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Border Adjustments in Climate Change Legislation: Here Today, Gone Tomorrow?

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On June 26, 2009, the House of Representatives passed the American Clean Energy and Security Act of 2009 (H.R. 2454), known as the "ACES" bill. The Bill, which would establish a federal cap-and-trade program for greenhouse gases (GHG), narrowly passed by a vote of 219 to 212 (eight Republican congressmen voted in favor of the legislation). At approximately 3 a.m. on the 26th, however, a potentially more interesting event occurred. The sponsors of the bill, House Energy and Commerce Committee Chairman Henry Waxman (D-Calif.) and Energy and Environment Subcommittee Chairman Ed Markey (D-Mass.), released an approximately 300-page manager's amendment and supplement to the proposed legislation (at the time already in excess of 1200-pages).

Included among the last minute revisions were specific trade-related border enforcement measures (called "border adjustments" in the legislation) that go much farther than any prior legislative proposal regarding how the United States would attempt to protect domestic industries from potentially adverse economic impacts related to climate change regulation. The following provides a generic overview of the key provisions.

1. Emissions Allowance Rebate Program (i.e. domestic subsidy)

- The U.S. would establish a GHG emission allowance rebate program for affected entities whereby entities would receive direct compensation (in the form of allowances) for the harm caused by being regulated under the cap-and-trade regime. Entities within designated industrial sectors (e.g. cement, steel, paper and pulp, chemicals, etc.) would be eligible to receive allowance rebates would include those that (1) belong to a sector than has an *energy intensity* of at least 5 percent (e.g. cost of purchased electricity of sector + fuel costs of the sector / value of sector shipments) OR had a GHG *Intensity* of at least 5 percent (e.g. (20 * tons of CO2-equivalent GHG emissions of

sector) / value of sector shipments) **AND** (2) have a *trade intensity* of at least 15 percent (e.g. value of total sector imports and exports / (value of sector shipments + value of sector imports)) OR have a GHG intensity of at least 20 percent.

- Emission allowance rebates would essentially be a per-unit supplemental allocation of allowances to entities within eligible industrial sectors. The allocation levels would be based on their demonstrated direct and indirect carbon factors (e.g., carbon emission intensity of the product, the product production method(s), or any other carbon components involved in the operations of the entity). The intent of the rebate subsidy would be to compensate the entities for the direct and indirect costs of having to comply with the GHG cap obligations.

2. Taking Stock of the Rebate Subsidy Program

- On or before January 1, 2017, the President would have to prepare and present a report on the effectiveness of the rebate program to mitigate carbon leakage (the displacement of GHG emissions from the U.S. to some other country due to implementation of a cap-and-trade program). The report would cover issues like the cost-of-production increases sustained by eligible industrial sectors receiving rebates, an analysis of subsidies or other assistance provided in other developed countries related to GHG regulations, and proposals for rebate policy adjustments and alternate policy options (e.g. direct border tax or adjustment options).
- In 2018, the U.S. must begin assessing whether the country of origin for 85 percent of imported covered goods (e.g. foreign goods produced within the eligible industrial sectors) are countries that comply with international GHG abatement treaties or have domestic GHG controls comparable to the U.S regime.

3. International Reserve Allowance Program (i.e. border adjustments)

- If a comprehensive multilateral GHG emission reductions treaty or other agreement has not been reached by January 1, 2018, the President must automatically establish and implement an "international reserve allowance" (IRA) program for each eligible industrial sector no earlier than January 1, 2020. The President can avoid the IRA requirement based only by certifying to Congress that the program would not be in the U.S. national interest. Any such certification would require congressional approval via joint resolution.
- Under the IRA program, importing entities within the designated industrial sectors would have to purchase and hold/retire some amount of IRAs in order to bring the goods into the U.S.
- The scope of an IRA program would apply to all importers of covered goods, which would include goods that are under an applicable heading of the Harmonized Tariff Schedule that (a) correspond to the NAICS code for an eligible industrial sector or (b) are manufactured for consumption. Exempt from the IRA program would be products with a country of origin that is (1) a party to an international agreement to which the United States is a party that includes a nationally enforceable and economy wide GHG emissions reduction commitment that that is "at least as stringent as that of the" U.S., or (2) a party to multilateral or bilateral GHG emission reduction agreement for that sector to the which the U.S. is a party.
- EPA, in coordination with the Customs Department, would establish regulations that:
  1. Govern the sale, transfer, exchange, and banking of IRAs;
  2.Ensure IRA prices would be equivalent to the latest auction clearing price of emission allowances (assuming that they're auctioned);
  3. Establish a methodology for determining the specific quantity of IRAs an importer must submit for a covered good;
  4. Establish requirements and procedures for the submission of IRAs for covered goods;
  5. Exempt from the IRA requirements products from certain countries, i.e. the least developed of developing nations and nations responsible for less than 0.5 percent of total global GHG emissions

and less than 5 percent of U.S. covered goods imports;
6. Specify customs procedures for declaration and entry of covered goods before and after IRA compliance; and
7. Establish procedures to prevent circumvention of IRA requirements.

By inference, the ACES bill appears to establish that the IRA amounts an importing entity would need to purchase would be quantified based on direct and indirect carbon factor calculations for the covered goods. However, no definitive answer is given regarding the methodology that the EPA and Customs are to use for determining the quantity of IRAs an importer must submit for a covered good with respect to the eligible industrial sector. In other words, the bedrock metric for the IRA system would be left to the EPA and Customs Department to figure out.

Climate Change Legislation Moves to the Senate

With that tremendous gaping hole and ambiguity aside, it looks like the international competitiveness provisions passed as part of the ACES bill may not go much further towards becoming reality. President Barack Obama has publicly stated his disagreement with the inclusion of border adjustment measures in any climate change legislation.

Moreover, this week the Senate Finance Committee has begun to take up the issue. In fact, Committee member Senator John Kerry (D-Mass) stated that the Senate won't accept the ACES border adjustment provisions. On Wednesday, July 8, 2009, the Committee held hearings to discuss the implications of border adjustments as a policy option to preserve domestic product competitiveness. The overwhelming conclusion drawn from the hearing is that border adjustments may potentially be more harmful than helpful to national economic and political interests.

Many speakers at the hearing discussed the possible conflict that a border adjustment regime would have on multilateral trade rules established by the World Trade Organization (WTO) agreements. Others discussed the potential trade war retaliation such measures could trigger from the European Community or China.

One of the speakers pointed to a recent report produced by the WTO in collaboration with the United Nations Environment Programme, which points out that some border measures would be permissible as part of a unilateral climate change package. A value-added type "tax" imposed in a non-discriminatory fashion on domestic and imported goods should be WTO compliant, for example, but after that it gets very difficult to design a border adjustment provision - especially if there are any restrictions or discriminatory treatments on which products are required to purchase IRAs.

Another speaker, Eileen Claussen (President of the Pew Center on Global Climate Change), discussed the economics of cap and trade as a reason not to develop border adjustment measures. Referring to a joint report produced by the Pew Center and Resources for the Future, Ms. Claussen identified that for energy-intensive industries (those whose energy costs exceed 10 percent of shipment value), the analysis projects that average U.S. output declines about 4 percent **and** overall consumption declines 3 percent. In other words, there would only be a net 1

percent or less decline in production for industrial sectors that could be attributable to imports due to a loss of competitiveness.

The Senate Finance Committee hearing is an opening salvo in what appears to be a summer filled with climate change legislation hearings and debates in various Senate committees. Senate Majority Leader Harry Reid (D-NV) has indicated he would like to bring a Senate climate change bill up for debate sometime later this fall. Based on public statements of other ranking Senators, however, the more realistic estimate would be that the Senate may push back taking up cap-and-trade legislation to some time in early 2010.

In the current economy the perception of losses in competitiveness to domestic industries may trump facts, figures and WTO consideration. The underlying policy driver of any border enforcement measures is an intent to protect the competitiveness of domestic industries, a concern that won't just go away due to frustration or impracticality. As the Senate attempts to navigate the urgency of climate change with these legitimate economic concerns, it may try to find another way of going about protecting domestic industry, and it may even end up coming full circle and include some form of border measure arrangement in a final bill. Politically speaking, in order to garner enough votes to pass climate change legislation in the Senate, border enforcement measures may be a necessity. Stay tuned.

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