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INTERPLAY OF INDIA'S CARBON PRICING SCHEMES WITH EUROPEAN UNION CARBON BORDER TAX - IMPACT ON INDIAN EXPORTERS

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The Carbon Border Adjustment Mechanism

The European Union's (EU) Carbon Border Adjustment Mechanism (CBAM) came into force on 16 May 2023. The CBAM aims to target carbon leakage, which the European Commission defines as occurring when industries transfer polluting production to countries with less strict climate policies. The CBAM will cover the import of goods from all non-EU countries. However, certain third countries that participate in the EU's Emissions Trading System (ETS) will be excluded from the mechanism.

This new regulation will enter into application in its transitional phase from 1 October 2023 and the permanent system will enter into force on 1 January 2026. During the transitional phase, the CBAM will focus on 6 (six) sectors at high risk of carbon leakage, i.e., cement, iron and steel, aluminum, fertilizer, hydrogen and electricity. In this phase, a reporting system will apply and importers in the recognized sectors will have to report emissions in covered goods but will start paying financial adjustment only in 2026.

Once the permanent system is in operation, the CBAM will require European Union (EU) importers to buy CBAM certificates for goods which are covered by the CBAM. EU importers will have to declare the quantity of goods and the embedded emissions in the goods imported into the EU in the preceding year by 31 May each year and surrender the number of CBAM certificates corresponding to the embedded greenhouse gas emissions. Notably, where a carbon price has already been paid during production of the imported goods and can be proved by the third country producers, the corresponding amount could be deducted – this is where the existing carbon/environmental price schemes in India assume importance.

CBAM and Emissions Trading System

The EU's ETS is a 'cap and trade' international emissions trading scheme which sets a cap on the greenhouse gas emission that industrial installations in certain sectors can release and allows the trading of permits between companies above or below the limits to meet the set targets. The CBAM is envisioned as an alternative that will further encourage investment in green production within and outside the EU and complement the ETS system. In effect, the CBAM will require importing companies to buy CBAM certificates to make up for the difference in carbon price paid in the country of production and the carbon price in the EU, thus ensuring 'equal treatment' and avoiding carbon leakage.

Effect on Indian Players

The CBAM will have major consequences for many Indian exporters. According to the Global Trade Research Initiative, 27% of India's iron, steel and aluminum exports, totaling $8.2 billion in 2022 went to the EU. The CBAM will thus be a substantial levy once it enters into full force, and it is expected that it could potentially lead to an increase of 20-35 percent in the landed cost for exports in the selected categories. Apart from a likely and significant financial impact, it also necessitates a serious introspection of the environmental regime in India and whether India imposes a 'carbon price' that could be proven to allow for deduction under the CBAM system during import.

In this context, there are some forms of environmental pricing built into measures such as Renewable Purchase Obligations and the Perform, Achieve and Trade Scheme (PAT Scheme) in India, as discussed below:

- The PAT Scheme, for example, a regulatory instrument under Section 56 of the Energy Conservation Act 2002 and administered by the Bureau of Energy Efficiency creates obligations upon certain specifically Designated Consumers to meet energy savings targets and involves the issuance of tradeable Energy Savings Certificates. These Energy Saving Certificates are issued to a Designated Consumer upon over-achieving their targets.

- Renewable Purchase Obligations, which function to promote generation of electricity from renewable sources and operate through each State Regulatory Commission, in exercise of its powers under Section 86 of the Electricity Act 2003, setting targets for a percentage of electricity that consumers/distribution licensees/other obligated entities must obtain from renewable sources.

Furthermore, the Ministry of Environment, Forest and Climate Change has recently notified Green Credit Programme Implementation Rules, 2023 to create a market-based mechanism to incentivize environment positive actions through the issuance of 'Green Credits' to individuals, cooperatives, private sectors, industries, organizations, etc. However, none of these steps operate in the exact same manner as the EU ETS 'cap and trade mechanism' and therefore, the EU may not readily accept the same as explicit carbon price mechanisms eligible for deduction under the CBAM.

However, the recently proposed Carbon Credit Trading Scheme (CCTS) in India (which is at a draft proposal stage), proposed under Section 14AA of the Energy Conservation Amendment Act 2022, may be a stronger candidate in this context since it potentially meets the requirements as it would be a 'cap and trade' scheme exactly like the EU ETS.

The CCTS is envisioned to set up a domestic carbon credit trading scheme and the draft CCTS issued by the Ministry of Power envisions both voluntary and compulsory elements. In light of the implementation of CBAM, it is imperative that the final contours of CCTS is designed in a manner that the CCTS would be considered an equivalent emissions trading system so as to allow Indian importers to seek exemptions from additional carbon levies under CBAM on their exports to EU.

Other Developments impacting Indian Exporters

Separately, the European Commission has also notified the EU Deforestation Regulations (EUDR) with respect to restrictions in trading of certain commodities and products associated with deforestation and forest degradation. While the regulations are effective from 29 June 2023, the main obligations thereunder shall not apply until 30 December 2024.

The EUDR permits only those companies to sell products and derivates in the European Union which have procured a confirmation from the suppliers of the goods / product a "due diligence" statement to the effect that the production of the relevant product has not led to degradation of forests and the product has not come from deforested land. The procedure for compliance with the EUDR by persons outside the European Union and the products is yet to pan out, however all relevant products are required to meet the obligations in the EUDR if such products are sought to be placed in the European market.

The EUDR only covers products manufactured from the following 7 (seven) commodities namely cattle, cocoa, coffee, oil palm, rubber, soya and wood and specified products derived from the foregoing commodities.

Conclusion

The European Commission has highlighted its commitment to work with partner countries toward implementation and identification of synergies to promote decarbonization during the transition period, which will have an impact on the final methodology to be used before the CBAM system begins to operate from 1 January 2016.

The Indian government has raised strong objections to CBAM and has even threatened to challenge the same in the World Trade Organisation. This has been discussed between EU and India in the Minister-level meeting in Brussels in May 2023. It is likely that further discussions will take place at a multilateral stage that will seek to mould the recognition of ‘carbon price’ as imposed on third parties to be more inclusive of different regimes. In the meanwhile, policy steps may also be taken in countries to harmonise their systems in some part to the EU’s ETS to allow their exporters who import goods into the EU to maintain competitiveness and avail themselves of deductions.

It will be critical for Indian exporters to EU to closely follow the developments in this regard – thorough review would need to be undertaken and detailed processes will need to be set up to comply with and mitigate carbon price impact whether owing to CBAM in EU or CCTS in India. One thing is clear - emission reduction will no longer be merely an ESG agenda driven goal; it will transcend to a critical-for-survival agenda item for businesses.

So also, the implementation of the EUDR will be a regulatory and environmental challenge and companies await more clarity on the implementation rules and procedure.

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