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Steps towards an alliance for climate, competitiveness and industry – building blocks of a cooperative and open climate club

The Paris Agreement is already of historic importance: seldom has an international agreement set in motion such a powerful dynamic for the good of humanity and future generations. Since its entry into force five years ago, the international accord has morphed into a broad movement. The European Council agreed in December 2020 to significantly increase the EU's climate targets. The EU wants to become climate-neutral by 2050; Germany plans to already achieve this by 2045. The US, UK, Japan, Canada, South Korea and China have announced ambitious climate goals. This is a very positive development which can help the international community to combine prosperity and climate action. Now that the US has rejoined the Paris Agreement, we have a new window of opportunity to intensify international cooperation in the area of climate policy, to create international lead markets for climate-friendly technologies, and to foster trust in international climate policy coordination. We should take advantage of this window, since the global problem of climate change especially requires international answers.

Practically all industrialised countries and emerging economies are facing the same overarching challenges: achieving the decarbonisation of the economy requires a massive technological effort. This can be tackled most efficiently together by means of international cooperation. While many countries are ramping up their efforts at the national (or European) level, we still lack a protective international framework – despite a large number of established initiatives and coordination forums – that would keep climate policy pioneers from being at a disadvantage in the international marketplace, especially when it comes to energy-intensive industries. As a result, the only option for pioneers is to take measures at the national or regional level to protect themselves from carbon leakage, which can hamper the efficiency of the transformation and make it harder to reach targets. It is clear that economies can only remain viable in the long term if there is an ambitious reduction in greenhouse gas emissions. At the same time, high climate standards should not place countries at a competitive disadvantage in the short or medium term, causing important industries to shift abroad.

An international climate alliance geared towards close collaboration – an open and cooperative climate club – can help to overcome this dilemma. If the climate club is large enough and manages to agree on WTO-compliant joint rules, it could have a strong appeal to other countries globally. The process to establish and deepen such an alliance could be discussed with further partners in G7 and, subsequently, in G20.

In this context, the climate club should also expressly take into account the interests of those partners who are not yet able to become members at the current time, but which are similarly willing to pursue higher ambitions if they receive corresponding support from other countries. For example, emerging economies and developing countries could also be given more intensive support, in the form of innovative sources of climate financing and capacity-building, to help them potentially become members of the climate club in the future, in case immediate membership is not possible for them. In order to avoid possible procedural or administrative hurdles, one possibility would be, for example, a staged approach with the gradual introduction of membership criteria or transitional phases.

The activities and initiatives of this project should be realised in the near future, exploiting the current international momentum, because international cooperation is key to climate action. As part of this, existing international formats should be taken into account, and the experience gained there should be used as a basis. The initiative should be based on three characteristics:

A) **AMBITIOUS:** The alliance will be a partnership of the countries of the world with the highest ambitions for climate policy. Participation is open in principle to all countries that commit themselves to corresponding targets and measures within the scope of their possibilities. Members will be committed to the 1.5 degree target of the Paris Agreement and accordingly to climate neutrality by 2050 at the latest (as a rule). They will set themselves ambitious interim targets and define reduction paths in line with their targets.

B) **BOLD**: The goal of the initiative is for as many countries as possible to support joint climate policy ambitions by means of coordinated and ambitious climate policy measures. To this end, they will work on a roadmap towards measuring CO_2 and determining (minimum) carbon prices and will coordinate their measures to prevent carbon leakage with each other. In addition, the members will also cooperate on the transformation of their industrial sectors, in order to establish a reliable framework and an international lead market for climate-friendly materials and products.

C) **COOPERATIVE**: The core of the initiative is the cooperation between the participating economies that are pressing ahead with the transformation, while wanting to prevent competitive disadvantages to their own economies as a result of the transformation. At the same time, these economies will invite all countries that share these goals, and the measures that are necessary to achieve them, to participate. The primary basis for the club are the arrangements made under the Paris Agreement on climate targets and climate financing, as well as technology cooperation and market mechanisms. Trade policy plays a supporting role as part of the WTO processes. The climate club must ensure compatibility with the Paris Agreement and with the UNFCCC principle of common but differentiated responsibilities and respective capabilities. The EU Commission should play a central institutional role in the initiative for the EU member states, especially in the context of possible negotiations with its international trading partners for establishing a climate alliance. This includes, in particular, also partners in the UNFCCC-negotiations and other relevant partners, including SIDS and LDCs. The particular challenges for developing countries should be taken into consideration, potentially including by means of exemptions. In addition, the international institutions and organisations like the WTO, OECD, IMF and World Bank offer a wide range of forums and specialist expertise that can support the alliance.

Elements of the initiative

A) <u>AMBITIOUS:</u>

- **1. Temperature goal of 1.5 degree:** The IPCC Special Report on Global Warming of 1.5°C clearly concluded that the effects of climate change will be significantly lower with warming of 1.5 degrees Celsius than with warming of 2 degrees Celsius. Keeping to the upper limit of 1.5 degrees Celsius requires decisive action by all countries, but especially by the main emitters. The members of the climate club will undertake ambitious and intensified efforts to reduce greenhouse gas emissions, to ensure that the 1.5 degree target of the Paris Agreement remains achievable.

- **2. Climate neutrality goal:** The members will accordingly strive to achieve climate neutrality generally by 2050 at the latest, or even earlier if possible. The targets will reflect countries' different capabilities and responsibilities.

- **3. Interim targets:** The members will commit themselves to ambitious, realistic interim targets for 2030 and for the further reduction path, and will strive to achieve significant emission

reductions by 2030, especially in the energy and industrial sectors but also in the other climate-relevant sectors.

B) <u>BOLD</u>

The members will coordinate a selection of climate-policy instruments with each other. These tools will be used to achieve the agreed reduction target and to comply with the reduction path. The selection of suitable instruments can differ from economy to economy. However, they should in every case include in the medium term a measure for (possibly implicit) carbon pricing, and they should not distort international competition. The set of possible instruments also includes, in particular, creating markets for carbon-free products, setting carbon prices and avoiding carbon leakage at the same time (ensuring a level playing field, especially for particularly energy-intensive industries):

- **1. Transformation of industry:** The members will cooperate in the transformation of their industries towards climate neutrality. Support for the industrial transformation in emerging economies and developing countries is a fundamental component of international climate cooperation, also to avoid future emission increases and lock-in effects in these countries. The members will create planning certainty for the necessary investments in new production facilities. They will develop global standards and will support new value chains for climate-neutral production. Possible options that should be addressed in the discussion include:

    - **1a. Joint transformation of energy-intensive industry.** Energy-intensive industry plays a crucial role worldwide in achieving climate neutrality. At the same time, it faces competition in the global marketplace. Uncertainty about the international level playing field, combined with significant additional costs compared with conventional technologies, all too often hinder the necessary investments in the transformation. The members could therefore agree on a specific timeframe for emissions-intensive goods such as steel and chemical products, and on joint initiatives in the area of research, development and innovation or new infrastructure. The members could create joint lead markets for climate-neutral materials and products and could together promote the market ramp-up of key technologies. In the medium term, they could agree on the same product standards for carbon intensities. Possible pilot sectors include i) the steel industry, where incentives should be created in particular for the ramping up of low-carbon production processes, with the perspective of using green hydrogen, ii) the chemicals sector, also with hydrogen-based carbon-neutral alternatives and a focus on investments in the circular economy, and iii) the cement sector, with a focus on research into new types of cement and the use of alternative building materials.

    - **1b. Hydrogen pact:** The members could work together on setting up a global supply chain for green hydrogen. To this end, they would agree (also with third countries) on reliable definitions of and certification for “green” hydrogen, so that producers do not have to deal with different requirements around the world. The members would coordinate support measures for production and trade with each other and would also coordinate these with third countries, in order to generate joint positive economies of scale as efficiently as possible. This would include in particular emerging economies and developing countries that are not yet members of the climate club but which have potential as producers of green hydrogen.

    - **1c. Additional areas of cooperation** could include, for example, the carbon-neutral production of ammonia and naphtha for the chemicals industry, as well as the production of carbon-neutral methanol and e-kerosene.

- **2. Roadmap towards the joint measurement and pricing of carbon emissions:** The members will work on a joint roadmap with milestones for the purpose of achieving comparable measurement of the carbon footprints of materials and products, and for determining existing carbon prices in the respective jurisdictions. In the medium to long term, they will strive towards similar or even uniform (minimum) prices for carbon emissions and will coordinate their protective measures against carbon leakage. More specifically, the following process is conceivable:

    - **2a. Measurement of CO_2 and greenhouse gas emissions:** The members will measure greenhouse gas emissions and calculate the carbon footprints of their goods as uniformly as possible. This also includes uniform procedures to measure and monitor greenhouse gas emissions at the producer level. It is possible that new internationally recognised standards will be necessary in order to facilitate transparent and uniform foundations for measurement and calculation. This is especially important in the context of cement, steel, aluminium, chemical products, fertilisers, glass and paper, as well as in all sectors where there is a risk of carbon leakage on the basis of defined criteria.

    - **2b. Implicit and explicit carbon prices:** The members will in the medium term assign a uniform (minimum) price to greenhouse gas emissions, at least in the energy and industrial sectors. Members will commit to no longer going below a jointly defined minimum price and will agree on a path for the minimum carbon price over time. The goal is the convergence of national carbon prices towards a uniform price. This can happen by means of emissions trading systems and carbon taxes, but also through implicit mechanisms, if they provide a comparable carbon price signal. A joint explicit or implicit minimum carbon price would reduce carbon leakage among the members of the alliance.

      In order to be able to achieve this goal, the members would as a first step agree on a common and uniform procedure for calculating their current explicit or implicit carbon prices in the (energy and) industrial sector(s). Explicit carbon prices refer to carbon taxes and allowance prices in emission trading systems. Implicit carbon prices also take into consideration additional energy and climate-related taxes (especially energy taxes) and duties (minus relevant benefits/subsidies), production-related standards and emission limits, converted into €/t of CO_2. As a result, they give a more comprehensive picture of the carbon price. A common method for calculating implicit carbon prices would, in addition, ensure that countries do not introduce compensatory relief for other duties, levies and taxes that would counteract the carbon prices. It would make sense to draw on preparatory work by international organisations and forums, in particular the work done by the OECD on calculating an “effective carbon rate” for individual countries and sectors.

    - **2c. Protection against carbon leakage:** If genuinely comparable climate action efforts are implemented, measures to protect against carbon leakage among club members in the energy and industrial sectors could become superfluous. At the same time, members could introduce joint measures to protect against carbon leakage in relation to third countries. The system could be designed in several ways. As is currently the case in the EU, relief for energy-intensive companies could initially be granted. However, the carbon price signal should be retained as far as possible. Another possibility would be a joint carbon border adjustment mechanism. This would have to conform with WTO rules and be implementable in administrative terms. In any case, there would need to be an arrangement for exporting industries, and the impact on developing countries would have to be taken into account. However, a cooperative approach

would be necessary, as part of which an offer of cooperation would be extended to all countries and which would enable coordination with regard to the introduction of instruments to protect against carbon leakage. A decision on the use of revenues from a possible carbon border adjustment mechanism would be made at a later time, if a border adjustment mechanism is even necessary. With regard to the use of funds, it would then also be discussed whether international climate financing and capacity-building in emerging economies and developing countries should be enhanced, which would help these countries to achieve possible future membership of the climate club.

C) <u>COOPERATIVE</u>

The key characteristic of the initiative is cooperation between members in implementing the specified climate action targets/measures and instruments.

Dealing with third countries outside the climate club: Entry to the club must be open at all times if corresponding climate action targets and measures are introduced. In many cases, joining the club will not be immediately possible, so that an offer of more intensive cooperation on industrial transformation and capacity-building should be made to third countries. In addition, it should be taken into consideration that the least developed countries (LDCs) and the Small Island Developing States (SIDS) bear the least responsibility for climate change, while at the same time being most strongly affected by it. Here, consideration should be given to exemptions/transitional phases or other support measures, in order to observe the principle of common but differentiated responsibilities.

In addition, the members of the alliance should also coordinate their action on international climate policy issues as closely as possible. Hence coordination work could also take place within the climate alliance on policy areas where to date no arrangements regarding international agreements, for example, have been achieved, or where these arrangements need to be improved. In addition, the members will actively strive to involve additional countries, in order to create incentives for international measures aimed at ambitious reductions in greenhouse gas emissions, and will strive to support these countries in this context, where necessary. Key issues therefore also include:

- the necessary reductions in emissions from international air and sea traffic (e.g. ICAO, CORSIA, internationally coordinated kerosene tax for aviation, IMO),

- cooperation on reducing emissions (in particular Article 6 of the Paris Agreement).If agreement is reached on a robust framework relating to Article 6, additional incentives for investments in climate action in developing countries and emerging economies could be created, and these countries' level of ambition and prospective membership of the climate club could be supported,

- international climate financing, technology cooperation and capacity-building (Articles 9, 10 and 11 of the Paris Agreement) and

- a supporting role for trade policy: Trade policy can support climate action measures and make an additional contribution to environmental protection and climate action. Members of the climate club should coordinate with each other on this issue, including with regard to trade with third countries that are not yet members of the climate club. When considering climate-relevant aspects, however, conformity with WTO rules must be ensured, and the individual national legal

and economic situations (of LDCs, for example) must be factored in. Measures at the WTO level should take priority, particularly within the framework of the Trade and Environmental Sustainability Structured Discussions (TESSD).