WTO CONSISTENCY OF "EXPORT ADJUSTMENTS" IN THE CONTEXT OF THE EU EMISSIONS TRADING SYSTEM (INCORPORATING A CARBON BORDER ADJUSTMENT MECHANISM)

EXECUTIVE SUMMARY

PART 2 OF A LEGAL ANALYSIS COMMISSIONED BY AEGIS EUROPE

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EXECUTIVE SUMMARY

1. The EU has taken concrete actions to meet its climate change objective of reducing greenhouse gas ("GHG") emissions. This includes the implementation of a market-based mechanism for limiting and pricing GHG emissions – the EU *Emissions Trading System* ("EU ETS"), which will soon incorporate a carbon border adjustment mechanism ("CBAM") to address emissions in relation to goods consumed within the EU but produced outside the EU.

2. Because third-country governments have still not limited or priced GHG emissions at the same levels as the EU, there is a difference in regulatory ambition that creates a risk of carbon leakage through the substitution of EU exports to third-country markets by products not subject to equivalent carbon limitation and pricing policies. In this situation, emissions limited in the EU would then be simply emitted in another third country, jeopardizing the EU's overall objective to reduce global GHG emissions. Export "adjustments" should therefore be established as a component of the EU ETS to prevent carbon leakage associated with exports from the EU.

3. The WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") defines a subsidy as a "financial contribution" by a government or any public body that confers a "benefit". The SCM Agreement prohibits "export" subsidies – *i.e.* subsidies contingent upon export performance (in law or in fact) and provides that other subsidies may be actionable if they are specific and cause certain adverse effects.

4. We consider that properly designed export adjustments would not constitute subsidies under Article 1.1 of the SCM Agreement because there is no financial contribution by the EU that confers a benefit. Accordingly, the export adjustments could not constitute prohibited subsidies under Article 3 or actionable subsidies under Article 5 of the SCM Agreement.

Design options for export adjustments

5. Two design options – which are functionally quite similar – have been considered to address exports within the context of an EU climate policy that imposes a regulatory burden on EU production.

6. *First*, the *de facto* export adjustments option is an extension of the allocation of free allowances to EU production that is exported. The carbon leakage policy of granting free allowances for exports would remain in force until other countries take equivalent and effective steps to impose carbon costs on competing foreign production. Thus, even if the allocation of free allowances for production destined for EU consumption declines, the free allowances for export consumption would not. The *de facto* export adjustment option would need to be designed in a way that ensures it does not affect the equilibrium of the EU ETS.

7. *Second*, the *de jure* export adjustments option is a refund/credit for allowance obligations on exports. For products consumed within the EU, the allowance obligation applicable to domestically produced products would correspond to the GHG emissions

in excess of a product-specific benchmark, with the equivalent obligation imposed on imports consumed within the EU through application of the CBAM. This equivalent allowance obligation would be rebated or refunded when the products are exported.

De facto or de jure export adjustments, when appropriately characterized within an integrated carbon reduction and limitation regulatory regime, are not subsidies under Article 1.1 of the SCM Agreement

8. Although the two options presented above may be required to operate in parallel depending on the evolution of the EU ETS, these options do not constitute subsidies under Article 1.1 of the SCM Agreement for the following reasons.

9. The EU ETS, including the export adjustments and CBAM, should be characterized under the SCM Agreement as an integrated carbon limitation and reduction regulatory regime, rather than a fiscal or financial measure, because the EU ETS imposes a significant and increasing burden or cost on the regulatory authorisation to emit GHG emissions.

10. In this case, the *de facto* export adjustments do not constitute financial contributions under Article 1.1(a)(1) of the SCM Agreement for the same reasons as those discussed in our 3 June 2021 paper[1]. A similar analysis applies to the *de jure* export adjustments. Although it has a different mechanism to implement the relevant regulatory burden imposed on EU producers, the option is based on the same underlying principle that the EU imposes a burden on EU operators rather than providing any financial contribution. Any refund or rebate for allowances corresponding to exported products simply calibrates the regulatory obligation and adjusts the net regulatory burden imposed under the regime.

De facto or de jure export adjustments, when characterized as a tax regime, are not subsidies under Article 1.1 of the SCM Agreement

11. If a WTO panel determines that the EU ETS, including the export adjustments and CBAM, is not a regulatory regime but is instead a fiscal/financial measure, the allowance obligations under the EU ETS constitute indirect taxes, and the exemption or remission/rebate of such taxes for exported products not in excess of those applied or accrued on products for EU consumption are not subsidies as provided under footnote 1 of the SCM Agreement.

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[1] *See* paras. 99-100 and footnotes 48-49 of our 3 June 2021 paper, "Consistency Of An EU Carbon Border Adjustment Mechanism ("CBAM") With World Trade Organization ("WTO") Rules".