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THE EU'S CARBON BORDER ADJUSTMENT MECHANISM – TRENDSETTER, OR DOOMED TO FAIL?

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As part of its efforts to tackle climate change, the European Commission has proposed the introduction of a new carbon border adjustment mechanism (CBAM) which aims to address the issue of "carbon leakage" – this involves EU companies moving carbon-intensive production to other countries to take advantage of lower standards or EU companies importing cheaper, more carbon-intensive products. In this briefing we explore the likely impact of CBAM, the challenges ahead, and whether it will provide an example for other countries to follow, or will fail.

CBAM is one of the most controversial measures in the European Commission's 'Fit for 55' initiative, which was launched in July 2021 and targets a 55% reduction in greenhouse gas (GHG) emissions by 2030. It imposes a levy on products imported into the European Union that are produced in countries with lower environmental requirements. EU importers will buy carbon certificates equal to the carbon price that would have been paid had the goods been produced under the EU's existing carbon pricing rules. If a producer outside the EU can demonstrate that it has already paid a price for the carbon used in the production of the goods, the corresponding cost can be fully deducted for the EU importer. The European Commission says that this will incentivise foreign producers to "green" production processes. Japan and Canada are considering similar initiatives, but China and Russia say that CBAM violates World Trade Organization rules, and Australia and India say that it could be discriminatory and regressive.

CBAM will initially apply to five sectors at high risk of carbon leakage: iron and steel, cement, fertiliser, aluminium, and electricity generation. It will then be extended to 63 sectors sometime after 2026, following a transition period to assess how well the system is working.

"The European Commission wants to achieve a level playing field but there is a big question as to how the whole system will be implemented and whether it will work or not," says Düsseldorf-based Partner, Mathias Elspass, Co-Head of Clifford Chance's German Energy and Infrastructure Group. "For CBAM to work, it requires that an importer of a product in the EU must know the carbon content of the product being imported. It's quite complex proving that and, to an extent, will rely on trust. The European Commission says that the importer will have to verify the emissions by collecting its own data or the European Commission will use a default value – 10% of the [worst - most polluting?] production of that product within the EU. If you are a smaller business with a one-off import then you may just accept the bad rate, but for larger companies that will not be sustainable."

He says that the fact that the levy will take the form of certificates adds another layer of complexity. "It's not a case of simply paying a duty or tax, you have to buy a CBAM certificate and surrender it a year after importing the goods. The European Commission looked at a number of different options – including a duty or tax – but settled on CBAM certificates, believing it to be the best way to incentivise producers to green their production processes."

London-based Partner and Head of Clifford Chance's Climate Change Group, Nigel Howorth, adds that it could be argued that certificates are the most economically efficient way to achieve reductions in greenhouse gases. "The companies that can make the most reductions are incentivised to do so, and for those for whom it would be very expensive to do so, they will have to pay. A pure carbon tax is blind to that, and charges you the same amount whatever your ability to reduce carbon."

The European view

CBAM is still in the very early stages as Gail Orton, Paris-based Head of Clifford Chance's EU Public Policy Group, explains: " The EU has bent over backwards to underline that this is an environmental policy that might have competitiveness implications. It is not a competitiveness policy that has climate implications. It is still at the proposal stage, it is not yet law. It must go through the co-decision process where the European Parliament and member states will have an equal say on the final text. Given the controversy the proposal is raising, I don't think we will see a final text before the summer of 2023."

The European Commission, in parallel with the European Parliament, is looking at various ideas for CBAM, but there is nervousness amongst the member states about the accumulated impact of all the EU's green policies on households. "None of the member states wants a pan-European gilets jaunes type of movement with people are out on the streets demonstrating." She adds that Spain has been very vocal on the impact of rising electricity costs and the additional burden on consumers, and Poland, which is heavily reliant on fossil fuels, has expressed similar concerns. Meanwhile, Germany's new coalition government will heavily support climate measures – but with rising energy prices, the public acceptance of such measures is doubtful. It faces challenges balancing climate issues with the impact on the economy.

There is also a debate about whether increased costs should be passed onto consumers and what happens to the money that is collected from CBAM. Should it go back to the member states or be placed in a European pot? Should it be invested into making the economy greener, or fed back to households?

Despite the difficulties, there is a lot of support for CBAM in the EU, and France has said it will be a priority for its presidency of the EU in the first part of next year. "As with all these things, there's going to be a lot of negotiation. Everybody will have to compromise and then they'll get in a room late at night and hammer out a deal. I think the important question is what will be the impact on the EU's partners around the globe?" says Orton.

The global perspective

Janet Whittaker, Washington, D.C.-based Senior Counsel, says from a political perspective there are a number of difficulties. Russia, which is Europe's biggest supplier of carbon-intensive products, says that it will be one of the biggest losers from CBAM and estimates that it will lose US$7.6 billion. China also says that it views CBAM as discriminatory. "The reality is that the current proposal only covers a small share of Chinese exports to the EU. A recent report found that the sectors covered by the current proposal represent less than 2% of Chinese export fees. Although China is the world's largest exporter of steel and aluminium, it only exports a small proportion of that steel and aluminium to the EU," she says. One of the criticisms of CBAM is that it does not take into account the fact that there are many products with high levels of embedded carbon that are not captured by the measure. However, the number of sectors will eventually increase and at that point there will be a potentially higher impact on the Chinese economy. "There is a real incentive for China to remain competitive, and I think we will see a lot of innovation and developments pushing the economy towards net zero because that will be the only way for its economy to remain competitive," Whittaker says.

The impact of CBAM on the US will, initially, have even less impact than on China – around US$1.1 billion – as most US exports to the EU do not fall within the covered sectors. However, that will change as the number of sectors covered by CBAM expands and as Whittaker explains: "Although it won't have a practical impact right now, it will have policy implications for the US. CBAM only offsets the direct carbon taxes of the exporting country, so when you present your data to the Commission you can show how much you paid for the carbon in your own country and can then offset this. The US doesn't have a trading system nationally, and so there is no such equivalent price on carbon, it's largely driven by regulation."

During the election campaign, President Biden was initially in favour of CBAM, but attitudes shifted under the influence of John Kerry, US Special Presidential Envoy for Climate, who argued that unilateral CBAMs could potentially impede progress on a multilateral level. "More recently we've seen a slight shift," says Whittaker. "It's a live issue on Capitol Hill, as the Democrats have announced that they will impose a carbon polluter import fee as part of a US$3.5 trillion spending plan." She adds that there is little detail as yet, but there is a key difference between the EU and the US – the EU is looking at the price on carbon whereas the US is looking at the cost that US producers will have to bear in complying with regulation. The US believes that it's possible to calculate the cost of compliance and that the import fee would then be based on that cost. "The US is very confident that it can do this but one of the potential difficulties is the fact that if the US doesn't have a domestic carbon price, then is it discriminatory to effectively impose one on importers, which could then involve the World Trade Organization." Another difference between the EU and the US is that the US is only focusing on the impact on US businesses and protecting its industry, rather than acknowledging that this will have an impact on consumers.

Countries that are impacted by CBAM or the US proposal could raise a challenge under World Trade Organization rules. As Whittaker explains, CBAM and the US proposal need to be consistent with the national treatment rule, which effectively says that imported products must be given no less favourable treatment than that given to domestic products. "Both the US and the EU proposals allow discretionary exemptions for qualified trading partners and those exemptions could potentially violate WTO rules on non-discrimination depending, of course, on their design, how they're implemented and what they ultimately look like."

COP26, the UN conference on climate change is unlikely to resolve these questions. "The details are too technical for COP26 – it was the big political issues that were discussed, says Elspass.

The impact on the UK, post Brexit

Following Brexit, the UK is potentially exposed to CBAM because it is a significant exporter of iron, steel and aluminium. The UK is not in the European Economic Area and its trading system is not linked, but that does not necessarily mean that UK exports of CBAM goods to the EU will be subject to the additional charge. Howorth says: "We now have a UK Emissions Trading Scheme (ETS) and that could just link that to the European ETS, or, alternatively, EU importers can take into account the carbon price paid by the UK when they're determining how many CBAM certificates they need to purchase and surrender. It's complex but resolvable."

The UK could bring in its own CBAM, or ensure that every product covered by the EU CBAM is covered by equivalent carbon pricing, whether through the UK ETS or a new carbon tax or other mechanisms. "However, it imposes huge administrative burdens on EU importers, but also on UK exporters who are already dealing with the additional burdens of Brexit," he says. It also presents a problem for the WTO; the mix of different systems, regulatory versus carbon pricing, how the different mechanisms will work and the burden on businesses, create huge uncertainties. There are growing calls for discussions within the WTO on how to align the different systems and to provide some common principles on how a CBAM should work to avoid these sorts of issues.

Meanwhile, the UK government has not made any announcements about a possible UK CBAM or linking the UK ETS with the EU ETS. "It says that for the moment it does not want to be tied to any commitment and wants the UK to retain its own control over carbon pricing. The UK may just be waiting to see what happens," says Howorth. "If the UK ETS is linked to the EU ETS, it could be done quite quickly."

Conclusion

Countries are now grappling with the increased expectations on them following COP26 to strengthen their carbon commitments in renewed Nationally Determined Contributions (NDCs) next year [***Listen to our podcast: COP26 Up Close and Personal.*** The continuing possibility of unilateral action on carbon pricing being taken by national or regional entities such as the EU's CBAM proposals will highlight the potential economic risks of other countries not raising their climate ambitions.

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