



## **CBAM AND WTO CONSISTENT ETS EXPORT ADJUSTMENTS:**

### **DEBUNKING THE MYTHS AND DESIGNING WTO-CONSISTENT MEASURES**

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AEGIS Europe is an industry alliance that brings together more than 20 European manufacturing associations committed to the principles of free and fair international trade and an effective international level-playing field. Our members account for more than €500 billion in annual turnover and millions of jobs across the EU.

The current proposal for a Regulation on the establishment of a Carbon Border Adjustment Mechanism (“CBAM”) fails to address the need to implement **a measure to prevent Union exports from causing leakage that would undermine EU and global climate change objectives as defined by the Paris Agreement.**

Although leakage is universally recognized as a threat to the EU’s climate objectives, a certain minority of interests is opposing the integration of an export adjustment under the EU’s Emissions Trading System (“ETS”) based on unsubstantiated, speculative, and dogmatic assertions of alleged inconsistencies with WTO rules.

Below are the reasons why the alleged ‘WTO obstacle’ is a **myth** that needs to be debunked to ensure that the EU’s goals to reduce GHG emissions globally will be met:

- 1) Reducing GHG emissions is a global challenge.** The reduction of GHG emissions in the Union is a critical and necessary objective. The EU, however, needs to ensure that its GHG reduction policy does not lead to a situation where emissions would just be ‘displaced’ from the Union to third countries with a lower level of GHG reduction ambitions, thereby undermining the EU’s GHG reduction goals. This situation is called carbon leakage.
- 2) The current draft CBAM only partially responds to carbon leakage concerns.** The Union’s first step to regulate GHG emissions was the implementation of the ETS, which is a market-based cap-and-trade system effectively imposing product-specific “allowance” compliance obligations above certain benchmarks on EU manufacturers.<sup>1</sup> It now intends to add a CBAM to the ETS regulatory framework that extends these same product-specific “allowance” compliance obligations to imports, with the objective of preventing leakage that would undermine the EU’s regulatory objectives under the ETS. However, the CBAM currently only captures the risk of leakage in relation to carbon competition in the internal Union market. It does not address the risk of leakage in relation to exports. The compliance obligation under the current ETS regulation results in Union manufacturers incurring a

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<sup>1</sup> In order to facilitate a common baseline of understanding among diverse stakeholders, we have simplified references to how the ETS is applied. For example, we recognize that the ETS imposes an obligation on covered EU producers to surrender allowances for all covered GHG emissions and also allocates free allowances up to applicable benchmarks. For purposes of this paper, we have simplified our characterization of the ETS to reflect the basic “accounting” involved, *i.e.*, the ETS effectively imposes a “net” regulatory compliance obligation equivalent to the number of allowances that must be surrendered above the applicable benchmark.

compliance obligation on all products manufactured in the Union, whether sold domestically or exported to third countries. In comparison, competitors in third countries with a lower level of GHG reduction ambitions will only be subject to this compliance obligation when their goods are exported to the Union. As Union industries export a significant part of their production outside the Union, the absence of an export adjustment would result in leakage (replacing EU carbon-reduced production with non-carbon-reduced third country production) that would severely undermine EU and global climate change objectives.

- 3) **A CBAM that includes export adjustments aims at creating a level carbon playing field in the Union and globally to prevent leakage that would undermine the EU’s regulatory objectives under the ETS.** The European Union made a policy choice to reduce GHG emissions and now must demonstrate the commitment to develop and implement effective measures to achieve its ambitious objectives. Export adjustments are currently the only viable WTO-consistent solution to meet the Union and global climate change objectives as defined by the Paris Agreement. The compliance obligation under the current ETS Regulation results in covered Union manufacturers incurring a compliance obligation on all products manufactured in the Union and consumed anywhere in the world. To ensure a level carbon playing field on export markets to prevent leakage, export adjustments should be introduced as a component of the ETS regulatory framework.
- 4) **ETS export adjustments are WTO compatible.** It is a myth to allege that WTO consistency is black or white. The WTO fully recognizes the need for WTO members to implement environmental regulations. If the export adjustment does not fall within the definition of a subsidy under the SCM Agreement, such adjustment cannot be considered a subsidy contingent in law or in fact upon exports in violation of the SCM Agreement. Export adjustments should be designed to exempt or re-calibrate the regulatory obligation (*i.e.*, the ETS allowance obligation) for EU manufactured products destined for consumption outside the EU market. As a threshold matter, the ETS regulatory framework together with this export adjustment do not provide any “financial contribution” to EU manufacturers but rather impose a regulatory compliance obligation. In addition, footnote 1 of the SCM Agreement explicitly excludes from the definition of a subsidy the exemption for exports from duties or taxes applied to the like product when destined for domestic consumption. It would be absurd for the destination principle to exclude financial measures, like duties and taxes, from the definition of a subsidy but for the same destination principle not to permit the exemption of climate change regulatory compliance obligations on exports.<sup>2</sup>
- 5) **ETS export adjustments are currently the most viable WTO-consistent solution to address the risk of leakage:** The myth that EU policymakers should reject an export adjustment because it might be an export subsidy and instead confer actual “green” subsidies to EU manufacturers amounts to nothing more than a dangerous distraction from a WTO consistent and immediately available regulatory solution. Because they are, in fact,

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<sup>2</sup> The “destination principle” generally provides that goods should be taxed where they are consumed. This principle enables “exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market” and enables “imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products.” *Border Tax Adjustments*, Report by the Working Party, L/3464 (BISD/18S/97) (adopted 2 December 1970), para 4. In other words, “products destined for export{ } can be exempted from taxes borne by like products destined for domestic consumption, the idea being that exported products will be taxed where they are consumed, *i.e.* in the country of destination.” Note by the Secretariat, Taxes and Charges for Environmental Purposes – Border Tax Adjustment, WT/CTE/W/47 (2 May 1997), para. 59.

“subsidies”, green subsidies raise actual (rather than speculative) legal and political hurdles. As a legal matter, green subsidies would simply replace allegedly prohibited export subsidies with potentially actionable subsidies under the WTO SCM Agreement. Moreover, it is extraordinarily difficult to design subsidies that are both targeted and sufficient to address leakage risk but are not otherwise specific to avoid constituting a subsidy under the SCM Agreement. As a political matter, the European Commission would need to allocate new or existing funds for “green” subsidies and would need to conclude WTO or other negotiations with trading partners to authorize such subsidies, in order to create the necessary certainty that such subsidies would not be the target of anti-subsidy investigations or WTO dispute settlement by EU trading partners.

This paper provides in:

- *Annex 1* further legal analysis for assessing the WTO consistency of measures necessary to prevent the loss of carbon-controlled Union exports from causing carbon leakage that would undermine EU and global climate change objectives;
- *Annex 2* a specific example of how the measures could be designed and implemented, including the impact on a sampled EU emissions intensive industry.

The arguments and practical examples in this paper on export adjustments should be compared with all other readily available options to achieve the EU’s goal of reducing GHG emissions both in the Union and globally. The approach explained in this paper achieves the EU’s carbon reduction policy in a manner most compatible with existing WTO law.

To the extent that one or more WTO member countries decide on new frameworks that share the EU’s ambitious climate objectives (such as through plurilateral agreements or a “climate club”), the EU can adapt its ETS, CBAM, and export adjustments. Similarly, if many years from now a future WTO dispute settlement panel finds that the EU’s ETS, CBAM, or export adjustments are inconsistent, in whole or in part, with WTO rules, the EU is only required to prospectively bring these measures into conformity. The EU should not let the myths of WTO inconsistency prevent the immediate action necessary to achieve the EU’s climate change goals.

## ANNEX 1

### ETS EXPORT ADJUSTMENTS: DEBUNKING THE MYTHS

#### 1. **The Myth: Free allowances under the ETS are a subsidy as defined under the WTO SCM Agreement.**

**The Truth:** As a matter of WTO law and jurisprudence, free allowances under the ETS are not a subsidy, and assertions to the contrary are simply incorrect. Moreover, assertions of WTO incompatibility regarding the WTO's treatment of free allowances (or any export adjustment) should not outweigh the climate imperative to adopt measures now that are necessary to achieve the EU's climate change objectives.

The ETS regulation, including the use of free allowances, is the Commission's policy choice regarding how to regulate GHG emissions across EU industries. It follows a similar regulatory template as other licensing regimes or permitting schemes. Like these other types of measures, the Commission effectively does not impose an obligation below a particular threshold or benchmark, using free allowances as the accounting mechanism to calibrate product-specific compliance obligations.<sup>3</sup> And, like these other regulatory approaches, the ETS and the free allowances are not a subsidy under the SCM Agreement.<sup>4</sup>

Notably, the Commission does not consider that free allowances are a subsidy and aggressively defended the legality of these allowances in two U.S. countervailing duty (anti-subsidy) investigations on forged steel fluid end blocks from Germany and Italy, which are still subject to judicial appeal in the United States.<sup>5</sup> The Commission should not abandon its defense of the ETS and effectively surrender how it designs and implements its climate change policy to the views of the U.S. Department of Commerce. Even in the worst-case scenario under which the U.S. Department of Commerce's mischaracterization of the ETS prevails, the subsidy rate for the free allocation of EU ETS allowances only amounted to 0.03 to 0.16 percent, far below the 1.0 percent *de minimis* threshold under Article 11.9 of the SCM Agreement and certainly not a sufficient material risk to justify the Commission ignoring or delaying effective climate change policy.<sup>6</sup>

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<sup>3</sup> As noted above, and as simplified for purposes of this paper, the effective ETS compliance obligation is equal to the total number of allowances subject to surrender, less the allocation of free allowances.

<sup>4</sup> See also AEGIS Europe, Consistency of an EU Carbon Border Adjustment Mechanism ("CBAM") with World Trade Organization Rules, June 3, 2021 (executive summary available at <https://static1.squarespace.com/static/5537b2f8e4b0e49a1e30c01c/t/60ec0a57e370ac6322a86209/1626081879682/AEGIS+Europe++CBAM+WTO+Legal+Analysis+-EXECUTIVE+SUMMARY+-KS+and+NCTM+-+Confidential+3+June+2021+REV.pdf>).

<sup>5</sup> See Issues and Decision Memorandum for the Final Affirmative Determination of the Countervailing Duty Investigation of Forged Steel Fluid End Blocks from the Federal Republic of Germany, December 7, 2020 (available at <https://access.trade.gov/Resources/frn/summary/germany/2020-27335-1.pdf>); Issues and Decision Memorandum for the Final Determination in the Countervailing Duty Investigation of Forged Steel Fluid End Blocks from Italy, December 7, 2020 (available at <https://access.trade.gov/Resources/frn/summary/italy/2020-27336-1.pdf>).

<sup>6</sup> The products countervailed in the United States were steel products, which are generally among the products with the highest level of free allowances.

**2. The Myth: Because the ETS adjustment only applies to exports, it constitutes a subsidy contingent in law or in fact upon exports in violation of the SCM Agreement and would subject EU exports to anti-subsidy duties in foreign markets?**

**The Truth**: This myth is built upon a false assumption that the ETS regulation, including the CBAM and the export adjustment, fall within the definition of a subsidy under the SCM Agreement. If the measure is not a subsidy in the first instance, however, the issue of export contingency is irrelevant.

The ETS (including free allowances) was designed in the same way as other environmental or similar regulatory measures, including licensing regimes and permitting schemes. The export adjustment simply recalibrates the applicable regulatory threshold, standard, or “benchmark” applicable to products not destined for consumption in the EU market. This distinction is very similar to other licensing and permitting regulations (*e.g.*, disposal, labeling, etc.) that exempt compliance or require different levels or types of compliance for products consumed outside the EU. Such regulatory adjustments for exports under these regulations are not considered “subsidies” under the SCM Agreement.<sup>7</sup>

Footnote 1 of the SCM Agreement reflects the “destination principle” and explicitly excludes from the definition of a subsidy the exemption of an exported product from duties or taxes applied to the like product when destined for domestic consumption. It would be absurd for the destination principle to apply to an exemption from duties and taxes on exports but not to apply to an exemption of climate change regulations on exports. The WTO member country negotiators did not need to be explicit for regulations because such regulations cannot be subsidies under the SCM Agreement’s definition (requiring a “financial contribution”). These regulations are simply not “financial” and do not involve any “contribution” to the recipient. Rather, as demonstrated in this instance, the ETS (together with free allowances, the CBAM, and the export adjustment) effectively calibrate the product-specific regulatory compliance obligations regarding GHG emissions necessary to achieve the EU’s critical climate change objectives.

Finally, the Commission is facing the virtual certainty that EU exports will be subject to increasingly significant ETS compliance costs and that such exports will be replaced with higher GHG intensive competing products, resulting in significant leakage and undermining EU climate change objectives. The Commission has the opportunity to amend the ETS to recalibrate the ETS regulatory compliance obligations for exports, address the significant risk of leakage, and encourage the EU’s trading partners to engage in a meaningful dialogue regarding meeting their GHG emissions reduction responsibilities. In the worst-case scenario in which the EU’s trading partners forsake their responsibilities to match the EU’s climate ambitions, they would simply impose insignificant anti-subsidy duties, which would likely cause less leakage than maintaining the full force of ETS compliance obligations on EU exports.

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<sup>7</sup> See also Aegis Europe, WTO Consistency of “Export Adjustments” in the Context of the EU Emissions Trading System (Incorporating a Carbon Border Adjustment Mechanism), June 28, 2021 (available at <https://static1.squarespace.com/static/5537b2f8e4b0e49a1e30c01c/t/60ec0a57e370ac6322a86209/1626081879682/AEGIS+Europe+-+CBAM+WTO+Legal+Analysis+-EXECUTIVE+SUMMARY+-+KS+and+NCTM+-+Confidential+3+June+2021+REV.pdf>).

3. **The Myth: The Commission should not address the leakage risk of EU exports through the ETS but instead should confer “green” subsidies to industries at risk of leakage based on objective criteria and not based on being contingent in law or in fact upon exportation.**

**The Truth:** This approach would simply replace allegedly prohibited export subsidies with potentially actionable subsidies under the SCM Agreement. Such an approach has significant legal and political hurdles.

As a legal matter, these subsidies would require reconciliation of, on the one hand, targeting sufficiently large subsidies to specific industries (*e.g.*, those facing a risk of leakage or environmental compliance obligation) and, on the other hand, adopting objective qualification criteria to avoid “specificity” under Article 2 of the SCM Agreement. In other words, it is extraordinarily difficult to design subsidies that are both specific to addressing leakage risk and not specific to avoid violating the SCM Agreement. This reconciliation was considered so difficult during the Uruguay Round that negotiators of the SCM Agreement adopted provisions “green lighting” certain non-actionable subsidies under Part IV of the SCM Agreement, including subsidies providing assistance to implement new environmental requirements. Part IV of the SCM Agreement expired over 20 years ago.

As a political matter, the Commission would need to allocate new or existing funds for “green” subsidies and, as noted above, would need to conclude WTO or other negotiations with trading partners to authorize such subsidies and create the necessary certainty that such subsidies would not be the target of anti-subsidy investigations by EU trading partners.

In other words, the myth that “green” subsidies are a solution amounts to nothing more than a dangerous distraction from a WTO consistent and immediately available regulatory solution. This distraction has far more risk of WTO violations, anti-subsidy duties, and significant delay in implementation of effective policy measures necessary to protect the EU’s climate change objectives. From a budgetary angle, the financing at EU level might prove extremely difficult to secure, and if financed at the national level, divergences might appear between member States due to different levels of financial resources and their distribution, even under the control of the Commission.

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## ANNEX 2

### A SPECIFIC EXAMPLE OF HOW ETS EXPORT ADJUSTMENTS COULD BE DESIGNED AND IMPLEMENTED

The European Commission made a policy choice to reduce GHG emissions through the implementation of the Emissions Trading System (“ETS”), which is a market-based cap-and-trade regulation. As the European Court of Justice has found, the ETS is not a duty, tax, fee, or charge.<sup>8</sup>

In general, the ETS achieves its regulatory objective of lowering GHG emissions from Union industries by effectively imposing product-specific compliance obligations<sup>9</sup> for GHG emissions that exceed a specific regulatory threshold or benchmark. If an EU manufacturer’s emissions exceed the applicable threshold or benchmark for a particular product, the manufacturer effectively incurs a compliance obligation. The objective of the ETS is to impose a sufficiently high and increasing compliance obligation to incentivize reductions in GHG emissions over time.

In designing the ETS regulation, the Commission had many possible options, including the following:

- The Commission could have used a direct command-and-control regulation to establish a prohibition on GHG emissions above a product-specific threshold or benchmark and impose increasing fines or other penalties on EU producers that release GHG emissions in excess of the threshold or benchmark.
- The Commission could have adopted a licensing regime that imposed no obligation up to a particular product-specific threshold or benchmark and then required the purchase of a license for GHG emissions in excess of the threshold or benchmark.
- The Commission could have adopted a permit scheme that imposed no obligation up to a particular product-specific threshold or benchmark and then required the purchase of permits for GHG emissions in excess of the threshold or benchmark.

Under all of these options, covered Union manufacturers are authorized to emit GHG emissions for “free” up to the product-specific threshold or benchmark and then incur compliance obligations for GHG emissions above this threshold or standard.

The Commission effectively followed this same approach in designing its ETS regulation. It designed a cap-and-trade regulatory regime that assigns “allowances” (*i.e.*, permits) for GHG emissions. Covered EU manufacturers receive free allowances for GHG emissions up to their applicable product-specific thresholds or “benchmarks” and must pay for allowances for GHG emissions above these thresholds or benchmarks.

The proposed carbon border adjustment mechanism (“CBAM”) adds to the ETS regulatory framework. The CBAM imposes a product-specific compliance obligation on imports for GHG

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<sup>9</sup> As noted above, we have simplified our references to the operation of the ETS. Notably, the ETS actually includes a range of different types of benchmarks. The analysis under this example refers only to product-specific benchmarks but would similarly apply to other types of benchmarks.

emissions above the applicable EU benchmark, with the objective of creating a level carbon playing field in the Union and preventing leakage that would undermine the EU’s regulatory objectives. As a result, importers essentially pay the same compliance obligation as EU manufacturers for products consumed in the EU market.

Current proposals provide for an increase in the ETS/CBAM compliance obligations over time through various policy design adjustments, including declines in the applicable product-specific benchmarks as free allowances are phased out.

Accordingly, in its simplest form, under the current ETS regulation, Union manufacturers incur a compliance obligation on products manufactured in the EU and consumed anywhere in the world based on the following formula:

*ETS Compliance Obligation*

$$= \text{Allowance Price} * \text{GHG Compliance Emissions}$$

$$= \text{Allowance Price} * (\text{Total GHG Emissions} - \text{Free Allowances})$$

$$= P * ((CI * O) - (B * O))$$

Where:

*P: Allowance Price*<sup>10</sup>

*O: Output for a specific covered EU producer*

*CI: Carbon intensity for the same EU producer*

*B: Benchmark for the applicable product*<sup>11</sup>

The following is a simplified, illustrative example of the calculation of an EU producer’s ETS compliance obligation and emissions profile over a five-year period.

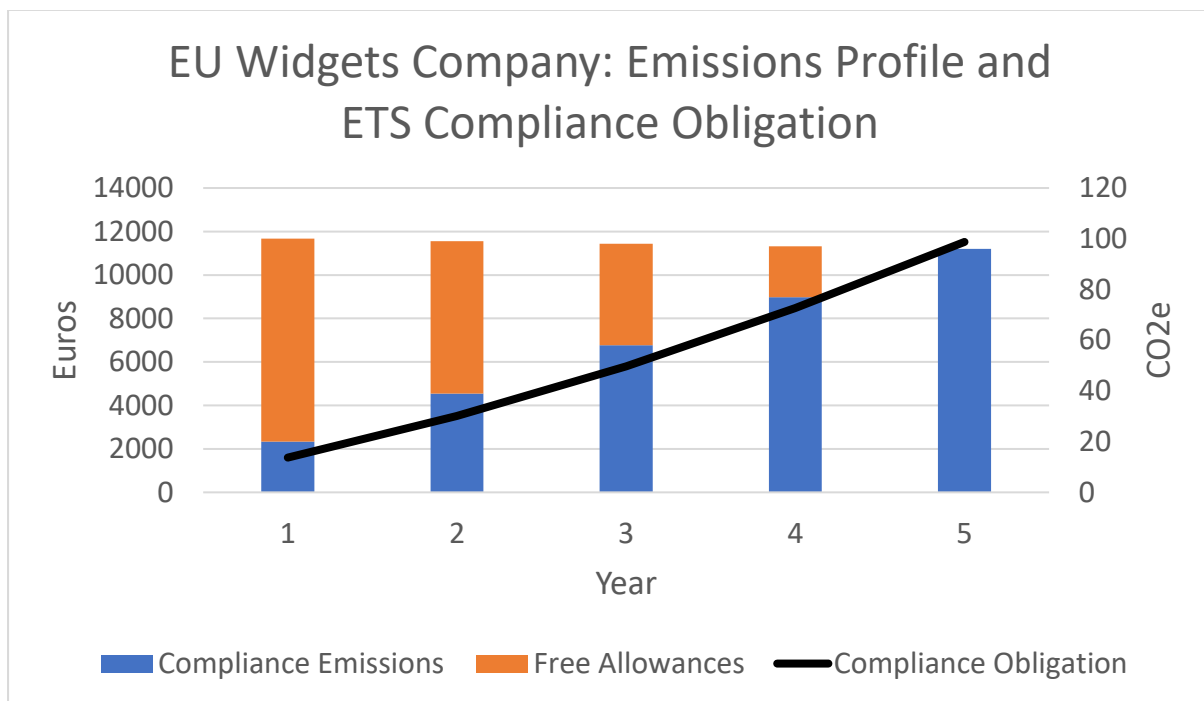
**EU Widgets Company – Example of Emissions Profile and ETS Compliance Obligation**

Year	1	2	3	4	5
Price (€)	80	90	100	110	120
Output (MT)	100	100	100	100	100
Carbon Intensity (CO2e/MT)	1	0.99	0.98	0.97	0.96
Benchmark (CO2e/MT)	0.8	0.6	0.4	0.2	0
Total Emissions (CO2e)	100	99	98	97	96
Free Allowances (CO2e)	80	60	40	20	0
Compliance Emissions (CO2e)	20	39	58	77	96
Compliance Obligation (€)	1,600	3,510	5,800	8,470	11,520

<sup>10</sup> The formula assumes that all allowances are bought and sold at the same allowance price.

<sup>11</sup> In this simple form, the “benchmark” is intended to incorporate adjustments to the calculation of the 10% most efficient EU installations, the phasing out of free allowances, and any adjustments for changes in an industry’s leakage risk or for reaching the cap on allocation of free allowances.





EU manufacturers will face significant increases in compliance costs as free allowances are phased out, the overall availability of allowances is reduced, and the allowance price increases. As a result, these manufacturers' exports will become less competitive in export markets and are likely to cause a shift in consumption to lower cost and higher GHG intensive substitutes. Such shifts in consumption will likely cause significant leakage and threaten to undermine the EU's climate change objectives.

To prevent export-based leakage, the compliance obligations under the ETS regulation should be suspended for products consumed outside the EU market. In other words, the phase out of free allowances should be suspended for exports destined for consumption outside the EU market.

Accordingly, in its simplest form, the compliance obligation when accounting for this export adjustment would be based on the following formula:

*ETS Compliance Obligation (with Export Adjustment)*

*= ETS Compliance Obligation: EU Market + ETS Compliance Obligation: Export*

*= (Allowance Price \* GHG Compliance Emissions: EU Market) + (Allowance Price \* GHG Compliance Emissions: Export)*

*= Allowance Price \* [GHG Compliance Emissions: EU Market + GHG Compliance Emissions: Export]*

*= Allowance Price \* [(GHG Emissions: EU Market – Free Allowances: EU Market) + (GHG Emissions: Export – Free Allowances: Export)]*

*= P \* [((CI \* O<sub>D</sub>) – (B \* O<sub>D</sub>)) + ((CI \* O<sub>E</sub>) – (EA \* O<sub>E</sub>))]*

*= P \* [(O<sub>D</sub> \* (CI – B)) + O<sub>E</sub> \* (CI – EA)]*

Where:

*P*: Allowance Price<sup>12</sup>

*O<sub>D</sub>*: Output for a specific covered EU producer destined for consumption in the EU market

*O<sub>E</sub>*: Output of the same producer destined for consumption outside the EU

*CI*: Carbon intensity for the same EU producer

*B*: Benchmark for the applicable product<sup>13</sup>

*EA*: Export adjustment corresponds to the adjusted Benchmark for calculating the level of free allowances applicable to exports

The following is a simplified, illustrative example of the calculation of an EU producer's ETS compliance obligation and emissions profile over a five-year period under the ETS with export adjustments. In this example, the export adjustment is fixed for the five-year period at the level of the Benchmark in year 1.

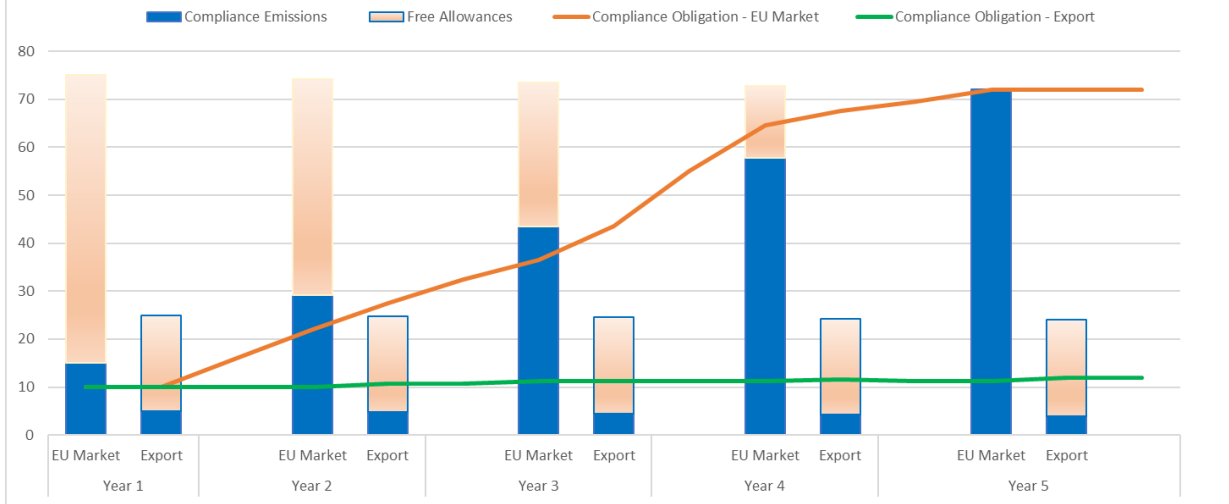
### EU Widgets Company – Example of Emissions Profile and ETS Compliance Obligation (With Export Adjustment)

Year	1	2	3	4	5
Price (€)	80	90	100	110	120
Output for EU Market (MT)	75	75	75	75	75
Output for Export (MT)	25	25	25	25	25
Total Output (MT)	100	100	100	100	100
Carbon Intensity (CO <sub>2</sub> e/MT)	1	0.99	0.98	0.97	0.96
Total Emissions (CO <sub>2</sub> e)	100	99	98	97	96
Benchmark (CO <sub>2</sub> e/MT)	0.8	0.6	0.4	0.2	0
Export Adjustment (CO <sub>2</sub> e/MT)	0.8	0.8	0.8	0.8	0.8
Emissions - EU Market (CO <sub>2</sub> e)	75	74.25	73.5	72.75	72
Free Allowances - EU Market (CO <sub>2</sub> e)	60	45	30	15	0
Compliance Emissions - EU Market (CO <sub>2</sub> e)	15	29.25	43.5	57.75	72
Compliance Obligation - EU Market (€)	1,200	2,633	4,350	6,353	8,640
Emissions - Export (CO <sub>2</sub> e)	25	24.75	24.5	24.25	24
Free Allowances - Export (CO <sub>2</sub> e)	20	20	20	20	20
Compliance Emissions - Export (CO <sub>2</sub> e)	5	4.75	4.5	4.25	4
Compliance Obligation - Export (€)	400	427.5	450	467.5	480
Total Compliance Emissions	20	34	48	62	76
Total Compliance Obligation (€)	1,600	3,060	4,800	6,820	9,120

<sup>12</sup> The formula assumes that all allowances are bought and sold at the same allowance price.

<sup>13</sup> In this simple form, the “benchmark” is intended to incorporate adjustments to the calculation of the 10% most efficient EU installations, the phasing out of free allowances, and any adjustments for changes in an industry's leakage risk or for reaching the cap on allocation of free allowances.

## EU Widgets Company: Emissions Profile and ETS Compliance Obligation – EU Market and exports



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