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Comments on the EU Commission proposal for a regulation establishing a carbon border adjustment mechanism – for external use

The EU Commission Proposal for a Carbon Border Adjustment Mechanism (CBAM) was released together with the 'Fit-for-55' package on 14 July and accompanied by an impact assessment analysis.

This document sets out Cepi's views that complement Cepi's earlier comments[1].

As the EU ambition to address climate change has dramatically increased, risk for carbon leakage has grown and needs to be addressed in a cost-efficient way.

As a significant number of EU's international trading partners do not have the same level of climate ambition as the Union, EU policymakers need to ensure that the EU's high climate ambition does not result in carbon leakage, either through relocation of EU production outside the EU, replacement of EU exports with high carbon footprint goods from other countries or increased imports into the EU of more carbon-intensive products. Additionally, carbon leakage should not be transferred onto downstream industries.

Failure to address these three forms of leakage would dramatically affect the capacity of EU industries to contribute to climate solutions and result in an overall increase in global emissions.

Cepi agrees with the decision of the EU Commission not to include the pulp and paper industry sector in its CBAM proposal. CBAM is not a universal tool that can prevent carbon leakage in all ETS sectors.

The pulp and paper industry is not retained by the EU Commission as a sector to be in the CBAM sectoral scope. The possible inclusion of the pulp and paper industry / products in the CBAM is discussed in the "accompanying staff working document" but its potential inclusion in the CBAM is not assessed from an impact point of view by the EU Commission. In Annex 7, it is clearly said that pulp and paper should not be included in the CBAM. For pulp and paper, HS/CN codes do not seem to be aligned with EU ETS benchmark classification, the specific emission costs are relatively low due to biomass use, the determination of embedded emissions seems difficult, and the administrative burden could exceed the benefit.

The European pulp and paper industry is indeed less suitable for CBAM than some other sectors for the reasons mentioned above and also because of its specific features, such as positive trade balance, large variety of production processes, complex value chains and high number of installations and small emitters.

Electricity is on the list of sectors and the potential impact on some Member States and their pulp and paper companies could be significant and will need to be addressed.

Electricity is not assessed for risk of leakage under the ETS, nor is it granted free allocation. It is included in the EU Commission proposal because of its high level of GHG emissions and because of the existing risk of carbon leakage at local level via the interconnections between the EU and third country generators. While electricity is included in CBAM scope, it would be subject to a separate set of rules.

CBAM would be applied to electricity generated in and imported from countries that wish to integrate their electricity markets with the EU until such a point that those electricity markets are fully integrated.

The potential impact on some companies located in Finland and the Baltic States could be significant because of the substantial electricity imports from Russia. CBAM could make these electricity imports unprofitable, which would

[1] Response of Cepi to the European Commission Public Consultation on the Carbon Border Adjustment (28 October 2020) and the Cepi comments on the EU Commission inception impact assessment (31 March 2020)

contribute to higher electricity prices on domestic markets. Such a development would have a negative effect on these countries' energy intensive industries and the conditions of their international competition. This could result in carbon leakage, instead of preventing it.

Access to affordable clean energy, and particularly electricity, is a prerequisite for jobs, growth, and competitiveness.

CBAM should complement, not substitute, existing tools addressing carbon leakage.

The EU carbon emission cost has jumped from €25 in November-December 2020 to approximately €60 in November 2021. None of the EU's competitors have had to absorb such a high, and increasing, carbon cost. To meet the European Green Deal ambitions, many sectors have sped up the implementation of low carbon projects. Removing or reducing free allowances below the current benchmark level would translate into an increase in ETS compliance costs for these industries. Undermining their competitiveness would in the end negatively impact the climate change objectives set out by the EU.

CBAM is not an alternative to the free allocation of emission allowances as both measures address different types of carbon leakage in the framework of the EU ETS. CBAM alone would not solve the issue of carbon leakage for EU industries that are mainly export-oriented like the pulp and paper industry.

From a legal point of view, the co-existence of free allowances and a CBAM under the EU ETS umbrella is WTO compatible. As shown by a recent legal study[2] commissioned by AEGIS Europe, an EU ETS – incorporating both free allowances and a CBAM - is a border adjustable internal measure which is consistent with GATT non-discrimination obligations as long as EU products and imports face an equivalent regulatory burden that is applied on an even-handed basis.

European producers are exposed to indirect carbon costs passed on by electricity producers. Due to the functioning of the electricity market, these costs are not linked to the emissions embedded in the electricity consumed but to the emissions of the marginal delivered electricity. Given that indirect costs from the electricity market are higher than those that would be derived directly from indirect emissions, the indirect costs compensation system under the ETS Guidelines must remain in place until it is demonstrated that a CBAM has the effect of avoiding carbon leakage due to these costs**.**

The automatic phase-out of ETS free allowances and indirect cost compensation should be opposed. They should be maintained in full - at least until 2030 - for such time as necessary to allow sufficient time for the deployment of low carbon technologies and until it is proven beyond any doubt that CBAM is effective and carbon leakage is averted.

Solutions for export adjustment need to be developed before CBAM can be extended to further industrial sectors.

The limiting of and setting a price for carbon emissions in the EU should not be detrimental to EU exports in global competition. Export adjustments need to be considered, especially due to the intended phasing out free allowances. They have benefited both domestic deliveries and exports while CBAM would only serve the former.

The European pulp and paper industry, like any other EU industries, exports its production outside the EU and on these export markets is in competition with more carbon-intensive products from third countries. If EU exports become uncompetitive because of the costs and regulatory burdens associated with decarbonisation, they will lose out to production of countries not decarbonising. EU low carbon products exports will be replaced by products from high carbon sources leading to carbon leakage likely to result in an overall increase in global emissions.

Providing a carbon burden adjustment for EU exports would avoid this type of carbon leakage and would effectively contribute to the achievement of the overarching climate goals.

[2] King & Spalding and NCTM legal study "*Consistency of an EU carbon border adjustment mechanism ("CBAM") with World Trade Organization ("WTO") rules - June 2021" - http://www.aegiseurope.eu/publications#publications*

The adoption of "export adjustments" should be an integral part of the EU ETS to ensure consistency with the WTO rules as shown in a recent study commissioned by AEGIS Europe[3]. This legal study shows that those export adjustments – which must be an integrated but independent component of the EU ETS – must be kept in place until third countries align their climate policies to the EU's since the carbon leakage risk would persist.

To maximise the effectiveness of its climate policies, the EU must strive to ensure the competitiveness of its exports. Thus, by becoming a significant exporter of low-carbon products and technologies and thus replacing high-carbon products in third countries, a significant reduction in global emissions would be triggered.

Countries with equivalent ETS systems - equivalent carbon costs and reduction obligations - should be treated fairly and CBAM exemptions should be envisaged as analysed in an additional recent study commissioned by AEGIS Europe[4].

Additional level playing field measures will have to be identified and put in place.

The application of CBAM may not be effective for all products and sectors. Because carbon leakage is a reality and is anticipated to increase with EU's higher climate ambitions and the scheduled reductions of free allowances, other measures need to be considered, in addition to free allowances and indirect cost compensation, in order to secure a level playing field, particularly for the sectors not covered by the CBAM.

These level playing field measures should be considered in various policy areas: EU general system of preferences, public procurement, environmental regulations, supply chain requirements, labelling requirements and international standards, R&D and innovation in low-carbon technologies and products (Carbon Contracts for Difference and Carbon Contracts for Avoidance), but also trade defence instruments, trade barrier regulation and free-trade agreements. Fair competition on EU markets can be achieved through different means and a better control of the imported products. Performance standards about product carbon footprint on EU market maybe an effective solution to incentivise GHG emissions reductions.

In any event, these level playing field measures, once identified, must be elaborated and assessed in close cooperation with concerned stakeholders, including industry.

Effectiveness of CBAM needs to be thoroughly analysed and EU prepared for third country reactions and possible retaliation measures.

The effectiveness of CBAM in preventing carbon leakage should be carefully monitored and assessed.

The CBAM proposal will undoubtedly trigger significant international reactions. Even if the compliance with WTO trade rules is ensured, it is fair to expect some WTO members to decide to take unilateral action and retaliate outside the WTO, targeting European exports of goods covered by CBAM or not. Trade partners will not only oppose the CBAM as a matter of principle, but will focus their criticism on specific provisions, such as the limited crediting of foreign climate policies, where the EU will only consider explicit carbon pricing.

If companies in countries with existing emissions trading schemes, such as South Korea, might see less difficulties to adjust to the CBAM, a strong reaction can be expected from countries which will potentially be the most affected by the mechanism, such as Russia, Turkey, China, the United Kingdom, Ukraine and North African countries, which are major exporters to the EU. The very concept of a CBAM has already been criticised by many EU trading partners, such as China and Russia. Escalating trade tensions could be expected because of the current deadlock faced by the WTO Appellate Body. Retaliation measures could potentially affect EU exports of goods like pulp and paper.

[3] King & Spalding and NCTM legal study *"WTO consistency of export adjustments in the context of the EU Emissions Trading System (incorporating a carbon border adjustment mechanism) - June 2021"* - http://www.aegiseurope.eu/publications#publications

[4] King & Spalding and NCTM legal study *"Treatment of alleged carbon cost burdens in third countries - June 2021"* - http://www.aegiseurope.eu/publications#publications

The EU should maintain its advocacy efforts towards trading partners and enhance its climate diplomacy aiming at urging third countries to increase their climate ambitions. Forums like the G20, G7, the WTO and the OECD could be instrumental to encourage all countries to develop and implement a carbon pricing system.

Extension to other sectors requires a robust impact assessment and long enough transition periods.

Cepi supports a targeted approach in terms of sectors covered by the scope since CBAM is not a tool that can be implemented in an effective way for all sectors under the EU ETS. As reflected in the EU Commission proposal, a transitional period of three years (until December 2025) will apply during which the sectors currently mentioned in Annex I will only be subject to reporting obligations. Considering that the CBAM proposal foresees the possibility for the Commission to propose in 2025 the extension of CBAM to other sectors, it is absolutely necessary to have a robust impact assessment and to grant a similar transitional period to any sector to which the scope would be extended. One cannot conceive that such sectors would suddenly be subject to the CBAM as of 2026 without having tested the system on these sectors the same way it will be tested during three years on the sectors already in the scope.

The possible inclusion of indirect emissions in the CBAM scope after the end of the transition period should also be thoroughly assessed.

Instead, the review by 2026 should focus on optimizing administrative procedures, while the main features of the measure should remain stable at least until 2030. The changes should aim at minimising the costs of reporting obligations and verification procedures.

Background information: EU Commission climate change policy and 'Fit-for-55' package, and the European paper industry's contribution.

On 17 September 2020, the European Commission presented its plan to reduce EU greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels. On 14 July, the EU Commission released its 'Fit-for-55 package' of proposals to make the EU's climate, energy, land use, transport and taxation policies fit for that purpose.

Our industry is up to the climate challenge. The European paper industry has already delivered a successful decoupling of carbon emissions from economic growth while reducing carbon emissions by 29% from 2005 to date, making our sector's direct emissions accountable for less than 0.7% of total EU GHG emissions: a leading performance amongst industrial sectors! By constantly investing in energy efficiency, our sector has achieved a remarkable decrease of over 12% in primary energy consumption over the period 2005-2018.

The carbon neutrality objective requires, however, for the European pulp and paper industry to become even more sustainable, efficient, and innovative. The industry's transformational journey must continue while maintaining competitiveness. The European paper industry expressed its ambition to go even further for climate in its recent CEO initiative[5]. It sets the path for the pulp and paper industry to become the most competitive and sustainable provider of solutions for a climate-neutral Europe in 2050, having a positive impact beyond our own emission reduction.

The industry has proved the climate friendliness of its products thanks to certified raw materials and a world class performance in recycling. It has delivered climate benefits for society. Our industry offers innovative and resource-efficient solutions for current and future challenges. As a vital part of a circular bio-economy and forest-based industry value chain, we provide consumers with a wide range of renewable and recyclable solutions for packaging, different papers, textiles, bio-composites, bio-chemicals and energy products.

The European paper industry contributes to the EU GDP with 20 billion euros annually and is a global leader, thanks to its exports - 22% of its production is exported, despite the absence of a global level playing field.

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[5] https://www.cepi.org/ceo-initiative-our-contribution-to-eu-2050-climate-neutrality/