



# CBAM

## Europe's attempt to prevent carbon leakage

On 14 July 2021, the European Commission published its proposal for the establishment of a carbon border adjustment mechanism (CBAM)<sup>1</sup>.

Under CBAM, the import of electricity, cement, iron, steel, aluminium and fertilizer into the EU will be subject to a levy reflecting parts of the greenhouse gas (GHG) footprint of these so-called CBAM goods. Other items, such as chemicals, refinery products and hydrogen, could be added to the list of CBAM goods in the future. The new mechanism will come into effect in 2023, with a transitional period until 2025, and full implementation by 2026.

As of now, CBAM should be on the agenda of companies involved in the trade of CBAM goods into the EU (ie producers of CBAM goods outside the EU; customers directly importing these goods into the EU, such as companies involved in the automotive, machinery and construction sectors; and metal and fertilizer traders). Indirectly, the new mechanism is of relevance to domestic producers, as it will lead to a phasing out of the free allocation of EU ETS allowances towards domestic producers of CBAM goods. Furthermore, CBAM should be of interest to financial sponsors and banks that are participating in the EU emissions trading system (EU ETS) or interested in how CBAM may affect global manufacturing conditions and distribution channels.

### CBAM administration – key details

#### Why will the EU introduce CBAM?

CBAM aims to tackle the risk of carbon leakage, which occurs if the high cost of GHG emissions in one country causes production to move from that country to other countries where GHG emission costs are lower.

Until now, EU companies exposed to a very high carbon leakage risk have obtained free allowances under the EU ETS to help them compete against non-EU producers. However, as from 2026, the Commission aims to gradually phase out the allocation of free allowances. (For more information, see this [blog post](#).)

Consequently, a new carbon leakage 'shelter' has become necessary. CBAM aims to provide this shelter with respect to domestic sales markets by mirroring the EU ETS for imports of non-EU products.

#### How does CBAM work?

CBAM complements the EU ETS by adopting an equivalent regime on imports into the customs union (purchasing and surrendering of CBAM certificates) and by coupling the price of CBAM certificates to EU ETS prices.

Consequently, CBAM aims to ensure equivalent carbon pricing for imports and domestic products. However, unlike the EU ETS:

- there is no fixed number of CBAM certificates and no trading of certificates;
- the obligation to surrender CBAM certificates is triggered by importation but not by production; and
- it is aimed at specific products, not sectors.

<sup>1</sup> This briefing is based on the draft CBAM regulation published on 14 July 2021. Amendments to this draft are to be expected in the course of the legislative process.

At the same time, CBAM interlinks with the Union Custom Code (UCC) and the provisions laid down therein when it comes to border procedures, product origin rules and the processing/return of goods.

## **How to comply with CBAM**

CBAM will be levied in the form of certificates based on a system of self-declaration:

- EU-based importers ('declarants') of goods subject to CBAM must first register with the competent authority to become 'authorised declarants'; and
- authorised declarants must then file CBAM declarations by 31 May each year for the previous calendar year.

In their CBAM declarations, authorised declarants must assess and declare, among other things, the emissions embedded in the total quantity of relevant CBAM goods imported. The declarant must have the embedded declared emissions verified by an accredited verifier.

Together with the declaration, the authorised declarants must surrender CBAM certificates in an amount reflecting the embedded emissions and that have been purchased from the respective national competent authority. Throughout each year, an authorised declarant must keep a certain number of CBAM certificates in its account.

During its transitional period (2023-2025), CBAM will only operate as a quarterly reporting mechanism for declarants, thus merely causing compliance and administration costs. Violations of these reporting requirements will be threatened with penalties.

## **Who administers and enforces CBAM?**

Each member state is to designate a competent authority to administer and enforce CBAM. The EU Commission will be assisting the competent authorities and remains in charge of fundamental workstreams such as controlling national CBAM registries, determining the CBAM certificate price and deciding which third countries and territories are subject to CBAM exemptions.

Custom authorities will also be included in the monitoring process as they are mandated to ensure that no goods are imported by persons other than authorised declarants. In addition, national custom authorities can inspect the goods, especially regarding their quantity and their country of origin. Periodic information by custom authorities to the competent authority allows for cross-checks.

## **Which products are included?**

Annex I of the CBAM Regulation contains a detailed list of the CBAM goods and their UCC nomenclature (CN) codes allocated to the product categories cement, electricity, fertilisers, steel and iron, and aluminium.

Once included in Annex I, the importation of goods under the listed CN codes triggers CBAM obligations even if the imported goods serve a different purpose. This applies, for example, to ammonia, which is listed in the category of fertilisers but can also be used as an energy carrier.

## **Which emissions are included?**

Initially, CBAM will only apply to direct emissions of GHGs emitted during the production process of a CBAM good. Indirect GHG emissions (including emissions from electricity generation, heating and cooling that are produced during the production of a CBAM good) will likely be included at a later stage, depending upon the results of the Commission's review process.

Furthermore, CBAM will apply only to the proportion of emissions that does not benefit from free allocation of allowances under the EU ETS. Currently, sectors at the highest risk of relocating their production outside of the EU will still obtain 100 per cent of their allocation of EU ETS allowances for free. Steel, iron, aluminium, cement and fertilizer fall into that category. The 100 per cent value represents a benchmark based on the average performance of the 10 per cent most efficient installations in a sector within the EU. As from 2026, this free allocation will be gradually phased out; the phase-out is likely to be completed between 2030 and 2035. The number of CBAM certificates to be surrendered will increase in line with this.

## Who could be exempted from CBAM?

Importers of CBAM goods are exempted from the obligation to surrender certificates if and as far as these goods originate from third countries/territories satisfying one of the following conditions:

- the EU ETS applies to the country/territory or an agreement has been concluded with the country/territory fully linking the EU ETS and the country's/territory's ETS;
- the price paid in the country/territory of origin is effectively charged on those goods; or
- in case of electricity, the country/territory is closely integrated into the EU's electricity market via market coupling (subject to further sustainability-linked requirements).

Currently, imports from Iceland, Liechtenstein, Norway and Switzerland as well as from certain EU customs enclaves are listed as generally exempt countries. However, the list of countries that qualify for an exemption from CBAM for electricity imports has yet to be finalised.

## CBAM challenges – some initial thoughts

There might be several challenges around CBAM – for the mechanism itself and its application – that may need careful navigation in the future.

### Compatibility with WTO law

CBAM concerns cross-border trade and is therefore subject to World Trade Organization (WTO) rules. This raises several issues concerning, in particular, GATT non-discrimination obligations and exceptions.

- First, there are indications that EU producers of CBAM goods might have an advantage over non-EU producers. For example, domestic GHG emitters can already now purchase and hoard EU ETS allowances, which are valid until 2030; they can also achieve cost-savings via intraday overperformance on the secondary market. Such opportunities are not available to CBAM importers. Determining the embedded emissions of complex goods might give rise to excessive compliance costs and, consequently, to de facto discrimination against imported products in violation of Article III of GATT 1994 and possibly also between imported products in violation of the most favoured nation obligation in Article I of GATT 1994.
- Second, the compensation rule for carbon prices paid in third countries could violate the WTO's most-favoured nation obligation in Article I of GATT 1994. This obligation requires unconditional equal treatment of products from different WTO members. Unconditional treatment means that no account can be taken of the exporting country's own policies, including whether or not it has a CBAM equivalent system.

Even if CBAM violates these two obligations – Article I and Article III of GATT – it may be permitted under Article XX of GATT, which establishes an exception for measures relating to exhaustible natural resources, provided that these measures are not unjustifiably discriminatory, and do not amount to disguised protectionism. The concept of an 'exhaustible natural resource' includes clean air, and it is likely that 'climate' will also count. More difficult is whether CBAM's potential discriminatory effects are justifiable. This depends on whether there is an alternative measure reasonably available to the EU that achieves its objectives in a less discriminatory manner (provided that CBAM is discriminatory at all). Much depends on the implementation of the measure in practice.

### Expansion of scope

The Commission openly names broad product coverage as an objective for CBAM in the preamble to the CBAM Regulation. Once political consensus on CBAM has been reached, the scope could be extended without prior debate. This may happen by either:

- applying the Regulation's ban on circumvention, which would allow for composite products as well as products with a higher degree of processing to be covered; or
- following designated rules to include either additional product categories (eg hydrogen, refinery products and numerous chemicals have a high chance of being included) or indirect emissions for the purposes of calculating the CBAM certificates to be surrendered.

## **CBAM compliance in multi-stakeholder setting**

Compliance with CBAM-related obligations, such as registration with the competent authority, filing CBAM declarations and surrendering CBAM certificates, lies with the authorised declarant. The authorised declarant will be held liable for any failure to comply with the CBAM Regulation, including being penalised by the competent authority.

The status as authorised declarant is tied to the obligation to lodge customs declarations. Thus, an authorised declarant may be a person who is lodging a customs declaration or in whose name a customs declaration is lodged. Consequently, there are several possible addressees for CBAM (importer, exporter or a service provider).

In settings involving multiple stakeholders, it may become necessary to contractually clarify who shall oversee CBAM compliance.

## **Exclusion from CBAM**

The first step towards CBAM compliance is registration with the national competent authority. Authorisation depends not only on meeting several, mostly formal, requirements but also the absence of any serious infringements of customs, tax and market abuse rules during the five years preceding the application.

The CBAM Regulation does not specify what the threshold for such serious (tax) infringements is. This is in sharp contrast to the grave consequences of failed CBAM registration: without registration, a declarant is *de facto* prevented from importing goods subject to CBAM into the EU.

While it is not unheard of to tie access to certain benefits to, for example, tax-governance standards (such as being recognised as an ‘authorized economic operator’ under the UCC), the *de facto* limitation of the freedom to pursue certain economic activities without further specifying the criteria could be seen as disproportionate.

## **Amount of CBAM certificates**

The calculation of embedded emissions seems to be the biggest challenge in CBAM compliance.

Annex III to the CBAM Regulation contains a rather complex formula, especially for goods that have already been transformed along their value chain. In addition, a reduction of CBAM certificates to be surrendered based on carbon prices paid in third countries will be possible, with the basis for reduction depending on certification by an independent person. For companies with complex value chains spanning multiple countries, a robust system that enables the exhaustion of possible reductions could be essential.

Where the calculation is not (properly) done, the Commission may set default values linked to the worst performing sites within the EU. The level of these default values may come under additional scrutiny in the legislative process.

## **‘Greenwashing’**

CBAM favours companies with manufacturing processes, and international trading relationships, that have low carbon footprints. However, the CBAM Regulation might favour business models that simply reduce their carbon footprint on paper.

Once indirect emissions are included in the CBAM mechanism, third countries will be incentivised to simply divert electricity from existing low-carbon sources primarily to companies producing (components of) CBAM goods exported to the EU.

Moreover, the third-country compensation rule could allow companies with global operations to achieve arbitrage profits by optimising their distribution structures.

## **Next steps**

This proposal is only the beginning of the legislative process in the EU. It has been sent to EU co-legislators, ie the European Parliament on the one hand and the Council (representing the 27 Member States) on the other hand.

Both institutions will separately examine the Commission proposal and make amendments to it. In a final phase, the Commission, the Parliament and the Council will try to agree on a final text in three-way negotiations.

The entire process should take between eight months and one year, meaning that the final CBAM text should be approved and published in the EU Official Journal around summer 2022.

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