

# Taxing carbon at the border: Current state of play

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## Takeaways

- Under the EU's CBAM, importers will be required to pay for carbon-intensive imports into the EU
- The EU is expected to introduce its CBAM in 2023, and other countries are currently discussing the introduction of their own measures
- The EU's measures will likely set the pace, with possibly conflicting rules adopted elsewhere
- Calculating carbon contents of imports and payments will require significant preparation work from exporting and importing companies
- Covered goods do not include energy goods yet



The European Union (EU) and a growing number of countries around the world are working on taxing at their borders the greenhouse gas (GHG) emissions embedded into imported products. This is seen, especially in Europe, as the only way to adopt an ambitious agenda for reducing GHG emissions and creating a level playing field where domestic and third-country producers pay the same level of emission rights or tax for the same product.

With its Carbon Border Adjustment Mechanism (CBAM) proposal, the EU takes the lead in setting up such a field, but other environmentally impactful countries, including the United States, are discussing their own measures. In this article, we take stock of the CBAM, and similar initiatives in the United States, Canada, the United Kingdom, South Korea, and China, and we explore what they mean for global businesses and the energy sector.

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The EU is expected to introduce the CBAM in 2023, which means that payment of CBAM certificates upon importation would already be required in 2026. Calculating how much is to be paid at the EU border will require knowledge of how much carbon is embedded in the imported product. Alternatively, the importing company can demonstrate that it has already paid emission rights elsewhere. The EU will indeed recognize certain foreign emissions reduction schemes as equivalent to the EU's own Emissions Trading System (ETS). Such "equivalence recognition" is mainly determined through bilateral discussions between the EU and the third country concerned. This bilateral engagement with the EU is likely to create an incentive for third countries to develop their own emissions reduction measures, which may lead to multilateral harmonization among like-minded countries. However, we are likely to see in the interim period a patchwork of different carbon pricing systems in different jurisdictions before countries agree to create a global or plurilateral carbon pricing system. The CBAM and similar schemes are also likely to apply to a rapidly growing list of products that will extend beyond the current products and commodities in scope. This is an area to watch, urgently.



## European Union

The European Commission tabled a [proposal](#) implementing the CBAM on July 14, 2021. This proposal is now with the EU's two co-legislators: the European Parliament and the European Council. The Council already approved the Commission's draft proposal, with minor changes, in March 2022. The Parliament is expected to adopt its own version, in June 2022. The text will then be finalized by the Parliament and the Council, in the presence of the Commission (a process known as a "trilogue"). The legislative process is expected to be completed by the end of the year.

The proposed CBAM aims to guarantee that carbon emissions embedded in imported goods are equally taxed in comparison with domestic productions, the latter being currently subject to the EU Emissions Trading System (ETS). This means that EU importers must pay for the carbon embedded into CBAM-targeted goods that are placed on the EU market by purchasing CBAM certificates upon importation.

The CBAM is expected to enter into force as early as 2023 in a transitional form, and it is likely to fully apply from 2026. During the transitional period (2023-2025), EU importers will have to comply with reporting requirements, but will not need to purchase CBAM certificates yet. Once the CBAM is fully in place from 2026 onward, importers will be required to purchase CBAM certificates in order to import CBAM goods into the EU.



The key features of the CBAM, once it is fully in place from 2026, are as follows:

- **Targeted sectors:** Five emissions-intensive, trade-exposed industries under EU ETS are targeted in the current proposal. In the first phase, the CBAM will impose a carbon price on imports of cement, fertilizers, iron and steel, aluminum, and electricity. However, the EU's ultimate objective is a broad product coverage of the CBAM, possibly including energy and other products.
- **Authorized declarants:** CBAM goods must be cleared through customs by declarants who are authorized to do so.
- **CBAM declaration:** EU importers must submit a CBAM declaration for the preceding year on the number of imported goods and their total (verified) embedded emissions. Embedded emissions in imported goods will be calculated on the basis of direct emissions of GHG per ton of goods produced in the production installations.
- **CBAM certificates:** EU importers must purchase CBAM certificates corresponding to the embedded emissions in the imported goods. The embedded emissions are either based on the default value or on the actual proven emissions, if lower.
- **Carbon prices already paid in the country of origin:** CBAM certificates can be reduced to account for carbon prices already paid in the country of origin, but this needs to be certified by an independent person.
- **Geographical exemptions:** Countries that adopt the EU ETS (Iceland, Norway, and Liechtenstein) or are linked with the EU ETS (Switzerland) are exempted from the CBAM. The EU will further elaborate a mechanism for other third countries to be exempted in the future.

While the CBAM may not initially cover energy products, it is expected to expand its targeted sectors quickly. For instance, before 2026, the Commission will consider broadening the CBAM to sectors identified as having the highest risk of carbon leakage in Decision (EU) 2019/708, which includes hard coal, crude petroleum, iron ores, non-ferrous metal ores, and others. It is therefore important for companies to pay close attention to the further development of the CBAM, even after its implementation.



## United States

The United States is considering the implementation of its own mechanism to tax carbon emissions at the border, although it trails the EU in the development of such a program due to a lack of consensus in Congress.

In July 2021, similar versions of legislation creating the [Fair, Affordable, Innovative and Resilient Transition and Competition Act \(FTCA\)](#) were introduced in the House of Representatives and the Senate. The legislation seeks to impose a cost on the GHG emissions associated with imported goods “to account for the marginal increased costs incurred by U.S. businesses to comply with laws and regulations limiting greenhouse gas emissions.” The bills require the Treasury Department to determine (1) the costs that U.S. companies in the covered sectors incur to comply with U.S. environmental policies, and (2) the quantity of greenhouse gas emissions associated with the production of each covered good.

### As drafted, the FTCA would, among other things:

- Impose a “border carbon adjustment” fee on imports of carbon-intensive goods into the United States, including but not limited to steel, aluminum, cement, and fossil fuels.
- Apply to regulated products made with “covered fuel,” defined as natural gas, petroleum, coal, or any other product derived from natural gas, petroleum, or coal that is used or may be used so as to emit GHGs into the atmosphere.

Unlike its EU counterpart, the FTCA is not accompanied by an equivalent domestic tax or price on carbon emissions per se – but it would impose a residual cost to offset the carbon emission costs incurred by compliant U.S. businesses.

The FTCA faces some hurdles. First, it has not advanced far (in terms of the congressional committee review process) after almost nine months. For example, the House version of the FTCA was introduced by a Democrat and was only co-sponsored by one other Democrat. Since being introduced, it has been referred to several different committees but has failed to pass out of any committee, let alone come up for a vote on the floor of the House, after which it would need to be approved in the Senate, where bipartisan approval will likely be needed and will be harder to achieve. Second, it is likely that ongoing conflict in Ukraine will further raise energy prices, which makes it less likely that the FTCA will pass in the near term. Finally, any U.S. carbon border adjustment will be scrutinized closely by U.S. trading partners, both in terms of its impact on trade flows and its consistency with World Trade Organization rules.

However, there are some existing CBAM-like programs in the United States that could create a precedent for future federal regulation in this area. California already has its own [Low Carbon Fuel Standard \(LCFS\)](#). The LCFS incentivizes regulated companies to utilize transportation fuels with relatively low carbon intensity (CI) in gas, diesel, and alternative fuel substitutes. CI is measured and benchmarked, with regulated parties needing to prove compliance with the fuels they sell in California.

The CI of each regulated fuel/substitute has to be measured through an approved “pathway” that will calculate carbon emissions associated with the fuel and its transport into California from anywhere in the world. Relatively low CI fuels generate “credits.” High CI fuels that are above the benchmark are issued “deficits.” Regulated parties above the benchmark can offset their compliance deficits and meet the benchmark by purchasing credits from compliant parties. In this way, the LCFS program incentivizes parties to transition to low CI fuels and substitutes to avoid these extra offset purchase costs.

Other states, including [Washington](#) and [Oregon](#), have developed, or are developing their own LCFS or “Clean Fuels” programs. These states have coordinated with British Columbia to collectively form the [Pacific Coast Collaborative](#) for, among other carbon-reduction initiatives, forming a west coast LCFS trading market. New York and New Mexico are considering LCFS programs, as are other states.



## Canada

Canada has shown interest in using a CBAM-like measure to tax carbon emissions at the border so as to reach its United Nations Framework Convention on Climate Change (UNFCCC) goals (for example, the stated 2021 goal of a 40-45 percent reduction below 2005 levels by 2030). Canada's version of the measure is called Carbon Border Adjustments (CBAs).

In August 2021, Canada issued a lengthy "Consultation" on "[Exploring Carbon Adjustments for Canada](#)." Among other topics, the Consultation considered the potential of CBAs both for import charges and export rebates. Examples include:

- Import charges applied to goods from countries that either do not have carbon pricing or apply a lower carbon price to ensure that they face similar carbon costs (such as per unit of emission resulting from the production of a good) to those that apply to domestic producers.
- Other measures that could apply a carbon price to imported goods include a domestic tax or charge levied on both high-carbon domestic and imported products or a requirement that emissions allowances be purchased for imported goods based on their carbon intensity.
- Export rebates provided to producers so that domestically produced goods compete on equal footing in foreign markets, alongside goods from countries with limited or no carbon pricing.

The Consultation pointed out the many complexities of using CBAs, including the impact on international trade. All of these hurdles were identified prior to recent developments in Ukraine, which will only complicate supply and demand issues further. The Consultation came to a non-committal conclusion that "[...] the Government intends to continue its discussions with Canadians and international partners over the coming months on this issue."

Since the Consultation was published, there appears to have been relatively little advancement on CBAs. First, the [2022-2023 Departmental Plan](#) from [Environment and Climate Change Canada](#) does not list CBAs as part of its named tools for achieving climate change goals during this period. Second, a March 22, 2022 search for pending legislation currently introduced in either the Canadian Senate or House of Commons returned no results when searching for "carbon border adjustments."

## United Kingdom

Currently, the United Kingdom partially addresses the risk of carbon leakage through the UK Emissions Trading Scheme, which grants free allowances for emissions to manufacturers at risk of carbon leakage.

In September 2021, an inquiry into the merits of introducing a mechanism to tax carbon emissions at the border was launched by the [Environmental Audit Committee](#) (EAC) of the UK Parliament. It aimed at collecting evidence to assess the role of such a mechanism in targeting carbon leakage risks and its potential role in broader long-term environment objectives, like decarbonization.

At the moment, the potential adoption of a UK CBAM is under assessment and no specific timelines have been published yet. Meetings on the UK CBAM at the EAC are still ongoing. A UK CBAM, in line with the EU initiative, would further address the risk of carbon leakage in the sectors that are caught by the UK ETS.





## South Korea and China

South Korea and China also address the risk of carbon leakage through their own emissions trading system:

- South Korea launched its emissions trading system (K-ETS) in January 2015, which was East Asia's first nationwide mandatory ETS and, at the time, the second-largest carbon market after the EU ETS. The K-ETS covers 685 of the country's largest emitters, accounting for 73.5 percent of national GHG emissions. It covers direct emissions of six GHGs, as well as indirect emissions from electricity consumption. The K-ETS plays an essential role in meeting South Korea's 2030 updated NDC target of a 24.4 percent reduction from 2017 emissions. In 2021, the K-ETS entered its third phase.
- After China launched its national ETS politically in December 2017 and built on its experience of piloting carbon markets in eight regions, it launched the national ETS in 2021. Key pillars of the development of the national ETS include reporting and verification of historical emissions data from eight emission-intensive sectors; development of the national registry, trading system, and national enterprise GHG reporting system; set-up of the legislative and regulatory framework; and capacity building. The existing Chinese regional ETS pilots are gradually transitioning into the national ETS.

At the moment, South Korea and China are not discussing a CBAM-like initiative in concrete terms. Rather, their focus is on how to address and limit the potential impacts of the introduction of the EU CBAM. In this context, some have flagged the introduction of a Chinese and South Korean CBAM-like mechanism, but this has not been followed up with concrete legislative proposals yet.

## Authors

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Adam is a partner in the London office and has 12+ years of experience advising on a broad spectrum of UK, EU and international environmental, health & safety, product compliance, carbon market and climate change law matters. He has a particular focus on the environmental aspects of ESG, and regularly advises on key topics, such as: climate change adaptation and mitigation projects; climate-related corporate reporting; carbon offsetting and neutrality objectives; renewables and alternative/sustainable fuels regulation, compliance and incentive schemes. He also regularly works on EU and international carbon and climate-related transactions, advisory matters and disputes, including emissions regulation, carbon trading and climate financing projects. His experience spans cap-and-trade schemes such as the EU, UK and Swiss ETS and regulatory / voluntary carbon offsetting schemes, including the UNFCCC CDM, the emerging Paris Agreement Article 6 mechanisms, CORSIA, REDD+, Gold Standard, VCS, etc. Adam is also experienced in EU renewable energy/fuel laws, and claiming/trading of UERs, RTFCs and other forms of green certificate. He has regularly been ranked as a "rising star" by *Legal 500* and as "up and coming" by *Chambers UK*.





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Todd is a partner in the San Francisco office with more than 30 years of experience helping clients maximize business opportunities and manage risks associated with environmental, energy, climate change and ESG/sustainability issues. He particularly prides himself on understanding his client's motivations and risk tolerances to provide cost-effective and practical guidance. His practice ranges from regulatory and business counseling to negotiating corporate and real estate transactions, as well as resolving administrative enforcement actions and litigation matters. Todd is also a member of the firm's global environmental, social and governance (ESG) advisory committee. He has a particular focus on the environmental and governance aspects of ESG.

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Yves has 20 years of experience as an international trade and customs lawyer in Brussels. He concentrates on trade remedies (anti-dumping measures, countervailing measures and safeguards re-balancing duties), customs laws and procedures, sanctions, export and import controls, and carbon trading and border adjustment. Yves has represented clients in more than 100 trade remedy investigations, and before the EU Courts in more than 30 disputes relating to international trade and customs laws, including in the landmark cases *Ikea Wholesale* (C-351/04), *XinYi PV* (T-586/14) and *Jiangsu Seraphim* (T-110/17) cases. He is part of the firm's global environmental, social and governance (ESG) practice, with a particular focus on supply chain due diligence and the enforcement of environmental (carbon border adjustment, deforestation, etc.) and labour (anti-slavery, compliance with ILO conventions) standards for goods crossing the EU's and the UK's borders. Yves is a member of the Editorial Board of the *Global Trade and Customs Journal* (Kluwer), a research fellow in customs and trade law at the University of Liège and a lecturer in Antwerp, Liège and Porto.

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