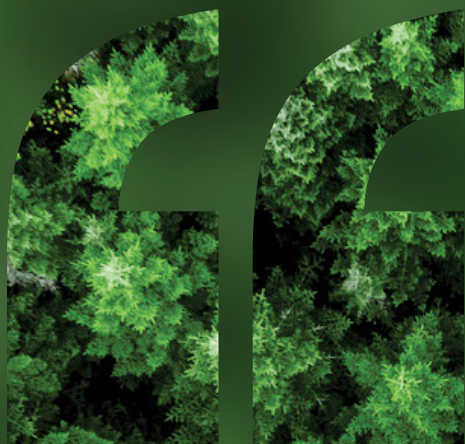
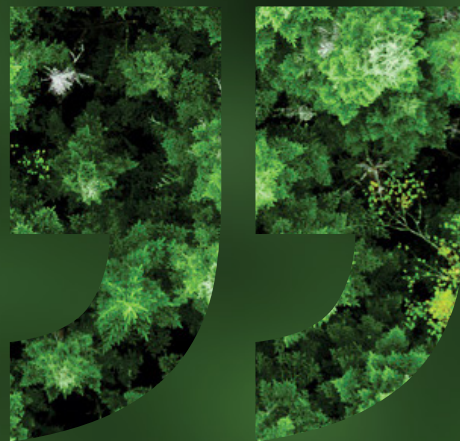


C L I F F O R D

C H A N C E



**10 QUESTIONS ON
THE PROPOSED
CARBON BORDER
ADJUSTMENT
MECHANISM**



— THOUGHT LEADERSHIP

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10 QUESTIONS ON THE PROPOSED CARBON BORDER ADJUSTMENT MECHANISM

The European Commission has published a proposal for a Regulation on a Carbon Border Adjustment Mechanism (CBAM) to deal with the long-standing problem of 'carbon leakage' that impedes the EU's decarbonisation plans. It is part of the Commission's 'Fit for 55' initiative published on 14 July 2021 that will help it achieve the EU's new target for a 55% reduction in greenhouse gas (GHG) emissions by 2030 (against 1990 levels). Here we answer 10 key questions about the proposal.

Key issues

- The European Commission has proposed a carbon border adjustment mechanism imposing a carbon price on imports of certain goods to prevent carbon leakage
- This briefing looks at 10 key questions on the CBAM:
 1. Why is the EU proposing a Carbon Border Adjustment Mechanism?
 2. What is the CBAM and which imports does it cover?
 3. How would the CBAM operate?
 4. How would emissions for individual goods be calculated?
 5. Will there be a phase-in period?
 6. How will the CBAM be enforced? In what circumstances might importers avoid being caught by the CBAM?
 7. What is the reaction so far to a CBAM?
 8. What are the WTO implications of the proposal?
 9. How will the CBAM link to discussions at COP 26?
 10. What are the next steps?

1. Why is the EU proposing a Carbon Border Adjustment Mechanism?

For many years the EU has struggled with perceived "carbon leakage," a problem that occurs when EU producers heavily regulated by schemes such as the EU Emissions Trading System (EU ETS) cannot compete with cheaper, more carbon-intensive goods manufactured outside the EU. This creates a risk that EU producers may relocate production to areas outside of the EU where carbon pricing measures are less stringent, or that customers may substitute EU products with cheaper (and more carbon intensive) imports. Carbon leakage therefore not only affects the competitiveness of EU business, but also shifts global carbon emissions outside the EU, potentially impacting global efforts to reduce carbon emissions, and the likelihood that Paris Agreement targets can be achieved.

The EU has sought to address this problem in the past in different ways, e.g. by granting free allocations of allowances to the best performing EU producers under the EU ETS, and allowing some carbon intensive industries to be compensated for the indirect carbon costs embedded in energy prices that they pay. However, these measures have been criticised as creating insufficient incentives for EU producers to decarbonise production of their products.

The proposed CBAM aims to prevent carbon leakage by imposing an emissions-based levy on imports of certain products, thereby aiming to

maintain the competitiveness of EU production in carbon-intensive sectors, and potentially allowing free allocation of ETS allowances to cease. As the EU ETS carbon price continues to climb, the clamour for some form of CBAM within the EU is intensifying.

2. What is the CBAM and which imports does it cover?

The European Commission consulted on various options for a CBAM in 2020 including a carbon tax at the border on imports or at consumption level, or an extension of EU ETS to importers; however, the final option, and the one ultimately chosen by the Commission, was an obligation for importers to purchase carbon allowances from a separate pool with prices linked to the EU ETS, which was felt to be more effective at preventing carbon leakage than other options.

The CBAM would apply to imports into the EU of various specific goods within the following broad categories: cement, electricity, fertilisers, iron, steel and aluminium (Relevant Goods). This is a narrowed list compared with the list of producers benefitting from existing carbon measures, and represents the industries where there is the highest level of embedded carbon in the upstream part of the value chain, and thus the greatest chance of carbon leakage.

In broad terms, importers of Relevant Goods would be required to purchase *CBAM Certificates* representing a calculated carbon price for the embedded carbon emissions in those goods, except

to the extent they can demonstrate that a carbon price has already been paid (See further Question 6). Embedded emissions include direct emissions released during the production process of the goods and their upstream products. Indirect emissions are not included but the CBAM may be extended to include them in the future.

The CBAM would be unilaterally imposed by the EU effectively forcing third countries to pay the carbon cost of their less climate-ambitious production policies, and in theory encouraging a race to the top through decarbonising production processes to remain competitive.

3. How would the CBAM operate?

Importers, or their representatives, declaring Relevant Goods at EU customs, will have to be authorised (Authorised Declarants) by the competent member state authority (National Authority) where the Authorised declarant is established.

By 31 May each year, Authorised Declarants will need to submit a CBAM declaration to the National Authority specifying:

- the amount of GHG emissions embedded in goods they imported during the last calendar year; and
- the number of CBAM certificates to cover those emissions being surrendered (1 certificate equates to 1T CO₂ equivalent of embedded emissions).

They would also need to surrender the relevant number of CBAM certificates to cover relevant emissions by that date.

Authorised Declarants would purchase CBAM certificates directly from the National Authority and they must ensure that, by each quarter date, they have purchased at least 80% of their CBAM Certificate requirement for the calendar year so far. The National Authority would sell each CBAM certificate for a price equating to the average EU ETS allowance auction price in the week before the sale. Where Authorised Declarants buy too many allowances, they will be able to seek a refund of up to

1/3 of their purchased allowances after their annual surrender. CBAM Certificates would be held in national registries.

Significantly and in contrast to the EU ETS, there is no proposal for a market for CBAM certificates to be traded between importers, or a wider trading market. Any allowances which were not refunded could be banked over to use in the following scheme year but would be cancelled thereafter if not used or refunded at that point (they cannot be traded). The Commission notes that this is intended to ensure that importers pay a set carbon price rather than be able to pay a lower price through trading. It remains to be seen whether, in the future, the CBAM could be linked more closely to the EU ETS.

The proposal confirms that free allocation of allowances to EU operators in sectors covering Relevant Goods would continue in full during the transitional period (See Question 5) and would reduce by 10% each year from 2026 when the full CBAM comes into force. However, the number of CBAM Certificates required to be surrendered would be reduced to reflect the level of free allocations granted in respect of the same kind of goods. This will help to deal with WTO concerns (see further Question 8).

Importers would need to demonstrate financial solvency and be free from serious customs, tax, market abuse or criminal breaches in the last 5 years. Financial security for CBAM certificate liability may also be required in certain cases.

4. How would emissions for individual goods be calculated?

For physical goods, emissions would be calculated by the importer but the Commission would set default values for each of the products to be used in cases where this was not done, or not done properly.

For imported electricity, for which embedded emissions may be more complicated to calculate, default values would be used unless the importer provided its own calculations based on an approved methodology.

While the draft Regulation sets out broad parameters for calculating embedded emissions, much of the detail will be contained in implementing acts. Key questions are likely to arise over matters such as how to set the 'system boundaries' for processes and whether offsets can be credited against emissions.

Notably, default values for physical goods will be set at the worst performing 10% of EU sites for the relevant processes. For electricity, it would generally be established using the average CO₂ equivalent emission factor for price-setting sources in the relevant country or region. Use of default values is likely to be disadvantageous for goods produced in highly efficient production process chains in third countries, while they might be favourable for goods produced in the most CO₂ intensive processes. It is possible that the Commission may come under pressure to set the default levels at even lower, more polluting, levels for reasons of fairness.

Many efficient third country manufacturers are likely to want embedded emissions in their products to be based on actual emission levels and it is clear that the process to achieve this could be burdensome. In particular, declared embedded emissions would need to be verified by an independent accredited verifier. For this reason, the Commission has proposed that manufacturers of goods in third countries can apply to be registered by the Commission and to have verified embedded emissions calculations confirmed for those goods (which can then be used by importers for their declarations for 5 years from registration). Over time this should relieve some of the compliance burden on importers and corresponding requirements they place on their overseas manufacturers to supply information for the CBAM process.

5. Will there be a phase-in period?

The full CBAM will come into force on 1 January 2026. From 1 January 2023, transitional provisions will impose a simple reporting obligation on importers when they import Relevant Goods. Under this obligation, importers will need to report to

the National Authority of import the total volumes of Relevant Goods imported and associated embedded emissions and any carbon price paid in the country of origin. Significantly, and unlike the full CBAM, indirect embedded emissions must be reported during the transitional period.

Where an importer has made imports into different Member States, they may report to any one of the relevant National Authorities. Reporting would be carried out on a quarterly basis. This light reporting regime is being imposed initially to alleviate the burden on importers and also to prevent major disruptions in trade.

It had been anticipated that a simplified levy payable upon each import and based on default emission values would apply during the transitional period. Given the administrative headache such a levy could have caused, the reporting obligation in the published proposal is likely to be a welcome move for importers. Given the urgency of industrial decarbonisation, many will be disappointed that substantive new carbon leakage measures under the CBAM will not come into force until 2026.

6. How will the CBAM be enforced? In what circumstances might importers avoid being caught by the CBAM?

Where an Authorised Declarant fails to surrender sufficient CBAM Certificates by the deadline, it faces penalties of EUR 100 for each CBAM Certificate not surrendered (equivalent to EU ETS penalties), in addition to having to satisfy the initial obligation.

Where embedded emissions relating to a product have already been subject to a carbon price in a third country, through a tax or emissions trading system, an Authorised Declarant may claim a discount on liability to surrender CBAM Certificates. In particular, the EU may conclude individual sectoral agreements with third countries to take into account of carbon pricing mechanisms in those countries. An obvious contender for such an agreement would be the UK Emissions Trading Scheme which is based on the

EU ETS and largely comparable to it. It is likely to be more challenging to agree a position for other types of carbon pricing mechanism where the carbon pricing methodology might be different or more opaque, e.g. in relation to some other carbon-related taxes / levies. The impact of other non-price related policies and regulations may also prove problematic. This area will be ripe for disputes.

It is possible that some importers may change their products to specifically seek to avoid the CBAM. However, where the Commission feels that the CBAM is being circumvented, e.g. by changes to products or patterns of trade with insufficient due cause or economic justification, the Commission will investigate and may extend obligations to 'slightly modified products'. An example might include a switch to a new aluminium shaped product different from the bars, rods, profile, wire, plates, tubes, pipes etc that are covered in the proposal.

7. What is the reaction so far to a CBAM?

Given the global impact of a unilaterally-imposed CBAM, it is not surprising that it was proving controversial even before the Commission's legislative proposal was formally issued. In particular, there are currently no proposals for exemptions or discounts from the CBAM for developing countries and this is likely to be a key area of dispute. The BASIC Countries (Brazil, South Africa, China and India) have officially criticised the CBAM as discriminatory (see Question 8 in relation to the WTO), and contrary to the principles of equity and common but differentiated responsibilities and respective capabilities, in the light of different national circumstances, recognised by the Paris Agreement.

The United States which has recently launched a major manifesto of climate policies under President Biden has been more equivocal. The Biden administration has announced that it is also considering carbon border tax measures similar to CBAM although Climate Envoy John Kerry has said that a CBAM should only be implemented as a last resort, given the

potential impacts on trade and that it should not be put in place before COP 26 (See further *Question 9*). Similarly, the UK government is considering a CBAM, recognising that since the EU and UK have similar levels of climate ambition, the UK will want to avoid any unreasonable trade barriers.

Reaction within the EU has been mixed. It has its detractors which include the Federation of German industries (BDI) which favours relying on retaining existing carbon leakage measures to support businesses' decarbonisation efforts (see further *Question 1*), a position also supported by the European Parliament and the EU Steel and Cement industry associations. The EU aluminium industry association has argued that a CBAM will be too complicated to implement in the industry.

Alternative options are also being floated. In a recent position paper 'Closing the Green Deal for Industry', an academic grouping notes that the CBAM would not deal with resource shuffling, where third country manufacturers attribute less carbon-intensive products to the EU market, and direct carbon intensive products elsewhere; nor would it protect the EU export market which potentially remains uncompetitive because of high domestic carbon costs. Their solution is for a climate combination based on full carbon costs to be levied on goods from domestic producers and importers alike on an excise basis, which can then be re-imbursed for EU exporters. Free allocations of allowances would continue but based on tonnage of materials production, and a Carbon Contracts for Difference (CCFD) regime (similar to that used for renewable energy generation) would then provide incentives for industrial decarbonisation. Whether this or other alternatives gain traction remains to be seen, but the debate for the best way to deal with carbon leakage is likely to continue for some time.

Ultimately, it is the European Parliament and Member States who will determine the final shape of the CBAM so lobbying efforts to amend the Commission's proposal will need to be targeted at those institutions.

8. What are the WTO implications of the proposal?

While the EU has committed to implementing CBAM in a manner that is consistent with its WTO obligations, there remain several political, legal and practical challenges for the EU to overcome in order to achieve this objective.

While proposals for carbon border adjustments are not new, to date no country has implemented such a mechanism and the WTO-consistency of such measures therefore remains untested. However, the inherent complexity of the CBAM, combined with its significant impact on some EU trading partners, means that there remain unresolved questions about whether the proposal would withstand scrutiny if challenged through WTO dispute settlement.

A CBAM has the potential to engage a number of core WTO obligations, including the cornerstone National Treatment, Most-Favoured Nation and Tariff Concession provisions of the GATT 1994. In general, these obligations require that a CBAM must not have the effect of according less favourable treatment to imported products than "like" domestic products; or to discriminate between "like" products originating from different countries. A critical question, which has not yet been conclusively resolved in WTO dispute settlement, is therefore whether products produced with different levels of emissions are "like" for the purposes of WTO rules. Since past WTO rulings have found products to be 'like' based on their competitive economic relationship in the market place, some commentators have suggested that it is most likely that domestic and imported products affected by the CBAM would be found to be 'like' irrespective of their carbon footprint.

However, even if CBAM violated a core WTO obligation, it may still be justifiable under Article XX of the GATT. Article XX contains several public policy exceptions, which could provide some further flexibility for the EU to implement CBAM. It should be noted, however, that successfully invoking such exceptions is

subject to meeting certain criteria (including non-discrimination conditions), which may be difficult to fulfil.

For this reason, the EU will need (at a minimum) to show that the charges imposed on imported goods are equivalent to those imposed on equivalent domestically produced goods under the EU ETS. This is the reason for the proposal to reduce CBAM Certificate liability to reflect the value of free allowances to EU producers. However, beyond this, there remain some practical challenges to ensuring imported products are not treated less favourably under CBAM. In particular, there are significant practical challenges in ensuring equivalence in how production emissions are calculated and verified, and in ensuring appropriate credit is granted for products produced in countries with their own carbon pricing mechanisms.

Against this complex legal backdrop, there is a risk that some trading partners (and exporters) will see the CBAM as a disguised form of trade protectionism developed to protect EU producers from foreign competition. This question was undoubtedly discussed by the Commission and checked by its legal service prior to publication, and it will have made efforts in the current proposal to minimise the likelihood of a challenge. We should expect further questions about the WTO-consistency of the proposal to arise during the legislative process.

9. How will the CBAM link to discussions at COP 26?

Beyond John Kerry's call to the EU to hold back on a unilateral CBAM before COP26, it is clear that the EU's CBAM potentially cuts across a number of the topics to be discussed at COP 26 in at least two ways:

- It potentially forces third countries to increase their climate ambition and strengthen their nationally determined contributions under Article 4 of the Paris Agreement (see the criticisms raised in Question 7 above); and
- It effectively imposes the EU carbon price on all its trading partners across the globe in relation to the goods it covers.

The UK COP26 Presidency has made it clear that strengthening of national contributions will be a key goal of COP26. Although the Paris Agreement does not specifically provide for carbon pricing, the market mechanisms it provides for under Article 6 could help in the development of a global carbon pricing mechanism, and substantive progress on those mechanisms is expected from COP26 (see box below). Moreover, many would argue that a robust global carbon reduction effort requires a global carbon price, and indeed the IMF is currently exploring how a global carbon pricing arrangement might work ([Proposal for an International Carbon Price Floor Among Large Emitters – IMF Staff paper - June 2021](#)). It is also clear, more generally, that there is an appetite for more globally negotiated solutions to climate action, and these solutions might include global carbon pricing. The June 2021 G7 Communiqué included the following endorsement: *"We recognise the potential of high integrity carbon markets and carbon pricing to foster cost-efficient reductions in emission levels, drive innovation and enable a transformation to net zero, through the optimal use of a range of policy levers to price carbon. We underline their importance towards the establishment of a fair and efficient carbon pricing trajectory to accelerate the decarbonisation of our economies, to achieve a net zero global emissions pathway."*

Paris Agreement, Article 6 - Market mechanisms

Although the detailed agenda for COP 26 is not yet available, it is likely that a significant chunk of the negotiations will cover Article 6 of the Paris Agreement. Article 6 contains the high level framework for a market mechanism for trading emissions reductions to replace the Kyoto Protocol. A market mechanism will allow a party to use third country emission reductions towards satisfying its own reduction commitments under the Agreement. Little progress has been made on the market mechanism since the Agreement was signed in 2015, but it is seen as key to drawing private finance in to developing country climate mitigation plans.

10. What are the next steps?

The Proposal will now pass to the European Parliament and Council for adoption according to the ordinary legislative procedure (formerly known as co-decision). It is always difficult to predict the length of time required for Parliament and Council to reach agreement but it is likely to take two years or more given the hugely controversial nature of the proposal and its sheer complexity.

As already noted above, one potential area of disagreement between the institutions is the treatment of energy-intensive sectors and their ability to continue to obtain free allowances under the ETS even once the CBAM is in force. This was heavily debated in the Parliament ahead of the adoption of a pre-legislative report in March 2021.

The Commission has proposed that the CBAM be in the form of an EU Regulation meaning that it will be directly applicable as soon as it comes into force, rather than dependent on individual states bringing it into force. The transitional simplified version of the CBAM would then be expected to begin on 1 January 2023, with the full regime beginning to operate from 1 January 2026.

The stakes are high and we should expect a lot of lobbying from the different stakeholders. It is also expected that the proposals will attract significant interest and input from key EU trading partners, and this is likely to affect the ultimate shape of the measures. Ultimately, the CBAM is a test of the EU's resolve on its climate ambition and climate leadership, and this is a gamble it doesn't want to lose.



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