

LeadIT dialogue: preventing the risks of carbon leakage



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Key messages

- Measures to prevent carbon leakage are not a silver bullet for decarbonizing heavy industry, but are instead complementary to market incentivizing policy mixes, industry action, and partnerships across value chains.
- The extent to which the EU's Carbon Border Adjustment Mechanism (CBAM) can spur innovation for industry transition is not yet clear, but progress on transition can be made by financially supporting research and innovation and subsidizing breakthrough technologies.
- While implications on climate mitigation, equity and trade of the CBAM have been widely discussed, international companies and countries are waiting for further crucial details from the EU, including the implementation of CBAM exemptions, to grasp the full extent of the mechanism's implications.

In March 2022, the LeadIT Secretariat hosted a cross-sectoral policy dialogue on carbon leakage prevention measures and their impact on industry transition globally. This brief summarizes the main themes of the session.

1. Setting the scene

Carbon leakage refers to the notion that businesses may move their production to countries where emissions constraints are less restrictive and the cost of compliance with climate policies is lower, to avoid potential competitive disadvantages. This is particularly important for heavy industries where companies operate in competitive international markets with thin profit margins. Addressing carbon leakage therefore has international implications for governments and businesses.

The policy dialogue began with an introduction to the most notable carbon leakage prevention measure, the Carbon Border Adjustment Mechanism (CBAM). The European Commission [proposed](#) the CBAM to reduce the risk of carbon leakage. The proposal forms part of the [Fit for 55 policy package](#), which aims to reduce the EU's greenhouse gas emissions by 55% by 2030. Details of the CBAM are currently under consideration within the EU.

CBAM's climate contribution is twofold. First, it is designed to reduce the risk of carbon leakage. Second, it could help accelerate climate ambition in countries with more lenient climate policies. The pilot phase of the measure is supposed to begin in 2023 and be fully enforced in 2026. The current proposal covers iron and steel, cement, aluminum, fertilizers, and electricity, with extended coverage of 56 categories of goods along associated value chains.

Policymakers in our dialogue referred to CBAM as a flagship tool for the EU that will have a snowball effect as more countries act and react to the policy. They also noted that CBAM is first and foremost a climate measure, and it should not be regarded as a tool to regulate trade or solely protect European industries. Technical experts in attendance agreed that CBAM could send a strong political signal to countries outside the EU, underscoring that the bloc is serious about reaching climate goals.

European industry representatives participating in the dialogue perceive that CBAM is aligned with their investments in decarbonizing their production processes and welcome the proposal. Upstream cement and steel producers will be particularly impacted by the CBAM. As yet, many details of the proposal are not fully defined. Hence, industry voiced clear demands for clarity and predictability on the design and implementation of the mechanism, especially given the uncertainty brought about by the current energy security crisis and supply chain disruptions.

2. International implications

The international nature of carbon leakage means that preventative measures have implications beyond the borders of countries implementing them, just as CBAM will have far reaching

implications beyond EU borders. These include implications for climate mitigation, equity and trade, linked to incentivizing other countries to strengthen their carbon pricing mechanisms and national climate policies. The CBAM therefore remains high on the agenda of European policymakers.

Policymakers stressed that there were already positive signs that the CBAM proposal alone encourages countries to redesign their climate policies, with Turkey already considering plans to adopt a [carbon pricing mechanism at COP26](#). At the same time, many in attendance stressed the importance of having constructive dialogues between EU Member States and third parties to ensure positive outcomes and avoid future disputes.^{1,2} Academic representatives also stressed that markets and industries are at very different levels of development around the world and that careful discussions and risk assessments need to take place before the CBAM is implemented.

EU policymakers assured that the proposal must and will be WTO compatible.³ Yet academic representatives stressed that the proposal should also be aligned with Paris Agreement commitments which specify a common but differentiated responsibility, bringing attention to the equity lens of these mechanism. A recent [IMF study](#) draws attention to welfare impacts of CBAM on emerging and developing economies, showing that the mechanism could worsen income inequality and welfare distribution between rich and poor economies and affect their ability to decarbonize. This issue is connected to the use of revenues generated by CBAM. Participants in our dialogue discussed whether these revenues should be used to fund innovation in Europe, through the Innovation Fund, or to support the climate efforts of emerging countries, or both.

Another consideration raised was the importance of ensuring that the CBAM, as an ambitious climate policy, has strong legitimacy and treats all trade partners equally and fairly. This includes working out details on how third parties' national climate policies such as carbon pricing will be accounted for when importing their products to the EU. Academics warned against jeopardizing the notion of a level playing field with all trading partners, including those that the EU has a bilateral agreement with, such as the recent [EU-US trade agreement](#) on steel and aluminium.

The issue of "resource shuffling" was also raised. This refers to the risk that rather than changing production methods, countries exporting their low-carbon products to the EU chose to keep the high emitting ones locally or to export to countries with less ambitious climate regulations. This would result in no net improvement of GHG emissions reductions. Participants noted that as CBAM comes into effect, trade flows must be monitored closely to understand whether resource shuffling is a direct consequence of CBAM, and how it can be prevented.

Alongside CBAM, our dialogue also covered possible impacts of other carbon leakage prevention measures, such as the "climate clubs" concept [proposed by Germany](#) for industry transition.

1 See indication of concerns raised by BRICS Environment Minister in the New Delhi [Statement on Environment](#) at the 7th Meeting of BRICS Environment Ministers.

2 [Exposure to CBAM fees varies by trading partners](#), with negligible impacts on trade with US and small impact on China and Russia.

3 Echoed by the Green Trade Network of policy experts in their [CBAM design and implementation principles](#).

A climate club is a cooperation among countries to incentivize action towards shared climate goals and to protect from competitive disadvantage and free riders. Germany is using its G7 presidency to push for the [G7 to become the core](#) of such an international climate club by agreeing to minimum standards, while emphasizing inclusivity by addressing technology transfers and climate finance. While this type of climate club is considered complementary to the CBAM by policymakers,⁴ some argued that putting in place other carbon leakage prevention measures such as CBAMs were preferable to waiting for climate clubs to materialize and deliver a common carbon price.

3. Complementary measures

Carbon leakage prevention measures alone should not be considered silver bullets, particularly not for accelerating industry decarbonization. Policymakers, industry representatives and experts acknowledged that CBAM is intended to function alongside other policies and regulations under the Fit for 55 package. Several industry representatives shared concerns over the pace of the CBAM's implementation, its links to other measures under Fit for 55 (including the reform of the EU Emissions Trading System) and the importance of allowing industry the time to adapt and avoid supply issues during this period.

Throughout the course of the dialogue, several complementary policy and market instruments were discussed. Among those, the role of higher carbon prices came top of the list. An increase in carbon prices can play a crucial role in sending the necessary price signals to the market. Ideally, a worldwide common carbon price would create a level playing field for industry, and ultimately drive global climate ambition. However, while carbon pricing can be an effective tool to address the carbon intensity of industrial production, the example of the Swedish steel industry indicates that the same cannot be said for its influence on accelerating innovation. Experts noted that the genesis of low-carbon steel in Sweden did not depend on a high EU carbon price.

Furthermore, industry representatives emphasized the importance of regulatory certainty, and encouraged governments around the table to consider predictability when designing policy mixes. Hence, industry representatives and experts around the virtual table called for a policy mix that acknowledges that decarbonization in different industries runs at different speeds. For instance, momentum has built behind the decarbonization of steel using hydrogen, which depends on the availability of hydrogen, while the rapid decarbonization of cement production rests on the deployment of carbon capture, utilization and storage solutions, which faces uncertainty over infrastructure and high commercial costs.

Because the key decarbonization challenges of industry centre around a few carbon-intensive processes (e.g. clinker process for cement or blast furnaces in steelmaking), academics and technical experts argued that stimulating innovation through targeted subsidies would complement measures to address carbon leakage. Specifically, dynamic subsidies provided

⁴ Complementary nature of climate clubs and CBAM aligns with [Agora Energiewende's findings](#).

through Carbon Contracts for Difference⁵ schemes, or funds aimed at overcoming the innovation “valley of death” and supporting breakthrough technologies, were deemed preferable to lump-sum subsidies.

Nevertheless, experts noted that subsidies still run the risk of betting unsuccessfully on certain technologies, thereby locking-in inefficiency. Many participants advocated for funnelling revenues from the CBAM to support research, development, and innovation within the EU, and ideally also abroad.

Technical experts also argued that aside from addressing innovation and disincentivizing carbon-intensive production through CBAM and carbon pricing, governments need to incentivize the uptake of low-carbon products and technology by creating lead markets and customers that are willing to pay a premium for low-carbon goods. The implementation of Green Public Procurement was highlighted as an example of government playing its role in creating such demand.

Lastly, industry representatives voiced their own responsibility, and the contributions industry can make alongside and complementary to political efforts. Finding the right partnerships to share the risks and opportunities of the transition across value chains, as well as joint commitments on climate pledges, were cited as examples of industry’s role into driving climate action.

The next seven years is crucial to align hard-to-abate industries with the Paris Agreement. The mix of complementary measures linked to preventing carbon leakage will have implications across countries and global value chains and should be designed and implemented by leveraging public-private partnerships and international trade relations.

As this dialogue demonstrated, bringing together people from policy, industry and civil society from around the globe can foster a constructive discussion – one where participants are willing to listen to each other and work towards creating a level playing field.

5 For further detail see [Carbon Contracts for Differences: An Essential Instrument for European Industrial Decarbonisation](#)

The cross-sectoral policy dialogue was co-organized by FLSmidth, Heidelberg Cement and SSAB, and brought together public and private sector representatives of LeadIT's Technical Expert Committee (TEC) and friends of LeadIT. The dialogue included members of the European Parliament, the European Commission, and participants from the World Economic Forum, International Renewable Energy Agency, International Energy Agency, European Climate Foundation, IDDRI, Lund University, Agora Energiewende and several embassies of LeadIT member countries in Sweden. The dialogue was funded by the European Climate Foundation Green Trade Network.