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EU's Proposed Carbon Border Adjustment Mechanism

IETA's Position

Net-Zero & Carbon Leakage

The European Commission has proposed a bold legally binding target of climate neutrality that reaches Net-Zero greenhouse gas emissions by 2050. IETA fully supports this climate neutrality objective, that is in line with the EU's commitment to global climate action under the Paris Agreement.

In order to reach Net-Zero emissions by 2050, the European Commission will have to take decisive steps to increase climate ambition. This will include ensuring a carbon price signal across all areas of the economy, and strengthening European climate policies including the EU ETS, resulting in higher carbon prices. IETA fully supports this objective, but accepts that this will cause further divergence between EU climate regulations and other jurisdictions, thus increasing the risk of carbon leakage. Unless other jurisdictions work toward a global level playing field in carbon regulation, the faster the EU moves toward Net-Zero, the higher the chance that carbon leakage will occur.

IETA strongly believes that the EU ETS is the most effective mechanism for driving Europe's decarbonisation. We recognise that carbon leakage measures no longer reflect the current situation, nor the future scenarios envisaged by the European Commission. The measures of free allowances and indirect cost are already incomplete for some sectors, and in the light of the EU's Climate Neutrality Target, carbon leakage policies will need to be updated and revised to align with this goal.

Carbon Leakage presents a two-fold challenge:

1. It undermines the EU's climate objectives and increases the risk that European decarbonisation can be made ineffective in global terms by GHG emission increases in other jurisdictions.
2. It reduces the ability of European industry to stay competitive at a time when Europe is rapidly decarbonising, and creates a disadvantage for European companies in other markets.

By proposing a Carbon Border Adjustment Mechanism (CBAM), the European Commission has initiated a much needed conversation about the growing risk of carbon leakage. IETA fully agrees with the need for discussion on this critical issue, which has created a unique chance to revaluate carbon leakage policies. IETA believes the best way of ensuring carbon leakage cannot undermine Europe's Net-Zero pathway is through recognising the benefits of market-based mechanisms to achieving effective and transparent decarbonisation.

The most efficient way to ensure that carbon leakage does not occur is through international cooperation in the area of carbon markets. This will require working toward a robust framework for Article 6 of the Paris Agreement, and ensuring that international action is enabled through EU law under specific conditions. Put simply, international linkages and harmonisation of carbon markets will provide the most cost-effective and efficient solution to the challenge of carbon leakage. This is an international solution for a global problem.

Whilst IETA strongly believes that that transforming the EU ETS from a regional tool to an international multilateral mechanism is the best way to address carbon leakage, we recognise that this is a long-term goal. In the short-term, IETA supports the proposal for a CBAM as a stepping stone to this goal, and as one part of the broader climate package proposed by the European Commission. Such a mechanism could be a pragmatic tool for harnessing the European market to achieve the goals of the Paris Climate Agreement, addressing emissions, encouraging global ambition, and preserving the competitiveness of European industry.

CBAM Mechanism

Of the four CBAM mechanisms mentioned in the public consultation, IETA strongly believes that the third would be both the most efficient and effective (The obligation to purchase allowances from a specific pool outside the ETS, dedicated to imports, which would mirror the ETS price).

This would constitute a separate pool of allowances, not simply another pool of EUAs, nor a standalone traded ETS. Importers would be obliged to surrender EUA-like allowances which exactly mirror the domestic ETS price and are regulated through ETS rules. Designing the CBAM in this way would allow the EU ETS to remain as Europe's primary decarbonisation instrument. Given the well-established efficacy of the EU ETS, a CBAM structure determined by EU ETS prices and rules can provide confidence that this mechanism ensures the same fair and transparent environmental result as the EU ETS, both today and in the future.

This system has clear benefits:

1. Ensuring that this separate pool is subject to the same price as the EU ETS is much more transparent and flexible than a fixed price. It is also the only way to protect this system from WTO discrimination challenges.
2. Pre-existing ETS rules are already well understood by European industry.
3. Such a scheme would be straightforward to fix and isolate in case of problems.

IETA proposes that to ensure this mechanism works as intended, there should be a trial phase for certain sectors. The same should be true for free allocation. If free allocation is to be replaced, it must be done gradually with a phase-in period to avoid the risk of shocks to the EU ETS and serious economic disruption within sectors covered by the CBAM.

Of the other three options proposed in the CBAM consultation, two alternatives (6.1 & 6.4) are taxes. IETA strongly opposes these measures. The simple reason behind the success of the EU ETS is that it is a market based mechanism which gives clear incentives to market participants through a tradeable commodity and a legally binding cap. These proposed taxes (6.1 & 6.4) are not able to give such clear incentives, and run the risk of double taxation for importers. Compared to options 6.2 or 6.3, which do not discriminate, are based on objective criteria, and have a clear environmental objective, it is doubtful that the tax options would be deemed compliant to WTO rules.[1]

Despite strongly supporting the continued success of the EU ETS, IETA does not feel that including imports into the EU ETS (6.2) from the beginning is the right way forward, although it is preferable to non-market-based approaches. Whilst the only other jurisdiction to implement a Border Carbon Adjustment (California) does include this mechanism within their Cap and Trade system, there is a critical difference. The Californian Cap and Trade system was established at the same time as the Border Carbon Adjustment. This meant that there was no pre-existing system which could have been jeopardised by the mechanism. The EU context is very different; the EU ETS has been running successfully for 15 years, and has become the cornerstone of European climate plans. It achieves verifiable climate goals through a defined emissions cap, is well understood by market participants, and is the foundation of the EU's Net-Zero target. We must be mindful that an extension of the EU ETS to imports carries potential risks to the system's effective functioning. What happens to the price when such a large sector is included is unknown, the overall EU carbon budget will be put into question, the pool of allowances will be impacted, as will the Cross-Sectoral Correction Factor. Should assurances and comprehensive evidence be provided that such issues could be solved in the longer term, IETA is supportive of considering eventual expansion of the EU ETS to directly include imports.

Carbon Intensity of Imported Products

IETA believes that it is the importers' responsibility to disclose the carbon footprint of what they are importing. The question of how to account for the carbon intensity of the product whilst taking into account complex global supply chains and varying carbon pricing regimes, is deeply complex. IETA acknowledges that there will always be a trade-off between accuracy and simplicity in relation to this issue.

Carbon footprinting methodologies exist across several sectors where traceability around carbon content disclosure is assured. IETA strongly encourages the European Commission to look at these pre-existing examples of how to calculate the carbon content of products. For example, in the cement sector, there is already a global standard for measuring carbon intensity (CEN EN 19694-3 1). This globally harmonised standard for calculating emissions derived from clinker and cement production is the foundation of the Getting The Numbers Right Database. This publicly available database lists all emissions (direct and indirect) associated with the global cement industry. Whilst IETA does not wish to advocate for any one methodology, this example illustrates that different sectors already have industry-wide standards which can be used as the basis for the CBAM's carbon disclosure process.

Given that the overriding aim of the CBAM must be to encourage global climate ambition, it is critically important to differentiate in a detailed way by products, facilities, and jurisdictions. The methodology must be based on verified emissions data, reflecting the calculation methodology used by the EU for benchmarking. However, if a methodology is used which simply adopts broad jurisdictional or industry-wide averages, there is no incentive for firms to invest and lower the carbon intensity of their products.

[1] Draft Opinion of the Committee on Economic & Monetary Affairs for the Committee on Environment, Public Health, & Food Safety: "*Towards a WTO-Compatible EU Carbon Border Adjustment Mechanism*" (Oct, 2020)

This would severely undermine the key motivation for implementing a CBAM; driving climate action by providing incentives to other jurisdictions and companies outside the EU to reduce their emissions.

IETA is in favour of strong regulation and transparent standards. If a CBAM is to be introduced, the EU must provide guarantees that importers will follow the MRV model. This would ensure that there is no avoidance of the CBAM by faking the origin of the products and claiming the product has originated from a country with similar carbon pricing standards.

CBAM & European Climate Policy

Although critical, IETA believes that the proposed CBAM should be viewed as one element in a broader package of climate policies. It will only be effective if complimented by other elements, such as outreach and diplomacy with global trading partners.

A key priority of the CBAM must be to encourage increased global climate ambition. It is IETA's view that the European Union should prioritise negotiations with trading partners likely to be affected, prior to the imposition of the CBAM. These negotiations should work toward helping other jurisdictions reach a level playing field in terms of carbon pricing. The most straightforward way to achieve this is through encouraging other jurisdictions to move toward emissions trading and eventual linkage with the EU ETS. Some jurisdictions already have ETS systems that are mature enough to allow for linkage, others will need more assistance in reaching this point.

Earlier this year, international linkage was achieved between the EU and Switzerland; an agreement that will clearly benefit both. This linkage proves that it can be done, and provides a framework for negotiations with other countries. The European Commission should be mindful that similar policy ambitions are needed for a link to happen, leading to an equal CO2 cost burden for industries in the two different jurisdictions.

Once linkage has been achieved (or an equivalent domestic carbon price put in place), the CBAM must dissolve. This provides a clear incentive for other jurisdictions to fast-track the process of implementing carbon pricing with a similar level of ambition to the EU. As a recent study from the Jacques Delors Institute notes, this must then be "*subject to periodic review and adaptation, as was the case for the implementation of the EU ETS*".[2] No variant of a CBAM is free of technical, legal, or political challenges. This makes the desirable long-term outcome one in which such mechanisms are no longer needed.[3]

Working with key trading partners to ensure parity in carbon pricing is not merely a tool to avoid the imposition of the CBAM. The most efficient way for carbon markets to truly effect an outcome consistent with the Paris Climate Agreement, is if Governments around the world work toward a series of ETS linkages and harmonisation that eventuate in a global carbon pricing system. The result of this would be a global level playing field in carbon pricing, and largely aligned cost implications for industry across jurisdictions. This has the global potential to enable $250 billion per year of cost reductions to Nationally Defined

[2] Europe Jacques Delors: "*Greening EU Trade – A European Carbon Border Adjustment Proposal* " (2020)
[3] ERCST: "*Border Carbon Adjustments in the EU – Issues and Options"* (2020)

Contributions (NDC) by 2030, according to a recent study modelled by the University of Maryland, and has the capacity to allow for a more even playing field in relation to competitiveness concerns.[4] In short, trading between sectors and countries that are subject to emissions limits/caps can enable and galvanize global community action to get farther and faster towards Net-Zero together.

IETA strongly encourages the European Commission to consider how to use the CBAM as an opportunity to spearhead the development of international carbon markets. However, if the EU wishes to bring other countries with them on the journey to Net-Zero, IETA is clear that the overarching purpose of the CBAM must be as a climate instrument rather than a resource tool. Revenue generation creates a perverse incentive for a CBAM. Putting a price on carbon is designed to minimise it, not to enable a new revenue stream for policymakers. A clear sign that the CBAM is functioning will come when the volume of imports having to comply with it reduces, meaning that any revenues created from such a policy will necessarily be unsustainable.

The danger of revenue generation driving the design of the mechanism is that it will obscure the two central drivers for this policy – 1. The desire to ensure that the EU can reach Net-Zero without the risk of carbon leakage, 2. The opportunity to encourage key trading partners to match the EU's level of climate ambition.

Conclusion

Carbon leakage is a clear threat to the EU's target of reaching climate neutrality by 2050. The imposition of a CBAM has the capacity to address carbon leakage, safeguard the competitiveness of European industry, and encourage global climate ambition. To achieve these goals and remain compliant under WTO law, the CBAM must be designed as a market-based mechanism. IETA's preferred option is the establishment of a separate pool of allowances for imports that mirror the ETS price and are regulated through ETS rules.

The overall objective should be that by creating a global level playing field in carbon pricing, a CBAM is no longer required. By helping other jurisdictions to institute carbon pricing regimes that match levels of climate ambition in the EU, and working toward linkages and harmonisation that reduce the cost burden of trading for industry, Net-Zero can be achieved both cheaper and faster.

[4] IETA & Carbon Pricing Leadership Coalition: "*The Economic Potential of Article 6 of the Paris Agreement and Implementation Challenges"* (2019)