

INITIAL OBSERVATIONS BY GRUPA AZOTY TO EC INCEPTION IMPACT ASSESSMENT ON THE CARBON BORDER ADJUSTMENT MECHANISM

Grupa Azoty, one of the largest EU producers of fertilizers, thanks the European Commission for the ability to contribute to the Inception Impact Assessment on the carbon border adjustment mechanism [“CBAM” or “measure”].

Grupa Azoty supports the introduction of CBAM as it addresses the key gaps in EU ETS system: allowing EU consumption to contribute to increased global emissions, while burdening EU producers with ETS costs. At the same, by failing to incentivize foreign producers to lower their emissions, ETS fails to achieve the key EU objective of lowering global emissions.

For these reasons, Grupa Azoty tentatively supports the idea of a CBAM, provided that (a) its main objective is to encourage non-EU producers to eliminate their greenhouse gas emissions, (b) EU carbon leakage avoidance schemes (mainly, free allowances) are not weakened, and (c) WTO compatibility is ensured by keeping the system non-discriminatory towards non-EU exporters, as close to ETS as possible, with solid reliance on GATT Article XX where required.

Grupa Azoty also believes that the fertilizer sector should be covered by the CBAM for the following reasons:

1. EU fertilizer producers have already made significant contribution to lowering their greenhouse gas emissions, by practically eliminating N₂O emissions and approaching technological limits for CO₂ process emissions from ammonia.
2. Our sector has clearly paid the price for ETS by suffering carbon-leakage: exports are down, imports are up, EU companies are taken-over by non-EU producers from countries with no carbon pricing, investment in EU production is down with most new investments made outside of the European Union (some of which are planned for exports to the EU).
3. Main competitors of the EU fertilizer industry come from countries that have no price on carbon emissions.
4. EU market is attractive for non-EU producers of fertilizers, hence introduction of CBAM will encourage 3rd country producers to limit their own emissions.
5. It is simple to calculate emissions in the fertilizer sector, because they occur in only two points of production and most of emissions are directly related to consumption of key raw material.
6. Most imports to the EU in our sector originate in a handful of countries, with a small number of producing exporters, making CBAM manageable at the border.

Grupa Azoty also welcomes the Commission's decision to carry out a full Impact Assessment that will analyze the most important elements of the system. Considering the complicated interplay with ETS, WTO, and current plans to increase EU ambitions in terms of climate, an Impact Assessment is absolutely necessary.

If the Impact Assessment is to analyze individual sectors, Grupa Azoty calls on the Commission to include our sector - the fertilizer sector - in the Impact Assessment and stands ready and willing to provide the Commission with any required data.

Below, Grupa Azoty lists a number of factors the Commission should investigate when designing CBAM and therefore should include in its Impact Assessment.

Purpose of the Measure. The single most important issue the Commission should first determine is the exact purpose of the measure. Only once the exact purpose of the measure is ascertained, only then can the detailed structure of the measure be determined, because the former informs the later. Official EU documents and speeches of EU officials suggest a mix of two purposes. On the one hand, suggestion is made that the purpose of the measure is to avoid carbon leakage. On the other, suggestion is made that the purpose is to encourage 3rd countries to increase their climate ambitions. However, both purposes require different measures. The primary tool to avoid carbon leakage have historically been free allowances, therefore the solution to avoid further carbon leakage in context of EU's increased climate ambitions would need to be based on the free allowances concept. If, on the other hand, the purpose of the measure is to encourage 3rd countries to increase their own climate ambitions by using access to the EU market as an incentive, then the mechanism should be a border measure imposing cost on polluting imports. This instrument, however, is not concerned with carbon leakage and therefore does not revolve around the free allowance concept and should be kept separate therefrom.

Carbon Leakage. If the Commission determines that avoiding carbon leakage is central to the new mechanism, a thorough analysis of carbon leakage that has already occurred since ETS was introduced should be carried out in order to identify the sectors most exposed (and therefore eligible for CBAM) and verify whether existing measures for preventing carbon leakage have been successful.

In this context, it is important to note that EU law does not provide a clear definition of what exactly constitutes carbon leakage. Different interpretations of this term lead different stakeholders and institutions to reach different results on whether carbon leakage actually occurs.

Grupa Azoty therefore ask the Commission to be flexible and inclusive. Specifically, any processes - such as changes in trade or investment patterns - that result in the manufacturing of products consumed in the European Union, or previously produced in the European Union (even if destined for exports) where they had been subject to ETS, to

increasingly take place outside the European Union, where they are not subject to carbon pricing, should be considered carbon leakage. In this sense, replacement of EU production by foreign production should always be considered as carbon leakage, as production is moving away from ETS-imposed carbon pricing. The exact reason for such shifts in trade or investment patterns is not as determinative as its result of avoiding cost of carbon emissions. The physical transfer of EU production facilities to 3rd countries should not be required to determine existence of carbon leakage.¹ In fact - such transfer will occur only in the most extreme of cases. Most carbon leakage occurs through EU producers losing domestic and exports markets to non-EU/ETS production, as well as investments into new capacities. This loss does not even have to occur within one company: if EU company decreases production, but another foreign company increases production, builds a new foreign production facility to supply the EU market, redirects its existing production to the EU market to replace the production lost by the EU company, or redirects its existing production to a 3rd market replacing prior EU exports to that market, that too is carbon leakage as EU production that was subject to carbon pricing is replaced by 3rd country production that is not subject to carbon pricing.

Therefore, while assessing carbon leakage, the Commission should take into account four easily ascertainable data points for the sector and its key products: (1) the volume of production, (2) the volume of imports into the EU;² (3) the volume of exports out of the EU; and (4) list of investments in new production capacities in the sector in both the EU and abroad, in particular in key countries exporting to the EU, especially if they are in close proximity to the EU. This data for the last fifteen years would allow the EC to establish carbon leakage in this sector. **For example, if imports into the EU are growing while exports are decreasing, both for the sector as a whole and its main products, and investments in new capacities are taking place outside of the EU at disproportionate rate compared to those in the EU, then carbon leakage is occurring.** If the opposite dynamic takes place, then no carbon leakage occurs.

In addition, other points need to be clarified. The Inception Impact Assessment states - following the Green Deal Communication - that “[a]s long as *many* international partners do not share the same climate ambition as the EU, there is a *risk* of carbon leakage. Carbon leakage occurs when *production is transferred* from the EU to other countries with lower ambition for emission reduction or when EU products are replaced by *more* carbon-intensive imports.” (emphasis added).

First, it should be determined whether in fact risk of carbon leakage occurs only if “many” international partners do not share the same climate goals as the EU. It may be that even

¹ In this sense, we encourage the Commission to use precise terminology when referring to carbon leakage and avoid phrases suggesting such transfer is required (such as “*Carbon leakage occurs when production is transferred from the EU to other countries.*”)

² In analyzing trade flows, EU should exclude any impact that EU trade defence could have on volume of imports into the EU.

a very limited number of partners not sharing EU climate goals and therefore not limiting carbon emissions in their territory could lead to significant carbon leakage, if they are in close proximity to the EU. A single or just a few countries with no carbon emission limits could easily become export hubs of carbon-intensive products to the EU market, if the risk is not addressed.

Second, some EU documents state that carbon leakage occurs when EU production is replaced by “more carbon intensive imports.” However, unless an exporting country has an ETS system that is linked to ETS, it is impossible to verify whether imports from non-EU countries are more or less carbon-intensive than EU production. Also, even if imports are just as emission-intensive as EU production, but more competitive due to lack of ETS costs in home countries, the replacement of EU production by such imports also may constitute carbon leakage. The Commission should therefore investigate how carbon leakage is described in its documents related to the new mechanism to ensure consistent messaging.

Free Allowances. As Grupa Azoty believes that the purpose of CBAM should be exclusively encouraging 3rd countries and 3rd country exporters to lower their carbon emissions, CBAM should not affect in any way the current carbon leakage measures, in particular free allowances. Grupa Azoty considers that free allowances do not conflict with CBAM, as any benefits that EU producers get from free allowances can be considered in the value of CBAM measure imposed on imports at the border, considering the emission-intensity of the imported product. For example, the net cost that an EU producer and a 3rd country producer with identical production emissions should pay could be analogous. **This needs to be emphasized and is key to securing the political support for CBAM: the purpose of CBAM is not to lead to double protection.** Its only purpose should be to incentivize 3rd countries and exporters to lower their emissions, by imposing a cost at EU border. This is not linked in any way to free allowances. The Impact Assessment should consider how to make this possible in a non-discriminatory way.

Production vs. Consumption Emissions. The Commission should study how the fact that most EU countries contribute to greenhouse emissions more by consumption than production,³ affects WTO compatibility of any border measures. It seems that since imports, not production, are major contributors to carbon emissions in the EU then a measure targeting imports should be consistent with environmental objectives of lowering carbon emissions.

Sectors. Another key question is what sectors should be covered by the mechanism. The Commission should use a number of objective criteria to select the sectors, to ensure the process is objective, fact-based and not political. Some of the criteria the Commission could use include:

- (1) anticipated/estimated carbon emissions of imports of this sector;

³ I.e. consumption emissions for most EU countries are higher than production emissions.

- (2) attractiveness of the EU market for imports of this sector;
- (3) historical volume of imports of this sector (import intensity);
- (4) whether the sector already pays for emission allowances under ETS or whether it has surplus allowances from previous years (i.e., whether the sector actually incurs a cost that is not compensated by current or past free allowances);
- (5) number of exporting countries and individual exporters supplying the EU market in this sector;⁴
- (6) impact on downstream industries (here, one of the key criteria is whether the product is mainly a finished good, or mainly an intermediate product);⁵
- (7) type of emissions (direct or indirect),⁶ and
- (8) production complexity of the sector in terms of calculating emissions.

The relative weight and importance of these criteria should be matched to the purpose of the measure: different criteria should be prioritized if the purpose of CBAM is prevention of carbon leakage, and different if the purpose is encouraging 3rd countries to increase their climate ambitions.

Type of the Measure. The Commission should evaluate what type of measure would best accomplish the objective and what features such measure should have. If - regardless of its ultimate objective - the measure is expected to be responsive to the emission-intensity of the imported product, then the measures would have to be devised in a way that allows the authority to establish the emissions related to the specific imported product and impose an adequate duty, cost or levy.

The best unilateral measure that the EU can introduce to incentivize 3rd countries to reduce their carbon emissions may be an import greenhouse gas emission tariff, the purpose of which is to introduce on imports ETS costs identical to producing in the European Union, inclusive of transport emissions of bringing the product to the EU border.⁷ The border is the place where emission-intensity of the imported product could most easily be evaluated. The Commission should therefore also study whether it is practically

⁴ The smaller the number of exporting countries and exporting companies, the more manageable the system would be in practice when assessing the level of the measure.

⁵ Finished goods should be preferred, as intermediate products could raise problems with decreasing competitiveness of the finished goods industry.

⁶ The mechanism should focus mainly on direct emissions, as indirect emissions are too difficult to properly quantify in a 3rd country, EU industry's emissions depend on their national energy mix (no reliable EU average), and some EU Member States may compensate them nationally in certain sectors, therefore it would be practically difficult to ensure nondiscriminatory treatment of imports.

⁷ Inclusion of emissions from transportation is necessary, as the objective is to eliminate emissions. Bringing the product to Europe leads to increased emissions, therefore should be included. However, transport emissions within the EU do not have to be included, until EU industry does not incur similar cost.

feasible for other forms of the measure, such as an internal consumption tax, to differentiate the value of the levy depending on the products' emission-intensity.

Variability of the Measure. The measure's main feature should be to impose cost on imports that compensates for direct carbon emissions during production of the product and bringing the product to the European Union. This implies that the same type of products could be subject to different level of tariff/tax/duty, depending on their exact production processes, installations, or transportation methods. Only this way a differentiation between "green" products and "polluting" products could be made. Accordingly, the mechanism should allow (1) assessment or verification of the emission intensity of the imported product, and (2) imposition of variable tariff, whose value depends on emission intensity of the product. The Impact Assessment should analyze how to structure a variable duty system that is practicable for the authorities, yet punishes polluting products and rewards the "green" products.

Two-Level System. To impose a carbon measure at the border in a non-discriminatory, WTO-complaint manner, that is at the same time practically manageable, the system could be based on a two-level approach.

First level. An estimation of emission-intensity of the product should be carried out, based on publicly available information,⁸ considering the exporting country or region. This evaluation should result in setting up an automatic default value to be used for majority of imports, depending on their origin. A default automatic system is necessary, as the system cannot function with detailed analysis of emission-intensity of every single import. This default value would be added to the EU customs system to be imposed on imports of specific products falling into covered customs codes, assigned to specific exporting countries (countries of origin), together with the regular import tariff. It would function as an "all others rate" in trade defence proceedings.

Second level. A system should also be introduced allowing individual exporters claiming lower emission intensity than the default one to prove that they qualify for preferential lower rate or no rate at all. Accordingly, a verification system could be created to allow verification of exporters' claims of lower emission intensity. This system could be modeled on trade defense proceedings, including exporters' questionnaires that are later verified on spot by EC staff or a private 3rd party certification system.

The Impact Assessment should analyze how best to establish the system so a fair duty can be imposed if no additional information on the imported product's emissions is available, but at the same time how to enable importers to benefit if their imports are verifiably "green".

⁸ This information could be secured from publications, available or commissioned studies provided by interested parties, technical brochures, or even materials collected as part of a public consultation or data gathering process preceding the introduction of the measure, enabling all exporters, their public authorities and other interested parties to contribute.

Subject Countries. In the Impact Assessment, the Commission should analyze whether all imports of the selected sectors are to be covered by the measure, or only imports from certain polluting countries. If some countries are exempt, the criteria for such an exemption must be determined.

Grupa Azoty believes it is paramount that the Commission does not exempt any countries *a priori*, as this (1) could raise WTO discrimination issues (no MFN treatment), (2) would lead to politization of the system (powerful countries could force the EC to exempt them), and (3) would weaken the carbon-reducing incentives of an across-the-board applicable system (formal compliance with environmental criteria would prevail over factual compliance or real cost imposed). Instead, any preferences given to countries lowering emissions should be dealt with within the value of the first level duty described above. For example, a country operating a domestic carbon-pricing system or formally complying with the Paris Agreement could be offered a lower default rate. Or - preferably - a case-by-case analysis should be done for each exporter claiming to be subject to a domestic carbon-pricing system. On spot verifications - similar to those conducted in trade defense cases - could verify that carbon emissions had in fact been paid for in the accounting documents of the producing exporter. The Impact Assessment should analyze which model of considering the exporting countries' different levels of climate ambitions could be most effective.

Carbon vs. Greenhouse Emissions. Grupa Azoty also believes that to achieve EU climate objectives, CBAM should not only cover *carbon* emissions (i.e., carbon dioxide), but *all greenhouse gas emissions* that are subject to the ETS for the given sector. In the case of fertilizers, this also includes N₂O.

Transportation Emissions. If the objective of CBAM is to eliminate or lower emissions generated by EU consumption through pressuring exporters and exporting countries to lower emissions involved in bringing the product to the European Union, then the Commission should consider including in the CBAM not only the emissions generated in the production process of the imported product, but also the transportation emissions generated in bringing the product to the EU border. While EU producers do not pay similar emission cost, they do not have these emissions at all, so WTO non-discrimination principle would be kept. The Impact Assessment should analyze how to quantify such emissions and whether they can be included in a WTO-compatible way.

Form of Payment. The final issue the Commission should consider is the form of payment of the measure. As the reference for the payment would be emissions per ton of imported product, a price needs to be allocated to each ton of these emissions and method of payment established. As for the method payment, a decision must be made whether it should be cash, an ETS allowance or some quasi-ETS allowances. Requiring ETS allowances from importers could equalize their situation to EU producers, but on the other hand would most likely require increasing the number of allowances available. A cash payment would require establishing a carbon price that is identical to prices paid by EU producers with analogous ability to plan head or hedge for risk, which may be difficult to do. The

Commission should therefore investigate whether creation of a system analogous to ETS allowances, but parallel to it could be a possible solution.

Grupa Azoty thanks the European Commission for the possibility to contribute in this consultation and looks forward to working with the Commission on developing the CBAM concept.

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