E3G

E3G VIEWS ON THE UK EAC ENQUIRY INTO CBAM

This is Third Generation Environmentalism (E3G)'s submission to the UK Environmental Audit Committee (EAC) enquiry into Carbon Border Adjustment Mechanisms (CBAMs).

Key recommendations

1. E3G cautions against exploring a unilateral UK CBAM and advises that the UK should seek to cooperate with other countries that are exploring CBAMs. Beyond CBAM, the UK should explore common approaches to carbon leakage and cooperate on deep decarbonisation of energy-intensive sectors with partner countries.

2. In line with the principle of common but differentiated responsibilities and respective capabilities (CBDR&RC), the UK should engage in dialogue with developing countries on how a UK CBAM might affect them and what technical, financial and capacity support measures could be taken to manage these impacts. The use of the CBAM's revenues will be crucial in this respect.

3. While a CBAM could address the risk of carbon leakage, it will not be a significant driver by itself of industrial decarbonisation in the UK or elsewhere. Domestically, the UK will need a wider policy toolbox for decarbonizing its heavy industry. Internationally, the UK should leverage CBAMs for a broader discussion with trade partners on decarbonizing heavy industry and better aligning trade and climate policy.

4. E3G advises to actively explore alternative approaches alongside a potential UK CBAM, including carbon product requirements.

E3G

Overview

E3G is pleased to note and provide feedback on the EAC's enquiry into CBAMs. Our feedback in this response focuses on the first 9 questions included in the terms of reference and builds on E3G's long standing experience working on climate policy, politics and diplomacy.

E3G recognises that a CBAM can level the playing field between the UK and foreign producers by imposing the same carbon costs on certain goods and products being sold on the UK market, regardless of whether they are produced domestically or imported from abroad.

While a *risk* of carbon leakage exists, to date there has been little to no empirical evidence of carbon leakage in the UK. Energy-intensive industries have received generous amounts of free emissions trading system (ETS) allowances to mitigate this risk. This has led to overprotection, in some instances, generated windfall profits, while muting the carbon price signal and decarbonisation incentives for highly polluting industrial sectors. Any future UK policy aimed at addressing the risk of carbon leakage should be limited and targeted, drawing lessons from these past mistakes.

Scope for cooperation around a UK CBAM

The international response surrounding the European Union's proposal to unilaterally introduce a CBAM has shown just how contentious an instrument this is. The EU CBAM has faced explicit pushback from many of the UK's closest trading partners, questioning the design, fairness, feasibility and legality of the measure. Countries like China, Australia and Russia, but also the United States, have pushed back openly against the idea.

The UNFCCC discussions last June already saw an aligned G77 + China caution that "the imposition of coercive economic measures, including unilateral sanctions, against developing countries" was in violation of Article 3.5 of the UN Climate Convention, with the most vocal condemnations coming from China for the Like-minded Developing Countries Group, Saudi Arabia for the Arab group as well as Bolivia.

However, the EU's move has also nudged major trade partners, including Canada, Japan, the US and the UK, to explore CBAMs as well. As these countries pursue increasingly ambitious climate policies and expect to decarbonise more

rapidly than other geographies, concerns over the risk of carbon leakage have grown.

Until recently the issue of carbon leakage has been addressed through domestic tools in most of these countries, mainly via exempting sectors deemed to be at risk of carbon leakage from environmental taxes and policies. However, as noted above, such policies have undermined incentives to decarbonise some of the most polluting sectors in these economies. Such an approach is no longer politically sustainable in the context of deep decarbonisation. CBAMs have emerged as one potential solution to this problem.

Against this backdrop, it makes sense that the UK is exploring the use of CBAMs: both in response to actions by its major trading partners, including the EU, and as a means of addressing the risk of carbon leakage as it pursues net-zero by 2050.

However, **E3G cautions against exploring a *unilateral* UK CBAM and stresses the need for the UK to explore common approaches to carbon leakage and cooperate on deep decarbonisation of energy-intensive sectors with partner countries.** The UK should seek to cooperate with other countries that are exploring CBAMs. This would not only send a strong signal in support of multilateralism, but also avoid multiple, competing CBAMs emerging in different jurisdictions, potentially leading to considerable administrative complexity and additional non-trade barriers. Lastly, cooperating with other countries exploring CBAMs would also strengthen the UK's position vis-à-vis those pushing back against such a mechanism.

Moreover, to respect the UK's international obligations and in the spirit of international climate justice, special consideration should be given to developing countries. The UK should engage in dialogue with developing countries on how a UK CBAM might affect them and what technical, financial and capacity support measures might be taken to manage any impacts. In this sense, E3G underlines the importance of countries' relative risks incurred by a CBAM, considering not only their trade exposure but also their vulnerability.[1]

Alternatives to a CBAM should be explored

A CBAM is not the only policy tool able to protect against the risk of carbon leakage and prompt trade partners to decarbonise. There exists a suite of policy

[1] **https://www.sciencedirect.com/sdfe/reader/pii/S2214629621003339/pdf**

tools able to address the risk of carbon leakage while also providing further environmental benefits.

Examples of alternative or complementary measures include the use of product standards and requirements applied to domestical products as well as imports, consumption charges, increased public investment in the deployment of clean industrial production technologies and the alignment of new and existing trade policies and agreements with promoting environmentally beneficial outcomes.

As highlighted in the recent report by the UK Board of Trade[2], the development of mandatory carbon product requirements for industrial materials is an especially promising alternative instrument, providing significant advantages over a CBAM**. E3G advises to actively explore these alternative approaches alongside a potential UK CBAM.**

A UK CBAM is no silver bullet for industrial decarbonisation

While a CBAM could address the risk of carbon leakage, it will not be a significant driver by itself of industrial decarbonisation in the UK or elsewhere. **The UK will need a wider policy toolbox for decarbonizing its heavy industry:** including procurement policies and regulation to build demand for cleaner industrial materials and seize the full potential of circular economy approaches, direct support for first demonstration projects of near-zero emissions technologies, and infrastructure investment to ensure cleaner energy and material feedstocks are available as new technologies come online.

The UK should seek to leverage CBAMs for a broader discussion with trade partners on decarbonizing heavy industry and better aligning trade and climate policy, exploring areas for cooperation alongside the CBAM on building markets for green industrial materials (harmonising and co-developing green product standards, joint pledges on public procurement, technology transfer schemes, lowering trade barriers), sector deals for key commodities and scaling up research & development.

Ongoing discussions on CBAMs should also be leveraged diplomatically by the UK to obtain more ambitious decarbonisation commitments from countries who have yet to commit to ambitious climate targets.

[2] **https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1008120/board-of-trade-report-green-trade.pdf**

The UK should work closely with partner countries to concretize the newly launched G7 Industrial Decarbonisation Agenda and commit to ambitious green public procurement policies under the Industrial Deep Decarbonisation Initiative, launched under the CEM and co-led by the UK and India. Supporting such initiatives will send a strong cooperative signal alongside exploring a UK CBAM, indicating openness to developing the CBAM in such a way that it is complementary to and supportive of alternative decarbonisation strategies.

E3G

Outline

Our consultation response is focused on the following 9 questions provided in the terms of reference to the enquiry. A short summary of our response to each of these is outlined below.

Question 1 – We acknowledge that there is a risk of carbon leakage. However, to date there has been little to no empirical evidence of carbon leakage in the UK. While the government's current approaches have been effective, they have been detrimental for climate ambition and go against the polluter-pays-principle.

Question 2 – We recognise that a UK CBAM can level the playing field between the UK and foreign producers. Moreover, if other carbon leakage measures are phased out as a CBAM is introduced, this could result in significant environmental co-benefits.

Question 3 – We believe that there is a huge scope for cooperation around CBAMs and that the UK should not strive for a unilateral approach. However, we think that the Government should also pursue other policies that are able to address the risk of carbon leakage, while providing further environmental benefits, such as mandatory product requirements.

Question 4 – We believe that the scope for a potential UK CBAM's should initially be limited to a relatively small number of carbon-intensive and trade-exposed sectors.

Question 5 – A UK CBAM can positively contribute to the competitiveness of covered industrial sectors, especially to the competitiveness of green frontrunners, vis-à-vis foreign producers. We believe that any negative impacts on consumers will be minimal, given the nature of the products that will likely be covered by a CBAM.

Question 6 – We believe there to be a suite of political and technical risks that need to be managed or resolved when designing and implementing a UK CBAM. It will be critically important to ensure that the UK CBAM is compatible with WTO rules and respects the principle of CBDR&RC under the UNFCCC regime.

Question 7 –Transitioning away from free allocation and introducing a CBAM could entail considerable environmental co-benefits. Moreover, CBAMs could be leveraged for a broader discussion on decarbonizing heavy industry globally and

E3G

better aligning trade and climate policy, exploring areas for cooperation alongside the CBAM.

Question 8 – We perceive designing a CBAM as a balancing-exercise between three (sometimes) competing axes: meeting environmental objectives, the feasibility of administering the mechanism, and adhering to international legal obligations.

Question 9 – In line with the principle of CBDR&RC in the UNFCCC regime as well as the SDT of the WTO regime, we believe that special considerations should be given to developing countries in the UK CBAM design. This can be done in different ways, including through adopting a waiver for LDCs or through ramping up financial and technical support for these countries. The use of the CBAM's revenues will be crucial in this respect.

E3G

E3G's response to the inquiry

QUESTION 1: What are the risks to the UK posed by carbon leakage? How effective is the Government's current approach to tackling carbon leakage?

At currently prevailing carbon price levels in the UK, there is a *risk* of carbon leakage for certain good and products. For illustrative purposes, at a carbon price of €50/tCO2, the increase in costs per tonne of products like cement, chemicals and crude iron and steel is in the order of 200-250% of per unit profit margins. At this price level shipping cement clinker, crude iron and steel, or chemicals from countries without similar carbon price levels in place could become attractive despite transport costs. The price of allowances on the UK carbon prices has been well above €50 for the entirety of 2021.

However, to date there has been little to no empirical evidence of carbon leakage in the UK.[3][4][5][6] At an aggregate level, while the UK's consumption emissions in 2015 were 34% higher than production emissions, up from 29% in 2005, consumption emissions declined by 24% in this 10-year period, compared to a decline of 24% for production emissions.[7] The department for Environmental Foods and Rural Affairs found that the share of imports in the UK's carbon footprint rose only marginally between 1997 and 2018, from 41% to 43% [8] This data also does not indicate that significant levels of carbon leakage have occurred so far.

In part, this can be explained by the prevailing low carbon prices of the past. Between 2013 and 2018, the average price of carbon was ten times lower than it is today. In theory, the recent increase in prices may not have impacted relocation or supply-chain decisions to date but could still have an impact moving forward. More importantly, however, the lack of empirical evidence for carbon leakage can also be explained by the effectiveness of the government's current approach to tackle carbon leakage. Sectors deemed to be at risk of

[3] **https://onlinelibrary.wiley.com/doi/epdf/10.1111/joes.12356**

[4] **https://icapcarbonaction.com/en/?option=com_attach&task=download&id=703**

[5] **https://onlinelibrary.wiley.com/doi/epdf/10.1111/joes.12356**

[6] **https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2019/01/working-paper-165-Dechezlepretre-et-al-July-2019.pdf**

[7] **https://www.oecd.org/sti/ind/TECO2_OECD_webdoc2020.pdf**

[8] **https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/979588/Defra_UK_carbon_footprint_accessible_rev2_final.pdf**

carbon leakage receive generous amounts of free allocation, often more than necessary to cover their emissions, leading to windfall profits.

Moreover, it is challenging to disentangle the impact of carbon costs and other environmental policies from the many other price and non-price factors that influence a UK companies' relative competitiveness to foreign competitors or their decision to relocate outside the UK. These include, but are not limited to, their ability to pass-through carbon costs; their trade exposure; effects of non-tariff trade barriers; access to natural resources and infrastructure; labour and taxation costs; and institutional and regulatory stability.

While free allocation and other forms of compensation schemes and (tax) exemptions given to industrial sectors may have been effective for mitigating carbon leakage, they have been detrimental for climate action. These policies have dampened the carbon price signal and, therefore, the incentive to invest in cleaner production processes – leading to industrial emissions remaining largely flat since the early 2000s. Moreover, the fairness of these policies should be questioned as they go against the '**polluter-pays principle'**.[9]

QUESTION 2: What role could a carbon border adjustment mechanism (CBAM) play in addressing carbon leakage and meeting the UK's environmental objectives?

A CBAM can level the playing field between the UK and foreign producers by imposing the same carbon costs on certain goods and products being sold on the UK market, regardless whether they are produced domestically or imported from abroad.

> A CBAM would fulfil the same function as free allocation currently does, to the extent that both mechanisms level the carbon costs domestic and foreign producers face. As such, these mechanisms should be seen as alternatives to one another when it comes to addressing the risk of carbon leakage.

Beyond levelling the playing field and addressing the risk of carbon leakage, transitioning away from free allocation and introducing a CBAM could entail considerable environmental co-benefits:

> Contrary to free allocation, a CBAM would not weaken the carbon price signal for UK producers, assuming that the system of free allocation is phased

[9] **https://consult.defra.gov.uk/environmental-principles/draft-policy-statement/supporting_documents/draftenvironmentalprinciplespolicystatement.pdf**

out. Hence, they will have to bear the full costs of carbon, incentivising mitigation action and low-carbon investments domestically, including resource efficiency and circular economy actions.

> A CBAM would effectively expand the carbon price signal to cover the *consumption* of the products and goods covered, next to the *production* of these products and goods. This broadening of the carbon price signal will raise the price for high-carbon goods, increase the cost-competitiveness of lower-carbon production processes, as well as facilitate substitution by lower-carbon alternatives and substitutes, in turn contributing to lowering the UK's carbon footprint.

> Depending on the CBAM's design, it can also provide an incentive for third countries to increase their climate ambition, and for producers in third countries to clean up their production processes.

> Both the phase-out of free allocation and introduction of a CBAM will generate additional revenues which can be used to further climate mitigation and adaptation activities domestically and abroad. However, these revenues are likely to remain fairly limited. Indeed, if a CBAM is effective it should catalyse climate action internationally leading to declining revenues as countries invest in cleaner production processes. **For both these practical, as well as political reasons, a UK CBAM should not be framed as a fiscal measure.**

Of course, the introduction of a CBAM in addition to a phaseout of the UK's current carbon leakage protection system can only *contribute* to the aforementioned objectives. A CBAM is by no means a silver bullet and decarbonising the UK's economy requires a suite of policies going well beyond carbon pricing alone.

A well-designed UK CBAM would be one which is situated in a wider policy toolbox for decarbonizing heavy industry, including: procurement policies and regulations to build demand for cleaner industrial materials and seize the full potential of circular economy approaches, direct support for first demonstration projects of near-zero emissions technologies, and infrastructure investment to ensure cleaner energy and material feedstocks are available as new technologies come online.

Question 3: Should the Government pursue a unilateral CBAM? If so, why and what form should this take? If not, are there alternative approaches to addressing carbon leakage which the Government should be considering?

The UK Government should not pursue a unilateral CBAM. The introduction of a CBAM is being explored in a number of other jurisdictions, most notably in the EU, but also in Canada, Japan and the U.S. Given its administrative complexity as well as the political sensitivity surrounding CBAMs internationally, the UK government should, to the full extent possible, engage with partners to cooperate on the development of its CBAM or alternative measures to manage carbon leakage.

Moreover, doing this would also send a strong signal in support of multilateralism, and ideally avoid multiple, competing CBAMs emerging in different jurisdictions, potentially leading to considerable administrative complexity and additional non-trade barriers.

There is huge scope for cooperation on a number of issues, including on principles aimed at ensuring WTO and Paris Agreement compatibility; design elements (e.g. sectoral and emissions scope); and infrastructure and methodologies for measuring carbon content.

Next to a CBAM, there are a suite of policies that are also able to address the risk of carbon leakage and provide further environmental benefits. Examples of alternative or complementary measures include the idea of climate contributions[10] , the use of product standards and requirements, increasing public investment in the deployment of clean industrial production technologies, and aligning current and new trade policies to promote environmentally friendly outcomes.

The development of mandatory carbon product requirements for industrial materials is an especially promising alternative instrument, providing significant advantages over a CBAM, as was highlighted in the recent report by the Board of Trade[11]**.** These benefits include the following:

> Product requirements are likely to be WTO-compatible, provided they meet certain basic criteria, such as consultation with trading partners, proportionality to the policy objective and non-discrimination.

> If major trading partners, such as the United States, do not opt for carbon pricing as a way to decarbonise industry, but prefer regulatory

[10] **https://climatestrategies.org/wp-content/uploads/2021/06/Closing-the-Green-Deal-for-Industry_FINAL.pdf**

[11]**https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1008120/board-of-trade-report-green-trade.pdf**

approaches instead, low-carbon product requirements could be more easily aligned across jurisdictions, until a global standard was reached.

- They would provide an irrefutable business case for investment decisions into climate-friendly production technologies for industrial stakeholders – both in the UK and externally.
- They could be implemented in a transitional way via a low-carbon product quota introduced for sellers of the relevant product in the EU's market. This would have some advantages in terms of easing political acceptance and mitigating the risk of 'resource shuffling.'
- They could go beyond carbon-intensity to also cover resource-intensity and broader environmental criteria.

Whatever (basket of) policy measure(s) the government chooses in addressing the risk of carbon leakage, it will require careful design, planning and diplomatic groundwork in advance of implementation. Many of these policy measures would also benefit from international cooperation and coordination.

Question 4: If the Government were to introduce a CBAM, which products or sectors should be included and why?

The CBAM's scope should initially be limited to a relatively small number of carbon-intensive and trade-exposed sectors.

- Since the primary objective of CBAM is to protect against the risk of carbon leakage, it should be limited to those sectors deemed to be at significant risk of carbon leakage given their high energy intensity and their exposure to international trade.
- Many trade partners have already expressed concerns or have criticised the idea, fairness and legality of a CBAM. There is still a real risk of coalitions forming against any jurisdiction that pursues a CBAM, with a potential negative impact on important climate diplomacy moments. As the CBAM's sectoral scope will be a strong determinant of the coalition that might form against it, initially limiting the sectoral scope would also ease the diplomatic process surrounding the CBAM: fewer trade partners would be affected, requiring less diplomatic legwork to manage their concerns.
- As the CBAM is still an untested instrument, initially limiting the scope to a set of goods with simpler supply chains would allow for the administrative infrastructure to de developed and tested, a process which would prove considerably more difficult for more complex goods.

E3G

> Lastly, limiting the CBAM to the most carbon-intensive goods which are at the highest risk of carbon leakage would underline the environmental objective of the tool, strengthening the case for it under WTO law. It would, moreover, limit the risk of it being seen as a protectionist tool, further mitigating the risk of being challenged at the WTO.

Question 5: What impact might a CBAM have on UK (i) industry, (ii) employment and (iii) consumers?

All other things being equal, if well-designed and implemented, a CBAM can positively contribute to the competitiveness of industries included in its scope vis-à-vis foreign producers, potentially leading to gains in output and employment levels, especially for green frontrunners. If the introduction of a UK CBAM is accompanied by the phase-out of free allocation, the competitiveness of green frontrunners and producers of low-carbon substitutes would also increase vis-à-vis UK manufactures of high-carbon goods and products.

However, the impact of a CBAM will very much depend on its design, what happens to existing carbon leakage protection measures, as well as what other policies are introduced.

Regarding consumer impacts, if a CBAM is introduced and free allocation is phased out, producers in sectors covered by the UK CBAM will have to pay the full carbon cost embedded in the products they sell on the UK market. Depending on the market structure of products covered by the UK CBAM, a share of these costs will likely be passed onto consumers.

Ultimately this is the goal of carbon pricing policies, including CBAM: the carbon price signal should make its way down the value chain, regardless of where the product originates from, leading to higher costs for high-carbon products and a premium for greener products and alternatives.

Given the nature of the products that will likely be covered by a CBAM, basic industrial materials, impacts on consumers will be minimal. Several studies have noted that for final products using industrial materials (a house, a car), given that they are already fairly expensive goods the relative increase of the price of industrial materials would have a fairly small impact on the overall cost to consumers. For example, the International Energy Agency estimates[12] that

[12] **https://aceroplatea.es/docs/Iron_and_Steel_Technology_Roadmap_IEA.pdf**

using green steel increases the cost of a mid-sized home by just 0.2% and a mid-sized car by only 0.1%, resulting in negligible increased costs for consumers and taxpayers.

Question 6: What risks would need to be managed when designing and implementing a CBAM?

The international response surrounding the European Union's proposal to unilaterally introduce a CBAM has shown just how contentious an instrument this is. The EU CBAM has faced explicit pushback from many of the UK's closest trading partners, questioning the design, fairness, feasibility and legality of the measure. Countries like China, Australia and Russia, but also the United States, have pushed back openly against the idea, raising concerns over the lack critical information they have been presented with and in some cases misunderstanding the signals being sent by the EU with their proposal.

Moreover, the experience of the EU's plans to extend the scope of the EU Emissions Trading System to international aviation in 2011 clearly showed how fast international opposition can mount up against a controversial policy initiative. This led to the EU proposing to 'stop the clock' on this plan in late 2012.

It is clear that the international political risks surrounding CBAMs are real and that they have to be carefully managed. This can be done, inter alia, by:

> Ensuring the CBAM is compatible with World Trade Organisation (WTO) rules and particularly the General Agreement on Tariffs and Trade (GATT), to limit the risk of third countries challenging the CBAM under international trade law.

> Ensuring the CBAM respects the principle of Common but Differentiated Responsibilities & Respective Capabilities (CBDR&RC) under the United Nations Framework Convention on Climate Change (UNFCCC), by exempting or giving special considerations to least developed countries (LDCs).

> Limiting the scope of the CBAM to a handful of sectors at the highest risk of carbon leakage, both to highlight the environmental motivation behind the CBAM, as well as to limit the impact on trade partners in the short term, while this mechanism is being tested.

Cooperation with other countries exploring CBAMs will also be key. E3G cautions against exploring a *unilateral* UK CBAM and stresses the need for the UK to explore common approaches to carbon leakage and cooperate on deep

decarbonisation of energy-intensive sectors with partner countries. This would not only send a strong signal in support of multilateralism, but also avoid multiple, competing CBAMs emerging in different jurisdictions, potentially leading to considerable administrative complexity and additional non-trade barriers.

There are also considerable risks in terms of international climate justice for countries from the Global South. Indeed, while the trading partners mentioned above may have high levels of exposure to CBAM given their export-oriented industries, they are resilient and adaptable economies. Other nations in the Global South face much higher risks, despite apparently lower levels of exposure.[13][14] Mitigating the impacts they face and building in time to properly consult with developing countries will be key, alongside a comprehensive support package for those most affected by a potential UK CBAM including capacity building and financial and technical support.

Lastly, as no jurisdiction has experience with designing and implementing a CBAM on the scale currently being discussed in the UK, there are a suite of technical risks that need to be taken into consideration, including how the CO2 embedded in products will be measured, reported and verified; how climate policies in third countries can be accounted for; and how to address the risk of resource shuffling (the situation where foreign producers would allocate or attribute less emissions-intensive materials or production processes towards exports to the UK).

Question 7: What wider opportunities and benefits might arise from introducing a CBAM?

As outlined in our response to question 2, we believe that transitioning away from free allocation and introducing a CBAM could entail considerable environmental co-benefits.

Moreover, CBAMs could be leveraged for a broader discussion on decarbonizing heavy industry across the globe and better aligning trade and climate policy, exploring areas for cooperation alongside the CBAM to build broader markets for green industrial materials (harmonising and co-developing green product

[13] **https://www.sciencedirect.com/sdfe/reader/pii/S2214629621003339/pdf**

[14] **https://ieep.eu/uploads/articles/attachments/0f93d0de-8ac8-491f-9756-31fc93cba720/What%20can%20climate%20vulnerable%20countries%20expect%20from%20the%20EU%20CBAM%20-%20IEEP%20et%20al%20briefing%20(002).pdf?v=63791839851**

E3G

standards, joint pledges on public procurement, eliminating trade barriers for environmental goods and services), striking sector deals for key commodities and scaling up R&D in developed as well as developing nations. The UK should work to concretize the newly launched G7 Industrial Decarbonisation Agenda and commit to ambitious green public procurement policies under the Industrial Deep Decarbonisation Initiative, launched under the CEM.

Question 8: How might a CBAM interact with the UK's international obligations, including on trade and the environment?

We perceive designing a CBAM as a balancing exercise between three (sometimes) competing axes: meeting environmental objectives, the feasibility of administering the mechanism, and adhering to international legal obligations. International legal obligations include adhering to the principle of CBDR&RC under the UNFCCC regime, as well as adhering to WTO and GATT agreements and principles.

Mainly triggered by the recent move by the EU to introduce CBAMs, there are challenges being discussed under the UNFCCC. Notably, the Katowice Committee of Experts on the impacts of the implementation of response measures will be considering the potential implications of CBAMs in its ongoing negotiations on just transition at COP26.

The compatibility of a UK CBAM with the WTO will depend on the design and implementation of the measure. To clear the minimum threshold of the non-discrimination rules of GATT it has to be applied in conjunction with a domestically applicable policy of similar magnitude. However, the issue of consistency is not limited only to multilateral agreements. These measures need to also be compatible with existing bilateral and plurilateral trade agreements.

To give one example of this balancing act, perfectly mitigating the risk of carbon leakage and sending the 'right' signal to foreign producers would call for measuring the 'real' carbon-content of goods, i.e. firm-level emissions data. This, however, conflicts with administrative feasibility: it would be immensely difficult and costly to collect robust data in many of the countries affected. As a result, many commentators call for using benchmark emissions data based on common emissions benchmarks for scope 1 and country-specific benchmarks for scope 2 emissions. The latter, in turn, may be problematic from a legal perspective. Measuring average carbon intensity of electricity at a country rather than a

producer-level may violate the WTO Most Favoured Nations principle, which prevents discrimination of products based on their country of origin.

Question 9: Should the CBAM design include any special regard, e.g. for developing countries or small and medium-sized enterprises? If so, which circumstances should be given special regard, and what impact might this have? If not, why not?

Yes, in line with the principle of CBDR&RC in the UNFCCC regime as well as the Special and Differential Treatment (SDT) of the WTO regime, the UK CBAM design should consider potential impacts on developing countries – in particular around the decisions of what to do with CBAM revenues.

One of the important challenges against the imposition of CBAMs is that it will create trade diversion from poorer countries that have to rely on older and more carbon intensive technology for their production to richer countries who have invested more in newer and cleaner technology. For example, analysis by UNCTAD found that at the carbon price point of $44/tonne of embedded CO2 emissions, exports from developing countries to the EU will be reduced by 1.4%. The income of developing countries will fall by 5.9 billion compared to increase in income of developed countries by 2.5 billion.[15]

There is merit and legal precedence for including a waiver in the UK CBAM for Least Developed Countries (LDC). However, doing this also poses the risk of leaving these countries stranded with carbon intensive production methods, especially if not accompanied by supportive measures.

Rather, the UK should engage in dialogue with developing countries on how a UK CBAM might affect them and what technical, financial and capacity support measures could be taken to manage these impacts.

The use of the CBAM's revenues will be crucial in this respect. Fully recycling revenues towards supporting the modernisation and decarbonisation of LDC's supply chains and industrial base would send a strong cooperative signal and would be welcomed by these countries. It would also help appease countries like the USA, who have voiced concerns about the impact CBAMs might have on these countries.

[15] **https://unctad.org/system/files/official-document/osginf2021d2_en.pdf**

E3G

CONTACT

For more information, please contact Domien Vangenechten at **Domien.Vangenechten@e3g.org** and Johanna Lehne at **Johanna.Lehne@e3g.org**. We would be happy to clarify our inputs and to engage further on the UK CBAM.

Acknowledgments

We would like to thank our E3G colleagues who have contributed input and ideas, including, Ignacio Arroniz Velasco, Ronan Palmer and Shane Tomlinson.

About E3G

E3G is an independent climate change think tank accelerating the transition to a climate safe world. E3G builds cross-sectoral coalitions to achieve carefully defined outcomes, chosen for their capacity to leverage change. E3G works closely with like-minded partners in government, politics, business, civil society, science, the media, public interest foundations and elsewhere. E3G has been ranked the seventh most globally influential environmental think tank in the 2020 Go To Global Think Tank Index Report. This is the fifth year running that E3G has placed in the top-10 of this category.

More information is available at www.e3g.org

Copyright