

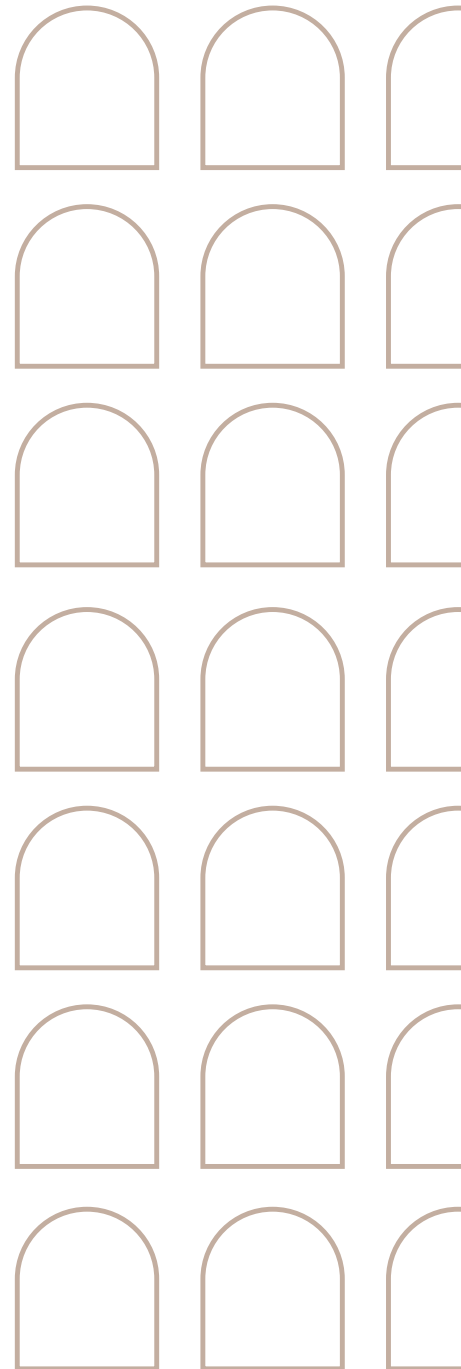
STG Policy Papers

POLICY BRIEF

HOW CBAM CAN BECOME A STEPPINGSTONE TOWARDS CARBON PRICING GLOBALLY

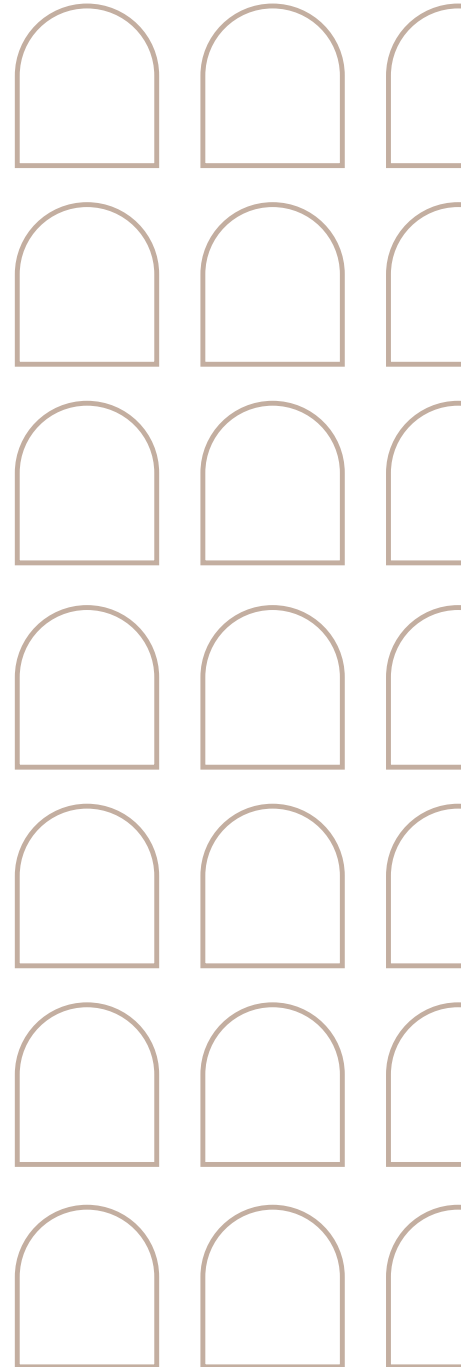
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EXECUTIVE SUMMARY

Following the introduction of the EU's Carbon Border Adjustment Mechanism (CBAM), this policy brief considers issues relating to its implementation, in particular the possibility to reduce CBAM liability if a carbon price has already been paid in the country of origin of the goods. This provision is designed to incentivise the use of carbon pricing across the world. However, the legal text leaves room for interpretation and the EU will have to clarify these issues further in the coming months. This offers a golden opportunity to encourage carbon pricing in third countries, whether regulatory or non-regulatory, and thereby strengthen global action to address climate change.



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1. INTRODUCTION

The EU's Carbon Border Adjustment Mechanism (CBAM) is now agreed and on the EU's statute books. It is a measure seeking to deal with carbon leakage as well as to encourage the introduction of carbon pricing by more countries outside Europe. The CBAM Regulation requires Monitoring, Reporting and Verification to start from 1 October 2023, and payments will become due from 1 January 2026. The legislation creates an obligation for producers of imported goods into the EU to buy and surrender CBAM certificates to the extent their products caused greenhouse gas emissions during their production. The price of these certificates will be linked to the price of the allowances used within the EU's Emissions Trading System (EU ETS). Imports from certain countries that are formally linked to the EU ETS are exempted. For goods that can be shown to have already paid a carbon price in the country of origin, a reduction of CBAM liability is allowed. Secondary legislation, of a more technical nature, now needs to be prepared and adopted. Only when this is done will third country businesses be able to plan with certainty for implementation.

2. CBAM FOCUSES ON EMBEDDED CARBON NOT ON CARBON PRICING

CBAM is a policy instrument that focuses on embedded carbon, not on carbon pricing. While embedded carbon is not easy to measure, it is feasible to do so, being technology and fuel specific. The primary way to reduce CBAM liability is to reduce the embedded carbon of goods imported into the EU. The CBAM aspires to be neutral with respect to emissions related to production inputs and non-discriminatory with respect to the country of origin of goods. It covers aluminium, cement, electricity, fertilizer, hydrogen, and steel. Also, indirect emissions (scope 2) are included to the extent these are not compensated for by the EU or its Member States, which de facto limits this inclusion to cement and fertilizer. Until now, free allocation has been the primary feature of the EU ETS to prevent carbon leakage. The EU has decided to phase out free

allowances by 2034 for the industrial sectors covered by the CBAM, and in the meantime foresees a correction mechanism to the extent that free allocation is still in use in order not to discriminate against imports.

CBAM is primarily product-based rather than origin-based, whereas a carbon price effectively paid in the country of origin of the goods is likely, though not necessarily, to be origin-based. A reduced CBAM liability is allowed for a carbon price already paid in the country of origin of imported goods. It refers to a carbon price "effectively paid" and not compensated for in a direct or indirect way. It is understood that all regulatory climate measures have a cost, and therefore an implicit carbon price. However, the reference to "effectively paid" and that "the authorised CBAM declarant shall also keep evidence of the actual payment of the carbon price" suggests that the EU legislation intends to focus only on explicit carbon pricing rather than implicit. If nothing else, a carbon price paid can be more feasibly demonstrated, so is more practical to administer.

3. VARIATIONS OF CARBON PRICING

The CBAM definition of carbon pricing reflects that across the world carbon pricing takes diverse forms. Carbon pricing varies from taxes, charges, fees, or levies on fossil fuels to emissions allowance trading and the generation of offset credits. In practice, there is a wide spectrum ranging from the EU ETS, which is harmonised across all EU Member States based on an absolute emission reduction target, to Voluntary Carbon Markets (VCMs) based on credits generated in comparison to a baseline without any regulatory intervention. Moreover, systems sometimes differ according to subnational jurisdictions.

Canada, for example, has a carbon pricing regulatory framework at Federal level, though Provinces may take different approaches in how they implement this framework, varying from Quebec's system of cap-and-trade (linked to California's) to taxes or fuel charges paid in other Canadian Provinces¹.

China too, has a nationwide emissions trading

¹ <https://www.canada.ca/en/environment-climate-change/services/climate-change/pricing-pollution-how-it-will-work.html>

system for the power sector that is to be gradually extended to industrial sectors. For the moment industrial sectors are sometimes covered by pilot emissions trading systems, with explicit carbon pricing, but this varies within the same country. China and Indonesia, for example, use intensity-based targets in their national emissions trading systems².

Non-regulatory carbon pricing systems are being explored in some countries that may entail the acceptance of absolute emission caps and be calibrated to deliver net zero emissions in 2050. These may include financial penalties for non-compliance underpinned by contracts enforceable in courts of law (so being legally binding). They could amount to being little different from regulatory emissions trading systems.

Finally, there are the more widespread VCMs representing the trading of carbon credits and offsets, mostly internationally. VCMs have been developing primarily in regions and countries where the political context makes the introduction of carbon pricing very difficult or where, for example, governance structures are too weak to make carbon pricing feasible. The environmental integrity of the VCMs continues to be a matter of much debate. However, it is notable that there is an absence of any overarching organisation and oversight that could improve the trust in these markets that are, by definition, voluntary.

4. OPPORTUNITIES FOR EU ACTION TO HELP DELIVERY OF THE PARIS AGREEMENT'S GOALS

Facing the complexity of carbon pricing measures across third countries, what systemic and fair approach will the EU take when developing its secondary legislation? It will probably not wish to evaluate the integrity of explicit carbon pricing systems in third countries on a case-by-case basis, at all times and at all respective levels of governance (national, sub-national, contractual obligations between companies, or baseline and credit VCM programmes).

First, the EU will wish to establish simple mechanisms for administering reductions of CBAM liability that are both environmentally robust and non-arbitrary. This would argue in favour of having a transparent, standardized, and pragmatic approach.

Second, in addition to preventing carbon leakage, the CBAM can also play a role in encouraging the use of carbon pricing in other jurisdictions. In the past, the EU allowed credits of the Clean Development mechanism (CDM) of the Kyoto Protocol for compliance purposes within the EU ETS. For several years the EU was the major buyer of those credits, with detrimental effects on the carbon price in Europe. Nevertheless, the experience considerably widened understanding of market-based mechanisms. By so doing, the CDM encouraged the establishment of carbon pricing in several countries, and some, such as China, are now developing nation-wide carbon pricing systems. Similarly, the carbon pricing provisions under CBAM secondary legislation could now foresee incentives towards a more generalised use of carbon pricing.

Third, the EU could also develop its secondary legislation allowing it to gain more leverage on issues related to VCMs and the ongoing negotiations in the UNFCCC on Article 6.4 of the Paris Agreement. So far, the EU has been standing away from VCMs, largely because its Climate Law and Nationally Determined Commitment under the Paris Agreement foresee domestic fulfilment of its commitment. This lack of engagement could change if payments made for some VCM credits, or those of the Article 6.4 mechanism, would qualify as payments of carbon pricing eligible for reductions of CBAM liability. The carbon pricing provisions of CBAM could, in other words, offer the EU greater influence in these discussions. By doing so the EU could maintain the domestic fulfilment of its own commitment under the Paris Agreement while helping to improve the integrity and the scale of VCMs and the Article 6.4 mechanism.

The reduced CBAM liability offers some

² <https://www.iea.org/reports/enhancing-chinas-ets-for-carbon-neutrality-focus-on-power-sector> and <https://icapcarbonaction.com/en/news/indonesia-launches-emissions-trading-system-power-generation-sector>

choice in countries where goods are produced for export to the EU either to allow the embedded carbon to be accounted for by CBAM certificates, or to introduce other forms of effective carbon pricing paid in the country of origin of the goods. Ideally, third countries would set up emissions trading systems of equivalent ambition to the EU ETS, such as Switzerland has done, and benefit from exemption from CBAM³. In the nearer term, several countries exporting products to the EU are considering how they could keep part of the revenues of carbon pricing for themselves instead of its producers paying the EU for CBAM certificates. By expressing the right modalities when developing its secondary legislation, the EU may succeed in bringing the world a step closer to the widespread use of carbon pricing. At the same time, it would facilitate more robust carbon accounting and ultimately improve implementation of the Paris Agreement.

5. EU APPROACH TO EVALUATE EFFECTIVE CARBON PRICING

In developing the secondary legislation relating to CBAM, it is important to remain within the legal parameters set by primary legislation both on the CBAM but also with respect to the EU's Climate Law and all its other policies in place (such as the EU ETS). Equally important is to develop a system that is easy to administer.

The EU may want to develop the following key elements:

i. Clarification on carbon pricing

The EU needs to explain in detail what the CBAM Regulation means by a carbon price that is a monetary amount “effectively paid in the country of origin of the goods” with respect to the calculated embedded carbon in products⁴. The CBAM Regulation does not specify whether carbon pricing must be regulatory or not, the only condition for a reduction of CBAM liability being that an effective carbon price is being actually paid. The reason is presumably that it

is not because an emissions trading system is a compliance system or a non-regulatory one that makes one necessarily better than the other in terms of environmental outcomes.

It further needs to be established that the carbon price was paid in the country of origin of the goods. This is easy when a national carbon tax or emissions trading system exists. It is moderately straight forward if the carbon price is paid in the context of a non-regulatory system of explicit carbon pricing with respect to emissions reductions made elsewhere in the country of origin of the goods. It becomes much harder if the explicit carbon price paid is with respect to reductions of emissions that occurred in a different country than the country of origin of the goods. Equally, where emissions trading systems are linked (e.g., Quebec and California) or if international offset credits are eligible for compliance purposes in an emissions trading system, as is often the case⁵, the geographic location of reductions is harder to directly link.

To illustrate the need for clarity, take the case of steel produced in India: would its products be eligible for a reduction of CBAM liability if the explicit carbon price was paid by the Indian steel producer, or would it have to be proven that the emissions reduction achieved by the carbon pricing was also achieved in India? The CBAM Regulation's wording is not clear, and one must recall that in the context of the EU ETS, linked with Switzerland, it is not possible to establish that an explicit carbon price paid corresponds to reductions made in the same country. The cost efficiency of an emissions trading system, as the EU knows very well, derives in part from the breadth of its geographic and sectoral scope.

ii. Assuring environmental integrity

As already mentioned, instead of buying CBAM certificates importers have the option to invest in other forms of explicit carbon pricing paid in the country of origin of the goods. At today's EU Allowance price of around €100, there is

³ Article 2(5) and Annex II, Section A, of the CBAM Regulation.

⁴ Article 9(1)

⁵ La Hoz Theuer, S., Hall, M., Eden, A., Krause, E., Haug, C., De Clara, S. (2023). Offset Use Across Emissions Trading Systems. Berlin: ICAP. <https://icapcarbonaction.com/en/publications/offset-use-across-emissions-trading-systems>

ample justification for the EU's implementing legislation to make the case in favour of high integrity carbon pricing, whether from compliance or non-regulatory carbon pricing systems. After all, the EU should insist that the foregone financial resources must be spent in credible carbon pricing systems supporting the reduction of global emissions, corresponding to the objective of the CBAM Regulation.

One possibility is to insist that the carbon price paid is part of a regulatory or non-regulatory system that ensures an absolute cap and/or quantifiable reduction in emissions. This is supported by the wording "under a carbon emissions reduction scheme" as part of the CBAM Regulation's definition of a 'carbon price'. Also, a credible commitment to net zero emissions by a given date could apply, although some checks will be necessary on the timescale in which actual emissions reductions would be delivered, given the variable quality of such commitments made. Equally, for VCM initiatives, minimum standards could be stipulated to ensure that these do constitute an "emissions reduction scheme", as required by the CBAM Regulation⁶. Other minimum standards might include application of the Core Carbon Principles and Assessment Framework of the Integrity Council for the Voluntary Carbon Market (IC-VCM)⁷. There is some analogy to be found for setting minimum standards in sustainable biofuel production programmes that are approved under the EU's renewable energy laws⁸.

Another or additional possibility is to follow a price level approach. Indeed, reference in the definition of carbon price as being "a monetary amount" lends itself to such an interpretation. A basic feature of explicit carbon pricing systems is that the prices reflect the degree of environmental ambition. High integrity systems with robust compliance provisions have higher carbon prices than those with lower integrity and compliance penalties. In the past, institutions such as the International Monetary Fund have stated that a global carbon price of

US\$75/tCO₂ by 2030 is necessary to deliver the climate ambition agreed upon in the Paris Agreement⁹.

In view of minimising the carbon price discrepancy with the EU, as well as to encourage the use of a meaningful carbon price, a price target per tonne of CO₂ could be set for the medium-term, e.g., by 2030, in the mid-range of an internationally suggested carbon price level. Only carbon pricing paid above that threshold would then be admissible to reduce the EU's CBAM liability. Setting such level of carbon pricing would stimulate that part of VCMs of the highest integrity.

iii. Additional finance for the climate transition

The climate transition requires very significant investments in all countries and explicit carbon pricing programmes might incentivise these. The EU may want to prioritise national offset programmes in, for example, cutting-edge (i.e., "additional") renewable energy projects, including the production of green hydrogen or high-performance batteries, and explicitly allow reduced CBAM liability through the effective carbon price paid by producers of goods exported to the EU from those same countries. In case the pricing mechanism would match reductions of emissions in the same country, no "corresponding adjustment" under Article 6 of the Paris Agreement would be necessary. The EU may even want to consider extra incentives in favour of investments in those technologies that support the climate and energy transition both in the EU and in the exporting countries.

CBAM liability reductions may be conditional upon there being EU recognition of eligible offset projects and programmes operating in each country of origin of goods covered by CBAM, depending on whether the EU insists that the carbon price paid corresponds also to emissions reductions made in the country of origin of the goods. Further criteria could be added, such as 'vintages' in view of excluding

6 Article 3(23)

7 <https://icvcm.org/the-core-carbon-principles/>

8 https://energy.ec.europa.eu/topics/renewable-energy/bioenergy/voluntary-schemes_en

9 <https://www.imf.org/en/Blogs/Articles/2022/07/21/blog-more-countries-are-pricing-carbon-but-emissions-are-still-too-cheap> and IMF Staff Climate Note

'old' projects that do not constitute additional reductions as of the introduction of CBAM, or certain project categories (such as those constituting emissions avoidances rather than reductions).

iv. Use of article 6.4 mechanism credits

The EU could apply a similar favourable implementation of reduced CBAM liability with respect to payments made for credits originating from some or all the categories of the Article 6.4 mechanism of the Paris Agreement, depending upon such projects being of the highest environmental integrity, and the reduction of CBAM liability corresponding to the monetary amount paid for such credits by the producer of goods in the country from which they originate. While that may be ambitious, it would be a concrete way in which the EU might once again stimulate the development of carbon pricing globally, as was the case for the EU's acceptance for more than a decade of offset credits of the Kyoto Protocol's CDM for EU ETS compliance purposes.

v. Scope for bilateral agreements in the context of implicit carbon pricing

The EU may also want to develop bilateral negotiations with countries in view of a mutual recognition of each other's climate policies. This could extend the interpretation of "effectively paid" carbon pricing as including an implicit carbon price. While the legal text does not say that carbon pricing must be explicit, there are several references that "'carbon price' means the monetary amount paid in a third country, under a carbon emissions reduction scheme"¹⁰, "effectively paid"¹¹, and "actual payment of the carbon price"¹². However, a great deal of data would be required to implement this recognition of effort by regulatory climate policies or other policy tools in third countries, and objective criteria would need to be established. More data will become available in the context of activities developed by the OECD such as the Inclusive Forum on Carbon

Mitigation Approaches (IFCMA)¹³ or, possibly in the context of G7's efforts to explore the concept of "Carbon Clubs" promoted in particular by Germany¹⁴. Much useful data may also become available following the gradual implementation of the Corporate Sustainability Reporting Directive (CSRD)¹⁵ disclosure rules, not least with respect to substantiating claims of climate neutrality made based on offsetting.

6. CONCLUSION

Operationalising the CBAM liability reduction with respect to effective carbon pricing paid, is an issue that climate policymakers need to discuss urgently. Several countries exporting products to the EU are considering how they could keep part of the revenues of carbon pricing for themselves instead of paying the EU for CBAM certificates. How effective carbon pricing is operationalised and whether it be done through regulatory or non-regulatory approaches, and with what geographic scope, are all crucial questions that need further clarification. A key issue that CBAM secondary legislation will have to address is how such reduced CBAM liability can contribute to a more general use of carbon pricing in the world, and how that can be done to ensure a high level of environmental integrity.

¹⁰ Article 3(23)

¹¹ Article 9(1)

¹² Article 9(2)

¹³ <https://www.oecd.org/climate-change/inclusive-forum-on-carbon-mitigation-approaches/>

¹⁴ <https://www.bmwk.de/Redaktion/EN/Pressemitteilungen/2022/12/20221212-g7-establishes-climate-club.html>

¹⁵ Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC, and Directive 2013/34/EU, as regards corporate sustainability reporting.

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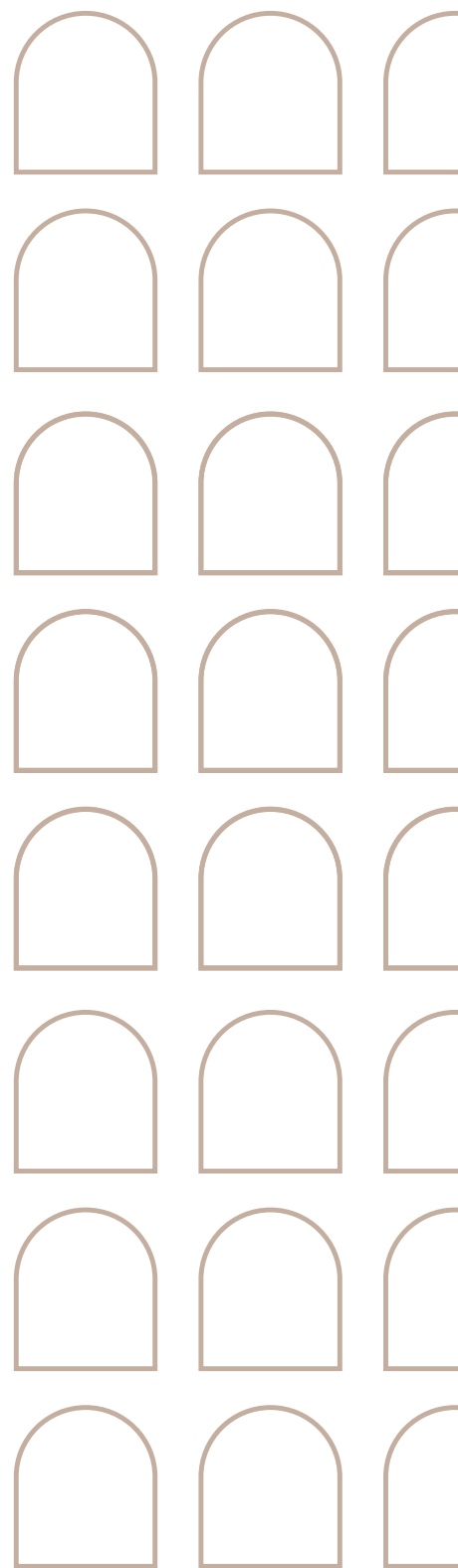
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