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EU GREEN DEAL ON STEEL

EU CLIMATE LEADERSHIP REQUIRES WATERPROOF CARBON LEAKAGE MEASURES

WHY A CARBON BORDER MEASURE NEEDS TO COMPLEMENT TEMPORARILY FREE ALLOCATION AND INDIRECT COSTS COMPENSATION IN THE TRANSITION TOWARDS CLIMATE NEUTRALITY

This paper clarifies the reasons why it is appropriate from environmental, economic and legal perspectives to implement initially a carbon border measure as a complementary provision in addition to the existing carbon leakage measures.

The EU Green Deal is a landmark for the EU leadership in the international fight to climate change. The Green Deal proposes to step up substantially not only the long-term climate objectives for 2050 but also the short-term ones for 2030. Considering the current Intended Nationally Determined Contributions (INDCs) of international partners, this is likely to increase even further the differences in levels of ambition worldwide. This trend can be assessed by the end of 2020, when signatories of the Paris Agreement need to submit their final NDCs as well as their mid-century strategies.

In this context, avoiding the risk of carbon leakage is a pre-condition for preserving both the environmental integrity of EU climate policy and industrial competitiveness, since it contributes to reduce emissions at global level while maintaining jobs and investments in Europe. This will also be instrumental in facilitating the social acceptance of EU leadership in climate ambition.

Due to the market characteristics of the sector, tackling successfully the risk of carbon leakage in the steel industry is particularly relevant. As recognised in the 2018 Commission Communication "A clean Planet for All" as well as in the 2015 Impact Assessment accompanying the Commission proposal on the post 2020 EU ETS Directive, the steel sector is the most exposed among all energy intensive industries, both in terms of possible impact on output and on investment.

The Green Deal underlines that the risk of carbon leakage can materialise in different forms, "*either because 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*". As long as there is no international binding agreement with a global carbon price and equivalent efforts, it is essential that the EU legislation adopts effective measures that avoid all forms of leakage in the short term but also in medium term.

While free allocation is designed mainly to address the risk of production relocation, a carbon border measure can be an effective instrument to address structurally the emissions embedded in trade. This measure should take into account the carbon intensity and related costs in the EU and compare them with third countries.

The border measure should be applied for a transition period until breakthrough technologies reach sufficient market penetration and CO_2-lean products represent a critical mass in the market. It represents a broader contribution to a clean planet, as it is also an effective tool of political diplomacy to foster climate ambition in third countries so that deeper emission reductions are delivered globally. Furthermore, it would provide additional revenues to the EU that should be fully

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used for climate measures, in particular for the development and upscaling of industrial breakthrough technologies.

An effective carbon border measure needs to take into account both direct and indirect costs of the EU ETS and to create incentives for third countries' competitors to implement similar emission reductions. As proposed by the Commission, it should apply initially only to few sectors and others could opt in gradually. In the case of steel, it could initially apply only to steel finished and semi-finished products such as coils, slabs, plates, bars, billets, etc, and be extended to steel input materials (scope 3 emissions). A workable solution should preserve also those downstream products that are primarily based on steel, such as tubes, fasteners and wire drawings. The EU could adopt "Agreements of Equivalence" with third countries that either join the EU ETS or have identical CO_2 cost constraints for their industry, in which case there will be no border measure.

The effectiveness of the border measure will depend on the details of its design and its ability to tackle delicate issues such as the risk of absorption and source shifting.

With regard to the former, it is important to consider that EU carbon costs are applied to the entire EU production, while any border measure would likely apply only to the marginal tonnes that third countries' producers export to the EU, hence having the possibility to absorb such costs throughout their entire production. As an example, an EU producer with a total production of 5 million tonnes of steel and an average carbon cost of 10€/tonne will pay €50 million, while a third country producer with the same total production but exporting to the EU 5% of its production (250,000 tonnes) would face only costs of €2.5 million, which are much easier to absorb. By doing so, the EU imports would still set the price at a low level that does not reflect the actual carbon cost. From the example, it is clear that a measure based on average carbon costs spread over the entire EU steel production would not align the true costs of EU domestic producers with those of imports, continuing to erode EU domestic steel producers' competitiveness and render EU climate legislation increasingly ineffective.

Source shifting refers to the possibility that a third country producer exports to the EU the low carbon footprint products while selling products with high embedded emissions in other markets. This practice, which is prohibited in the Californian ETS, may prove difficult to identify and discipline.

These complex issues need to be fully solved in order to have an effective carbon measure. Applying full auctioning as soon as the border measures is implemented would expose the whole EU production to the full carbon costs in the decisive period where breakthrough technologies are being developed and upscaled. As long as EU imports would be setting the steel price at lower value, this situation would cause the concrete risk of leaking emissions, jobs and investments to third countries, hence undermining on one side the environmental integrity of the mechanism and on the other side the social acceptance of EU leadership in climate policy. This would be counterproductive for the successful implementation of the Green Deal.

Against this background, and considering all the elements below, it is essential that a carbon border adjustment is implemented as a complementary measure in addition to existing carbon leakage provisions in the transition towards climate neutrality:

- A carbon border measure aims to reach the combined environment objectives of the EU policy: reducing emissions, avoiding carbon leakage and complying with the costs of the cap & trade system. A complementary border adjustment would not lead to double protection, since existing carbon leakage measures are already partial and digressive. In fact, even with free allocation and compensation, EU producers bear carbon costs that are not applied to extra EU competitors. This divergence will further increase in the future.
- Moreover, EU producers are subject not only to compliance costs for the difference between their emissions and free allocation and between indirect costs and compensation (i.e. the

"trade" element of the EU ETS), but also to the full abatement costs that are necessary to develop the breakthrough technologies required to fulfil the emission reduction targets (i.e. the "cap" element of the EU ETS). A border adjustment replacing the existing carbon leakage measures would undermine their financial ability to invest in those technologies.

- While it is important to develop the border adjustment as soon as possible, its implementation should not lead to abrupt modifications of existing provisions in order to secure legal certainty for long term investment decisions. In particular, rules on carbon leakage measures for the period until 2030 have been adopted very recently and should not be modified.
- A carbon border measure implemented as a complementary instrument would also reduce the direct impact on trade flows and would mitigate trade tensions as it would provide a longer transition for negotiations with international partners to align climate ambition.
- Similarly, a border measure complementary to free allocation and indirect costs compensation would decrease the product price impact on downstream sectors within the EU, hence better preserving the entire value chain.
- As long as it is uncertain whether a border measure may address the environmental and competitiveness concerns linked to EU exports in third countries, a border measure with full auctioning for EU producers would burden them with the full carbon costs, thereby undermining their ability to access export markets.
- If a carbon measure is implemented with full auctioning for some sectors, the legal framework will lead to significant distortions of competition against other sectors that are still largely shielded from the carbon costs through free allocation and indirect costs compensation.
- It is clearly possible to design a WTO compliant carbon border measure that complements free allocation and indirect costs compensation in a transition period, since there is no WTO legal obligation to reduce or phase out these measures.

While a border adjustment based on the equivalent direct and indirect ETS costs can be an effective measure in the initial transition phase, a long-term regulatory framework is required for the advanced transition phase and the post-transition, i.e. when the breakthrough technologies reach sufficient market penetration and CO_2-lean steel represents a critical mass of the market, but operation costs are still significantly higher than for competitors with CO_2-intensive production. Such framework should be based on the actual CO_2 footprint of the product over the entire life-cycle, requiring the development of a proper accounting system, both at EU level and at the border