public Health and Food Safety (ENVI) Rapporteur on the Carbon Border Adjustment Mechanism (CBAM), the legislative process for the introduction of adjustment for carbon at the border of EU has entered a new phase. The Draft Report includes significant departures from the European Commission Proposal (EC Proposal)² put forward in July 2021 and needs to be read in the context of the EP’s Own Initiative Resolution (EP Resolution) of March 10, 2021³.

An assessment of the amendments suggested in last week’s ENVI draft report can only occur against the broader context and the challenges which the CBAM is intended to address. It is generally accepted that a new solution is needed to address carbon leakage in the EU, as asymmetrical climate policies under the Paris Agreement are very real and can impact competitiveness leading to carbon leakage.

ERCST sees three key criteria that any outcome of the CBAM legislative process will need to observe: a) the EU meets its decarbonization targets, b) the end of the process sees a decarbonized and not deindustrialized EU, c) the transition is sustainable.

The ongoing legislative process has to offer a roadmap towards upholding these criteria, and it has to do so in the near term as the various other elements of the European Green Deal (EGD)⁴ and in particular the ‘Fit for 55’ legislative package progress through interinstitutional coordination.

The time horizon for the discussion is important. In the short-term a CBAM accompanying the EU ETS is the only realistic approach. In the long-term the broader context, including the climate policy ambition of trade partners around the world may prompt a more fundamental rethinking of the EU’s approach, including the EU ETS.

Analysis of the Draft Report

This paper is based on the analysis of issues and options related to the CBAM undertaken as part of ERCST work in 2020 and 2021, especially the Sectoral Deep Dive⁵ and the Analysis of the EC proposal⁶.

Drawing on this earlier work and extensive engagement of stakeholders within and beyond the EU, ERCST has identified a number of issues that have remained controversial or defied a straightforward solution in the EC Proposal and remain ‘crunch issues’ in the light of the amendments proposed in last week’s draft ENVI Committee report.

¹ <https://twitter.com/MChahim/status/1478664374936080392>

² <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0564>

³ https://www.europarl.europa.eu/doceo/document/TA-9-2021-0071_EN.pdf

⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1576150542719&uri=COM%3A2019%3A640%3AFIN>

⁵ https://ercst.org/wp-content/uploads/2021/03/20210317-CBAM-II_Report-I-Sectors.pdf

⁶ <https://ercst.org/ercst-guide-to-the-eu-cbam/>

1. Scope of Covered Products

Compared to the earlier EC Proposal, the product coverage would be enlarged by the amendments suggested in the Draft Report to include organic chemicals, hydrogen, and polymers, even if the complexity of adding these sectors is acknowledged. This is an ambitious proposal, and a better solution may be to consider such an extension as part of the proposed review.

In terms of scope, two elements need to be mentioned: sectoral coverage and value chain coverage.

In the analysis of ERCST, due to the particularities of the sectors proposed for inclusion, the instrument as currently put forward in the EC proposal and in the Draft Report is unlikely to provide the requisite protection against leakage for these sectors as the cost of carbon increases, which may in turn necessitate other forms of protection. The review mandated for 2026 offers an important opportunity to assess and propose ways to overcome the existing technical and administrative challenges to their inclusion in the CBAM, before making the decision to include them.

No changes are proposed in terms of value chain coverage, but it can be expected that an extension could be considered and expected as part of this legislative process. The limited proposed coverage both sectorally and down the value chain results in an instrument that is technically and administratively relatively feasible.

2. Emissions Scope and Circumvention

Emissions scope represents an important change from the EC Proposal. The Report departs from the EC Proposal by including Scope 2 emissions from electricity, but not heat and steam, in the CBAM. This is consistent with the EP Resolution issued on March 10, 2021.

While there are provisions on carbon intensity, the calculation of indirect emissions is to occur based on a delegated act, which retains more say for the EP. The provisions in the Draft Report, to use the carbon intensity of the “marginal or other price-setting generator”, would seem to better recognize operational reality.

However, the main concern about inclusion of Scope 2 emissions relates to circumvention, and there is no additional consideration given to this quite real concern. While its relevance for the CBAM may be limited given the much narrower scope, the only border carbon adjustment (BCA) that has been implemented to date – the Californian BCA – has faced serious scrutiny due to a suspected high level of circumvention through resource shuffling. The EP Draft Report recommend no meaningful changes to the EC Proposal in this respect, yet greatly expands the possibilities of circumvention by proposing the inclusion of Scope 2 emissions.

3. Free Allocation and Treatment of Exports

Treatment of exports and free allocation of allowances in the EU ETS are issues which are interrelated. The current EC Proposal allows for a gradually declining share of free allocation to provide a temporary safeguard against leakage related to EU exports into third countries. The difficult debate on this issue was already present in the last minute flip-flop that took place during the European Parliament’s Own Initiative process on CBAM.

In the Draft Report there has been no departure from the EC Proposal, and therefore there is no provision for exports. One exception is the clarity with which the Draft Proposal states that the CBAM is an alternative to free allocation. A second departure is the mandated report on the impact on exports due by December 2026.

Considering that the proposed timeline for the CBAM contained in the Draft Report envisions a start in 2025 rather than 2026, there would be a significant gap before that review occurs and is then considered, with potentially significant implications for EU exports that may be challenging to reverse.

In its analysis, without a specific proposal to address exports on the table, ERCST viewed the ten-year sliding scale as a potential solution – but one that itself requires further consideration considering the international climate policy framework, including the Global Stock takes under the Paris Agreement scheduled for 2023 and 2028.

4. Timeline

The timeline for the implementation of the CBAM would change considerably if the amendments proposed in the Draft Report are adopted, with the transitional period shortened to 2023-2024 and free allocation being phased out much more rapidly from 2025-2028. For cement, free allocation would already expire in 2025.

These are quite radical measures that may satisfy the environmental community, but carry a considerable risk of harming EU industry and inciting considerable political pushback from the various constituencies that would be negatively affected. Such pushback, in turn, could erode political support for the EGD, resulting in an outcome that is detrimental for both the EU economy and the global climate.

ERCST continues to maintain that, in the absence of a solution for export-related leakage and greater experience with the practical operation of the CBAM, the timeline outlined in the EC Proposal as well as in previous papers that ERCST has published in 2020 and 2021 offers a more balanced approach and allows for considerable mitigation of carbon leakage risks that result from a loss of competitiveness of EU producers.

5. Policy Crediting

Crediting of foreign climate policies does not see any significant changes proposed in the Draft Report, except for the fact that it more explicitly rules out crediting non-explicit carbon costs. Accounting for non-explicit carbon costs is complex, but it would seem unwise at this point to explicitly exclude it for two reasons.

First, if the EU is truly committed to multilateralism, including the rules-based regime of the WTO, it would seem appropriate to show the same level of commitment to the Paris Agreement. Excluding consideration of all climate policies other than explicit carbon pricing would seem difficult to see how it would align with the Paris Agreement and its fundamental premise of nationally determined climate action.

Secondly, and on the practical side, there are major trading partners who will be unwilling or unable for many reasons to have an explicit carbon price. If the EU is sincere about its desire to avoid a confrontational CBAM, the language in the Proposal would see to offer a better alternative.

6. Governance

CBAM governance would also see important changes under the proposed amendments in the Draft Report, with a CBAM authority being proposed instead of 27 national authorities. ERCST has generally favoured EU-wide solutions where they are implementable, as it helps eliminate distortions in relations with non-EU countries.

7. Revenue

Revenue use is more precisely outlined in the Draft Report than in the EC Proposal, and has two elements.

A first proposed amendment recommends that 50% of EUAs auctioned as a result of eliminating free allocation should go to the Innovation Fund, with the balance accruing to the EU budget. ERCST would find it more justifiable that all CBAM revenue be spent on addressing climate change, and would urge that the balance be devoted to Just Transition.

The second proposed amendment envisions that support, in an amount equivalent to the revenue generated by the CBAM, should go to Least Developed Countries (LDCs), marking a departure from the normal practice under the UNFCCC, which usually lumps together LDCs and Small Islands Developing Countries (SIDS).

Conclusions

The Draft Report, coming from the lead rapporteur in the EP Committee leading the CBAM file, takes a more aggressive stance and places greater focus on achieving the EU target on climate change, but seems less concerned about impacts on competitiveness of EU industry and the resulting risk of emissions leakage to third countries. Ironically, achievement of the EU mitigation targets could thus come at the expense of increased global emissions.

Given the previous pronouncements of the EU Parliament, including the EP Resolution in its “Own Initiative” process, this is not entirely unexpected, and is likely to lead to a hard debate in the full ENVI Committee as well as in the plenary vote.

The elements outlined in this short paper can be expected to prove the most challenging “crunch issues” politically in the upcoming legislative battle.