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smarter climate policy

Response to the Open Feedback invitation on an inception impact assessment for the implementation of Border Carbon Adjustments

This is Sandbag's response to the March 2020 open feedback invitation launched by the European Commission on the topic of the introduction of Border Carbon Adjustments (BCAs). This policy tool is part of the current Commission President's political mandate for 2019-2024 and of the EU Green Deal, as well as it is part of the EU Industrial Strategy. Our organisation's response summarises the conclusions of our recent research work on BCAs.

It draws on analysis in Sandbag's two recent reports on BCAs, published in December 2019[1], covering both power sector and industrial imports, which both provide further details on the issues covered here.

Conclusion on BCA from previous research: BCAs appear to be the most direct and best option for addressing the issue of creating a level playing field for EU industry on their way to developing net zero processes.

The EU Climate Law presented in March 2020 introduces the net-zero economy into EU law. It focuses on the importance of a trajectory as a means to reach this goal. This transition is imperative and requires urgent action, the longer we delay the bigger the burden left on industry, which would otherwise need to deliver a whole system change in less than 20 years (i.e. by pushing a change in the system post 2030).

The EU ETS is the only currently standing policy in the EU with its built in trajectory and will be of fundamental importance in capping emissions to ensure the net-zero goal is reached. Currently covering industry and power generation, it is clear that the trajectory will bring both to the same end point by 2050, even though looking at the past and next decade it is quite clear that industry has been lagging behind, partly due to the built in counter incentives the ETS has created for EU industry.

Free allocation of EUAs has been used until now to address the so-called "risk or carbon leakage" in industries covered by the EUETS. This system is flawed in several respects[2].

[1] https://sandbag.be/index.php/project/the-abc-of-bcas/ and www.sandbag.org.uk/thepathofleastresistance

[2] See previous Sandbag report https://sandbag.be/index.php/project/carbon-leakage-conundrum/

Nevertheless, the use of free allocation combined with the low prices for EUAs prevailing for much of the last decade has meant that there is no evidence of significant leakage to date.

However, it is clear that free allocation is not sustainable into the long term and the cancellation mechanism built into the Market Stability Reserve of the EU ETS further strengthens this principle. As the EUETS cap declines, eventually towards net-zero by 2050, there will be fewer and fewer allowances to allocate. Our analysis shows that this is problem is likely to make full continuation free allocation unsustainable sometime in the early 2030s. However, giving industry an incentive to reduce emissions as well as a guarantee of a level playing field only in 2030 is too late. Action is needed now and it is clear that a Border Carbon Adjustment could be a good policy tool to transition EU industry outside of the free allocation regime already in the second phase of Phase 4 of the EU ETS.

If the carbon costs of EU industry cannot be lowered, the only alternative that adequately addresses the risk of carbon leakage is to raise the cost of emissions embodied in imports. Direct financial subsidies to all EU producers to compensate for their carbon costs is not a realistic option for a variety of reasons. Zero carbon production, which would not incur a carbon price, would be another solution but it is not realistic in the short to medium term, especially for existing production.

This means that some form of BCA will in any case be required.

Alternative approaches: Product standards can and are welcome to complement BCAs, but cannot replace them – a portfolio of policies is needed

BCAs and product standards are sometimes characterised as alternative policies, with a choice of one or the other policy required. However, in practice they are different tools having different effects. Consequently, product standards and BCAs can be introduced together, and indeed can complement each other as part of a wider policy package.

BCAs provide a continuous (linear) incentive to reduce emissions, with higher costs the higher the emissions embodied in imports. The greater the reduction in emissions that is achieved, the greater the reductions in costs.

In contrast product standards have a yes/no character, although they do mandate a clear direction of transformation. Products are compliant or not. The yes/no nature of product standards means that they do not adequately address the complex problems of leakage, unless all current EU production has lower emissions than all production outside the EU (which will almost never be the case). For example, suppose EU production has emissions in the range 1.5 to 1.9 tonnes per tonne of product, and imports have embodied emissions in the range 1.5 to 2.1. Setting the standard tighter than 1.9 would mean some EU production being required to close, so not be achieve the objective of avoiding leakage. A product standard of no more than 1.9 tonnes per tonne of product would eliminate some high

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https://sandbag.be/index.php/project/results-barriers-to-decarbonisation-call-for-evidence/

carbon imports. However the remainder, with emissions at similar levels to EU production, would meet the standard and could be imported into the EU paying no carbon price, while EU producers continue to be subject to the EUETS.

In contrast BCAs solve this problem by imposing a price on imports for every tonne of embodied emissions, further incentivising third countries on their decarbonisation trajectory.

We urge the Commission to assess in its impact assessment the complementarity and synergy, which could result from implementing a combination of both as of 2025, while also keeping in mind that they are not interchangeable and that a combination of several policies will be required to deliver net-zero by 2050.

Recommendation 1: BCAs should apply initially to emissions intensive trade exposed sectors plus power generation

BCAs ought to be applied to sectors covered by the EUETS, specifically the power sector and industries covered by the carbon leakage list. The priority sectors should be those which are most emissions intensive and trade exposed, and so have a significant leakage risk, and those which have the largest emissions in absolute terms, so the environmental benefits of BCAs (from providing an enhanced carbon price signal) are greatest.

Sectors included are likely to include cement, steel, aluminium, parts of the chemicals sector and possibly pulp and paper. BCAs may be extended to cover other sectors over time, drawing on lessons learned and the administrative infrastructure established in the initial sectors.

Imports of electricity from outside the EU are only a small proportion of the total EU electricity market. However due to the emissions intensity of the power sector there is substantial scope for distortion of price signals for imports and the absolute volumes of emissions involved remaining material. For these reasons inclusion of the power sector in BCAs seems appropriate.

Recommendation 2: To avoid windfall gains to emitters, BCAs and free allocation should not cover the same emissions

Free allocation of allowances and shielding from BCAs should not both apply to the same part of emissions from EU producers. If they do, the producer in the EU will benefit twice, from the value of free allowance, and from the increase in costs for importers increasing market prices. This will create excess profits.

Something very similar to this has already been seen in the EUETS. There were surplus profits ("windfall gains") totalling tens of billions of Euros in the power sector during Phase 1 and Phase 2 of the EUETS, which our organisation has documented thoroughly.

To prevent this double profit, a BCA should be imposed only on the difference between any free allocation to EU producers and the amount of emissions embodied in imports. The

quantity of embodied emissions subject to BCAs may then be increased as free allocation reduces.

Recommendation 3: Implementation of BCAs should be phased in during Phase IV of the EU ETS.

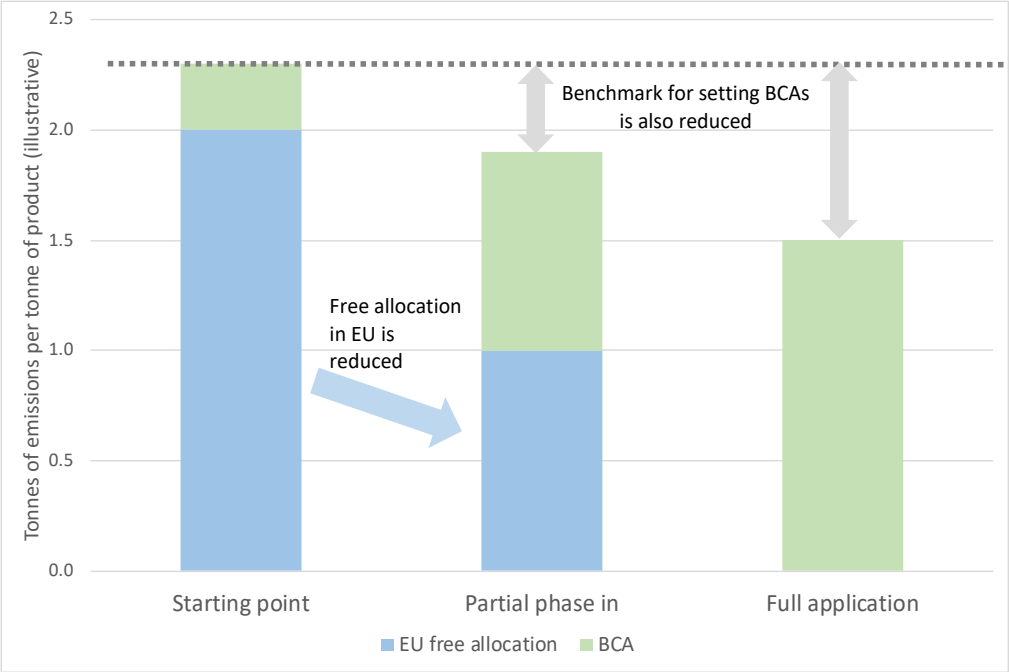
Time will be needed to establish the systems required to implement BCAs, and it seems unlikely to be possible to implement them before the mid-2020s. The most appropriate timing for the introduction of BCAs appears to be the next ETS mid-Phase review period, referred to in the Directive as 2023-2024, which would then mean the phased in regime could start end of 2025, covering the latter half of Phase IV and to coincide with the next revision of commitments under the Paris Agreement.

Phasing in BCAs during Phase IV of the EUETS has a number of advantages. It will allow systems to be established and payments to be made while the size of the payments is relatively small, because some of free allocation remains in place. The effect on production and markets can then be assessed. This will enable informed, evidence-based decisions for Phase 5 in the 2030s.

One way of achieving this is illustrated schematically in the chart below. Initially there is free allocation at 100% of benchmark (2 tonnes per tonne of product in this illustrative case). Importers are subject to a small BCA (on 0.3 tonnes), because the benchmark used to set BCAs (2.3 tonnes) is above the free allocation benchmark. Over time the amount of free allocation decreases. As this happens the amount of embodied emissions in imports for which EUAs must be surrendered increases.

The benchmark for setting BCAs also falls over time as production becomes more efficient globally. However free allocation decreases more rapidly than the BCA benchmark, so the amount of emissions covered by the BCA increases. In the illustrative case shown the BCA benchmark falls to 1.9 tonnes per tonne of product, but free allocation falls to 1 tonne, so the BCA is payable on 0.9 tonnes. Eventually free allocation is removed completely, and the BCA is payable on the full benchmark amount.

Chart: schematic illustration of phase in of BCAs



Recommendation 4: EU producers will benefit in industries where importers have emissions above the EU free allocation benchmark

There are potential advantages to industry if BCA benchmarks are above current EU benchmarks. This arises if the international benchmark used to set BCA is above the EUETS benchmark (see first column on above chart). In this case free allocation can continue at a level sat by the benchmark, while there is a BCA imposed on the difference between the EU benchmark and the BCA benchmark. The additional emissions embodied in imports will be priced, so creating an advantage for the lower emissions EU production.

Recommendation 5: Work on establishing rules and data for implementation should begin immediately

There are various aspects of design that require careful design of rules and protocol to avoid discrimination between competing suppliers and retain the advantages of BCAs in providing appropriate price signals. These include adjusting for any carbon price already paid, tracking jurisdiction of origin, setting benchmarks, and MRV for importers wishing to use their own emissions rather than a benchmark value. The issues raised are complex and data intensive.

To avoid undue delay to implementation of BCAs we recommend that work to establish these protocols begins immediately, and that is makes use of existing work, including existing databases, where possible.

Recommendation 6: To minimise International opposition BCA's they need to be designed to fit clear and well-defined criteria

In particular BCAs should be designed under the environmental exemption clauses of the GATT agreement and under the environmental provisions of the WTO protocols, as this policy is fundamentally a climate policy and contributes to international security, since

climate threat is one of the biggest threat to it. They should also be made in such a way to be non-discriminatory and meet clear environmental goals. This is likely to help minimise political opposition and ensure compatibility with WTO rules.

Recommendation 7: Design of measures to counteract resource shuffling can draw on experience in California

There is a substantial risk of importers to the EU rerouting of products to minimise liability for BCAs without any reduction in emissions. This is known as "resource shuffling". Rules will be needed to minimise this risk.

In establishing BCAs for electricity imports, California has included detailed rules to address the problem of resource shuffling for electricity imports. We recommend that the EU Study these rules and how they have been applied during the last few years to learn lessons about what might prove effective in Europe. This should include holding discussions with the California Air Resources Board.

Recommendation 8: Value added thresholds should be used to avoid bypass of BCAs

Another problem is the potential bypass of BCAs is by importing semi-finished goods which lie outside the scope of the BCA rather than the commodity covered by the BCA. The claim to be outside the BCA may be made even of the further processing of the commodity is minor ("few holes drilled into some sheets of steel").

One potential way round this is to define the bulk commodity as including all goods with value added up to a certain threshold. An EU producer may be vulnerable to competition from imports which have been categorised as semi-finished goods even though their value added to the bulk quality is small. We recommend examining application of a value added threshold (e.g. perhaps 20%), such goods are exempt from the BCA only if they have a value added greater than the threshold. Suitable measures would need to be imposed to prevent the transfer pricing within companies to circumvent such rules.

Recommendation 9: BCAs should be part of a package that also includes other measures

BCAs will not be enough on their own to put European industry on a pathway to net-zero emissions by 2050. A wider policy package is needed. This includes policies to support innovation, continuing reforms to the EUETS, and measures to ensure that reducing emissions are a central part of the circular economy package. Sandbag's forthcoming report on industrial decarbonisation will provide further details of what is required.

Recommendation 10: Revenue from BCAs could be used to reinvest in climate measures and fund innovation

BCAs will generate significant additional revenue. This could be used to help fund innovation in EU industry, lowering the cost of low carbon processes, and helping establish a prosperous zero carbon European economy. This leadership could in turn be leveraged,

leading to faster emissions reductions elsewhere and part of the revenues could be used to support innovation abroad.