Mexico-EU Town Hall on Border Carbon Adjustment: An Update on Developments in the EU

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Why Are We Discussing This Now?

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- **Asymmetrical climate change policies**
- **Old methods may not work**
- **Increased level of ambition**
  - Paris Agreement → continued asymmetry of climate efforts
  - European Green Deal
  - Carbon neutrality targets
- **How do we deal with competitive pressures and carbon leakage?**
  - Free allocation/compensation of indirect costs
  - Internationalization/linking/Article 6 Paris Agreement
  - Border carbon adjustments
  - Other options (e.g. consumptions charges; contracts for difference; product standards)?
    - **Consumption charges**: charge that extends the carbon price to consumers based on the weight and type of material in a final product
    - **Contracts for difference**: financial award for low-carbon investments based on the amount of avoided carbon and a set carbon price

Context: „European Green Deal“

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New European Commission under Ursula von der Leyen takes office in December 2019, announces ambitious **‘European Green Deal’** with the following elements:

- Climate neutrality by 2050, to be enshrined in a ‘European Climate Law’ (also strong push to increase 2030 target from current 40%)
- Action on circular economy (e.g. single-use plastics), biodiversity conservation & sustainable farming, adaptation, ‘zero-pollution’
- ‘Sustainable Europe Investment Plan’ of €1 trillion for 2021-2030
- **‘Carbon Border Adjustment Mechanism’** to address trade impacts

→ Europe’s executive, the European Commission, is currently elaborating the legislative framework for these components on an ambitious timeline

The „European Green Deal“

Europe‘s Border Carbon Adjustment: State of Play

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- December 2019: **European Council** endorses work, states that ‘facilities in third countries need to adhere to the highest environmental … standards’
- March 2020: **Inception Impact Assessment Roadmap** and public consultation on the elements of the CBAM feedback IA; 219 submissions
- May 2020: European Commission mentions CBAM revenue (‘€5 to €14 billion per year’) as potential source for EU Recovery Plan **(‘Next Generation EU’)**
- Confirmed by the historical **European Council** in July (EU budget 2021-2027, Recovery Package) – BCA introduction by 2022…
- Next steps: **public consultations** until October 28; **proposal** expected around June 2021

Border Carbon Adjustment: What do We Know? (1)

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- **Political Guidelines of 16 July 2019:**

  *'To complement this work, and to ensure our companies can compete on a level playing field, I will introduce a **Carbon Border Tax** to avoid carbon leakage. This should be **fully compliant** with World Trade Organization rules. It will start with a number of **selected sectors** and be **gradually extended**.'*

Border Carbon Adjustment: What do We Know? (2)

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- Mission Letter to **Paolo Gentiloni**, incoming Commissioner for the Economy, 10 September 2019:

*'You should **lead** on the proposal of a **Carbon Border Tax**, working closely with the Executive Vice-President for the European Green Deal. This is a **key tool** to avoid carbon **leakage** and ensure that EU companies can compete on a level playing field. The Carbon Border Tax should be fully compliant with **WTO rules**.'*

Member States Support BCA

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EU nations pressure Brussels to bring forward carbon border tax proposals

Published 21:05 on February 27, 2020 / Last updated at 21:05 on February 27, 2020 / EMEA, EU ETS / Carbon Pulse

EU member states want Brussels to propose an EU carbon border adjustment tax earlier than 2021 to help safeguard the bloc's heavy industry, several national ministers said on Thursday.

Council of the European Union meeting (27 February 2020):

- *"The competitiveness of our industry is at stake due to the risk of carbon leakage, so we need to start working on in the second half of this year"*, **Maria Reyes Maroto, Spanish** Minister for Industry, Trade and Tourism
- *Germany, France and Italy [are also] "impatiently waiting" for Commission's proposals on border measures*

Member States Support BCA

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- **Germany / France** supported the idea of CBAM supplementing the existing instruments in line with WTO in the statement on the **Recovery Package 18, May**
- The Ursula's von der Leyen **Commission** put the BCA among the fiscal issues (DG TAXUD) leading to EU's own resources and making it more likely to implement
- **Poland** is in line with the CBAM as a mechanism protecting EU's competitiveness and potential source of funding to the modernization / innovation / just transition mechanisms

Inception Impact Assessment and results

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Inception Impact Assessment Roadmap

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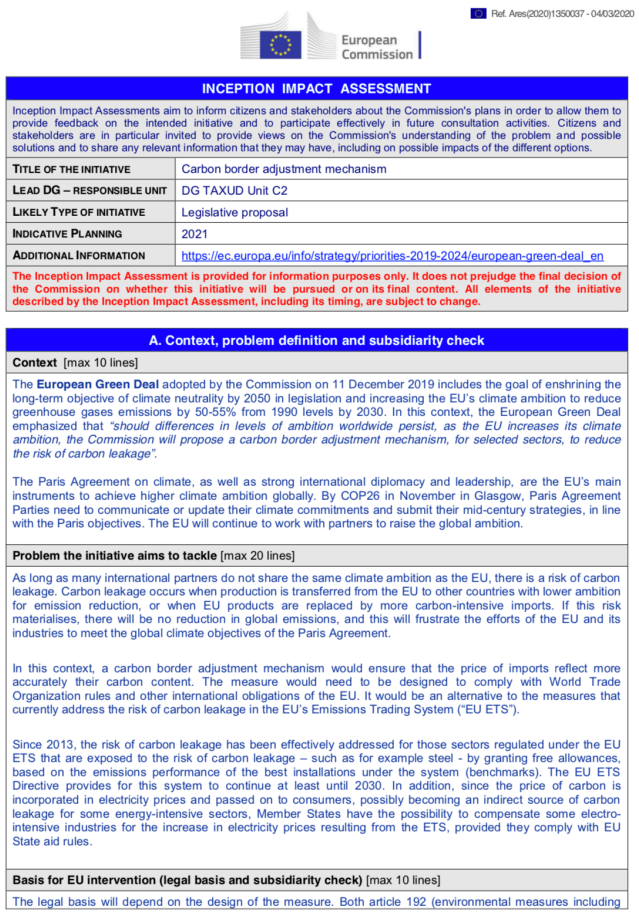
(Published 4 March 2020)

Timeline

- Feedback period: 4 March-1 April 2020
- Commission adoption: planned for second quarter 2021

Issues to be studied:

- Type of <u>policy instrument</u>:
  - carbon tax on selected products (imports & domestic)
  - a new carbon customs duty or tax on imports
  - extension of the EU ETS to imports
- <u>Methodological approach</u> to evaluating the carbon content and carbon pricing of imported products
- <u>Sectoral scope</u>



Ref. Ares(2020)1350037 - 04/03/2020

European Commission

INCEPTION IMPACT ASSESSMENT

Inception Impact Assessments aim to inform citizens and stakeholders about the Commission's plans in order to allow them to provide feedback on the intended initiative and to participate effectively in future consultation activities. Citizens and stakeholders are in particular invited to provide views on the Commission's understanding of the problem and possible solutions and to share any relevant information that they may have, including on possible impacts of the different options.

TITLE OF THE INITIATIVE	Carbon border adjustment mechanism
LEAD DG – RESPONSIBLE UNIT	DG TAXUD Unit C2
LIKELY TYPE OF INITIATIVE	Legislative proposal
INDICATIVE PLANNING	2021
ADDITIONAL INFORMATION	https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

The Inception Impact Assessment is provided for information purposes only. It does not prejudge the final decision of the Commission on whether this initiative will be pursued or on its final content. All elements of the initiative described by the Inception Impact Assessment, including its timing, are subject to change.

A. Context, problem definition and subsidiarity check

Context [max 10 lines]

The **European Green Deal** adopted by the Commission on 11 December 2019 includes the goal of enshrining the long-term objective of climate neutrality by 2050 in legislation and increasing the EU's climate ambition to reduce greenhouse gases emissions by 50-55% from 1990 levels by 2030. In this context, the European Green Deal emphasized that *"should differences in levels of ambition worldwide persist, as the EU increases its climate ambition, the Commission will propose a carbon border adjustment mechanism, for selected sectors, to reduce the risk of carbon leakage"*.

The Paris Agreement on climate, as well as strong international diplomacy and leadership, are the EU's main instruments to achieve higher climate ambition globally. By COP26 in November in Glasgow, Paris Agreement Parties need to communicate or update their climate commitments and submit their mid-century strategies, in line with the Paris objectives. The EU will continue to work with partners to raise the global ambition.

Problem the initiative aims to tackle [max 20 lines]

As long as many international partners do not share the same climate ambition as the EU, there is a risk of carbon leakage. Carbon leakage occurs when production is transferred from the EU to other countries with lower ambition for emission reduction, or when EU products are replaced by more carbon-intensive imports. If this risk materialises, there will be no reduction in global emissions, and this will frustrate the efforts of the EU and its industries to meet the global climate objectives of the Paris Agreement.

In this context, a carbon border adjustment mechanism would ensure that the price of imports reflect more accurately their carbon content. The measure would need to be designed to comply with World Trade Organization rules and other international obligations of the EU. It would be an alternative to the measures that currently address the risk of carbon leakage in the EU's Emissions Trading System ("EU ETS").

Since 2013, the risk of carbon leakage has been effectively addressed for those sectors regulated under the EU ETS that are exposed to the risk of carbon leakage – such as for example steel - by granting free allowances, based on the emissions performance of the best installations under the system (benchmarks). The EU ETS Directive provides for this system to continue at least until 2030. In addition, since the price of carbon is incorporated in electricity prices and passed on to consumers, possibly becoming an indirect source of carbon leakage for some energy-intensive sectors, Member States have the possibility to compensate some electro-intensive industries for the increase in electricity prices resulting from the ETS, provided they comply with EU State aid rules.

Basis for EU intervention (legal basis and subsidiarity check) [max 10 lines]

The legal basis will depend on the design of the measure. Both article 192 (environmental measures including

Feedback to IIA overview

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- **219 submissions** presented by April 1, 2020
- Both from the EU and outside:
  - Companies/business organizations (62), business associations (89), academic/research institutions (10), consumer organizations, individuals (21), non-governmental organizations (21) and (4) public authorities (from Malta, Sweden, Ukraine, Italy)
- Based on the quality and the relevance of the submissions, the overview of **32** was presented in the summary **in alphabetical order**
- Most numerous categories were put in the **synthesis** (industry/associations, NGOs, think tanks/research institutes)

Key elements

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The **key elements of the synthesis** focus on the following aspects:

- The perceived objective of a BCA (environmental, competitive, diplomatic, fiscal);
- Developing policy options:
  - Type of policy instrument;
  - The methodological approach to evaluating the carbon content;
  - Emissions/sectoral and geographical/trade scopes;
- The use of revenues (internal, external);
- The operationalization of a BCA (cooperation)

ERCST Takeaways

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- Carbon Border Adjustment Mechanism (CBAM) topic of high interest and relatively **high on the agenda**
- The feedback was **generally positive** both from NGO and business circles
- Most submissions focus on the **essence of the mechanism**, less on the scope of the IIA itself
- As a consequence of submitted papers, there will be need for further thinking how to design the mechanism and a single or multiple **formula for calculating the adjustment**

Direction of ERCST Study

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ERCST Activities

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- **Project:** 'Border Carbon Adjustments in the EU: Issues and Options'
  - Full **Report** 30 September 2020
- Submitted **Feedback** to the Inception Impact Assessment consultation
- Ongoing **stakeholder engagement and convening**:
  - March 5th: Dissecting and Assessing CBAM Design Options
  - March 25th: High-Level International Roundtable
  - April 15th: Evaluating Alternative CBAM Scenarios
  - May 28th: Inception Impact Assessment Feedback Summary & Synthesis
  - June 9th: Exploring Alternatives to the CBAM
- **International outreach** ('Virtual Town Halls') to EU trade partners: USA, South Korea, India, Japan, South Africa, Mexico, Russia, Ukraine

Project website: https://ercst.org/border-carbon-adjustments-in-the-eu

Our Approach: Decomposing, Evaluating & Comparing

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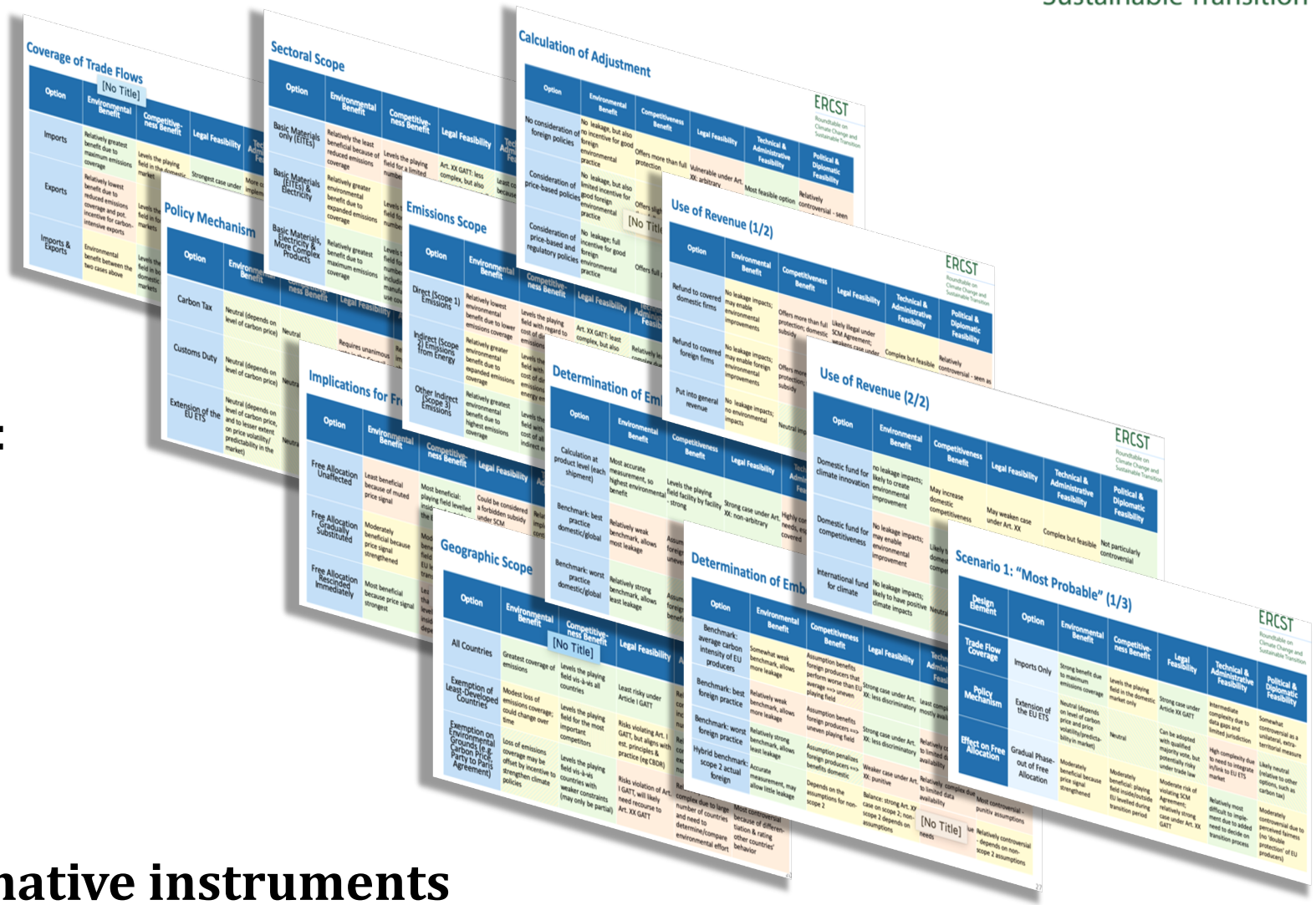
- **Nine Design Elements**:
  Coverage of trade flows
  Policy mechanism
  Geographic scope
  Sectoral scope
  Emissions scope
  Determination of embedded emissions
  Calculation of adjustment
  Use of revenue

- **Five Evaluation Criteria**:
  Environmental benefit
  Competitiveness benefit
  Legal feasibility
  Technical and administrative feasibility
  Political feasibility

- **Scenario-Building:**
  'Most Probable'
  'Play it Safe'
  'Go Getter'

- **Comparisons** with **alternative instruments**



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Example: Decomposition of BCA Design Steps (here: 'Trade flow')

Option	Environmental Benefit	Competitive-ness Benefit	Legal Feasibility	Technical & Administrative Feasibility	Political & Diplomatic Feasibility
Imports Only	Relatively greatest benefit due to maximum emissions coverage	Levels the playing field in the domestic market	Strongest case under Article XX GATT	More complex to implement due to data gaps and limited jurisdiction	Controversial as a unilateral, extraterritorial measure
Exports Only	Relatively lowest benefit due to reduced emissions coverage and pot. incentive for carbon-intensive exports	Levels the playing field in foreign markets	Risks being considered a forbidden subsidy under SCM Agreement; weak Art. XX GATT case	Least complex to implement because purely domestic and data readily available	Least controversial because purely territorial measure with no obligations for foreign producers
Imports & Exports	Environmental benefit between the two cases above	Levels the playing field in both domestic & foreign markets	Same as above, plus even greater risk under SCM Agreement	More complex to implement for imports due to data gaps and limited jurisdiction	Most controversial because of extraterritoriality and perceived protectionism

Example: BCA Scenario-building (here: 'Most Probable', 1/3)

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Design Element	Option	Environmental Benefit	Competitive-ness Benefit	Legal Feasibility	Technical & Administrative Feasibility	Political & Diplomatic Feasibility
Trade Flow Coverage	Imports Only	Strong benefit due to maximum emissions coverage	Levels the playing field in the domestic market only	Strong case under Article XX GATT	Intermediate complexity due to data gaps and limited jurisdiction	Somewhat controversial as a unilateral, extra-territorial measure
Policy Mechanism	Extension of the EU ETS	Neutral (depends on level of carbon price and price volatility/predicta-bility in market)	Neutral	Can be adopted with qualified majority vote, but potentially risky under trade law	High complexity due to need to integrate in/link to EU ETS market	Likely neutral (relative to other options, such as carbon tax)
Effect on Free Allocation	Gradual Phase-out of Free Allocation	Moderately beneficial because price signal strengthened	Moderately beneficial: playing field inside/outside EU levelled during transition period	Moderate risk of violating SCM Agreement; relatively strong case under Art. XX GATT	Relatively most difficult to imple-ment due to added need to decide on transition process	Moderately controversial due to perceived fairness (no 'double protection' of EU producers)

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Example: Comparison of BCA Scenarios

Scenario	Design Choices		Environmental Benefit	Competitive-ness Benefit	Legal Feasibility	Technical & Administrative Feasibility	Political & Diplomatic Feasibility
'Most Probable'	**Trade Flow Coverage:** **Policy Mechanism:** **Geographic Scope:** **Sectoral Scope:** **Emissions Scope:** **Calc. of Embedded Carbon:** **Calculation of Adjustment:** **Use of Revenue:**	Imports only Extension of the EU ETS Exemption of LDCs Basic materials & electricity Scope 1 & Scope 2 Benchmark (avg. EU) Price-based policies Domestic innovation fund	Extends carbon price to imports & replaces free allocation; but use of averages limits benefits	Effectively levels the playing field in the domestic market, but not in foreign markets, nor downstream	Likely to pass muster under WTO law due to Article XX GATT; requires qualified majority vote in the EU Council	Intermediate complexity in terms of data needs and administrative/ regulatory framework	Intermediate risk of controversy as a unilateral, extra-territorial measure
'Play it Safe'	**Trade Flow Coverage:** **Policy Mechanism:** **Geographic Scope:** **Sectoral Scope:** **Emissions Scope:** **Calc. of Embedded Carbon:** **Calculation of Adjustment:** **Use of Revenue:**	Imports only Extension of the EU ETS Exemption of LDCs Basic materials only Scope 1 only Benchmark (best practice) Price-based policies International climate fund	Extends carbon price to imports; limited scope and use of generous averages limits benefits	Somewhat levels the playing field in the domestic market, but not in foreign markets, nor downstream	Very likely to pass muster under WTO law due to Article XX GATT; requires qualified majority vote in the EU Council	Lowest complexity in terms of data needs and administrative/ regulatory framework	Lowest risk of controversy as a unilateral, extra-territorial measure
'Go Getter'	**Trade Flow Coverage:** **Policy Mechanism:** **Geographic Scope:** **Sectoral Scope:** **Emissions Scope:** **Calc. of Embedded Carbon:** **Calculation of Adjustment:** **Use of Revenue:**	Imports and exports Extension of the EU ETS Exemption of clim. leaders Basic+complex goods, elec. Scope 1, 2 & 3 Actual emissions Price and regulat. policies Domestic innovation fund	Extends carbon price to imports, but exempts exports; broad scope and actual carbon intensity strengthen benefits	Effectively levels the playing field in domestic and foreign markets as well as downstream	My not pass muster under WTO law due to SCM and complexity; requires qualified majority vote in the EU Council	Highest complexity in terms of data needs and administrative/ regulatory framework	Highest risk of controversy as a unilateral, extra-territorial measure

Example: Comparison across Instruments

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Policy Option	Proposal/ Variant	Environmental Benefit	Competitive-ness Benefit	Legal Feasibility	Technical & Administrative Feasibility	Political & Diplomatic Feasibility
Border Carbon Adjustment	"Most Likely"	Extends carbon price to imports & replaces free allocation; but use of averages limits benefits	Effectively levels the playing field in the domestic market, but not in foreign markets, nor downstream	Should pass muster under WTO law due to Article XX GATT; requires qualified majority vote in the EU Council	Intermediate complexity due to data needs and administrative/regula tory framework	High degree of controversy as a unilateral, extra-territorial measure
Consumption Charge	"Inclusion of Consumption"	Internalizes cost of carbon across value chain, but no or limited differentiation	Without free allocation: only protects against its own competitive-ness impacts	Does not impinge on WTO/state aid rules; but may require a unanimous vote in the EU Council	High complexity due to data needs and administrative/regula tory framework	Likely minimally con-troversial as purely internal measure, but increases prices → material substitution
Contracts for Difference	"Carbon Contract for Difference"	Strong incentive to scale up early-stage clean technology; but scope limited to selected projects (and by available resources)	Levels the playing field between clean and dirty products, but only affects competition w. foreign producers for selected projects	Does not impinge on WTO rules if open to foreign bidders; should pass muster under state aid rules if competitive tender	Relatively easier to implement due to limited scope and provision of data	Relatively least controversial as a support measure

Takeaways from Analysis & Stakeholder Events (I)

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Selected Design Elements:

- **Trade flow coverage:** Debate about leakage also needs to consider role of European exports and their competitiveness in foreign markets
- **Free allocation:** Replacing free allocation will face considerable pushback in the EU, making a phased approach more likely
- **Sectoral scope:** Basic goods with relatively low trade-intensity – such as cement – may offer a good piloting opportunity; also possible: electricity
- **Determination of embedded emissions:** Use of default values with individual adjustment is very likely, but choice of default plays large role
- **Revenue use:** International revenue transfers face political obstacles

Takeaways from Analysis & Stakeholder Events (II)

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General Observations:

- **Objective:** No credible BCA can avoid violating free trade disciplines; justification as an **environmentally** motivated measure is thus key
- **Intrinsic tradeoffs** across multiple criteria between narrower scope and more aggregation vs. broader scope and more granularity
- **Downstream impacts** and **substitution effects** have to be considered
- Avoiding **resource shuffling** and evasion tactics will be a challenge
- **Other instruments**, e.g. consumption charges & contracts for difference, can help address certain aspects of leakage, but there are **no silver bullets**

Thank you!

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