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The Carbon Border Adjustment Mechanism

Teneo has reviewed a leaked version of the European Commission's draft proposal on the Carbon Border Adjustment Mechanism (CBAM). Please note that this draft proposal could change as it is still being discussed within the Commission's inter-services.

The CBAM

The European Commission is expected to present its CBAM proposal on 14 July as part of a comprehensive overhaul of EU climate and energy legislation, which aims to put the region on track to meet its enhanced 2030 greenhouse gasses (GHG) emissions-reduction goal of -55% below 1990 levels.

The CBAM aims to price GHG emissions embodied in imports of a handful of carbon-intensive and heavily traded goods to ensure a level playing field with domestic production which is subject to a carbon price. The purpose is to prevent the risk of production and investment relocation outside of the EU to jurisdictions with no or lower carbon pricing and hence no reduction in global emissions, known as carbon leakage. The EU also hopes that this mechanism will act as an incentive for trading partners to step up climate action and introduce their own carbon pricing mechanisms.

Details of the draft proposal

The draft proposal confirms that for the goods concerned, the CBAM would be an alternative to measures currently in place to prevent the risk of carbon leakage under the EU Emissions Trading System (ETS), namely the free allocation of emission permits and the possibility of financial compensation for indirect emissions in electro-intensive sectors. For goods subject to free allocation in the EU, the CBAM price to be paid upon imports of such goods would be reduced by a corresponding amount. The CBAM would initially apply to a selected number of carbon and trade intensive goods including cement, iron and steel, aluminium, fertilizers and electricity. The proposal foresees that other goods could be added to this initial list further down the road.

Under the proposed mechanism, certified importers of selected goods will have to buy electronic emission certificates, so-called CBAM certificates, the price of which is linked to the price of carbon permits under the EU ETS. Each certificate will correspond to one metric ton of embedded CO2 in the imported goods and the price will be calculated on the average weekly price of one ton of emissions under the EU ETS.

The CBAM will apply to goods imported from countries and territories outside of the EU, except countries that already have an EU-aligned carbon pricing system in place, such as Iceland, Liechtenstein, Norway and Switzerland. Where goods are already subject to a carbon price in their country of origin, they will qualify for a rebate corresponding to the carbon price already paid.

Emissions embedded in goods will be calculated based on information to be provided by the importer related to the production of concerned goods and verified by an accredited third party. Where this is not possible, they can be based on default values calculated on the basis of emissions of the 10 per cent worst-performing sites in the EU producing such good.

Each year by May, certified importers will have to provide a CBAM declaration including the emissions embedded in imported goods during the previous calendar year, and surrender a corresponding number of CBAM certificates. Failure to do so will result in a penalty amounting to three times the average price of CBAM certificates in the previous year for each certificate that they failed to surrender.

To “reduce the risk of disruptive impacts on trade flows and alleviate the initial administrative burden for importers”, the Commission envisages a simplified system for a transitional period of up to three years during which embedded emissions will be based on default values (rather than information to be provided by the importers) and the CBAM price will be paid upon import (rather than annually).

Revenues generated by the CBAM will serve to finance the functioning of the system and any surplus will be assigned to the Union budget.

Next steps

Following its official publication on 14 July, the CBAM will have to undergo a complex approval process in two parts.

The Draft Regulation will have to be, first of all, approved through the ordinary legislative procedure (i.e. co-decision between the European Parliament and Council of the EU). For the moment it’s unclear if unanimity will be needed in the Council. The leaked text refers to the ordinary legislative procedure (with qualified majority voting in the Council rather than unanimity) but sets out a derogation to the use of qualified majority voting including for “provisions primarily of a fiscal nature”. Our analysis is that it is very likely that the Council will insist on considering the CBAM as a fiscal measure and thus on the use of unanimity but we will have to see what will be included in the final text from the Commission.

The Commission will also introduce a separate proposal for the part of the CBAM that will feed into the EU’s budget and create new EU “own resources”. This proposal will have to undergo a similar ratification process as the current Next Generation EU instrument (i.e. unanimity in the Council and ratification by member states’ national parliaments). We expect that the Commission will make a proposal that will cover both the CBAM and the Digital tax. If adopted, the levy is expected to enter into force in 2023.

The proposal is closely in line with what was expected based on the Commission’s announcements and intelligence gathered to date. With no surprises on content, the main point is that the EU seems determined to go ahead and introduce such a measure as soon as 2023. However, the CBAM will still have to overcome many obstacles before seeing the light of day.

In addition to the technical and administrative difficulties linked with the need to quantify embodied carbon emissions, the CBAM implementation may also be controversial at the international level. It may trigger retaliation from trading partners such as China and Russia, similar to when the EU included international aviation under the EU ETS but eventually limited the scope to intra-Europan flights. The mechanism is also facing some resistance within the EU, with large exporting countries like Germany expressing concerns over possible trade retaliation.