

Carbon Border
Tax Adjustment
(CBAM): Everything
but not tax!



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Carbon Border Tax Adjustment (CBAM): Everything but not tax!

It is proposed by many that COVID-19 pandemic is merely a preview of things to come in the coming times, with much greater challenges of climate change and biodiversity also being a constant threat. This year, the heatwave and floods have swept across continents. Germany alone may require emergency aid upwards of EUR 300 million in the near term . Overall, economic loss due to floods in 2021 across Europe is valued at US\$10 billion . Given this, there is growing pressure on the world governments to ensure the success of COP26 which happens later during the year.



EU Fit for 55 packages

In line with its objective to achieve carbon neutrality by 2050, in December 2019, the EU Commission announced the European Green Deal to decouple economic growth from the use of natural resources and ensure no one is left behind in the green transition

Following the European Green Deal, the European Climate Law set legally binding climate targets to reduce greenhouse gas (GHG) emissions by at least 55% by 2030, as compared to 1990 levels, and subsequently net zero emissions by 2050. The European Commission's "Fit for 55" legislative package, adopted on 14th July 2021, lays down the framework for achieving the 55% emissions reduction target, an important interim goal for achieving and the goal of climate-neutrality by 2050. One of the important elements of the package is the proposal for a carbon border adjustment mechanism ('CBAM') which will tax imports to address risks of carbon leakage. This carbon border tax would reflect the amount of emission associated with the goods imported into the 27-nation region. CBAM policy being implemented has important proponents in Europe. But also has significant impact on the affiliated trading counties and on companies with higher greenhouse gases footprint in Europe.

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<https://www.dw.com/en/germany-promises-massive-aid-for-flood-victims/a-58306951>
<https://www.artemis.bm/news/european-floods-aon-says-economic-loss-very-likely-over-10bn/>

The Fit for 55 package consists of a set of inter-connected proposals, which drive towards the same goal of ensuring a fair, competitive and green transition by 2030 and beyond. Some of the key elements of the inter-connected proposals include the following:

Changes in the EU Emission Trading System (EU ETS)

- ▶ Lower the overall emission cap even further and increase its annual rate of reduction
- ▶ Phasing out of free allowances to by 2026 for aviation sector
- ▶ Include shipping emissions
- ▶ New emissions trading system is set up for fuel distribution for road transport and buildings
- ▶ Increase the size of Innovation and modernization funds

Land use, forestry, and agriculture

- ▶ Target to remove carbon by natural sink equivalent to 310 million tons of CO2 emissions by 2030
- ▶ By 2035, the EU should aim to reach climate neutrality in the land use, forestry and agriculture sectors
- ▶ EU Forest Strategy aims to improve the quality, quantity, and resilience of EU forests
- ▶ Plant 3 billion trees across Europe by 2030

Renewable energy directive

- ▶ Energy production and use accounts for 75% of EU emissions
- ▶ Produce 40% of energy requirement through Renewable sources by 2030
- ▶ Member states will contribute to this goal and specific targets are proposed for renewable energy use in transport, heating and cooling, buildings and industry

Energy effective directive

- ▶ Set more ambitious binding annual target for reducing energy use at EU level
- ▶ Help and guide member states to double the annual energy saving obligation
- ▶ Public sector will require to renovate 3% of their buildings each year to drive the renovation wave, create jobs and bring down energy use and costs to the taxpayer

Standards for cars and vans

- ▶ Zero emission mobility: average emissions of new cars to come down by 55% from 2030 and 100% from 2035 compared to 2021 levels
- ▶ Alternative fuel infrastructure regulations, require member states to expand charging capacity in line with zero emission car sales
- ▶ Start applying emissions trading from 2026 for road transport and buildings

Clean energy supply

- The Alternative Fuels Infrastructure Regulation requires that aircraft and ships have access to clean electricity supply in major ports and airports:
- ▶ Refuel EU Aviation: low carbon fuels known as e-fuels for the aviation industry
 - ▶ Fuel EU maritime: sustainable maritime fuels and zero-emission technologies by setting a maximum limit on the greenhouse gas content

Energy taxation directive

- ▶ Align the taxation of energy products with EU energy and climate policies
- ▶ Remove outdated exemptions and reduced rates that currently encourage the use of fossil fuels
- ▶ Reduce harmful effect on energy tax competition
- ▶ Secure revenues for member states from green taxes, which are less detrimental to growth than taxes on labor

Carbon Border Adjustment Mechanism

- ▶ CBAM will put a carbon price on imports of a targeted selection of products to ensure that ambitious climate action in Europe does not lead to "carbon leakage"
- ▶ European emission reductions contribute to a global emissions decline, instead of pushing carbon-intensive production outside Europe

Carbon Border Adjustment

The CBAM is a climate measure that should prevent the risk of carbon leakage and support the EU's increased ambition on climate mitigation, while ensuring World Trade Organization (WTO) compatibility. The CBAM will equalize the price of carbon between domestic products and imports and ensure that the EU's climate objectives are not undermined by production moving to countries with less ambitious policies. The tax imposed on imported goods from countries with less strict climate policies will spur adaptation of cleaner technologies.

How will this mechanism work?

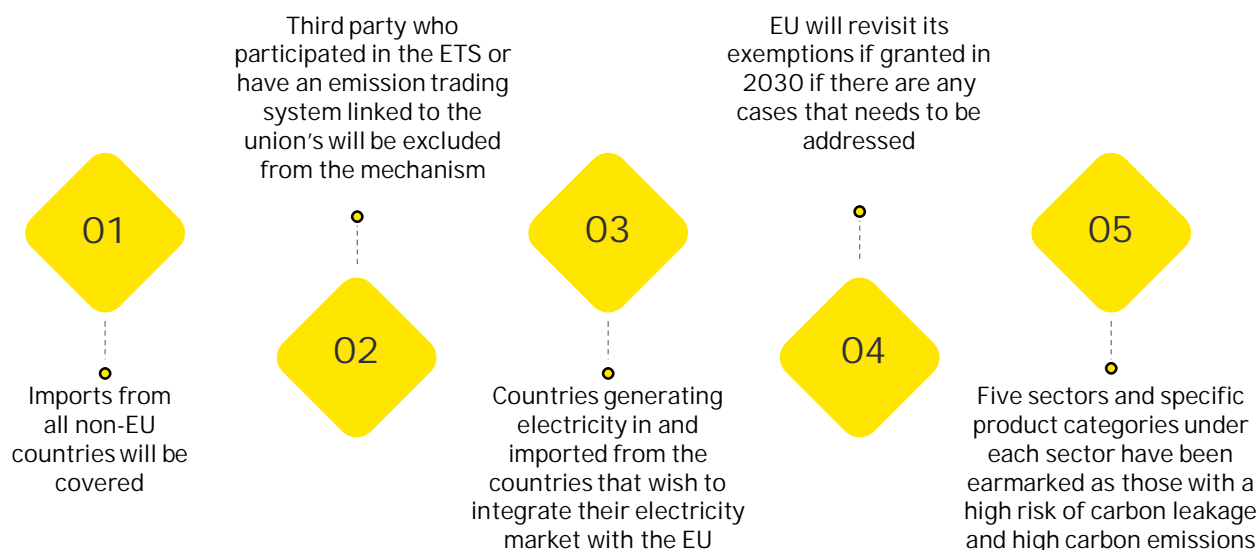
EU importers will buy carbon certificates as CBAM certificates, corresponding to the carbon price that would have been paid, had the goods been produced under the EU's carbon pricing rules. Conversely, once a non-EU producer can show that they have already paid a price for the carbon used in the production of the imported goods in a third country, the corresponding cost can be fully deducted for the EU importer. The price of CBAM certificates is expected to be updated on a weekly basis, unlike the price of EU allowances which changes based on auctions. However, it is also expected that the price of CBAM certificates will closely reflect the price of EU ETS allowances.

The EU Commission has proposed that the CBAM would allow industries in countries outside the EU to register their manufacturing facilities in a central database and to make their verified embedded GHG emissions from production of goods available to authorized declarants in the EU. This would allow operators of installations in countries outside the EU to reduce CBAM certificate requirements for importers of their products in EU by reducing GHG emissions in their operations.

The CBAM is expected to be implemented by 2023, with a transitional period proposed from 2023 until 2025. During this period, a CBAM without financial adjustment is expected to be operational, with the objective to facilitating the introduction of the mechanism with reduced the risk of disruptive impacts on trade. From 2026 onwards, the CBAM is expected to be fully operational.

The CBAM will help reduce the risk of carbon leakage by encouraging producers in non-EU countries to green their production processes. While the CBAM will support the competitiveness of the EU's own production, it will also encourage third countries to develop their own climate regulation and emissions pricing systems.

Scope of CBAM



01	Sector	Materials or material products
	Cement	<ul style="list-style-type: none"> ▶ Clinker ▶ Portland cement
02	Sector	Materials or material products
	Aluminium	<ul style="list-style-type: none"> ▶ Aluminium unwrought ▶ Aluminium unwrought alloyed ▶ Aluminium products ▶ Alloyed aluminium products
03	Sector	Materials or material products
	Iron & Steel	<ul style="list-style-type: none"> ▶ Iron and steel primary forms ▶ Hot rolled and further steps ▶ Coated hot rolled and further steps ▶ Forged, extruded and wire
04	Sector	Materials or material products
	Fertilizers	<ul style="list-style-type: none"> ▶ Ammonia ▶ Urea ▶ Nitric acid ▶ AN (ammonium nitrate)
05	Sector	Materials or material products
	Electricity generation	<ul style="list-style-type: none"> ▶ Electricity

How will CBAM impact developing countries like India?

Effects would vary significantly by country, depending on their export structure and carbon production intensity. India is the third largest trading partner with European Union. India has introduced mechanisms such as Perform Achieve and Trade to apply energy efficiency targets to energy-intensive sectors and Renewable Purchase Obligation to introduce renewable energy targets for industries with captive power plants. India is currently on target to overachieve against the Nationally Determined Contributions (NDCs) for 2030, including the goal of increasing share of non-fossil-based power generation capacity to 40%. India is one of the largest producers of renewable power in the world and has a market ecosystem in which solar power is cost effective compared to coal-based power.

However, in the absence of regulatory carbon pricing in India, and an abundance of coal, the hard-to-abate sectors in India, in general have relatively high GHG emissions intensity. While there is a provision for industrial consumers to procure renewable energy through the grid, namely the open access mechanism, significant regulatory barriers and wide variation in policies from state to state remain. Finally, as there are no caps on absolute GHG emissions and there is no direct carbon taxation in the country, there is limited incentive for Indian businesses to invest in capital-intensive low-carbon technologies that are currently under nascent stages of development. Therefore, the speed of adoption of emerging decarbonization technologies in India such as carbon capture storage and utilization, green hydrogen-based power production and fuel cell technologies are likely to lag compared to other markets which have stronger regulation.

Even in the absence of strong regulatory drivers, leading Indian companies have been voluntarily adopting GHG emission reduction targets. Until July 2021, 24 Indian companies have declared Science Based Targets to reduce GHG emissions aligned with Paris Agreement goals and an additional 33 Indian companies have committed to doing so.

Introducing CBAM will pose challenges to those industries which are exporting to European markets. For example, metal producers in countries with an abundance of low-emission sources for captive power (e.g., hydropower) and with restrictions on fossil-fuel based power plants in the grid will have an advantage over metal producers in India. To drive decarbonization in hard-to-abate sectors in India, a favourable market ecosystem for the adoption of emerging decarbonization technologies is required. A favourable market for utility scale solar based power plants already exists – but this needs to be replicated for a larger range of upcoming technologies through the collaboration between government and business. Some businesses are taking steps in this direction, for example, with the formation of the India Hydrogen Alliance, to support commercialization of hydrogen technologies and to support the proposed National Hydrogen Energy Mission announced in the last Union Budget.

While the current scope of the CBAM may be limited to a few sectors and may not cover most Indian exports to the EU, the CBAM may only be the first step in a global transition in international trade. In the case of steel, China and the Russian Federation would be more affected due to high carbon intensity in production. At the same time, Turkey and India would become more attractive due to low carbon production processes in this sector. Many higher-grade products such as sheets made of iron or steel used in vehicles manufacturing, can still only be produced with blast furnaces. Therefore, EU steel producers could gain an advantage with the carbon border tax they have already lowered their carbon footprints over the years by investing heavily in environmentally friendly and energy-efficient technology. Other nations blast furnace mills may not have made such investments.

Apart from the EU, other geographies such as the United States and Japan have also been considering similar mechanisms and may follow suit. Further, the EU may expand the scope of CBAM to additional sectors to further mitigate the risk of carbon leakage. Therefore, Indian businesses particularly in export-oriented sectors needs to develop long term strategies to mitigate the risk of becoming non-competitive in the international markets with increasing application of carbon border tax.

India's total export

FY 2020-21

21,54,33,924.30

FY 2021-22

2,28,39,089.59

Export to EU Countries

FY 2020-21

3,05,87,907.65

FY 2021-22

31,12,569.12

Share

FY 2020-21

14.2 %

FY 2021-22

13.63 %

Share of materials

Share of Aluminium

FY 2020-21

0.99 %

FY 2021-22

1.608487653 %

Share of Cement

FY 2020-21

0.0000013%

FY 2021-22

0.0000019%

Share of Iron & steel

FY 2020-21

8 %

FY 2021-22

16 %

Share of Fertilizer

FY 2020-21

0.001 %

FY 2021-22

0.00025 %

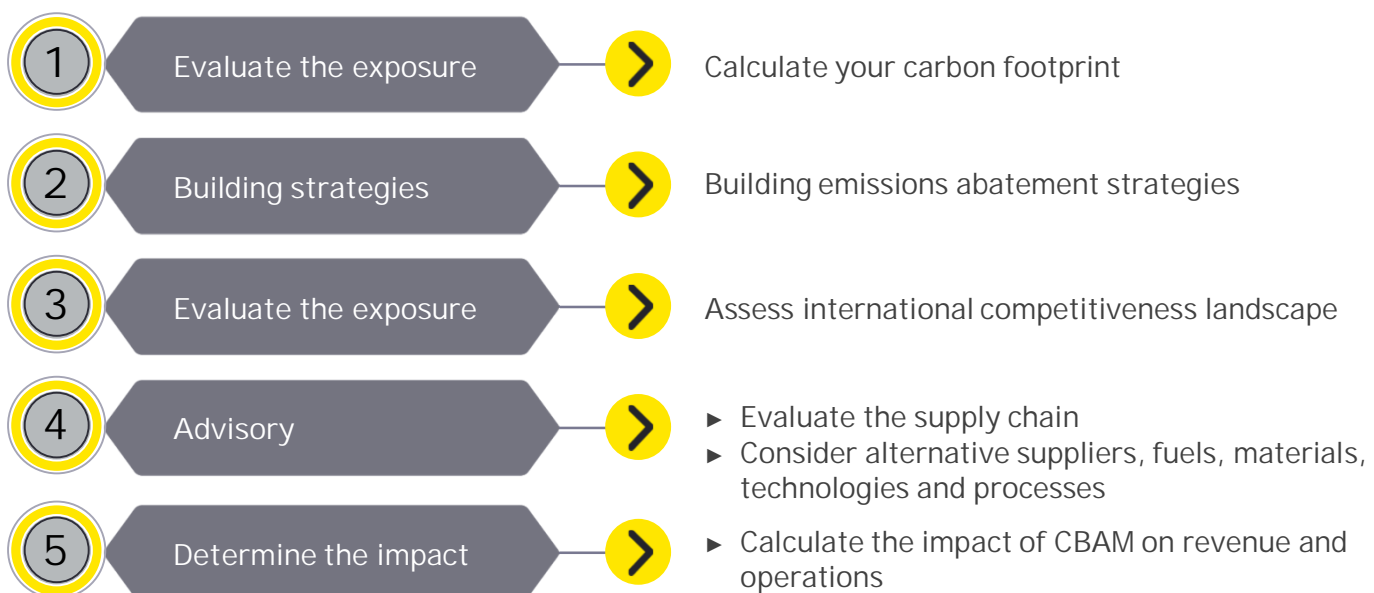
How to prepare for the carbon border tax?

For many countries, carbon border tax could be an opportunity for further innovation in adopting cleaner technologies and for some it would present difficult and urgent, strategic challenges. There will be a dramatic change for companies that rely on the EU as an exporter like India in terms of competition. European companies could be stronger competitors as they would have already borne high capital cost of adopting more eco-friendly production technology, low indirect emission and experience in understanding and managing carbon footprints. Non-European companies might face regulatory pressure to analyse, report and manage their emissions.

Adequate assistance for new technologies and finance needs to be provided without which it would levy taxes on developing countries. Currently it is clear on how EU would assess emission of an imported product, the actual "embedded" emissions covering direct emission associated with the production of the goods, confirmed by an "independent verifier", or will be determined by reference to certain default values for that class of goods.

The price mechanism being uncertain presently, companies should start shaping the policies and strategies as per the European carbon border tax for smoother trading. Recent statements by EU leader's emphasis on environmental challenges at the top of the economic agenda even as the world recovers from the COVID-19 crisis.

The below exhibit suggests the five steps to be adapted by companies on how to prepare for CBAM mechanism:



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