ERCST

Roundtable on
Climate Change and
Sustainable Transition

2020

Feedback on the

Inception Impact Assessment

Carbon Border Adjustment Mechanism

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A. Problem the initiative aims to tackle.

The stated aim of the initiative is to tackle **asymmetrical climate ambition** between the EU and its trade partners which may result in carbon leakage. Carbon leakage is defined in the Inception Impact Assessment (IIA) as the transfer of production and investment to countries with lower climate ambition and/or the replacement of EU products with more carbon intensive ones from outside the EU

Therefore, the stated focus of the initiative is entirely environmental and is aimed at limiting global emissions. However, another aspect needs to be considered, which is also related to global emissions, but is focused on the issue of competitiveness, and how domestic mitigation measures affect competitiveness and carbon leakage. Addressing competitiveness should ensure that products that have a lower carbon intensity are not disadvantaged in the domestic as well as international markets, resulting in higher emissions.

Consequently, the issue of competitiveness, and ensuring a level playing field between jurisdictions with asymmetrical levels of ambition is another objective that should be considered in finding an approach to dealing with asymmetrical climate change policies.

This is already raised in the IIA in expressing that the "price of imports reflect more accurately their carbon content" as well as references to the fact that the current approach is through the granting of free allocation for those sectors that are open to global competitive pressures and cannot pass costs trough.

As such, we would, in the course of the examination of how to address carbon leakage, urge a more open debate, with border carbon adjustments being one option. Other options, which may be complementary to BCA should not be disregarded, including the creation of a framework that will lead to a market for low carbon products. Without such a market the tools available to the EU to implement the EU Green Deal will be incomplete.

We must remember that a number of options have been considered to address the risk of carbon leakage, with some being more mature and/or more tested than others, including:

- Free allocation/compensation of indirect costs
- Internationalization of the carbon market through linking and the use of Article 6 Paris Agreement
- Border carbon adjustments
- Other potential options
    - **Consumption charges**: a charge that shifts the carbon price to consumers based on the weight and type of material in a final product
    - **Contracts for difference**: a financial mechanism to safeguard the profitability of low-carbon investments based on the amount of avoided carbon and a set carbon price

ERCST is currently considering these issues in much greater depth in a project entitled "Border Carbon Adjustments in the EU – Issues and Options" and will contribute to subsequent public consultations.

Border carbon adjustments (BCAs) seek to alleviate the negative effects of uneven (asymmetrical) climate policies and may include **imports** and/or exempt **exports.** Ensuring that both these aspects are included in the examination is critical for the effectiveness and credibility of any approach being adopted.

In the same train of thought, it is important that **both direct and indirect emissions** are included in the examination that the European Commission is proposing.

BCAs have three main **objectives**:

- Prevent leakage of carbon emissions to jurisdictions with weaker policies;
- Create a level playing field in competitive markets;
- Incentivise trade partners to strengthen their own climate efforts.

Being clear on the objectives will ensure that there is a good basis for making choices when we enter the design phase of the chosen approach. In addition, many would regard the consideration of the BCA as having tactical or strategic justification. While there is always a balance, the primary consideration needs to be selecting an approach that meets the primary objectives, which will be more strategic, that is, that carbon leakage is avoided, including through a level playing field for competitiveness.

One additional remark that is triggered by the reference in Part A of the IIA to the fact that "the EU ETS Directive provides for this system (of free allocation) to continue at least until 2030". This is important as it would seem to indicate that any BCA mechanism will not be made operational prior to 2030, or potentially operate in parallel. The current pandemic notwithstanding, some studies would indicate that the current approach of using free allocation may not be enough under certain scenarios in the second half of 2020s, as shown by Figure 1 and 2 below.

Figure 1: Free Allocation demand/supply and CSCF under a *high demand* scenario for free allocation – 50% EU headline target *(ETS – ESR shares remains unchanged*)

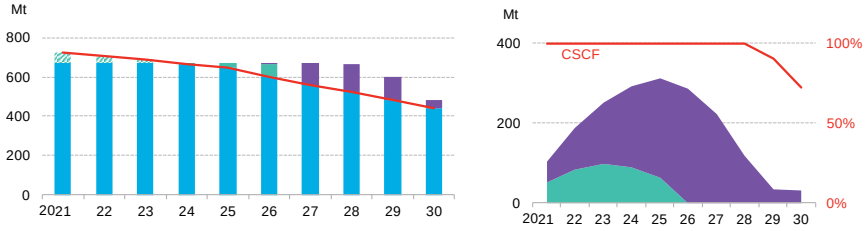
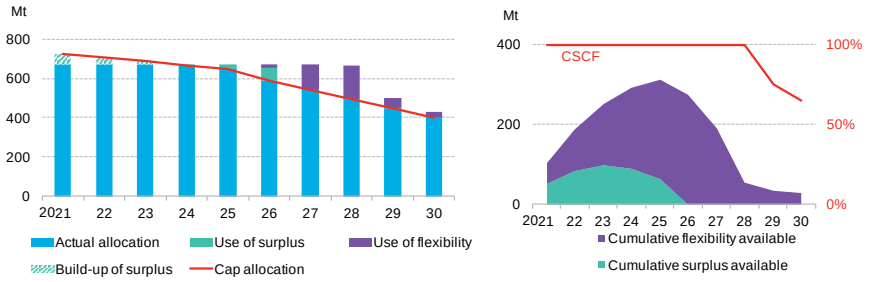


Figure 2: Free Allocation demand/supply and CSCF under a *high demand* scenario for free allocation – 50% EU headline target *(ETS – ESR shares remains unchanged*)



Source: BloombergNEF

Also, the CBAM must be seen as part-and-parcel of the EGD and cannot be approved as an afterthought or be backloaded. On the contrary, it should be frontloaded and be an integral part of the revamping of the EU ETS proposal package which is expected in June 2021.

B. Policy options

The IIA identifies three building blocks that will be used to build policy options:

1. Type of policy instrument. One important aspect that needs to be highlighted for examination and consideration is the dynamics between current and future approaches to address carbon leakage. This needs to be considered in light of the rationale for seeking new approaches – why and when would free allocation not be "fit for purpose"
2. Methodological approach to evaluating the carbon content and carbon pricing of imported products
3. Sectoral scope

As part of the "Border Carbon Adjustments in the EU – Issues and Options" study that ERCST is undertaking we have determined that any BCA needs to make design choices on a set of key features, each of which offers alternative options with varying trade-offs and implications for the achievement of the policy objectives of the BCA. Below is a list of the design aspects considered by ERCST in its analysis of BCA design options, which in some cases are a more granular outline of the items identified in IIA:

- **Objective**: What is the overarching goal of the BCA (i.e. to mitigate emissions, secure competitiveness, etc.)? This aspect guides the selection of the following elements.
- **Policy mechanism**: Through what mechanism will the BCA be implemented? For example, will it be implemented by way of an extension of the EU ETS, or through a standalone tax or tariff?
- **Trade coverage**: Which direction of trade is affected by the BCA (i.e. imports, exports, or both)?
- **Sectoral scope**: What sectors or products will be covered by the BCA?
- **Geographic scope**: What countries or regions will be covered by the BCA? If exemptions are made, on what basis (including legal justification)?
- **Emissions scope**: What emissions will be covered by the BCA (direct, indirect, or both)?
- **Estimation of embedded emissions**: Will the carbon intensity of goods be calculated on the basis of actual reported and verified emissions, or based on sectoral or other benchmarks?
- **Calculation of adjustment**: On what basis will the policy differential the BCA adjusts for be determined between the European Union and covered third countries (i.e. which policies – if any

– will be taken into account when calculating that differential, e.g. only explicit carbon prices, or also other climate policies)?

- **Use of revenue**: How will the revenue generated from the BCA be used?
- **Administrative aspects**: How will the BCA be administered and rendered operational?
- **Institutional governance**: Can existing entities govern the BCA, or will a new institution have to be set up for routine management and decision making?
- **Timeline**: Will the BCA be rolled out quickly or in phases (for example, will it replace free allocation of allowances from the outset or gradually over time? Will it start with broad coverage or begin with one sector and expand over time)? Will it have a set expiration/sunset date?

In addition, in determining policy options, ERCST would also recommend focussing on five (5) criteria

1. Meeting environmental objectives
2. Addressing competitiveness concerns that may also lead to carbon leakage
3. Legal feasibility
4. Technical feasibility
5. Administrative implications

ERCST would again like to emphasize the importance of ensuring that this is an exploration of means to achieve the stated objectives, and that the analysis and impact assessment should not be limited to adjustments at the border. We therefore urge that the a CBAM be compared with other approaches, with some being potentially more appropriate than others for some sectors.

In addition to assessing the economic impact of a carbon border adjustment mechanism versus the economic impacts of not implementing this mechanism (inaction), consideration should be given to alternatives to a CBAM, including consumptions charges and contracts for difference.

Finally, ERCST would also like to highlight that the IIA is entirely focused on treatment of imports and that it is completely silent on any reference to the treatment of exports. This is not a minor issue.

C. Preliminary assessment of expected impacts

In a globalized and interconnected world, it is important to analyse the socio-economic impacts of measures to address climate change, both domestic as well as international. When doing this analysis, ERCST suggests analysing the effects on all three pillars of sustainable development: the economic, environmental and social dimensions. They should also be quantified wherever possible. The analysis should also reflect both the positive as well as the negative, and both the intended and unintended impacts.

Domestically, the impact assessment should be assessed in terms of impact on the economy as well as social impacts and how the just transition highlighted in the EGD will be impacted, and what measures are specifically put in place to deal with these impacts. In this context, triggering Article 30 of the EU ETS that looks at free allocation and how it deals with climate change policies and measures in other countries,

will be an important element. Analysing how the BCA helps or hinders the creation of a market for low carbon products is another critical element of the impact assessment.

Internationally, ERCST supports the intention of the Commission to analyse the expected socio-economic effects of the measure on third countries. Such assessments are an important element in ensuring that policy measures have the desired effect, both within and outside of the EU's jurisdiction. The Commission should clarify the extent and how it intends to make this assessment (the methodology) as soon as possible. The analysis should be in line with UNFCCC provisions and made as granular as possible, e.g. by analysing the effects of the measure on other countries' GHG emissions, on household income, or on individual sectors. To make the extent of the analysis manageable, ERCST would recommend focusing on a limited number of countries that are likely to be impacted by the CBAM. Vulnerable countries will likely vary over the policy options being considered e.g. which sectors are to be included in the policy measure will impact which countries can be expected to be impacted.

In determining which countries to include in the assessment, we suggest looking at two variables:
1. The value added (either as an absolute value, or relative to national GDP) of those sectors on which the CBAM will apply.
2. Intensity of a country's trade with the EU.

ERCST has developed an additional methodology on how to do such an analysis, which is available from the ERCST project using Chile as a case study.[1]

The analysis of impacts should also address the use of revenues from any measures to address carbon leakage, and how these measures would interact with the provisions and ethos of the Paris Agreement. The success and international acceptability of such a mechanism will depend on how it addresses carbon leakage but also on the perception and its international political acceptability.

The analysis of the introduction of such a mechanism should focus largely on it being a cooperative approach and not a punitive one.

D. Evidence base, data collection and better regulation instruments

Currently, the only known carbon border adjustment mechanism in operation is applied to the power sector and is not applied at a national, but only a subnational border. While certain elements may be learned from this mechanism, it should be noted that the measures in California are inherently much simpler than any proposed mechanism that the EU would need to implement. Since these existing measures only capture Scope 2 emissions from power generation, there is no need to calculate embedded carbon content of complex supply chains. In addition, the EU CBAM may not have the same level of flexibility as these measures since it must adhere to international law.

[1] "Chile Case Response Measures Study" can be found at https://ercst.org/reporting-on-the-impacts-of-response-measures/

We would again like to emphasize that the timeline would need to be legally frontloaded, not supplementary after the implementation of other measures (of EGD). The ambition for carbon neutrality needs to be matched with measures giving the industry chance to compete on the global market.