

Making Carbon Border Adjustment proposals WTO-compliant

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Introduction

This note is prepared as a briefing document to help inform discussion at a roundtable on Carbon Border Adjustment Mechanisms (CBAMs). It examines at a high level whether a CBAM could be compatible with World Trade Organization (WTO) rules. At the time of writing, the most developed proposals to implement a CBAM have come from the European Union (EU) and so this note will mainly focus on that initiative.

This note is for discussion purposes only and does not represent advice or the opinion of any KPMG Member Firm.

EU Proposals

The EU has indicated its intention to introduce a Carbon Border Adjustment Mechanism (CBAM) no later than 2023 (<https://www.europarl.europa.eu/news/en/press-room/20210201IPR96812/carbon-levy-on-eu-imports-needed-to-raise-global-climate-ambition>). On 5 February 2021, The European Parliament's Committee on Environment, Public Health and Food Safety adopted a resolution on a WTO-compatible EU CBAM (https://www.europarl.europa.eu/doceo/document/ENVI-PR-648519_EN.pdf) 58 votes in favor, eight against and 10 abstentions. The European Parliament's Plenary is set to vote on the resolution in its session of 8-11 March 2021. The European Commission (EC) is expected to present a detailed proposal in the second quarter of 2021 for adoption in June 2021.

The media release announcing the passage of the resolution states that Members of the European Parliament (MEPs):

"... support the introduction of a WTO-compatible CBAM to place a carbon price on imports of certain goods from outside the EU, if these countries are not ambitious enough about climate change. This would create an incentive for EU and non-EU trade industries to decarbonize in line with the Paris Agreement objectives.

MEPs underline that it should be designed with the sole aim of pursuing climate objectives and a global level playing field, and not be misused as a tool to enhance protectionism."

The European Commission has stated many times that the CBAM will be designed in such a way as to ensure it is compliant with WTO rules. This paper sets out the CBAM design features considered necessary to ensure WTO compliance.

What form might an EU CBAM take?

The EU's consultation paper released on 22 July 2020 [[available here](#)] canvassed four options for a CBAM:

1. A tariff on imports at the EU border on selected products whose production is in industries that are at risk of carbon leakage;
2. An extension of the EU Emissions Trading System (EU ETS) to imports, requiring the purchasing of EU ETS emission permits by either foreign producers or importers;
3. A requirement on exporters to the EU to purchase emission permits from a pool separate from the EU ETS, at a price that would mirror the ETS price; and

4. A carbon tax on the consumption of selected products whose production is in sectors that are at risk of carbon leakage, which would also apply to EU production.

The resolution passed by the European Parliament's Committee on Environment, Public Health and Food Safety specifically links the CBAM to the EU ETS. Such an approach would rule out a carbon tariff (Option 1) and a carbon consumption tax (Option 4)¹.

That leaves Options 2 and 3. An obvious problem with Option 2 is that importers of products covered by the CBAM would bid up the price of permits in the EU market, increasing costs for producers within the EU. It is assumed, therefore, that any EU CBAM will be along the lines of Option 3. This could involve creating a pool of permits outside the EU ETS, dedicated to imports, that would mirror the prevailing EU price. Alternatively, it is possible that the CBAM could be a tax charged on imports, but the amount would be calculated according to the prevailing EU ETS permit price.²

Product Coverage

While, over time, the EU's CBAM might be extended to a large number of carbon-intensive imported products, it is understood it would initially apply to a fairly small selection. Frequently mentioned by EU officials and parliamentarians are: steel, aluminum, cement, chemicals, paper, glass and fertilizers.

In order to avoid carbon leakage following the establishment of the EU ETS, producers of goods such as steel, cement, chemicals and fertilizers were given free permits. Linking the CBAM price of imported products to the zero price of the same product produced with the EU would result in a zero CBAM price for those goods. The result would be an inconsequential CBAM. It is therefore assumed that a CBAM would be accompanied by a phase out of free permits.

How could a CBAM be WTO compliant?

Under WTO rules, a CBAM cannot:

1. Favor domestically produced goods over imports;
2. Discriminate against any individual trading partner;
3. Prevent exporters from calculating their own carbon intensities; or
4. Impose unduly harsh compliance costs on exporters.

1. The CBAM must not favor domestic production over imports

WTO compliance could be achieved if the CBAM price was sufficiently high to prevent carbon leakage – but no higher than that paid by domestic producers. That is, the CBAM price should not include a component of hidden trade protectionism.

If a country imposing a CBAM uses a carbon tax as its carbon pricing mechanism, the CBAM should therefore impose an import tariff which is no higher than the domestic tax.

However, where the domestic carbon pricing measure is an ETS (as in the EU) the price fluctuates, which could mean that a straightforward tariff could lead to an importer paying either more or less than domestic producers.

¹ However, the EC could still recommend Option 1. The final recommended option is not yet known.

² Comments made by Benjamin Angel, [Director Indirect Taxation and Tax Administration, DG TAXUD, European Commission](#), at the AFEP Webinar, "Trade and Climate: Friends or Foes" on 14 January 2021 suggests this may be the proposal the EC will make.

It is assumed this is the reason why it appears the EU proposal will be based on Option 3 above; that is, the CBAM charge will be effectively tied to the prevailing EU permit price.

2. The CBAM must not discriminate against any individual trading partner

A question arises as to whether a CBAM should apply to all exporting countries or – in order to reduce compliance costs – only to those which are considered to have low ambition for emission reductions.

In the EU context, there are indications that the CBAM would apply to some countries but not to others. For example, the resolution adopted by the European Parliament's Committee on Environment, Public Health and Food Safety:

“Strongly deplores the non-cooperative and disloyal behavior of some of the Union’s trade partners in international climate negotiations, as recently observed at COP25 and considers that this behaviour hampers our collective global ability to reach the objectives of the Paris Agreement”.

This appears to indicate that the EU is contemplating applying the CBAM only to those countries it considers have lower emission-reduction ambition.

However, if a CBAM provides exemptions for countries with high ambition, this could discriminate between imports based on their national origin. This is likely to be inconsistent with the WTO's Most Favoured Nation (MFN) obligation (in GATT art. I:1).

It would not be enough for a country exporting to a CBAM jurisdiction to issue a statement that it had high ambition, such as zero net emissions by 2050, if that ambition were unmatched by carbon pricing consistent with achieving the stated target.

To illustrate, consider steel imports from two countries: one with high ambition as reflected in a target of zero net emissions by 2050 and the other with low ambition. Now suppose steel imported from the high-ambition country was nevertheless produced using electricity generated by coal-fired power stations and the country's high ambition was not supported by a carbon price on its steel commensurate with the importing country's carbon price. This might occur, for example, on the basis that the high-ambition country categorized steel production as an emissions-intensive trade exposed industry and applied a carbon price at a rate below the generally prevailing rate in that country or exempted steel production from its ETS altogether.

Suppose, further, that steel from the low-ambition country was nevertheless produced using emissions-free hydroelectricity. Applying the CBAM to the low-emission steel from the low-ambition country while exempting the high-emission steel from the high-ambition country would violate the WTO rules requiring non-discrimination among countries.

In order to be WTO-compliant, a CBAM would need to be based on the actual emission intensity of products from various countries and not on the basis of countries being considered to have lower or higher ambition for overall emission reductions.

3. Exporters must be allowed to calculate their own carbon intensities

For reasons of administrative efficiency, a country applying a CBAM may wish to develop and apply its own estimates of the carbon intensities of particular products from each exporting country. Nevertheless, irrespective of whether the domestic carbon price is set by a carbon tax or an ETS, the cost impact on any domestic product will vary depending upon the carbon intensity of the actual production process.

By developing its own estimates of the carbon intensities of products from various countries, the CBAM country would apply averages, which for some products and countries would result in a carbon price being above the domestic price. For example, aluminum production in one country might have come from a plant using electricity

generated by renewable energy despite several other plants in the same country using electricity generated by fossil fuels. By applying an average that includes the fossil-fueled plants, a CBAM charge would be applied to the aluminum from the renewable energy plant that exceeds the charge allowable by WTO rules. Not allowing foreign producers to be levied according to their actual, individual intensities would be inconsistent with the WTO's national treatment obligation (as set out in GATT art. III:2).

4. The CBAM must not impose an unduly heavy compliance burden

The WTO's national treatment obligation would not prevent a country from developing its own estimates of carbon intensities for the products of various exporting countries. If exporters from those countries considered the estimates reasonable, they could accept them. But if an exporter insisted on developing its own estimate of the carbon intensity of a product it wished to export, it would need to be allowed to do so.

In these circumstances, the importing country would be obliged to avoid imposing unjustifiable compliance costs on exporters through unreasonable requirements in specified methodologies or through burdens of proof, such as factory inspections, that the product truly originated from a low-emissions plant.

Possible justifications for apparent WTO non-compliance

A GATT violation can still be justified under the WTO's general exceptions clause (GATT art. XX). The exceptions clause allows members to pursue legitimate domestic policy objectives that may affect international trade if they are applied in a non-discriminatory manner. One such permissible objective is the conservation of exhaustible natural resources. Another relates to the protection of human, animal or plant life or health. The CBAM regime could be acceptable under WTO exceptions because it relates to the conservation of exhaustible natural resources, notably the atmosphere, or to the protection of human, animal and plant life or health by contributing to mitigating the risks of climate change. It therefore contributes genuinely to the conservation and environmental protection goals – as long as it imposes restrictions equally on imports and domestic production.

Specifically, to be justified under the general exceptions clause a measure must not violate the conditions set forth in the *chapeau* of that clause (art. XX). The *chapeau* prohibits the application of the measure in a manner which constitutes "a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail" or "a disguised restriction on international trade."

Consequently, to the extent possible a CBAM must meet the following requirements:

- The environmental and conservation objectives must be front and centre in all the legislative processes, debates and detailed legislation relating to the development of the adjustment measure.
- The CBAM must be considered necessary to achieve the stated environmental and conservation objectives. Under WTO law, necessity is a holistic legal test requiring weighing and balancing of various factors, including the availability in the implementing country of less trade-restrictive alternative measures which might be able to achieve the same public policy results.
- The CBAM must be enforced with respect to domestic producers as well as all other WTO members in an even-handed manner without discrimination and without any disguised objective of protecting domestic producers.

In practice, in order for the general exceptions clause to apply in the case of a CBAM, it would need to be demonstrated that all imports from countries with similar conditions, including emissions reduction policies, were being treated equally. This would necessitate a demonstration of how the environmental standards or conditions existing in other countries were being assessed and duly considered when determining the applicability of the border adjustment measure.

For example, the use of domestic carbon emission averages to calculate the CBAM charge may be justifiable with reference to administrative feasibility if alternative measures were not available. However, to avoid the risk of non-compliance, any CBAM regime should allow exporters to quantify their actual emissions.

Comments on EU'S CBAM

The EU appears to prefer a CBAM linked to its own EU ETS such that exporters to the EU would be obliged to pay an amount based on the prevailing EU ETS permit price.

It is likely that this form of a CBAM can be made WTO-compliant. However, it would need to avoid including a component of hidden protectionism; not be based on the overall emission-reduction ambition of various exporting countries but on the actual emission intensities of particular products of different exporters; allow exporters to calculate their own carbon intensities; and avoid imposing unjustifiable compliance burdens on exporters through unreasonably onerous obligations or burdens of proof that a product truly originated from a low-emissions plant.

While some inconsistencies with WTO obligations might be justifiable on the basis of the WTO's general exceptions clause, these would likely be contested by complainant members and the outcome of inevitably protracted dispute-settlement processes would be highly unpredictable.

What are other jurisdictions doing?

The only other national proposals for a CBAM are those of Britain and the US. The US state of California operates a limited CBAM.

Britain

Britain left the EU at the end of 2019 and the transitional period finished at the end of 2020. Britain is in the process of developing an ETS based on the one it shared with the rest of the EU when it was a member. Enabling legislation for Britain's ETS has not yet been considered by Parliament but the UK government has indicated auctions of UK carbon permits will start no later than the second quarter of 2021. Details of the UK's scheme have already been announced. For a summary, see <https://icapcarbonaction.com/en/news-archive/737-uk-confirms-launch-of-ets-from-january-2021>

An important difference over time between the UK's ETS and the EU's ETS, is likely to be the level of ambition: Prime Minister Boris Johnson has set for Britain an objective of cutting emissions by 68 per cent by 2030, which is considerably higher than the EU's target of 55 per cent. Logically, this could be expected eventually to result in a UK carbon price higher than that yielded by the EU's ETS.

While the UK government has not yet announced that it will introduce a CBAM, this is a logical step in the context of the EU's implementation of a CBAM. If the UK's ETS yields higher carbon prices than the EU's ETS, owing to the UK's higher level of ambition, it is likely that any UK CBAM charge would be higher than that of the EU's CBAM.

United States

President Joe Biden's Plan for a Clean Energy Revolution and Environmental Justice (<https://joebiden.com/climate-plan/#>) includes proposals for 100 per cent carbon-free electricity by 2035 and US\$1.7 trillion in green investments over the next 10 years. The plan also includes a stated intention to introduce a CBAM, which it calls "carbon adjustment fees or quotas on carbon-intensive goods from countries that are failing to meet their climate and environmental obligations." No further details are available at this stage.

At the date of writing, the Biden plan does not include any indication of a carbon pricing mechanism to accompany its proposed CBAM.

Dr Janet Yellen, former Reserve Bank Chair and now Treasury Secretary said in 2020 (<https://www.reuters.com/article/us-usa-climate-tax-idUSKBN26T23L>) that countries that introduced CBAMs could form "carbon customs unions" compliant with WTO rules adding: "Our thinking is that countries with

carbon pricing would form essentially clubs, or carbon customs unions, within which there would be frictionless trade.” Dr Yellen was not, however, speaking for the Biden campaign and the campaign did not comment. Without more detail on the countries which would be involved, their carbon pricing mechanisms and how any associated CBAM would work, it is not possible to comment on whether such a “carbon customs union” would work.

California

California has a state-wide ETS covering around 85 per cent of the state’s carbon emissions. While a free-allocation system is in place to counter carbon leakage from most trade-exposed covered sectors, a form of border carbon adjustment is in operation for the electricity sector. California’s electricity sector is heavily interconnected with neighboring states as part of the Western Interconnection, as well as with parts of Canada and Mexico. Importers of electricity are required to submit emissions permits for their imported electricity based on their reported emissions intensities or a default factor for unspecified power generation sources.

Electricity is relatively straightforward in CBA design since it is a homogeneous product and data on emissions produced during power generation are generally available and of good quality.

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