

Re: Carbon inclusion mechanism (CIM)

1 – Carbon leakage creates a major risk for climate.

The introduction by the European Union of a policy to reduce greenhouse gases based on the determination of a cost of CO₂ for emitters would, in the absence of comparable efforts by other countries as a result of the international negotiation, probably lead to the relocation of some production to those countries, and therefore to an increase in global CO₂ emissions. This would have a negative impact on climate change mitigation, undermining the stringent measures applied by the European Union, whose industry would also suffer from unfair competition.

2 – That concern has been incorporated into the European Union Emission Trading Scheme (ETS) directive

The directive provides for **free allowances** to be distributed to the sectors exposed to a risk of carbon leakage. The allowances would cover the average CO₂ emissions of the most efficient 10% of installations in a sector or sub-sector in Europe. The free allowances therefore do not eliminate the risk of carbon leakage since on average they will cover only a percentage of actual emissions. Industry will therefore need to purchase a significant share of its allowances to cover needs.

The directive provides therefore for the possibility of including importers of the relevant products into the Community system (**carbon inclusion mechanism**), in the light of the report that the Commission will produce by 30 June 2010. The objective of the mechanism is to prevent carbon leakage by ensuring that the installations in sectors subject to the ETS in the European Union remain on a level playing field with the installations of the same sectors in third countries, and thus to preserve the environmental integrity of the efforts made in the European Union. For the same reasons, the United States has included comparable provisions in bills currently being examined.

3 – In the course of the international negotiation, the aim must be to prevent carbon leakage within the framework of a global and ambitious agreement. It is therefore essential to prevent any country from taking advantage of its refusal to participate in such an agreement; to obtain guarantees of effective compliance with the commitments made; and to set up incentive systems to reduce emissions. **The carbon inclusion mechanism responds to that need by encouraging the countries concerned to adopt appropriate measures in the relevant sectors.**

The European Union should thus propose to each of these countries a **sectoral partnership**, covering the sectors exposed to the risk of carbon leakage, including technological support. The aim being (i) to achieve reduction measures of comparable scope, and (ii) to encourage the development of low-carbon technologies in these countries, which would allow the exemption of products exported to the European Union from the carbon inclusion mechanism. In the event of temporary imbalance of efforts in a given sector, the carbon inclusion mechanism could be accompanied, under the sector partnership, by the return of the proceeds to the country concerned in order to help it meet its commitments.

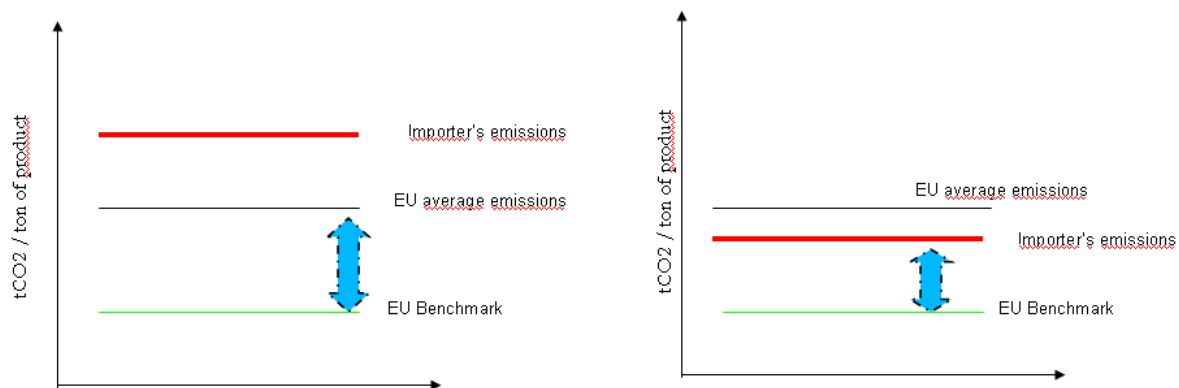
In the event of the negotiation “in good faith” failing and a country refusing to participate in a satisfactory international agreement or participating in it insufficiently in the sectors that expose the European Union to carbon leakage, the mechanism would be applied to the country as a whole or to the relevant sector or sectors. The proceeds from the mechanism could fund actions planned under the international agreement (most vulnerable countries, forests, etc.).

The least developed countries, which come under a different approach, would be exempted from the carbon inclusion mechanism.

4 – **The carbon inclusion mechanism is technically feasible**

Under the mechanism, the importer would return the same amount of allowances that a European producer would have to purchase on the market to produce the same quantity of goods. In order to factor in the carbon intensity of products made in third countries, a “flat rate” approach could be adopted (i.e. without measuring the exact emissions generated by the production of an imported product): the amount of allowances to be returned by the importer would be the same as that which the average European producer would have had to purchase on the market. Consequently:

- either the imported products come under the “flat rate” approach and the importer returns allowances equivalent to the difference between average emissions in the European Union and the European benchmark;
- or the importer chooses to provide proof that the products it sells in Europe are more carbon-efficient than the European average and only returns the differences between its emissions and the European benchmark.



This would not require setting up a system from scratch. The carbon inclusion mechanism could build on the “single administrative document” for customs, to which a classification by product of the emissions allowances system would simply be added.

5 – A carbon inclusion mechanism is not a protectionist instrument

The mechanism, which responds first and foremost to an environmental objective within the framework of the international negotiation on climate change, would seek only to preserve current competitive conditions. From a technical point of view, it would not amount to a border tax. Thus, would a product cost 100 to produce in the European Union, compared with 70 to import it, the application of the ETS would raise the price of that product to, for example, 120. In that case, the CIM would raise the imported product by the same amount (to 90), enabling the import to enjoy the same price difference when it enters the European market (the price difference could even be greater if the product in question were produced with more carbon efficiency in a third country).

6 – A joint report by UNEP and the WTO released on 26 June 2009 set forth the conditions under which a carbon inclusion mechanism would be compatible with WTO rules. The mechanism, which should obviously comply with the general principles of non-discrimination, would come under the public policy objectives defined by Article XX of the GATT:

- the CIM would come under the WTO members’ prerogative to adopt “measures necessary to protect human, animal or plant life or health” (paragraph b); or
- would correspond to the obligation of impartiality defined in paragraph g (WTO members

can adopt measures “relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption”.

Furthermore, in cases where importers are more carbon-efficient than the European average, such mechanism can take into account that situation favourably in the allocation of allowances to importers.

7 – Possibilities exist so that the increase in demand for allowances stemming from the application of the CIM does not push up the price of carbon in the European Union.

It would suffice to provide for an annual marginal adjustment of the quantity of allowances auctioned based on estimates of the quantity required to meet demand from importers. Those estimates would be adjusted the following year so that the total volume of supplementary allowances issued would only vary by the exact number of allowances returned by importers over the year. An alternative solution would be to create an ad hoc reserve.

8 – Lastly, if an increase in the costs of imported products can be expected in the case of application of the mechanism, that would simply be the price signal which the European Union seeks to favour through the implementation of the revised ETS, by extending it to all products consumed in the European Union. It would be paradoxical for imported products to escape from the price signal, which is the cornerstone of the European climate policy. In addition, such a signal would be expected from comparable efforts in exporting countries, which is the European Union’s aim in the international negotiation./.