

Legal Issues with the European Carbon Border Adjustment Mechanism

BY JAMES BACCHUS

The European Commission has proposed a carbon border adjustment mechanism (CBAM) as part of its European Green Deal. The CBAM would require importers to purchase carbon emissions certificates for imports that the European Union (EU) determines are not produced under emissions standards similar to those of the EU. The aim is to apply a carbon price to imported products that is equivalent to the carbon price applied to products manufactured in the EU. Although the CBAM may not be implemented for several years, merely proposing it has opened an entirely new front for trade confrontations. The prospect of the CBAM raises numerous

issues about its consistency with the rules of world trade.

The immediate questions are: How will other members of the World Trade Organization (WTO) react? Will this proposed action by the European Union set off a chain reaction of similar climate-related trade restrictions elsewhere? Or will it provoke a wide outcry of global criticism of green protectionism, leading to a legal showdown in the WTO? The question over the longer term is: How will these proposed restrictions shape the future of both trade and climate policies and governance globally? Without revision and careful application, the EU's proposed CBAM may be inconsistent with fundamental WTO rules.



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BACKGROUND

Since 2005, many EU industries have been covered by the EU's Emissions Trading System (ETS), which charges polluters for the carbon they emit. The ETS is a cap-and-trade system that puts a cap on overall carbon emissions, lowers that cap over time, and sells the right to emit carbon at an increasing price. Companies in carbon-intensive sectors covered by the system must purchase emissions allowances from the EU and then surrender them for every ton of carbon they emit. If a company reduces its emissions, it can keep its spare allowances for its future needs or sell them to other companies. The ETS reduces the number of emissions allowances over time, which in turn drives up the price of the allowances and provides an incentive to adopt cleaner production techniques. The intention of the ETS is to send a price signal that will encourage European producers to shift away from carbon-based production.

The EU's Green Deal builds upon the ETS by seeking carbon neutrality by 2050.¹ Toward this end, the EU's aim is to reduce its carbon emissions 55 percent from 1990 levels by 2030.² Anticipating that higher carbon prices will result, prices for emissions permits for industries that are now part of the EU's Emissions Trading System have rocketed to record highs, exceeding 50 euros per ton.³

European businesses are worried that a higher carbon price in the EU will put them at a competitive disadvantage relative to firms in countries without carbon pricing. This could spark a further shift to more offshore production that would shrink economic activity in the EU. Climate activists everywhere are concerned that these proposed restrictions will result in shoving emissions to countries with lower carbon emissions standards, resulting in no net reduction in overall global emissions.

The European Commission released the details of its carbon border adjustment mechanism (CBAM) on July 14 as part of the European Green Deal.⁴ If the legislation is enacted, there would be a transition period of three years beginning on January 1, 2023, with the CBAM entering fully into force on January 1, 2026. The proposal requires the approval of the European Parliament and the European Council before taking effect. There is still much debate about the shape of the CBAM in the EU, where some of the affected industries remain resistant.⁵ Negotiations await among the EU's 27 member states. The European Parliament

has already adopted a resolution in support of the CBAM—provided it is consistent with WTO rules.⁶

Accompanying the commission's CBAM proposal is a proposal to expand the ETS to include more sectors of the European economy.⁷ The EU would establish a new authority to implement and operate the CBAM in concert with the ETS by applying a carbon price to imported products that is equivalent to the carbon price applied to products manufactured in the EU. Under the CBAM, the EU would require importers to purchase emissions certificates to account for the emissions embedded in certain carbon-intensive imported products. At the outset, the imported products requiring these emissions certificates would be those of the heavy-emitting electricity, iron, steel, aluminum, cement, and fertilizer industries. Although climate activists had hoped that indirect emissions would be included, the emissions counted would be only those that result directly from owned or controlled sources of production.

The prices of the certificates would be linked to the prices of the emissions allowances under the ETS. Only "authorized" importers would be permitted to import the products falling within the scope of the CBAM. To be authorized, importers would need to report on the embedded emissions in their imported products on an annual basis and would need to surrender a corresponding amount of CBAM certificates that they would have purchased in advance. Importers who do not have a carbon-audited supply chain after the transition period ends would be required to buy CBAM certificates priced at default values of carbon content equal to the average emissions of like products in the EU during the transition period.

The EU crafted these climate-related trade restrictions with the professed goal of ensuring that they are consistent with the EU's WTO obligations.⁸ Nevertheless, Brazil, China, India, and South Africa have already expressed "grave concern," and have declared that the CBAM is protectionism disguised as climate action that will impose unfair discrimination on European imports of their traded products.⁹ These concerns are widely shared. One recent European study concluded that the most-affected products would be Colombia's cement, China's plastics, North Africa's fertilizers, and South America's pulp exports.¹⁰ Products from Russia, South Korea, Ukraine, and other countries are also likely to be affected.¹¹

U.S. climate envoy John Kerry warned that CBAM should be a last resort, as it could detract from efforts to get more

countries to elevate their climate ambitions before the upcoming UN climate summit in Glasgow in November 2021.¹² But, on the same day the EU announced the CBAM, congressional Democrats announced that they will propose a similar restriction as part of their pending \$3.5 trillion spending plan.¹³ In contrast to the detailed EU proposal, Democrats made their announcement of “polluter import fees” before deciding precisely what their proposal will be.¹⁴ Elsewhere, Canada has announced that it, too, is considering its own CBAM.¹⁵ Meanwhile, many countries are lining up to express their belief that the CBAM proposal by the Europeans is inconsistent with the EU’s WTO treaty obligations.

DOES THE EU’S CARBON BORDER ADJUSTMENT MECHANISM PROPOSAL COMPLY WITH WTO RULES?

The CBAM is a long way from being applied; it may be modified along the way, and precisely how it would be applied to individual traded products in particular factual circumstances cannot be foreseen. Nor can we foresee which of those products and circumstances would give rise to claims against the EU in WTO dispute settlement. Thus, any legal analysis is necessarily preliminary and provisional. Nevertheless, the legal issues raised by the CBAM about its compliance with the EU’s WTO obligations are likely to include at least three concerns.

First, the CBAM could be inconsistent with the most-favored-nation treatment rule that 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.¹⁶ The CBAM would violate the most favored-nation treatment rule if it discriminated between and among like imported products originating in different WTO member countries based on their carbon content. In self-judging other WTO members on the extent and quality of their climate actions, and thus picking and choosing which imported products members will have to buy emissions certificates for, and how many they will have to buy, the European Union would be discriminating between and among other WTO members in trade in like products.

Second, because the CBAM could apply a charge on imported products in excess of the ceilings on customs duties and

other charges connected with importation that have been agreed by the EU in its WTO schedule of commitments, the CBAM could also be inconsistent with another basic WTO rule.¹⁷ This inconsistency seems likely because the price of the new emissions certificates would start off fairly high and then climb higher as the EU implements and expands the CBAM and takes other climate actions over time.

The EU will likely contend that this rule does not apply here because the CBAM would not be a border measure. The EU will likely maintain that the CBAM is a requirement of an internal regulation. On this reasoning, it would fall instead under another WTO rule, which imposes no quantitative limits on the impact of such requirements. As a result, there would be no legal violation if the prices for emissions certificates rose over time and exceeded the agreed ceilings of the EU’s commitments on customs duties.¹⁸ However, the fact that the CBAM mandate to purchase an emissions certificate would be triggered by the act of importing that product and would *not* accrue due to an internal event—such as the distribution, sale, use, or transportation of the imported product—argues against an EU contention that the CBAM would be an internal regulation. The WTO Appellate Body has ruled that the question of whether there is an import measure or an internal regulation turns on what triggers the obligation to pay. If the obligation to pay accrues at the moment of and “by virtue of the event of importation,” then it is an import measure.¹⁹ As it has been proposed, this would seem to be the case with the CBAM.

Third, even if the CBAM were deemed a requirement of an internal regulation, it could be inconsistent with the national treatment rule that requires that imported products be given no less favorable treatment than that given to like domestic products.²⁰ One reason would be, in recent years, 43 percent of the available ETS emissions allowances have been allocated for free to European firms.²¹ Under the CBAM as proposed, the number of free emissions allowances for all sectors would decline over time and eventually be phased out, but they would continue for some years after the CBAM entered into effect.²²

Some of the affected European industries are protesting that the CBAM, as proposed, would not provide them sufficient protection from the “carbon leakage” of EU jobs and production offshore that they fear. So, they are fighting hard to keep the free emissions allowances as part of the expanded

ETS. Keeping free emissions allowances for European products, while also requiring the purchase of CBAM certificates for like imported products, would unquestionably be a violation of the national treatment rule. In effect, it would provide double protection for the European products.

This is because domestic products will have lower costs than will like imported products, so long as European producers continue to receive free emissions allowances, thus placing the imported products at a competitive disadvantage. For this reason, the EU would be acting inconsistently with the national treatment rule if it continued to provide free allowances because imported products would be denied an equality of competitive opportunities with like domestic products in the European market.²³

The free emissions allowances currently granted to domestic producers by the EU through the ETS are arguably already illegal under WTO rules that limit the grant of governmental subsidies where they distort global trade.²⁴ To date, no other WTO member has challenged this vulnerable aspect of the ETS in WTO dispute settlement. With the CBAM, though, the potential legal inconsistency with the national treatment rule could be meliorated—although not necessarily eliminated—if the EU offsets the full amount of the free emissions allowances it currently gives to producers of domestic products on the prices of the emission certificates required for the importation of like products.

Could the Carbon Border Adjustment Mechanism Be Excused by the General WTO Exceptions for Health and Environmental Measures?

Assuming the EU violates one or more of these three WTO rules, the legal question then becomes: Will the EU violations be excused by one of the general exceptions permitted under WTO rules for health and environmental measures?²⁵ To be entitled to the benefit of a general exception, the CBAM must be imposed for health or environmental reasons. The EU has been careful in saying that the CBAM would be a climate measure motivated solely by climate concerns relating to health and the environment. But these EU statements, in and of themselves, have no legal significance. What matters is the structure of the measure itself and how it is applied. Upon scrutiny by WTO jurists in the

settlement of a trade dispute, what would the design, architecture, and revealing structure of the measure say about whether it is truly a climate measure?

Exceptions are available under the rules for measures necessary to protect human, animal, or plant life or health,²⁶ and for measures relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.²⁷ The EU is unlikely to be able to prove that the CBAM is necessary, in part because there is at least one reasonably available alternative that would be consistent with WTO obligations, less restrictive of trade, and achieve the EU's desired level of protection from climate change: a carbon tax.²⁸

However, the EU may well be able to demonstrate that the CBAM is a measure relating to the conservation of exhaustible natural resources—in this case, air at a livable temperature in a climate fit for human habitation. The EU can do so if it can prove that there is a “close and genuine relationship” between the means used in the CBAM and the end it seeks, and also prove that the restrictions on imported products are evenhanded in how the design of the measure imposes them.²⁹ Toward this end, importantly, the CBAM will be made effective in conjunction with comparable domestic measures.

Must a measure of the type that is potentially entitled to a general exception be one that relates to the territorial jurisdiction of the WTO member applying that measure? Could the EU apply a unilateral measure to remedy a perceived health or environmental problem that is unrelated to the territory of the EU? The WTO Appellate Body has not ruled on the question of whether there is an implied jurisdictional limit to the application of unilateral measures affecting trade in furtherance of the policy goals contained in the general exceptions of what would otherwise be trade obligations.³⁰ However, just as endangered sea turtles swim across national territorial borders (as noted in a previous WTO dispute), so too does air circulate across national borders.³¹

The extraterritorial application of the EU CBAM would likely prove less significant in a WTO dispute than the question of how it is applied. For the EU will also have to prove that CBAM has been applied in a manner justifying its entitlement to one of the general exceptions. The CBAM must not be “applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between

countries where the same conditions prevail,” and it must not be “a disguised restriction on international trade.”³² The CBAM inspires a number of questions about whether it will satisfy these additional legal requirements.

As to whether the CBAM will be “arbitrary or unjustifiable discrimination,” a long string of WTO jurisprudence dating back decades shows that a measure must be evenhanded in its application to be entitled to one of the general exceptions.³³ Will the CBAM be evenhanded if the EU imposes its own climate standard on its trading partners without giving them a chance to suggest changes in that standard or to appeal the application of that standard to their products? It will not be enough for the EU simply to explain its chosen standard to these affected countries; the EU must engage in the due process of a mutual dialogue with them before setting and applying the standard in a way that takes the views of its trading partners into account.

Also, if the EU grants exceptions to the CBAM emissions certificate requirements to some WTO members solely based on what the EU perceives as the sufficiency of their carbon pricing and their other climate actions, will that discrimination be arbitrary or unjustifiable? What is the proper measure of such sufficiency? Is it whether another WTO member has enacted carbon pricing, whether it is keeping its promises of emissions-cutting under the Paris climate agreement, whether it has pledged to increase those promised emissions cuts, or something else? So far, the climate negotiators have been unable to agree on a single global standard for calculating carbon and other greenhouse gas emissions. Is it arbitrary or unjustifiable discrimination if the EU imposes its own standard on other countries?

The EU could grant exemptions from certificate payments for the least-developed countries that are WTO members. If enacted, this discrimination would not seem to be either arbitrary or unjustifiable. The least-developed countries are the poorest countries in the world. They have made the fewest carbon and other greenhouse gas emissions and yet are, in many cases, suffering the most from the consequences of the global extent of those emissions.

But what if the EU also decides to exempt products originating in the United States from the requirement to purchase emissions certificates? The United States has not adopted carbon pricing; President Joe Biden’s proposed climate policies are not law yet, and the polluter import fee

suggested by the Democrats is also not law. Based on the extent of its climate actions so far, is the United States more deserving of an exemption by the EU than, say, China?

And why is it not arbitrary or unjustifiable discrimination for the EU to be the sole judge of the sufficiency of the climate actions of other WTO members? Can the EU reach so far under the WTO rules as to impose its standard on the production processes of products made in other countries? Certainly, multilateralism has already been tried by the EU and the rest of the world on climate change, through three long decades of tortuous global negotiations. WTO jurists have also acknowledged that a WTO member can condition access of the products of other WTO members to its domestic market on whether those other members adopt or comply with a policy unilaterally prescribed by the importing member. But would not WTO approval of the CBAM leave other WTO members free to impose their own standards, and perhaps their own similar fees, on imported products from the EU based on global concerns other than carbon emissions?

It must be remembered that WTO obligations are not obligations to other countries or to individual traders; they are obligations with respect to the treatment of individual traded products. Thus, to prevent discrimination in the CBAM from being arbitrary or unjustifiable, it must be founded on an assessment of the carbon emissions that result from the production of individual products, and not on a judgment about the adequacy of the overall emissions cuts that have been made or promised by the countries from which those products originated. Emissions certificates must not be required for a product that was produced in a climate-friendly way just because it originated in a WTO member country that has taken no meaningful action to reduce emissions.

Lastly, as to any “disguised restriction on international trade,” here, too, the legal answer will be found in the structure and the design of the measure itself. As on the national treatment issue, the greatest vulnerability for the EU would be if it continued to grant free emissions allowances for select domestic producers. To fulfill its WTO obligations, the best course for the EU would be to resist domestic industry pressures and abolish these allowances. Keeping them as they are would be a fatal legal mistake. Phasing them out over time—even with the addition of purportedly equivalent

price offsets for certificates required of like imported products—may, in the end, not be enough to survive legal scrutiny in WTO dispute settlement.

CONCLUSION

The EU's CBAM would be the first climate-related trade restriction. This proposed new European restriction will, however, not be the last. Thus, these and other questions about the lawfulness of such measures under the WTO

NOTES

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treaty must be asked and answered. And far better to ask and answer them in negotiations between the EU and its trading partners now—before the CBAM is applied—than to wait and try to answer them amidst a global flurry of similar actions and counteractions that will have severe trade consequences. Without revision and without careful application, the EU's proposed CBAM may turn out to be inconsistent with fundamental WTO rules, and it may not qualify for one of the general health or environmental exceptions permitted under the WTO treaty.

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31. “United States—Import Prohibition of Certain Shrimp and Shrimp Products,” par. 133.

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33. See especially “United States—Import Prohibition of Certain Shrimp and Shrimp Products.”



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