Comments on the Commission's proposal for a regulation establishing a carbon border adjustment mechanism

ABOUT AEGIS EUROPE

AEGIS Europe is an industry alliance that brings together more than 20 European manufacturing associations committed to free and fair international trade ensured by an effective international level-playing field. Our members account for more than €500 billion in annual turnover, as well as for millions of jobs across the EU.

Introduction

This document sets out AEGIS Europe's views on the recent Commission's Proposal for a Carbon Border Adjustment Mechanism (CBAM) published on 14 July 2021.

These views must be read in the light of AEGIS Europe's earlier comments[1] and position papers[2] which focused on ensuring that the new regulation is an effective tool in tackling climate change, by fully addressing the risks of carbon leakage.

The EU industrial sectors grouped within AEGIS Europe are more than determined to participate in the emissions reduction efforts. However, given that significant numbers of the EU's international trading partners do not have the same level of climate ambition as the Union, EU policymakers need to ensure that the EU's high climate ambition does not result in carbon leakage, either through relocation of EU production outside the EU, replacement of EU exports with high carbon footprint goods from other countries or increased imports into the EU of more carbon-intensive products. On the other hand, carbon leakage should not be transferred onto downstream industries.

Failure to address these three forms of leakage would dramatically affect the capacity of EU industries to contribute to the climate challenge without any corresponding benefit since carbon leakage will automatically result in an overall increase in global emissions.

Need for a targeted approach for all sectors where CBAM is deemed appropriate, effective and feasible following the transition period

CBAM is not a tool that can be implemented in an effective way for all sectors under the EU ETS. As mentioned below, AEGIS does not support the unilateral, ex-ante free allocation phase out for CBAM sectors. In addition, should other sectors be added in the scope of the measure, they should also be entitled to a transition period before the full application of the CBAM, as it is currently proposed for the first batch of sectors.

Need to maintain free allowances

As already emphasised by AEGIS Europe and its members, it is absolutely necessary to maintain free allowances to all exposed manufacturers in Europe in order to avoid disruptive impacts on manufacturing costs and allow sufficient time for the deployment of low carbon technologies, as well as to minimise the impact on downstream industries and users.

Free allowances

The EU carbon cost has jumped from €25 in November-December 2020 to approx. €60 in November 2021. None of the EU's competitors have had to absorb such a high, and increasing, carbon cost. In order to meet the European Green Deal ambitions, many sectors have sped up the implementation of low carbon projects. In this context, removing or even reducing free allowances below the benchmark level would translate into an increase in ETS compliance costs for these industries, and thus the competitiveness of EU industries would be undermined which in the end would negatively impact the climate change objectives set out by the EU.

CBAM is not an alternative to the free allocation of emission allowances as both measures address different types of carbon leakage in the framework of the EU ETS. For instance, a CBAM alone would not solve the issue of carbon leakage for EU industries that are mainly export-oriented. From a legal

[1] Response of AEGIS Europe to the European Commission Public Consultation on the Carbon Border Adjustment, 28 October 2020 accessible here.

[2] AEGIS Europe position paper on "*Designing a Carbon Border Adjustment Mechanism that works for the EU*" accessible here.

point of view, the co-existence of free allowances and a CBAM under the EU ETS umbrella is WTO compatible. As shown by a legal study[3] commissioned by AEGIS Europe, an EU ETS – incorporating both free allowances and a CBAM – is a border adjustable internal measure which is consistent with GATT non-discrimination obligations as long as EU products and imports face an equivalent regulatory burden that is applied on an even-handed basis[4].

Indirect cost vs indirect emissions

European producers are exposed to indirect carbon costs passed on by electricity producers. Due to the functioning of the electricity market, these costs are not linked to the emissions embedded in the electricity consumed but to the emissions of the marginal delivered electricity. Indirect costs from the electricity market are higher than those that would be derived directly from indirect emissions, the indirect costs compensation system allowed by the ETS Guidelines should keep a central role until it is demonstrated that a CBAM has the effect of avoiding carbon leakage due to these costs**.**

Bottom line, AEGIS Europe firmly opposes the automatic phase-out of ETS free allowances and considers these should be maintained in full for such time as necessary to allow sufficient time for the deployment of low carbon technologies and until it is proven beyond any doubt that CBAM is effective and carbon leakage is averted.

Need to address carbon leakage associated with EU Exports

The European Commission has not proposed the granting of export adjustments (reimbursements or rebates according to the terminology used in the Impact Assessment reports) at this early stage in the drafting process[5] and has so far rejected the concerns of many sectors that were spelled out in their submissions and comments on the Commission's first ideas on a possible CBAM.

By refusing to address the carbon leakage associated with EU exports in its proposal, the Commission has failed to address a fundamental element that must be part of an overall climate strategy to prevent all forms of carbon leakage. This failure puts at risk the achievement of the EU's ambitious climate goals.

EU industries export their production outside the EU – amounting to more than 135 billion EUR yearly for direct exports of AEGIS Europe members - and on these export markets they are in competition with more carbon-intensive products from third countries. If EU exports become uncompetitive because of the costs and regulatory burdens associated with decarbonisation, they will lose out to exports from countries not decarbonising since carbon-limited exports will be replaced by products from high carbon sources leading to another form of carbon leakage likely to *in fine* result in an overall increase in global emissions.

AEGIS Europe thus considers that providing a **carbon burden adjustment for EU exports** would avoid this type of carbon leakage and would effectively contribute to the achievement of the overarching climate goals.

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[3] AEGIS Europe legal study "*Consistency of an EU carbon border adjustment mechanism ("CBAM") with World Trade Organization ("WTO") rules"* accessible here.

[4] Even if an EU ETS – incorporating both free allowances and a CBAM – would be considered by a Panel as WTO inconsistent, AEGIS Europe considers that such a system can still be justified under GATT Article XX since it would fall under the GATT general exceptions relating to the conservation of exhaustible natural resources (GATT Article XX(g)) or to the necessity to protect human, animal or plant life or health (GATT Article XX(b)). Moreover, it would not arbitrarily or unjustifiably discriminate between countries where the same conditions prevail or represent a disguised restriction on international trade.

[5] See Commission Staff Working Document Impact Assessment Report Accompanying the document Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 14 July 2021, part 1/2 page 42.

The adoption of "export adjustments" should be an integral part of the EU ETS to ensure consistency with the WTO rules[6] as shown in the AEGIS Europe legal study.[7] *De facto* export adjustments (i.e., extending free allowances to EU production destined for export) and/or *de jure* export adjustments (i.e., granting refund/credit for allowance obligations on exports) cannot be qualified as subsidies under Article 1.1 of the WTO SCM Agreement because no financial contribution is provided by the EU and no benefit is conferred. The AEGIS Europe legal study shows that those export adjustments – which must be an integrated but independent component of the EU ETS – must be kept in place until third countries align their climate policies to the EU's since the carbon leakage risk would persist.

It goes without saying that in order to maximise the effectiveness of its climate policies, the EU must strive to avoid carbon leakage and promote low-carbon production. Thus, by becoming a significant exporter of low-carbon products and technologies and thus replacing high-carbon products in third countries, a significant reduction in global emissions would result. However, this result cannot be achieved by EU industry alone since they are in the middle of deploying low carbon technologies which have triggered considerable investments in very dire market conditions since the carbon costs are at all-time high and likely to increase.

Success in achieving the EU's ambitious climate goals can only come from well-designed and integrated programmes to prevent all forms of carbon leakage, including carbon leakage associated with exports from the EU. Failing to take this fundamental aspect into the EU's overall climate strategy would only result in an overall increase in global emissions, thereby annulling all the efforts made within the EU to achieve EU's ambitious climate goals.

AEGIS Europe thus urges the European Commission to reconsider its rejection of export adjustments and to design a carbon adjustment for EU exports factoring in the recommendations of the legal study through which the WTO compatibility of such an adjustment has been established provided that such a measure comes firmly within the wider EU ETS umbrella.

AEGIS Europe supports the EU's climate change targets and recognises that the achievement of these targets requires deep and structural transformations to the European economy. These can only be successful if the EU carefully crafts and gradually implement such transformations. In particular there is a clear need for a well-considered staged roll-out of new climate trade related measures, with continuous consideration, to what is or will be possible and permissible, now or in the future, taking account of the classic trade and economic regimes under the EU and WTO acquis.

Climate change does not stop at the borders of the Union. Border adjustments fail on the overarching climate goal if they result in the replacement of European low-carbon exports with carbon intense products. Export levelling mechanisms are needed to complement the inward oriented CBAM. But as of today, an export pillar to CBAM is evidently and unfortunately missing in the current EC proposal. This regrettable situation reinforces that the EU should maintain free allowances in order to prevent the local EU industry (directly exposed to EU ETS or sourcing inputs from EU industries under ETS) from carbon leakage.

[6] In particular the WTO Agreement on Subsidies and Countervailing measures

[7] AEGIS Europe legal study "*WTO consistency of "export adjustments" in the context of the EU Emissions Trading System (incorporating a Carbon Border Adjustment Mechanism)"* accessible here.

Furthermore, as the EU travels on its pathway it is essential that it strikes an optimal balance between the export interests of the EU downstream industry currently managed under the EU's duty relief schemes and in particular the inward processing relief scheme and the interests of the EU upstream industry manufacturing input materials.

Actual equivalence of carbon cost burden in third countries

AEGIS Europe considers that an EU CBAM must apply to products from all origins as shown in the legal study[8] commissioned by AEGIS Europe. However, countries with equivalent ETS systems - equivalent carbon costs and reduction obligations - should be treated fairly and CBAM exemptions should be envisaged. "Double carbon costs" or unjustified export adjustments should be avoided when implementing the overall EU ETS mechanism in order to ensure consistency with WTO rules.

Thus, foreign products should be able to obtain an adjustment of the CBAM if the importer is able to prove the product's carbon footprint based either on the actual carbon footprint, the average carbon footprint for the sector in the country of origin or a default value set by the EU authorities considering the most carbon intensive production methodology in the country of origin. Having proven that the foreign product has been subject to comparable carbon costs and reduction obligations in the place where essential manufacturing occurs, the necessary adjustments must be applied.

However, AEGIS Europe observes that rigorous controls should be envisaged to evaluate the equivalence of carbon costs and reduction commitments in third countries. Thus, when the EU competent institutions address the equivalence of carbon costs burdens and limitations in third countries, AEGIS Europe considers that the following elements should be factored in:

i) the foreign system should reflect, in law and practice, the equivalence of carbon pricing and reduction;
ii) the possibility to verify that the carbon cost borne by the foreign producer is not compensated or neutralised via other domestic measures. In this respect, AEGIS Europe calls for a mechanism that would automatically disregard any equivalence of carbon cost system with respect to third countries where significant distortions in the system have been identified until the situation has been corrected;
iii) in case of partial equivalence, the possibility to modulate the CBAM and to account only for the difference between the foreign and EU systems could be envisaged.

If the EU competent authority reaches the conclusion that third countries have equivalent carbon costing and reduction systems, they should not simply exempt those origins from the relevant parts of the EU ETS. Rather, the overall mechanism should be maintained, and a simplified administrative procedure allowing exemption from CBAM compensated payment at the EU border so as to limit the risk of circumvention.

Circumvention and resource shuffling

AEGIS Europe considers that the CBAM proposal is complex which could become an instrument prone to gameing, loopholes and circumvention. To begin with, the definition of circumvention in the current CBAM proposal[9] is narrow and vague since it only covers cases of slight product modification and does not cover, for instance, resource shuffling and cost absorption.

[8] AEGIS Europe legal study "Treatment of alleged carbon cost burdens in third countries" accessible here.
[9] Article 27 of the Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism

Even though resource shuffling was considered in the Impact Assessment reports, the Commission did not address it in the Proposal since it considered that "*importers are perfectly entitled to direct lower-carbon products to the EU".* However, the Commission is also aware that "*while resource shuffling of this scale would improve the EU's carbon footprint, it could result in higher carbon leakage, thereby undermining the effectiveness of the CBAM*". However, it considered that despite such "*negative implications, resource shuffling should be balanced against the fact that third countries would have to make an effort to produce low carbon-intensive products for the EU market and this will be positive from a climate perspective*". [10] AEGIS Europe considers that not addressing resource shuffling opens the door to circumvention practices and thus undermines the EU's overarching climate goals.

Need to strengthen the envisaged legal framework and to identify additional measures

AEGIS Europe reiterates that a CBAM will not work for all sectors. For some sectors with very specific value chains, products, and global trade flows, a CBAM will not be an effective tool to address carbon leakage, reduce emissions, and create leverage towards third countries to up their climate ambition. On the contrary, it will lead to further costs for the industry and increase carbon leakage rather than prevent it.

The European Commission is aware that the CBAM will not respond to all the challenges posed to economic sectors as a result of the European Green Strategy, including those challenges posed to EU downstream industries. This is the reason why it has also considered a strengthening of EU rules to accompany the development of a sustainable EU economy, in particular through strengthened environmental standards all along the value chains with the appropriate controls[11].

AEGIS Europe concludes that achieving decarbonization and limiting the rise in global temperatures to 1.5° will require a range of policies in addition to a reformed EU ETS with effective carbon leakage instruments.

[10] See Commission Staff Working Document Impact Assessment Report Accompanying the document Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, 14 July 2021, part 1/2 page 30.

[11] See the EU Commission's Communication entitled "Trade Policy Review – An Open, Sustainable and Assertive Trade Policy" (18 February 2021), in which it emphasized the need to "*mak[e] supply chains more sustainable, in particular by promoting sustainability standards across global value chains*" and stated that "[*i]mports must comply with relevant EU regulation and standards. […] Global trade rules aim at securing a predictable and non-discriminatory framework for trade while safeguarding each country's right to regulate in line with their societal preferences. The legitimacy of applying production requirements to imports is based on the need to protect the global environment or to respond to ethical concerns".*