

EU Carbon Border Adjustment Mechanism – Key Issues Going Forward

About four months ahead of the global climate summit in Glasgow, the European Commission revealed the details of its controversial proposal for a carbon border adjustment mechanism (CBAM). If adopted by the European Parliament and Council, the proposed CBAM would make the EU the first jurisdiction worldwide to extend its domestic carbon price to emissions that are produced outside its borders but are embedded into its imports of carbon-intensive commodities. While aligning with the EU’s long-standing ambition to play a leadership role in the global battle against climate change, this novel regulatory initiative raises a number of critical legal and policy questions – i.e., would it be effective, legal and ‘fair’?

Main Elements of the Proposed CBAM

While carbon border adjustments have been a popular topic in the scholarship over the past two decades, prospects for their actual implementation seemed fairly remote until recently as policy-makers have generally dismissed such measures for being complex to administer and likely to trigger trade disputes and undermine multilateral climate change negotiations.¹ On 14 July 2021, however, the European Commission published its proposal for an EU regulation establishing a carbon border adjustment mechanism.² The Commission first announced its intention to propose a CBAM in the European Green Deal of December 2019³ and the proposed regulation forms part of its ‘Fit for 55 Package’ adopted in July 2021,⁴ which puts forward an ambitious set of legislative proposals with a view to meeting the targets enshrined in the European Climate Law –i.e., a reduction in EU greenhouse gas (GHG) emissions by (at least) 55% when compared to 1990 levels by 2030, and the ultimate objective of ‘climate-neutrality’ (net-zero GHG emissions) by 2050.⁵ Among these legislative initiatives, the most closely linked to the CBAM is the revision of the EU’s Emission Trading System (ETS), which is the market-based mechanism for putting a price on carbon and reducing GHG emissions that presently operates in the European Economic Area (EEA) (i.e., the 27 EU Member States, plus Iceland, Liechtenstein and Norway) and covers GHG emissions from about 11,000 energy-intensive power stations and industrial plants, as well as commercial flights between these 30 countries.⁶ The underlying idea is that carbon emissions must have a price “because nature cannot pay the price anymore”,⁷ and the CBAM is intended to align the carbon price to be paid on imports into the EU with the price paid under the ETS for carbon emissions produced within the Union/EEA.

¹ For an overview of earlier proposals, see Michael Mehling et al., *Designing Border Carbon Adjustments for Enhanced Climate Action* 113(3) *American Journal of International Law* 433, 448-456 (2019).

² European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism’ COM(2021) 564 final, 14.7.2021 [CBAM Proposal].

³ European Commission, ‘The European Green Deal’ COM(2019) 640 final, 11.12.2019, at 5.

⁴ Legislative proposals available at: https://ec.europa.eu/commission/presscorner/detail/en/IP_21_3541.

⁵ Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulation (EU) 2018/1999, OJ L 243, 9.7.2021, Arts 2(1) and (4).

⁶ Consolidated version of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Union, OJ L87, 1.1.2021 [ETS Directive].

⁷ CBAM Proposal, *supra* n.2, at 2.

This price alignment is thought to be necessary by the Commission to address “the risk of carbon leakage” as the EU increases its climate ambition in line with the 2030 and 2050 targets, and is presented as the overarching objective of the proposed CBAM.⁸ Carbon leakage would occur *if* GHG emission reduction efforts within the EU are offset by increasing GHG emissions outside the Union, through the relocation of EU industries to countries with less stringent climate policies and/or increased EU imports of carbon-intensive products from such countries.⁹ That would not only undermine the effectiveness of the EU’s climate mitigation efforts, but could also result in no net reduction (or even an increase) in global GHG emissions and thereby jeopardise the achievement of multilaterally-agreed goals under the international climate change regime.¹⁰ In fact, concerns over carbon leakage need to be placed in the context of the 2015 Paris Agreement and its heterogeneous approach to international climate cooperation. Each Contracting Party is left to choose its own level of climate ambition (through nationally-determined contributions (NDCs)) reflective of its common but differentiated responsibility and respective capability, as well as its domestic circumstances.¹¹ Inevitably, this has resulted in asymmetrical climate mitigation policies across countries at present and for the foreseeable future. The CBAM is advanced as an alternative to the current (purely domestic) measure for managing the risk of carbon leakage under the ETS –that is, the free granting of emission allowances to EU industries in energy-intensive and trade-exposed sectors. This has been considered one of the problematic aspects of the system for weakening the carbon price signal to EU industries compared to full auctioning and thereby damping the incentive to invest in low-carbon production.¹²

Turning to its basic functioning, the CBAM is expected to enter into force on 1 January 2023 and would apply to products in five sectors (cement, iron and steel, aluminium, fertilisers and electricity) imported into the EU from all third countries, with the exception of Iceland, Liechtenstein, Norway (already part of the EU’s ETS) and Switzerland (whose ETS is linked to the EU one).¹³ During a three-year transition period until 31 December 2025, importers of these products would only be subject to a reporting obligation, rather than incurring a direct financial burden.¹⁴ From 1 January 2026, such importers would continue to declare (on an annual basis) the total actual direct emissions embedded in their imports as verified by accredited verifiers and, in addition, would have to buy and surrender sufficient CBAM certificates to cover these emissions.¹⁵ The price of these CBAM certificates will mirror the weekly average price of emission allowances auctioned under the EU ETS, thereby ensuring that importers and domestic producers pay the same carbon price so as to level the playing

⁸ CBAM Proposal, *supra* n.2, at 2 and 24 (Art. 1(1)).

⁹ *Ibid.*, at 1.

¹⁰ United Nations Framework Convention on Climate Change (UNFCCC), adopted 9 May 1992, entered into force 21 March 1994, 1771 U.N.T.S. 107, Art. 2; Paris Agreement, adopted 12 December 2015, entered into force 4 November 2016, U.N. Doc. FCCC/CP/2015/L.9/Rev/1, Art. 2(1)(a).

¹¹ Paris Agreement, *supra* n.10, Art. 4(1)-(3).

¹² ETS Directive, *supra* n.6, Art. 10; and for further discussion, see Denny Ellerman et al., *The European Union Emissions Trading System: Ten Years and Counting* 10(1) Review of Environmental Economics and Policy 89, 96-103 (2016); Kati Kulovesi, ‘EU Emissions Trading Scheme: Preventing Carbon Leakage before and after the Paris Agreement’ in Rafael Leal-Arcas and Jan Wouters (eds), *Research Handbook on EU Energy Law and Policy* (2017), at 422-423.

¹³ CBAM Proposal, *supra* n.2, Art. 2(1)-(3), Annex I and Annex II (Section A).

¹⁴ *Ibid.*, Art. 35, providing they should report on a quarterly basis the actual carbon emissions embedded in their imports, detailing both direct and indirect emissions, as well as any carbon price paid abroad.

¹⁵ *Ibid.*, Arts 6-8 and Annexes III-V.

field for European industries.¹⁶ An importer may, however, claim a reduction in the number of required CBAM certificates to take account of any carbon price paid in the third-country of production (whether in form of carbon tax or under an ETS).¹⁷

The proposed CBAM regulation is subject to adoption by the Council and the European Parliament (EP) and may well undergo substantial changes during the legislative process. Along the way, it is important to further reflect on the following legal and policy questions.

An Effective Tool?

From a policy perspective, the obvious question that arises is whether the proposed CBAM will be effective in achieving its professed objective of preventing the risk of carbon leakage in order to fight climate change. The answer is not entirely straightforward, partly because its coverage is limited to five sectors and direct emissions only (i.e., GHG emissions released during the production process, and not indirect emissions such as those from electricity used in that process), and partly because it is unclear how real the risk of carbon leakage actually is. As the Commission has itself acknowledged, “[t]he evidence of the existence of carbon leakage is not always conclusive or suggests that it is difficult to isolate carbon leakage as a single factor in [firms’] relocation decisions.”¹⁸ In fact, it is mainly *ex-ante* theoretical analyses that point to a substantial risk of carbon leakage in the absence of protection mechanisms (such as free allocation of emission allowances under the ETS), particularly for emission-intensive and trade-exposed sectors, whereas *ex-post* studies often find that carbon leakage is occurring at a much lower rate.¹⁹

Similarly, it remains uncertain whether the CBAM will create sufficient political leverage for more ambitious climate action across the EU’s trading partners that reduces existing differences in carbon pricing policies.²⁰ This expectation is based on the economic pressure exercised by the large size of the EU market and the incentive given to importers who can claim a reduction in the CBAM carbon price for any carbon price paid in the third-country of production. It follows the logic of what Scott and Rajamani have termed ‘contingent unilateralism’ in EU external climate action, and which has been successfully applied in the past by the Union with regards to GHG emissions from international aviation.²¹ But unsurprisingly, third-country reactions to the proposed CBAM have been mixed thus far. Canada and the United States (US) have announced to be considering similar measures,²² while US climate envoy John Kerry has warned that carbon border adjustments should be a last resort as such measures could detract from efforts to get more countries to elevate their climate ambitions before the upcoming United Nations climate summit in Glasgow in November 2021.²³ The BASIC countries (i.e., Brazil, China, India and South Africa) have

¹⁶ Ibid., Arts 20-21.

¹⁷ Ibid., Arts 3(24) and 9.

¹⁸ European Commission, ‘Staff Working Paper – Impact Assessment Report’ SWD(2021) 643 final, 14.7.2021, at 7 [CBAM Impact Assessment].

¹⁹ For further discussion, see Kulovesi, *supra* n.12, at 420-421; Mehling et al., *supra* n.1, at 444-446.

²⁰ See World Bank Carbon Pricing Dashboard: <https://carbonpricingdashboard.worldbank.org>.

²¹ Joanne Scott and Lavanya Rajamani, ‘Contingent Unilateralism – International Aviation in the European Emissions Trading Scheme’ in Bart Van Vooren, Steven Blockmans and Jan Wouters (eds), *The EU’s Role in Global Governance – The Legal Dimension* (2013).

²² *Canada Eyes CBAM Consultation as Budget Sets Out More Stringent Climate Target*, Carbon Pulse (19 April 2021); *Striking a Balance on Climate Change and Global Trade*, The Hill (19 July 2021).

²³ Leslie Hook, *John Kerry Warns EU against Carbon Border Tax*, *Financial Times* (12 March 2021).

expressed “grave concerns” regarding the EU’s proposed CBAM for creating new trade barriers and going against the principle of common but differentiated responsibilities and respective capabilities (CBDRRC), and Russia has voiced similar concerns.²⁴ This political backlash against the CBAM may well foreshadow potential legal challenges in the World Trade Organization (WTO), which will be briefly discussed next.

A Legal Tool?

The need to comply with WTO rules figures prominently in the Commission’s CBAM proposal, possibly responding to the emphasis placed on this matter by the EP as a co-legislator²⁵ and also due to the enforceability of WTO obligations through a relatively robust dispute settlement mechanism. While any assessment of WTO-legality is necessarily preliminary at this early stage of the legislative process, most commentators coincide that the proposed CBAM would likely be in tension with WTO core non-discrimination disciplines (at the very least, the most-favoured-nation treatment obligation) but may well be justified under the environmental exception clause (Article XX(g) GATT).²⁶ However, this is ultimately down to the CBAM’s final design and actual implementation, and the EU should pay particular attention to two issues.

Firstly, Article XX(g) GATT requires that environmental restrictions (*in casu*, carbon pricing) be applied in an even-handed manner between domestic and foreign producers.²⁷ As contemplated in the Commission’s proposal, the CBAM should be gradually phased-in against a correspondent reduction of emission allowances given for free to domestic producers under the ETS, which are only expected to be fully phased-out by 2035. Until that date, the number of CBAM certificates to be bought by importers would need to be adjusted to reflect any free allocation of emission permits to domestic producers under the ETS.²⁸ Put simply, a carbon price should only be charged on foreign goods imported into the EU (through CBAM certificates) insofar as it is equally charged on domestic goods under the ETS (through auctioned instead of free allowances) for the sectors concerned.

Secondly, Article XX(g) GATT further requires environmental regulations to be designed in a flexible manner so as to recognize third-country regulatory programmes that are comparable in environmental effectiveness.²⁹ While *a priori* exempting some countries from the application of the CBAM (e.g., Switzerland), the Commission’s proposal contains no specific provision on equivalence recognition of third-country carbon pricing schemes. Only

²⁴ Yuliia Oharenko, *EU Carbon Border Adjustment Mechanisms: Can it Make Global Trade Greener While Respecting WTO Rules?*, International Institute for Sustainable Development (17 May 2021), <https://sdg.iisd.org/commentary/guest-articles/an-eu-carbon-border-adjustment-mechanism-can-it-make-global-trade-greener-while-respecting-wto-rules/>.

²⁵ European Parliament, ‘Resolution of 10 March 2021 – Towards a WTO-compatible EU Carbon Border Adjustment Mechanism’ (P9_TA(2021)0071).

²⁶ James Bacchus, *Legal Issues with the European Carbon Border Adjustment Mechanism*, CATO Briefing Paper No145 (9 August 2021), <https://www.cato.org/briefing-paper/legal-issues-european-carbon-border-adjustment-mechanism>; André Sapir, *The European Union’s Carbon Border Mechanism and the WTO*, Bruegel (19 July 2021), <https://www.bruegel.org/2021/07/the-european-unions-carbon-border-mechanism-and-the-wto/>.

²⁷ WTO, *United States: Import Prohibition of Certain Shrimp and Shrimp Products – Report of the Appellate Body* (6 November 1998) WT/DS58/AB/R, para 143.

²⁸ CBAM Proposal, *supra* n.2, Art. 31.

²⁹ WTO, *United States: Import Prohibition of Certain Shrimp and Shrimp Products (Recourse to Article 21.5 by Malaysia) – Report of the Appellate Body* (21 November 2001) WT/DS58/AB/RW, paras 142-144.

the explanatory memorandum vaguely mentions that the EU will engage with affected countries “to explore possibilities to conclude agreements to take account into account their carbon pricing mechanisms”, but that such agreements would be considered “an alternative to the application of CBAM in case they ensure a *higher degree* [rather than just comparable] of effectiveness and ambition to achieve decarbonisation of a sector”³⁰ – which seems clearly at odd with the WTO flexibility requirement.

A ‘Fair’ Tool?

A final but essential question that arises from the proposed CBAM is how it would fit with the principle of common but differentiated responsibilities and respective capabilities, which has underpinned global efforts to combat climate change from the very start and is enshrined in both the UNFCCC and the Paris Agreement.³¹ While the legal status and exact implications of the CBDRRC principle remain highly contested, it still creates normative expectations on the ‘fair’ burden-sharing of climate change mitigation efforts among countries. For this reason, it is regrettable that, unlike WTO law, compatibility with the CBDRRC principle has received almost no attention in the Commission’s proposal.³²

On the one hand, the principle calls on developed countries to take the lead in mitigation efforts given their higher historical contribution to climate change and greater financial and technological capabilities to address it. And it is hard to see how they could do so if increasing their level of climate ambition would simply result in carbon leakage as the EU fears. On the other hand, the principle reflects a multilateral recognition that not all countries have the same responsibility for climate change, nor the same capability to tackle it, and hence should not be expected to contribute in equal measure to the common goal of climate change mitigation. Against this backdrop, isn’t it awkward and disproportionate that the proposed CBAM seeks to impose the very same ETS-determined carbon price (currently about €50 per tonne of CO₂) on domestic and imported products, without any differentiation as to whether the latter originate in a developed country, or a developing country or even a least-developed country (LDCs)? Equally striking in this regard is the vagueness in the Commission’s proposal with regards to the use of revenues generated through the CBAM as of 2026. It merely states that most of it would accrue to the EU budget and may be used to finance the Union’s COVID-recovery instrument ‘NextGenerationEU’.³³ Is this an appropriate use when such revenue is collected from imports originating in developing countries and LDCs, or should it revert back to these countries in order to financially support their climate change mitigation and adaptation efforts?

To sum up, the EU has undoubtedly shown great courage in experimenting with climate policies that have not yet been tried elsewhere and which have the potential of incentivizing urgently needed global action to fight climate change. But before its CBAM sees the light of the day, the EU needs to engage with affected trading partners in order to ensure that this novel instrument is embedded into the existing multilateral trade and climate change regimes, including the CBDRRC principle, without which the pursuit of global climate targets would ultimately be in vain. As we have seen, this raises some challenging legal and policy questions which must be resolved through political dialogue and cooperation, and not

³⁰ CBAM Proposal, *supra* n.2, at 2-3.

³¹ UNFCCC, *supra* n.10, Art. 3.1; Paris Agreement, *supra* n.10, Arts 2.2 and 4.4.

³² CBAM Impact Assessment, *supra* n.18, at 8 and 30.

³³ CBAM Proposal, *supra* n.2, at 10-11.

delegated to an eventual trade dispute in the WTO dispute settlement system.