INTERVIEW

Adam Berman, European Policy Director of the International Emissions Trading Association (IETA)

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1. Please describe your background in environment policy, how you gained your experiences in these fields, and what you do now at the International Emissions Trading Association ('IETA').

As the question makes clear, my experience is in environmental policy, not trade. As European Policy Director at the International Emissions Trading Association (IETA), I advocate for market solutions to climate change. In this position, I provide analysis and advice on European Climate Policy, with a particular emphasis on the EU's Emissions Trading System (EU ETS) and related policies. Prior to IETA, I worked as an analyst in the energy industry on international climate policy issues. I began my career working on environmental policy in the Parliament of the United Kingdom (UK).

2. Please tell us about IETA: what it does and why businesses should join.

The International Emissions Trading Association is a non-profit business organization created to advocate for the use of carbon pricing around the world, and to establish a functional international framework for the trading of carbon internationally. IETA's membership includes leading companies from across the carbon trading cycle; from industrial companies with compliance obligations under various global carbon pricing regimes to traders and banks which act as financial intermediaries in the trading of carbon.

3. The European Union ('EU') plans to introduce a Carbon Border Adjustment Mechanism ('CBAM') from 2023 to address carbon leakage. While the CBAM aims to support the EU's climate goals, it raises concerns on international trade. What are your view on the CBAM in general?

The EU is in a tricky situation. Whilst goods made in the EU are subject to a carbon price through the EU ETS, imports face no such charge. As Europe decarbonizes, it faces the risk that its efforts could be undermined through carbon-intensive imports (so called 'carbon leakage'). The traditional policy response to carbon leakage has been provision of free allowances under the EU ETS which provide a de facto carbon price discount for industries at risk of carbon leakage. Goods at high risk of carbon leakage which currently benefit from free allowances under the EU ETS include metals, mineral products, and chemicals. European policymakers have made clear that to ensure industry faces the correct incentives, free allowances must decline over time. Without subjecting imports to a carbon price, European industry faces the challenge of grappling with a higher carbon price burden in addition to unfair competition from abroad.

Border Carbon Adjustments (BCAs) are not a new idea, and yet until now, no nation state or bloc has ever introduced one. Why? Because they are legally, politically, and technically complex. Yet, their moment may now have come.

In a European context, there are two ways to look at the CBAM. The first is as a domestic mechanism which ensures European industry can remain competitive internationally, and provides another source of revenue to the EU as policymakers struggle with an economic crisis caused by the Coronavirus disease 2019 (COVID-19) pandemic. The other is to view it as an international climate mechanism. Only 22.3% of global emissions are covered by carbon pricing schemes.[1] This needs to rapidly increase if the world is to limit global warming. The CBAM

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[1] World Bank, Carbon Pricing Dashboard, https://carbonpricingdashboard.worldbank.org/ (accessed 16 Apr. 2021).

could play an important role in encouraging countries to introduce carbon pricing domestically, but only if the EU is serious about outreach to key trading partners, and being willing to share expertise and best practice in relation to carbon pricing policy.

Of these two narratives, I stand firmly in the second camp. Designing the CBAM as a mechanism to bring other countries with the EU on its journey to Net-Zero, rather than as a protectionist and largely punitive tool, is surely the preferable option. As the question rightly points out, the CBAM does raise concerns in terms of international trade. The only way to alleviate those concerns is for the EU to ensure that the CBAM represents the next step in the bloc's efforts to encourage the proliferation of carbon pricing worldwide. Put simply, the more carbon pricing we have, the less need we have for BCAs.

4. The European Commission proposed four options for designing the CBAM.[2] In your view, which option is the most practical and why?

It's important to stress that no CBAM will be free of design challenges. But the simplest option by far is what the European Commission call a 'notional ETS'. Rather than buying allowances through the EU ETS, importers would be obliged to surrender ETS-like allowances which exactly mirror the domestic ETS price and are regulated through ETS rules. These rules are robust and well understood by large swathes of industry.

5. What are the main challenges for introducing the CBAM in the EU?

The technical challenges of introducing a CBAM are substantial, which lead some observers to believe that the proposed implementation date of 2023 is somewhat unrealistic.

Foremost among these challenges is the question of how you measure the carbon intensity of a product. This is the most complicated technical task for the European Commission, as no comprehensive international system exists for this purpose. There are more questions than answers when it comes to how such a methodology should work. Should the calculations be based on EU/regional/domestic benchmarks? Should sectoral or industry methodologies be used? Should direct and indirect emissions be included? How should the EU account for carbon pricing schemes abroad? (Some countries have explicit industry-wide carbon prices, others might have an implicit carbon price through a bewildering assortment of regulations, standards, and levies.)

The EU plans to begin by including only raw materials in the CBAM. This is a sensible move. But semi-finished products will be considerably more complicated. Supply chains often extend across multiple different facilities and countries. The problem is that in measuring the carbon footprint of a product, there will always be a trade-off between accuracy and simplicity.

Another key challenge is deciding which sectors to include in the CBAM. Starting with the industries most at risk of carbon leakage is practical, but this must also be balanced by the complexity of that product's carbon supply chain.

6. How do businesses view the EU proposal to introduce the CBAM?

The European business community has been largely supportive of the CBAM, whilst being wary of exchanging a tried and tested tool for limiting carbon leakage (free ETS allowances) for a novel mechanism that has never been used at scale. There is no reason in principle why free allowances could not exist in parallel with the CBAM. Article III of the General Agreement on Tariffs and Trade (GATT) allows for the imposition of a charge at the border, on the condition that it is equivalent to a domestic tax on that product. If the business community wants to keep free allowances in addition to the CBAM, importers could either be rebated the amount of the free allowances, or receive some sort of discounted CBAM rate.

However, some actors in the business community want to go a step further, and have pushed for a CBAM charge at the level of the full European carbon price in addition to free allowances. In other words, giving more carbon leakage protection than European industry currently benefits from. This position is understandable – European heavy industry is at a tricky point in their decarbonization journey. But, from a World Trade Organization (WTO) perspective, such a position is clearly unviable.

7. How could businesses prepare for the CBAM at this point and going forward?

There are two aspects to this. Firstly, what does this mean for European industry? The EU ETS has existed

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[2] These four options are: (i) carbon tax on selected products, applying to both imported and domestic products; (ii) carbon customs duty (tariffs) on imported products only; (iii) extension of the EU Emission Trading System ('ETS')to imports, which could require the purchasing of emission allowances under the EU ETS; and (iv) notional ETS.

since 2005, and the CBAM will likely bring changes to the way that free allowances are handed out. Industry may have to become accustomed to effectively paying a higher carbon price for their activities. The challenge for industry will be to persuade policymakers that if the European Green Deal is to be a strategy for green growth, then Brussels must provide higher levels of funding assistance in decarbonization and investment in cleaner technology.

Secondly, what does this mean for importers? At the simplest level, complying with the CBAM will place a higher regulatory burden on importers. Understanding how the EU ETS works, and the market dynamics behind EU ETS prices, will be critical in business forecasting, hedging, and preparing for the CBAM.

8. The EU has emphasized that the CBAM will be fully compatible with World Trade Organization ('WTO') rules. What elements should the EU take into account to design a WTO-compatible CBAM?

Whilst the European Commission is confident that their CBAM proposal will be fully in line with WTO rules, its important to note that there is significant uncertainty about what the CBAM means in international trade and legal terms. This is the first mechanism of its kind. Much of the thinking around how to design a WTO-compliant BCA is largely educated speculation, and different WTO conditions will have to be met if the CBAM is based on taxation or ETS principles.

What we do know is that the CBAM must be mindful of a two key principles. Firstly, the key driver of the mechanism should be climate and not revenue nor industrial protectionism. Statements by leading European policymakers have already called this into question, and will almost certainly result in dispute settlement. Secondly, the CBAM charge must be equivalent to the EU's domestic carbon price. Article III of the GATT bars the EU from discriminating between domestically produced products and imports. If the EU were to subject imports to higher charges than European producers face through the EU ETS, it would be considered discrimination under the WTO.

9. Other countries expressed their concerns that the CBAM could be abused as a protectionist measure. Do you think the CBAM could lead to trade tensions (e.g., WTO dispute, retaliatory duties) between the EU and other countries?

BCAs are certainly a controversial tool, and they shouldn't be used lightly. The ideal scenario is one in which the EU allows a window of time – say two or three years – to discuss this policy proposal with key trading partners. This would give other countries time to enhance their carbon pricing domestically, allow for the possibility of a carbon club emerging, and ensure that the CBAM doesn't interfere with the United Nations Climate Change Conference (COP) process. The CBAM would be implemented at the end of this discussion period. Such a timeline would allow the global community to be persuaded that this was not a protectionist measure, and that the EU would prefer to work multilaterally on climate issues. The danger is that the EU needs the revenue as soon as possible. The EU's Coronavirus Recovery Package (NextGenerationEU) has already allocated revenue from the CBAM in its financial projections. Some fear that revenue pressures will push the EU into rushing through the CBAM and causing international problems.

10. How can the EU and other major economies come together on introducing a CBAM, and how can this work in terms of carbon pricing?

Several countries in addition to the EU have expressed interested in BCAs. These include the United States (US), Canada, and the UK. The idea of countries cooperating through BCAs is relatively new, and owes much to a 2015 paper by the economist William Nordhaus. Nordhaus suggested that countries could come together in a 'climate club' predicated around the idea of an 'international target carbon price'.[3] This trading club would provide preferential access to member countries, and sanctions for non-participants.

If done right, there's every chance that such a club could work well – it would provide a level playing field in carbon pricing between the member countries, and deliver a strong incentive to other jurisdictions to introduce carbon pricing domestically.

But such a club would require difficult political conversations. The Paris Agreement recognizes what it calls 'common but differentiated responsibility', by which it means that whilst all countries have a duty to tackle climate change, some have more historical liability than others depending on their developmental trajectory. A climate club goes

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[3] William Nordhaus, *Climate Clubs: Overcoming Free-Riding in International Climate Policy,* 105(4) Am. Econ. Rev. 1339–1370 (2015), https://www.aeaweb.org/articles?id=10.1257/aer.15000001 (accessed 16 Apr. 2021).

against this principle, and implicitly punishes developing nations. One option would be to exempt least-developed countries ('LDCs'), but where do you drawn the line?

Other issues include how to measure carbon pricing across jurisdictions. As mentioned previously, some countries have explicit carbon prices through taxes or cap-and-trade systems whilst others have a patchwork of regional and national regulation on climate. If a carbon club was based around the idea of similar levels of carbon pricing, how do you compare an explicit carbon price with an implicit carbon price? This is not merely an academic problem; the US doesn't have a federal carbon price. If the US was to join a carbon club, a complex methodology would have to be developed to aggregate all of the complex federal and state climate policies into one simple number.

Another technical approach might be for countries to pursue a carbon 'Customs Union' under Article XXIV of the GATT. This would allow countries within the carbon customs union to charge a common external tariff. The difficulty with this approach is that the idea of a customs union under the WTO is predicated on the principle that it cannot make trade more expensive for those outside the union. This stands in opposition to William Nordhaus' idea that such a club would necessarily be punitive to non members.

In addition to technical challenges, there are also political hurdles. There are fears from some quarters that a focus on BCAs might damage more truly multilateral climate efforts. During a year in which climate-watchers are desperately hoping to finalize the Paris Agreement rulebook at COP26, it would be deeply unfortunate if the issue of BCAs got in the way of international negotiations.

11. What other trade mechanisms might allow the EU to cooperate with key trading partners in tackling climate change?

BCAs are a very political tool, but there's another mechanism that doesn't lead to the same geopolitical headache – linking emissions trading systems. By linking one ETS with another, participating countries create a much larger market in emissions reductions. The end result is a single carbon price across the linked carbon markets, making life considerably easier for business which no longer has the regulatory burden of having to face different carbon prices in different countries. In short, linkage allows countries to reach Net-Zero cheaper and faster.

But like any international trade mechanism, they require careful negotiation. Alignment on environmental ambition is the most critical factor, but ETS design is also important. The EU already has one linkage with Switzerland and some speculate that there is potential for an EU-UK linkage. In the long term, linkage negotiations could even take place with China which is introducing a national ETS in 2021.

12. EU trade agreements include a Trade and Sustainable Development ('TSD') chapter to address environment and labour issues arising from trade. Do you think the TSD chapter has sufficiently contributed to dealing with these issues?

The fact that you've asked a climate policy expert to evaluate this question rather than a trade expert shows the inherent problem. For too long, climate and trade expertise have been siloed – climate and broader sustainability issues will only truly be integrated with trade when different disciplines speak to one another. The BCA is an interesting example of a policy which allows that to happen; with trade experts talking about climate, and climate experts having to think through complex trade issues often for the first time.

The TSD chapter is a positive development, as is the added focus that the EU placed on climate issues in negotiating the UK-EU Trade and Cooperation Agreement ('TCA'). But, there is still much further to go. For as long as climate is primarily an after-thought in Free Trade Agreement ('FTA') negotiations rather than a crucial and integrated parameter of discussions, the important climate decisions will be made in other fora such as COP negotiations, G7/G20 discussions, and regional trading blocs.

13. In November 2020, several WTO Members published a declaration on enhancing trade and environmental sustainability, and emphasized the importance of creating and deepening dialogues between WTO Members and private stakeholders (e.g., business, civil society).[4] In your view, how could this dialogue be facilitated for private stakeholders to provide meaningful inputs?

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[4] WTO Committee on Trade and Environment, Communication on trade and environmental sustainability (WT/CTE/W/249), 17 Nov. 2020.

Particularly when it comes to the environmental agenda, civil society engagement with the WTO is of critical importance. Some of the most impactful climate policy decisions over the last few years have stemmed from civil society movements. Bringing that to the WTO would be a step in the right direction. But, beyond dialogues, the key question is how to translate civil society's views into WTO decisions. When it comes to the discussion around BCAs, it's striking how few people are asking whether the WTO rules are the right ones for today. Climate change is one of the key global problems of the day, but the WTO has yet to treat it as such.