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Carbon leakage provisions and ETS Linkage

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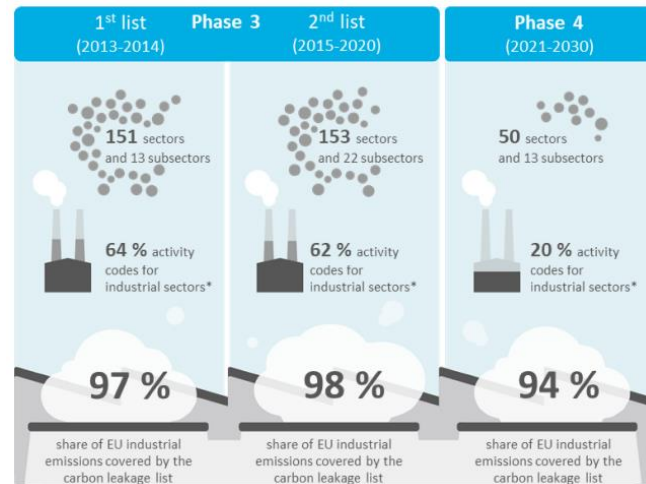
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Brief overview of carbon leakage concerns

- Literature review:
- ex ante modeling in a « Kyoto world » predicts small carbon leakage (to a big extent through energy prices channel)
- Ex post econometric studies mostly do not find any evidence (explanations: free allowances, low carbon prices, other...)
- Potential changes in a « Paris world »: higher environmental ambition of some Parties (climate neutrality, -50/60% in 2030), reduced free allocation due to cap reduction

Free Allocation Systems

- Definition of sectors « at risk of carbon leakage » : indicators (carbon intensity, trade intensity). Different indicators/thresholds/tiers.
- Main allocation methods: grandfathering, historical benchmark, output-based
- Issue of indirect emissions leakage



Free Allocation Systems

- Free allocation is imperfect and can lead to distortions:
 - Limited number of benchmarks
 - Sectoral benchmarks may protect carbon intensive processes for similar products (ex BOF vs EAF steel)
 - Carbon prices is not reflected in products in competition (ex wood vs cement in construction)
 - Thresholds based on historical production can incentivize plants to overproduce
 - Issue of intermediary products (clinker vs cement)
 - Issue of fall-back benchmark (ex heat) with output-based allocation and energy efficiency

Carbon Leakage provisions and linking

- Linking can reduce carbon leakage (convergence of carbon prices) but not entirely (distortions remain if carbon leakage provisions are different)
- Totally harmonized carbon leakage provisions is not required for linking (necessary features are allowances mutual recognitions and registry links)
- In practice, an extensive technical work is required to harmonize carbon leakage provisions (some leeway and mutual recognition of similar stringency is easier to implement)
- Offsets in another way to deal with CL concerns, and can lead to distortions with linking if different rules

Alternative Carbon Leakage Provisions

- Carbon Border Adjustment Mechanism (French government support for pilot sectors)
- Other instruments supporting decarbonization (CCFDs, product requirement, innovation support, consumption charges).
- Specificities of ETS linking with CBAM:
 - Understanding of CL provisions of other jurisdictions to potentially take them into account in CBAM design
 - Case if one jurisdiction implement CBAM with linked ETS (ex: Switzerland)

Current policy implications (case studies)

- **Switzerland – EU ETS**
- Article 11 (coordination) linking agreement « The Parties shall coordinate efforts in areas of relevance to this Agreement, and, in particular, on the criteria set out in the Annexes, to [...] ***avoid carbon leakage and undue distortion of competition*** between the linked ETS.
- Annex I to the Linking Agreements (Essential Criteria). Modification of legislation -> modification of Annex I. Dispute settlement. Suspension of 4(1) (allowances mutual recognition).

Current policy implications (case studies)

- **EU – UK**
- Issue of « de-linking » and carbon leakage (ex benchmarks)
- Issue of carbon leakage in EU UK relationship deal (dynamic adjustment of legislation, with increase of ambition in the EU with EU Green Deal)

Related Work

ICAP workstream:

- *Carbon intensive trade database*

Subset of comtrade database for selected carbon-intensive products and selected jurisdictions, computation of trade indicators.

Goal: better understand the trade of CI products to assess leakage risk

- *Carbon Policy Data Book*

Dashboard with CL measures for different jurisdictions, and carbon price taking into account Free Allocation for some sectors

Related Work

ICAP workstream:

- *Guide to linking*
esp. 4.7 (allowances allocation) and 4.8 (offsets)
- *Carbon leakage and deep decarbonization* (ongoing)
- *ETS Handbook* (in revision)

esp. Step 5 (allowances) and Step 9 (linking)

Related Work

Florence Process workstream:

- develop a common understanding of benchmarks in the different carbon markets
- Questionnaire factual information by jurisdiction (how benchmark are defined, sectors, update, indirect emissions, etc)
- More indepth work on cement sector (benchmark boundary and value)

Main points

Carbon leakage is a major issue in virtually every ETS design

Each jurisdiction has its own way to address the issue. Free Allocation is the norm but there are different rules of implementation

Linking with different carbon leakage provisions can lead to distortions