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BUSINESSEUROPE INPUTS TO PUBLIC CONSULTATION ON THE CARBON BORDER ADJUSTMENT MECHANISM

We appreciate the opportunity of the European Commission to provide our assessment on the desirability and added value of creating a carbon border adjustment mechanism. Some of the multiple choice questions in the questionnaire cannot be answered conclusively as important nuances depend on the interpretation of the question and/or depend on the final design of the proposal.

That said, carbon border adjustments (CBAs) are a sensitive measure and we at this point do not take a position neither for nor against it. Should such a CBA one day be introduced, it is however crucial that its goals and design are analysed in great detail before it is introduced. The open questions in our annex should also be addressed.

GOALS

In terms of goals, a CBA if designed and implemented efficiently could offer an effective way to convince other world economies to **converge with the climate objectives** of Europe so as to reduce global GHG emissions. By doing so, a CBA should also aim at minimising the threat that production is transferred from the EU to other countries with lower ambition for emission reduction, or because EU products are replaced by more carbon-intensive imports (**'carbon leakage'**) as well as the threat of them deciding to gradually shift more investments outside of the EU (**'investment leakage'**) depending on the carbon price. These two goals are intrinsically related with each other: The threat of investment leakage and carbon leakage cannot be fully mitigated as long as others are not also aiming to move to a climate neutral economy at the same speed as Europe. Therefore, the priority should be given to establishing well-functioning international carbon markets and a global carbon price in line with Article 6 of the Paris Agreement, which would eventually render the CBA discussion obsolete.

DESIGN

Designing a CBA will be politically and legally challenging and subject to many risks, practical problems and uncertainties. Nevertheless, it is pivotal that the European Commission considers any CBA option along the following guiding principles:

A. EU ETS-compliant

The EU Emissions Trading System (EU ETS) is and should remain the key market-based instrument for Europe's industries and power sector to cost-effectively reduce their GHG emissions. This includes the **system of free allowances** that provides the key stimulus for industry installations under the EU ETS to be amongst the best in class¹ and the **compensation of indirect ETS costs**.

Therefore, **we urge the European Commission to consider a scenario in its future impact assessment where the existing carbon leakage measures co-exist with a CBA**, and therefore strongly reject the notion that a CBA is an alternative to these measures. In particular, in contrast to what is sometimes claimed, the existing free allowances system next to a CBA would not necessarily amount to double protection. In some CBA designs, if importers can demonstrate with verified data that their imports are at least as efficient as the best in class, they can avoid a CBA charge. This would be the **equivalent for importers to receiving free allowances**. To avoid new market distortions between EU producers and importers, the existing system of free allowances should then also be maintained for EU producers.

Replacing the existing carbon leakage measures by an untested mechanism could create considerable uncertainties and risks for the European industry. For example, shifting to a system of full auctioning when a CBA is in place would:

- **Increase the risk of retaliation.** Under the current EU ETS Directive, free allowances will gradually decline over Phase IV (2021-2030). This can be reflected towards importers through a CBA charge that gradually increases over time. Through this approach, importers will have time to adjust to a system where the CBA charge rises gradually. However, if the CBA replaces the free allowances system for EU producers overnight, then importers should also be faced with a CBA even if they would be amongst the best in class, in order to avoid market distortions with EU producers. In this case, the "pain" of the CBA measure will be considerably high even for importers importing products from the most efficient installations in the world. Consequently, the risk of retaliatory measures by trading partners will increase significantly.
- **Create significant investment uncertainty.** Firstly, the EU ETS Directive including free allocation and indirect cost compensation has only very recently been revised for the period until 2030. Changing this recently adopted legislation by scrapping free allocation and indirect cost compensation would disrupt long-term investment decisions already taken. Secondly, EU producers not only face compliance costs (the EU ETS costs), but also abatement costs since they make investments in breakthrough technologies to reduce emissions. A CBA fully

¹ The EU identifies the 10% most efficient installations for each sector on the EU ETS carbon leakage list. Based on the average of these best in class, product benchmarks are designed. If a domestic installation beats the benchmark, that installation in theory receives all its allowances for free, otherwise it has to buy part of all of its allowances on the market, depending how far it is removed from the benchmark.

replacing existing carbon leakage measures would significantly impact a company's financial ability and willingness to invest in such breakthrough technologies in Europe.

- **Decrease European companies' cost-competitiveness in third markets.** A CBA mechanism could encourage foreign companies to produce more environmentally friendly if they want to enter the EU market, but not necessarily if they want to access their own market or third markets without carbon pricing. EU companies losing free allowances would therefore be at a disadvantage vis-à-vis these foreign companies when competing for third markets access. This is the reason for continuing the system of free allowances for the best in class as is currently the case under the EU ETS Directive. Furthermore, the Commission must explore in its impact assessment ways of mitigating the already ongoing loss of export competitiveness from European industry, while of course making sure that such measures comply with WTO rules in the area of subsidies.

B. WTO-compliant

We agree with the Commission that the CBAM must be compliant with the current WTO rulebook. Compliance with the WTO rulebook is not only crucial to avoid risky dispute procedures and improve regulatory predictability for the implementation, but also to minimise the risk of retaliatory measures by our major trading partners. Transparency and close dialogue with trading partners will be very important to minimise any risks.²

C. Circumvention-proof

As section 13 of the consultation correctly points out, the CBA should have adequate anti-circumventing mechanisms. For each of the four circumvention examples mentioned in the consultation plus one additional example, we believe the following solutions could potentially help addressing them:

- **Substitution between primary inputs and semi-finished goods.** For example, if the CBA is only charged on the imports of basic materials, it might encourage importers to move away from such materials and import more semi-finished products instead, which would not be subject to a CBA. In this situation, the CBA would simply transfer the risk of carbon and investment leakage to the next level of the value chain, and the net effect of a CBA on pushing other major economies to increase their climate actions (and thus the net effect on global emission reductions) would be significantly diminished.

² For example, some EU neighborhood countries have agreed to approximate their respective legislation to EU law, including policies on climate and environment, over a certain period of time. Therefore, proper consideration should be given how to best accommodate any CBA design with such agreements.

Possible solution: The risk of substitution between imports of raw materials and finished or semi-finished products could be solved in the long term through the implementation of a CBA that covers multiple parts of the value chain. Doing so would best work for simple products with relatively short supply chains.

- **Resource shuffling or “source shifting” in the form allocating low carbon production only to the EU with no or negative effect to the overall CO₂ emissions.** For example, producers in China or elsewhere could reorganise their trade flows in such a way that the products produced in their cleanest installations are exported to Europe, thereby minimising any CBA charge, whereas the products from their dirtiest installations are sold domestically or to other parts of the world.

Possible solution: We believe that one of the effective ways to reduce such circumvention risks is to base the calculation of carbon content of imports on producer-specific benchmarks. In other words, the carbon content is based on the average of all installations of a particular producer. This would make it significantly more difficult for producers to game the system, and they will be incentivised to reduce the carbon content of their entire product offering, not just the part they export to Europe.

- **Transshipment strategies if the possibility for exempted countries is included.**

Possible solution: The operation of the EU ETS is based on rigorous monitoring, reporting and verification (MRV) rules. Therefore, complementing the EU ETS with a CBA would also mean we must apply these MRV rules to imports. As part of implementation of the Paris Agreement, work on common MRV systems that are robust can ensure that any transshipment strategy is useless to pursue. There should also be strict conditions on when a country can become exempted, one of those being that these countries should closely cooperate with the EU to prevent these transshipment strategies. Europe can build on the experience that exists in Trade Defence Instruments and involve OLAF-European Anti-Fraud Office whenever necessary.

- **Avoidance based on slight modification of the product.**

Possible solution: The CBA should cover installations from third countries that match the characteristics of the sectors under the EU ETS (mostly NACE code, but also PRODCOM), combined with a proofing and monitoring system that a product was indeed manufactured in an ETS-like installation. This would reduce the risk that imports are falsely declared as being manufactured by a non-ETS-like installation. Possible penalties should be considered if there is a clear intent to circumvent the legislation.

- **Provided information on carbon content of imports is unreliable.**

Possible solution: The collection and disclosure of carbon content data will be decisive for the success of measures relating to the carbon intensity of production worldwide.

The system and procedure that will be applied for this must be an internationally recognised certification system that is objective and independent. This is partly dealt with in section 11 of the consultation, but must go further. Objective data brought by European producers should also be considered. There should be the possibility for the commission services to verify, in-situ, when there is reasonable doubt that the information provided is not reliable. That said, we should avoid putting a lot of administrative burden on European companies, especially SMEs.

D. Comprehensive, transparent and manageable (administratively & financially)

The design and WTO-compatibility of the CBA will be difficult to assess with certainty. Therefore, while analysing the effectiveness of the CBA in tackling carbon and investment leakage, the impact assessment should look at how a CBA would fare in terms of ensuring fairness, additionality, transparency and predictability, also at a sector level. This needs to consider both European businesses that could potentially bear the additional administrative requirements and see their value chains impacted, as well as Europe's trading partners that need full transparency from the EU as to which objective criteria will be used to assess their exports to the EU. Such full transparency and early dialogue with trading partners will be key for implementation.

E. Initially limited in scope

Uncertainty must further be addressed in the impact assessment by looking at how any CBA option could initially be started with a limited number of (sub-)sectors, and what are the likely risks of legal challenges and retaliation for doing so. If other sectors are to be included gradually, quantitative and qualitative assessments should be carried out in order to capture certain sectorial specificities and needs. Furthermore, the gradual introduction of (sub-)sectors must be done in a way that does not create competitive distortions between competing sectors.

F. Only climate-related

Part of the risk of any CBA measure is that it sets a precedent for further restrictions on trade in the future based on other, non-climate related matters. It will already be extremely challenging to reliably measure and verify the carbon content of traded materials, especially if full consideration is given to life cycle CO₂ emissions. Therefore, the EU should oppose calls for broadening the goals of any CBA option to anything else other than global climate action and the risk of carbon/investment leakage.

G. Limited in duration

As CBAs are in principle trade restrictive, the impact assessment should look into the ease with which CBAs could be reviewed in order to be adjusted or even removed once breakthrough technologies reach global marketability, global climate ambitions are converged, and /or when retaliation occurs.

Annex: Open questions

In addition to addressing the aforementioned points, further questions need to be discussed, including but not limited to the following:

Q1: How could the revenues generated with the CBA be used most effectively and in line with international rules?

The impact assessment should look into how the CBA's revenues can be used to achieve the two main goals, i.e. minimise carbon and investment leakage, as well as converging global climate ambitions. For example, should the revenues flow into EU internal climate funds, such as the EU ETS Innovation Fund to help bring the costs down of EU-based low-carbon RDI, or should it be used to fund low-carbon investments in third countries? An additional layer of complexity arises here in the form of additionality: For example, how to make sure that a third country doesn't simply reduce its domestic climate action expenditures by the same amount as it stands to receive from the EU's CBA revenues, thereby annulling the additionality effects of the CBA?

Linkage to support of EU policies through CBA revenues should be carefully designed in line with existing international law and WTO rules.

Furthermore, earmarking part of CBA revenues for transfers to least developed countries might facilitate international negotiations.

Q2: How does the Commission take the impact on the value chain into account and how will we avoid that the competitiveness of the EU industry including its export capacity is eroded?

In line with section 15 of the consultation, assuming the CBA is not applied to finished goods but more upstream goods of activities, it will be important for the impact assessment to calculate the estimated increased costs of the CBA throughout the value chain, and whether this in turn would result in increased costs of imported goods in Europe and potentially undermine the EU's export capacity.

Q3: How will the CBA be aligned with existing customs' regimes and how will it be calculated?

The EU has an external tariff that includes in some cases preferential rates, for instance for countries that have a free trade agreement with the EU or countries that are GSP-Generalised System of Preferences beneficiaries. The applied duties are collected when the products are imported into the EU with some exceptional regimes, such as outward or inward processing. It will be important to define how the CBA will be calculated and how it will be collected from importers. For example, will it be added to the normal tariff of an imported product, or will it be based on an average amount paid on an annual/monthly basis? Moreover, a CBA should be compatible with the EU

customs regimes and hence not be applied to goods benefitting from these regimes (e.g. goods imported and then re-exported outside the EU).

Q4: International obligations under EU FTAs

How will CBAM be aligned with preferential tariffs under EU FTAs? Even if the WTO compatibility can be demonstrated, the border measure may be challenged under bilateral trade agreements that enact reciprocal tariff concessions.