

International Trade Alert

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EU Reaches Provisional Agreement on Carbon Import Charge

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Key Points

- The co-legislators of the EU recently reached a provisional agreement on a regulation for a CBAM.¹
- CBAM will require importers to the EU of covered carbon-intensive products to pay a charge for the carbon embedded in such products identical to the charge imposed on EU producers under the EU ETS.
- If approved, CBAM will apply effective October 1, 2023, subject to a transition period during which the obligation of the importer would be limited to reporting requirements. The EU will phase-in the CBAM charge over a period of nine years, starting in 2026.
- CBAM agreement requires formal approval by ambassadors of the EU member states and the European Parliament, which is expected to happen during the first quarter of 2023. While the main features of the agreement are known, the text is currently undergoing technical and legal checks. Although not yet released officially, the draft text has been leaked.
- Businesses that import carbon intensive products to the EU, or produce such products, should pay close attention to these developments, as they could soon face significant reporting requirements and—eventually—charges for carbon usage.

What is CBAM?

The Carbon Border Adjustment Mechanism (CBAM) is part of the European Union's (EU) "Fit for 55" package, a series of legislative proposals aimed at reducing EU greenhouse gas emissions by at least 55 percent by 2030 as compared to 1990 levels. It is companion legislation to the EU emissions trading system (ETS), which imposes charges on high-carbon emitters in the EU by requiring that producers of these products relinquish carbon emission certificates to the government equal to the amount of carbon they release during production.

With CBAM, the EU aims to reduce "carbon leakage," which occurs when producers move production from a country with strict emission constraints (such as the EU ETS)

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to a country with less burdensome requirements or when customers increase imports of carbon-intensive products instead of purchasing domestic products subject to these emissions standards. The imposition of CBAM signals a policy shift in the EU in the method used to address carbon leakage. Under current rules, the EU provides free allowances to certain EU producers subject to the EU ETS to allow them to better compete with products produced in jurisdictions without strict emissions constraints. With the imposition of CBAM, the EU will impose a tax on imported products made in countries that impose no or a low carbon charges. The scheme seeks to equalize the price of carbon paid for EU products under the EU ETS and the carbon price for imported products.

How will CBAM work?

Under CBAM, importers into the EU of covered products will have to buy carbon emission certificates for a price that corresponds to the carbon price an EU producer of the goods would have paid (through the purchase and submission of carbon emissions certificates) under the EU ETS. Non-EU producers that have already paid a price for the carbon used in the production of the imported goods in a third country may deduct the corresponding cost. This means that—in principle—exporters in countries that impose a carbon charge under an ETS, such as Korea and Singapore, can deduct the corresponding carbon charge from the amount due under CBAM when importing covered products into the EU. However, this deduction is not available to imports from countries that do not impose a carbon charge, such as the United States,² even if those countries impose other measures to reduce carbon output such as imposing carbon limits.

CBAM exempts some countries from coverage altogether, including Switzerland, which has imposed an ETS linked to the EU ETS, and the European Economic Area (EEA) countries (Norway, Iceland, Liechtenstein) who participate in the EU ETS. The EU may eventually conclude agreements with additional third countries that implement an ETS, exempting covered products from the application of CBAM reporting requirements or charges. The EU may also consider specific exemptions for third countries or territories which have an electricity market integrated with the EU.

The price of CBAM emissions certificates will depend on the weekly average auction price of EU ETS allowances expressed in euro per tonne of CO₂ emitted. In other words, the price for CBAM certificates will mirror the price of EU ETS allowances.

CBAM will gradually replace the free allocation of EU ETS allowances which are currently granted to the most energy-intensive EU industries (which comprise 94 percent of industrial emissions).³

What products will subject to CBAM?

CBAM will initially apply to imports of the following products:

- Cement
- Iron and steel
- Aluminum
- Fertilizers
- Electricity

- Hydrogen.

In addition, certain precursors and a limited number of downstream products, such as screws, bolts and similar articles of iron or steel, will be covered by CBAM.

These sectors and products were selected by the EU because these industries have high carbon emissions and intensity and also face a high risk of carbon leakage. In addition, EU legislators determined that implementing CBAM was feasible from an administrative and technical perspective for these sectors.

EU legislators intend CBAM to have broad product coverage, and the list of covered products is expected to expand as the mechanism evolves. Before 2026, the European Commission will assess possible expansion of CBAM to other products at risk of carbon leakage, including organic chemicals and polymers. The goal is to include all products covered by the EU ETS by 2030, which currently covers the following sectors and gases:⁴

- Carbon dioxide (CO₂) from
- Electricity and heat generation
- Energy-intensive industry sectors including oil refineries, steel works and production of iron, aluminum, metals, cement, lime, glass, ceramics, pulp, paper, cardboard, acids and bulk organic chemicals
- Commercial aviation within the EEA
- Nitrous oxide (N₂O) from production of nitric, adipic and glyoxylic acids and glyoxal
- Perfluorocarbons (PFCs) from production of aluminum.

Under certain conditions, indirect emissions, such as emissions generated from electricity used for manufacturing, heating or cooling during the production process will also be used as a basis for CBAM charges. The Commission will assess the methodology for indirect emissions before the end of the transition period.

How will emission values be calculated?

CBAM will apply to direct emissions of greenhouse gasses emitted during the production process of the imported products. The methods for calculating emission rates will be set out in an annex to the Regulation.

Calculations for the emissions will be based on the total embedded emissions, expressed as tonnes of CO₂e per megawatt-hour of electricity or, for other goods, such as CO₂e emissions per tonne of each type of good.

When a CBAM declarant cannot accurately determine actual emissions, default values will be used. Default values for goods other than electricity will be set at the average emission intensity of each exporting country and increased by a “proportionately designed” mark-up. Default values for electricity will be set at the CO₂ emission factor in the third country based on the best data available to the European Commission.

When will CBAM apply?

Under the provisional agreement, CBAM will be subject to a transitional implementation period. It will begin in October 2023 only as a reporting obligation, i.e.,

no charge will be imposed. From 2026 onwards, CBAM charges will be phased-in over a nine-year period, as follows:

- 2026: 2.5%
- 2027: 5%
- 2028: 10%
- 2029: 22.5%
- 2030: 48.5%
- 2031: 61%
- 2032: 73.5%
- 2033: 86%
- 2034: 100%.

In parallel, the free allocation of allowances under the EU ETS will be phased out at the same rate. CBAM will therefore start in 2026 and be fully phased-in by 2034.

Is CBAM WTO compatible?

The EU has stated that it designed CBAM to be compatible with the World Trade Organization (WTO).⁵ However, WTO members and others have raised questions about CBAM's compliance with the EU's WTO obligations. WTO rules are relevant not only to the broader question of whether a carbon charge may be legitimately imposed on imports into the EU, but also to the specific elements of the scheme, including the methodologies for calculating the emissions and the import charge, the collection methods, any exemptions, any free allowances given to EU industry, and the reporting requirements, among others. The relevant WTO rules include:

- **MFN obligation:** The most favored-nation treatment (MFN) obligation in Article I of the WTO General Agreement on Tariffs and Trade ("GATT 1994") requires that any advantage granted to the imported products of one WTO member must be accorded immediately and unconditionally to the like products originating from all other WTO members. If CBAM discriminates between "like" products imported from different countries, Article I would be violated.
- **National treatment obligation:** Article III:2 of the GATT 1994 requires that imported products be treated no less favorably than similar domestically produced goods with respect to internal taxes. If CBAM charges are considered an internal tax, CBAM must not treat imported products worse than the like domestic products. The EU may argue that, because EU producers are subject to an identical charge under the EU ETS, there is no discrimination between domestic and imported products. Further, if CBAM imposes more burdensome reporting, bookkeeping or administrative requirements on imported products, compared to like domestic products, this could violate GATT 1994 Article III:4.
- **Tariff commitments:** Under Article II of the GATT 1994, the EU has committed to a maximum customs duty ("bound rate") on imported products. If CBAM charges are viewed as a customs duty, CBAM may be determined to exceed the EU's bound rate. However, Article II:2(a) allows WTO members to impose a charge equivalent to an internal tax if certain conditions are met. These charges are known as "border

adjustments,” and the EU may try to raise this provision based on the EU ETS if it faces an Article II challenge.

- **Obligations related to quantitative restrictions:** Article XI:1 of the GATT 1994 prohibits quantitative import restrictions. CBAM may be inconsistent with Article XI if it is viewed as a border restriction, rather than a tariff or an internal regulation, that *de facto* imposes quantitative restrictions on imports.
- **Obligations related to the administration of trade regulations:** Article X:3 of the GATT 1994 requires that members administer their trade regulations in a fair, reasonable and impartial manner. CBAM may be inconsistent with Article X:3 if, in practice, it imposes a higher administrative burden on imported goods compared to domestic goods.

Even if CBAM violates the EU’s WTO-obligations as described above, the EU could claim that CBAM is justified under the general exceptions contained in Article XX of the GATT 1994. Article XX allows WTO members to apply measures that would otherwise be inconsistent with the agreement under certain conditions. The EU would have to show that CBAM is necessary to protect human, animal or plant life or health, or measures relating to the conservation of exhaustible natural resources. The EU additionally would have to establish that CBAM comports with the *chapeau* of Article XX; namely, that it is not “arbitrary or unjustifiable discrimination between countries where the same conditions prevail” or a “disguised restriction on international trade.”

Finally, the EU industry has called for an export rebate for EU producers that export products subject to a charge under the EU ETS. The CBAM agreement reached by EU legislators does not include such a mechanism over fears that it would be inconsistent with WTO rules. However, the European Commission has been tasked with assessing the risk of carbon leakage for products produced in the EU and intended for export to non-EU countries. Accordingly, the Commission will produce a report by 2025 and, if needed, present a legislative proposal compliant with WTO rules to address this risk.⁶

Next steps

The CBAM agreement is conditional on a formal approval by the co-legislators of the EU—the Council of the EU (where EU governments are represented) and the European Parliament. The text of the agreement is expected to be formally published in the next two weeks, with a plenary vote in Parliament in March. If approved, the new law would come into force 20 days after its publication in the EU *Official Journal*.

¹ Press Release: Deal reached on new carbon leakage instrument to raise global climate ambition, European Parliament

² There are indications that the EU may be open to negotiating a separate solution with the United States, exempting U.S.-origin goods from CBAM.

³ European Commission (2019). Adoption of the Delegated Decision on the carbon leakage list for 2021-2030.

⁴ EU Emissions Trading System (EU ETS), European Commission

⁵ European Green Deal: Agreement reached on the Carbon Border Adjustment Mechanism (CBAM), European Commission (13. Dec, 2022)

⁶ Climate change: Deal on a more ambitious Emissions Trading System (ETS), European Parliament (18 December 2022)