Intelligence MEMOS

From: Jon Johnson

To: Global Affairs Canada

Copy to: Environment and Climate Change Canada and Natural Resources Canada

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Re: **THE PROPOSED US FAIR TRANSITION AND COMPETITION ACT: LESS THAN FAIR**

Last month, Democrats Senator Chris Coons and Representative Scott Peters introduced border carbon adjustment legislation, dubbing it the *FAIR Transition and Competition Act* (FAIR) i.e.: "Fair, Affordable, Innovative, and Resilient")

The move follows the recently proposed European Union version of such measures, which are designed to impose a cost (with a tax or by a requirement that importers to buy certificates covering the carbon content in their imports of steel, aluminum, cement and fertilizer), with deductions allowed for costs incurred covering carbon emission pricing in exporting countries.

The FAIR Act applies to "covered goods" including "covered fuels" (natural gas, petroleum, coal, or products derived therefrom that emit greenhouse gases.) Covered goods also include goods produced within a "sector", meaning industrial facilities producing steel, aluminum, cement, or iron, or products containing these products.

In addition to the gases covered by the EU proposal (carbon dioxide, nitrous oxide and perfluorocarbons), the FAIR Act includes methane, hydrofluorocarbons and sulfur hexafluoride.

The US bill requires an annual determination of the domestic environmental cost incurred for each sector, and for the production of each covered fuel. These determinations are based on the cost of complying with US legislation designed to limit or reduce greenhouse gas emissions.

The FAIR Act border carbon adjustment commences at the start of 2024 and is to apply to imports into the US of covered fuels and of products produced within the designated sectors.

With imports of covered fuels, the border carbon adjustment equals (A) the domestic environmental cost incurred in the production of such fuel, multiplied by (B) a yet to be defined "upstream greenhouse gas emissions of such fuel." This feature of the proposed border carbon adjustment is highly relevant to Canada and its daily 3.5 million-barrel flow of oil to the US.

With imports of products produced within a sector that are not covered fuels, the border carbon adjustment equals (A) the domestic environmental cost incurred for the sector in which such product was produced, multiplied by (B) a yet to be defined "production greenhouse gas emissions of the product."

In determining the production greenhouse gas emissions of a covered good, the Secretary of the Treasury shall use "reliable methodologies which are consistent with international treaties and agreements, including free trade agreements." This imprecise provision is better than the EU assertion (disputed by former Appellate Body member James Bacchus) that its proposal is consistent with WTO requirements.

Unlike the EU proposal, the FAIR Act exempts imports from some lower income nations. It also exempts imports from countries deemed to enforce laws and regulations designed to limit or reduce greenhouse gas emissions that are at least as ambitious as US federal laws and regulations. The "at least as ambitious" standard, one hopes, is flexible enough to accommodate varying greenhouse gas reduction regimes including Canada's Output-Based Pricing System Regulations.

The credibility of the FAIR Act is undermined by a requirement that a country cannot qualify for an exemption if it imposes a border carbon adjustment on US products. Determination of the proper carbon adjustment therefore rests only with the US and precludes other nations' right to deem US carbon policies deficient.

If Canada imposes a border carbon adjustment against any US product, Canadian exports of petroleum to the US would be fully exposed to the FAIR Act border carbon adjustment.

If every nation included a similar qualification in its border adjustment, no country would have any incentive to apply it and the whole regime would be meaningless.

While a one-size-fits-all approach isn't necessary, border carbon taxes will only work with some degree of consensus and co-ordination among major players such as the US, the EU, the UK and Japan, as well as other countries including Canada. Unilaterally imposed border carbon adjustments run the risk of triggering WTO challenges or unilateral trade retaliation while doing nothing to reduce global greenhouse gas emissions.

Canada could constructively assist by persuading major players to adopt a commonly agreed approach to border carbon adjustments, but should also continue to exercise caution before adopting its own carbon border adjustment regime.

The BASIC countries (Brazil, South Africa, India and China), strongly oppose border carbon adjustments and prefer to work through COP26, the 2021 United Nations climate change conference that starts in Glasgow on October 31. No doubt the launch of proposed schemes to impose carbon adjustments on imports will be on everyone's minds, as they contemplate how to give effect to ambitious emissions reduction targets.

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