The EU Carbon Border Adjustment Mechanism in Seven Questions for MENA Industries

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On 14 July 2021, the European Commission published a proposal for a regulation establishing a carbon border adjustment mechanism ("***CBAM***"). The proposed regulation is part of the European Union's ("***EU***") initiatives to address climate change, in line with the objectives of the Paris Agreement.[1]

According to the European Commission, the CBAM is meant to address the risk of carbon leakage in order to fight climate change by reducing greenhouse gas ("***GHG***") emissions, both in the EU and globally.[2] Carbon leakage refers to the situation that may occur if, for reasons of costs related to climate policies, businesses were to transfer production to other countries with less stringent emission constraints or imports from these countries were to replace equivalent but less GHG intensive products due to differences in climate policy stringency.[3] In other words, the CBAM aims to create a level playing field for EU domestic producers, who will be subject to ever more stringent climate regulations and third-country producers, who might otherwise gain a significant comparative advantage due to laxer environmental regulations abroad.

The CBAM will affect some goods imported into the EU that are carbon-intensive to produce. In particular, the proposal will impose **a price on GHG emissions embedded in certain aluminium and steel products, cement, fertilizers, and electricity** (the "***CBAM Products***") **imported from third countries.**

Middle East and North Africa ("***MENA***") exporters of the CBAM Products will likely be affected by the measure. Exports from several MENA economies represent a significant portion of the CBAM Products imported into the EU, particularly from Egypt and several Gulf Cooperation Council ("***GCC***")[4] countries like the UAE and Bahrain.

This article, therefore, answers seven frequently-asked questions about the impact of the proposed CBAM for MENA industries. These answers will guide MENA producers who wish to prepare their operations to comply with the CBAM.

Lastly, it is essential to note that the proposed CBAM regulation is merely a draft and not yet final. As it currently stands, the draft also provides that several important details relating to the operation of the CBAM will only be determined by the European Commission, at a later date, through delegated and implementing acts. Therefore, all information in this article is subject to change when the regulation is finally adopted and implemented.

1. What is the Carbon Border Adjustment Mechanism?

According to the European Commission proposal, the CBAM imposes an obligation on EU importers to purchase and surrender CBAM certificates corresponding to the amount of GHG emissions embedded in

1 European Commission, Proposal for a Regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, COM(2021) 564 final, 14.7.2021 ("***Proposed Regulation***"), available here.
2 Proposed Regulation, Explanatory Memorandum, p. 2.
3 European Commission, Climate Action, available here.
4 The GCC countries are Saudi Arabia, United Arab Emirates, Bahrain, Kuwait, Oman, and Qatar.

CBAM Products originating in third countries. EU importers must buy CBAM certificates at the carbon price that would have been paid had the goods been produced under the EU's carbon pricing rules (*i.e.*, the EU Emissions Trading System ("***EU ETS***")).[5] However, if a non-EU producer can show that it has already paid a price for the carbon emitted in producing the imported goods under a carbon-pricing scheme in a third country, the corresponding cost could be deducted for the EU importer.[6]

Initially, only *direct* emissions of GHG from the production of the CBAM Products will be taken into account to determine the amount of CBAM certificates that must be surrendered.[7] Direct emissions, in contrast to indirect emissions, are emissions from the production processes of goods over which the producer has direct control.[8] Albeit not yet fully specified in the Proposed Regulation, direct emissions may refer to emissions from combustion in owned or controlled boilers, furnaces and vehicles, in addition to emissions from chemical production in owned or controlled process equipment.[9] By contrast, indirect emissions refer to emissions from electricity, heating, and cooling consumed during the production process.[10] After a transitional period of three years and subject to an assessment by the European Commission, the CBAM may also apply to indirect emissions in the future.[11]

Under the proposed system, the carbon content of the CBAM Products will be established through several alternative means. First, importers will have the opportunity to demonstrate the actual emissions embedded in their CBAM Products, which must be assessed and then verified by an accredited verifier. If the actual emissions cannot be adequately determined, the carbon content will be based on default values calculated by the EU authorities. These default values may be country-specific values. If no reliable data is available for an exporting country, the default value will be based on the 10% of the EU's worst-performing installations.[12]

2. Which Products are Subject to the CBAM?

The CBAM will initially apply to goods considered by the EU as highly exposed to carbon leakage. Other products are also included despite their low level of embedded emissions in order to prevent circumventing the scope of the CBAM Products by modifying the pattern of trade towards downstream products.[13]

The sectors targeted by the CBAM are the aluminium, iron and steel, fertilizers, cement, and electricity industries. The Proposed Regulation includes an annex with the specific list of goods subject to the CBAM and their European harmonized system tariff codes.[14]

Of particular importance to MENA countries are the aluminium, iron and steel, and fertilizer products. The aluminium products covered by the CBAM include unwrought aluminium, aluminium powders and flakes, and aluminium bars, rods, sheets, plates, wires, tubes and fittings. The iron and steel products include almost all

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5 The EU carbon pricing rules are based on the EU Emissions Trading System (EU ETS). The system works on the "cap and trade" principle. A cap is set on the total amount of certain GHG that can be emitted by the installations subject to the EU ETS. Within the cap, installations buy or receive emissions allowances, which they can trade with one another as needed. After each year, an installation must surrender enough allowances so as to cover its emissions in full. If an installation reduces its emissions, it can keep the spare allowances in order to cover its future needs or else sell them to another installation that is short of allowances. The cap is reduced over time so that total emissions fall. *See* European Commission, EU Emissions Trading System (EU ETS), available here.

6 Proposed Regulation, Article 9.

7 *See* Proposed Regulation, Recital 17.

8 Proposed Regulation, Article 3(15).

9 *See* Sinwoo Lee, Dong-Woon Noh, and Dong-hyun Oh, Characterizing the Difference between Indirect and Direct CO2 Emissions: Evidence from Korean Manufacturing Industries, 2004–2010, *Sustainability, 01 August 2018, available* here.

10 Proposed Regulation, Article 3(28).

11 Proposed Regulation, Recital 17.

12 Proposed Regulation, Article 7 and Annex III.

13 Proposed Regulation, Recital 35.

14 Proposed Regulation, Annex I.

iron and steel in their primary forms (products generally classified under Chapter 72 of the Harmonized System (HS)), including other worked products such as tubes and fittings, structures, and railway materials. The fertilizers include nitric acid, sulphonitric acids, ammonia, and mineral and chemical fertilizers.

It is important to note that the ultimate objective of the CBAM is a broad product coverage beyond the sectors initially selected. The European Commission has confirmed that it has commenced with several sectors with relatively homogeneous products at risk of carbon leakage. These sectors were selected to test the application of the CBAM.

However, the list of sectors deemed at risk of carbon leakage by the EU is broad.[15] These sectors are already covered by the EU ETS, and the CBAM is intended to eventually reflect the activities of the EU ETS.[16] If the CBAM is successful, the European Commission will likely expand its application to other sectors covered by the EU ETS, beyond aluminium, iron and steel, fertilizers, cement, and electricity.[17] Some of these sectors are extremely important for MENA economies. They include, for instance, the extraction of crude oil, refined oil products, plastics, and organic and inorganic basic chemicals.[18]

In conclusion, beyond the initially proposed sectors, the CBAM will likely impact other MENA industries in the future.

3. Are All Countries Subject to the CBAM?

The Proposed Regulation exempts imports from certain third countries and territories from the measure. The exemptions are granted to third countries subject to the EU ETS or that have a domestic emissions trading system linked to the EU ETS under an agreement with the EU.[19] The exempt countries are Switzerland, Norway, Iceland and Liechtenstein, as well as other European territories.

4. When Will the CBAM Be Implemented?

The European Commission intends to introduce the CBAM for a transitional period commencing on 1 January 2023 and ending on 31 December 2025. The purpose of the transitional period is to facilitate a smooth rollout of the mechanism and reduce the risk of a disruptive impact on trade.

During this period, a CBAM without financial adjustment will apply. This means that, until the end of 2025, EU importers will have an obligation to report on a quarterly basis the actual embedded emissions in the CBAM goods imported, detailing direct and indirect emissions and any carbon price paid abroad. However, importers will not be liable to buy any CBAM certificates as of yet.[20]

5. Which MENA Industries Will Likely Be Impacted by the CBAM?

According to the European Commission's assessment, several MENA countries are among the countries that would potentially be most exposed to the CBAM. The European Commission has determined that Egypt,

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15 Commission Delegated Decision (EU) 2019/708 of 15 February 2019 supplementing Directive 2003/87/EC of the European Parliament and of the Council concerning the determination of sectors and subsectors deemed at risk of carbon leakage for the period 2021 to 2030 (OJ L 120, 8.5.2019, p. 2) ("***EU Sectors and Subsectors Deemed at Risk of Carbon Leakage***"), available here.

16 Proposed Regulation, Recital 26.

17 *See* Proposed Regulation, Explanatory Memorandum, p. 6 and Article 30.

18 EU Sectors and Subsectors Deemed at Risk of Carbon Leakage, Annex.

19 Proposed Regulation, Recital 14 and Article 2(5)(a).

20 Proposed Regulation, Annex II.

Algeria and Morocco are among the top affected countries with exporters in most of the CBAM initial sectors.[21] Moreover, several other MENA countries, including most GCC member states, appear on the list of top 30 exporters in each of the four sectors subject to the CBAM, as detailed below.

In aluminium, 85% of EU imports come from 10 exporters, which include the UAE and Bahrain, each representing 8% and 3% of such imports, respectively.[22] In addition, Saudi Arabia (19th), Oman (24th), and Qatar (28th) appear on the list of the top 30 exporters to the EU.[23]

With respect to fertilizers, 85% of imports are accounted for by five countries, including two MENA countries, namely, Egypt (21%) and Algeria (20%).[24] Moreover, Libya (16th), Oman (17th), Saudi Arabia (18th), Tunisia (21st), and Qatar (28th) appear on the list of the top 30 exporters to the EU.[25]

For cement, Algeria (6%), Morocco (5%), and Tunisia (3%) are among the top exporters that account for about 80% of the total imports to the EU. Saudi Arabia, Kuwait, Jordan, and the UAE occupy the 12th, 25th, 28th, and 29th place on the list of top 30 exporters to the EU, respectively.[26]

Finally, for steel, Tunisia, Egypt, the UAE, and Saudi Arabia occupy the 17th, 21st, 23rd, 25th, and 30th place on the list of the top 30 exporters to the EU, respectively.[27]

Irrespective of the quantity of their exports, however, all MENA exporters of CBAM Products will be subject to the CBAM if they wish to continue their export to the EU.

6. How Can MENA Exporters Prepare for the CBAM?

The implementation of CBAM will entail a significant administrative burden and costs for businesses. Therefore, third-country producers must start immediately to establish the necessary administrative capacity to prepare for the CBAM. Early preparation will also ensure that producers minimize the potential trade disruptions caused by the CBAM.

According to the Proposed Regulation, EU importers are obliged to make all declarations and filings concerning the embedded emissions in their imports. Moreover, should EU importers opt to use actual emissions in order to determine the number of CBAM certificates to be surrendered, the burden will fall on third-country producers to provide the emissions information. Operators of production installations in third countries can register with the relevant EU authorities to report their actual emissions. They can then make their verified embedded GHG emissions data available to importers in the EU.[28]

The Proposed Regulation sets forth the requirements for operators to rely on actual embedded emissions. Among other things, embedded emissions must be calculated according to the methods set out in the proposal.[29] The information must also be verified by an *EU-accredited* verifier[30] based on certain verification principles stated in the Proposed Regulation. The verification principles generally require mandatory visits by

21 All data are based on 2019 imports. *See* CBAM Impact Assessment, Part 1, p. 66.
22 CBAM Impact Assessment, Part 1, p. 66.
23 CBAM Impact Assessment, Part 2, Annex X, p. 100.
24 CBAM Impact Assessment, Part 1, p. 66.
25 CBAM Impact Assessment, Part 2, Annex X, p. 101.
26 CBAM Impact Assessment, Part 2, Annex X, p. 101.
27 CBAM Impact Assessment, Part 2, Annex X, p. 100.
28 Proposed Regulation, Recital 42 and Article 10.
29 Proposed Regulation, Article 7(1) and Annex III.
30 The verifiers must be accredited according to the EU's Implementing Regulation (EU) No 2018/2067. This regulation sets forth the accreditation requirements for GHG emissions verifiers under the EU ETS.

verifiers to production facilities[31] and the preparation of detailed verification reports.[32]

In addition to the above, MENA industries should consider the following points in their preparation for the CBAM. First, the Proposed Regulation includes an option for the European Commission to broaden the scope of the verifiers that could be used for auditing emissions data.[33] In this regard, the Proposed Regulation could potentially allow for the establishment of foreign-based verifiers or agents. However, until the European Commission allows for foreign-based verifiers, third-country operators must seek verification with EU-based verifiers.[34]

Second, companies with their own importing operations should be aware of the need to retain an EU-based customs agent or establish a local office for CBAM purposes.[35] According to the Proposed Regulation, only authorized "*declarants*" are permitted to import goods subject to the CBAM. The declarants must be established in the EU; however, they could also be customs agents acting on behalf of third-country producers.[36]

Third, third-country operators are heavily encouraged to assess their actual emissions. Installations are encouraged to do so even if such a process will likely require significant amounts of data to be collected and audited, and the associated costs. This is because the default CBAM values will likely be disadvantageous for third-country producers, particularly if they are based on the EU's worst performers or if such third-country producers have lower emissions than the average in their home country.

In fact, some MENA producers are already involved in carbon reduction initiatives.[37] Such producers will likely benefit from using their actual emissions instead of default values.

Given these detailed requirements, affected MENA industries are advised to prepare for the CBAM and familiarize themselves with the system as soon as possible.

7. Can MENA Countries Participate in Shaping How the CBAM Regime is Implemented?

The EU welcomes dialogue on the implementation of the CBAM. The European Commission has stated that "dialogue with third countries should continue and there should be space for cooperation and solutions that could inform the specific choices that will be made on the details of the design of the measure during the implementation, in particular during the transitional period".[38] In fact, informal dialogues with some affected trading partners are already taking place. Public comments are also welcome until 27 October 2021.[39]

Given this space for cooperation, EU trading partners from the MENA region should consider initiating dialogue with the EU institutions to ensure that the implementation of the CBAM is mutually beneficial and considers the specific needs and challenges of MENA exporters. MENA countries could consider several areas of dialogue with the EU. We discuss some of these opportunities below.

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31 Proposed Regulation, Annex V(1)(c).
32 Proposed Regulation, Annex V(2).
33 Proposed Regulation, Article 18(2).
34 Proposed Regulation, Article 18(3).
35 *See* Proposed Regulation, Article 5.
36 Proposed Regulation, Article 5(1).
37 For instance, Emirates Steel is currently engaged in CO_2 emissions data collection to reduce its carbon emissions. *See* Emirates Steel, Sustainability, available here. Moreover, Ma'aden Aluminium Company in Saudi Arabia boasts of its most efficient vertically integrated aluminium complex globally and technology considered a "major strength[] in today's carbon-constrained world". *See* Ma'aden, Aluminium, available here.
38 Proposed Regulation, Recital 53.
39 EU Green Deal (carbon border adjustment mechanism), European Commission, available here.

First, MENA countries may consider discussing with the EU the establishment of in-country accreditation bodies. As mentioned above, the proposal leaves room for the EU national accreditation bodies to expand the number of verifiers eligible to verify emissions data in third countries to cover non-EU established verifiers.[40] For instance, the GCC, being the EU's 6th largest export market,[41] could propose establishing a supranational accreditation body based in the GCC to support all GCC exporters.

Such discussions could be conducted under the framework of currently existing cooperation and trade agreements. For example, the current EU-GCC Cooperation Agreement encourages cooperation and exchange of information between the contracting parties on their respective environmental policies.[42] Environmental cooperation is also part of the EU-Egypt Association Agreement.[43]

Second, MENA countries may cooperate with the European Commission to establish their country-specific default values. As mentioned above, such values could be advantageous since many MENA producers are already engaged in carbon-reduction initiatives.[44]

Third, another crucial area is the calculation method for direct emissions, particularly the definition of the "production process boundary" under the Proposed Regulation. The "production process boundary" is the area where the counting of emissions would terminate. The current proposal does not yet establish such boundaries, but leaves it open for future implementing regulations to be adopted by the European Commission. Thus, MENA countries could consider calling on the European Commission to ensure that the boundaries do not go so far upstream as to impose an unreasonable burden on third-country producers.

Fourth, given the novelty of the regime, MENA economies could also consider requesting technical assistance from the EU on implementing the measure. Such requests could come from several MENA countries as a group. A group approach could maximize the transfer of knowledge from the EU to its trading partners within the shortest possible time. It could also ensure that MENA economies can provide mutual support to each other.

Lastly, discussions with the EU may also help MENA countries achieve their obligations under the Paris Agreement. The EU's environmental policies could provide third countries with additional policy tools to achieve more significant reductions of GHG emissions, thereby achieving their nationally determined contributions under the Paris Agreement.

Given the openness of the EU to receive input from its trading partners, MENA countries could shape the implementation of the CBAM for the mutual benefit of all parties.

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40 Proposed Regulation, Article 18(3).
41 European Commission, Gulf Region, available here.
42 EU-GCC Cooperation Agreement, Article 9, available here.
43 Euro-Mediterranean Agreement establishing an Association between the European Communities and their Member States, of the one part, and the Arab Republic of Egypt, of the other part, Article 44, available here.
44 *See* Question 6 above.