KING & SPALDING

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

PART 2 OF A LEGAL ANALYSIS COMMISSIONED BY AEGIS EUROPE

Hervé Jouanjean
Stephen Orava
Marie-Sophie Dibling
King & Spalding
Bastion Tower
5 Place du Champ de Mars
1050 Brussels
Belgium

Bernard O'Connor
Nctm
Avenue de la Joyeuse
Entrée, 1
1040 Brussels
Belgium

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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.

* * *

[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".

INTRODUCTION

12. The EU has taken concrete actions to meet its objective to limit the rise in global atmospheric temperature, including the implementation of a market-based mechanism for limiting and pricing greenhouse gas emissions – the EU *Emissions Trading System* ("EU ETS"), which will soon incorporate a carbon border adjustment mechanism ("CBAM").

13. Climate change is a global phenomenon requiring global solutions. Many third country governments have still not limited or priced GHG emissions at the same levels as the EU. While this difference in regulatory ambition lasts, there is a severe risk that emissions limited in one territory are simply emitted in another territory. This is carbon leakage. The EU ETS limits and prices emissions in the EU. As a component of the EU ETS, the CBAM is being implemented to address emissions in relation to goods consumed within the EU but produced outside the Union. However, this system does not address the full risks of carbon leakage.

14. Carbon leakage also occurs when EU exports to third countries are substituted, in those markets, by products - whether foreign or domestic - not subject to equivalent carbon limitation and pricing policies. The end result is that the EU's ambitious commitment to reduce GHG emissions could paradoxically lead to higher global GHG emissions. Thus, the EU ETS must be supplemented by an additional component that addresses carbon leakage through EU exports.

15. This paper provides a legal analysis of the WTO consistency of certain export "adjustments" within the EU ETS to prevent carbon leakage associated with exports from the EU. The analysis is organized as follows: (I) policy objectives, (II) design options, (III) WTO consistency under the SCM Agreement, and (IV) conclusions. This analysis should be read in conjunction with our 3 June 2021 paper regarding the WTO consistency of the application of free allowances and a CBAM under the EU ETS, which provides significant additional background information and analysis on, in particular, the structure and policy underlying the EU ETS and proposed CBAM and the nature and scope of carbon leakage.

I. POLICY OBJECTIVES

16. The objective of the EU ETS, within the overall EU objective of limiting temperature rise, is to achieve a targeted reduction of GHG emissions attributable to EU production. Under the EU ETS, the EU imposes a progressively declining cap on GHG emissions to achieve its targets.

17. To implement the EU ETS and its declining cap, the EU created allowances that each correspond to the emission of one tonne of CO2 equivalent. The EU also established a declining annual cap on the number of available allowances, which would necessarily result in reducing GHG emissions within the EU.

18. One component of the EU ETS to avoid carbon leakage resulting from, for example, the closing down of EU production and the opening up of equivalent production in low ambition territories is the issuance of free allowances. These free allowances are used to implement different requirements across the range of EU economic entities in order to achieve (and not undermine) its climate change objectives. Entities within carbon

leakage sectors are allocated allowances for free up to product-specific benchmarks and are required to purchase the remainder through auctions or trading.

19. The use of different allowance obligations across different industries, implemented through free allowances, also addressed the risk of leakage, *inter alia*, in export markets. By maintaining incentives to continue reducing GHG emissions through the product benchmark, the free allowances lessened the compliance costs. As a result, EU emission-limited exports did not become significantly more expensive in third countries, which minimized carbon leakage by removing the incentive to supply those markets from unregulated sources.

20. As the EU GHG emission reduction targets become stronger, the carbon compliance costs for EU producers will increase. Although the CBAM can, if designed and implemented properly, ensure a level playing field in the EU market, the higher cost EU exports will not be able to compete with products from territories with little or no carbon costing. Carbon limited EU exports will lose out to non-carbon limited products. This carbon leakage will remain until all third countries adopt credible and effective measures to limit and price GHG emissions in a manner that ensures a global level playing field in relation to carbon costs across all markets.

II. DESIGN OPTIONS

21. Although functionally quite similar, we propose consideration of two design options to address the severe risk of leakage by substitution away from EU exports: (1) *de facto* export adjustments, *i.e.*, extension of the allocation of free allowances to exports and (2) *de jure* export adjustments, *i.e.*, refund/credit for allowance obligations on exports. For the reasons developed below, we consider that both options are WTO consistent and may be required to operate in parallel depending on the evolution of the EU ETS.

A. *De facto* Export Adjustments (Allocation of Free Allowances for Exports)

22. The first option is to use the same mechanism under the EU ETS (benchmarking, free and auctioned allowances) to adjust the different allowance obligations across the range of covered industries to ensure that the EU's overall climate change targets can be met. Under this option, allowances would be allocated for free for EU production that is exported.

23. Like the CBAM, the free allocation of export allowances would remain in force until other countries take equivalent and effective steps to impose carbon costs on competing production. In case there is an agreement with a third country regarding the treatment of embedded carbon emissions, the provisions of this agreement would take precedence over the general rule proposed above. Thus, this option both addresses the significant risk of leakage and encourages other countries to take concrete action to achieve global GHG emissions reduction targets and to cooperate bilaterally with the EU or as part of a global system (club).

24. The *de facto* export adjustments option must be designed in a way that ensures it does not affect the other components of the EU ETS. In this respect, special attention must be given to a design that will not create direct or indirect inter-sectorial competition by affecting the fragile balance between the free and auctioned allowances. The *de facto* export adjustments would have to include alternative options to mitigate any negative

consequences in the overall EU ETS. Free allowances for export consumption will have to be clearly distinguished from free allowances for production destined for EU consumption. Thus, to the extent that the allocation of free allowances for production destined for EU consumption declines, the free allowances for export consumption should not.

25. This relatively simple integration of the free allowance concept is compelling from a policy perspective because it aligns with the existing EU ETS regulatory regime's historical approach to minimizing leakage, maintains the discipline of the overall cap on emissions, continues to incentivize reductions through the use of benchmarking, and is administratively feasible and effective.

B. *De jure* Export Adjustments (Refund/Credit for Allowance Obligations on Exports)

26. The second option is to re-characterize the above option into the equivalent of a consumption-based regulatory burden, similar to the destination principle in the area of indirect taxes, such as VAT. Under this option, the consumption of the product within the EU, or not, would dictate whether the product-specific allowance obligation would apply. 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.

27. Similar to indirect tax regimes, the objective of a market-based GHG emissions reduction mechanism is to assign a carbon price that is borne by the product in order to facilitate pass-through of higher carbon costs to consumers.

28. These adjustments for EU exports can also be used – together with the CBAM for imports – for leveraging other countries to undertake climate change measures. This option would lay the groundwork for multilateral or plurilateral negotiations to determine (i) whether to regulate carbon based on consumption, which would mean that the EU would maintain the CBAM and the adjustments for exports and assume that the EU's trading partners will enact something similar that creates an overall level playing field; or (ii) regulate based on production, which would mean the likely formation of a plurilateral group composed of those with effective carbon costs and for which neither a CBAM nor an export adjustment would be needed for trade within the group.

C. WTO Consistency under the SCM Agreement

29. The analysis of the WTO consistency of export adjustments is structured as follows: (1) analytical framework under the SCM Agreement, (2) characterization of the measures, (3) financial contribution, and (4) benefit.

1. Analytical framework under the SCM Agreement

30. The WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") disciplines WTO Members use of subsidies. The analysis of whether a specific measure violates the SCM Agreement starts with an analysis of whether the measure constitutes a subsidy under Article 1.1 of the SCM Agreement.

31. Under Article 1.1 of the SCM Agreement, a subsidy is deemed to exist if (1) "there is a financial contribution by a government or any public body within the territory of a Member" and (2) "a benefit is thereby conferred."

32. If a subsidy is found to exist, such subsidy is only actionable if it is "specific" within the meaning of Article 2 of the SCM Agreement. However, this specificity requirement does not apply to prohibited subsidies under Article 3 of the SCM Agreement.

33. Article 3.1(a) of the SCM Agreement prohibits "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I" of the SCM Agreement. If the "export adjustments" addressed in this paper are deemed to be subsidies under Article 1.1 of the SCM Agreement, the assumption is that they would be expressly conditional or dependent upon export performance and thus would constitute prohibited subsidies under Article 3.1(a) of the SCM Agreement.

34. As demonstrated below, properly designed *de facto* or *de jure* "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 adjustments would not be prohibited export subsidies under Article 3.1(a) of the SCM Agreement[2].

2. Characterization of the measures

35. An important threshold question is whether the EU ETS, including the export adjustments and CBAM, should be characterized as an integrated regulatory regime more similar to typical command-and-control environmental regulations or as a fiscal or financial measure more similar to a tax regime. Any WTO panel should consider the objectives, design, architecture, and revealing structure of the EU ETS (incorporating the export adjustments and the CBAM) in assessing how it should be characterized, and such characterization will likely have a material impact on how any WTO panel applies the applicable provisions of the SCM Agreement.

36. For all of the reasons stated in the 3 June 2021 paper, the EU ETS is more appropriately characterized as a regulatory regime, and the integration of export adjustments into that

[2] As discussed below, the export adjustments should not be deemed to be subsidies under Article 1 of the SCM Agreement and thus cannot constitute prohibited subsidies under Article 3 or actionable subsidies under Article 5 of the SCM Agreement.

regime does not alter this characterization. The EU Court of Justice has determined that the EU ETS is not a tax system but a climate policy regime.

37. At its core, the EU ETS is intended to achieve the EU's climate change objectives by imposing a cap on GHG emissions from EU production, and the CBAM and export adjustments are critical elements to achieve the EU's regulatory objectives by addressing carbon leakage. Rather than providing any contribution ("financial" or otherwise) conferring any benefit, the regime imposes a significant and increasing burden or cost on the regulatory authorisation to emit GHG emissions. As a result, the EU ETS (incorporating a CBAM and export adjustments) should be characterized as a regulatory regime when analysed under the SCM Agreement.

38. Alternatively, as explained in more detail below, if a WTO panel determines that the EU ETS is not a regulatory regime but is instead more similar to a fiscal or financial measure, it satisfies the definition for indirect taxes under the SCM Agreement.

3. Financial contribution

39. Article 1.1(a)(1) of the SCM Agreement defines a financial contribution to include:

> *"(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);*
>
> *(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits){footnote omitted};*
>
> *(iii) a government provides goods or services other than general infrastructure, or purchases goods;…."*

40. The Appellate Body described this provision as follows:

> "*Beginning with the general architecture and structure of the provision, we note that Article 1.1(a)(1) defines and identifies the government conduct that constitutes a financial contribution for purposes of the SCM Agreement. Subparagraphs (i)-(iv) exhaust the types of government conduct deemed to constitute a financial contribution. This is because the introductory chapeau to the subparagraphs states that "there is a financial contribution by a government ...,i.e. where:".{footnote omitted} Some of the categories of conduct—for instance those specified in subparagraphs (i) and (ii)—are described in general terms with illustrative examples that provide an indication of the common features that characterize the conduct referred to more generally. Article 1.1(a)(1), however, does not explicitly spell out the intended relationship between the constituent subparagraphs. {footnote*

omitted} Finally, the subparagraphs focus primarily on the action taken by the government or a public body"[3].

41. The analysis below demonstrates that export adjustments, whether characterized as part of an integrated regulatory regime or as part of an indirect tax regime, are not financial contributions and are otherwise not subsidies under the SCM Agreement.

a) The EU ETS as a regulatory measure is not a financial contribution

42. When characterized as part of an integrated regulatory regime, export adjustments under either design option set forth above would not constitute financial contributions under Article 1.1(a)(1) of the SCM Agreement.

43. Regarding the *de facto* export adjustment option, a similar mechanism under the EU ETS will be used to allocate free allowances for EU production that is exported.

44. Therefore, the analysis of the WTO consistency of such *de facto* export adjustments is similar to analysing the WTO consistency of the current free allowances under the SCM Agreement. The analysis is thus similar to the analysis provided by the Commission[4] and discussed in our 3 June 2021 paper[5] regarding whether the allocation of free allowances under the EU ETS constitutes a specific subsidy. Although the U.S. government rejected the Commission's position and found that the EU ETS was a specific subsidy under U.S. countervailing duty law, the Commission's arguments are likely to be compelling in any defence under the SCM Agreement in WTO dispute settlement.

45. As explained above, the *de facto* export adjustment would be an integral part of the EU ETS system that is intended to impose a significant and increasing burden or cost on the regulatory authorisation to emit GHG emissions[6]. In this context, the only way for a WTO panel to determine that free allowances – and thus the *de facto* export adjustment – falls within the scope of the SCM Agreement would be to analyse them outside the whole EU ETS context, leading to a "*biased assessment*" according to the Commission[7].

46. In the U.S. countervailing duty investigation on imports of forged steel fluid end blocks from Italy, the discussion mainly focused on the qualification of free allowances as

[3] Appellate Body Report, *U.S. – Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, WT/DS353/AB/R (adopted 23 March 2012), at para. 613.
[4] U.S. countervailing duty investigation on imports of forged steel fluid end blocks from Italy initiated in 2020.
[5] *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".
[6] The Commission described the EU ETS as "*an integrated system of provisions where different kind of operators are subject to requirements variously modulated depending on the nature and characteristics of the operators' activities, on the basis of clearly defined rules that neither the Commission nor the individual EU governments can modify. The existence of different levels of upfront allocation of allowances for different kind of operators is the basis itself for the existence of the system and its economic viability*". Commission Pre-Prelim Comments in Fluid End Blocks at 4.
[7] The Commission argued exactly this in defending the U.S. countervailing duty case, contending that the petitioners "*cut{} the single ETS system into pieces and parts and, in a tortious manner, taking one of these parts, the free allowances, out of context in order to make a biased assessment of both the economic and legal viewpoints*". Commission Pre-Prelim Comments in Fluid End Blocks at 2.

representing government revenue foregone or not collected that is otherwise due under Article 1.1(a)(1)(ii)of the SCM Agreement.

47. In this case, the Commission argued that the free allocation of allowances does not constitute government revenue foregone or not collected that is otherwise due:

> *"The allocation of allotments of allowances upfront for free is therefore an integral part of a system, which aims at regulating the level of emissions that operators can make.*
>
> *Because free allowances decrease gradually – but constantly - they are a transitional element in order to achieve the final environmental aim stated above, i.e. climate neutrality in 2050. It is simply not possible to achieve climate neutrality in one single step, as this would render vast parts of the economy unsustainable. Hence, a transitory mechanism is necessary that achieves a gradual transformation of the economy towards climate neutrality.*
>
> *Therefore, by distributing free allowances, neither the EU nor the Member States have foregone any revenue, because no one, neither the EU nor the Member States, are allowed to sell or to auction any of the so-called free allowances.*
>
> *This is also demonstrated by the fact that the free allowances issued by the EU for free distribution by the Member States never enter as an asset either in the EU budget or in Italy's or Germany's national budgetary accounts.*
>
> *In conclusion, as shown above, free allowances do not represent government revenue foregone or not collected that is otherwise due, as claimed by the petitioners[8]".*

48. The Commission further explained that:

> *"Nor can the free allowances be seen as any other form of financial contribution, because they do not involve any transfer of funds of any type, nor do they involve any provision of goods or services. As said above, they simply establish a threshold beyond which the emissions made by industrial operators are considered as excessive and are therefore subject to payment.*
>
> *The free allowances are not an exception from the general rule of a system, granted to some enterprises in order to provide them with a benefit. They are an essential feature of the system itself, which has been created in a certain way in order to reduce overall emission levels in an economically sustainable way.[9]"*

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[8] EU Comments and Questionnaire Response from the Delegation of the European Union to the United States of America to The Honorable Wilbur Ross, Secretary of Commerce, U.S. Department of Commerce in U.S. Countervailing Duty Investigation of Forged Steel Fluid End Blocks from Italy (26 March 2020), p. 3.

[9] Commission Pre-Prelim Comments in Fluid End Blocks at 6-8.

49. Regarding the *de jure* export adjustment option, the allowance obligation applicable to domestically produced products (which is the portion in excess of a product-specific benchmark) would be rebated or refunded when the products are exported.

50. Although less readily apparent than for free allowances, a similar analysis would apply to the *de jure* export adjustment if characterized as part of an integrated regulatory regime. The only difference is the mechanism used to implement the relevant regulatory burden imposed on EU producers in order to achieve the overall objective of reaching ambitious GHG emissions targets and not undermining this objective through carbon leakage.

51. Under the EU ETS regulatory regime, when viewed objectively and holistically, the EU imposes a burden on EU operators rather than providing any financial contribution, and any refund or rebate for allowances corresponding to exported products simply calibrates the regulatory obligation and lessens the net regulatory burden imposed under the regime[10]. Thus, a *de jure* export adjustment is not a financial contribution under Article 1.1(a)(1) of the SCM Agreement.

b) The EU ETS as a fiscal/financial measure is not a financial contribution

52. If a WTO panel were to disagree with the characterization of the EU ETS as a regulatory regime and consider that the EU ETS is similar to a tax regime, the export adjustments are not a subsidy under footnote 1 of the SCM Agreement.

53. Footnote 1 of the SCM Agreement states:

> *"In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."*

54. Footnote 1 begins with the words "*in accordance with the Note to Article XVI*[11] *and Annexes I to III of the SCM agreement*", which has been interpreted to mean that

[10] The Appellate Body has found that the key features of a particular measure may result in finding that such measure falls outside the scope of Article 1.1(a)(1). *See* Appellate Body Report, *United States – Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, Recourse to Article 21.5 of the DSU by the European Union, WT/DS353/AB/RW (adopted 12 April 2019), para. 5.51. After an extensive examination of the negotiating history for "financial contribution" under the SCM Agreement and review of reports by the Tokyo Round Group of Experts, a WTO panel found that the use of "financial contribution" was intended to prevent any government action from constituting a subsidy. Panel Report, *United States – Measures Treating Exports Restraints as Subsidies*, WT/DS194/R (adopted 23 August 2001), at para. 8.73. Notably, the Group of Experts characterized the types of contributions covered under Article 1 of the SCM Agreement as specific examples of the general principle that "subsidies exist where the government exercises its authority to impose tax and expend revenue, whether directly or through delegation of its taxing and [sic] authority". Subsidies and Countervailing Measures - Note by the Secretariat, MTN.GNG/NG10/W/4, 28 April 1987, Section 4.1.A. This supports the view that a climate change regulatory regime reviewed holistically constitutes the type of government measure that falls outside the definition of a financial contribution and thus outside the SCM Agreement.

[11] *See* Appellate Body Report, EU — PET (Pakistan), para. 5.107: "The language of the Ad Note to Article XVI of the GATT 1994 is identical to the second part of footnote 1 of the SCM Agreement. Like footnote 1, the Ad Note is explicit in limiting the financial contribution element of the subsidy to the excess amount of the remission,

Footnote 1 should be read "in agreement", "in conformity", or "in harmony" with all of the provisions referred to therein[12]. Importantly, Annex I to the SCM Agreement provides an illustrative list of export subsidies. In particular, Annexes I(g) identifies the following as an export subsidy:

> *"(g) The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes[58] in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.*
>
> -----------------------------
>
> *[58]For the purpose of this Agreement:*
> *The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;*
> *The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;*
> *The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;*
> *"Prior-stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product;*
> *"Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production;*
> *"Remission" of taxes includes the refund or rebate of taxes;*
> *"Remission or drawback" includes the full or partial exemption or deferral of import charges."*

55. An export adjustment that provides EU entities with an exemption, credit, or refund for their allowance obligation (*i.e.*, equivalent to the purchased allowances in excess of any product-specific benchmark) upon export of a product would constitute an "exemption of an export product from duties or taxes borne by the like product when destined for domestic consumption" or "remission of such duties or taxes in amounts not in excess of those which have accrued" within the meaning of Footnote 1 of the SCM Agreement, read in accordance with Annex I(g).

56. First, we have assumed that a WTO panel decided to (mis)characterize the requirement to obtain allowances as a financial or fiscal measure, similar to a tax regime, rather than a regulatory regime. If so, the allowance obligations to which the export exemption/remission apply are most similar to "indirect taxes" borne by a product as

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as opposed to the entire amount of the remission. The Ad Note reflects this focus on the excess amount of the remission without making any reference to any other provisions of the covered agreements."

[12] *See* Appellate Body Report, EU — PET (Pakistan), para. 5.105.

defined under the SCM Agreement. In other words, the obligations are more like "product-based consumption taxes" than corporation taxes[13].

57. Footnote 58 of the SCM Agreement defines "indirect taxes" as "*sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges*". Given that "direct taxes" are generally defined to encompass only income and property taxes[14], the allowance obligations under the EU ETS are most appropriately treated as indirect taxes.

58. More importantly, however, the allowance obligations under the EU ETS have key characteristics shared by other product-based consumption taxes, such as sales, excise, value-added and the other taxes described in the definition of indirect taxes in footnote 58. The allowance obligations are designed (for underlying policy reasons) to be shifted forward to consumers in order to internalize certain negative externalities otherwise not reflected in product prices, *i.e.*, cost of carbon. Moreover, the obligations are calculated based on GHG emissions per ton of product and are linked to a product-specific benchmark.

59. Second, the design options for export adjustments of these "indirect taxes" would constitute either an "exemption" or a "remission" of the applicable allowance obligation applicable to exports. Although the actual design would dictate which of these terms is more appropriate, an "exemption" could simply remove the allowance obligation for any exported products, and, consistent with the definitions in footnote 58, a "remission" could include the refund or crediting of an EU operator's allowance account for its exports[15].

60. Finally, the allowance obligation applicable to EU covered entities would generally be the obligation applicable to GHG emissions above the product-specific benchmark. Any export adjustments would be equivalent to this allowance obligation to ensure that any adjustments (in whatever form) are not in excess of the amount applied or accrued domestically.

61. Accordingly, if characterized as a fiscal/financial measure, the allowance obligations under the EU ETS constitute indirect taxes, and the exemption/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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[13] Appellate Body Report, U.S.-FSC, WT/DS108/AB/R (adopted 20 March 2000), at 93.

[14] *See* J. Pauwelyn and D. Kleimann, 'Trade Related Aspects of a Carbon Border Adjustment Mechanism. A Legal Assessment', Briefing requested by the INTA Committee, EP/EXPO/INTA/FWC/2019-01/Lot5/1/C/02 (2020) p. 8-9. "it is confirmed that only 'indirect taxes' -- and not 'direct taxes' -- are border adjustable. However, adjustable 'indirect taxes' are broadly defined as 'all taxes other than direct taxes'. Direct taxes, in turn, are limited to income and property taxes. Since a carbon tax is neither an income nor property tax it would most likely be qualified as an adjustable 'indirect tax'. In addition, adjustable 'indirect taxes' explicitly include not only consumption taxes or taxes on final products (such as VAT) but also inter-mediate taxes 'in respect of the production and distribution' of products'. In other words, process or production taxes including taxes on inputs such as fuels (and fuel-related carbon emissions) could be 'indirect taxes' adjustable at the border".

[15] Although similar, this paper is not examining the WTO consistency under the SCM Agreement of a rebate on the CBAM allowance obligation applicable to imported inputs used in a downstream product that is exported.

4. Benefit

62. In the event that a WTO panel found that the export adjustments constituted a financial contribution under Article 1.1(a)(1) of the SCM agreement, the next issue is whether such financial contributions confer a benefit within the meaning of Article 1.1(b) of the SCM Agreement.

63. To determine whether a benefit (*i.e.*, an advantage) is conferred, WTO case law generally assesses whether the financial contribution has made the recipient better off vis-à-vis the market than it would have been, absent that contribution[16]. A test must be carried out to this effect, which consists of comparing the financial contribution provided by a government and a market benchmark[17].

64. As discussed above in the context of a financial contribution, if examined as an integrated regulatory regime, the *de facto* and *de jure* export adjustment options do not make the recipient better off than they otherwise would be in the market. The EU ETS imposes a significant regulatory burden and these export adjustments only calibrate the obligation and lessen the overall burden in complying with the regulatory authorisation to emit GHG emissions.

65. If a WTO panel treats the EU ETS as a fiscal/financial measure similar to a tax regime, the critical issues are addressed under the above analysis of financial contribution and footnote 1 of the SCM Agreement. In the event that a panel finds a financial contribution, particularly in the form of government revenue forgone, there is more likely to be a finding of benefit[18].

III. CONCLUSIONS

66. In view of the above, we consider that properly designed export adjustments – whether *de facto* or *de jure* export adjustments - do not constitute subsidies under Article 1.1 of the SCM Agreement and therefore do constitute prohibited subsidies under Article 3 or actionable subsidies under Article 5 of the SCM Agreement.

[16] Appellate Body Report, Canada – Aircraft, para. 157.

[17] Appellate Body Report, EC and certain member States – Large Civil Aircraft (Article 21.5 – US), para. 5.119.

[18] *See* Panel Report, *EU – Countervailing Measures on Certain Polyethylene Terephthalate from Pakistan*, WT/DS486/R (adopted 28 May 2018), para. 7.36 ("Attaching footnote 1, which refers to a "subsidy", to Article 1.1(a)(1)(ii), which defines a "financial contribution" (i.e. a part of a subsidy) in terms of revenue forgone otherwise due, indicates that it should be interpreted vis-à-vis that article, and is further an implicit recognition of the close relationship between the concepts of revenue forgone otherwise due and a subsidy. That is, as panels have observed, where "financial contributions" exist in the form of revenue forgone otherwise due, a finding of a "benefit"–and hence a "subsidy"–readily follows.).