THE EU'S CARBON BORDER ADJUSTMENT MECHANISM

— CBAM DRAWS STRONG OPPOSITIONS, BUT IT ALSO PUSHES SOME NON-EU COUNTRIES TO TAKE MORE CLIMATE ACTION —

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SUMMARY

- On July 14, 2021, the EU announced its legislative proposal for the Carbon Border Adjustment Mechanism (CBAM). The CBAM is a measure to reduce the risk of carbon leakage by charging a carbon price on imports from countries with less strict climate change policies than those of the EU, ensuring a level playing field.

- There are oppositions from both the EU and non-EU countries against the CBAM, causing concerns over a risk of trade friction. The CBAM, however, has also pushed some countries such as Turkey amongst others, to strengthen their climate change policies. The EU and the US have also agreed to negotiate to establish a trade framework to curb imports of carbon intensive steel and aluminium products.

- Following the European Commission's CBAM proposal, the European Parliament and the Council of the European Union are now reviewing the proposal and will present their amendments in consideration of discussions with trading partners and the CBAM's consistency with the WTO rules.

1. INTRODUCTION

On July 14, 2021, the EU announced its legislative proposal for the Carbon Border Adjustment Mechanism (CBAM) as a part of its comprehensive climate change policy package, "Fit for 55". The CBAM levies a carbon price on imports from countries with climate change policies that are less stringent than those of the EU. The aim of this report is to present an overview of the CBAM, as well as to take a look at reactions from both the EU and non-EU counties and developments towards the strengthening of climate change measures by the EU's trading partners. It also touches on the obstacles to the introduction of the CBAM and the potential revisions.

2. OVERVIEW OF THE CARBON BORDER ADJUSTMENT MECHANISM

In December 2019, the European Commission President Ursula von der Leyen announced the commission's intention to introduce a Carbon Border Adjustment Mechanism (CBAM) as a one of the core policies of the European Green Deal, which aims to make the EU climate neutral by 2050. The objective of the CBAM is two-fold: first to prevent the risk of carbon leakage (less-stringent emission regulations in non-EU countries weakens EU businesses' competitiveness, forcing them to transfer their production to other countries with less emission restrictions. This undermines efforts to reduce global emissions)[1]. Second objective is to promote the strengthening of climate change policies in non-EU countries.

2-1. Addressing carbon leakage risk: a shift from allocation of free EU-ETS emission allowances to the CBAM

The EU introduced its emissions trading system (EU-ETS) in 2005. The EU-ETS is enforced in the EEA (European Economic Area), which consists of the 27 member states of the EU, plus Norway, Iceland, and Liechtenstein. It is applied to approximately 10,000 electricity and industrial facilities as well as flights operating within the EEA. The greenhouse gas (GHG) emissions of these facilities and flights account for approximately 40% of the EU's total emissions. The EU-ETS is a cap-and-trade system which sets an upper limit on greenhouse gasses emitted by the installations covered. The cap is reduced gradually to reduce the EU's total emissions.

To reduce the risk of carbon leakage, the EU has been allocating EU-ETS emission allowances free of charge to carbon-intensive and export-oriented sectors considered to be at high risk of carbon leakage[2]. To reduce GHG emissions by 55% (compared to 1990 levels) by 2030 and achieve its goals of climate neutrality by 2050, however, it will be essential for the EU to accelerate emission reductions in the EU-ETS sectors, including phasing out the free allowances. To that end, the EU has decided to gradually end the free allocation of allowances in the EU-ETS. Meanwhile, the EU has also decided to introduce the CBAM as a new measure to reduce carbon leakage risk to ensure a level playing field by imposing an emissions cost on imports from non-EU countries as they were produced in the EU.

2-2. CBAM as an incentive for non-EU countries to strengthen their climate change measures

Introduction of the CBAM can work as an incentive for the non-EU countries to strengthen measures to address climate change. While the EU-ETS is an effective tool to reduce emissions in industries within the EU, it has not led to stricter climate policies in non-EU countries. Under the CBAM, a charge will be levied on imports in accordance with the direct emissions generated during the production process. If the country where the goods was produced has a carbon pricing system, the charge payable to the EU will be reduced by the amount paid in the country of origin. In other words, the mechanism provides incentive both to introduce emission reduction technology in production processes and to introduce carbon pricing systems in non-EU countries. Speaking at COP26 in the UK on November 2, 2021, European Commission President Ursula von der Leyen reiterated the EU's intention to introduce the CBAM. She said, "We will, to avoid carbon leakage, now introduce, slowly but surely a carbon border adjustment mechanism", adding that the EU would prefer that producing countries introduce carbon pricing systems and keep the money in their economies rather than paying it to the EU[3].

2-3. Schedule and scope of the CBAM

Under the current proposal, the CBAM will initially apply to steel, cement, fertilizer, aluminium, and electricity, and will become effective from 2023 (Figure 1). The first three years up to the end of 2025 will be a transition period during which no charge will be levied, and the only requirement will be to report embedded emissions.

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[1] In a speech given at a European Economic and Social Committee's public hearing on September 16, 2021, WTO Deputy Director General Jean-Marie Paugam stated "So far, the available analyses have not definitively established that carbon leakage has occurred to any significant extent, but these findings derive from a context of low carbon prices. The fear is that if the leading economies diverge significantly in their climate ambitions, leakage could occur as a result". Jean-Marie Paugam (Deputy Director-General of WTO), "WTO rules no barrier to ambitious environmental policies", September 16, 2021,
https://www.wto.org/english/news_e/news21_e/ddgjp_16sep21_e.htm
In fact, the EU-ETS carbon price doubled from 30 euros per tonne of CO_2 at the beginning of 2021 to more than 60 euros per tonne in September 2021, raising concerns over carbon leakage risks in the EU.

[2] Sectors that have been recognized as being at high risk of carbon leakage risks based on an evaluation of risk factors such as the direct and indirect cost burden of the EU-ETS and export dependency. Those sectors include steel and aluminum manufacturing, fertilizers, cement, paper products, refined petroleum products, and chemicals.

[3] Paola Tamma, "EU pushes carbon border tax at climate talks in Glasgow", Politico, November 2, 2021,
https://pro.politico.eu/news/eu-pushes-carbon-border-tax-at-climate-talks-in-glasgow

The CBAM will become fully operational in 2026, and the mechanism will be phased in gradually. As mentioned above, the CBAM is an alternative to the free allowances in the EU-ETS as a means of reducing carbon leakage. Under the proposed revisions of the EU-ETS, which was announced at the same time as the CBAM, the free allocation of allowances in the sectors covered by the CBAM, such as steel, will be reduced by 10% annually over the ten years starting from 2026. The CBAM will be phased in in conjunction with this, and the carbon leakage reduction measures will be completely replaced by the CBAM in 2035.

Figure 1: Overview of the CBAM

Purpose	● Prevention of carbon leakage caused by differences in climate change policies between the EU and non-EU countries ● Strengthening of climate change measures in non-EU countries
Schedule	● There will be a transition period from 2023 to 2025 during which importers will only be required to report embedded emissions, etc. The mechanism will become fully operational from 2026.
Target countries	● Non-EU countries (excluding Switzerland, Norway, Iceland, and Liechtenstein)
Goods covered	● Imported goods classified under steel, cement, fertilizer, aluminum, and electricity
Levy	● Applied to direct emissions of greenhouse gases emitted during the production process of the products covered. It mirrors the EU-ETS price.
Payment	● Importers of goods covered by the CBAM purchase a CBAM certificate. The price is linked to the EU-ETS price. Importers declare the embedded emissions of imports by May each year and surrender the certificates corresponding to the emissions declared.
Exemption/ deduction conditions	● EU-ETS participants (Norway, Iceland, and Liechtenstein) or countries with an equivalent system that are linked to the EU-ETS (Switzerland) are exempt. ● If a non-EU producer can show that it has already paid a price for the carbon used in the production of the imported goods in a third country, the corresponding cost can be fully deducted for the EU importer.
Review	● Following the transition period (2023-25), the CBAM will be reviewed based on the operational needs and the data collected during the transition period. Expansion of the scope of CBAM to other goods and indirect emission will be considered. ● As for the candidates for the goods covered, priority will be given to the EU-ETS sectors with high carbon leakage. Chemicals, which were considered as potential targets during the initial review stage of the CBAM, may be included following the review.

Source: Compiled by MGSSI from materials of the Delegation of the European Union to Japan, European Commission

Following the transition period, a review will be conducted on the expansion of the covered goods under the CBAM and whether to include indirect emissions. As for the expansion of covered goods, priority will be given to the sectors covered by the EU-ETS which are deemed to be at high risk of carbon leakage. Chemicals and some other sectors, which were amongst the goods considered to be included during the initial stage of developing CBAM, are the likely candidate. During the transition period starting from 2023, it is required to report indirect emissions as well as direct emissions in order to gather data as reference point to impose a charge on indirect emissions.

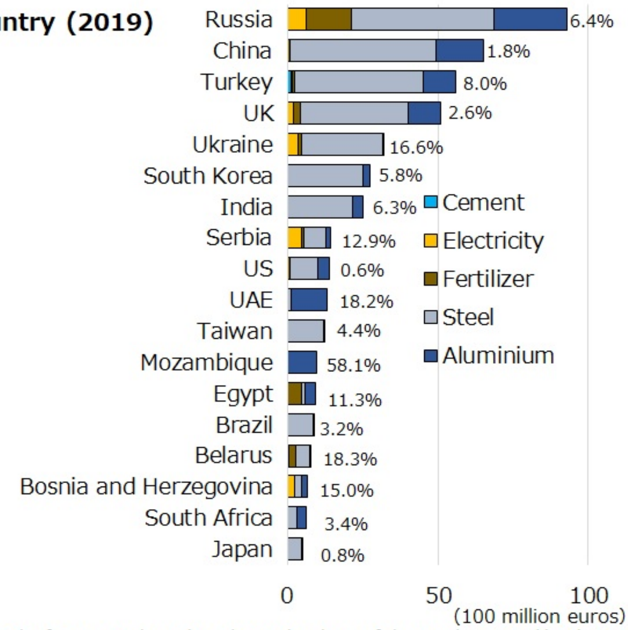
3. REACTION TO THE CBAM FROM WITHIN AND OUTSIDE OF THE EU

3-1. Criticism from within and outside of the EU

Countries such as Russia, China, and India that export significant amount of goods covered by the CBAM to the EU (Figure 2) criticize the mechanism as protectionism disguised as climate action. They also threaten to take the EU to WTO claiming that the CBAM breaches WTO rules. Industrial bodies in Germany, which has a large export industry, are concerned over the potential retaliatory actions by those countries.

There is criticism that application of the CBAM to developing countries, and particularly the least developed countries (LDCs), would be unfair[4]. Under the current proposal, there is no exemption for LDCs, and no provision for using revenue from the CBAM to support decarbonisation in the LDCs. Discussions on the CBAM in the European Parliament's Committee on International Trade have started from November 9, 2021, where many European parliamentarians raised concerns over the risk of trade friction as well as the adverse effect on LDCs.

Figure 2: Imports subject to the EU's CBAM by country (2019)



Note: The figures on the right indicate the share of the goods covered by the CBAM in the total import of each country.
Source: Compiled by MGSSI based on data from Eurostat

3-2. Moves towards strengthening climate measures in non-EU countries

While the CBAM has attracted a good deal of opposition, some countries have begun strengthening their climate change measures in a bid to avoid or mitigate CBAM's impact. In October 2021, Turkey announced that it would aim to be climate neutral by 2053 and plans to introduce an emissions trading system as well. According to the European Roundtable on Climate Change and Sustainable Transition (ERCST), the cost levied on Turkey under the current CBAM proposal is estimated to be about 400 million euros[5] (approximately 51.9 billion yen). About 40% of Turkey's exports are destined for the EU. Should the scope of the CBAM be expanded, the impact will be even greater. According to Turkish government sources, Turkey's emissions trading system will resemble the EU-ETS[6], which could allow the country to be excluded from the CBAM. Russia, too, is planning to introduce an emissions trading system in Sakhalin[7].

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[4] Daniel Gay, "Smooth transition for graduating LDCs under the EU Carbon Border Adjustment Mechanism", United Nations, May 4, 2021, https://www.un.org/ldcportal/smooth-transition-for-graduating-ldcs-under-the-eu-carbon-border-adjustment-mechanism/

[5] A study conducted by the European Roundtable on Climate Change and Sustainable Transition (ERCST) commissioned by the European Bank for Reconstruction and Development (EBRD). The estimate is based on Turkey's average exports to the EU of electricity, cement, steel, and aluminum from 2017 to 2019, calculating direct emissions at a carbon price of 70 euros/CO_2 tonne. "Implications of EU Carbon Border Adjustment Mechanism for Turkey", Roundtable on Climate Change and Sustainable Transition, July 28, 2021, http://bestanden.turkishcarbonmarket.com/20210728_Turkey_CBAM%20final%20results_v1.pdf

[6] Addressing the media at COP26, the Turkish representative said that the introduction of the CBAM by the EU was one of the factors that led Turkey to strengthen its policy on climate change. Zia Weise, "EU's looming carbon tax nudged Turkey toward Paris climate accord, envoy says", Politico, November 6, 2021, https://www.politico.eu/article/eu-carbon-border-adjustment-mechanism-turkey-paris-accord-climate-change/

[7] Georgy Safonov, "Climate Darling or Potemkin Village? Russia's Carbon-Neutral Experiment in Sakhalin", Center for Strategic & International Studies, September 20, 2021, https://www.csis.org/analysis/climate-darling-or-potemkin-village-russias-carbon-neutral-experiment-sakhalin

3-3. Coordination with the US

There is also a development towards cooperation between the EU and the US on a framework for promoting decarbonisation. On October 31, 2021, US President Joe Biden and European Commission President Ursula von der Leyen agreed to start discussions on establishing a Global Arrangement on Sustainable Steel and Aluminium to address the carbon intensity and the issue of global excess capacity[8] of those sectors.

In a joint statement, the two parties agreed to use trade policy to confront the threats of climate change and global market distortions. Countries who participate in the arrangement will make efforts to decarbonise their steel and aluminium industries and will limit market access for imports from non-participating countries that do not meet low carbon standards (Figure 3).

Figure 3: Excerpts from the Joint EU-US Statement on a Global Arrangement on Sustainable Steel and Aluminium

- Each participant in the arrangements would undertake the following actions:
  1. restrict market access for non-participants that do not meet conditions of market orientation and that contribute to non-market excess capacity, through application of appropriate measures including trade defence instruments;
  2. restrict market access for non-participants that do not meet standards for low-carbon intensity;
  3. ensure that domestic policies support the objectives of the arrangements and support lowering carbon intensity across all modes of production;
  4. refrain from non-market practices that contribute to carbon-intensive, non-market oriented capacity;
  5. screen inward investments from non-market-oriented actors in accordance with their respective domestic legal frameworks.
- To enhance their cooperation and facilitate negotiations on a global sustainable steel and aluminium arrangements, the EU and the United States agree to form a technical working group. Through the working group, the EU and the United States will, among other things, confer on methodologies for calculating steel and aluminium carbon-intensity and share relevant data.

Source: Compiled by MGSSI from materials of the European Commission

At the joint press conference, President Biden said that the arrangement would "restrict access to our markets for dirty steel from countries like China", making it clear that the US aims to curb the influx of carbon intensive Chinese products. Press releases from the US government have also made it abundantly clear that the purpose of the arrangement is to confront Chinese overcapacity. Nevertheless, the objective of the arrangement and the CBAM has the same principle, encouraging other countries to reduce emissions by limiting carbon intensive imports. The fact that the EU has brought the US into establishing such a framework could be counted as one of the successful outcomes of the CBAM.

While the details of the arrangement will be negotiated over the next two years, the focus will be on how to curb the influx of carbon intensive products from non-participating countries. It also needs to be consistent with WTO rules. The EU argues that the CBAM is WTO compatible as it applies EU-ETS price on imports therefore the cost incurred on imports is equivalent to the cost on products produced within the EU. With this, the EU says, the CBAM does not constitute discrimination against imported goods and does not violate WTO rules. The ideal approach for the EU-US agreement would be to establish a framework like the one so-called climate club[9]. In climate club, participating countries establish common standards and rules, such as carbon pricing system, to promote decarbonisation within the framework while applying a carbon border adjustment measure to imports from non-participating countries. The US, however, has no federal level carbon pricing system, such as

For further analysis on Russia's climate change policies, see MGSSI report "Russia's climate change measures entering a transitional period – Analysis in terms of increase and decrease –" (November 11, 2021, Daisuke Kitade)
https://www.mitsui.com/mgssi/en/report/detail/__icsFiles/afieldfile/2021/12/08/2111e_kitade_e.pdf

[8] On October 31, 2021, the US agreed it will no longer apply the Section 232 tariffs - which were imposed under the former Trump administration - on a certain amount of EU exports to the US of steel and aluminium under "tariff-rate quotas". . The EU agreed to halt the retaliatory tariffs on part of imports from the US. The arrangement on steel and aluminum not only pledges to address GHG emissions, but also to address the issue of excess capacity, with China in mind. "Steel & Aluminium: EU-US Joint Statement", European Commission, October 31, 2021, https://trade.ec.europa.eu/doclib/docs/2021/october/tradoc_159890.pdf

[9] The climate club was proposed by Professor William Nordhaus of Yale University. Olaf Scholz, then the finance minister under Angela Merkel administration and now the new German chancellor, tabled a proposal to establish a climate club to the cabinet in August 2021 . He called G20 nations, including China and India, as well as the US and other G7 nations to discuss measures to reduce carbon leakage, including introduction of carbon border adjustment mechanism, unification of CO_2 measurements and the establishment of a minimum carbon price. "Joint key-issues paper presented to the federal cabinet", August 25, 2021.
https://www.bundesfinanzministerium.de/Content/EN/Pressemitteilungen/2021/20210825-german-government-wants-to-establish-an-international-climate-club.html

emissions trading or a carbon tax, and it is politically difficult to introduce such a system out of fear that the cost will be passed onto consumers. As the framework of the EU-US arrangement may affect the detailed design of the EU's CBAM, the negotiations on the arrangement will be one of the focal points ahead.

4. TOWARDS LEGISLATION OF THE CBAM: POTENTIAL REVISIONS AND OBSTACLES

For the legislation of the CBAM, the European Parliament and the Council of the European Union need to reach an agreement, and discussions have already begun. While it normally takes about two years from submission of a bill to its passage, the CBAM has only a year and a half from its submission in July 2021 to its proposed adoption in 2023. Within this tight schedule, the proposal needs to be amended, taking opinions of trading partners, consistency with WTO rules, and the different views of member states (as mentioned above, German industries have expressed strong concern over the potential for trade friction) into consideration and secure an agreement from the parliament and the council. For example, countries which have introduced or are planning to implement carbon pricing system - China launched a national emissions trading system in July 2021 and Turkey and Russia are planning to introduce similar measures - are likely to seek exemptions or relaxation of the conditions for deductions of CBAM charges. The EU may also offer concessions to the LDCs, such as exemptions and/or funds to support LDCs' decarbonisation. In addition to these, other adjustments may be considered, such as an extension of the transition period or the more gradual implementation of the CBAM. Since relaxation of the eligibility requirements for exemption/reduction of CBAM charges or extension of the transitional period would risk diluting the effect of the CBAM, delicately balanced discussions/negotiations will be required within a tight schedule. There is even a view that the approval of the European Parliament may not be attained until just before the end of the current parliamentary session in May 2024[10].

[10] Manon Dufour, "Fit for 55% package: Briefing ahead of the July 14 release", E3G, July 6, 2021, https://www.e3g.org/wp-content/uploads/E3G_Press-Briefing_Fit_for_55-July-2021.pdf