

10 Key Principles for a Carbon Border Adjustment Measure (CBAM)



Carbon Market Watch Position paper · update October 2020

With more information on the design options that the European Commission is considering for a Carbon Border Adjustment Measure (CBAM) and slightly more clarity on the different options available, Carbon Market Watch has updated its position and refined the key principles originally presented in the [briefing](#) “Carbon Border Adjustments: Climate Protection or Climate Protectionism?” published in March 2020.

1) All forms of free allocation under the EU Emissions Trading System (EU ETS) are phased out completely and rapidly

Maintaining free allocation, at any level, while introducing CBAM would mean protecting industries twice against a risk which has never materialised, and which is unlikely to materialise in the foreseeable future. It would discriminate against foreign imports while continuing to hand out massive subsidies to large European polluters.

In order to incentivise climate action globally and emission reductions within the EU, a CBAM should be implemented only as an alternative to current carbon leakage protection measures, including the free allocation of allowances and state aid for indirect cost compensation.

Several benefits would stem from this:

- This would ensure that EU industry is finally paying for its carbon pollution and that the “polluter-pays” principle as enshrined in the European treaty is fully applied.
- More auctioning revenues would be generated through the EU ETS. Under the last agreed EU ETS revision instead, governments will hand out up to 6.5 billion free emission allowances with a market value of about €165 billion between 2021 and 2030.
- A higher cost for pollution would create a greater incentive for industry to switch to cleaner production processes and contribute to meeting Europe’s climate goals.

Moreover, introducing a CBAM while keeping free allocation and state aid for indirect cost compensation would likely not be compatible with the WTO rules as both provisions are considered subsidies.

2) The CBAM is based on carbon performance benchmarks

Ideally, the carbon intensity of each product would be measured and accounted for as it enters the European market and would be priced for its verified emissions.

If this is not feasible, then each product should be priced according to a performance benchmark reflecting the carbon intensity of the average EU producer of that good.

This approach would ensure that importers are charged with a price that is as close as possible to what an equivalent European installation is subject to. However, to ensure that values reflect reality as much as possible, an approach that differentiates production routes by carbon intensity should be implemented.

3) The CBAM should cover the highest emitting sectors

The CBAM should not focus on ETS sectors at the highest risk of carbon leakage. As a climate policy tool, CBAM should aim to deliver the greatest emissions reductions.

Initially, steel, cement and bulk chemicals (for example polyethylene and fertilisers) should be covered by a CBAM, as these three sectors account for almost 60% of industrial emissions under the EU ETS. Furthermore, the power sector -a sector generally not considered at risk of carbon leakage- should be included in specific cases where high carbon imports of electricity from neighbouring countries occur.

4) The CBAM should cover direct and indirect emissions

The CBAM should cover not only direct emissions but also include indirect emissions that occurred in the production of the electricity used to produce the product.

This would result in a larger environmental benefit as it would provide importers with an incentive to adopt cleaner production processes and the development of renewable energy in the foreign country. Moreover, it would better reflect the carbon cost borne by the European industry where the power sector is covered under the EU ETS and subject to full auctioning.

Like for direct emissions, indirect emissions should also be calculated in the country of origin and should reflect the real emissions generated by the electricity used in the production process.

However, if this option is deemed unfeasible, then a country of origin-specific emissions factor (for example the average carbon intensity of the electricity mix of the country) should be applied.

5) The most suitable design for a CBAM is “an extension of the EU Emissions Trading System to imports, which would require the purchasing of emission allowances under the EU Emissions Trading System by either foreign producers or importers”

Setting up a border tariff would be the most straightforward route to implement a CBAM. However, it is also the most sensitive implementation strategy when it comes to the political reality of European and international negotiations. For example, EU decision-making requires unanimity for taxation matters.

The EU should implement a CBAM by requiring companies wishing to import products into the EU to purchase EU ETS allowances (EUAs). The EUAs would be cancelled immediately when a product enters the EU single market (as opposed to on an annual basis). The total cap of EUAs set should not be modified to account for this, given the relatively small amount¹ of embedded

¹ Embodied CO₂ emissions from steel and cement imported to the EU in 2016 were around 70Mt and 1Mt respectively . For electricity imports, the value was at 26Mt in 2019. Data on embedded emissions in chemical imports is not available but we conservatively estimate it to be less than 50 Mt (based on the fact that emissions from chemical productions in the EU are around 115Mt, and EU sales are about 5 times higher than the value of imported chemicals). Together, these would amount to 147 Mt, or around 8% of total annual emissions under the EU ETS in 2018.

emissions in imports of steel, cement, chemicals and power, and given that the EU ETS is currently significantly oversupplied.

In order to promote transparency, EUAs surrendered under the CBAM should be uniquely identifiable and traceable in a publicly accessible registry.

Extending the EU ETS to cover imports while maintaining the cap would increase demand for EUAs and therefore strengthen the carbon price signal, which is essential to trigger emission reductions.

Moreover, this option would ensure that foreign installations are treated in exactly the same way as EU producers, being subjected to the same price and rules of the (reformed) phase 4 of the EU ETS.

In order to avoid a negative impact on price dynamics and volatility in the EU ETS, a provision should be included whereby the Market Stability Reserve takes into account the allowances surrendered by importers.

Separate pool of allowances?

One of the options discussed by the European Commission is to design the CBAM as an “obligation to purchase allowances from a specific pool outside the ETS dedicated to imports, which would mirror the ETS price”.

Despite being the option that would fully shield the EU ETS from potentially negative impacts on price dynamics, this option is not preferable for a number of reasons.

Firstly, the obligation to purchase allowances from a separate pool would not expose importers to exactly the same conditions to which EU industry is subject, which in turn would undermine its effectiveness in ensuring a level playing field.

Moreover, setting up a separate pool that mirrors exactly the price fluctuation in the EU ETS seems unrealistic or at least complex to achieve. If a separate market is created that functions like the EU ETS, it will be very difficult if not impossible to ensure the same carbon price signal without having the option of trading allowances, as well as all performing other market operations.

6) The CBAM should allow importers to demonstrate their product is less carbon-intensive

To ensure that a CBAM still provides an incentive to decarbonise, non-EU producers should be allowed to demonstrate that their product is less carbon-intensive than the carbon performance benchmark.

The verification should be conducted by an independent third party and would result in a lower compliance cost under the EU CBAM system.

7) The CBAM should allow for country-based exemptions

While implementing a CBAM, the EU should recognise other countries' need to develop, as well as the relative impacts of carbon prices, which can be much higher for low-income countries.

For this reason, Least Developed Countries (LDCs) and Small Island Developing States (SIDS) should be exempted from any CBAM.

Moreover, if a partner country has a similar climate policy regulating the sectors and products subject to CBAM, then they should be exempted from the carbon cost.

8) The revenues from CBAM should be recycled towards climate action

The revenues collected from a CBAM should be earmarked in full to fund further climate action, both within and outside the EU. Part of the revenues could be distributed to developing countries in the form of climate finance contributions. The rest could be directed to EU funds

such as Innovation Fund and Modernisation Fund to support climate-neutral breakthrough technologies and innovative industrial processes and further develop renewable energy capacity in the EU.

9) There should be no rebates on exports

Rebates for exports would lower the carbon price effectively faced by European industries and risk to create perverse incentives. Moreover, export rebates would not be coherent with higher EU climate ambition and the drive to encourage higher climate ambition globally. Carbon should be priced regardless of the market on which a product is sold.

However, should rebates be adopted, the following conditions should be met:

1. Dirty and cleaner exports should not face the same final level of carbon costs and must therefore receive the same level of rebates. This way, more polluting goods will face a higher cost because the carbon cost is based on the actual carbon content of products, while the rebate is based on the carbon efficiency of the cleanest producers. By using product-based benchmarks set on the basis of the most-efficient producers (as is done for free allocation under the EU ETS) exports that are less carbon-intensive than the benchmark would be net-beneficiaries of the rebates, while exports that are dirtier than the benchmark would not receive a rebate for their full carbon cost.
2. Therefore, if a rebates system was adopted, it should be based on benchmarks, and it should be applied after the company has paid the carbon cost. The latter point is important, as it is necessary to ensure that a company faces the full extent of the carbon price before applying the rebate. Otherwise, this is tantamount to free allocation under the EU ETS which leads to windfall profits and, in practice, clearly reduces the effectiveness of the system.

10) The CBAM should be complementary to international climate diplomacy and product requirements

The Carbon Border Adjustment Mechanism should not be seen as an alternative to either product requirements or international climate diplomacy. On the contrary, parallel approaches should be pursued to complement the CBAM.

As already publicly mentioned by the European Commission, a crucial part of the CBAM exercise should be a dialogue with trading partners. The goal is to build collaborations, to impress the urgency of the climate change challenge and to encourage trading partners to take up more ambitious climate policies. This can and should be done in parallel to the development of the CBAM proposal.

Product requirements set a limit on embedded carbon emissions in products but do not put a price on the emissions that nonetheless occurred during production. The CBAM would instead provide the carbon price signal to producers. Therefore, the CBAM can be complementary to product requirements but should not replace them. This way, product requirements would ensure that only “cleaner” products can access the EU market, while CBAM would put a price on embedded emissions that occurred within the value set by the product standards. The combination of the two instruments would provide the highest incentives for emission reductions.

Contact

Agnese Ruggiero - Policy Officer
agnese.ruggiero@carbonmarketwatch.org