KIEP Opinions

EU CBAM: Legal Issues and Implications for Korea

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Background

Following the announcement of the European Green Deal in 2019, the European Commission announced on 14 July 2021 a proposal[1] for establishment of the Carbon Border Adjustment Mechanism or "CBAM" as part of its “Fit for 55” legislative package. The Commission explained that in order to avoid carbon leakage and to level the playing field for EU producers it needs a mechanism to impose on imported carbon-intensive products the equivalent amount of carbon price as paid by EU producers.

According to the proposal, for the first three years from 1 January 2023 to 31 December 2025, EU importers of carbon-intensive products will be required to notify a competent authority of an EU Member State of the amount of embedded carbon emissions from their imported products.

[1] European Commission, Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism, 14.7.2021, COM(2021) 564 final, 2021/0214 (COD).

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Starting from January 1, 2026, they will additionally be required to purchase and surrender "CBAM certificates" according to the amount of embedded emissions in their imported products.

The EU alleges that the CBAM intends to avoid carbon leakage and induce voluntary climate mitigation efforts on the part of its trade partners. However, since the CBAM is not only an environmental but a *trade* measure, there is a controversy over its consistency with WTO law. This would not be the first instance where the EU's environmental ambition has set off international trade disputes, as have been witnessed in WTO disputes such as *EU and Certain Member States - Palm Oil (Malaysia)*(DS600) and *EU - Palm Oil (Indonesia)*(DS593), and also in the EU's previous attempt to incorporate international aviation into the EU ETS. Further, there will likely be significant "trade risks" for interested parties once the Commission's proposal becomes more materialized through the EU's ordinary legislative procedure.

Against this backdrop, this Opinion examines essential elements of the Commission's CBAM proposal and its compatibility with WTO law, and discusses some strategic implications for Korea's future negotiations with the EU.

Scope

Annex I of the proposal defines in detail the material scope, listing combined nomenclature (CN) codes of the carbon-intensive products. The CBAM will apply to steel, aluminum, fertilizers, cement, and electricity, only with respect to their direct emissions (Scope 1) and excluding indirect emissions (Scopes 2 and 3). The current scope of application is limited to upstream goods, and downstream products produced using the CBAM goods are, in principle,[2] not subject to carbon adjustment. As for the personal scope, the CBAM applies to imports from all non-EU states, except that the EU can exclude countries or territories if they have participated in the EU ETS or linked their ETS with the EU ETS. Accordingly Annex II of the proposal has excluded four countries[3] and five territories[4] so far.

Requirement to Surrender CBAM Certificates and Verification Requirement

Once the CBAM is fully implemented, only EU importers who are authorized by EU Member States can import CBAM goods into the EU. As "authorized declarants", they are required by

[2] As an exception, processed goods resulting from the inward processing procedure are subject to the CBAM. *See*, e.g., the Commission proposal, Arts. 2(1), 6(3), and 36(1).
[3] Iceland, Liechtenstein, Norway, and Switzerland. *Ibid*., Annex II, Sec. A.
[4] Büsingen, Heligoland, Livigno, Ceuta, Melilla. *Ibid*., Sec. B.

31 May each year to submit a declaration including the amount of verified embedded carbon emissions in their imported products, and purchase and surrender a number of CBAM certificates corresponding to the declared emissions to a competent authority. The price of CBAM certificates for each tonne of CO2-eq. is calculated as the average of the closing prices of EU ETS auctions during the previous week, thus mirroring the EU ETS price. The amount of embedded emissions of CBAM goods is to be calculated in accordance with Annex III of the proposal. Where importers cannot acquire accurate data for the actual amount of embedded emissions, a "default value" applies instead.

In terms of verification of their embedded emission, the proposal provides that (i) a person accredited under the EU ETS pursuant to Implementing Regulation (EU) No. 2018/2067[5] or (ii) a person accredited by a national accreditation body (NAB) pursuant to Regulation No. 765/2008[6] can serve as a verifier for the CBAM purposes, and that the European Commission can specify "conditions for the control and oversight of accredited verifiers, for the withdrawal of accreditation and for *mutual recognition* and peer evaluation of the accreditation bodies [emphasis added]" by adopting delegated acts pursuant to Article 28 of the same proposal.

Another distinguishable feature of CBAM certificates is that they have only limited validity compared to European Union Allowances (EUAs) under the EU ETS. An authorized declarant can request the competent authority to re-purchase only up to one third of total CBAM certificates excessively[7] purchased in the previous year. For the remaining certificates after the re-purchase, the competent authority shall cancel all of them by 30 June of the following year.

Possible Adjustments to CBAM Requirements

While the proposal provides that the number of CBAM certificates required to surrender is to be reduced on the account of the carbon price paid in a country of origin,[8] it only allows for such adjustment where an exporting country implements a carbon tax scheme or an emis-

[5] Commission Implementing Regulation (EU) 2018/2067 of 19 December 2018 on the verification of data and on the accreditation of verifiers pursuant to Directive 2003/87/EC of the European Parliament and of the Council

[6] Regulation (EC) No 765/2008 of the European Parliament and of the Council of 9 July 2008 setting out the requirements for accreditation and market surveillance relating to the marketing of products and repealing Regulation (EEC) No 339/93.

[7] This is partly due to the requirement that by the end of each quarter the authorized declarant shall deposit at least 80 per cent of the CBAM certificates required for their embedded emission "determined by reference to default values". The Commission proposal, Art. 22(2).

[8] The Commission proposal, Art. 6(2)(c).

sion trading system,[9] leaving out a plethora of other policy instruments for climate change mitigation, such as RPS, FITs, or direct emission regulations. The EU may conclude agreements with exporting countries for such CBAM adjustments. The proposal also provides for additional CBAM adjustments, which are scheduled to be implemented corresponding to a phased reduction of free allowances under the EU ETS. The Commission intends free EU ETS allowances for industries subject to the CBAM to be cut down by 10 percent points each year starting from 2026 and completely phased out by 2036.

WTO Compatibility

Firstly, with respect to the legal characterization of CBAM certificates, it remains not quite clear whether they should be seen as fiscal measures such as taxes or non-fiscal measures such as technical regulations or emission regulations. In the Opinion of Advocate General Kokott of *ATAA v. Secretary of State for Energy and Climate Change*[10] in 2011, it was held that the EU ETS is not a taxation system but a "market-based measure" mainly because the price of its allowances is not pre-determined as opposed to taxes and governed solely by supply and demand in the market.[11] Unlike EU ETS allowances, however, trade in CBAM certificates or trade with EU ETS allowances is not allowed. Also, since the price of CBAM certificates simply mirrors the average auction price of EU ETS allowances on the previous week, and is *not* decided according to supply and demand, the price appears to be pre-determined and thus fits the definition of a "tax". If determined to be a fiscal measure, the CBAM will be scrutinized under Article III:2 of the GATT. If determined to be of a non-fiscal character, it will be subject to Article III:4 of the same Agreement, possibly providing a tad bit more leeway for the EU in defending its measure. Not only in the legal sense but in terms of the CBAM's legitimacy it might be strategically inconvenient for the EU if the CBAM is categorized as a taxation system, as many countries associate additional taxes with trade barriers and protectionism. Further, multilaterally and bilaterally via WTO/FTAs, the EU has already conceded to zero tariffs for most of the steel and steel products falling under HS/CN codes 71 and 72. Thus for many of the EU's trading partners,[12] if determined as a tax, the CBAM could almost feel as if the EU were reintroducing tariffs on steel and steel products,

[9] The Commission proposal, Art. 3(23).

[10] OPINION OF ADVOCATE GENERAL KOKOTT delivered on 6 October 2011 in Case C-366/10, *Air Transport Association of America and Others v Secretary of State for Energy and Climate Change*.

[11] *Ibid*., paras. 215-216.

[12] For many of the EU's trading partners including Korea (3,018,451,000 USD, based on export values of 2019), following China (USD 5,005,107,000), Russia (4,716,548,000), UK (4,059,987,000), Turkey (3,608,202,000), and India (3,626,555,000), the steel and steel products industry is expected to be most affected by the CBAM. See Cheon-Kee Lee, Ji Hyun Park and Hyeri Park (2021), "EU Carbon Border Adjustment Mechanism: Legal Analysis and Implication for the Korean Industries," KIEP World Economy Today, Vol. 21, No. 15, p. 23. (in Korean)

possibly in excess of the EU's bound tariff rates under WTO/FTA schedules of concessions.

Secondly, as regards possible inconsistencies with WTO law, CBAM seems highly likely to be determined as a *prima facie* violation of Articles III and I of the GATT as a *de facto* discrimination between EU products and imported products, and between imported products, respectively. This is because the amount of the certificates to be surrendered under the CBAM depends on the amount of embedded emissions during the production process of the covered goods in exporting countries. Thus the CBAM constitutes a measure based on non-product-related process or production methods or "NPR PPMs". GATT/WTO jurisprudence has categorically declined to consider NPR PPMs in determining a discrimination under Articles I and III of the GATT. More specifically, panels and the Appellate Body have ruled consistently that NPR PPMs are irrelevant in determining likeness between products. Thus, by differentiating the amount of CBAM certificates to be surrendered (i.e. the CBAM imposition level), which appears to be an indispensable element to fulfill the EU's objective, it would be systematically unavoidable that the CBAM will get to discriminate between like products in the sense of Articles I and III of the GATT. Additionally, in looking at the details of the proposal, one might find quite easily that the CBAM bears a number of distinguishable elements from EU ETS: (i) by setting and applying "default values" as the emission amount of 10% of the worst performing installation in the EU, the CBAM practically introduces the principle of adverse inference at possible risk of abuse, while the same principle cannot be found under the EU ETS; (ii) as pointed out earlier in this Opinion, CBAM certificates are valid only for a very limited period of time due to the proposal's cancellation requirement, in contrast to EU ETS allowances which remain valid throughout the entire Phase 4 of the EU ETS, by 2030. Thus while participants under the EU ETS can choose favourable buying prices and even hoarding appears possible, authorized declarants under the CBAM will not be able to do the same. Such systemic differences can lead to price differences, and in turn induce EU downstream producers to favour EU-made CBAM goods over imported ones. Also, (iii) the requirement on authorized declarants to maintain for their imported products 80 per cent CBAM certificates of default values calculated based on *adversely-inferred, practically worst available technologies* seems problematic. The CBAM is designed to apply retrospectively. A yearly payment for imported products' embedded emission is to be made by 31 May of the following year. Thus a certain form of deposit would be necessary, as commonly can be found in countries using a retrospective antidumping imposition system such as the United States. Even given such practical inevitabilities, the Commission's idea to use default values as a benchmark for a quarterly deposit requires reconsideration in order to avoid an apparent violation of the non-discrimination principle of Article III of the GATT.

Thirdly, the Commission's proposal remains quite blurry when it comes to its plan for the use of CBAM revenues. In order to defend the CBAM as a measure for environment protection under Article XX(b) or (g) of the GATT as an affirmative defense, the EU would need to provide clarification on its position to use CBAM revenues to recover the European economy after COVID-19, as has been stated in its *Recovery Plan for Europe* of 27 May, 2020. In order to successfully invoke Article XX GATT, the EU would bear the burden of proof in demonstrating that the CBAM is an environmental measure necessary to protect human life or health or related to conserving exhaustible natural resources. A measure taken to help economic recovery is not one of the exceptions allowed under the GATT. The EU has repeatedly argued that the CBAM is consistent with its international obligations including the WTO agreements. Since, as this Opinion has explained earlier, the CBAM would be systemically difficult to comply with the non-discrimination obligations under the GATT, it is going to be very important that the EU should and will be able to show the object and purpose of the same measure is purely environmental, not trade protectionist.[13]

Implications for Korea

It should be noted that the Commission's proposal of 14 July 2021 is not the final version of the EU carbon border adjustment. The Commission's proposal is subject to the EU's ordinary legislative procedure. It is currently being examined by the European Parliament and the European Council, and there can be structural and substantive changes or modifications until the final legislation. Further, there are still many elements to be filled by the European Commission itself, such as a more detailed rule for CBAM verification and accreditation of CBAM verifiers; the definition and the scope of "slightly modified products" for anti-circumvention of the CBAM regulation; a calculation method and formula of embedded emissions and the definition and the scope of "system boundaries"; and CBAM adjustment methods and timelines corresponding to EU ETS free allowance reduction, etc. Accordingly, close monitoring is needed for any development of the CBAM's legislative process. Once the mechanism is

[13] Accordingly, this Opinion suggests that comments such as the following in the CBAM Explanatory Memorandum of 14 July 2021 are not really helping EU's case: "Most revenues generated by CBAM will go to the EU budget. In the special European Council of 17-21 July 2020, EU leaders agreed on the recovery instrument NextGenerationEU. The instrument will provide the EU with necessary means to address the challenges posed by the COVID-19 pandemic and, therein, support investment in the green and digital transitions. In order to finance it, the Commission will be able to borrow up to EUR 750 billion on financial markets. In that context, the European Parliament, the Council and the Commission agreed that 'the Institutions will work towards introducing sufficient new own resources with a view to covering an amount corresponding to the expected expenditure related to the repayment' of NextGenerationEU. The Commission committed to put forward proposals on new own resources, which would include the CBAM in the first semester of 2021[emphasis added]". *See* European Commission, *Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism - EXPLANATORY MEMORANDUM*, 14 July 2021, pp. 10-11.

deemed to be virtually finalized by the European Parliament and the European Council to a certain degree of stability and legal predictability, the Korean government would need to redo its assessment previously based on the Commission's proposal on the CBAM's advantages and disadvantages for our industries. This also means there is still time for our industries and the Korean government to discuss with the EU for any of its concerns, requests or suggestions about the CBAM. Particularly, this Opinion expects that an early (or at least a draft) agreement for mutual recognition for verification of embedded carbon emissions in the context of Article 18(3) of the proposal would be the most significant outcome of such process. Lastly, as there are a number of trade concerns that both sides might wish to discuss bilaterally, including industrial subsides and competition issues, EU's recent extension of the steel safeguards and Korea's notification to the WTO for possible retaliation for EU's said measure,[14] this Opinion suggests that a package dialogue could be one way to effectively pursue such dialogue with the EU.KIEP

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[14] Korea's notification is strictly based on Article 8 of the WTO Safeguard Agreement, not a unilateral one. *See*, e.g., G/SG/N/8/EU/1 (4 January 2019).