

The EU Carbon Border Adjustment Mechanism (CBAM)

PRELIMINARY ANALYSIS OF THE EUROPEAN COMMISSION
PROPOSAL FOR A REGULATION ESTABLISHING A CARBON BORDER
ADJUSTMENT MECHANISM, 14 JULY 2021 (COM(2021) 564 FINAL)

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Background

As part of its “Fit for 55” climate and energy package, the European Commission issued a [proposal for a regulation establishing a Carbon Border Adjustment Mechanism](#) (CBAM) on 14 July 2021. The mechanism seeks to address the risk of carbon leakage by imposing a carbon price on imports of certain carbon intensive goods from outside the EU. It is a proposal that few would have anticipated not so long ago.

This paper aims to provide a quick review of its provisions and high-level preliminary conclusions, with more to come from ERCST.¹

Central Elements of the CBAM Proposal

The main elements of the proposed CBAM design are outlined in the following table:

Design element	Proposed design in EC proposal
<i>Trade flow coverage</i>	Only imports to the EU are covered. There are no export rebates, but free allocation of EU ETS allowances is maintained (and gradually phased-out by 2035, see below).
<i>Policy instrument</i>	‘Notional ETS’ without a cap, whereby importers of covered products have to surrender CBAM certificates (priced on the basis of EU ETS allowances, see below) equal to the embedded emissions in their imports.
<i>Effect on free allocation of EU ETS allowances</i>	<p>The CBAM is put forward as an alternative to free allocation of EU ETS allowances in the covered sectors, and would therefore replace free allocation over time. To allow producers, importers and traders to adjust to the new regime, the reduction of free allocation will be implemented gradually while the CBAM is phased-in.</p> <p>Sectors covered by the CBAM will eventually stop receiving free allocation. The Commission proposes a 10-year transition period before free allocation is fully phased-out. The share of free permits for the sectors affected will still be 100% in 2025, and will gradually decline by 10 percentage points each year to reach zero in 2035.</p> <p>During the period when free allocation is maintained, the CBAM will only apply to those emissions above the free allocation received by domestic producers. The methodology for calculating the reduction in the number of CBAM certificates to be surrendered by importers to reflect free allocation will be determined by implementing acts.</p>
<i>Geographical scope / exemptions</i>	Countries that are part of or linked to the EU ETS (currently Iceland, Liechtenstein, Norway and Switzerland) are exempted. Some special territories of the EU are also exempted. Additional exemptions may be provided for imports of electricity from countries that fulfill certain conditions.
<i>Sectoral/product scope:</i>	Five sectors are to be covered initially: cement, steel, electricity, aluminium, fertilizers. Covered products within these sectors include both ‘simple’ goods (i.e. primary materials) and more ‘complex’ goods (i.e. semi-manufactured goods that use primary materials as inputs). The European Commission can add products /sectors to the list through delegated acts.

¹ For previous reports, events and ongoing analysis related to the EU CBAM, please visit the ERCST project website at: <https://ercst.org/border-carbon-adjustments-in-the-eu>.

Design element	Proposed design in EC proposal	
<i>Emissions scope</i>	Only direct emissions (Scope 1) are covered, including emissions attributed to covered goods and those embedded in input goods deemed to be within the system boundaries of the production process. Indirect emissions from electricity (Scope 2) are not covered, though a review will make recommendations in 2026 on whether to include these going forward.	
<i>Determination of embedded emissions</i>	<p>For products:</p> <ul style="list-style-type: none"> ▪ Based on actual emissions at installation level verified by accredited verifiers, with fallback default values set at the average emission intensity of each exporting country for each of the goods, increased by a mark-up (to be determined in implementing acts). ▪ When reliable data for the exporting country cannot be applied for a type of goods, the default values shall be based on the average emission intensity of the 10 per cent worst performing EU installations for that type of goods. ▪ During the initial transitional phase (2023-2025), where importers may not yet be able to produce the data required on actual emissions, default values could also apply. 	<p>For electricity:</p> <ul style="list-style-type: none"> ▪ Based on third country-specific default values that correspond to the average CO₂ emission factor in tonnes of CO₂ per MWh of price-setting sources in the third country ▪ Where third country-specific default values have not been determined, the calculation will be based on a default value set at the average CO₂ intensity of electricity produced by fossil fuels in the EU. ▪ A different (lower) default value can be established for a third country that demonstrates, based on reliable data, that the average CO₂e emissions factor of price-setting sources in the country is lower than the default value that represents the CO₂ emissions factor from EU fossil fuel-based generation. ▪ If a set of certain conditions are collectively met (e.g. declarant has concluded a power purchase agreement with a producer of electricity located in a third country), a declarant can opt for declaring actual emissions.
<i>Level of adjustment (CO₂ price):</i>	The level of adjustment will mirror the average auction price of EU ETS allowances each week. Crediting of policies in the country of origin will only recognize explicit carbon pricing policies (e.g. a carbon tax or ETS), with prices paid deducted from CBAM.	
<i>Use of revenues</i>	The CBAM will not generate revenue in the transitional period from 2023 to 2025. Revenue generated as of 2026 will be collected nationally by competent authorities, and the intent is that most of it will accrue to the EU budget. No mention of earmarking of revenues for specific purposes (e.g. for climate purposes domestically or abroad).	
<i>Implementation timeline</i>	<ul style="list-style-type: none"> ▪ 2023-2025: transitional CBAM entailing no financial adjustments ▪ 2026: Full implementation of the CBAM 	

Preliminary Analysis

More than a decade since border carbon adjustments were first discussed as a policy option in the EU, the proposed regulation released as part of the 'Fit for 55' legislative package marks the most credible effort so far to impose this unilateral policy on internationally traded goods. Central features of the final proposal – such as the policy mechanism and covered sectors – were widely anticipated based on earlier statements from the European Commission as well as rumours and documents circulating in Brussels in recent weeks.

Compared to the full range of possible design choices, however, the proposed CBAM design ends up taking a mostly measured approach: payment obligations for importers do not begin until 2026, following a transitional period; free allocation will be phased out gradually, prorating the initial payment obligation for importers; importers that fail to declare the emissions embedded in imports will be subject to a relatively favourable default value, the average carbon intensity for comparable products in the country of origin; and indirect emissions from electricity use are altogether excluded.

This approach is likely owed to concerns over diplomatic and legal pushback from trade partners, a desire to minimize resource shuffling, as well as power wrangling and industry concerns articulated by the Member States. Still, that does not mean that the CBAM as proposed will be able to avoid controversy: EU producers, for instance, will rally against the lack of provision for European exports, which will be vulnerable to leakage as free allocation subsides; trade partners, meanwhile, will not only oppose the CBAM as a matter of principle, but will focus their criticism on specific provisions, such as the limited crediting of foreign climate policies, where the EU will only consider explicit carbon pricing.

Even though the CBAM proposal sets out a less aggressive policy design than many expected, it nonetheless bears noting that this type of instrument – long shunned as overly complex and risky in the halls of Berlaymont – reflects a widening paradigm shift in how jurisdictions navigate their path to decarbonization and what is becoming an acceptable policy option: considering the climate efforts of foreign countries and producers and unilaterally imposing consequences. How this matches with the spirit, as well as the letter, of the Paris Agreement – with its bottom-up approach premised on Nationally Determined Contributions – is something that has yet to be seen.

Although the CBAM proposal issued on 14 July 2021 will evolve as it proceeds through the legislative process, one thing is clear: with domestic climate efforts around the world becoming increasingly ambitious, yet still displaying great heterogeneity, we can expect more countries to follow through the door which the EU has just opened.