

## OUTCOME PAPER

### Carbon border adjustment mechanism: How to make it work

#### SUMMARY

This position paper outlines the Institute of European Democrat's main policy recommendations on the carbon border adjustment mechanism. To be fully effective, the proposal must be anchored in multilateral climate diplomacy to ensure acceptance from trade partners. The most cost-effective and functional design for CBAM is to work in conjunction with the EU ETS. A gradual phase-in of the measures will be key to ensure visibility for economic actors.

#### 1. Introduction

This position paper is built on the IED webinar "[Green no deal? Carbon Border Adjustment Mechanisms: How to make it work](#)". Throughout the panelists' contributions, there was consensus that the EU and its trade partners are on critical paths to carbon neutrality & contribute towards the green deal. Economic agents' exposure to some form of carbon pricing is bound to increase progressively if the world is to move towards a decarbonized economy.

EU producers are exposed to carbon pricing, either at national level or via the EU Emission Trading System (ETS). To create a level-playing field between EU and third country producers, a Carbon Border Adjustment Mechanism (CBAM) could expose an additional burden to third country exporters to the EU. CBAM is set to contribute to EU's increased climate ambition. In no way it is a protectionist measure aimed at advantaging EU producers. It is recognized that international trade contains a significant part of emissions and the EU has leverage over its partner's climate engagement via its strong trade ties.

#### 2. Key guiding principles for BCA design

From a the perspective of European Democrats (European Democratic Party and its affiliated Institute of European Democrats), 4 key principles should guide any design features of the CBAM.

##### 2.1. Multilateral climate diplomacy

To avoid disruption of existing trade relations, CBAM must:

- (1) observe the principle of **non-discrimination** against foreign producers;
- (2) aim to agree on carbon content assessment methodology at **multilateral** level;
- (3) avoid any doubt on whether it would be used as a **trade barrier**.

First, implementing these principles is a pre-requisite for WTO (World Trade Organisation) compatibility and prevent any trade partner filing a complaint through WTO dispute settlement. Second, the EU must apply these principles taking into account its trade partner's climate efforts. While the EU is a global climate leader, the EU's closest trade partners are swiftly catching up and are on comparably ambitious decarbonization paths.

CBAM should therefore be developed cooperatively with trade partners. While all third country importers to the EU must be exposed equally to EU's CBAM, nothing prevents to concentrate its

concertation efforts on a few selected trade partners with the highest GHG emissions accounts. By collaborating with its main trading partners, the EU can incentivize some of the biggest worldwide emitters to decarbonize their production.

A conflict resolution mechanism compatible with WTO law can help alleviate concerns from trade partners. The narrative around the announced measures should ensure making clear that this is not a punitive, protectionist measure, but is attempting to tackle emissions in spirit with the Paris Agreement and invites third countries to join up with the EU in the climate fight. The worst outcome would be the fragmentation of the broad climate alliance achieved with the Paris Agreement caused by EU unilateralist action.

However, climate efforts are a patchwork of announced, planned, negotiated and implemented ambitions, targets and measures. Not all are necessarily verifiable or lead economic actors along value chains to resort to more carbon-efficient measures. A strong and reliable benchmark is therefore needed.

## 2.2. A CBAM benchmark aligned with the EU ETS – avoiding getting lost in the weeds

The EU cannot impose a carbon burden beyond levels European companies are exposed to via the EU ETS (Emission Trading System). To mitigate these risks, a full alignment of CBAM on the EU Emission Trading System (ETS) will be necessary. The ETS would allow an equal treatment and defining a benchmark for foreign manufacturers. The EU ETS can easily be used as the main price signal for the CBAM and act as a “mirror mechanism”: what EU producers are exposed to as carbon price, third country producers must pay as well.

Several design features must be observed to ensure the ETS provides the appropriate price signal:

- (1) **Carbon price signal.** The EU ETS allowance price must remain stable to prevent any CBAM price erosion. A sharp price decrease would be highly disruptive as to the aim of the CBAM. Also, in the long-term the EU ETS must be aligned with the EU’s carbon neutrality ambitions, by ensuring a steadily rising CO<sub>2</sub> price (by reducing supply of allowances). This will ensure predictability for both EU and third country producers. The upcoming reform of the EU ETS should ensure this. Finally, once CBAM is in place free allowances for European companies will have to be phased out gradually in conjunction with equal application of third party manufacturers so as to create a level playing field.
- (2) **Transparency.** EU ETS allowances are subject to very specific price formation mechanisms, i.e. a regulated demand and supply of certificates (linear reduction factor, benchmarks, market stability mechanism). It is paramount that third country importers are well-informed about these dynamics to ensure transparency and prevent any suspicion that the EU aims to overburden certain third country producers.
- (3) **Emissions.** In an ideal world, carbon pricing will take into account country-specific carbon intensity of the electricity grid or the country-specific energy mix and use this as a proxy. This means CBAM would be levied on direct emission plus indirect emissions from electricity. Product-specific benchmarks would create administrative burden and come with high transaction costs, and therefore hard to implement.
- (4) **Equivalence.** WTO compliance means that the EU will have to consider any carbon prices foreign producers might already be exposed to in their country of origin and discount them from their CBAM exposure. Where no carbon pricing exists, a way to create fairness could be

to add the possibility for individual producers to demonstrate that they have a more carbon-efficient value chain than the benchmark has identified.

- (5) **Incentive.** Exposing 3<sup>rd</sup> country importers to the EU has the aim to incentivize more carbon-efficient production methods. A good way to re-utilize the income from CBAM could be to promote low-carbon technologies use by developing countries that lack access or resources to finance their energy transition and large infrastructure projects to decarbonize their energy mix. The European Investment Bank (EIB) can play a key role and position the EU as an alternative to China's road and belt initiative.
- (6) **Carbon price link.** Strategically, the EU would be well-advised to open the door for third countries to link up their emission trading system with the EU. This would create tremendous synergies between regulators and create predictability for producers and investors.

### 3. Risk mitigation

**Reduce retaliation risk.** The above measures must all be accompanied with increased efforts from EU and European capital's diplomacy to inform, communicate and accompany partner countries into the changes that come with CBAM.

**Compliance.** While multilateral collaboration is paramount to the success of CBAM, the EU must ensure that the CBAM is complied with. The biggest risk is missing, misleading or falsified information on a producers' origin country emission levels. A transparent process must ensure continuous updates and clear guidelines for foreign producers.

**Trade deviation.** A likely outcome of imposing CBAM will be trade deviation if key products to other countries. It is difficult to predict the outcome reliably but an assessment of likely outcomes and potential price increases of raw materials for the European market is essential. Mitigation measures for European producers facing increased costs and/or supply risks must be implemented, including potential earmarking CBAM income for supporting these producers. Any significant consumer price increases due to producers externalizing costs must be averted.

### 4. Phasing

The EU would be well-advised to phase in the CBAM progressively, both in scope and magnitude. The roll-out plan could look as follows:

1. **Preparations:** Announcement. The European Commission, together with its draft legislative proposal, notifies key trading partners about its intention to pass the CBAM legislation with the existing ETS framework.
2. **The first CBAM phase.** Implementation of a CBAM for raw materials + sectors covered by EU ETS (steel, concrete, chemicals, other raw materials).
3. **The second CBAM phase.** CBAM applies for the direct carbon content in all products (including processed products), taking into account the country-specific energy mix.
4. **The third CBAM phase.** Where possible, the EU links up the EU ETS with carbon price mechanisms in key trading partner countries.

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