

We must take a pragmatic approach to carbon pricing

17/10/2024

At the recent Energy Transition Summit, finance minister Nirmala Sitharaman underscored the adverse impact of unilateral and arbitrary policies such as the EU's Carbon Border Adjustment Mechanism (CBAM) on India's trade and green-transition pathways, noting that India's decarbonization journey should be guided by its own development needs and not by the Global North. Sitharaman was referring to the EU's measure that would impose a charge on imports into the EU of products of aluminium, iron and steel, cement, fertilizers, electricity and hydrogen beginning January 2026. The CBAM levy will be calculated on the difference between the carbon price determined under the EU's Emission Trading System (ETS) and the carbon price paid in the export country for the production of such products. The EU's move is accelerating trade friction, given the new barrier it sets up. The US is also reportedly examining a carbon pricing system for imports along similar lines.

There are over 78 different carbon pricing and taxation models worldwide. These fall into two broad categories: ETS and carbon taxes. An ETS works on a cap-and-trade principle, capping the total level of greenhouse gas emissions above which producers pay for their emissions, with prices determined by the demand and supply of emission certificates on a trading platform. A carbon tax sets a state-determined price for carbon by taxing every tonne of carbon dioxide (CO₂) emitted by a production process.



PRACHI PRIYA & R.V. ANURADHA



PRACHI PRIYA & R.V. ANURADHA

While India does not have a formal price for carbon emissions, it is not free. Energy-efficiency targets for energy-intensive sectors, including aluminium and iron and steel, are set under India's Perform, Achieve, Trade (PAT) regulations that have been in place for over 15 years. Renewable Purchase Obligations (RPOs) under the Electricity Act mandate the use of a specified proportion of renewable energy by all distribution companies and captive power plants, the trajectory for which is expected to increase. Indian industry is expected to transition from PAT to the recently announced Carbon Credit Trading Scheme (CCTS), which, like the EU's ETS, should deliver an explicit price for emissions in India.

The carbon price in India is likely to be much lower than in the EU, where a tonne of CO₂ has been in the \$80-100 range over the past year. Under China's ETS, which was rolled out in 2021, carbon is priced at around \$10. The difference between Indian and EU prices is likely to be vast, so CBAM charges would still be a heavy burden on our exports.

We cannot expect uniform prices globally for carbon emissions, not least because each country has different targets under the Paris Agreement. This global pact recognized that developed countries, which are responsible for the bulk of industrial pollution, must bear a higher burden of emission reductions, whereas developing countries must straddle the dual challenge of emission reductions while ensuring sustainable economic development. This is often referred to as the CBDR-RC principle: Common but Differentiated Responsibility and Respective Capabilities.

The price of carbon emissions needs to be based on internationally agreed differential climate obligations of countries. In an op-ed three years ago, the World Trade Organization's (WTO) Director General Ngozi-Iweala highlighted the need for a carbon price that is aligned with the Paris Agreement's nationally determined contributions for emission reductions based on the CBDR-RC principle. While this idea makes immense practical sense, any resolution would necessarily have to account for legal principles, not just of the WTO, but also the UN Framework Convention on Climate Change (UNFCCC), the 29th conference of which (CoP-29) is scheduled for November in Azerbaijan. CoP-29 must address this issue, since the EU's CBAM not only upends WTO principles, it is also an assault on the legal framework under the UNFCCC.

An agreement recognizing differential carbon prices across countries will effectively mean that the EU's CBAM cannot be premised on the EU's ETS price. Achieving a consensus on this, however, appears improbable before 1 January 2026, when the CBAM kicks in. While India's government should fight unilateral measures like CBAM at both the WTO and UNFCCC, we will need short-term measures to mitigate its impact on Indian industry. First, the Centre must assist industry in arriving at an implicit price of CO₂ emissions by setting a standardized approach for calculating the impact of prevailing instruments such as PAT and RPOs. A second important step would be to explore how multiple levies on coal, mining, electricity, fuels, etc, can be rationalized as these also contribute to the cost of energy-intensive goods. In the case of some industries, the cumulative impact of PAT and RPOs, along with other taxes and levies, has been estimated at approximately \$25-30 per tonne of CO₂, which is almost one-third of Europe's current carbon price. It is unlikely, however, that the EU's CBAM would allow the adjustment of this entire amount, since not all of these are explicitly tied to a price on emissions. Whether the many different taxes that industry pays can be consolidated into a single carbon tax is an important

point for consideration. This will potentially ease the compliance burden of Indian businesses, streamline government revenues and also help India seek adjustments for carbon taxes and prices in any form globally.

These are the authors' personal views.