

CARBON BORDER ADJUSTMENT MECHANISM (CBAM) - EU PROPOSAL

The long awaited Proposal for an EU Carbon Border Adjustment Mechanism ("CBAM") was published by the European Commission on 14 July, alongside 12 other legislative proposals in the "Fit for 55" package.¹

The CBAM mechanism is an important item among the specific actions foreseen in the European Green Deal Communication,² through which the EU has set ambitious climate goals: achieve carbon neutrality by 2050 and reduce its greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels.

Outside the EU, however, third countries do not necessarily share such climate ambitions. This regulatory divergence amplifies the risk that European climate policies result in offshoring of the production of carbon-intensive goods outside the EU, and re-importation of these goods to the European single market. This phenomenon, known as "carbon leakage", risks undermining the effectiveness of European emissions-reduction efforts. The European industry has to pay for its carbon emissions under the EU Emissions Trading Systems ("EU ETS") and is penalized when faced with international competitors who are not subject to the same obligations.

The CBAM aims therefore to further reduce the risk of carbon leakage and create a level playing field between climate regulations that European producers have to endure and their absence in third-countries, which inevitably affect goods imported in the EU.

After long discussions involving private and public stakeholders, the Commission has put together a robust and feasible Proposal for a CBAM regulation, which aims to begin the transition from a system in which carbon leakage is exclusively addressed by free allowances to a system in which carbon leakage with respect to imports is addressed by a carbon border adjustment mechanism. As explicitly mentioned already on Article 1 of the text, the CBAM will progressively become an alternative to the existing EU ETS to imports into the EU. This is confirmed by a number of references to the Directive 2003/87/EC, which implements the EU ETS, in the text of the Proposal, including for the definition of terms used.

In essence, the mechanism imposes on importers the duty to provide data on the imported goods into the EU and buy certificates corresponding to the emissions embedded in these goods, sold based on the prices of auctions of EU ETS allowances. Special attention was given to the issue of WTO compatibility, and the Proposal tries to ensure that imports will not be afforded any less favorable treatment than treatment accorded to domestic EU producers.

SCOPE

First of all, in terms of scope, the CBAM shall apply to the goods listed in Annex I (Art. 2). The Proposal covers cement, electricity, fertilisers, iron and steel and aluminium. The Commission's ambition is that, at first, CBAM will apply to sectors which are most at risk of carbon leakage and, at a later moment, the mechanism will be extended to cover other sectors.

It should be highlighted, however, that the goods included in Annex I only cover a very small part³ of the sectors identified in the current official EU ETS list of 63 sectors and sub-sectors deemed at risk of carbon leakage.⁴

¹ *The Fit for 55 Package under the European Green Deal*. Available at: <https://www.europarl.europa.eu/legislative-train/theme-a-european-green-deal/package-fit-for-55>

² COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS, *The European Green Deal*, available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1596443911913&uri=CELEX:52019DC0640#document2>

Regarding the countries to which the regulation will be applicable, as a general rule, imports from all non-EU countries will be covered by the mechanism. However, the CBAM shall not apply to third countries who participate in the ETS or have an emission trading system linked to the Union's, which are listed in Section A of Annex II (Art. 2). These are Iceland, Liechtenstein, Norway and Switzerland, as well as the territories Büsingen, Helgoland, Livigno, Campione d'Italia, Ceuta and Melilla. The EU may conclude agreements with third countries to take into account their carbon pricing mechanisms.

We stress this has more to do with the burden of the carbon prices paid by producers than with the existence of such mechanisms in itself. This possibility intends to make sure that a price will have been paid for carbon emissions, either when goods enter the EU, through the CBAM, or when goods are produced in their country of origin, through local carbon pricing systems. The recognition of third-countries' carbon pricing mechanisms is not automatic, and will involve negotiations with the Commission.

The Proposal also establishes, in Annex II, that the regulation might not apply to some countries and territories with regard to the specific importation of electricity (Art. 2). This is the case when a third country or territory has an electricity market which is integrated with the Union internal market for electricity through market coupling. No country or territory has been listed under this exemption in Section B of Annex II so far. It is noteworthy that both exceptions described above are only valid if a certain number of cumulative conditions are fulfilled. For instance, for the exemption on importation of electricity, the third country or territory will also need to have committed to climate neutrality by 2050.

CERTIFICATES

Each EU Member State shall designate the competent authority to carry out the obligations set by the CBAM regulation. Importation of goods can only be made by a declarant authorized by the authority which is competent at the place where the declarant is established. Any person can apply for authorization to import goods, which will be granted based on the fulfillment of certain criteria (Article 17), such as absence of serious infringement of customs legislation and taxation, as well as absence of criminal offense, and financial solvency (Art. 4 and 5).

Importers (declarants) are expected to, by 31 May of each year, submit a CBAM declaration to the competent authority indicating, in relation to the previous calendar year, (i) the total quantity of each type of goods imported; (ii) the total emissions embedded in the imported goods; and (iii) the number of CBAM certificates corresponding to the total embedded emissions in imported goods that the declarant states to be surrendered. (Art. 6). Each certificate to be given up (surrender) by the importer comes at a cost.

The embedded emissions in goods other than electricity shall be determined based on the actual emissions, pursuant to the methods set out in Annex III (Art. 7). The declarant shall keep records of the information required to calculate the embedded emissions pursuant to requirements of Annex IV, which should be detailed enough to allow verification from the competent authority, in accordance with Article 8 and Annex V. When the actual emissions cannot be determined, or in the case of imported electricity, the embedded emissions will be fixed by reference to default values.

With regard to the number of certificates to be surrendered, it shall be calculated after the reduction due to the carbon price paid in the country of origin and the necessary adjustment in consideration to EU ETS free allowances (Art. 31). The CBAM gradual introduction will ensure that the new levy will only apply to the proportion of emissions that do not benefit from free allowances under the EU ETS. Meanwhile, the possibility to adjust the number of certificates needed considering the existing EU ETS free allowances is in line with Commission's preoccupation that, at no point in time, imports are afforded less favorable treatment than domestic EU producers.

Also in this regard, as anticipated, the Proposal gives importers the possibility to ask for a reduction in the number of CBAM certificates to be surrendered corresponding to the carbon price already paid in the country of origin of the declared emissions (Art. 9). The declarant will need to submit information demonstrating the carbon price has been paid in the country of origin and cannot be subject to an export rebate. This mechanism will allow the Commission to take into

³ The list of sectors and sub-sectors identified in the current EU ETS list is expressed in NACE Codes, whereas the goods included in Annex I are indicated in CN Codes. The sectors covered by the CBAM draft only correspond to 4 of the 63 NACE Codes listed to be at risk of carbon leakage by the EU ETS.

⁴ COMMISSION DELEGATED DECISION (EU) 2019/708 of 15 February 2019 supplementing Directive 2003/87/EC of the European Parliament and of the Council concerning the *determination of sectors and subsectors deemed at risk of carbon leakage for the period 2021 to 2030*. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2019:120:FULL&from=EN>

account similar carbon-reduction efforts of third-countries, and the proposal explicitly includes the possibility of the EU concluding sectoral agreements with third countries on this matter.

When it comes to the carbon market itself, the competent authority of each Member State shall sell CBAM certificates to declarants (Art. 20). Auctioning and pricing of CBAM certificates will closely follow the EU ETS mechanism, although the certificates are meant to be distinct from ETS allowances and not interchangeable with them. The price of each CBAM certificate is calculated by the Commission based on the average of the closing prices of EU ETS allowances on the common auction platform for each calendar week. The average price will be published by the Commission on its website on the first working day of the following calendar week (Art. 21).

Declarants they will also have the possibility to request competent authorities to re-purchase the excess of CBAM certificates after the yearly surrender, up to the limit of one third of the total certificates purchased, at the same price paid by the importer (Art. 23). Any other remaining CBAM certificates will be cancelled by 30 June of each year (Art. 24).

Most revenues generated by the sale of CBAM certificates will go to the EU budget (Explanatory Memorandum). In the Subsidiarity Grid, document accompanying the Proposal, it is explained that revenues will finance the implementation costs of CBAM as well as generate new own resources⁵ for the EU. The system of own resources aims to contribute for the development of EU policies.

COMPETENT AUTHORITIES

As already briefly indicated above, the CBAM will not be implemented and enforced by a centralized authority: the Proposal establishes that each Member state shall designate a competent authority to execute the obligations set out in the text (Art. 11). A list of all competent authorities will be published in the Official Journal. Competent authorities of each Member State shall establish national registries containing information of the declarant, operator and third country installations that will be regrouped in a central database accessible to public to be established by the Commission (Art. 14).

Despite the absence of a central authority, the Commission will, in addition to assisting the competent authorities and coordinating their activities (Art. 12), act as central administrator (Art. 15), maintaining an independent log on CBAM certificates. As central administrator, the Commission shall also carry out risk-based controls on transactions recorded in the national registries.

Regarding the accreditation of verifiers, who perform the obligations of control of the embedded emissions applying the principles laid down by Annex V, any person accredited pursuant to the EU ETS shall be considered as accredited verifier under the CBAM Regulation (Art. 18).

The Proposal establishes that a review of CBAM declarations should be conducted until the end of the fourth year after the year in which the CBAM declaration has been submitted. It consists mainly in cross-examining the information received by the competent authorities with the information communicated to customs authorities. If the declared number of CBAM certificates is incorrect, the competent authorities shall adjust it. In case CBAM certificates have been surrendered in excess, the competent authority shall reimburse the excessive certificates (Art. 19).

ENFORCEMENT

If the importer (declarant) fails to surrender, by 31 May of each year, a number of CBAM certificates corresponding to the emissions embedded in his imported goods or submits false information, it will be subject to a penalty identical to that set out in the EU ETS Directive.⁶ It should be added that the payment of the penalty does not release the authorized

⁵ "The system of own resources of the Union must ensure adequate resources for the orderly development of the policies of the Union, subject to the need for strict budgetary discipline. The development of the system of own resources can and should also contribute, to the greatest extent possible, to the development of the policies of the Union." - Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing Decision 2014/335/EU, Euratom.

⁶ " Article 16 (3):The excess emissions penalty shall be EUR 100 for each tonne of carbon dioxide equivalent emitted by that installation for which the operator has not surrendered allowances. Payment of the excess emissions penalty shall not release the operator from the obligation to surrender an amount of allowances equal to those excess emissions when surrendering allowances in relation to the following calendar year." - 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 Community and amending Council Directive 96/61/EC.

declarant from the obligation to surrender the outstanding number of CBAM certificates (Art. 26). In addition to the fine, Member States may apply administrative or criminal sanctions for failure to comply with the CBAM legislation in accordance with their national rules.

The Commission can take action to address circumvention, following a complaint from an interested party. As the Proposal suggests, a significant decrease of goods included in the scope of the Regulation and an increase of volume of imports of slightly modified products which are not included in the list of Annex I might indicate a case of circumvention. In that situation, the Commission may decide to extend the scope of the Regulation to imports of slightly modified products (Art. 27).

TRANSITIONAL PERIOD

The proposal envisages 1st of January 2023 as the starting application date for the CBAM, with a transitional period of three years and full application from 1 January 2026 (Art. 36). During the transitional period, the CBAM shall apply as a reporting obligation (Art. 32): importers will have to monitor and report their emissions before the full mechanism is in force. The transitional period will allow the Commission to understand the market and gather information on the carbon footprint of each producer. The need to pay a carbon adjustment levy for imports will only start as from 2026. Until then, the reporting obligations in place from 2023 to 2025 will force companies to develop methods to calculate the carbon content of their imports.

Before the end of the transitional period, the Commission shall present a report to the European Parliament and the Council containing, in particular, an assessment on the possibilities to expand the scope of the Regulation to other sectors at risk of carbon leakage, including transportation services and goods further down the value chain (Art. 30).

REMAINING ELEMENTS AND PENDING QUESTIONS

The Proposal does not provide any exemptions or differential treatment for developing or least developed countries (LDCs). However, in the Impact Assessment of the Regulation (p. 30), the Commission acknowledges that a gradual phasing in of the CBAM could be considered for the existing production capacities in LDCs.

Another element that has not been included in the Proposal is the possibility of export rebates. They could fit an environmental narrative since EU's carbon emissions are on average significantly lower than third countries'. Export rebates could be awarded only for imports to countries that are not exempted from the application of the CBAM and encourage third countries to adopt equivalent charges. However, it is not surprising that they do not appear in the proposal, as the Commission seemed reluctant to adopt export rebates because of concerns on WTO compatibility.

Furthermore, the Proposal allows a reduction of the number of CBAM certificates that will have to be paid by the importer if a carbon price has already been paid in the country of origin. It is equally possible to request for compensation under these terms after the payment of the certificates have already been done. In previous declarations, the Commission had explored the possibility of creating a list of "compatible" countries, but this has not been incorporated in the Proposal.

The Commission will have the power to adopt implementing and delegated acts to detail the implementation of the Regulation. These acts will clarify and amend several points, such as the lists of countries and territories in Annex II, rules for accreditation of verifiers, the scope of the Regulation for anti-circumvention purposes, calculation methods set out in Annex III, rules for verification of emissions, rules to define the methodology to calculate the average price of CBAM certificates, rules to calculate the reduction of certificates to be surrendered in accordance with EU ETS free allowances, among others.

CONCLUDING REMARKS

The text released confirms the ambitions of a Commission committed to fighting climate change and reaching the targets of the Paris Agreement, even beyond the EU borders. The proposal will now be discussed by the European Parliament and the Council. Reviews should be undertaken by environment committees with help from trade instances to ensure WTO compatibility. A final legislation will be then negotiated among the three EU institutions.

As presented, the CBAM Proposal follows Commission's intentions of designing a mechanism that would mirror as much as possible the existing EU ETS. At first, the CBAM will only apply to some specific sectors, but the ambition is that

scope will be later expanded. As a matter of fact, the target sectors for this first phase represent only a very small part of the 63 sectors and sub-sectors deemed at risk of carbon leakage by the EU ETS.

Regarding the combination between the CBAM and the system of free allowances currently in place with the EU ETS, the idea is not to suppress free allowances overnight, although the ultimate objective is to bring both mechanisms into alignment in that respect. The EC argues that these are no longer an effective measure to achieve the goal of reducing 55% of CO2 emissions by 2030. This is why it wants to put in place the CBAM simultaneously with the phasing out of free allowances. In the current EU ETS, free allowances are fixed until 2025, also the end of the CBAM transitional period. From 2026 onwards, a reduction of 10% of free allowances per year is expected, in order to reach total abolition in 2036. Hence, the CBAM will be phased in from 2026 at a rate proportional to the amount of free allowances given to each sector.

Overall, the Proposal confirms many of the expectations of what the CBAM would look like even if some concerns of certain industries remain with a question mark (e.g. export rebate, maintenance of free allowances...). If the important administrative work that will be needed to put it in practice is correctly done, the mechanism has a strong potential of helping to level the playing field for EU producers and to minimize risks of carbon leakage.

Nevertheless, the Proposal will undoubtedly trigger significant international reactions. If companies in countries with existing emissions trading schemes, such as South Korea, might see less difficulties to adjust to the CBAM, a strong reaction can be expected from countries which will potentially be the most affected by the mechanism, such as Russia, Turkey, China, UK, Ukraine and North African countries, which collectively export large amounts of the sectors targeted in Annex I. The very concept of a CBAM has already been criticized by many EU trading partners, such as China and Russia. Threats retaliation from certain trading partners can therefore certainly not be excluded.

The US, that had shown negative reactions to the announcement of the preparation of the Regulation, have been softening the discourse lately. The US Secretary Janet Yellen acknowledged in July 2021 that the use of carbon-pricing schemes such as the CBAM might work, but need to take into account other emission-cutting initiatives. Democrats even proposed their own version of a tax on imports from countries lacking substantial climate policies. While the latter is much less detailed than the EU CBAM, it might be a sign that discussions around the CBAM have fostered similar reflections in other countries.

In the coming months, the international pressure and opposition will test the determination and the strength of the European Commission and the Union's commitment as a result of the Paris agreement and the recently adopted EU Climate Law.

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