

LEVELING THE PLAYING FIELD: EU FIRST OUT OF THE GATE WITH PROPOSED CARBON BORDER ADJUSTMENT MECHANISM

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The European Commission announced its official proposal for a Carbon Border Adjustment Mechanism (“**CBAM**”) on July 14, 2021.^[1] The CBAM is part of a wide-ranging set of proposals to assist the EU in reaching its goal of becoming the first climate neutral continent by 2050.^[2] The EU Commissioner for the Economy, Paolo Gentiloni, emphasized the level playing field rationale for the CBAM and also asserted that it will comply with international trade rules:

We are proposing a carbon border adjustment mechanism that will align the carbon price on imports with that applicable within the EU. In full respect of our WTO commitments, this will ensure that our climate ambition is not undermined by foreign firms subject to more lax environmental requirements. It will also encourage greener standards outside our borders. This is the ultimate now or never moment. With every passing year the terrible reality of climate change becomes more apparent.^[3]

The CBAM is designed to deter the carbon leakage that may occur in response to the EU’s expansion of its internal climate policies and carbon pricing regime.^[4] Carbon leakage occurs when producers re-locate production of carbon-heavy goods to jurisdictions without or with very low carbon pricing to avoid compliance with climate measures.

What sectors are covered by the CBAM?

The CBAM will assign a carbon price on imports of products into the EU from specified industries identified as carbon intensive. The CBAM will initially apply only to traded goods from the iron, steel, cement, fertilizer, aluminum, and electricity generation industries. The EU identified these industries for the CBAM first phase because they are considered high risk for carbon leakage.

Although the EU plans to expand the scope of the CBAM to more industries, the sectors subject to this expansion have not yet been announced. It can be expected that carbon intensity and carbon leakage risk will be key factors in identifying additional sectors.

How will the CBAM work?

Non-EU exporters of goods from the specified industries will need to purchase CBAM certificates to offset the embedded cost of carbon in their exported products. Each CBAM certificate will be equal to one tonne of CO₂. The cost of each CBAM certificate will be based on the weekly average of the daily carbon price certificates in the EU's internal carbon pricing system, which creates a close alignment between the CBAM charges and the EU's carbon prices.

The CBAM will have no cap on the number of certificates available for sale. All CBAM certificates will remain valid for two years after the date of purchase. The EU will require exporters to “build up” their number of CBAM certificates by regularly purchasing certificates throughout the year as products are imported into the EU and to report quarterly and yearly on the number of certificates purchased.

Non-EU exporters will need approval from a competent authority within the EU to export goods covered by the CBAM to the EU. The competent authority in each EU Member State will sell CBAM certificates at the price authorized by the EU.

How will the CBAM affect Canadian exporters?

Initially, only a modest number of Canadian exporters to the EU that operate in the iron, steel, cement, fertilizer, aluminum and electricity generation sectors will be affected by the CBAM. In 2019, the EU reported about €122 million in imports from Canada across these six product categories^[5] relative to a reported €20.9 billion in total Canadian goods exported to the EU, which represented about 1% of Canada's total exports to the EU.^[6] Of the €122 million in Canadian imports, almost all were iron and steel valued at about €118 million. No fertilizer imports from Canada for use in agriculture, horticulture and forestry were reported in 2019.

The CBAM in its initial phase will only apply to the direct emissions released during production. However, the EU will consider the possible future expansion of the regime in its second phase to cover the indirect emissions necessary to generate electricity during the production process used to manufacture products, as well as to downstream processing and production activities.

Canadian exporters of products to the EU will need to calculate the amount of embedded carbon in their products. Exporters will also need to have this calculation verified by an EU accredited verifier and keep a copy of the verifier's report as well as any records of information required to calculate the embedded emissions for a period of four years after the verification.^[7] If a producer cannot calculate the amount of embedded emissions in its products, then a default value will apply that is equivalent to the average emission intensity of the 10% worst emitters for similar products in the EU.

Canadian producers will be entitled to a reduction in the number of CBAM certificates required to be

purchased to the extent that the goods being exported are already carbon priced within Canada, in accordance with Article 9 of the proposed CBAM:

Article 9 Carbon price paid in a country of origin

1. An authorised declarant may claim in its CBAM declaration a reduction in the number of CBAM certificates to be surrendered in order for the carbon price paid in the country of origin for the declared embedded emissions to be taken into account.

This is an important element of the CBAM which in concept is designed to levy a charge that reflects the differential between the carbon price in the EU and any particular exporter's local regime. For example, a Canadian producer that exports a carbon-intensive product covered under the CBAM to the EU may claim in its CBAM declaration a reduction in the number of CBAM certificates to be submitted where there is a price for carbon already paid under a Canadian federal or provincial/territorial carbon pricing system.

The CBAM proposal may have a relatively less negative effect on Canadian producers in the covered sectors than firms they compete against from other countries that currently are not charging any significant price for carbon. Given that most Canadian products in the six EU designated sectors are already subject to a carbon price and will be able to claim a reduction in CBAM certificates, the majority of Canadian exports to the EU will be put back on a more level playing field with similar exports from countries without domestic carbon pricing regimes.

The CBAM contemplates that the EU may enter into agreements with non-EU countries to take into account their carbon pricing mechanisms. If Canada negotiates a CBAM-related agreement with the EU, the export of Canadian goods into the EU may become easier and more streamlined. The exact form and function of any EU-Canada agreement on carbon intensive imports remains to be formally negotiated at the international level.

CBAM timeline and reporting requirements

The first phase of the CBAM is scheduled to take place from 2023 to 2025. It will require exporters to comply with new reporting requirements, but none of the financial requirements of the regime will be operative. This transitional phase is designed to allow exporters to adjust to the administrative and reporting requirements of the CBAM without having to actually purchase certificates. It also provides time for them to consider whether and how imports will be able to compete in the EU market once they become subject to incremental costs that correspond to EU carbon price levels.

The second phase of the CBAM is scheduled to begin in 2026. It will require all non-EU exporters in the covered sectors to purchase CBAM certificates to cover their carbon emissions at prices that correspond with the EU's carbon prices for their goods imported into the EU.

Participation in the CBAM system will require non-EU exporters to report to the EU every May 31st regarding the amount of emissions embedded in their products exported to the EU and the total number of certificates purchased. In addition to the yearly reporting requirements, exporters will have quarterly reporting requirements to report, among other things, the direct and embedded emissions in the goods being exported and, any carbon price paid outside the EU.

Before the CBAM can take effect, it is subject to approval by both the European Parliament and the Council of the EU. Either process could potentially impact the proposed implementation timelines.

Other jurisdictions considering border carbon adjustments

To date, the EU is the only jurisdiction to present a formal proposal for implementing border carbon adjustments. However, various other jurisdictions such as Canada,[\[8\]](#) the United States, and the United Kingdom are considering whether to develop their own carbon adjustment mechanisms. Once a jurisdiction has established meaningful domestic pricing for carbon, a border adjustment mechanism potentially becomes very attractive to place domestic producers affected by such import costs on a level playing field with competing imports.

Will international trade rules affect the CBAM?

Canada's *Comprehensive Economic and Trade Agreement* ("**CETA**") with the EU contains an environmental chapter that recognizes and reaffirms commitments to and consultations regarding multilateral environmental agreements. Specifically, Article 24.4 of CETA contains provisions: (1) recognising the value of international environmental governance and agreements and the need to enhance the mutual supportiveness between trade and environment policies, rules, and measures; (2) reaffirming commitments to fully implement multilateral environmental agreements to which a party has agreed; and (3) regarding consultation and cooperation with respect to environmental issues of mutual interest including trade-related issues.[\[9\]](#) Accordingly, it is reasonable to expect that consultations between Canada and EU trading partners would take place prior to the implementation of the CBAM, in addition to a potential Canada-EU CBAM implementation agreement.

It seems likely that the CBAM may face scrutiny under international trade agreements. The General Agreement on Tariffs and Trade ("**GATT**") contains broadly framed commitments related to tariffs (Article II), taxes, internal regulations and charges (Article III), quantitative restrictions on imports (Article XI), and various other matters that could be relevant to the design and implementation of border carbon adjustments. There is a broad exemption for various environmental measures in Article XX of the GATT, but there are non-discrimination and other conditions attached to its use.[\[10\]](#)

The CBAM structure clearly indicates an attempt to avoid some of the GATT provisions related to the trade of goods, for example by adopting an internal regulation and charge measure rather than a new tariff. However, given the open-textured nature of some of the GATT provisions, exporting countries with no (or negligible) domestic carbon pricing may be incentivized to bring dispute resolution proceedings to challenge the compatibility of the CBAM with the EU's GATT and other trade agreement obligations.^[11]

[1] European Commission, "[Carbon Border Adjustment Mechanism: Questions and Answers](#)," (accessed August 8, 2021).

[2] Regulation of the European Parliament and of the Council, [Proposal for a Regulation establishing a carbon border adjustment mechanism](#), 14.7.2021 COM(2021) 564 final. Explanatory Memorandum.

[3] European Commission, "[European Green Deal: Commission proposes transformation of EU economy and society to meet climate ambitions](#)," (accessed August 3, 2021).

[4] For more information on carbon leakage, please refer to McMillan's bulletin "[Greening Canada's Borders – Canada Considers Border Carbon Adjustments for Carbon-Intensive Imports](#)"

[5] Eurostat, "[DS-045409 EU Trade since 1988 by HS2-4-6 and CN8](#)", Canada imports from Jan-Dec 2019; including data from product HS categories 2510, 2606, 9028, 72, 843240 and 2523.

[6] Government of Canada, "[An overview of Canada-EU trade performance under CETA](#)", Figure 1, (accessed August 9, 2021).

[7] Regulation of the European Parliament and of the Council, [Proposal for a Regulation establishing a carbon border adjustment mechanism](#), 14.7.2021 COM(2021) 564 final. Explanatory Memorandum, Article 9.

[8] For more information on Canada's contemplation of border carbon adjustments, please refer to our recent bulletin [here](#).

[9] *Canada's Comprehensive Economic and Trade Agreement*, 30 October 2016, Chapter 24, Article 24.2, paragraphs 1-3 (entered into force 21 September 2017).

[10] *General Agreement on Tariffs and Trade*, 30 October 1947, particularly Articles II, III, XI and XX (entered into force 1 January 1948).

[11] A detailed assessment of the prospects for such a challenge is beyond the scope of this bulletin.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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