



AEGIS EUROPE LEGAL ANALYSIS SERIES:

**CONSISTENCY OF AN EU CARBON BORDER ADJUSTMENT MECHANISM
("CBAM") WITH WORLD TRADE ORGANIZATION ("WTO") RULES**

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EXECUTIVE SUMMARY

1. In accordance with Articles 191 and 192 of the Treaty on the Functioning of the European Union, the European Union (“EU”) and its Member States adopted strong domestic measures and a proactive position in international fora to achieve their climate change objective of substantially reducing greenhouse gas (“GHG”) emissions.
2. To facilitate achieving this objective, the EU established the *Emissions Trading System* (“EU ETS”), which is a market-based mechanism establishing a progressively declining cap on GHG emissions attributable to, *inter alia*, EU production in certain industrial sectors. The cap on EU GHG emissions is implemented by creating “allowances”, each of which corresponds to one tonne of CO₂ equivalent. The sectors subject to the EU ETS system must then obtain and submit allowances annually corresponding to the GHG emissions from their activity, with the number of available allowances declining over time.
3. The EU allocates a certain number of “free” allowances in sectors subject to the EU ETS that are considered to be at risk of carbon leakage, *i.e.*, when compliance costs related to climate policies cause a shift in production and/or consumption (either within the EU or in third countries) resulting in an increase in net global GHG emissions. The EU allocates free allowances for GHG emissions up to product-specific benchmarks, and entities must obtain allowances for GHG emissions in excess of these benchmarks by purchasing allowances through auctioning or trading in the market.
4. Under the recent European Green Deal, the European Commission (the “Commission”) has proposed a carbon border adjustment mechanism (“CBAM”). This proposal aims at addressing carbon leakage in the context of the EU’s stronger commitments to reduce GHG emissions by 2030 and achieve climate neutrality by 2050 and in the absence of equivalent policies by the EU’s trading partners.

A CBAM is an integral part of the EU ETS regulatory framework

5. The design, development, implementation and enforcement of the EU ETS and its component parts, including free allowances and a CBAM, are directed toward achieving ambitious climate change goals. Under the EU ETS, both the free allowances and a CBAM are necessary to prevent undermining these goals by addressing the risk of carbon leakage, including intra-industry leakage and inter-industry leakage in the EU market and in third country markets.
6. The CBAM, as envisioned by the Commission, would be part and parcel of the overall internal EU ETS regulatory regime that is enforced with respect to imports at the border. Thus, under the most likely approach to be taken for the CBAM, in the same way that EU producers must submit allowances for GHG emissions associated with products produced within the EU, importers would similarly be required to submit allowances for GHG emissions associated with imported products sold in the EU.
7. If the approach taken by the EU is to require emission allowances for imports, then a CBAM constitutes a border adjustable internal measure under GATT Article III, rather than a “border measure” subject to the requirements of GATT Articles II and XI.

An EU ETS - incorporating both free allowances and a CBAM – is consistent with GATT non-discrimination obligations

8. The WTO compatibility of a CBAM with GATT national treatment and MFN obligations will mainly depend on the design and application of the CBAM. A well designed – and applied – CBAM would ensure that the GATT general exceptions would only need to be used as a “safety net” to justify the application of a CBAM in the event any WTO dispute settlement panel finds GATT violations.
9. In this framework, EU products and imports should face an equivalent regulatory burden that is applied on an even-handed basis. This equivalent treatment should be assessed by comparing the overall regulatory burden of the EU ETS (including free allowances, reduction and abatement, and the CBAM) on EU-produced products with the regulatory burden applied to imports. Any adjustments to the design of the CBAM to achieve equivalence and even-handed treatment will have to be carefully considered in order to ensure WTO consistency.
10. A CBAM applied in a manner that equalizes the GHG emissions regulatory burden when integrated with the EU ETS (including the use of free allowances) would be compatible with GATT Article III:4 (national treatment) and Article I:1 (MFN) because:
 - i. It would not give any advantage to EU products over imports but would simply ensure that imported products face an equivalent regulatory burden to EU like products in assigning an appropriate cost of carbon; and
 - ii. It would not give any competitive advantage to imports originating from one WTO Member as compared to imports originating from another WTO Member. Rather, it would simply ensure that all imported products regardless of origin face an equivalent regulatory burden assigning an appropriate cost of carbon.

An EU ETS - incorporating both free allowances and a CBAM – is justified under GATT Article XX

11. If the EU ETS incorporating both free allowances and a CBAM is found to be inconsistent with one of the GATT non-discrimination obligations (although we strongly argue that such a system is not discriminatory), it could still be justified under the general exceptions under GATT Article XX because:
 - i. It would fall under the GATT general exceptions relating to the conservation of exhaustible natural resources (GATT Article XX(g)) or necessary to protect human, animal or plant life or health (GATT Article XX (b)); and
 - ii. It would not constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade.

Free allocations are consistent with the WTO SCM Agreement

12. Free allocations of allowances under the EU ETS are not actionable subsidies under the WTO SCM Agreement because:
 - i. They are simply used to implement the different, product-specific allowance obligations applicable to sectors at risk of carbon leakage.
 - ii. They do not constitute a financial contribution in the form of government revenue that is forgone or not collected because neither the EU nor the Member States are allowed to sell or to auction free allowances. Free allowances also do not constitute any other form of financial contribution, because they do not involve any direct transfer of funds or any provision of goods or services;
 - iii. They do not confer a benefit because they are part of an integrated regulatory framework that imposes product-specific allowance obligations and are only used to implement this obligation. Accordingly, they do not make the recipients better off than they would otherwise be in the market;
 - iv. They would not be specific to certain enterprises or industries. All operators within an industry sector (selected based on an objective evaluation of carbon intensity) are allocated free allowances, which they use for compliance, and there is substantially no discretion in the application of the EU ETS rules; and
 - v. They would not cause adverse effects to the interests of other WTO Members because the EU ETS cannot create any possible competitive advantage for European producers as compared to competitors from other WTO countries.

Conclusions

13. In view of the above, we conclude that an EU ETS incorporating both free allowances and a CBAM can be WTO-consistent. Its WTO robustness will mainly depend on the design and application of the CBAM incorporated into the EU ETS.
14. While the EU is implementing its climate change measures, the absence of similar measures among its trading partners means that the EU's actions limiting GHG emissions for EU industries could cause significant leakage, which would undermine the EU's climate change goals and could increase global GHG emissions. In order to address leakage effectively, the EU can design and implement an EU ETS incorporating both free allowances and a CBAM in a manner that is WTO consistent.
15. It is likely that EU measures to fight climate change – which is an existential threat to the EU and the world – will raise questions in the WTO¹. However, the EU's climate ambition should not be jeopardized by threats of WTO legal actions, and the implementation of a CBAM presents an opportunity to encourage other WTO Members to take more proactive measures to address climate change.

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¹ Certain provisions of the EU Renewable Energy Directive (RED II) – key EU legislation in the EU's climate strategy – are currently being challenged by certain WTO members before the WTO Dispute Settlement Body. See DS593 and DS600.