

Response to Public Consultation on Carbon Border Adjustment Mechanism



October 2020

Sandbag welcomes the opportunity to contribute to the public consultation on the Carbon Border Adjustment Mechanism (CBAM) and includes this explanation of our answers to the consultation questionnaire.

1. Aims of the CBAM

According to the Communication on the European Green Deal, the CBAM is contingent on increasing climate ambition within the EU. As EU production practices become less carbon-intensive, the CBAM will allow for the more equal treatment of domestic and imported goods, thereby reducing the risk of carbon leakage. As such, the CBAM will be an alternative to the measures that currently address the risk of carbon leakage under the EU ETS, such as the free allocation of allowances. The CBAM will therefore form an integral part of the EU ETS framework and must share its key aims of combating climate change and achieving greenhouse gas emission reductions cost-effectively. **The CBAM should support the core mechanism of the EU ETS** (i.e. its increasing carbon price in relation to raised ambition) by correcting the competitive distortions which an increased ambition may create. The CBAM also confers a responsibility on the industries which it protects from carbon leakage. As such, **it should come with a clear zero-carbon 2050 target for industry**, and industrial actors should use the level playing field provided by the CBAM to invest in new zero-carbon technologies.

2. Addressing Carbon Leakage

While **there has been no real evidence of carbon leakage to date** (other than in the power sector¹), it should still be considered a possible risk of a substantial increase in the EU's climate ambition. The current means of addressing carbon leakage, through the free allocation of allowances, is not effective as it does not incentivise the take-up of alternative materials and transformative decarbonisation technologies and processes. Allowances can often end up overly sheltering specific production processes and create distortions with sectors not covered by the EU ETS. As such, **the free allowance system intended to compensate for hypothetical carbon leakage actually limits the ability of the EU ETS to properly function as a driver of decarbonisation**. The European Court of Auditors' recent audit of free allocation found that free allowances are not adequately targeted to the sectors that are at the most risk of carbon leakage.²

Furthermore, as the EU ETS cap decreases, and with it the number of overall allowances, free allocation will become unsustainable by the early 2030s. The EU's increased 2030 ambition will likely lead to a lower cap and a steeper Linear Reduction Factor, which will further shorten the viability of free allowances. **Another means of safeguarding against carbon leakage is clearly needed** and a CBAM appears to be the most direct option for creating a level playing field for EU industries as they undergo their net-zero transformations.

¹ Ember (2020). The Path of Least Resistance: How electricity generated from coal is leaking into the EU. <https://ember-climate.org/wp-content/uploads/2020/10/Ember-Path-of-least-resistance-2020.pdf>

² European Court of Auditors (2020). Special Report 18/2020 The EU's Emissions Trading System: free allocation of allowances needed better targeting. <https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=54392>

3. CBAM and Product Requirements

The ambitions of the European Green Deal require a portfolio of approaches which includes both a CBAM and product requirements. **The two policy instruments are complementary but have different approaches.** A product requirement sets a maximum limit for the embodied carbon of a product, but there is no cost on carbon below that limit. As such, there is no incentive to reduce the carbon content of a product below the limit set by the requirement and no level playing field between different types of products. On the other hand, a CBAM applies a cost to embodied carbon evenly across product types, providing an incentive to reduce a product's carbon footprint as cost-effectively as possible. However, a CBAM does not completely remove the most carbon-intensive products from the market in the way that product requirements do, nor does it address non-price barriers to decarbonisation. For certain sectors where practices will need to be substantially reformed in pursuit of decarbonisation (e.g. building materials), product requirements may also be needed for decarbonisation. In this way, product requirements are complementary to a CBAM, but should not replace it. It will be important to assess the interaction of the CBAM with other legislation which regulates the carbon impact of products.

4. Options for a CBAM

The public consultation presents four options for a CBAM, all of which have their own advantages, disadvantages and complexities:

- I. **Tariff applied on imports at the EU border:** A tariff has the advantage that it can be applied without having any effect on the existing EU ETS and without raising concerns of how the CBAM will interact with the decreasing number of EUAs. It is able to charge for any amount of CO₂ emissions (even fractions of tonnes and not just integer multiples of the EUA price), which also makes it easier to calculate refunds/exemptions to importers from jurisdictions with carbon pricing schemes. However, to be completely effective at providing a level playing field, **the tariff would need to follow the EUA price very closely** and any discrepancies between the tariff and the EUA price could cause problems at WTO level. With a very close tracking of EUA prices, importers would be able to hedge their carbon costs at production when selling for future delivery, by just buying forward EUAs at the same time. The question of reciprocity could be raised about a border tariff, as it would not solve the competitiveness problem of exporters selling to countries without carbon pricing in place, unless a symmetric subsidy system is set up.
- II. **Extension of the EU ETS to imports:** This option could be implemented in two ways:
 - a. by bringing emissions from imports under the EU ETS cap, with its built-in trajectory to reduce emissions, likely requiring an adjustment in the number of allowances released to cover imports, or
 - b. by requiring the surrendering of allowances against imports and granting the same proportion of free allowances to exports.

EU-based producers are at a disadvantage if their products are exported to countries that do not have a similar carbon price to the EU, so option 2b would compensate for this by providing exporters with free allowances from those surrendered by importers under the CBAM. These free allowances should only be granted for exports to countries that do not have a carbon price equivalent to that of the EU. This would be advantageous in terms of trade fairness, as it would put imports on par with domestic production. Although to properly level the playing field, the allowances for exports should be granted according to a benchmark based on the average carbon intensity of EU producers, for WTO compatibility reasons it would be more appropriate (and not materially different) that they be granted **on the back of**

actual carbon costs paid by producers. To align the exporter allowances more closely with the polluter pays principle, a limit to the level of their carbon costs per exported unit that exporters can receive in the form of exporter allowances could be set. The export allowances should be granted after the product is exported and not as an advance. Option 2b would not require any adjustment to the number of allowances released as long as imports exceed exports (which tends to be the case for commodity materials). As such, option 2b would not unduly distort the EU ETS and would pose no difficulties for the changes to the cap and LRF which are required in view of the EU's increased climate ambition. Under option 2b, the EU's trade balance would impact scarcity in the EU ETS.

- III. **Obligation to purchase allowances outside the EU ETS:** This option removes any potential risk of disrupting the EU ETS supply/demand balance. This solution would be equivalent to a border tariff (and would not address the cost hedging issue for importers) unless these allowances were tradable, and they would need to be priced at the same value (or very close) to EU ETS allowances. Simply put, they would need to be EUAs or exchangeable for EUAs. Similarly to option 2b above, such allowances could also be granted for free to exporters to ensure reciprocity.
- IV. **Carbon tax at consumption level:** This option would avoid international legal barriers but may prove politically difficult within the EU as taxation is a Member State competence. It also does not necessarily prevent carbon leakage unless free allocation is continued (which is unsustainable in the long run), as EU installations would be subject to the EU ETS and the tax, while importers would only have to contend with the tax.

5. Scope of the CBAM

The **CBAM should target those high-emitting sectors covered by the EU ETS, particularly cement, steel, electricity and certain chemicals** (e.g. ammonia, polyethylene for plastic production). However, for a limited number of secondary products with a high value share of a covered material (and therefore a high carbon price impact), the CBAM should be extended down the value chain to reduce risks of circumvention. For example, different blends of clinker should be included with cement, fertilisers with ammonia, etc. As these products have short value chains, they would be relatively simple to manage and monitor.

The CBAM should be implemented as soon as practicable during Phase IV of the EU ETS. If necessary, a sector-by-sector introduction could be used. A sector-by-sector introduction allows for a smaller scale to start, giving time to assess the impacts of the CBAM on the market and to make adjustments while the scope of the mechanism is still relatively manageable. However, the sector-by-sector approach would also mean the prolongation of free allocation for sectors not initially covered by the CBAM, extending its dampening effect on the EU ETS and depriving Member States of potential auction revenues.

The CBAM and free allowances should not be applied to the same emissions. That is to say, importers should only pay for the embodied emissions of their products that are in excess of the free allowances available to EU producers. **Free allowances should be phased out as soon as the CBAM is in place, leading to the abolishment of free allocation by 2030 at the very latest.** As the number of free allowances are reduced, the amount paid by importers under the CBAM will increase accordingly. While there have been suggestions that free allocation should be maintained until the CBAM is well established, this poses problems in terms of unequal treatment of domestic producers and importers, would delay increased revenue from the auctioning of formerly free allowances, and would further limit the decarbonisation incentive of the EU ETS.

6. Setting the Level of the CBAM

Determining the price to be paid by importers under the CBAM is a balance between precision and administrative feasibility. While verified emissions per product would be the most precise measurement, this would be logistically very difficult. The average embodied emissions of products could be assessed per importing country, but this would require access to national emissions data, presenting a large administrative burden, and could trigger concerns about country-specific trade discrimination. Keeping in mind the purpose of the CBAM to level the competition playing field, the CBAM should address carbon price effects (in terms of marginal costs) in the EU compared to its trade partners. This would suggest setting up benchmarks, based on EU average emissions for a tonne of each product. The benchmarks might need to be disaggregated at product level (e.g. for different grades of steel) and would need to be updated periodically to ensure that developments in low-carbon production are adequately included. These benchmarks should be introduced alongside the legislative proposal for the CBAM. **Importers should have the option to deduct from the benchmark their actual carbon costs paid**, which would necessitate a conversion of this cost into a number of allowances, using e.g. the EUA spot market value and the actual cost paid per tonne by the importer.

These benchmarks should be different to those currently used within the EU to allocate free allowances, as the free allocation benchmarks may not reflect the embodied carbon of domestic or imported goods. This is particularly the case because the EU benchmarks relate to the most efficient installations and not the average carbon intensity of a product.

7. Direct and Indirect Emissions

The CBAM should only cover direct emissions. Indirect emissions do not have a particularly distorting effect on competition, as it is not the emission intensity of electricity which impacts electricity costs, but the existence of carbon pricing, regardless of how carbon intensive the electricity is. As the implementation of the CBAM will accompany the introduction of stricter decarbonisation targets for the EU ETS, the price of EUAs will likely increase, and the price of electricity within the EU will increase as a result. As decarbonisation requires the electrification of industrial processes wherever possible, it is important that electricity-intensive industries, or industries that will be electrified in the future, are not overburdened by this increase in electricity prices. However, the competitive imbalance in electricity use should not be dealt with by a CBAM covering indirect emissions, but by other mechanisms. Currently the EU ETS state aid guidelines treat this issue by means of compensation, which is not optimal, as it will require a large amount of state funds to meet an ever-increasing electricity demand. There are suggestions that auction revenues from the sale of EUAs should be used to compensate electricity-intensive industries. However, while electricity demand will increase significantly in the future, the supply of EUAs is set to decrease. Rather, **measures external to the CBAM should allow electricity-intensive industries to bypass the effects of the carbon price on electricity**. One possibility is to reform the Energy Taxation Directive so that it ceases to provide advantages to gas over electricity, for example by eradicating fossil fuel subsidies and restructuring taxation to focus on the carbon content of energy sources. Other solutions include the Mankala practice in Finland, whereby electricity-intensive industries form cooperatives to purchase renewable energy infrastructure for their direct use. National utilities could allocate lower-cost electricity to electricity-intensive industries – for example France's EDF is obliged to allocate 100 TWh of its nuclear production annually at a discounted price.

8. Risk of Circumvention of the CBAM

There are several potential avenues for the circumvention of a CBAM, which would reduce its effectiveness in both tackling carbon leakage and encouraging emission reductions. Importers may bypass the CBAM by moving along the value chain, e.g. by importing semi-finished products rather than raw materials. This could be avoided by **defining bulk commodities as including all goods made with those commodities with added value up to a certain threshold** (e.g. 20%), and with measures to prevent transfer pricing within companies. As mentioned under point 5, for **certain secondary products made from a large proportion of high-emission materials the CBAM could be extended down the value chain to include these secondary products.**

Resource shuffling also presents a risk that importers will prioritise low-carbon products for the EU market and simply sell high-carbon products elsewhere. The Californian carbon border adjustment legislation prohibits resource shuffling, with an exhaustive series of exceptions. However, our proposal to **set the CBAM price to an EU benchmark (not on carbon content) and grant a discount according to carbon costs actually paid** would prevent such risk.

Thirdly, jurisdictions could support their exporters with state aid or subsidies to overcome the added costs of the CBAM. However, **sustained multilateral efforts on behalf of the EU can help minimise these risks by pursuing international agreements on ending subsidies for polluting industries.**

9. Exemptions to the CBAM

There have been suggestions that producers in LDCs should be exempt from paying the CBAM, but this risks effectively subsidising more polluting practices in those countries, and that carbon-intensive products from other areas could be 'channelled through' exempted countries. Instead, **the EU should increase its financial support for climate mitigation and adaptation measures in developing countries.** (If the CBAM takes the form of a border tariff, these revenues could go directly to an international climate fund. If the final form of the CBAM is an extension of the EU ETS, revenues will go to Member States and potentially as an Own Resource, but this increased revenue should allow for greater international climate financing by the EU). Furthermore, **European Union funds and the development banks of EU Member States should not continue financing fossil fuel infrastructure in third countries** only to expose producers in those countries to a CBAM because of their carbon-intensive production.

Another proposed exemption is for jurisdictions with their own carbon trading scheme or carbon tax. While a flat exemption would be the simplest option, it would reduce the effectiveness of the CBAM as the carbon price imposed in other jurisdictions may not match the EU ETS price. More effective options would be a lower tariff/requirement to surrender allowances, or **a rebate for any double-payment for emissions.** In setting CBAM prices for these jurisdictions, it is important to examine whether the jurisdictions have free allowances, subsidies for exporters or other instruments which dampen carbon price effects. Setting the CBAM for these cases will likely require significant cooperation with authorities in these jurisdictions. This cooperation could improve the amenability of third countries to the CBAM and lay the groundwork for multilateral climate action.

10. Impact Assessment

Environmental effectiveness: The CBAM will likely lead to the carbon price being incorporated into the market price of a product, incentivising a move towards low-carbon alternatives. The removal of free allocation will also

avoid lock-in of high carbon production processes and encourage switching to lower-carbon alternatives. The reduction in GHG emissions due to a CBAM is estimated to be about 24 Mt CO₂.³

Economic impact: A report by Poland's National Centre for Balancing and Managing of Emissions found that the price of imports would increase by on average 1.6% by 2030 under a CBAM. There would be a decrease in the value of imports from sectors covered by the CBAM of on average 3.4%, varying across industries. Overall, total imports across all sectors would decrease by 0.5%. There would also be a decline in the value of EU exports and a drop in exports, but only presuming that there is no measure to support exporters included in the CBAM. On balance, the result would be a very small (around 0.1%) increase in GDP.⁴

Revenue raised: A CBAM can create revenue either through tariffs or through the sale of additional importer allowances. These revenues could total around €7.61bn.⁵ In addition, the CBAM would allow for the phase-out of free allocation, and so would release a much larger pool of allowances for Member States to auction. Finally, the increased EU ambition facilitated by the CBAM would raise the carbon price and so increase the revenue raised from the sale of allowances. It has been suggested that revenue from the CBAM will become a new source of Own Resources to contribute to the repayment of loans under the Recovery and Resilience Fund. However, **it should also be considered that these revenues could be redirected into funds to support international climate mitigation and adaptation** (see point 9). This would not only work towards improving global climate ambition but could also reduce international opposition to the CBAM. It would also strengthen the EU's case in a potential WTO appeal against the CBAM, by demonstrating the EU's continued engagement with multilateral climate action.

Political resistance from EU industry: Industries may prefer free allocation because they are familiar with the system, which shelters them from carbon costs and may even generate windfall profits. **However, free allocation ultimately needs to be phased out as the EU ETS cap is reduced, so a replacement needs to be found.** It is likely that the most acceptable approach for industry would be to phase in the CBAM while phasing out free allocation, with an awarding mechanism to exports.

Compatibility with WTO rules: Most relevant in the case of the CBAM are the GATT and the Agreement on Subsidies and Countervailing Measures (SCM). There is a lack of established case law, but it is clear that to apply under Article XX of the GATT, the CBAM would need to demonstrate equivalence of treatment between imports and domestic products, as well as environmental benefits. A set of WTO-compatible design principles should be set when developing the CBAM.⁶ The CBAM would have more coherence with Article XX, and with the CBDR principle of the Paris Agreement, if it is **justified on the grounds of preventing carbon leakage (and thus making EU climate policy more effective)** rather than on the grounds of directing the domestic climate policies of third countries. While there is likely to be some opposition whatever the measure introduced, the EU should nevertheless continue in its efforts to tackle carbon leakage, while remaining open to and facilitating discussion of multi-lateral solutions to the issue. More broadly, **the EU should work to reform the WTO rules to enshrine compatibility with the Paris Agreement in global trade policy.**

International response: The CBAM may encourage other jurisdictions to develop their own carbon pricing systems and/or reduce the carbon intensity of their production. However, there is also a risk of retaliation from other jurisdictions. Substantial diplomatic effort and bilateral discussions are likely to be required. Trade partners

³ Centre for Climate and Energy Analysis (2020). The effects of the implementation of the Border Tax Adjustment in the context of more stringent EU climate policy until 2030. <http://climatecake.pl/wp-content/uploads/2020/09/The-effects-of-the-implementation-of-the-Border-Tax-Adjustment-in-the-context-of-more-stringent-EU-climate-policy-until-2030.pdf>

⁴ Ibid.

⁵ Ibid. – based on the development of carbon prices in line with a 55% emission reduction by 2030.

⁶ Cf. Jacques Delors Institute (2020). Greening EU Trade 3 : A European Border Carbon Adjustment Proposal. https://institutdelors.eu/wp-content/uploads/2020/06/PP_200603_Greeningtrade3_Lamy-Pons-Leturcq_EN-1.pdf

should be consulted throughout the CBAM development (this would also stand as evidence of the EU's commitment to multilateralism in any potential dispute settlement process).

Administrative burden: The CBAM would require the tracking of both embodied emissions and the price paid for those emissions (after any free allowances). The monitoring system would likely require third-party verification and would need to be flexible to accommodate both benchmarks and specific values for individual producers. However, in the last few years a number of multiregional GHG footprint databases have been developed that would make this task easier. **The EU may need to provide administrative support for jurisdictions with less-developed administrative capacities** – this could be funded by revenue from the CBAM. Rules regarding product origin and transshipment (moving a product via intermediate jurisdictions) will need to be defined and a system put in place to implement them. This will be particularly difficult across jurisdictions with differing carbon pricing policies.

11. Conclusion

While the CBAM could be a promising tool for augmenting the effectiveness of the EU ETS in tackling greenhouse gas emissions, it will require careful crafting to ensure that it respects both EU climate ambition and fair competition. Sandbag looks forward to engaging further with the Commission and other stakeholders on the development of this policy instrument.