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Status of the Border Carbon Adjustments' international developments

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Background

The first version of this paper was published in March 2021 with the intention to provide an update on the status of discussions on border carbon adjustments (BCA) around the world. The paper is intended to be updated on a regular basis in order to illustrate the latest developments on BCAs.

This is the second edition of the paper with updates on the BCA discussion up to April 2021. It includes recent developments from the EU, the US Leaders' Summit on Climate, Canada's Supreme Court ruling and other jurisdictions' reactions to the EU discussion, including the formulation of positions from the EU Member States.

A BCA is seen as a tool to address the impacts of asymmetrical climate change policies that are emerging under the national determined contributions (NDCs) which Parties to the Paris Agreement have to submit. As a result, the level of effort in different jurisdictions is asymmetrical, resulting in potential impacts on competition and carbon leakage. Countries, especially those that have set ambitious targets and have put in place carbon pricing mechanisms (such as an ETS or Carbon tax), have concerns regarding the impact of carbon leakage and competitiveness on energy-intensive-trade-exposed (EITE) industries.[1]

While under the Kyoto Protocol this was the case only for developed countries, under the Paris Agreement all countries are concerned. Therefore, they seek solutions that will allow them to decarbonize while ensuring that they maintain their competitive stance during this transition period.

Among the solutions put in place to address these issues, free allocation for direct emissions has been the one that has been most used, together with compensation for indirect costs, in some EU jurisdictions. As the level of effort increases, together with the corresponding rise in cost of domestic compliance and the decrease in the amount of free allocation available for EITE industries, new solutions are being explored.

BCAs are not something new, but the EU's political commitment and the expected proposal for a CBAM from the European Commission in June have galvanized discussions and raised interest around the world. So far, California is the only jurisdiction where this tool is used for electricity imports.

EU process

After the 2019 announcement of the European Green Deal, consultations began to prepare the proposal for a carbon border adjustment mechanism (CBAM), to be included in the "Fit for 55" legislative package expected in June 2021. As part of the official consultation process, the Inception Impact Assessment and the Public Consultations took place in 2020. Following this process, the European Commission will finalize the Impact Assessment, which will accompany the proposal.

[1] ERCST CBAM for the EU – Policy Proposal published on April 22, 2021

The European Commission was initially considering four options for a CBAM design: 1) Import tax; 2) ETS extension; 3) Notional ETS with a separate pool of allowances; 4) Consumption tax (excise or VAT type). Currently, No. 3 is widely considered the preferred option.

In the meantime, the European Parliament used its prerogative to build its own non-binding position through the Own Initiative Towards a WTO-compatible EU Carbon border adjustment mechanism. The Plenary vote took place at the beginning of March and provided some indication on where the EP stands on the CBAM, before the EC put forward its proposal and formal negotiations start among the European Commission, Parliament and Council in the second half of 2021.

The heated debate during the European Parliament's plenary on March 8th resulted in a compromise. The resolution includes the removal of a reference to CBAM as an alternative to current carbon leakage measures and avoids calling for the gradual phase-out of free allowances. The Parliament's resolution still underlines the absence of a double protection for the EU industry, which can be interpreted as the coexistence and not the overlap between free allocation and CBAM.

On 23 March 2021, several European countries, including France, Austria, Czechia, Denmark, Lithuania, Luxembourg, Slovakia, Spain and the Netherlands called for an effective, legitimate and fair mechanism for a BCA[2]. **Member States** solidify their initial positions towards the start of the formal negotiations after the publication of the European Commission proposals.

On the other hand, there are different signals coming from Germany and France. Internal discussions in Germany from the pro-business Free Democratic Party (FDP) suggest a plan to enter the upcoming election campaign with a pledge to extend emissions trading as the main tool for fighting climate change. The party wants to extend trading to all sectors and other geographic areas as quickly as possible in order to protect the climate "in a market-based and scientifically secure manner." The **French** President, Emmanuel Macron, held a Summit on the 16 April 2021 inviting China's leader, Xi Jinping. [3]

The **Commission's leadership** continues to stress the fact that CBAM would remain obsolete in the case that the other economies would follow the Paris Agreement. EU's Climate Commissioner Timmermans stated, "the EU would have "no hesitation" in using a carbon border adjustment mechanism to protect its industries if the bloc's trading partners put companies in the region at a disadvantage over climate targets". **Brussels** said that the mechanism will be designed to target imports "surgically", and it is expected to be applied initially to certain goods from neighbouring countries in Eastern Europe, Turkey and North Africa.

A day before the Leader's Summit on Climate, hosted by the U.S. President Joe Biden, representatives of EU governments and the European Parliament agreed in principle on the so-called **European**

[2] https://www.politico.eu/article/europe-climate-change-carbon-leakage/
[3] https://www.reuters.com/business/environment/chinas-xi-attend-climate-change-summit-video-conference-with-france-germany-2021-04-15/

Climate Law, which foresees a reduction of at least 55% in net greenhouse gas emissions by 2030, compared to 1990 levels, and net zero emissions by 2050.

During the Summit, the President of the European Council Charles Michel, said "preserving a global level playing field is essential. We must set the right incentives at the global level. Because carbon leakage across our economies is detrimental. That's why we intend to introduce a carbon border adjustment mechanism. This is needed to ensure a level playing field. And it must be compatible with WTO rules. We are ready to work with all our partners on carbon pricing."

US overview

A series of recent White House announcements have put the climate policy at the center of the political agenda of the new Administration: a commitment to a decarbonized power sector by 2035, a net zero economy by 2050 and the organization of a climate summit in April were expected to give a legislative action boost on a federal level. That said, US climate envoy John Kerry warned the EU to wait until after the COP summit to move forward with the CBAM[4].

Joe Biden announced during his opening remarks for the two-day summit that the U.S. will reduce its own greenhouse gas emissions by 50%-52% from 2005 levels by the end of the decade. The U.S. is comparable, but less ambitious than the European Union's target of reducing its emissions 55% from 1990 levels by 2030, and it falls below a coming U.K. goal to achieve a 78% reduction by 2035 from 1990 levels. A 50% cut from 2005 emissions would amount to just a 40% cut for the U.S. when recalibrated to the same 1990 baseline.

The Leader's Summit on Climate on April 22-23, saw the participation of 40 global state leaders including China, Russia, EU, as well as leaders from the business environment and international institutions. This summit proved that climate change is a common trans-border issue which allows for dialogue and remains a central ground of communication beyond the differences that arise in the international diplomacy.

The Biden Administration might consider a border carbon tax as part of its trade agenda[5]. As it was an integral part of the presidential campaign, it would follow the logic that expects domestic polluters to bear the full cost of their carbon emissions and would impose carbon border adjustment fees or quotas on carbon-intensive goods from countries that are failing to meet their climate and environmental obligations.[6]

What is less clear, however, is how a BCA could be calculated without a federal carbon price. A number of more detailed policies already exist or are under discussion at a State level.

[4] https://carbon-pulse.us10.list-manage.com/track/click?u=98e16e4087837ec9f0445f260&id=e45b3fb931&e=01ed772568
[5] https://www.bloomberg.com/news/articles/2021-04-23/biden-exploring-border-adjustment-tax-to-fight-climate-change?sref=vdNmoUVL
[6] https://joebiden.com/climate-plan/

California BCA for Electricity Imports

California's ETS contains a provision of "first deliverers" of electricity being liable for emissions of electricity imported from outside California (in the US). Where the carbon intensity of an electricity source is unspecified, it is assumed to be above the coverage threshold and subject to a default emissions factor.

This can create the challenge of resource shuffling – entities which lower their compliance obligation by substituting low-carbon electricity and swapping out related PPAs. This has been addressed by updating the regulatory framework, which now expressly forbids resource shuffling and sets out a detailed list of "safe harbor" practices. In a nutshell, these are changes to electricity offtake arrangements that are not considered resource shuffling.

New York

The Regional Greenhouse Gas Initiative (RGGI), covering 11 North-Eastern and Mid-Atlantic States, puts a regional cap on emissions from power generation. The program began in 2009 and the price of carbon in RGGI is around $6/ton. In **the State of New York**, the Independent Service Operator (NYISO) released its final draft of a Carbon Pricing Proposal to formally put a price to carbon dioxide emissions on the wholesale power market – and it contains a BCA provision. To avoid creating distortions, the NYISO proposes to apply carbon charges to external transactions so as to make them compete with internal resources (and each other) as if the NYISO was not applying a carbon charge to internal suppliers (i.e. on a status quo basis).[7]

Canada: federal level

The Canadian provinces of Saskatchewan, Ontario, and Alberta went to court to argue that the Greenhouse Gas Pollution Pricing Act was unconstitutional because Ottawa was stepping into provincial jurisdiction. Appeals from the courts of Saskatchewan and Ontario in 2019 determined that the policy was constitutional, while in February 2020 the Alberta Court of Appeal said it was not. The cases were all appealed to the Supreme Court, which ruled on March 25, the carbon price being a federal prerogative, against that the energy issues reserved traditionally to the provinces.

The type of policy instrument matters, too. Calling the regime a tax, it could probably take advantage of leeway under WTO law to adjust taxes on exports (A. Cosbey, 2021).

Canada is exploring the potential of a border carbon adjustment and has committed to discussing this idea with international partners[8]. This type of adjustment is intended to prevent carbon leakage. The **policy instrument** would presumably be the output-based pricing system (OBPS), a regime established under the Greenhous Gas Pollution Pricing Act. The GGPPA gives flexibility to provinces by establishing a minimum CO2 price. The charge, which will rise to $50 per ton of CO2 by 2022, began at $20 in 2019 and will increase by $10 per year until 2022, in discussion is $170 by 2030[9].

[7] NYISO Carbon Pricing Proposal
[8] Statement (roadmap)
[9] strengthened climate plan

The Canadian government will soon launch a consultation process on a carbon border adjustment mechanism (CBAM), while it also explores options for carbon capture, utilisation and storage (CCUS) tax credits and other climate funding strategies to hit a more ambitious GHG reduction goal. On the grounds of climate diplomacy, it must also be recalled that in the past Canada has cohosted MoCAs[10] together with the EU and China, in the absence of US engagement.

Canada: provinces and territories

Although there are regional carbon markets linkages on a subnational level (California/Quebec), establishing a border adjustment is a federal competency. Provincial regulations are supported by local statutes and autonomies. The Government of **British Columbia** introduced a carbon tax in 2008. **Quebec** participates in an international emissions trading scheme with the US state of California. **Alberta** announced a carbon tax in 2015. **Ontario** joined the Western Climate Initiative in 2017 but later withdrew. In the event of no single carbon price in Canada, will there be a need for an adjustment on the provincial border? It's more likely that any BCA would assume that the Federal level GGPA was the prevailing policy instrument. This could be justified by the legal assumption, made in the GGPA, that if the provinces don't have regulations of equivalent effect in place, the GGPA will apply as a federal backstop.

A key issue for Canada is how to move forward with any BCA or similar instrument, given Canada's intense and complex trading relationship with the United States. The US, as noted above, do not have a carbon price, so it is not clear either how they might protect their EITE firms in the context of high climate ambition, or how Canada might coordinate with whichever policies the US do put in place.

With the support of the WTO Secretariat, Canada has recently organized a webinar on border carbon adjustments for WTO negotiators including a significant number of other stakeholders, and which attracted significant interest[11].

Australia

Canberra, which has refused to commit to a net-zero emissions target by 2050, is concerned that the measures could hit Australian exporters. The Trade Minister Dan Tehan is trying to lobby his counterparts to drop plans for a CBAM.

China

China remains cautious towards the EU CBAM, especially because of trade issues. China's NDC and climate policy is based on the announcement of carbon neutrality by 2060 and putting the power sector under an emissions trading scheme.

The impact of the EU CBAM on EU–China relations will depend largely on how it is designed and negotiated. This will also depend on making any EU CBAM WTO compliant. Using revenues and allowing for crediting of existing policies will be important considerations in these discussions.

[10] https://ec.europa.eu/clima/events/ministerial-climate-action_en
[11] https://twitter.com/CarolynDeere/status/1367381457602232320/photo/1

Chinese President Xi Jinping slammed the EU's plan for a CBAM in a call with the leaders of France and Germany, “tackling climate change is a shared responsibility … and should not become a geopolitical bargaining chip or used to attack other countries (or impose) trade barriers,” Xi told France’s Emmanuel Macron and Germany’s Angela Merkel on the sidelines of a virtual climate summit on April 16, 2021.

BRIC

Brazil, South Africa, India and China say EU plans for a carbon levy on imported products like steel and cement will unfairly penalise their economies.[12]

Interpretation from the CBAM Sectoral Analysis report by the European Roundtable on Climate Change and Sustainable Transition singled out that the industries beyond the EU sectors that will be most affected by the EU proposal include Colombia’s cement industry, China’s plastics sector, North African fertiliser and South American pulp exports.

Russian Federation

The 20th of April 2021, Russian lawmakers gave preliminary approval to the country’s first climate law which aims to enable emissions trade and require large polluters to report their GHG output.

Russia must adapt its industries to climate change and establish strict controls in the fight against harmful emissions. That's according to President Vladimir Putin, who said that companies must be punished for causing damage. “We must respond to the challenges of climate change, adapt agriculture, industry, utilities, the entire infrastructure,” Putin said. “[We must] create an industry to recycle carbon emissions, achieve a reduction in their volume and introduce strict control and monitoring.” Putin also noted that, over the next 30 years, the country could reduce its volume of net greenhouse gases to below that of the EU, which he called a “difficult task” due to Russia's size, geography, and climate.

The Russian Federation has been alarmed by the discussion on an EU CBAM and, together with China, Paraguay, Uruguay and the United States, sought assurances from the European Union that its European Green Deal would be consistent with the WTO principle of non-discrimination. WTO members discussed the European Union’s plans for a carbon border adjustment mechanism at the virtual meeting of the Council for Trade in Goods held on 10-11 June 2020[13].

Artem Bulatov, deputy director of the Department of European Cooperation of the Russian Foreign Ministry, during a seminar of the Russian International Affairs Council on the prospects of cooperation between Russia and the EU in the environmental sphere. "We are ready for widest possible cooperation. All our offers are on the table. But we won’t be knocking on locked doors. The ball is in EU’s court," he said, **according to Russian news agency TASS**, taking particular issue with the EU's plan

[12] https://www.climatechangenews.com/2021/04/09/emerging-economies-share-grave-concern-eu-plans-carbon-border-tax/

[13] https://www.wto.org/english/news_e/news20_e/good_11jun20_e.htm

to implement a carbon border adjustment mechanism as part of its European Green Deal. "We would like to avoid implementing response measures. We believe that this is not a time for trade wars even under the current geopolitical conditions," he added.

UK – COP 26 and G7 presidencies

The UK is also preoccupied with how to address competitiveness and carbon leakage, considering that it is not part of the EU ETS anymore. It is currently assessing different options and identifying sectors vulnerable to leakage, while evaluating policy options and their implications.

The UK will have an important and visible role in 2021 as Chair of G7 and president for COP 26 in Glasgow. Recent statements from Prime Minister Boris Johnson point to consideration being given to making this an item for discussion at the G7. Raising this at COP26 may be politically sensitive.

Ukraine – geographic scope example

Ukraine is in a transition period towards establishing the ETS system and eventually linking it with the EU ETS. Ukraine may consider mechanism like EU CBAM[14] as a part of such transition. This could be supported by existing bilateral or regional arrangements – such as the EU Association Agreement – as grounds to merit an exemption. Firstly, countries in such relationships have close and deepening trade relationships with the EU. Secondly, as part of their agreements, those countries have typically committed to strengthen environmental and climate policies by adopting the EU's *acquis.*

Turkey

The European Bank for Reconstruction and Development (EBRD) is working with Turkey to develop a domestic carbon market in order to prepare the country – one of the EU's largest trading partners – for the introduction of protective border measures by the neighbouring bloc.

Japan

Japan announced its target of carbon neutrality by 2050. This pledge should be fulfilled mostly through electrification and decarbonization, including negative emissions. However, on the carbon market this is still limited to the automotive sector through carbon offsets and the first mandatory ETS was established in the Tokyo Metropolitan area[15]. In the view of summer 2021, Japan is considering a carbon border tax that would impose tariffs on imports from countries with insufficient environmental standards. [16]

Japan is considering upping its ambition under the Paris Agreement to a 40% cut below 2013 levels by 2030, compared to the current goal of 26%, according to the Kyodo news agency.[17]

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[14] https://eba.com.ua/en/plata-za-klimatychnu-bajduzhist-chy-protektsionizm/

[15] https://icapcarbonaction.com/en/?option=com_etsmap&task=export&format=pdf&layout=list&systems[]=51

[16] https://www.nippon.com/en/news/yjj2021021400298/

[17] Japan considers raising Paris emissions reduction target to 40% -reports

WTO

WTO discussions on BCAs are still at a relatively initial stage. At this point, the EU is the only stakeholder with a working plan aiming to achieve a BCA – other WTO members are at a less advanced stage (e.g. Canada is only starting to explore how/whether a BCA could be designed).

The Council for Trade in Goods required further details on how a BCA would be implemented and the assurance that it will not be used as disguised barriers to trade. The EU presented the Green Deal at the Committee on Trade and Environment and received questions on the design and implementation of the BCA[18].

On 12th and 16th November 2020, at a meeting of the WTO Committee on Market Access, WTO members raised a number of trade concerns, including the EU's planned CBAM. During this meeting, members were concerned about the consistency of a future CBAM with WTO rules and requested the EU to shed light on the status of the relevant legislation, as well as the sectors and products affected. Several members pointed out this measure needs to be designed and implemented fairly, recognizing carbon pricing systems already in place in other countries (including at the sub-national level) and recalled the Paris Agreement's principle of "common but differentiated responsibilities."

Similarly, some members criticized the EU's intention to use the CBAM as a new source of EU own revenue. Not aiming at climate protection, this would set economic and fiscal objectives.

In March 2021, the WTO convened the inaugural meeting of a new "Trade and Environmental Sustainability" joint initiative group, which is expected to be a forum to discuss carbon border taxes. Over 50 WTO member countries have already expressed their interest in participating to identify goals and objectives related to trade and sustainable development through "structured discussions ... on actions and deliverables" in this area.

French Finance Minister Bruno Le Maire and WTO's new leader Ngozi Okonjo-Iweala told during a press conference in Geneva that they would set up a working group to examine the proposed CBAM. The plan, which is still in the early planning phases, would be aimed at shielding EU companies against cheaper imports from countries with weaker climate policies. Le Maire said the working group being set up between the WTO and a number of European countries would mull "how to ensure that this mechanism conforms with WTO rules and how to guarantee a fair transition for developing countries." France, which takes over the EU's rotating presidency next January, was intenting on ensuring that the new mechanism "respects WTO rules".

OECD

The incoming secretary-general of the OECD, in an interview with the Financial Times, Mathias Cormann[19] added that the same internationalist principles should make the EU think twice before introducing unilateral tariffs to punish countries that take a different approach to global warming.

[18] https://www.wto.org/english/news_e/news20_e/envir_20nov20_e.htm
[19]https://www.ft.com/content/870bca64-8b75-45d3-8ca7-840cb0a7d652

Export issues, political acceptability, equivalence of measures and calculation of its value – are central to the discussion in the OECD Round Table on Sustainable Development [20]

IMF

IMF also appears on the map of key fora where carbon border adjustments can be discussed. At the moment the global climate price floor would be seen as a solution looking for the global carbon price.[21]

IPCC

The EU cannot neglect the projected growth in emissions from least-developed countries (LDCs) when designing its carbon border adjustment mechanism (CBAM), an IPCC senior advisor said on March 23[22].

[20] Ensuring the Acceptability of Border Carbon Adjustments, 25 March 2021
[21] High-level conference - Carbon Border Adjustments for Climate, Paris March 23, 2021
[22] EU carbon border levy “can’t neglect least-developed countries”, says IPCC advisor