大成 DENTONS

The EU Carbon Border Adjustment Mechanism

The world's most important climate policy initiative?

18 May 2021

Carbon border adjustments

An idea whose time has come?

Plugging a gap in action on climate change

Climate change is a global problem, but binding global agreement on tough GHG emission reductions is almost certainly unattainable

↓

Solution? “Nationally Determined Contributions” regime (Paris Agreement)

↓

Countries can set (and meet) demanding NDCs, yet still cause high GHG emissions

↓

Carbon border adjustment is a way for unilateral measures to have global impact

Introducing

What is CBAM?

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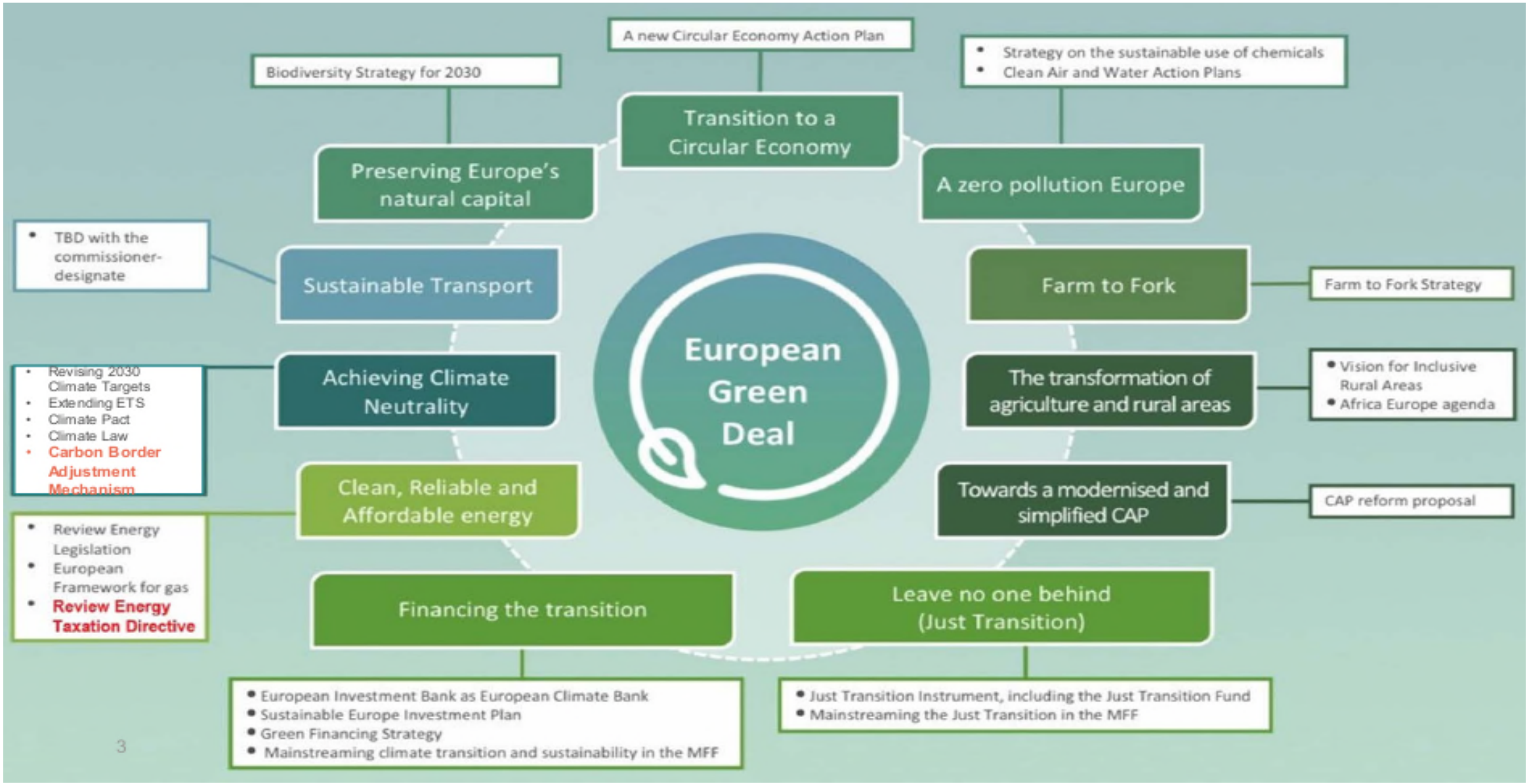
Carbon border adjustment mechanism

EU legislative and policy context

CBAM in context: overview of the EU Green Deal



Key relevant policies and legislative initiatives

High-level Green Deal climate policy objectives	• EU to be a fair and prosperous society with a modern, resource-efficient and competitive economy • By 2050: Europe to be the first climate-neutral continent • By 2030: reduce EU CO_2 emissions by 55% (from 1990 level)
Key EU decarbonisation priorities	• EU energy intensive industry needs to make substantial investments in new plant in order to reduce emissions • Impacts of (successful) EU policies: risk of carbon leakage • Green recovery / just transition
Relevant legislative initiatives	• “EU Climate Law”: sets EU emissions targets • EU ETS (carbon pricing regime): proposed expansion / reform • Energy Taxation Directive: proposed reform • Carbon Border Adjustment Mechanism (CBAM)

EU Emissions Trading System: some key features

Covers all of EEA (EU + Norway, Iceland, Liechtenstein); mostly CO_2, some N_2O and perfluorocarbons

Applies to c.11,000 installations in specified "heavy" industries + 600 aircraft operators flying to / from EEA

A "cap and trade" scheme: cap set at EU level and reduces annually at steady rate

Surrender 1 EU allowance per tCO_2e emitted or face heavy financial penalty

EU-wide auction process to purchase allowances (revenues ➔ Member States: c. € 14 billion)

Free allocation of allowances for emitters in some sectors

EU Emissions Trading System: evolution to date

Phase 1: 2005-2007
Phase 2: 2008-2012
Phase 3: 2013-2020
Phase 4: 2021-2030

Fewer allowances allocated free, on a more targeted basis, and subject to benchmarking

Market Stability Reserve (and "shelf life" for allowances) introduced to deal with problem of "surplus" allowances

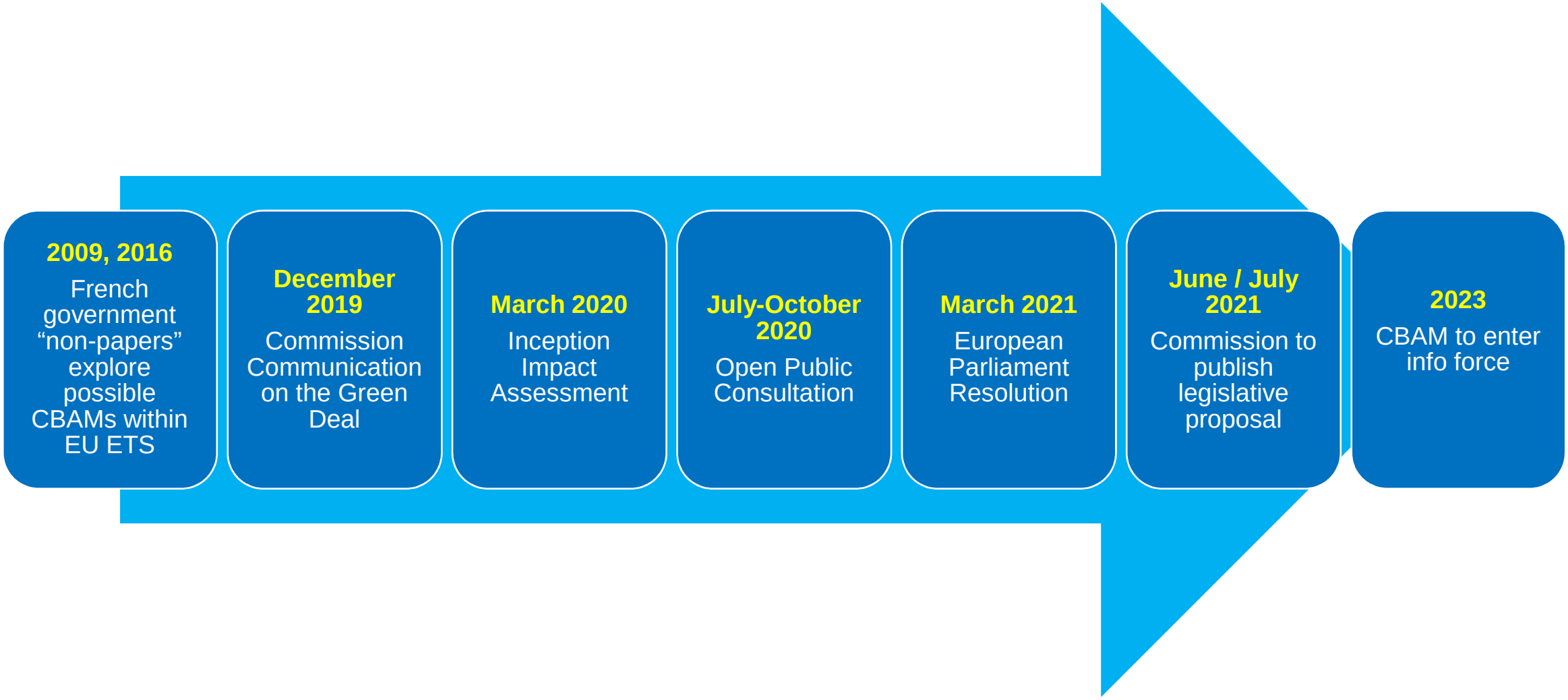
Phase 4: Member States can include additional sectors and exclude small emitters

Key question now: how to adapt EU ETS to hit revised 2030 GHG emissions reduction target (increased from 40% to 55% on 1990 levels)

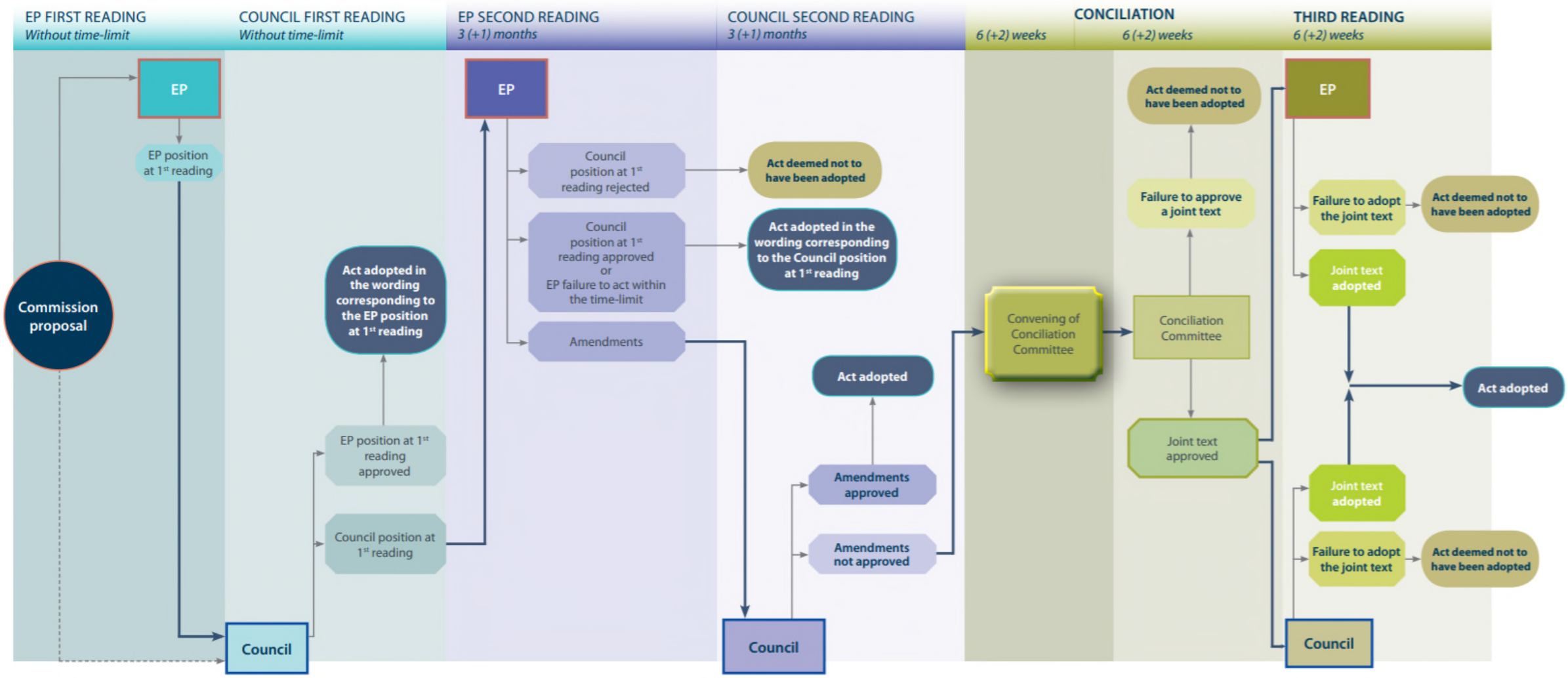
EU CBAM

Likely shape of proposals and path to implementation

Development of EU CBAM policy: key milestones

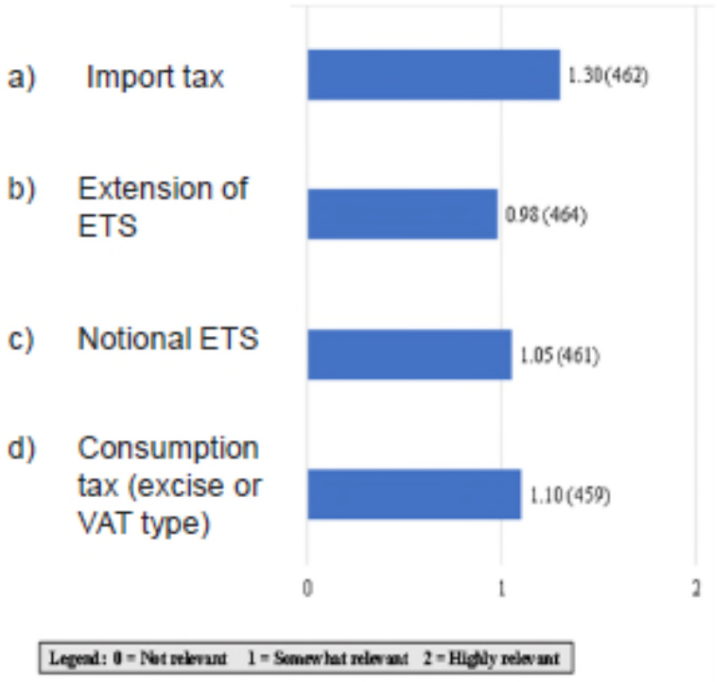


Summary of EU “ordinary legislative procedure”

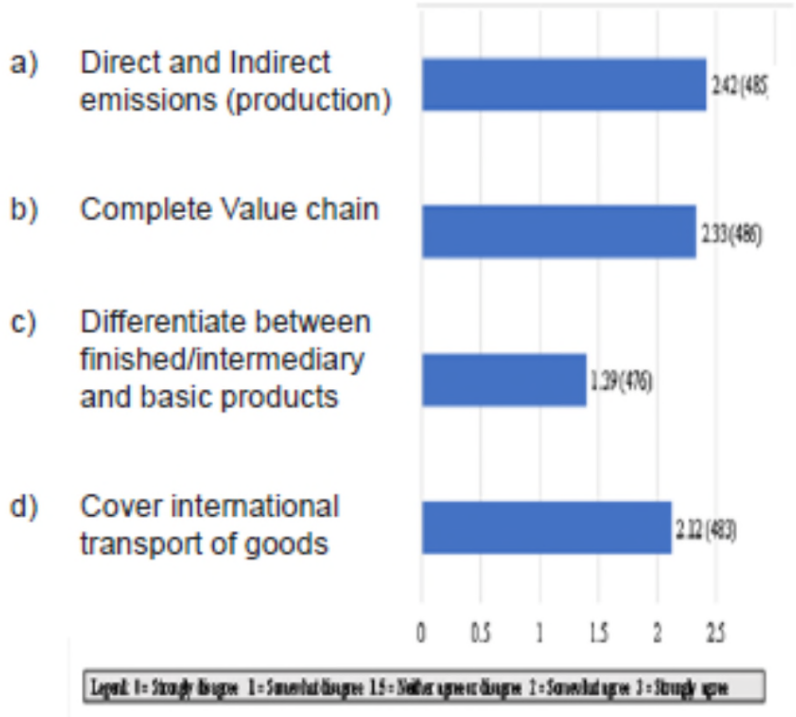


Open public consultation: feedback on CBAM design options and coverage

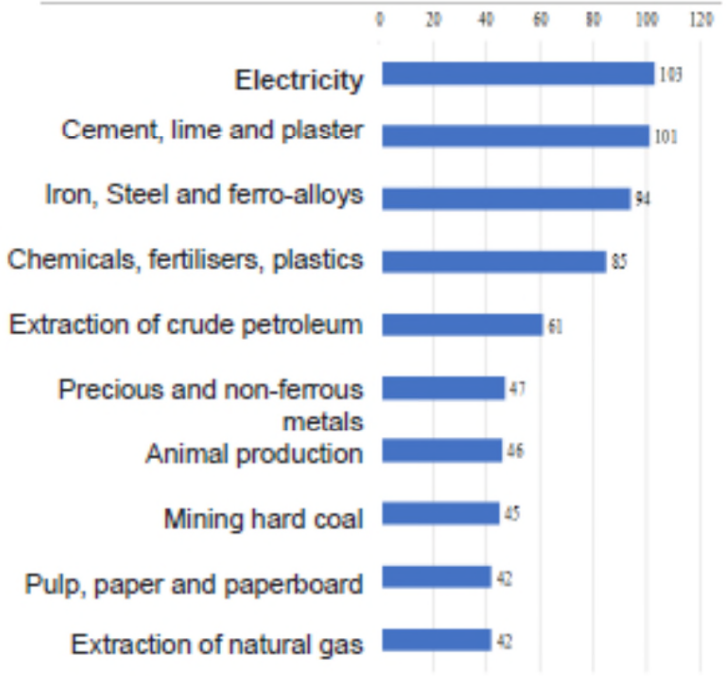
Design Options



Scope of Emissions



Top 10 Sectors



European Parliament resolution (March 2021): Key points (1)

Justification for an EU CBAM	• EU's increased climate ambition should not lead to carbon leakage • Importance of taking full-lifecycle approach to CO_2 emissions • Net imports into EU represent 20% of EU's domestic CO_2 emissions • Trade as tool of sustainable development, EU as global standard setter • Expectation of positive response from US
Climate change mitigation, not protectionism	• Designed exclusively to advance climate objectives • Should not enhance protectionism, unjustifiable discrimination or restrictions • Not a substitute for other policies (e.g. low carbon subsidies & standards) • Minimise risk of circumvention (re-routing, exporting semi-finished goods)
CBAM to be based on reformed EU ETS	• Separate pool of EU allowances for importers; pricing to reflect EU ETS price • Cover all products / commodities in EU ETS (including when embedded) • Start with power sector and energy intensive sectors (cement, steel, aluminium, refineries, paper, glass, chemicals, fertilisers (94% of EU industrial emissions) • Carbon embedded in logged wood and depleted soil should have a price

European Parliament resolution (March 2021): Key points (2)

"Trade-related aspects"	• EU trade policy to be consistent with Paris Agreement / help to achieve its goals • CBAM can be GATT-compliant if it only pursues environmental aims • Global action should make CBAM redundant • Commission to initiate WTO / G20 negotiations: update GATT for climate crisis • Export rebates: only if WTO compatible and have positive climate impact
Use of proceeds	• Revenues from CBAM (? €5-14 billion): a new "own resource" for Commission • CBAM should not be treated as a cash-machine • Revenues should support Green Deal (just transition, EU decarbonisation) • Increased finance for Least Developed Countries and Small Island States • Reduce some pressure on Member States to fund EU programmes
Implementation	• Commission should design CBAM with a clear and ambitious timeline • Need to evaluate impact on SMEs and possibly provide support for them • Most climate-friendly materials should not suffer competitive disadvantages

CBAM design and implementation challenges (1): calculating how much importers should pay

Potential volatility of market-based EU carbon price

Complexity of the EU carbon price: free allocation of allowances

Comparison with exporter jurisdiction: explicit carbon prices

Comparison with exporter jurisdiction: effective / implicit carbon prices

Individual adjustment mechanism (IAM) for exporters who “beat the average” for their jurisdiction?

Supply chain traceability (carbon content); robustness of data and verification processes

CBAM design and implementation challenges (2): avoiding unintended consequences

Differentiation

- Take account of actual emissions to encourage greener exporters (IAM)
- Green output ➔ EU; "dirty" plants' ➔ rest of world: no climate gain?
- Even with IAM, selling to non-EU importers is more profitable
- ➔ A form of carbon leakage (if those other markets have no CBAM)?

Scope

- Practicability ➔ (initial) narrow / shallow scope
- But (1) choice of narrow scope likely to be arbitrary; (2) less impact
- So go for wider / deeper scope?
- Impact should be greater, but complexity increases more?

Impact on EU industry

- EU exports become more expensive / may be shunned by some buyers
- ➔ More emissions globally
- Export rebate? ➔ Trade law difficulties
- Free allocation? ➔ Weakens carbon price, distorts market

Introducing

Responding to CBAM: Our panelists

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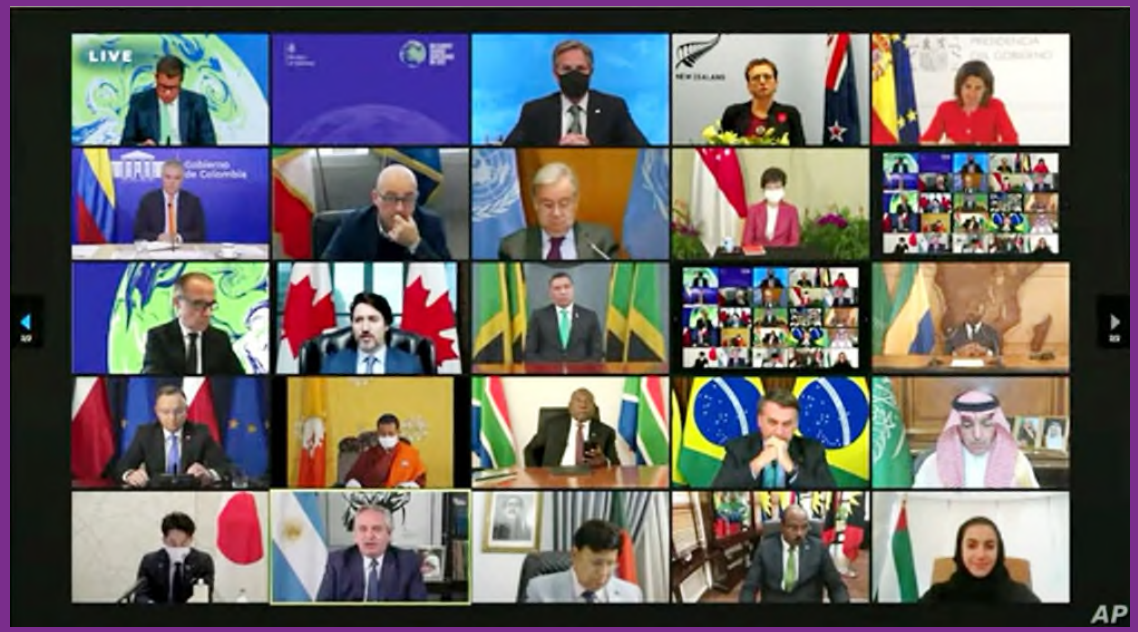
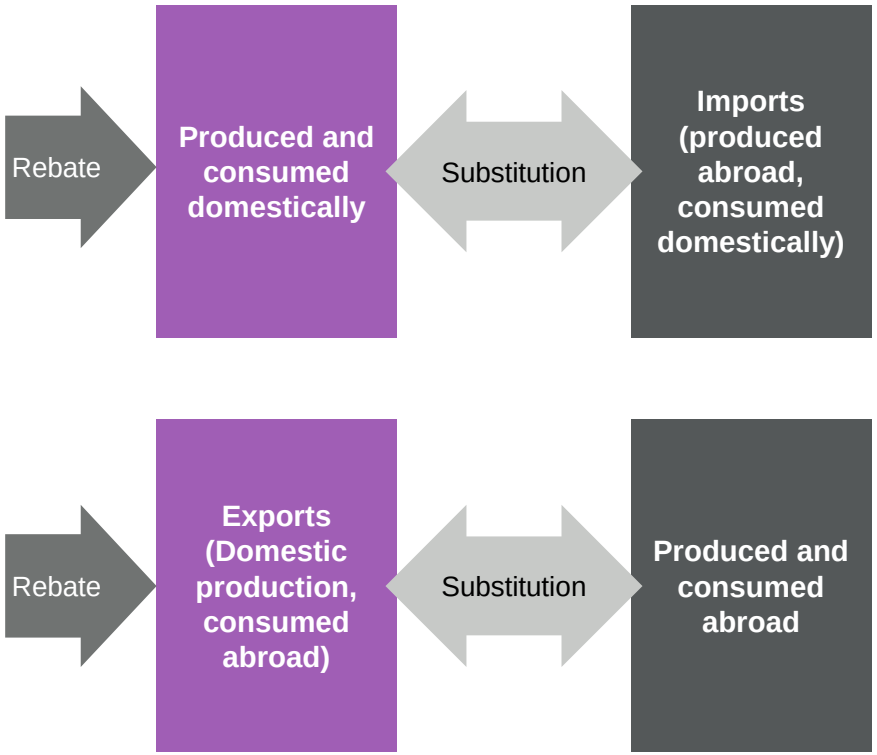
Carbon border adjustments
Responding to EU CBAM



Free allocation of EUAs and the EU's CBAM proposal both aim for a level playing field

Free allocation



Functioning of border tax adjustment

Source: Frontier Economics

Snapshots on China ETS

Phase I – Regional ETS (Since 2013)	Phase II – National ETS Development (since 2016)
a) 9 pilot regional ETS b) 2,837 controlled entities, 1,082 non-controlled entities and 11,169 individuals by September 2020 c) Trade products: allowances and CCER (China Certified Emission Reduction) d) Free allocation of allowance e) Cover 20+ industries, including steel, electricity, cement, etc f) Accumulative trading volume exceeding 400mt and CNY 9bn by mid August 2020 g) As each of the regional ETS is isolated and the standards are different from the others, liquidity of the market is not high	a) NDRC announced "Development Plan for National ETS (Electricity Industry) in Dec 2017 b) Three phases: • foundation build-up period (developing unified national data reporting system, registration and trading system, and carbon market regulatory system) – almost completed • simulative run period – electricity industry only - covering ~9% of the global emission and 30% -40% of the China emission (expected to start the simulative run in this June) • deepening and perfecting period – covering more industries such as petrochemical, steel, non-ferrous, aviation, etc c) 2,225 electricity companies to be under China ETS d) Expected in 2025, the trading volume > 3bn e) Important step for the goal of reaching carbon peak in 2030 and carbon neutral in 2060

US CBAM discussion – early stages, but Biden Administration signals support

- Sec. Kerry, during the recent International Climate Leaders' Summit, indicated that the Biden administration is exploring a carbon border adjustment.
- In a recent trade report, the US Trade Representative indicated that they are considering carbon border adjustments as part of the Biden administration's effort to use market and regulatory approaches to address GHG emissions in the global trading system.
- Major carbon pricing bills all include carbon border adjustments provisions but these bills are unlikely to be enacted in the near-term.
- In the absence of Congressional action, it remains to be seen how the Biden administration might move forward in calculating, implementing and enforcing a CBAM regime.