

Carbon Border Adjustment Mechanism

EUROFER's recommendations for strengthening carbon leakage protection while increasing climate ambition

Our key messages

- Increasing climate ambition and rising carbon costs require strengthened rather than weakened carbon leakage protection
- The inclusion of the steel sector in the CBAM entails a high degree of complexity and risk, since steel products are traded with many third countries, under more than 100 customs codes, with different production routes and embedded emissions and with high risks of circumvention
- The inclusion of the steel sector in the first or subsequent CBAM wave should be linked to the timeline required for developing and proving an effective regulatory framework for a complex and sensitive sector such as steel
- Free allocation at full benchmark level complementing the CBAM is needed at least until 2030 to allow companies focussing on low carbon investment and to assess the effectiveness of the CBAM
- Any subsequent phase out after 2030 should be conditional to a monitoring system assessing the effectiveness of the CBAM coupled with an emergency solution to strengthen carbon leakage protection if needed
- A solution for EU exports is possible and essential
- Timeline and substance of the secondary legislation need to provide a predictable and effective framework
- Default values should be sufficiently high to avoid free riding when real data are not provided
- Other circumvention risks, including resource shuffling and cost absorption, need to be addressed effectively

1. CBAM as a tool to strengthen rather than weakening carbon leakage protection while increasing climate ambition

The EU steel industry has been acknowledged as one of the very few sectors at highest risk of carbon leakage in all impact assessments so far. Considering the increased EU 2030 climate ambition and related rising carbon costs, such risk will be higher than ever at least in the transition until 2030, since no major competitor in the world will be facing comparable costs, if any at all. Therefore, the CBAM should be seen as an instrument to strengthen rather than weakening the carbon leakage framework, by complementing it with full benchmark based free allocation at least until then.

Steel products sold on the EU market, whether produced in the EU or imported from third countries, need to have similar carbon cost constraints. EU steel exports need also to have carbon cost level playing field on all global markets.

A well designed CBAM with effective anti-circumvention measures and with a solution for exports can provide a sustainable carbon leakage protection in medium term, provided that its effectiveness is tested and demonstrated with certainty. However, in order to ensure that steel companies may focus financial resources on low carbon projects within a predictable legal framework, it should complement full benchmark based free allocation at least until 2030.

The steel sector entails a high degree of complexity for the CBAM, since it covers numerous product categories (more than 100 customs codes), with different production routes and embedded emissions, with large trade flows with virtually any producing third country and with high risks of circumvention, resource shuffling and absorption of the levy. Hence, it will be the real “stress test” of the CBAM and any weakness of the carbon leakage framework that may arise will lead to major losses in terms of output, employment, investment and overall increase of global emissions.

Therefore, if applied to steel products, the CBAM should be introduced with great care, without abrupt modifications of the existing regulatory framework on free allocation, since this has been taken as a reference by companies for planning investments. On the contrary, if, as proposed, free allocation is irreversibly reduced already as of 2026 regardless of any certainty on the actual effectiveness of the CBAM for complex and sensitive sectors like steel, it may result in higher carbon leakage and lower ability for EU companies to invest in low carbon technologies.

Against this background, the inclusion of the steel sector in the first or subsequent CBAM wave should be linked to the timeline required for developing and proving an effective regulatory framework for a complex and sensitive sector such as steel.

2. Free allocation at full benchmark level complementing the CBAM is needed at least until 2030 to allow companies focussing on low carbon investment and to assess the effectiveness of the CBAM

Free allocation is already partial and digressive, as it is based on tight benchmarks set by the average of the best 10% installations and further reduced by the cross sectoral correction factor when the ETS cap is too strict.

Even with 100% benchmark based free allocation according to the EU ETS rules before the ongoing revision, the EU steel industry will have an allowance shortage of 600 million tonnes of CO₂ in the period 2021 to 2030 resulting in a cost burden of € 36 billion at a carbon price of €60, or € 55 billion if the carbon price increases linearly to € 100 by 2030. During the transition, and at least until 2030, the CBAM needs to complement 100% benchmark based free allocation instead of the gradual and irreversible phase out mechanism proposed by the Commission. Any subsequent phase out after 2030 should be conditional to a monitoring system assessing the effectiveness of the CBAM coupled with an emergency solution to strengthen carbon leakage protection if needed. This is essential for the following reasons:

- The effectiveness and WTO conformity of the CBAM needs to be fully tested and ensured before reducing irreversibly the existing measures, even gradually. With the Commission proposal, the CBAM entails financial costs for EU importers only as of 2026, when the free allocation phase out starts. Furthermore, major elements of the design (default values, boundaries of embedded emissions, etc.) will be set only at a later stage in secondary legislation. Finally, the proposal does not provide any solution for circumvention risks like resource shuffling and costs absorption. Hence, there is no possibility to assess the actual impact of the CBAM before reducing the free allocation.
- The transition towards low carbon technologies will be gradual and most of the promising low carbon projects are expected to deliver significant emissions reductions around 2030. If free allocation is reduced significantly before 2030, and considering also the increased carbon price, EU steel producers will be exposed to much higher compliance carbon costs, which will be extremely difficult to recover from the product prices due to the uncertainty of the CBAM in delivering a truly level playing field. For instance, increased EU steel prices resulting from higher carbon costs will also create new business opportunities for importers that are currently not competitive in the EU market due to their cost structure and the EU market price. In such a situation, the financial ability of EU producers to invest in low carbon technologies will be undermined exactly when it is needed the most. On the contrary, once low carbon projects in the EU will have delivered significant emissions reductions, the exposure of EU producers to compliance carbon costs will diminish and the free allocation phase out will have a less disruptive impact.
- In the absence of a solution for exports, as the Commission proposal stands, the phase out of free allocation would be a major threat to exports' competitiveness.
- The free allocation phase out for CBAM products exposes inevitably downstream sectors to increasing costs and distorts competition with sectors that are not subject to the CBAM.

- It is clearly possible to design a WTO compliant carbon border measure that complements full benchmark based free allocation in a transition period; hence, there is no WTO legal obligation to reduce or phase out free allowances.
- A CBAM complementing full benchmark based free allocation at least until 2030 would also reduce the direct impact on trade flows because importers would have to pay a lower level. This would mitigate trade tensions as it would provide a longer transition for negotiations with international partners to align climate ambition.

3. A solution for EU exports is possible and essential

The Commission proposal does not envisage any structural solution for preserving EU exports to third countries. The EU steel industry exports around 25 million tonnes with a value of around 30 billion €. Loosing access to third countries would jeopardise not only these volumes but the entire competitiveness of companies since they would strive to achieve sufficient capacity utilisation to secure their sustainable viability.

An adjustment for exports is not only a measure of industrial competitiveness but also -and mainly- of environmental integrity, since it secures that industrial production remains subject to the declining cap of the EU ETS rather than being replaced by third countries producers with higher footprint and/or not subject to a foreseeable emission reduction pathway.

A solution for preserving exports, like the *de jure* and *de facto* adjustments proposed by the law firms NCTM and Kings & Spalding -attached-, would be WTO compliant and allow to combine climate ambition with effective carbon leakage protection. (These options include the possibility of maintaining also in long term -i.e. after 2030- full benchmark based free allocation for EU exports).

4. Timeline and substance of the secondary legislation need to provide a predictable and effective framework

4.a Timeline of the secondary legislation and feasibility for the steel sector

While the legislative process has just started with the COM proposal and will require the agreement of European Parliament and Council, most of the essential elements for the actual functioning of the measure as of 2023 will be set only in implementing and delegated acts afterwards. This timeline is extremely ambitious and may impact the robustness and quality of the provisions to be developed. While some other sectors included in the scope of the draft Regulation are relatively simple, the steel industry entails a very high level of complexity due to several characteristics (many products and customs codes, different production processes and embedded materials, trade flows with numerous third countries, very high risks of circumvention, etc.). Simplified rules developed under such a time pressure risk delivering a counter-effective impact on the steel sector due to its high exposure to international trade.

4.b Emissions scope and definition of embedded emissions for waste gases

The definition of direct emissions refers to “emissions taking place as part of a production process of goods of which the producer has direct control”. The methodology for calculating embedded emissions described in Annex III foresees an adjustment for the emissions linked to the transfers of waste gases. It is essential that the rules on the CBAM calculations are consistent with those set in the EU ETS, in order to secure a level playing field. Such rules require very detailed and complex data. If real data provided by importers are used, it is essential that such data are properly verified by independent experts or specialised Commission teams, similar to those in trade defence investigations, including on-the-spot verification in order to ensure their robustness. Verification of individual emission data should take place yearly and EU industry should be consulted and have the possibility to comment on findings, while preserving business confidentiality. Actively withholding data or non-cooperation should lead to adverse adjustments of individual company data to encourage full cooperation. Penalties such as the withdrawal of the import authorisation should be included for cases where producers effectively try to disguise their real data or withhold information.

With regards the scope of emissions to be covered by the CBAM, the current proposal focuses on direct emissions. However, indirect emissions linked to electricity consumption (usually defined as scope 2 emissions) represent also an important source of carbon leakage risk that requires effective protection. This would be delivered by a CBAM covering such scope 2 emissions while complementing the existing system of indirect costs compensation, which should remain in place and be fully implemented in all member states to address the challenge of indirect costs passed on in electricity prices within the EU.

Regarding the value chain’s impact, the Commission proposal to take into consideration the emissions of upstream materials is of particular importance for alloy steel and stainless steel, for which the major part of emissions arises in connection with the production of upstream materials (pig iron and ferro-alloys). Capturing appropriately such upstream emissions through the CBAM is required to ensure the effectiveness of the measure for alloy and stainless steel.

4.c Default values

Default values are an essential element for the effectiveness of the CBAM. The Commission proposal foresees to set them firstly at the level of the average emission intensity of each exporting country increased by a mark-up, the latter to be determined in an implementing act. When reliable data for the exporting country cannot be applied for a type of goods, the proposal foresees that default values shall be based on the average emission intensity of the 10% worst performing EU installations. Yet, this may still grant importers an advantage when extra EU production is more carbon intensive than the worst 10% EU producers. For tackling that, default values should be cross checked with best available data (for instance on most intensive worldwide production) and further increased by a markup so that there is a real incentive to declare real values. Furthermore, default values can be adapted to particular areas, regions or

countries where specific characteristics prevail in terms of objective factors such as geography, natural resources, market conditions, energy mix, or industrial production. The rationale and impact of this derogation needs more clarification and, in any event, should not undermine the effectiveness of the measure.

In order to ensure the environmental integrity of the measure, it is essential that the use of default values is limited and avoids free riding practices. To that purpose, if a product can be produced via different production processes (e.g. from primary or secondary steel making), the most carbon intensive one shall be used to set the default, without averaging the emissions intensities of the different processes.

Penalties for free riding practices should include also the option of withdrawing the import authorisation.

4.d Adjustment for the free allocation granted to EU industry

The methodology for calculating the adjustment of the CBAM level for the free allocation granted to EU industry will be set in the secondary legislation. In order to ensure a level playing field such methodology needs to be fully consistent and reflect the actual absolute shortage that EU industry faces as a result of all the relevant elements (i.e. distance from the benchmark, possible cross sectoral correction factor, possible free allocation phase out).

5. Other circumvention risks (including resource shuffling and cost absorption) need to be addressed effectively

The draft provisions on circumvention are very narrow. They cover only cases of circumvention based on slight modification of products. Yet, the effectiveness of the CBAM will be undermined by several practices, including:

- Resource shuffling: this refers to the practice of exporting to the EU only products with lower carbon footprint while deviating other products to other markets. This risk is very relevant due to the flexibility of the rules with regards the definition of embedded emissions in imports both with real values and default ones: e.g. in one country some companies can use site specific emissions and in other countries default value set by average emissions to avoid or minimise the levy. Resource shuffling, which is prohibited for instance in the Californian ETS for electricity imports, would undermine the environmental integrity of the measure, since it would not reduce global emissions. In the case of steel, this risk is very concrete in several ways: for instance, secondary steel from a country could be channelled to the EU while primary steel would be diverted to other markets. In this way, EU primary steel producers would be heavily impacted by the free allocation phase out and replaced by secondary steel importers that would avoid (or minimise) the CBAM obligations, while primary steel producers in third countries could still sell their products on other markets than

the EU. Such a situation would undermine jobs and investment in the EU without any reduction in global emissions.

- Absorption of the CBAM levy: the rationale of the CBAM is to ensure that carbon emissions come with a cost and that such cost is visible to customers. Since the CBAM is applied only to a small part of the total production of the non-EU producer (usually less than 5%), such producer could absorb partially or totally the cost of the CBAM by reducing the price of the products at the EU border and/or by spreading the levy across his entire production. In the context of global overcapacities, this risk is even higher in the steel sector due to the possibility by importers of selling to the EU borders products at the level of variable costs instead of full costs, as acknowledged in the EU steel safeguard case. This undermines the environmental objectives of the measure and jeopardises the competitiveness of EU producers that are subject to carbon costs on the entirety of their production.
- Circumvention in the value chain: as long as value chains are not entirely covered by CBAM, the measure will create incentives on production outside the EU to adjust by focusing on imports not covered by CBAM.
- Substitution of products: as long as CBAM does not contribute to full carbon leakage protection, all products not covered by CBAM are likely to bear lower carbon costs than those covered and, consequently, gain economic advantage over those products covered by CBAM. This holds true for products produced within the EU as well as for imports and may even induce higher overall GHG emissions.

The comparability and highest achievable levels of the accuracy, quality and trustworthiness of the data used by non-EU-producers, importers and declarants are an essential element for the success of CBAM. Consequently, there should only be one technical base for the accreditation of verifiers to be applied by all Member States. Therefore, the option to allow national accreditation bodies to accredit a person as a verifier should be removed.

6. Inward processing procedure should not undermine the integrity of the CBAM

The current proposal exempts from the CBAM third-country goods imported into the customs territory of the EU, transformed into the EU and then re-exported outside the EU under the inward processing procedure. This derogation risks undermining the environmental integrity of the CBAM and distorting competition on global markets. As mentioned above, it is essential to develop a structural solution to preserve the competitiveness of all EU exports (not only of those exports that are based on imported products).

7. Product scope needs to be extended to forged products and wind towers

In order to avoid carbon leakage in downstream sectors that are closely linked to the steel industry, also steel forged products that are classified under the code 7326 as well as steel wind towers in codes 7308 and 8502 should be included in the scope of the measure.