BRIEFING

EU Legislation in Progress

European Parliament

EU carbon border adjustment mechanism

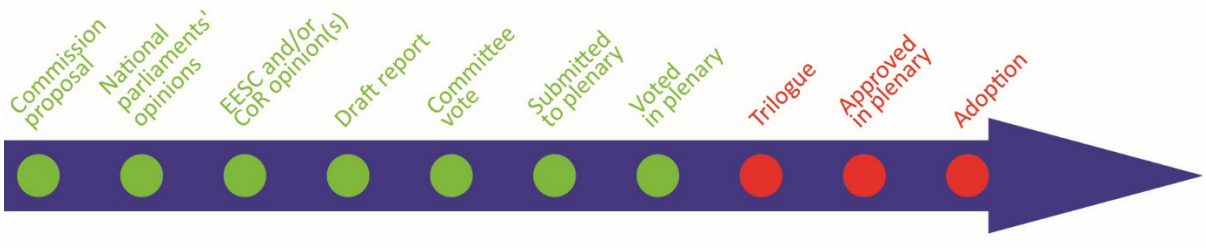
Implications for climate and competitiveness

OVERVIEW

The EU has implemented the world's largest carbon-pricing system, the emissions trading system (ETS). While pricing emissions can encourage industrial decarbonisation, it also risks carbon leakage, whereby EU companies move their production abroad. To date, the EU has mitigated carbon leakage through free allocations to certain industries, but with rising climate ambition and higher carbon prices, the Commission seeks to phase out free allocations. In parallel, a novel carbon border adjustment mechanism (CBAM) would be introduced, requiring EU importers, as of 2026, to purchase certificates equivalent to the weekly EU carbon price. The CBAM would initially apply to imports in five emissions-intensive sectors deemed at greater risk of carbon leakage: cement, iron and steel, aluminium, fertilisers, and electricity. The CBAM charge would cover imports of these goods from all third countries, except those participating in the ETS or a linked mechanism.

The CBAM aims to contribute to the EU's climate neutrality objectives, and encourage partner countries to decarbonise their production processes by levelling the playing field in carbon pricing between the EU and third-country producers; less developed countries could be supported in their climate transitions. Following publication of the Commission proposal on the CBAM in July 2021, Parliament referred the file to the Environment Committee. On 22 June 2022 the Parliament adopted its position, while on 15 March 2022 the Council had adopted its general approach.

Proposal for a regulation of the European Parliament and the Council establishing a carbon border adjustment mechanism		
Committee responsible:	Environment, Public Health and Food Safety (ENVI)	COM(2021) 564 14.7.2021
Rapporteur:	Mohammed Chahim (S&D, the Netherlands)	2021/0214(COD)
Shadow rapporteurs:	Adam Jarubas (EPP, Poland) Nicolae Ştefănuță (Renew, Romania) Manuela Ripa (Greens/EFA, Germany) Catherine Griset (ID, France) Hermann Tertsch (ECR, Spain) Malin Björk (The Left, Sweden)	Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Next steps expected:	Continuing trilogue negotiations	



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Authors: Jana Titievskaia and Henrique Morgado Simões with Alina Dobreva
Members' Research Service

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Introduction

The European Union (EU) is a pioneer of large-scale carbon pricing, and the EU emissions trading system (ETS), established in 2005, is the world's biggest carbon market. The ETS puts a cap on greenhouse gas (GHG) emissions, and divides these into emission allowances that permit the emission of one tonne of carbon dioxide (CO_2) or CO_2-equivalent (CO_2e);[1] some of these allowances are auctioned. Through market-based determination of prices, the system encourages emissions reductions. The European Commission (hereafter 'the Commission') gives the rest of the allowances for free to sectors at risk of 'carbon leakage', whereby companies offshore production to jurisdictions with laxer environmental regulations. The emissions allocations are administered by the Member States, and the lists of installations eligible for free allocation are regularly reviewed.

In December 2019, the Commission put forward the European Green Deal, which commits the EU to reaching carbon neutrality by 2050. The new goal is to reduce net GHG emissions by at least 55 % by 2030, compared to 1990 levels. In July 2021, the EU announced a set of proposals (also known as the 'Fit for 55' package) that would deliver the Green Deal and help achieve the emissions reduction target while creating new social and economic opportunities. As part of this package, a carbon border adjustment mechanism (CBAM) would be gradually introduced for certain imports from third countries.

The aim of the CBAM is to equalise the carbon price between domestic and foreign products, thereby limiting carbon leakage; the measure could also encourage partner countries to adopt carbon pricing that tests the prediction of a Brussels effect. From 2026, the Commission is planning to phase out free allocations to the sectors concerned under the ETS, to ensure a level playing-field between EU producers and third-country importers. Until free allocations end in 2035, the CBAM will only apply to the proportion of emissions that do not receive free allowances under the EU ETS.

The CBAM will initially cover five industrial sectors: iron and steel, cement, fertilisers, aluminium, and electricity generation. The Commission has selected these sectors because of their risk of carbon leakage, the magnitude of their carbon emissions, and for administrative feasibility. The proposal lists, with commodity codes, several sub-categories of goods (from base materials to certain semi-finished products) in these sectors. In the transitional phase, as of 2023, importers in these sectors will have to report their embedded GHG emissions of CO_2 and, where relevant, nitrous oxide (N_2O) and perfluorocarbons (PFCs). They will not yet have to pay the financial adjustments.

At the end of the transition period, the Commission will re-evaluate whether to extend the scope of the CBAM to indirect emissions and to more products down the supply chain. Once the CBAM becomes fully operational in 2026, EU importers of these products will need to obtain authorisation from a CBAM authority and purchase carbon certificates corresponding to the carbon price that would have been paid to produce the goods in the EU.

Context

Calls for a CBAM pre-date the EU ETS, but several problems have thus far impeded the introduction of this novel type of instrument. Initially, the price of carbon emissions under the EU ETS was too low to warrant corrective measures at the border. Rising EU carbon prices have jumped from about €30 per tonne of CO_2 in December 2020 to €80 in December 2021. This can make carbon leakage more likely, and has enhanced the need for a corrective measure such as the CBAM.

In past debates, the EU's trade partners have also raised concerns about the compliance of the CBAM with the rules of the World Trade Organization (WTO). In particular, the EU needs to ensure that the CBAM does not violate the principles of non-discrimination between domestic and foreign producers (e.g. by charging the equivalent carbon price, as is charged under the EU ETS). The CBAM should also not discriminate between different third-country importers. After the EU proposed an aviation directive with CBAM-like features for emissions allowances in the context of inter-continental flights, in 2012 several WTO members threatened retaliation. With the present

introduction of the CBAM, the Commission has expressly stated the objective of ensuring WTO compatibility from the outset to mitigate these concerns.

In parallel, global ambitions to tackle climate change have strengthened, and the EU has enhanced its own climate objectives. In a March 2021 opinion piece, a number of EU Member State ministers backed the CBAM as a means to tackle carbon leakage and achieve stronger international climate cooperation.

The CBAM proposal is multidisciplinary and complex, touching upon aspects of climate and environmental policy, trade, customs and taxation, as well as budgetary and economic issues. Therefore, it has been accompanied by intense negotiations over its legal basis and the terms of its adoption. The legal basis is Article 192(1) of the Treaty on the Functioning of the EU (TFEU), which allows the EU to take action that contributes to the pursuit of environmental and climate objectives specified in Article 191(1) TFEU; this means that the CBAM proposal will be adopted through the ordinary legislative procedure. In contrast, fiscal measures would require unanimity (Article 192(2)a). However, EU case law has established that the content of the measure determines the choice of legal basis. As the CBAM is based on the emissions content of imports, it is considered to align with the environmental and climate objectives included in the legal basis.

Existing situation

In the existing situation, the EU has opted for free allowances under the EU ETS to discourage offshoring and carbon leakage. However, these are meant to be transitional measures and subject to revision. A 2020 ETS report by the European Court of Auditors underlined the need for better targeting in the system of free allocations, and noted that these could jeopardise decarbonisation. The Commission impact assessment on the CBAM noted that, while free allocations are effective in fighting carbon leakage, they have a financial and climate cost that appears to warrant their phase-out. Thus, the aim of the CBAM proposal is to level the playing-field between EU producers, who are subject to the EU ETS, and foreign producers, who may not have an equivalent system in place.

EU debate has therefore focused on feasible policy designs for the CBAM, which has ranged from options such as a border tax or a customs duty, to a carbon tax (akin to an excise duty or a value added tax) on consumption, an obligation to purchase CBAM certificates, or an extension of the EU ETS to imports. However, the occurrence of carbon leakage in itself is subject to debate, with some studies failing to find evidence that the EU ETS has caused it in the context of (previously) low carbon prices and free allocations to key industrial sectors.

Comparative elements

To date, no national or supranational jurisdiction has implemented a CBAM. A limited carbon border adjustment is in place as part of the US state of California's cap and trade system for electricity imports, while Canada and Japan are planning carbon border adjustments of their own. Yet, in the years to come, and if there is no global carbon-pricing regime, emissions trading systems and carbon border adjustment measures are likely to proliferate.

To date, 45 national jurisdictions have some type of carbon pricing initiatives in place, covering an estimated 18.8 % of global emissions. China launched a national ETS in 2021, and Canada plans to introduce a federal ETS as of 2022. These developments have given rise to a debate over the creation of a 'climate club', where significant emitters agree to a common minimum carbon price. Some Member States have implemented national carbon taxes, and Member States can maintain these taxes if they have a higher level of ambition than EU-level action in this field.

Parliament's starting position

In March 2021, the Parliament adopted an own-initiative resolution on a 'WTO-compatible EU carbon border adjustment mechanism'.

The Parliament supports the CBAM in principle, as long as it is designed in a WTO-compatible way, with climate objectives at the forefront and not being used as a means of protectionism. The possible revenues raised through the CBAM should be used to support the aims of the Green Deal.

In the Parliament's view, the CBAM should cover all imports of products and commodities under the EU ETS. The Parliament stated that, following an impact assessment, the CBAM should cover sectors such as cement, steel, aluminium, oil refining, paper, glass, chemicals and fertilisers. The Parliament also underlined the need to give special treatment to least developed countries (LDCs).

Preparation of the proposal

In December 2019, the European Commission adopted its communication on the European Green Deal, which included the commitment to put forward the CBAM for selected sectors in 2021. Preparatory work by the Commission included an inception impact assessment published in March 2020, and a public consultation took place between 22 July and 28 October 2020. On 16 September 2020, Commission President Ursula von der Leyen announced that a legislative proposal on the CBAM and the CBAM as an own resource would be in the Commission's 2021 work programme.

On 14 July 2021, the Commission adopted its proposal for a CBAM, which would equalise the price of the GHG emissions concerned between domestic products and imports in selected sectors. An impact assessment accompanied the proposal, which confirmed the target sectors most at risk of carbon leakage, and the most feasible option for a CBAM (option 4). EPRS has published an initial appraisal of that impact assessment. The proposal was open for feedback until 18 November 2021 and received nearly 200 responses from stakeholders.

The changes the proposal would bring

The CBAM aims to prevent carbon leakage, while ensuring the effectiveness of EU climate policy. In addition, the CBAM could incentivise third-country governments to put in place greener policies and third-country producers to reduce their emissions. The proposal would extend to imports from all third countries, including the United Kingdom (with the possible exception of Northern Ireland); exemptions will be given to imports from Iceland, Liechtenstein and Norway, which participate in the EU ETS, and Switzerland, whose ETS is linked to the EU ETS.

In the impact assessment report, the Commission estimates that the preferred option for a CBAM (option 4) put forward in the regulatory proposal would lead to a 13.8 % reduction in EU emissions for the CBAM sectors relative to the baseline in 2030. In the rest of the world, emissions in the CBAM sectors would decrease by about 0.3 %.

For EU producers, the phase-out of free allocations is expected to increase the incentive to decarbonise, while for third-country producers the CBAM surcharge increases the incentive to make efficiency improvements. Carbon leakage would be mitigated to a degree (estimated at -29 % in the CBAM sectors in 2030), while the negative effects on gross domestic product and consumption are considered to be limited.

The Commission has proposed that the CBAM would only apply to direct emissions (scope 1) released during the production process of the goods covered by it. Indirect emissions (scope 2 and scope 3), such as the emissions generated from electricity used for manufacturing, heating or cooling during the production process, will not be used as a basis for the CBAM charge. This is meant to ensure administrative simplicity, as indirect emissions come from sources other than the reporting entity and can therefore be hard to measure. However, the Commission proposes that declarants would report their embedded emissions corresponding to the previous quarter's imports, detailing direct and indirect emissions, and any possible carbon price already paid abroad.

The CBAM may be extended in future iterations to encompass indirect emissions from purchased energy (scope 2). In addition, the Commission can define the calculation methods, including system boundaries, for embedded emissions at a later stage through delegated acts.

Potential changes for importers and manufacturers

The CBAM would bring about different changes for different stakeholders in the five sectors concerned, while third-country manufacturers of products covered by the CBAM would face an additional fee for their exports. The price of the CBAM certificates would be directly linked to the weekly price of EU ETS allowances, which could incentivise decarbonisation of emissions, particularly if alternative low-carbon technologies are available and affordable. On the other hand, third-country producers could also engage in 'resource reshuffling', whereby they export products with low carbon content to the EU, while reserving dirtier products for domestic or non-EU markets.

The bureaucratic burden of the CBAM would mostly be borne by EU importers. Third-country producers could choose to import through an EU customs broker, or set up a local EU business unit to act as a declarant for CBAM purposes.

From January 2023 to December 2025, over the course of the transition period, importers would be responsible for calculating and reporting carbon emissions in line with EU requirements, with the Commission collecting accurate CO_2-equivalent emissions data from the importers concerned. There would be no payment of financial adjustments during the transition period.

From January 2026 onwards, importers would be responsible for procuring CBAM certificates for each metric tonne of CO_2 and, where relevant, N_2O and PFCs. Declarants would be able to purchase CBAM certificates at any time and they would remain valid for 2 years; they will also be liable for ensuring independent verifications of emission calculations. In addition, importers will have to obtain possible exemptions for qualifying products from jurisdictions that implement carbon pricing equivalent to the EU ETS.

The CBAM proposal would also influence EU industry in various ways. According to the Commission impact assessment report, EU producers of the five product categories could potentially see their output increase as competing imports from third countries fall under the CBAM. At the same time, they would see their free allowances under the EU ETS phased out, which could result in a reduction of EU exports compared to a scenario where the EU ETS cap is strengthened but free allocations are maintained.

Meanwhile, EU downstream producers that use the five product categories as inputs (e.g. manufacturers of components or finished goods) in their supply chains could also be affected. Analysts expect that industries such as the automotive, construction, packaging and consumer appliances industries will incur higher costs if their imports are covered by a CBAM charge, which could harm their competitiveness. Downstream producers could be encouraged to reconsider their suppliers, actively seeking out less carbon-intensive inputs to avoid paying the financial adjustment.

Some third countries could opt to invest in cleaner products for export purposes. The Commission estimates that the raw material represents such a limited part of the added value of such finished products that the impact on competitiveness would be modest. In the coming years, the Commission will re-evaluate the need to expand the CBAM to more sectors and to further products downstream in the supply chain, and to indirect emissions.

Potential changes in the EU budget

Reform of the own resources system

The 2021-2027 multiannual financial framework (MFF) came in a package that included the Next Generation EU (NGEU) instrument – a response to the pandemic's severe adverse effects on the EU economies – and was linked to the Own Resources Decision, which includes the CBAM. An Interinstitutional Agreement (IIA) was also reached and included a roadmap to new own resources.

The motivation for introducing new own resources has various aspects, which have been debated over the years. To the long-term considerations related to helping deliver policy objectives, a new

motivation was added after the start of the Covid-19 pandemic, namely the need to repay the unprecedented EU borrowing used to finance the NGEU instrument.[2] Ratified by all 27 Member States by 31 May 2021, the Own Resources Decision entered into force in June 2021.

This first step in the own resources reform was necessary to allow NGEU to come into force, increase the own resources ceiling and introduce the first new own resource – a new contribution based on non-recycled plastic packaging waste, which was introduced as of 1 January 2021. This adoption of the Own Resources Decision took approximately 6 months – an unusually short period compared to the 28 months it took in 2014.[3]

The roadmap sets out steps to further reforms, which include the introduction of other new own resources, namely a CBAM, a digital levy and the EU ETS. The Commission did not meet the requirement under the IIA to submit proposals for these new own resources by June 2021; instead, they were presented on 22 December 2021. Own resources reform is extremely difficult, as it is one of the heaviest and lengthiest of all EU procedures, requiring unanimity in Council and national ratification. The current delays already raise concerns regarding the timely implementation of the new own resource system.[4]

There are other own resources options to be considered, according to the IIA, at a later stage, i.e. a financial transaction tax and own resources linked to corporations and a new common corporate tax base. The Commission will endeavour to make such a proposal by June 2024, based on impact assessments and the experience with the new own resources.

CBAM as a new own resource

In its 2020 opinion, the BUDG committee states that introducing the CBAM new own resource would help to ensure the impact is fairly distributed across Member States and to reduce the share of GNI-based contributions; this would help focus expenditure better, and achieve high efficiency, at EU level on priority areas and common public goods. Moreover, the Parliament considers that the nature and origin of CBAM revenues would be strictly linked to EU-level climate policies, external borders and trade policy, and therefore constitute a highly suitable basis for an EU own resource.

According to a study commissioned by the Parliament, carbon emissions embedded in EU imports currently correspond to over 20 % of EU emissions. As the CBAM price on the emissions of an import should be equal to the price an EU producer would pay for its allowance in the EU ETS, the revenue resulting from this source could be just as volatile as that from the EU ETS. According to the BUDG committee's 2020 opinion, the estimates of CBAM revenues range from €5 billion to €14 billion per year, depending on the scope and design of the new instrument. The Commission impact assessment accompanying the proposal to establish a CBAM provides a more precise estimate of the revenue generated from the CBAM as an own resource under six different options for its design and modalities, using time frames both before and after 2030.

The CBAM has long been a candidate for a genuine, green source of own revenue in the EU budget. According to the IIA, and as set out in the European Council conclusions of July 2020, the CBAM should be introduced by 1 January 2023 at the latest. As the plan is for the CBAM to be phased in gradually, payments from EU importers are planned to start as from 2026.

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion on the proposal, prepared by the section for Agriculture, Rural Development and the Environment (NAT), on 8 December 2021. The EESC welcomes the proposal and calls for the extension of the impact assessment to export activities within the sectors covered. Furthermore, the EESC's opinion is in favour of supporting the industrial transition of the affected sectors by directly allocating revenue from the CBAM. The EESC expects the Commission to address the possible effects of the CBAM through the value chain by means of an impact study.

The European Committee of the Regions adopted an opinion on making the EU ETS and CBAM work for EU cities and regions on 28 April 2022. It supports the introduction of CBAM as a means to address carbon leakage and to encourage global climate action. Furthermore, the opinion highlights that the mechanism should be regularly reviewed, in terms of its sectoral scope and emissions covered, taking into account its local and regional impacts.

Stakeholder views[5]

The European climate action network of non-governmental organisations (NGOs) has noted that the CBAM is one key tool in the broader policy mix required to reach the EU's climate goals, and that potential negative impacts in third countries should be mitigated in line with the principles of a just transition. The European Environmental Bureau highlighted the need to accompany the CBAM with a strong monitoring, reporting and verification system to avoid the redirection of dirtier products towards non-EU markets. Sandbag has underlined that the climate impact of CBAM would be minor and consumers might be the ones to bear its costs.

Many EU industry representatives welcome the general idea of the CBAM to the extent that it can level the playing-field vis-à-vis foreign competitors, but express reservations about its design, timing and implementation. In addition, their stances differ depending on their position in the value chain, trade exposure and sector of economic activity. For some, the preservation of free allowances under the EU ETS would be preferable to the CBAM. For instance, the European Cement Association (Cembureau) called for the initial co-existence of the CBAM with the EU ETS's free allowances; the steel and aluminium industry has argued that the phase-out of free allocations would raise production costs and reduce the resources available to invest in decarbonisation; BusinessEurope has highlighted the need for WTO compatibility to avoid retaliation from third countries, and the long-term ambition for a climate club instead of unilateral measures; and a legal study commissioned by AegisEurope has argued that the co-existence of free allowances and the CBAM can be WTO-compatible.

One core concern is calculating the carbon content of foreign imports, and whether to benchmark against the average emissions of the best-performing EU countries or based on pre-determined default values; numerous examples of circumvention have also been raised. As long as only a sub-set of the supply chain of a given sector is covered by the CBAM, imports could shift into product categories that are not covered by it. A possible solution could be a wider coverage of product categories under the CBAM, including downstream in the supply chain.

In addition, representatives of the sectors covered by the CBAM have flagged concerns about the competitiveness of their exports as some of their input products become covered by the CBAM charge. Industry representatives have proposed a system of export rebates to mitigate this risk.

Third countries have been critical of the CBAM proposal, and neighbouring countries, whose exports are particularly exposed to the CBAM, have voiced concerns over the WTO-compatibility of the measure. Ukraine's steel industry has highlighted the national commitment to EU standards under the EU-Ukraine Association Agreement, calling for an exemption for the steel industry; the Turkish Industry and Business Association has called for EU funding to support Turkey's alignment with the CBAM; Russia has stated that the EU appears to be using the climate agenda to erect new trade barriers; China has underscored the Paris Agreement's principle of wealthier countries bearing a proportionally greater responsibility of cutting emissions; and, in a joint statement, Brazil, South Africa, India and China have expressed concerns that the CBAM would have negative implications for developing countries.

Academic views

Energy economics literature on the subject of carbon border adjustment has studied its potential to reduce carbon leakage effectively. In a briefing commissioned by the Parliament's INTA committee in 2020, Felbermayr and Peterson showed that direct leakage can be reduced by a CBAM, but less

so through energy markets. Kuik and Hofkes (2010) found that, in the EU context, a CBAM could reduce leakage rates for the iron and steel industry, but less so for cement. Winchester et al. (2011) found that carbon border adjustments could reduce leakage by up to two thirds, but less so global emissions, suggesting a modest net climate impact. This echoes Fischer and Fox (2012), who compared different leakage policies and concluded that all, including carbon border adjustment, can foster competitiveness but do not reduce global emissions.

Kuusi et al. (2020) say that a realistic CBAM policy design, consisting of a narrow set of emission-intensive imports, would act more as a signal of the EU's determination to resolve carbon leakage, while the economic and environmental impact would remain small. More recently, Fragkos et al. (2021) concluded that the CBAM could be effective in reducing leakage through the channel of competitiveness, but noted that the legal and administrative burden may reduce its efficiency gains. To mitigate this, the authors suggest paying close attention to how the possible revenues derived from a CBAM-like measure could be used optimally, such as for social purposes.

Legal and policy scholars have studied the optimal policy design, including compatibility with the rules of the WTO. In a legal assessment commissioned by the Parliament's INTA committee in 2020, Pauwelyn and Kleimann provide an overview of relevant WTO disciplines for the purposes of the CBAM, including the possible justification of the measure on environmental grounds. Balistreri et al. (2014) argued that, to ensure WTO compatibility, the optimal carbon price under a CBAM-like measure should be about half – and not equivalent to – the domestic carbon price. Evans et al. (2021) noted that an imports-based carbon border adjustment would level the playing-field but fail to help EU exports, suggesting that the free allocations for exports could be warranted.

The CBAM's implications for third countries, including its potential to encourage emissions reductions, has been a focus of recent academic studies. Eicke et al. (2021) consider that risks for third countries depend on exposure and ability to adapt to the EU CBAM, concluding that most vulnerable countries are located in Africa and south-eastern Europe. Chepeliev (2021) has calculated that Ukraine could face a per capita income change of -0.4 % and reductions in domestic iron and steel production of up to 3.9 %. The Institute for European Environmental Policy considers that the negative implications of the CBAM for climate-vulnerable countries could be addressed through stronger dialogue, avoidance of double compensation for EU industries, potential exemptions and a supply of wider aid measures, including through CBAM revenues.

Legislative process

On 9 September 2021, the Commission presented the CBAM proposal in the ENVI committee, followed by a discussion. In September 2021, the Parliament appointed Mohammed Chahim (S&D, The Netherlands) as the rapporteur for the CBAM under the ordinary legislative procedure. The lead committee is ENVI, while INTA, BUDG and ITRE serve as associated committees.

On 21 December 2021, the rapporteur presented his draft report on the proposal. The rapporteur refers to the need for the mechanism to cover organic chemicals, hydrogen and polymers, as well as indirect emissions in all sectors covered by the CBAM, as a means of broadening its scope. The draft report also addresses the CBAM's phase-in, and suggests that it should be done in an incremental and speedier manner. Furthermore, the draft report is in favour of a CBAM central authority. It notes that the CBAM should be regarded as an instrument that promotes cooperation in decarbonisation efforts, especially with LDCs.

As regards the budgetary implications of the CBAM, there are MEPs that support the earmarking and reinvesting of (part of) the CBAM revenues in climate action policies or decarbonisation of LDCs. This opinion finds some common ground with the position of the BUDG committee, which stresses that the revenues generated from the CBAM would not be used, for reasons of environmental integrity, to subsidise policies or actions which run counter to the Paris Agreement and the objectives of the European Green Deal. However, the BUDG committee underlines that any earmarking of CBAM revenues would contravene the IIA, the Own Resources Decision and the Financial Regulation.

According to them, the CBAM-based own resource will be part of a basket of own resources that will be sufficient to cover the expected costs of repaying the principal and interest on the borrowing incurred under the Next Generation EU instrument, while respecting the principle of universality. In addition, any surplus from the repayment plan must remain in the EU budget as general revenue.

The associated INTA committee discussed its draft opinion on establishing the CBAM on 29 November 2021. Rapporteur Karin Karlsbro (Renew, Sweden) emphasised that bureaucracy needs to be limited, e.g. with a single information portal for declarants. A phase-out of free allowances under the EU ETS needs to complement the CBAM, and the possible revenues derived from the CBAM should be invested in developing countries' climate transition. During the discussion, MEPs underlined the need to enhance the CBAM's climate ambition and ensure WTO compatibility.

The ENVI committee adopted its report on 17 May 2022 with 49 votes in favour, 33 against and five abstentions. The report increases the scope of products covered to include, from the outset, hydrogen, organic chemicals and polymers, and by 2030, all EU ETS sectors. By June 2025, the Commission must adopt a delegated act with a timeline for the gradual inclusion of all covered goods. Furthermore, the Commission would have to add downstream products through delegated acts. In addition to the direct emissions covered by the mechanism, the report adds indirect emissions from electricity. As concerns trade flows, the Commission would have to perform an annual CBAM assessment to verify the mechanism's effectiveness in addressing carbon leakage risk and its impact on EU exports.

The report introduces changes to the proposed timeline; the transitional phase should run in 2023 and 2024, while free allocations should be phased out between 2025 to 2030. The end year for the phase-out for these allowances within the initially covered sectors would be 2030 (10 % in 2025, 20 % in 2026, 30 % in 2027, 50 % in 2028, 75 % in 2029, 100 % in 2030). Other EU ETS sectors to be included by 2030 would have a four-year phase-out period (30 % reduction in the second year, 60 % in the third and 100 % at the end of the fourth year).

For the determination of embedded emissions related to products, fallback default values for each exporting country and each good would be set at the average emission intensity of the 10 % worst-performing installations in each exporting country; when reliable data for that country cannot be applied, the default would be set at the average emissions intensity of the 5 % worst-performing EU installations. Furthermore, the determination of embedded emissions for electricity would be based on actual verified emissions, with the default values based on the 10 % worst-performing installations producing electricity in the third country.

The report mentions that revenue from CBAM shall accrue to the EU budget, and that the EU's financial support to decarbonisation efforts of LDCs must be equivalent in value to the revenues generated by the sale of CBAM certificates. In terms of governance, the report favours centralised administration with the creation an EU CBAM authority, unlike the Commission's proposal, which envisages decentralised administration by each Member State.

The report strengthens the powers of the Commission to monitor and address circumvention practices and defines additional cases that can constitute circumvention, such as: direct and indirect subsidies to absorb the costs related to a CO_2 price; CO_2 prices paid in third countries which are placed only on goods exported to the EU; outsourcing of production of downstream products as a means to not be obliged to pay the CO_2 price in the EU; transhipment; and patterns and channels of sale and production reorganisation by exporters.

During the June I 2022 plenary session, the report was referred back to the committee, without any vote on its content, following the rejection of the parallel report on the review of the EU ETS. Subsequently, during the June II plenary session, the Parliament adopted the report with amendments on 22 June, with 450 votes for, 115 against and 55 abstentions. On the same day, the Parliament also adopted the report on the review of the EU ETS.

The Parliament's position in respect of the increased scope of the CBAM would require the Commission to conduct an assessment of the technical specificities in relation to organic chemicals and polymers to guarantee smooth implementation.

The adopted text introduces changes to the Commission's proposed timeline, with the transitional phase running from 1 January 2023 until the end of 2026. The phase-in of CBAM requirements would be coordinated with the phase-out of free allocation in the EU ETS[6] between 2027 and 2032, on a yearly basis: 93 % in 2027, 84 % in 2028, 69 % in 2029, 50 % in 2030, 25 % in 2031, and reaching zero in 2032. Additional products to be covered by the CBAM will follow the same reduction speed and would need to reach 0 % after six years. However, free allocations would continue for products covered by CBAM, as long as those are produced for export to the outside of the Union to countries where no carbon pricing mechanisms, similar to the ETS, are in place. Nonetheless, the Commission would have to present a report, by the end of 2025, to the Parliament and the Council in which it assesses the effects of both EU ETS and the CBAM on the production of goods for export and on WTO compatibility. Furthermore, the Commission would need to present a legislative proposal addressing carbon leakage if appropriate.

The Parliament calls on the Commission to establish a 'Carbon Club' – an open non-exclusive international forum – which would have the purpose of ensuring uninterrupted dialogue with the Union's trade partners. The adopted text suggest that the 'Club' could be established within an international multilateral organisation such as the WTO or the Organisation for Economic Co-operation and Development (OECD).

On 15 March 2022, the Council adopted its general approach on the CBAM. The Council introduces changes to the CBAM governance, in comparison to the Commission's proposal, by means of greater centralisation, e.g. an EU-level centralised registry of CBAM declarants (importers). Furthermore, the Council, to reduce administrative complexity, would establish a minimum threshold exempting consignments with a value of less than €150 from CBAM obligations. In addition, the Council suggested the establishment of a 'climate club' through an alliance of countries which have in place carbon pricing instruments or other comparable instruments.

On 11 July 2022, a first session of trilogue negotiations was held.

EP SUPPORTING ANALYSIS

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ENDNOTES

1 The gases covered by the EU ETS are carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs) and sulphur hexafluoride (SF_6).

2 For further details and background information, see D'Alfonso, A., Own resources of the European Union: Reforming the EU's financing system and Implementing the Own Resources Decision, EPRS, European Parliament, 2021.

3 For further details and background information, see D'Alfonso, A., National ratification of the Own Resources Decision: Procedure completed on 31 May 2021, EPRS, European Parliament, 2021.

4 As the BUDG committee recalled in its 2020 opinion, any failure to respect the terms agreed in the IIA by one of the three institutions could expose it to a legal challenge by the others.

5 This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

6 The Parliament's adopted text on the review of the EU ETS, includes the exact same schedule for the phasing out of free allowances.

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