Carbon Border Adjustment: opportunities to complement efforts under the Green Deal

Eurelectric position paper

March 2020

Eurelectric represents the interests of the electricity industry in Europe. Our work covers all major issues affecting our sector. Our members represent the electricity industry in over 30 European countries.

We cover the entire industry from electricity generation and markets to distribution networks and customer issues. We also have affiliates active on several other continents and business associates from a wide variety of sectors with a direct interest in the electricity industry.

We stand for

The vision of the European power sector is to enable and sustain:
- A vibrant competitive European economy, reliably powered by clean, carbon-neutral energy
- A smart, energy efficient and truly sustainable society for all citizens of Europe

We are committed to lead a cost-effective energy transition by:

investing in clean power generation and transition-enabling solutions, to reduce emissions and actively pursue efforts to become carbon-neutral well before mid-century, taking into account different starting points and commercial availability of key transition technologies;

transforming the energy system to make it more responsive, resilient and efficient. This includes increased use of renewable energy, digitalisation, demand side response and reinforcement of grids so they can function as platforms and enablers for customers, cities and communities;

accelerating the energy transition in other economic sectors by offering competitive electricity as a transformation tool for transport, heating and industry;

embedding sustainability in all parts of our value chain and take measures to support the transformation of existing assets towards a zero carbon society;

innovating to discover the cutting-edge business models and develop the breakthrough technologies that are indispensable to allow our industry to lead this transition.

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WG Climate Change and Decarbonisation

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KEY MESSAGES

- Eurelectric views the EU ETS as an effective instrument for delivering significant GHG reduction across Europe. However, we recognise the need to address the increasing carbon leakage risk for the ETS-related industries in the context of greater climate ambition. Therefore, Eurelectric supports the ongoing European Commission work on assessing carbon border adjustment mechanism focused on environmental integrity and competitiveness.

- The power sector observes increased cross-border power trading and imports from third countries with high carbon content, requiring the investigation of a carbon border adjustment mechanism. As a result, electricity-intensive producers covered by the EU ETS as well as others outside its scope could be negatively impacted. An impact assessment needs to analyse the respective effects on the power market and the overall compatibility of the mechanism in relation to its scope and coverage.

- Designing criteria for carbon border adjustment mechanisms would need to be workable and in compliance with international agreements, while at the same time raising mitigation efforts in third countries. Additionally, ensuring fairness could foresee a part of the derived funds being earmarked for green power generation projects in third countries.

- Ultimately, the solution to prevent carbon leakage in the power sector would be a more global carbon pricing. Greater collaboration with other regions is essential and climate diplomacy will play a key role. Eurelectric supports the European Commission for engaging the international community with ambitious carbon pricing policy frameworks.

1. Addressing the structural problem of carbon leakage

The European Green Deal has put forward a proposal for a border adjustment for 'selected sectors' aiming at import of carbon intensive products. The path to reaching climate neutrality in 2050 requires a toolbox of policy solutions, notably in view of the risks for carbon leakage.

Eurelectric recognises the need to address the impact of carbon leakage in industries which engage in global or cross-border competition with third countries and this has to be carefully evaluated and addressed at EU level. The power sector itself is already affected as seen in the cases of fossil fuels based electricity imports along the EU external borders to the Baltic states, Bulgaria, Croatia, Finland, Greece, Poland and Spain.

In 2019 alone, 33 TWh of electricity (21 TWh of which coal-based) has been imported to the EU ETS region.[1] This imported electricity is not subject to carbon pricing and has in most cases a lower cost (and price) than domestically produced electricity in the importing Member States, resulting in carbon import distorting competition and impacting EU-based generators negatively. Electricity-intensive producers covered by the EU ETS as well as others outside its scope could in turn be negatively impacted. As Europe takes global leadership in addressing climate change, European industry must be able to compete while knowing that investing in decarbonisation efforts is a no-regret decision.

Eurelectric's view is that the Green Deal should include ambitious international dimension. In addition, the EU should promote mechanisms to make domestic producers more carbon efficient while at the same time encourage third countries to become more climate friendly. Europe should put forward complementary policies and tools with the ultimate goal of developing a more global carbon price and market, making it unnecessary to rely on applying potentially perilous unilateral carbon border adjustments in the long term. In this context, climate diplomacy will play a key role to engage the international community with ambitious climate policy frameworks.

To prevent placing European industry at a disadvantage in the meantime and keep the carbon price signal to decarbonise efficiently, we have looked at key requirements for the effective design of carbon border measures in order to improve environmental integrity and competitiveness aspects of EU climate policies.

2. Policy objectives

Ahead of setting design parameters for tackling carbon leakage, the following policy objectives must be met in developing a carbon border adjustment mechanism:

- ✓ Ensure level playing field for the European industry on the European market and abroad
- ✓ Enhance the effectiveness of the EU ETS by preventing carbon leakage
- ✓ Raise mitigation efforts outside Europe by promoting introduction of carbon pricing systems in third countries
- ✓ Achieve measures in the most cost-efficient and socially acceptable manner
- ✓ Maintain full compliance with WTO and Energy Charter treaty principles

[1] The path of least resistance, Sandbag, 2019

- ✓ Preserve full consistency with UNFCCC principles ("common and differentiated responsibilities and respective capabilities")

3. Scope and coverage

The European Commission should carry out an impact assessment regarding the scope and coverage of different sectors in the context of a carbon border adjustment.

The power sector is likely to be considered as the EU power markets are already exposed to carbon leakage. A carbon border adjustment would be easier to design for the power sector than for other internationally traded goods because calculating the carbon emissions for electricity generation is relatively straightforward. Mitigating carbon leakage for the energy-intensive sectors[2] could require different design and solutions.

4. Options to implement a carbon border adjustment mechanism in the power sector

There are several options for implementing a carbon border adjustment. The options are not mutually exclusive, as different mechanisms could be applied in parallel in respect of different third countries. The ideal outcome would be that the third country implements equivalent carbon pricing, so that border adjustment is not required.

Implementation of a carbon border adjustment for the power sector would therefore be a two stage process:

Stage One: Check if equivalent carbon pricing is applied (or will be applied) in the third country, as this largely removes the need for a carbon border adjustment. Carbon pricing can be applied through a carbon trading scheme (the most robust option is to link this to the EU ETS) or a carbon tariff.

This is an important stage to ensure full compliance with the WTO rules and show there is no arbitrary or unjustifiable discrimination against jurisdictions with carbon pricing. In case of imports from jurisdictions with carbon pricing, carbon border adjustments need to be modified and take into account the already paid carbon price in the third country. Moreover, the availability of an emission cap needs to be considered as well as any implications derived from the existence of EU's Market Stability Reserve.

Additionally, offering the removal of the carbon border adjustment if equivalent carbon pricing is applied would provide an incentive for the adoption of stronger decarbonisation measures in third states.

Stage Two: If equivalent carbon pricing is not currently possible, then a carbon border adjustment can be applied and ways forward include:

[2] Based on the significance of their carbon intensity as well as electricity intensity of production, example sectors are: steel, chemicals, cement, aluminium.

- Carbon ‘involvement’ mechanism

An alternative solution to a tariff is to link the market participation of importers to the same conditions as domestic producers who pay a price on carbon. If importers are made subject to the EU ETS, then the impacts on the operation of the EU ETS must be managed (for example, by a separate category of allowance for the importers). To ensure balance and avoid protectionist measures, the mechanism should create an own envelope where a part of the derived funds are earmarked for green power generation projects in the third countries.

The separate category of allowances for importers (that are issued on demand at the current EUA price) is effectively a tariff, but the level varies automatically with the traded EU ETS price. The reason for creating a separate category is to avoid impacts on the operation of the EU ETS itself. If importers of goods are involved in the ETS and entitled to purchase ETS allowances, whilst this is convenient, it could have unforeseen and unpredictable impacts on the EU ETS supply-demand balance and resulting impacts on carbon price. The risks to EU ETS stability are likely to outweigh the convenience of using an existing mechanism, so this issue would need to be thoroughly assessed.

The European Commission needs to set clear conditions under which carbon trading scheme in third countries could be linked to the EU ETS. Green trade agreements can enable this option.

- A new generation of EU Green Trade Deals

Including effective climate provisions in trade agreements can potentially provide a much-needed counterbalance to the negative climate aspects of distortions through trade. The EU could leverage its ability to conclude bilateral trade deals with partners and help level the regulatory playing field. This approach should remain consistent with possible adoption of other carbon pricing measures by third countries.

An example is the Ukraine-EU Association Agreement within the framework of the European Neighbourhood Policy, which obliged the creation of a national ETS fit to link with the European system. This approach appears to be a logical alternative at EU’s borders, where Contracting Parties to the Energy Community Treaty are protected from a direct carbon border tariff. In this sense, developing a carbon pricing mechanism at the level of the Energy Community is a logical step.

Issue linkages between trade and climate can also stimulate discussions for implementation of carbon reduction projects under Article 6 of the Paris Agreement and/or implementation and linking of ETS systems in third countries.

Another option on a multilateral scale would be to open negotiations in the WTO in order to set up standards of carbon clean products and allow the specific treatment of carbon content in the technical regulations. This could be based on incorporating climate change as environmental challenge in the WTO rules.

- WTO compliance

Carbon border adjustments are technically feasible and legally compatible with GATT and WTO rules, provided they are designed in the right way. The key assessment criteria to ensure compliance with international trade rules are proportionality, fairness and transparency. Article XX of GATT allows the adoption of policies that are incompatible with WTO rules but necessary to protect on health reasons. What is more, the Montreal Protocol has already set a relevant precedent as it implemented trade restrictions on ozone depleting substances, and in turn preventing leakage and encouraging broad international cooperation.[3]

5. Concluding remarks

The EU has to ensure the competitiveness of European companies exposed to global competition. This does not concern only industry, but also the power sector. Cross-border power trading between EU Member States and third countries is expected to increase and potentially resulting in increasing carbon leakage risks.

The primary solution to prevent carbon leakage is a more global carbon pricing. Collaboration with other regions is crucial in order to promote and implement ambitious climate policies and especially develop international carbon markets. At the same time, various options to establish a carbon border adjustment mechanism for power sector should be investigated. Such a mechanism would incentivize low-carbon electricity generation and respective investments in neighbouring countries and the spread of meaningful carbon pricing.

[3] Climate-linked tariffs and subsidies, WTO

Eurelectric pursues in all its activities the application of the following sustainable development values:

Economic Development

- Growth, added-value, efficiency

Environmental Leadership

- Commitment, innovation, pro-activeness

Social Responsibility

- Transparency, ethics, accountability

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