

## IFIEC's position on the Carbon Border Adjustment Mechanism (CBAM)

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IFIEC supports the discussion initiated by the EU Commission to improve carbon leakage protection for the European industry in light of increased climate ambition. The commission's as well as the ENVI proposal, however, raise concerns that IFIEC would like to comment on.

More clarifications are needed, which requires a more cautious, stepwise approach. An extended evaluation phase should allow for a detailed Impact Assessment, based on clear design parameters, before a decision regarding coverage of a specific value chain by a CBAM is taken.

### Following is needed from the CBAM regulation:

1. Need for integration with the EU ETS revision;
2. Thorough impact assessment needed before extension to other sectors;
3. Exports need a carbon leakage solution;
4. Free allocation and indirect cost compensation phase-out only when CBAM proved effective;
5. Value chain shifts due to CBAM need to be avoided;
6. CBAM circumvention needs to be avoided;
7. Correct calculation of embedded emissions is vital.

### 1 Need for integration with the EU ETS revision

The measures envisaged in the EU ETS revision to achieve the climate ambitions such as increasing the LRF, strengthening the MSR as well as the "re-basing" will have the effect of a decrease in free allocation as well as higher certificate prices, which will put additional pressure on the competitiveness of European industries and increase the risk of carbon leakage.

Decreasing the overall amount of free allocation will already lead to a distortion of competition for European industry. Phase out of free allocations for CBAM sectors as proposed by ENVI would start sooner and also progress more rapidly, while the actual effectiveness of the CBAM will not be tested yet. This acceleration will increase the carbon leakage risk significantly. The conversion of industrial processes to climate-neutral technologies will not be completed in the next three years, so more time must be made available for the transformation to climate neutrality. During this transition period, it is essential that effective carbon leakage protection remains in place.

It is therefore vital that:

- a) both drafts are discussed/negotiated simultaneously as they do affect each other, and
- b) that current measures to avoid carbon leakage such as free allocation and indirect cost compensation are being continued.

## 2 Thorough impact assessment needed before extension to other sectors

For imports into the EU, the determination of “CO<sub>2</sub> emissions embedded in goods” seems very complex, and places very high demands on data availability and quality as well as agreements on global allocation rules.

The current proposal to extend CBAM to additional sectors entails an extension with a very large number of products and will increase the complexity of determining the exact carbon footprint of individual products and the associated administrative burden even more. IFIEC therefore welcomes the approach taken by the Commission to demand verification by accredited entities, where allocation rules exist, while providing a fallback option based on default values.

IFIEC therefore calls for a very high degree of scrutiny to ensure the robustness of such to avoid any circumvention and/or free riding. Introduction of CBAM and phase-out of free allowances and indirect cost compensation as a safeguard against carbon leakage needs to be assessed independently and thoroughly. Before any extension of CBAM to other sectors is proposed a thorough impact assessment must be undertaken by the Commission as well as a relevant transition period needs to be granted to those sectors (similar to the transitional period granted to those who are proposed to be in CBAM already).

Circumvention and greenwashing needs to be avoided, in same time administrative burden needs to be minimised to avoid unnecessary hurdles for imports.

The draft proposal in its exceedingly complex form involves a great deal of administrative effort to implement. Some value chains involve several cross-border transfers, where intermediate products cross EU borders in various stages of completion and return to the EU before becoming a final product, which will put an unreasonably high bureaucratic burden and additional costs on companies. The scope extension to include more sectors will exacerbate this burden even more.

The lack of definition and clarity in the proposal with regards to several crucial aspects such as export protection, maintaining free allocation of allowances, the inclusion of value chains and verification of carbon content, will lead to massive uncertainty for industry and also international trading partners. To address these challenges, the reform of the EU ETS and the CBAM proposal must be negotiated as an integrated legislative package/proposal.

## 3 Exports need a carbon leakage solution

The ENVI draft, like the commission’s proposal, still does not include an exemption mechanism for exported products for CO<sub>2</sub> costs, which means that exporters cannot be reimbursed for the CO<sub>2</sub> costs incurred in the EU.

For European manufacturers, the EU CO<sub>2</sub> price applies to their entire production, while foreign manufacturers “only” must pay the marginal CO<sub>2</sub> levy for the part of their production that is actually exported to the EU. If, with border adjustment, exports from the EU are thus burdened with significantly higher costs that international competitors do not have to pay, European industry will be at a clear disadvantage. If there is no explicit export adjustment system, the competitiveness of the European export industry will be at stake.

Therefore, there should be a complete cost exemption, for exporters, to offset increased production costs of climate-friendly technologies that disadvantage export into the global market. CO<sub>2</sub>

avoidance costs must be compensated as well, to not only avoid carbon leakage, but also investment leakage.

If there is no explicit WTO compatible export adjustment system, the competitiveness of the European export industry will be at stake. Existing carbon leakage measures must remain in place.

#### **4 Free allocation and indirect cost compensation phase-out only when CBAM proved effective**

The energy-intensive industry plays a crucial role for the European economy, and it is therefore essential that carbon leakage measures are appropriate and efficient.

Considering the increased EU 2030 climate ambition and related rising carbon costs, the carbon leakage risk will be higher than ever at least in the transition until 2030, since no major competitor in the world will be facing comparable costs, if any at all. Therefore, the CBAM should be an instrument to strengthen rather than weakening the carbon leakage framework, by complementing it with full benchmark based free allocation at least until then. The ENVI proposal, however, intends to start reducing free allocation already as of 2025 and accelerate the reduction rate, without ensuring certainty on the actual effectiveness of the CBAM. This further increases the risk of carbon leakage and will lower EU companies' ability to invest in low carbon technologies.

Similarly, the compensation of indirect costs must be maintained and even strengthened, while promoting consistent application throughout the member states in order to avoid any distortion of internal competition.

Maintaining the current carbon leakage measures with a complementary CBAM also reduces the level of the border measure, since CBAM takes into account the free allocation granted to EU industry through a reduction of certificates for importers. Hence, while remaining WTO compliant, it could mitigate the impact on trade flows and facilitate international trade relations compared to a CBAM without existing carbon leakage measures which would apply the full carbon costs to traded products. Furthermore, such approach will considerably smoothen the impact of CBAM on European value chains. It would also allow to test the mechanism safely. To this end, the envisaged test phase should not be condensed, and the already existing and proven methods of carbon leakage protection should be maintained in the test phase. This should also include a regular evaluation of the effectiveness of the CBAM.

#### **5 Value chain shifts due to CBAM need to be avoided**

Production costs for a whole range of final and intermediate products that are produced in Europe will increase while importers of the same products will not be exposed to similar cost increase. This issue is exacerbated if free allocation is phase out to CBAM sectors. Since CBAM does not cover the whole value chain, many important products will not be under any carbon cost regime. For example: Ammonia and nitric acid, which are crucial starting materials for many products and value chains, are included here.

A carbon border adjustment mechanism needs to cover the entire value chain. Otherwise, the carbon leakage risk will only be shifted within the value chain, but not removed. If the scope is too narrow, as it is in the Commission proposal, global trading partners will simply export products outside the list of products in Annex, with no CO<sub>2</sub> costs to the detriment of EU producers' competitiveness. In order to maintain carbon leakage protection at least at today's level for the whole value chain, in which parts might be covered to an extent by CBAM and parts need free

allocation as measure, existing carbon leakage measures must remain in place for products that are delivered to sectors not covered by the CBAM or destined for export.

## 6 CBAM circumvention needs to be avoided

The risk of resource shuffling, whereby exporters reduce their climate obligations by crediting low-carbon electricity/utilities to supplies directed to European countries while allocating high-carbon electricity/utilities to the domestic market or other markets with lower climate costs, must be mitigated. The risk of transshipping, where products from a country without a carbon price are routed through a country with a comparable carbon price so that they appear to come from the second country, will have to be addressed as well. Global certification systems would have to be implemented, to be audited by independent third parties. Rather than assuming an average of 10% of EU's most CO<sub>2</sub>-intensive producers in the absence of data on embedded emissions, which could still be more efficient than some global producers, there should be an obligation on producers outside the EU to provide these data. Furthermore, the framework needs to mitigate also the risk of absorption of the CBAM levy: the rationale of the CBAM is to ensure that carbon emissions come with a cost and that such cost is visible to customers. Since the CBAM is applied only to a small part of the total production of the non-EU producer (usually less than 5%), such producer could absorb partially or totally the cost of the CBAM by reducing the price of the products at the EU border and/or by spreading the levy across his entire production.

To avoid the risk of transshipping, carbon pricing systems in third countries must be consistent with and match ambition and pricing levels of the EU ETS, to guarantee a level playing field for all participants. Crucial details, such as expanding the list of exempted third countries, or establishing the methodology for calculating the reduction in the number of CBAM certificates to be surrendered for products produced in third countries with a carbon price, are to be developed under delegated or implementing acts. IFIEC is opposed to this approach and believes these decision-making processes should be transparent for all stakeholders, keeping in mind the risk of litigation and possible trade disputes.

## 7 Correct calculation of embedded emissions is vital

Emissions embedded in goods will be calculated based on information to be provided by the importer related to the production of concerned goods and verified by an accredited third party. If they do not provide sufficient data, the Commission intends to estimate the CO<sub>2</sub> costs. IFIEC would like to point out that transparent data sources must be used. Any default values must be sufficiently penalizing. Even a reverse benchmark approach, such as using the worst 10% of EU installations which could still be more CO<sub>2</sub>-efficient than third party installations, might not suffice to have a protective effect for the EU industry.

In addition, there is currently no existing global agreement on how to determine embedded emissions of products and how to trace emissions throughout the value chain. Embedded emissions for most products, but particularly for complex products, lack clear scientific, objective, and reliable verification processes. Robustness and accuracy of data must be secured, while minimising administrative risk and legal confrontation.

Indirect emissions cannot be easily incorporated in CBAM as a replacement for indirect costs compensation, because:

**The European electricity market design does not reward low carbon electricity consumption**

In the EU, the day-ahead trading price for consumers of carbon-free power is the same as non-carbon-free power. This is due to the marginal electricity pricing system in Europe. Today, ETS State Aid rules allow Member States to partially compensate eligible sectors for these unilateral indirect carbon costs. Only those consumers eligible for indirect cost state aid and in few Member States that apply this, are compensated for these indirect costs up to max. 75% (regardless of energy source).

Producers outside EU may have other than a marginal pricing regime and CBAM requires the option to allow for individual emissions assessments to importers. If indirect emissions are included in a CBAM, low carbon importers to Europe (without marginal pricing systems) will pay no/less CBAM for indirect emissions, while European low carbon producers would still face high indirect costs due to the price effect described above. This puts the European low-carbon manufacturers at a competitive disadvantage.

CBAM effectiveness in avoiding carbon leakage has still to be proven and there should be a solution for covering export. Until then, direct allocation and indirect cost compensation should stay in place as safeguard against carbon leakage. Embedded emissions of imported products need to be thoroughly determined and independently verified.

If indirect emissions were covered by a CBAM and Indirect cost compensation system would be replaced by another, the following needs to be considered:

- The difference between the actual indirect emissions and the indirect emissions costs. In EU, CO2 costs elevate the day-ahead trading price of all electricity sources due to marginal energy pricing concept. In the event CBAM covers indirect emissions, it should address the real costs to avoid distortive carbon price signals.
- Low-carbon product allocation to EU vs rest to world.
- Data quality of non-EU electricity emissions.

## **Industry will be the driver on the way to climate neutrality through innovation, but needs support for increasing and additional CO<sub>2</sub> costs as well as a predictable framework to deliver low-carbon investments**

Due to the EU climate ambition that is higher than in other regions and will still increase, it is essential to develop a regulatory framework that will provide adequate carbon leakage protection and drive transformation with the following elements in mind:

### **Industry will be the driver on the way to climate neutrality through innovation, but needs a predictable framework to deliver low-carbon investments**

The energy-intensive industry plays a crucial role for the European economy, and it is therefore essential that carbon leakage measures are appropriate and efficient. To ensure future competitiveness, CBAM should not replace already existing measures such as the EU ETS free allowances and indirect cost compensation. Current carbon leakage protection measures should only be replaced if a new measure ensures at least equivalent protection<sup>1</sup>. Since CBAM currently does not offer any exemptions mechanism for exports, the level of protection is not sufficient, hence existing carbon leakage measures must remain in place. Also, due to the unforeseeable consequences of a systems change, free allocation of allowances and compensation of indirect CO<sub>2</sub> costs must be maintained at least for a transitional period.

### **Long-term certainty necessary for transformation**

Transformation towards climate neutrality is only possible with the help of industry, through innovation and rapid marketability of climate-friendly technologies. Unilateral acceleration of emission reductions will entail significant transformation costs for industry. The European industry is clearly committed to climate protection and the goals formulated by the EU Commission and has already embarked on an ambitious but necessary transformation path. Efficient carbon leakage protection for imports and exports is crucial, since without it, European producers would be exposed to full carbon costs and their financial ability to invest in low-carbon technologies would be undermined. Reliability and planning security are indispensable, both for the preservation of the EU as an industrial location and for a successful transformation process. Climate-friendly technologies such as carbon capture are unlikely to be commercially viable this decade. Therefore, a planning horizon until at least 2030 should be provided, to grant certainty for long-term green investments.

In this context, IFIEC would like to emphasize that other aspects of the “Fit for 55” package such as the CEEAG, RED and ETD reviews will also have to be aligned with these goals. Any additional burdens or obligations that may arise from these amendments must be precluded to avoid impacting industry’s competitiveness and enable the necessary transformation process.

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<sup>1</sup> 2020 New EU Industrial Strategy – COM (2021) 350 Final – Page18

*The Commission will present a Carbon Border Adjustment Mechanism for selected sectors, to better address the risk of carbon leakage, in full compliance with WTO rules. Existing tools to address the risks of carbon leakage of globally exposed energy-intensive industries should continue to be used until fully effective alternative arrangements are in place.*

### **Additional instruments are necessary for the transformation**

Additional measures that will provide carbon leakage protection and at the same time support the much-needed industrial transformation are equally important. To this end, different instruments such as, e.g., Carbon Contracts for Difference (CCfD) which are an important financing instrument to secure long-term investments in new technologies, as well as common international emission trading systems should be considered.