

Summary

- On 14 July 2021, the European Commission released its proposal for the creation of a **Carbon Border Adjustment Mechanism (CBAM)**, to be introduced across the European Union (EU) from **2023**.
- The CBAM is part of a broader EU plan to reduce greenhouse gas emissions by 55% by 2030, and become climate neutral by 2050.
- In its current form, the CBAM would subject certain goods in the **cement, iron and steel, aluminium, fertilisers** and **electricity** sectors to a carbon adjustment cost based on their emissions when imported into the EU.
- The stated objective of the CBAM is to address the risk of “**carbon leakage**”, that is, the movement of polluting industries from the EU to other parts of the world in order to avoid compliance with more ambitious EU environmental laws and carbon pricing. The European Commission also hopes that the CBAM will incentivise other countries to reduce their emissions and adopt green policy frameworks.
- The Commission has proposed a phased approach to the introduction of the CBAM, with the **initial transition period** from 2023—2025 to be focused on **information gathering** – during this phase, importers will only be subject to carbon reporting obligations. At the end of the transition period, the Commission will carry out an evaluation, focusing in particular on the possibility of extending the CBAM to cover indirect emissions and other goods and services – including further down the value chain.
- The CBAM proposal will now face complex and **lengthy negotiations** involving EU institutions and member states, before possible approval and implementation. Political resistance to the proposal is expected, and many details (such as possible exemptions for third countries with their own carbon pricing mechanisms) are still to be worked out

Report

- The draft regulation on a **Carbon Border Adjustment Mechanism (CBAM)** is one of the key milestones in EU environmental policy this decade, and forms an essential element of the ‘[Fit for 55](#)’ package of policies presented on 14 July.
- The European Commission (the EU’s executive branch) is proposing the adoption of a CBAM in order to address the risk of “**carbon leakage**”, that is, the movement of polluting industries from Europe to other parts of the world in order to avoid compliance with more ambitious EU environmental laws and European carbon pricing. The Commission argues that as long as industrial installations outside the EU are not subject to similarly ambitious environmental laws and carbon pricing, these industries will move production outside Europe and continue polluting, undermining efforts to reduce the emission of greenhouse gases in the EU and globally.
- Although CBAM is frequently described as a border tariff on imports based on their carbon content and the “polluters pay principle”, the European Commission has presented the measure as “an **environmental policy tool** that will equalise the price of carbon between domestic products and imported goods for certain sectors”.

The CBAM Regulation

- The main elements of the proposed CBAM are as follows:

i) Policy mechanism

- The CBAM will be based on the EU's internal carbon pricing mechanism, known as the [Emissions Trading System](#) (ETS). The CBAM will take the form of a '**notional ETS**' without a cap, whereby importers of covered products will be required to surrender CBAM 'certificates' (priced on the basis of the average auction price of EU ETS allowances) equal to the embedded emissions in their imports. CBAM certificates will not be tradeable, but will be able to be sold back to national authorities.

ii) Scope

- The proposed EU CBAM would apply only to certain imported goods in sectors deemed to be most at risk of carbon leakage: **cement, iron and steel, aluminium, fertilisers and electricity**. The European Commission would be able to add products/sectors to the list in the future through secondary legislation.
- The CBAM will only cover **direct emissions** related to the production process (scope 1 emissions). Indirect emissions from electricity (scope 2 emissions) are not covered, though an evaluation in 2026 will assess whether these should be included going forward.

iii) Implementation and transition period

- If the European Commission's proposal is approved by the European Parliament and the 27 EU member states represented in the EU Council, the CBAM will be introduced in what Executive Vice-President (and Commissioner for Trade) Valdis Dombrovskis called a "prudent and gradual way", **applying in a transitional form from 2023 until the end of 2025**.
- During this initial period (2023-25) the CBAM will apply only as a **reporting mechanism**. This means that while importers will have to report the actual emissions embodied in their goods, they will not have to start paying a financial adjustment until the CBAM becomes fully operational.
- At the end of the transition period, the Commission will carry out an **evaluation**, focusing in particular on the possibility of extending the CBAM to cover indirect emissions and other goods and services – including further down the value chain.

iv) Exemptions

- Countries that are part of or linked to the EU ETS (currently Iceland, Liechtenstein, Norway and Switzerland) are exempted from the CBAM, as are some special territories of the EU. Importers from all third countries will be able to seek a reduction in the number of CBAM certificates they have to surrender if they can prove that they have already paid a carbon price in the country of origin. The draft regulation also envisages that the EU will be able to negotiate sectoral agreements with third countries with a view to simplifying this process.
- The European Commissioner for the EU Economy, Paolo Gentiloni, elaborated in a press conference that during the initial transition period (2023-25), the EU will develop a "white list" of exempted exporters from "a very limited list of countries", based on discussions with certain countries that have "already contributed to carbon pricing" with similar national carbon pricing rules to the EU.
- The Commission's CBAM proposal does not currently include exemptions for least-developed countries (LDCs). The draft law limits itself to stating that "the EU stands ready to work with low and middle-income countries towards the de-carbonisation of their manufacturing industries", and commits to supporting LDCs with technical assistance.

v) Free allowances and WTO compatibility

- Under the EU's ETS, free allowances for carbon emissions are currently allocated to heavy industries like cement, steel and chemicals that are deemed to be at risk of carbon leakage.
- The Commission is proposing to gradually phase-out free allowances for sectors covered by CBAM over a ten-year period starting in 2025, declining by 10% each year to reach zero in 2035.
- During the period when the allocation of free allowances is being reduced, the CBAM price will only apply to those emissions above the free allocation received by EU producers, in order to ensure that importers receive the same treatment as EU producers.
- The Commission argues that, along with the clear environmental objectives of the CBAM, this balance between the phase-in of the CBAM and phase-out of EU ETS free allowances is a key factor in making the CBAM WTO-compatible by avoiding providing "double protection" for EU producers.

vi) *Enforcement and anti-circumvention*

- Companies trading with the EU who fail to surrender the required amount of CBAM certificates will be subject to fines corresponding to the number of certificates which they failed to surrender (similar to penalties under the EU ETS).
- Attempts to circumvent the CBAM by reclassifying goods will be addressed through a notification system. EU member states will be able to alert the Commission if they detect that there has been a significant change in trade flows suggesting that circumvention is taking place. The Commission will also monitor trade flows at an EU level. If circumvention is detected, and will be able to add additional products to the regulation.

vii) *CBAM and international cooperation*

- A key point in the political debate over CBAM is whether the EU will be able to secure international support from third countries (or at least prevent outright opposition and trade retaliation) for a unilateral CBAM.
- **European Commissioner Gentiloni** set out the EU's hope that with the unilateral introduction of the CBAM, "companies elsewhere will be incentivised to 'green' their production processes" and foreign governments will be encouraged to introduce greener policies for industry. At the same time, he acknowledged that "there is great interest in how we can cooperate on carbon pricing measures globally" and that the EU stood "ready to discuss the CBAM in the context of the WTO and at the COP26. Cooperation at a global level and European ambition can and will go hand in hand".
- If approved, the lengthy transition period (2023-25) before CBAM becomes fully operational appears to have been designed to leave room for diplomatic talks and the possible conclusion of agreements with third countries that already make companies pay for carbon emissions through their own national carbon pricing schemes.

Reactions to the CBAM proposal

- As discussions begin in earnest after the northern summer break, the EU's CBAM proposal is likely to receive criticism from many internal and external stakeholders - including industries affected by higher carbon pricing, environmentalist groups wanting more ambition to combat the climate crisis, as well as third countries who fear that the proposal may be incompatible with international trade rules.

Comment

- While the release of the draft regulation is a significant milestone in EU policy to combat the climate crisis, **there is still a long road ahead for the CBAM**, both in terms of policy development and eventual implementation. Following the northern summer break, the EU's legislative process will kick into gear, with engagement by the member states in the EU Council and the European Parliament. **The CBAM proposal is expected to evolve in the months to come.**
 - The long transition period and cautious, graduated approach to implementation of the CBAM, combined with an acknowledgement of the need to cooperate actively with international partners,
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suggests that there will be **opportunities for engagement** with the EU on the final design and implementation of the CBAM as the legislative process unfolds.

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