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Netherlands Institute of International Relations

Clingendael Alert

NOVEMBER 2022

Positively curious: the Dutch position on the EU's Carbon Border Adjustment Mechanism (CBAM)

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The EU's upcoming CO_2 charge at the border, CBAM, is likely to have a considerable impact on the Netherlands. It is a large trading nation, with exports accounting for roughly a third of GDP, and its economy is strongly dependent on its external environment. A large proportion of products on the CBAM's list, for example steel, enter north-western Europe through the port of Rotterdam. Traditionally, the Netherlands has been a staunch supporter of free trade, but it equally is a staunch supporter of the European Green Deal. Due to shifting geopolitics and rising great power rivalry, it has become more conducive to industrial policy, 'open strategic autonomy' and other policies that aim to protect European industry from unfair competition.

The European Parliament (EP) and Council are currently in the final stages of negotiations on the CBAM proposal as part of a larger package of EU climate policy proposals linked to the European Green Deal. This so-called *Fit for 55* package aims to bring down the EU's carbon emissions by at least 55% by 2030 compared to 1990 levels. It includes new policies and a reinforcement of existing ones, notably the EU Emissions Trading System (ETS), which sets a price on carbon emissions from the energy sector and heavy industry through a market-based cap-and-trade system. The resulting CO_2 price – currently at around 75 euros per ton CO_2 – provides an incentive for them to decarbonize. Currently some industries still receive free ETS allowances up to the set cap, but in future they would have to buy them. To ensure a level playing field between EU and non-EU businesses, companies importing products covered by CBAM in the EU would also have to pay the CO_2 price that applies within the EU, although this could be (partially) suspended if the importers have a similar carbon policy in place at home.

The objective of CBAM is to prevent carbon leakage, which is a shift in emissions due to the relocation of carbon-intensive industries from the EU to countries with less stringent carbon reduction policies. CBAM also aims to provide an incentive to other countries to install their own carbon pricing instrument in order to avoid paying for their CO_2 pollution to the EU. It is considered an important new element of EU climate policy as it will use the EU's market power to pursue its green objectives, making polluters from other countries pay for their emissions if they want to continue exporting their products to the EU. Therefore, at first glance, CBAM fits nicely into the shifting preference of the Netherlands for a trade policy in balance with climate and competitiveness considerations.

This Clingendael Alert reviews the Dutch position on CBAM to a greater extent. What is the Dutch position on contentious issues, such as the sectors to be covered and the collection and use of revenues? It will also briefly discuss the possible political pressure to allow a CBAM exemption for likeminded partners, such as the US. This is related to *inter alia* the debate on a climate club that took place in the G7 and is strongly promoted by Germany.

The Dutch position on CBAM

In its response to the European Commission's Green Deal Communication of December 2019 the Dutch government indicated to be positively curious about CBAM. A motion by Tom van der Lee (Greens MP) adopted in the Dutch parliament in June 2020 supported this position and Dutch ministers co-signed a letter calling for an effective, legitimate and fair CBAM proposal in *Politico* in March 2021.

The positive attitude can be considered a break from the past, when the idea of a carbon border levy was advocated by only some actors, notably France and the European Parliament, mainly in the lead-up to the 2015 Paris Agreement. At the time, the Netherlands, together with other 'champions of free trade' like the UK and Sweden, opposed the idea of pricing carbon-intensive imports. With CO_2 policies becoming more costly for industry sectors, and international economic relations more influenced by geopolitical considerations, the Dutch became more in favour of policies safeguarding domestic industries. Support is also given to a more stringent climate policy and green industrial policy in order to accelerate the green energy transition and move away from fossil energy import dependencies.

When the CBAM proposal was published in summer 2021, a more elaborate Dutch position was developed, as happens for all new Commission proposals. In this so-called BNC-fiche, we can read that the Dutch government:

- Appreciates CBAM's ability to help achieve an equal level playing field, which leads the Dutch government to be 'positively curious' towards the proposal. It considers the proposal to be in line with the national Dutch climate agreement (Klimaatakkoord).
- Supports the 'step-by-step' gradual approach, with a continued investigation of World Trade Organization (WTO) compatibility, which hinges on the details of implementation.
- Is concerned that while the current CBAM proposal leads to a level playing field within the EU, it could entail carbon leakage after 2026, in particular through resource shuffling. In other words, third countries could escape CBAM by exporting less emission-intensive materials to the EU, while using high-emission materials at home and for export to other countries.
- Is concerned about indirect emissions, which are missing from the Commission's proposal. While direct emissions

(scope 1) occur during the production process, indirect emissions (scope 2) are generated from the electricity used to produce the goods. The exclusion of indirect emissions from CBAM could lead to carbon leakage in electricity-intensive sectors. The Dutch government understands the Commission's preference from a feasibility perspective to leave out applying CBAM to later stages in complex production chains, but it looks forward to proposals on gradually expanding the scope of CBAM.
- Seeks clear rules for third countries, in which CBAM charges could be substituted with domestic carbon taxes, and for a good dialogue to help third countries decarbonise.
- Is concerned about the administrative costs of CBAM. While the competitiveness of sectors included in CBAM will improve, there will be extra costs as a result of the administration involved in CBAM.

CBAM issues still debated

What is not included in the fiche are: which sectors could be included in the future; support for sectors now confronted with sky-high fossil energy prices; and ending free allowances. An example is chemicals. The Royal Association of the Dutch Chemical Industry (VNCI), in an advice to European Commissioner Frans Timmermans on 2 October 2020, advocated the creation of a so-called External Cost Charge (ECC). Instead of buying ETS allowances, chemicals would be taxed when sold in Europe, but not when sold abroad. As 80% of Dutch chemical production is destined for export, of which 20% goes outside the EU, this would help Dutch chemical companies to stay competitive.

The chemicals sector was left out of the Commission proposal, but the EP prefers parts of the sector to be included. In the Dutch parliament a motion was adopted to study the inclusion of the chemicals sector in CBAM, and this study is currently ongoing. This motion was initiated by Joris Thijssen (Social Democrats) and Suzanne Kröger (Greens). The Dutch government has no objections in principle against the inclusion of chemicals but prefer to start with a functioning CBAM that can later be expanded.

Another example is international transport that is not included in CBAM either. There are concerns about unfair competition for Schiphol Airport from Turkish Airlines and Istanbul Airport that will not have to abide to European climate laws. Nevertheless, to Transport Minister Harbers it is 'logical', for the time being, for aviation not to be included in CBAM. There is no clear way to include aviation in CBAM, and according to the Dutch, international flights would rather have to be included in ETS to eliminate price differences. Furthermore, CBAM would only be relevant for international aviation if there was a risk of carbon leakage, and according to a report by the Netherlands Aerospace Centre (NLR) and SEO Economisch Onderzoek, this risk is minimal.

Moreover, the Confederation of Netherlands Industry and Employers (VNO-NCW) and the Royal Association MKB-Nederland have drawn attention to possible carbon leakage when large 'harbour hubs' are formed close to the EU, for example in the UK or Morocco. MEP Caroline Nagtegaal (Liberals/VVD) has supported an amendment asking for the European Commission to explore mechanisms to mitigate potential competitive distortion between feeder flights from EU and non-EU hubs as well as between EU and third country shipbuilding players.

On revenue collection, in line with earlier decisions on the EU's Multiannual Financial Framework for 2021-2027, the Dutch government appears to tacitly accept that CBAM revenues will flow into the EU budget. Yet, The Hague is concerned about EU member states having to carry the administrative burden – and associated costs – of implementing CBAM. In an exchange with Parliament it is clear that the Dutch government prefers that CBAM revenues are collected at national level and not at EU level.

Finally, little attention is paid to the impact of CBAM on relations with countries that export a significant number of energy-intensive products to the EU. The Netherlands expressed its concern only about CBAM's impact on developing countries that struggle to export to the EU and which might not be able to handle the administrative and financial burden of CBAM. However, no position is taken on what this means for the grounds of exemption to CBAM or for developing countries receiving part of the CBAM revenue for their own climate transition. The Dutch government seems opposed to CBAM exceptions for countries with which the EU is generally on friendly terms, but which do not (yet) have a carbon price linked to the ETS, but there is no firm position on this issue. The most obvious case in point is the US. It might also be relevant for countries such as Algeria and Azerbaijan, from which the EU now imports more gas and oil to substitute for Russian imports, and which might request a CBAM exemption in return.

Negotiating CBAM in Council and with the European Parliament

After the publication of the Commission's proposal for the CBAM Regulation in July 2021, the Council agreed its position (general approach) on CBAM on 15 March and on the related phase-out of ETS free allowances on 29 June. Then, the European Parliament (EP) adopted its position by voting on 22 June on the report of CBAM's rapporteur Mohammed Chahim, a member of the Dutch Social-Democratic Party. The legislative procedure has now entered the phase of trilogue where the two co-legislators will negotiate on a number of key issues.

On the sectoral scope, the Council agrees with the five sectors proposed by the Commission (steel, cement, aluminium, electricity, fertilizers), while the EP would like to extend CBAM to hydrogen, polymers and organic chemicals. The same divergence goes for emissions scope, with the Council targeting only direct emissions and the Parliament aiming to also include indirect emissions. On these issues, the position of the Netherlands seems more aligned with the views of the EP.

A crucial issue for discussion is the pace of free-allowance reduction. On the one hand, the Council wants to progressively end free allowances over a ten-year period between 2026 and 2035. On the other hand, Parliament aims for a later but quicker reduction from 2027 to 2032. Linked to this, a major issue which would need to be resolved in the trilogue is that of export rebates, that is a refund for EU companies exporting to countries that do not have an equivalent carbon price. As the CBAM is designed to function in parallel with the ETS, export rebates might be interpreted as a distortion of free trade and thus create disputes with trade partners. This is a scenario that the Netherlands would seek to avoid as much as possible, as trade disputes could lead to retaliation and political tensions.

Another delicate matter is the use of the envisaged CBAM revenues and how they will be collected. The original Commission proposal would see the majority of revenue income flowing into the EU budget, thus becoming one of the few own sources of EU income (the rest being EU budget contributions from member states). During the negotiations in Brussels, an issue to discuss is the extent to which a share of revenue income might still become national revenues that would, for instance, compensate for member states' administrative costs, as is argued for by the Dutch.

Regarding the implementation of CBAM, the Commission has proposed a decentralised system, meaning that CBAM certificates can be bought from local authorities in the EU member states. However, the Council, supported by the Netherlands, opted for a greater centralisation of CBAM governance, 'where it makes sense and contributes to greater efficiency'. An example might be the centralisation at EU level of the new register of CBAM declarants (importers). The European Parliament voted in favour of a single central EU CBAM authority, claiming it would be more efficient and transparent than 27 competent authorities. The revenues generated by CBAM (€1 billion per year) would then serve to finance the central authority and also to support decarbonisation in least developed countries, as strongly advocated by rapporteur Chahim. The Dutch government intends to separate the discussion on the Commission proposal to create own resources through CBAM revenues from that on the underlying policy proposal of CBAM. It is thus holding its fire on who's budget CBAM revenues will be until it is clear how they will be collected.

The future of CBAM and the Dutch position

The trilogue negotiations on CBAM are in full swing and soon Council and Parliament will need to work through the political frictions. It will be interesting to see if, in the lead-up to the trial stage, more third countries adopt a carbon price and ask the European Commission for an exemption or discount. If that happens, CBAM would de facto constitute the development of a climate club.

In debates on climate club the link to CBAM is often made. The climate club idea originally was to support cooperation in the field of progressive climate policy outside of the official UN framework and is supported by the G7. A joint carbon price and border levy would logically form the backbone of such cooperation. Germany allegedly brought up the climate club idea, as it considered it a way out of a possible trade war with the US and other trade partners resulting from CBAM. In the Council's general approach on CBAM EU Ministers note 'the importance of greater international cooperation with third countries, including through the establishment, in parallel to the CBAM, of a climate club where carbon pricing policies can be discussed and encouraged'.

However, it is still unclear what happens with regard to countries that indicate they have set-up a carbon pricing system, but where it is not yet functioning well (e.g. Kazakhstan) or established in time (e.g. Turkey, Ukraine, Montenegro, Morocco, etc). And what will the Commission do with third countries that combine a carbon pricing scheme with free allowances or a rebate, or if they establish a carbon price only for exports going to the EU? An exemption might be for CBAM not to apply to countries in conflict – Ukraine, for example.

With regard to the US, the problem is that currently there is no carbon price in place or envisaged at federal level. The recent Inflation Reduction Act seeks to reduce emissions by 40% by 2030 compared to 2005 levels. It will do so not by putting a price on pollution, but rather by subsidising clean energy and decarbonisation efforts, among other things, in the form of carbon capture and storage. Just before the adoption of this Act, the US Supreme Court ruled that it would be illegal for the US Environmental Protection Agency to use the Clean Air Act as a basis to regulate CO_2 emissions as it had intended. This means that for the US to adopt a carbon policy equally as heavy as the EU's ETS scheme, a new law would have to be developed and adopted. Without such a policy, the grounds for exempting the US from CBAM look dim and incompatible with the WTO. It furthermore raises the question of what a climate club would look like, as the climate policy approaches on both sides of the Atlantic are so different. It is unclear what the EU and the Netherlands would do should the US still claim a CBAM exemption – and what would be the basis for a climate club if the US does not have a form of carbon pricing in place.

For the Netherlands, the jury is still out on the extent to which energy-intensive industry will survive the current period of high fossil energy prices, and how quickly low-carbon alternatives such as green hydrogen will become available. Will industries get their energy subsidised? Will they relocate or decarbonise their production processes? Or will their products be partially substituted by other products (e.g. using wood instead of steel)? The Netherlands is likely to continue to be positively curious, but its position on CBAM might yet change if pressured by industry sectors considered to be strategically important or by international partners threatening retaliation if they are not exempted from CBAM. The Dutch political debate on CBAM may very well still be in its infancy rather than its conclusion.

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Clingendael – the Netherlands Institute of International Relations – is a leading think tank and academy on international affairs. Through our analyses, training and public debate we aim to inspire and equip governments, businesses, and civil society in order to contribute to a secure, sustainable and just world.

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