COUNTERING CARBON LEAKAGE: THE EUROPEAN UNION MOVES FORWARD TO OVERHAUL ITS CARBON MARKET AND TO ADOPT A CARBON ADJUSTMENT BORDER MECHANISM

Early Sunday morning, following a reported 30 hours of final "trilogue" negotiations, the European Parliament and the Council reached provisional agreement to strengthen the EU Emissions Trading System ("ETS"), to broaden the sectors covered by the ETS and to establish a Social Climate Fund. Enhancing the ETS is a critical part of the EU commitment (based on the European Green Deal) to reduce GHG emissions across the European Union by at least 55% (from 1990 levels) by 2030, and to do so in such a way that the effect of the transition to net-zero by 2050 will not disadvantage any members of society. The agreement was reached against the backdrop of the war in Ukraine and the heightened focus on energy security across Europe.

The agreement on the enhanced ETS comes shortly after similar provisional agreement was reached (on December 13) on the EU Carbon Border Adjustment Mechanism ("CBAM"), the world's first major carbon border tax. These two regimes are closely intertwined, and in effect are mirror images of one another. They, by far, are the bedrock of the European Green Deal.

The enhanced ETS and the new CBAM are part of a 13-element package known as Fit for 55 in 2030 (reducing GHG emissions by 55% by 2030), first proposed in July 2021, and are key to delivering on the European Green Deal. Both regimes now will need to be formally approved by the European Parliament and the Council. At their core, the initiatives are intended to mitigate the likelihood that, as European industry moves to decarbonize, companies will choose to relocate to jurisdictions outside the European Union that have less stringent climate policies.

An Enhanced Emissions Trading System

The ETS[1] sets a cap on the amount of GHG emissions that can be released from industrial installations in certain sectors: power and heat generation, energy-intensive industrial sectors and commercial aviation. The ETS enshrines the principle of the "polluter pays" and puts a price on carbon (GHG emissions) and lowers permitted levels of GHG emissions on a rolling basis in each subsequent year. Emissions allowances must be bought on the ETS trading market, though a number of free emission allowances were distributed to prevent carbon leakage. The free allowances were the only means of preventing carbon leakage at the time (2005).

In 2021, the installations covered by the ETS represented approximately 40% of total EU GHG emissions. The strengthened ETS targets a 62% reduction (one point higher than that proposed by the Commission) in emissions by 2030 (relative to a 2005 baseline), compared to a 43% reduction under the current ETS regime. The reduction will be accelerated from 2.2% per year to 4.3% in 2023-2027 and 4.4% thereafter. This comes

[1] The ETS is based on Directive (2003/87/EC), last amended in 2018 (by Directive 2018/410/EU), and a series of Decisions and Regulations.

on top of a one-off reduction in each of 2024 and 2026. The Market Stability Reserve, which stabilizes the carbon market by removing surplus allowances, will be strengthened. (*See* European Parliament Press Release and Council Press Release.)

Under the enhanced ETS, free emission allowances will be phased out for those sectors covered by the CBAM as leakage for those sectors will be addressed via the CBAM (*see* below).[2] As for other installations that benefit from free allocations, they will need to comply with conditionality requirements, including in the form of energy audits and for certain installations climate neutrality plans. Additional transitional free allocations may be granted under certain conditions to the district heating sector in certain member states, in order to encourage investments into decarbonizing that sector. Over time, the overall number of free allowances will be reduced.[3] (*See* Commission Q&A.)

The enhanced ETS will now also include shipping (maritime transport) emissions, making the European Union the first jurisdiction to put an explicit carbon price on emissions from the maritime sector. (*See* European Parliament Press Release.) Member states will also need to measure, report and verify emissions from municipal waste incineration installations beginning in 2024, with the aim of including such installations in the enhanced ETS from 2028, with a possible opt-out until 2030 at the latest.

To support member states in their efforts to reduce emissions from buildings and road transport, and certain industrial sectors, a new separate emissions trading system (ETS II) will begin in 2027 for relevant fuel use. ETS II could be postponed until 2028, if energy prices are exceptionally high.

The New Social Climate Fund

Generally, member states are expected to spend the entirety of their emissions trading revenues under the ETS on climate and energy-related projects. The Social Climate Fund, which will start operating in 2026, will provide dedicated financial support to member states to help vulnerable households, micro-enterprises and transport users with investments in energy efficiency measures such as home insulation, heat pumps, solar panels and electric mobility. The fund is intended to offset the impact of ETS II. The fund will also provide direct income support covering up to 37.5% of the new national Social Climate Plans.

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2 *See* explanation of the free allowances in a briefing note published in February 2022 by The Jacques Delors Institute and E3G. The phase-out schedule is as follows: 2026: 2.5%, 2027: 5%, 2028: 10%, 2029: 22.5%, 2030: 48.5%, 2031: 61%, 2032: 73.5%, 2033: 86%, 2034: 100%.

3 For an overview of arguments in favor of reforming the ETS and embracing the CBAM, *see* the open letter submitted on behalf of climate activists and civil society organizations.

The fund will be financed by €65 billion from the EU budget (derived from auctions of ETS II allowances) as well as 25% co-financing by member states, bringing the total to €86.7 billion. (*See* European Parliament Press Release.)

The New Carbon Border Adjustment Mechanism

The CBAM puts a price on the carbon emitted during the production of carbon-intensive goods that are imported into the European Union.[4] It addresses so-called "carbon leakage" that occurs when companies based in the European Union move carbon-intensive production outside the European Union to countries where climate policies are less stringent than in the European Union, or when EU products get replaced by more carbon-intensive imports due to less stringent emissions standards outside the European Union. The CBAM is meant to level the playing field in both scenarios.

Imports of goods in covered sectors from all non-EU countries will be covered by the CBAM. Certain third countries that participate in the ETS or have an emissions trading system linked to the European Union's system, such as members of the European Economic Area and Switzerland, will be excluded from the CBAM.

The CBAM regime initially will apply to the import into the European Union of a selected number of goods in emissions-intensive sectors at high risk of carbon leakage: iron and steel, cement, fertilizer, aluminum and electricity generation, as well as to hydrogen, indirect emissions under certain conditions, certain precursors as well as some downstream products such as screws and bolts and similar articles of iron or steel. (*See* European Parliament Press Release and Council Press Release.)

Under the CBAM, EU importers will buy carbon certificates corresponding to the carbon price that would have been paid had the imported goods been produced under the EU's carbon pricing rules.[5] Conversely, if a non-EU producer can show that it already has paid a price for the carbon used in the production of the imported goods in a third country, the

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4 The Council reached agreement (general approach) on the CBAM in March.

5 National authorities will be responsible for selling CBAM certificates to importers. Importers, either individually or through a representative, will have to register with national authorities in order to purchase CBAM certificates. Importers will need to declare by May 31 of each year the quantity of goods and the embedded emissions in those goods imported into the EU in the preceding year, and must surrender CBAM certificates they have purchased in advance.

The information on embedded emissions for goods subject to the CBAM should be communicated to importers registered in the EU by their non-EU producers. If this information is not available, EU importers will be able to use default values (even once the definitive system is operational) on GHG emissions for each product to determine the number of certificates needed to be purchased. Importers will be able to demonstrate actual GHG emissions during a reconciliation process, and surrender the appropriate number of CBAM certificates, accordingly.

corresponding cost can be fully deducted for the EU importer. In effect, the CBAM is intended to encourage non-EU jurisdictions to follow the EU lead on carbon pricing.

Importers will have to report emissions embedded in their goods without paying a financial adjustment in a transitional phase starting in October 2023 and finishing at the end of 2025. Once the system becomes fully operational in 2026, importers will have to declare annually the quantity of goods and the amount of embedded emissions in the total goods they imported into the EU in the preceding year, and surrender the corresponding amount of CBAM certificates.

As initially proposed, the CBAM was to apply to direct GHG emissions associated with the production processes of the covered products, and by the end of the transition period, the Commission was to evaluate how the CBAM is working and whether to extend its scope to more products and services - including down the value chain, and whether to cover so-called "indirect" emissions (*i.e.*, carbon emissions from the electricity used to produce the good). The most recent announcements note that, before the end of the transition period, the Commission is to assess whether to extend the scope to other goods at risk of carbon leakage, including organic chemicals and polymers, with the goal of including all goods covered by the ETS by 2030. The Commission will also assess the methodology for indirect emissions and the possibility of including more downstream products.

Relationship between the ETS and CBAM

The ETS has been effective in addressing the risk of carbon leakage but it also dampens the incentive to invest in greener production at home and abroad. The CBAM will progressively become an alternative to this. To avoid in effect double protection of EU industries, free emission allowances under the ETS will be phased out, and in their place the CBAM will be phased in at the same speed, between 2026-2034 for those sectors covered by the CBAM.

The CBAM will mirror the ETS in the sense that the relevant carbon price will be based on the price set under the ETS. The price to be paid by importers for certificates will be calculated depending on the weekly average auction price of ETS allowances. By ensuring importers pay the same carbon price as domestic producers under the ETS, the CBAM is designed to ensure equal treatment for products made in the European Union and imports from outside the European Union.

Concluding Thoughts

While most countries signed up to the Paris Agreement and therefore should all be on the same path to net-zero, that is very much not the case. In particular, there is no standard price for carbon and manufacturing processes differ significantly. Not surprisingly then, the CBAM has been criticized by EU trading partners, including the United States and China, as well as by countries in the Global South (for different reasons).

The overall goal should be to avoid damaging protectionism. (Ironically, as highlighted in a prior briefing note (available here), the European Union has levelled its own criticisms at the United States over concerns that the Inflation Reduction Act's "buy American" construct is protectionist.) The Commission has emphasized that the CBAM has been crafted to comply with WTO rules and principles of the General Agreement on Tariffs and Trade, largely based on the mirror image phase-out of the free allowances under the ETS. In theory, as more of the world commits to GHG reductions, the less the friction. But that is a ways off, and there are countless details that will need to be understood over the course of period during which the regime will be phased in.

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December 19, 2022