CARBON BORDER ADJUSTMENT MECHANISM: THE END OF "ETS STATE AID MEASURES" AND THE BEGINNING OF AN INTERNATIONAL TRADE DISPUTE?

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1. INTRODUCTION

The European Green Deal describes the climate ambitions that the European Commission ("Commission") has defined for the EU to reduce greenhouse gas emissions. According to the targets in the Green Deal, greenhouse gas emissions should be 50-55% lower by 2030 than they were in 1990, with full climate neutrality being achieved by 2050. If other countries outside the EU do not pursue similar climate ambitions, however, the EU's ambitions will increase the risk of "carbon leakage". This is an increase in global greenhouse gas emissions when companies shift production outside the EU because they cannot pass on their cost increases caused by EU policy to their customers without significant loss of market share.[1] The Commission's Green Deal will introduce a 'carbon border adjustment mechanism' for specific sectors to reduce this risk, and to help achieve the climate objectives described in the Paris Climate Agreement.[2] The purpose of that mechanism is to ensure that import prices for products reflect their carbon content, and as such the corresponding emission costs for EEA companies. This should then create parity between imported products and products manufactured by EEA companies. On 22 July 2020, the Commission launched a consultation on its proposal to introduce a carbon border adjustment mechanism. That proposal does not, however, describe precisely how the mechanism will be given shape.

In early 2019, the Commission organised a public consultation on a draft revised version of the guidelines for State aid measures in the context of the greenhouse gas emission allowance trading scheme ("ETS guidelines").[3] In light of the climate ambitions described in the Green Deal, the new ETS guidelines (replacing the existing ETS guidelines[4] on 1 January 2021) set out what State aid measures will be permitted for the next emission trading period (2021-2030) to prevent the prospect of carbon leakage as a result of significant indirect costs, for example passing on greenhouse gas emission costs in electricity rates. According to the Commission's consultation paper for the carbon border adjustment mechanism, that mechanism will serve as an alternative to such State aid measures, which are based on the EU Emissions Trading System, or "EU-ETS".[5] The purpose of the State aid (and other measures), that allow free allocation of emission allowances or compensation for the increase of electricity charges, is to prevent carbon leakage. This raises the question of whether the introduction of a carbon border adjustment mechanism will spell the end of the "ETS State aid".

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1 See the definition of "carbon leakage" at 14(3) in the Draft Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post 2021.
2 Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, The European Green Deal, COM(2019) 640 final, pp. 5 and 6.
3 Draft Communication from the Commission, Guidelines on certain State aid measures in the context of the system for greenhouse gas emission allowance trading post 2021 (https://ec.europa.eu/competition/consultations/2020_ets_stateaid_guidelines/index_en.html).
4 Communication from the Commission, Guidelines on certain State aid measures in the context of the greenhouse gas emission allowance trading scheme post-2012 (SWD(2012) 130 final) (SWD(2012) 131 final), OJ C 158, 5.6.2012, page 4.
5 Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, OJ EC 2003, L 275/32.

As is evident from the consultation paper on the carbon border adjustment mechanism and the published reactions so far, the mechanism's viability will depend entirely on whether it is compatible with the international trade agreements formed under the auspices of the World Trade Organization (WTO). Although it is not clear at this point precisely how the carbon border adjustment mechanism will be given shape, or how it will work, the issue of such a mechanism's compatibility with the WTO rules has long been fuelling discussion. So far, those discussions have been confined to professional literature and political circles. Since this will be the first mechanism of its kind to be introduced, no WTO dispute settlement body has pronounced any opinion on its compatibility with the WTO rules. When the introduction of a carbon border adjustment mechanism was first announced, several WTO members expressed concern about the compatibility of the mechanism with the WTO rules, announcing that they would challenge the mechanism if they believed that it constitutes a protectionist or discriminatory mechanism, instead of a valid "anti-climate dumping charge".[6]

This article is composed as follows. Section 2 describes the principal features of the EU-ETS and the permitted State aid measures for the next emission trading period (2021-2030) under the draft ETS guidelines to prevent the risk of carbon leakage. Section 3 describes the key aspects of the carbon border adjustment mechanism as they have been disclosed so far. Section 4 discusses the legal challenges facing the carbon border adjustment mechanism based on WTO rules. Lastly, section 5 concludes on the preferred and most viable way of structuring the carbon border adjustment mechanism, and how this mechanism will impact the EU-ETS, and the remaining scope for State aid measures to prevent carbon leakage.

2. STATE AID AND THE EU-ETS

2.1. EU-ETS: general comments

Launched in 2005, the EU-ETS is the European system for globally trading greenhouse gas emission allowances. The EU-ETS is based on the 'cap and trade' principle on the one hand, and on the trade in EU emission allowances on the other hand. The system basically restricts the total volume of greenhouse gases that selected installations are allowed to emit.[7] The selected installations must hand in one emission allowance for every tonne of carbon equivalent emitted. The total emission allowances available are limited in number. Under the 'cap' on greenhouse gas emissions, companies can receive or buy emission allowances, which they can then trade with each other as needed. A company whose greenhouse gas emissions exceed its predefined threshold will have to buy additional emission allowances from companies that have managed to keep their emissions below the cap. Companies that do not hand in sufficient emission allowances to cover their total emissions during a particular reporting period are subject to severe penalties.

Since 2013, the risk of carbon leakage in the sectors that are regulated in the EU (for example the steel and cement industries) has been addressed using the same measures as laid down in the EU-ETS. One of the measures to limit the risk of carbon leakage is allocating free emission allowances according to the emission performances of the best installations under the system (benchmarks).[8] Member States also have the possibility to prevent carbon leakage by compensating some electricity-intensive sectors for the higher electricity rates caused by the costs that the EU-ETS carries for electricity producers. However, that compensation must then be compatible with the rules for State aid.[9]

6 For example, see "Russia warns EU against carbon border tax plan, citing WTO rules", 28 July 2020 (https://www.climatechangenews.com/2020/07/28/russia-warns-eu-carbon-border-tax-plan-citing-WTO-rules/); "US keeps wary eye on EU carbon border tax plans", 23 March 2020 (https://www.cleanenergywire.org/news/us-keeps-wary-eye-eu-carbon-border-tax-plans) and "The EU can expect heavy pushback on its carbon border tax", 1 September 2020 (https://chinadialogue.net/en/business/eu-can-expect-heavy-pushback-carbon-border-tax/).

7 More than 11,000 factories, power plants and other installations in the 28 Member States, Iceland, Liechtenstein and Norway fall under the EU-ETS.

8 See Article 10a(2) of Directive 2003/87/EC.

9 See Article 10a(6) of Directive 2003/87/EC.

2.2. New draft ETS guidelines

The ETS guidelines set out the conditions for the State aid measures to prevent carbon leakage as a result of the indirect costs of the EU-ETS. Considered against the backdrop of the climate ambitions defined in the Green Deal, the new draft guidelines provide an update and include a restriction of the sectors that the Commission believes carry the greatest risk of carbon leakage[10] and are eligible for State aid. The 'new draft ETS guidelines' also limit State aid measures for compensating the indirect emission costs, lowering them from 85% to 75%.[11] However, those draft guidelines also offer Member States the possibility to compensate the beneficiaries' exposure to indirect ETS costs by more than 75% if this is necessary to properly protect against the risk of carbon leakage. This new feature limits the exposure to indirect ETS costs for specific sectors where those costs represent a disproportionate part of the gross added value. Compared with the existing ETS guidelines, the State aid may continue at the same level of intensity during the next emission trading period. It is no longer required to be degressive. Additionally, State aid may still be granted for capital expenditure on modernising electricity generation in the form of free allocation of emission allowances.[12]

The reactions to the consultation reflected heavy criticism of various features, including restricting the sectors and which sectors were selected. According to the Commission, the restriction reflects the revision of the carbon leakage indicator as set out in Article 10b of the ETS guidelines, and is based purely on the indirect costs.[13] When the new ETS guidelines are finalised, the Commission might include further sectors, based on the commentary presented.[14]

3. CARBON BORDER ADJUSTMENT MECHANISM

3.1. A carbon border adjustment mechanism: what it means

The principle of a carbon border adjustment mechanism is based on the option for WTO members to apply border tax adjustments, as provided for under the General Agreement on Tariffs and Trade ("GATT") (see also section 4 below). The concept of a border tax adjustment was introduced to impose the internal taxes levied on products also on imports. The mechanism is based on the destination principle, under which goods are taxed in the jurisdiction where they are used or consumed. A border tax adjustment makes it possible for each country to introduce its own tax regime, while also ensuring that international trade flows are neither exempt from tax nor subject to double taxation. One method of border tax adjustment is to specify a charge based on the internal tax, which is then also imposed on imported products. Alternatively, the mechanism can provide for a rebate on internal taxes for products that are intended for export and as such are not used or consumed in their country of origin.[15]

3.2. Carbon border adjustment mechanism: background and object

According to the Commission, the necessity of introducing a carbon border adjustment mechanism lies in the continued global differences in levels of climate ambition.[16] Given the more ambitious climate objectives under the Green Deal, those differences are likely to increase. This will also elevate the risk of carbon leakage in some sectors, which will then need to be limited using an adjustment mechanism. As explained above, the carbon border adjustment mechanism's objective is to ensure that the prices of imported products more closely reflect their carbon content, by imposing a charge that is the same as the taxes on like carbon-intensive domestic products to raise the prices of those carbon-intensive imports on the domestic market. According to the Commission, besides creating parity within the EU,

10 The restriction involves bringing back the total number of sectors from fifteen to eight (Annex I to the draft ETS guidelines): 1. Manufacture of leather clothes, 2. Aluminium production, 3. Manufacture of other inorganic basic chemicals, 4. Lead, zinc and tin production, 5. Manufacture of pulp, 6. Manufacture of paper and paperboard, 7. Manufacture of basic iron and steel and of ferro-alloys, 8. Manufacture of refined petroleum products.
11 Draft ETS guidelines, at 3.1.
12 Draft ETS guidelines, at 3.2.
13 See also the published report containing a review of the impact of the indirect ETS costs (https://ec.europa.eu/competition/consultations/2020_ets_stateaid_guidelines/consultance_report.pdf).
14 See the Explanatory note accompanying the proposal for the revision of the Emission Trading System Guidelines, p. 3.
15 Matsushita M., Schoenbaum T.J., Mavroidis P.C., Hahn M., *The World Trade Organization: Law, Practice and Policy*, 3 ed., OUP: 2015, p. 761.
16 Communication from the Commission of 11 December 2019, COM(2019) 640 final, The European Green Deal, p. 6.

the adjustment mechanism may also encourage a shift towards more sustainable products, both in the EU and elsewhere.[17] The carbon border adjustment mechanism would therefore not only support the EU's climate policy, but also indirectly incentivise its trading partners to introduce similarly ambitious climate policies.

3.3. Carbon border adjustment: design

The Commission has remained vague on how the carbon border adjustment will be given shape. In general terms, the Commission has stressed that the legal and technical viability will need to be reviewed carefully in light of the EU trade acquis[18] and other international obligations.[19] Another issue that will require attention is whether the carbon border adjustment mechanism is complementary to the State aid and other measures under the EU-ETS for preventing carbon leakage, given that the mechanism is intended as an alternative to those measures. In so far as the adjustment mechanism and the measures can exist side by side, the impact of those measures on EU carbon prices under WTO rules will need to be taken into account in determining what border adjustment to apply (see section 4 below).[20]

As matters stand, only the general proposal to introduce a carbon border adjustment has been presented for consultation.[21] The first option that the Commission describes for giving shape to the carbon border adjustment is a border tax or customs duty on imports of selected products that are manufactured in sectors with a high risk of carbon leakage.[22] The eight sectors[23] listed in the draft ETS guidelines are an important indication of which sectors this means. A second option is to expand the scope of the EU-ETS to include imports, meaning that foreign manufacturers or importers would be obliged to buy emission allowances and accordingly participate (at least in part) in the EU-ETS. The third option is an obligation to buy emission allowances from a specific pool that is separate from the EU-ETS and is intended for imports, and which reflects the prices under the EU-ETS. The final option is a carbon tax, for example an excise duty or VAT levy on the consumption of selected products that are manufactured in sectors with a high risk of carbon leakage. That tax would then apply to production within the EU and to imports.

The precise design of the carbon border adjustment will be detailed in a proposal for a directive, which the Commission is likely to adopt in Q2 of 2021.[24] Two elements that will be detailed are the carbon border adjustment mechanism's area of applicability and its scope, including the sectors, the geographic regions, the type of carbon restrictions and the trade flows that will be affected by the mechanism. Particular challenges include developing a methodology for calculating the emissions of foreign companies and establishing the actual level of the adjustments. At a minimum, based on WTO rules, that methodology will need to reflect whatever immunities and rebates are granted to domestic manufacturers (see also section 4 below).[25] The proposal will also need to describe how the mechanism will be introduced and implemented, ensure fair and honest treatment of the products concerned and explain how the revenues from the mechanism will be spent.[26] Those revenues are projected to yield 5 to 14 billion euros, on top of the revenues of approximately 10 billion euros that the emission trading system will generate, depending on future carbon prices and whether the system is expanded to include other sectors.[27] The extra revenues are intended (at least in part) to finance the European Recovery Fund that the Member States have agreed to in response to the impact of the COVID-19 crisis, and which will be used to finance, or be put towards financing, incentives for the green transition of Europe's economy and society.[28]

17 Inception Impact Assessment Carbon border adjustment mechanism, Ref. Ares(2020)1350037 - 04/03/2020, section C.
18 The agreements formed under the auspices of the WTO and the EU's other trade deals.
19 Inception Impact Assessment Carbon border adjustment mechanism, Ref. Ares(2020)1350037 - 04/03/2020, section B. See also the Communication from the Commission of 11 December 2019, COM(2019) 640 final, The European Green Deal, p. 5.
20 Inception Impact Assessment Carbon border adjustment mechanism, Ref. Ares(2020)1350037 - 04/03/2020, section C.
21 See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism
22 Inception Impact Assessment Carbon border adjustment mechanism, Ref. Ares(2020)1350037 - 04/03/2020, section C.
23 See footnote 10.
24 See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism
25 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 443.
26 *Ibid*.
27 Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions, The EU budget powering the recovery plan for Europe, COM(2020)422, pp. 16 and 17.
28 See https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/recovery-plan-europe_en.

3.4. History of the carbon border adjustment

The idea of a carbon border adjustment is not a new one. When the EU introduced its emission trading system in 2005, this immediately triggered a debate on the need to create parity between the conditions for companies established in the EU and the conditions for competing products imported from countries where "decarburising" rules are more relaxed or even non-existent.[29] Initially, emission allowances were allocated for free. After 2007, however, it became standard practice in the electricity sector for emission allowances to be auctioned: from only 20% of all emission allowances in 2013 to 70% industry-wide by 2020. This major change in the process of allocating emission allowances has added new fuel to the discussion about the measures aimed at limiting the risk of carbon leakage, including measures at the border.[30]

Several proposals have been made since 2007 to introduce a carbon border adjustment mechanism. One of the Commission's proposals, in 2007, included an obligation to acquire import allowances.[31] That obligation would then have applied to products exposed to risks of carbon leakage or to unfair international competition, until the countries in question adopted comparable measures to reduce their greenhouse gas emissions. The calculation of the carbon border adjustment on imports would have taken the equivalent of the average emissions caused by the products in the EU, subtracted the free allocation of emission allowances, and then multiplied the difference by the weight of the imports. The Commission's proposal also included an export adjustment based on emission allowances.[32] This proposal was ultimately not included in the published proposal for the third phase of the EU-ETS.[33] Article 10b(1) of Directive 2009/29/EC[34] only sets out the possibility for the Commission to also declare the EU-ETS applicable to importers of products manufactured by the sectors or subsectors established in accordance with Article 10a.[35] That provision does not describe what specific requirements would need to be satisfied if the scope of the EU-ETS were expanded to include imports. However, the importance of compatibility with the WTO agreement was highlighted in connection with this provision.[36] Two other proposals were made for introducing a carbon border adjustment based on that provision.[37] However, in light of the legal uncertainty about whether a carbon border adjustment mechanism would be compatible with WTO rules (and other systems), none of the proposals to date has led to introducing an adjustment.[38]

4. COMPATIBILITY OF THE CARBON BORDER ADJUSTMENT MECHANISM WITH WTO RULES

4.1. 4.1. General

The GATT,[39] from 1947, is an important touchstone for determining whether a carbon border adjustment mechanism is

29 This discussion gained speed when the United States withdrew from the Kyoto Protocol in 2001 and was given renewed vigour when the US announced they were withdrawing from the Paris Climate Agreement.
30 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 449.
31 Draft Commission Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC (10 December 2007, version 14), unpublished but described in Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 449.
32 *Ibid*.
33 COM(2008) 30 final, 23 January 2008.
34 Directive 2009/29/EC of the European Parliament and of the Council of 23 April 2009 amending Directive 2003/87/EC so as to improve and extend the greenhouse gas emission allowance trading scheme of the Community, OJ L 140, 5.6.2009, p. 63.
35 This possibility is explained as follows in recital 25 of the preamble to Directive 2009/209/EC: *"(...) Energy-intensive industries which are determined to be exposed to a significant risk of carbon leakage could receive a higher amount of free allocation or an effective carbon equalisation system could be introduced with a view to putting installations from the Community which are at significant risk of carbon leakage and those from third countries on a comparable footing. Such a system could apply requirements to importers that would be no less favourable than those applicable to installations within the Community, for example by requiring the surrender of allowances."*
36 See recital 25 of the preamble to Directive 2009/29/EC.
37 French government non-paper Mechanism for the Inclusion of Importers in the EU Emission Quota Trading Scheme, 2008, and non-paper Carbon Inclusion Mechanism for the Cement Sector, 2016. Neither paper was ever published, but both are described in Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, pp. 450-451.
38 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 451.
39 The GATT was incorporated into the WTO and its legal sources after that organisation was founded in 1995.

compatible with WTO rules. The idea behind the GATT is to deregulate international trade by lowering customs duties, eliminating restrictions on trade and generally opening up national markets.

The GATT offers a specific basis for border tax adjustments such as the carbon border adjustment mechanism, provided that certain requirements are met. Article II:2(a) of the GATT provides a general exception for applying a border tax adjustment that is equivalent to an internal tax imposed on corresponding domestic products. A fundamental requirement that these border tax adjustments must satisfy is the principle of non-discrimination, and specifically the principle of national treatment and the most-favoured-nation principle. Another option is to structure the carbon border adjustment to make it possible to draw on one or more of the grounds listed in Article XX of the GATT for justifying an exception to the free trade rules. Specifically, a basis could be found in the exception for measures necessary to protect human, animal or plant life or health (Article XX(b) of the GATT) or measures relating to the conservation of exhaustible natural resources (Article XX(g) of the GATT).

4.2. Qualification of the carbon border adjustment mechanism

If the carbon border adjustment mechanism is designed as a border tax or a customs duty on specific products, it will be necessary to determine whether it in fact constitutes a duty on imports or an internal tax. Article II of the GATT, which governs customs and import duties, states that WTO members are not permitted to impose any duties or charges in excess of those listed in the Agreement's Schedules of Concessions. Under Article II:2(a) of the GATT, WTO members may subject imported products to charges equivalent to the internal taxes that are imposed in respect of like domestic products or in respect of articles from which the imported products have been manufactured or produced in whole or in part. Such a border tax adjustment is considered to constitute an internal tax within the meaning of Article III of the GATT, and does not qualify as an import duty, provided that the adjustment mechanism is not linked to the imports as such, but to an internal factor such as selling a particular product (for example steel) on the domestic market.[40]

If the carbon border adjustment is given shape by expanding the scope of the EU-ETS to include imports or by introducing similar obligations separate from the EU-ETS, it will need to be determined whether an obligation to purchase and hand in emission allowances qualifies as a charge within the meaning of Article III:2 of the GATT for which a border adjustment is permitted under Article II:2(a) of the GATT. If not, i.e. if the EU-ETS must be considered to be an internal *regulation* within the meaning of Article III:4 of the GATT, Article II:2(a) of the GATT will not offer any basis for a border adjustment.[41] In professional literature, some authors have defended the position that an obligation to purchase and hand in emission allowances can be equated with an internal tax, given the mandatory nature of the obligation and the absence of any consideration given in exchange.[42] The introduction of a carbon tax on products carrying a risk of carbon leakage can most clearly be qualified as an internal tax within the meaning of Article III:2 of the GATT. In that scenario, it is indisputable that a border adjustment charge on imported products is permitted, provided that it is non-discriminatory.

As can be deduced from Article II:2(a) of the GATT, border adjustments are only permitted if they are equivalent to an internal tax levied directly or indirectly on like domestic products. An important factor, if the carbon border adjustment mechanism is matched to the costs that European companies incur under the EU-ETS, is that it is still unclear whether a border adjustment charge is also permitted if it also covers the carbon used in the "inputs" (such as raw materials and semi-finished goods) that were consumed during the production process but are no longer present in the product.

40 Appellate Body Report, China—Measures Affecting Imports of Automobile Parts, WT/DS339/AB/R, WT/DS340/AB/R, WT/DS342/AB/R (12 January 2009), at 161.

41 Article III:4 of the GATT states as follows on this subject: "*The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.*"

42 For example, see Javier de Cendra, "Can Emissions Trading Schemes Be Coupled with Border Tax Adjustments? An Analysis Vis-à-Vis WTO Law", [2006] 15 REV. EUR. COMM. & INT'L ENVTL. L. 131, pp. 135-136.

As matters stand, this question has not yet been answered by a GATT or WTO Panel.[43] It is therefore still uncertain whether the tax based on the amount of energy used in the production process may be taken into consideration.

4.3. Principle of non-discrimination: principle of national treatment

Article III:1 of the GATT sets out a general prohibition on protecting domestic production through internal taxes and charges or other regulations affecting processes such as the sale, transportation, distribution, processing or use of products. Article III:2 of the GATT states that imported products may not be subjected, whether directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. A "like" product in this clause should be construed in a broad sense of the definition, including not only identical products but also directly competitive or substitutable products.[44]

Whether or not a product qualifies as a "like" product should be determined based not only on the product's physical properties, the end use and consumers' preferences, but also on the purpose of the measure. The purpose of Article III of the GATT is to prevent internal taxes and regulations from being applied to imported or domestic products with a view to protecting domestic production; it is not intended as a way of harmonising WTO members' internal taxes and regulations, however, which differ from country to country.[45] Considering the purpose of the carbon border adjustment mechanism and consumers' preferences, it might be possible to argue that imported carbon-intensive products cannot be equated with low-carbon products, even if steel produced using fossil fuels could be said to be similar to steel that is produced from renewable energy sources.[46] As can be inferred from *Asbestos*, a key factor is whether consumers make a distinction between low-carbon products and carbon-intensive products, in the same way that they distinguish between asbestos-free products and products that contain asbestos.[47]

For products that cannot be regarded as "like" products, it must then be determined whether they fall within the scope of the broader definition of directly competitive or substitutable products. Among other elements, this requires assessing the product's nature and properties, the competitive conditions in the relevant market, the end use, the tariff classification,[48] and in some cases also the inputs and production processes.[49] Internal taxes are only considered discriminatory if imported products that are directly competitive to or substitutable with domestic products are not taxed in a similar manner, and if the measure is in fact intended to protect the domestic product. As such, it is permitted to levy higher taxes (at least slightly higher) on imported products.[50] It would seem plausible that low-carbon and carbon-intensive products will become involved in this form of competition. For that reason, the carbon border adjustment cannot immediately be labelled as discriminatory if the effect for imported products is not precisely the same as the internal tax.

If the carbon border adjustment mechanism is challenged on grounds of incompatibility with the principle of national treatment, it will need to be demonstrated that any taxation differences are intended to protect domestic products. This means that whether or not the carbon border adjustment is compatible with Article III:2 of the GATT will depend on the degree of guaranteed equivalence that the carbon border adjustment offers. Although the carbon border adjustment mechanism is not intended as a way of protecting domestic products, but instead as a way to limit the risk of carbon leakage, it is advisable to base the carbon border adjustment mechanism on the lowest costs for domestic manufacturers

43 In *U.S.-Superfund* (GATT Panel Report, United States – Taxes on Petroleum and Certain Imported Substances, BISD 34S/136 (17 June 1987)), the GATT Panel only expressed an opinion on whether a tax was permitted on chemical substances that had been used as "inputs" for manufacturing finished products. The Panel did not distinguish between inputs that were still present in the finished product and inputs that had been exhausted during the production process.
44 GATT, Border Tax Adjustments: Report of the Working Party, L/3464, BISD 18S/97 (2 December 1970), par. 14.
45 See the interpretative note ad Article III, "National Treatment on Internal Taxation and Regulation", WTO, pp. 125 and 126.
46 Appellate Body Report, European Communities—Measures Affecting Asbestos and Asbestos-Containing Products, WT/DS135/AB/R (5 April 2001), at 122.
47 *Ibid*.
48 Appellate Body Report, Japan – Taxes on Alcoholic Beverages, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R 22 (4 October 1996), p. 25
49 Appellate Body Report, Canada—Certain Measures Affecting the Renewable Energy Generation Sector, WT/DS412/AB/R, WT/DS426/AB/R (6 May 2013), at 5.63.
50 Appellate Body Report, Japan – Taxes on Alcoholic Beverages, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R 22 (4 October 1996), at 5.11. Matsushita M., Schoenbaum T.J., Mavroidis P.C., Hahn M., *The World Trade Organization: Law, Practice and Policy*, 3 ed., OUP: 2015, pp. 762 and 763.

and producers in the specific sectors, to avoid a situation where the carbon border adjustment charge is qualified as a discriminatory measure.[51] In addition, the amount of the carbon border adjustment will need to take account of national compensation measures and free allocation of emission allowances that are available for the domestic products.

4.4. Rule of non-discrimination: most-favoured-nation principle

The second fundamental principle of market access that the carbon border adjustment will need to satisfy is the general most-favoured-nation principle as laid down in Article I:1 of the GATT. This principle essentially entails that any direct or indirect advantage, favour, privilege or immunity granted for import and export duties and charges as described in Articles III:2 and III:4 that is granted to products originating in or destined for any other country must be accorded immediately and unconditionally to like products originating in or destined for the territories of all other WTO members. A key factor in the scope of this principle is that the text and the interpretative note ad Article I of the GATT refer exclusively to "like products". This means that Article I of the GATT is narrower in scope than Article III of the GATT, which also extends to directly competitive or substitutable products.[52] Assuming that the carbon-intensive products that become subject to the carbon border adjustment mechanism cannot be equated with low-carbon products, the most-favoured-nation principle does not appear to pose any obstacle to distinguishing between countries based on their methods of production. Although this manner of distinguishing between like products was previously held to be incompatible with the most-favoured-nation principle,[53] it has been argued in professional literature[54] that the Panel in *Canada-Autos* nuanced this concept.[55] This is subject to the condition that the distinction in applying the carbon border adjustment mechanism is phrased in neutral terms, and is not linked to the products' origins but to the processes and production methods used. [56]

Moreover, the most-favoured-nation principle does not prevent the measure from providing an exception for products that originate in or are intended for developing countries. Under the 1979 Enabling Clause,[57] members of the WTO may grant developing countries a differentiated and more favourable treatment (on the terms described in that exemption), without violating the most-favoured-nation principle of Article I:1 of the GATT. However, applying this clause should not result in a measure that could create obstacles to other WTO members' trade. It will also need to be demonstrated that a sufficient degree of correlation exists between on the one hand the preferential treatment and on the other relaxing the development, financial and trade needs of developing countries.[58]

4.5. Compatibility of the carbon border adjustment mechanism with the exceptions for environmental measures

If the carbon border adjustment mechanism does not satisfy the requirements described in Article II:2(a) of the GATT, it might be possible to invoke one of the exceptions for environmental measures under Article XX of the GATT. Article XX contains a limited list of grounds that WTO members may invoke to justify measures that are incompatible with the rules on free trade, by reason that those measures are necessary to protect human, animal or plant life or health (Article XX(b) of the GATT) or relate to the conservation of exhaustible natural resources (Article XX(g) of the GATT).

4.5.1. Article XX(b): protection of human, animal or plant life or health

It should not be difficult to argue that the carbon border adjustment should fall under the exception for measures that are necessary to protect human, animal or plant life, or health. In *Brazil-Taxation*, the WTO Panel found that

51 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 461.
52 Interpretative note ad Article I ("General Most-Favoured-Nation Treatment"), p. 36. See also the Panel's report in *EEC-Measures on Animal Feed Proteins*, L/4599, BISD 25S/49 (14 March 1978), at 103.
53 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 463.
54 For example, see Joost Pauwelyn, "Carbon Leakage Measures and Border Tax Adjustments Under WTO Law", in Research Handbook on Environment, Health and the WTO 448 (Denise Prevost & Geert Van Caster eds, 2013), at 495, and Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 463.
55 Panel Report, Canada—Certain Measures Affecting the Automotive Industry, WT/DS139/R (11 February 2000).
56 *Ibid*, at 10.25.
57 Decision of 28 November 1979 (L/4903).
58 European Communities—Conditions for the Granting of Tariff Preferences to Developing Countries, WT/DS246/AB/R (20 April 2004), at 164.

"*the reduction of CO_2 emissions is one of the policies covered by subparagraph (b) of Article XX, given that it can fall within the range of policies that protect human life or health*".[59] It follows from the dispute settlements on this exception that a measure may be regarded as "necessary" if it materially contributes to achieving the purpose of Article XX(b) of the GATT. The necessity requirement also entails that the measure must be proportionate to the purpose pursued, which means that no alternative measure may exist that achieves the same end but has a less restrictive effect on trade.[60] For the first requirement, the WTO's Appellate Body noted in *Korea-Beef* that a measure is more likely to satisfy this condition if it pursues vital and important common interests.[61] The carbon border adjustment mechanism seems capable of satisfying that condition. Professional literature has also highlighted the risk that potential challengers could argue that free allocation of emission allowances should be regarded as an alternative and more proportionate measure.[62] To limit that risk, it remains possible that the carbon border adjustment will be set at a lower value, to allow for free allocation of emission allowances in the separate Member States; however, that might make the adjustment less effective. An alternative option would be that free emission allowances are no long allocated to products that are subject to the carbon border adjustments, unless a demonstrable need exists, taking into account the border adjustment on imports. This would involve significantly modifying the EU-ETS, however.

4.5.2. Article XX(g): conservation of exhaustible natural resources

A second exception that could offer grounds for justifying a carbon border adjustment charge is found in Article XX(g) of the GATT and refers to the conservation of exhaustible natural resources. The Panel in *U.S.-Gasoline* recognised that clean air is a natural and exhaustible resource within the meaning of this exception.[63] The Appellate Body in *U.S.-Shrimp* added that this ground for exception should be construed against the backdrop of current concerns about protecting and conserving the environment.[64] In relation to the carbon border adjustment, the widely supported concern about climate change as a result of greenhouse gas emissions is underlined by the Paris Climate Agreement. In addition, the measure must be reasonably related to the end pursued, and the scope of application of the legislative framework introducing the carbon border adjustment may not be disproportionately broad relative to that end.[65] In professional literature, some authors have argued that, without flagrant inconsistencies or protectionist properties, the legislation on climate change, including the carbon border adjustment mechanism, would normally need to pass this "relatedness" test.[66] Lastly, it follows from the conditions of Article XX(g) of the GATT that the measure (which here refers to the carbon border adjustment) must be effective. [67]

4.5.3. Article XX, opening lines

Based on the foregoing, it seems possible to argue that a carbon border adjustment mechanism can be justified on grounds of both of the exceptions described. However, for both grounds, it will need to be examined whether the conditions set forth in the opening lines of Article XX of the GATT are satisfied. Those conditions state that the carbon border adjustment mechanism may not constitute an arbitrary or unjustified discrimination between countries where the same conditions prevail, or a disguised restriction on international trade. Whether the manner in which the carbon border adjustment mechanism is structured can satisfy these conditions will depend on the specific details of the mechanism and how it is given shape.

59 Panel Report, *Brazil - Certain Measures Concerning Taxation and Charges*, WT/DS472/R, WT/DS497/R (30 August 2017), at 7.880.
60 Appellate Body Report, European Communities—Measures Affecting Asbestos and Asbestos-Containing Products, WT/DS135/AB/R (5 April 5, 2001), at 172.
61 Appellate Body Report, Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef *(Korea – Beef)*, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, at 163 and 166.
62 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 466.
63 Panel Report, United States—Standards for Reformulated and Conventional Gasoline, WT/DS2/R (20 May 1996), as modified by the Appellate Body Report, WT/DS2/AB/R (20 May 1996), at 6.37.
64 Appellate Body Report, United States - Import Prohibition of Certain Shrimp and Shrimp Products, WT/DS58/AB/R (6 November 1998), at 129.
65 *Ibid*, at 141.
66 Michael A. Mehling, Harro van Asselt, Kasturi Das, Susanne Droege, Cleo Verkuijl, "Designing Border Carbon Adjustments for Enhanced Climate Action" [2019] ASIL, p. 467.
67 Panel Report, United States—Standards for Reformulated and Conventional Gasoline, WT/DS2/R (20 May 1996), as modified by the Appellate Body Report, WT/DS2/AB/R (20 May 1996), p. 19.

If the adjustment mechanism is based on the costs of the existing EU-ETS, the question is whether an effective adjustment mechanism can be designed that is also compatible with the rule of non-discrimination. Besides the practical questions of how to objectively calculate the carbon footprint of imports, and how to assess comparable emission trading systems in third countries, the system does not appear suited for allocating emission allowances to companies established in third countries. Under the existing EU-ETS, the number of allowances that each Member State receives is linked to a series of factors, including GDP. Moreover, continuing the free allocation might in any case be incompatible with the rule of non-discrimination if no allowance is made in the amount of the carbon border adjustment. For that reason alone, a uniform system of taxation or charges will be less open to challenges of protectionism and discrimination and will be more likely to satisfy the conditions of the "environmental exceptions".[68]

5. CONCLUSION

A mechanism that ensures parity between carbon-intensive imports and Europe's own low-carbon products is needed to prevent a situation where European companies become less competitive as a result of the climate ambitions under the Green Deal and are forced to shift their production to countries outside the EU. A carbon border adjustment mechanism could be a suitable instrument for achieving this. However, given the strict requirements under the WTO's rules, and in particular the GATT, designing such a mechanism poses a challenge. First, it is still very uncertain whether it is in fact possible to apply such a mechanism, if it is based on the costs that an internal system such as the EU-ETS carries for domestic products. Instead, an adjustment charge for marketing imported products that is based on an internal carbon tax for European companies would seem a better fit for the WTO system. A second uncertainty is whether the border adjustment mechanism may make allowance for the internal 'tax' based on the energy used during the production process: such a mechanism is permitted only for internal taxes on *products*. Third, it is unclear whether it is possible to design an effective border adjustment mechanism without it becoming discriminatory. That issue will undoubtedly be seized on to challenge the mechanism.

The best solution to fit the WTO system seems to be introducing an internal carbon tax. However, that would require overhauling the EU-ETS. The same is true if the scope of the existing EU-ETS is expanded to include imports, since the present system does not seem to be capable of being applied one-on-one to imported products. An obligation to purchase emission allowances for imported products, separate from the EU-ETS, will need to reflect the 'EU-ETS costs' of EU products as closely as possible, if it is to satisfy the rule of non-discrimination.
Instead of justifying the carbon border adjustment mechanism on the basis of an internal tax, the mechanism could also be designed to satisfy one of the grounds for exception under Article XX of the GATT. Article XX of the GATT provides an exception to the provisions on free trade for measures that are necessary to protect human, animal or plant life or health (Article XX(b) of the GATT) or that relate to the conservation of exhaustible natural resources (Article XX(g) of the GATT). However, it will only be possible to rely on these exceptions if the mechanism demonstrably contributes to those ends and is proportionate, necessary and non-discriminatory.

Besides the challenges of the uncertain incompatibility with WTO rules, designing the border adjustment mechanism is also an extremely complex issue. For example, each of the options for the carbon border adjustment mechanism described by the Commission will require, at a minimum, an objective method for establishing the carbon footprint of imported products, based on the type and volume of energy consumed in the production process. This will involve an objective method for assessing emission measures in third countries. Given the far-reaching implications of a carbon border adjustment mechanism, and the number of questions that it raises based on the WTO rules (GATT), it seems virtually inevitable that other WTO members will challenge the mechanism.

68 Matsushita M., Schoenbaum T.J., Mavroidis P.C., Hahn M., *The World Trade Organization: Law, Practice and Policy*, 3 ed., OUP: 2015, p. 767.

As an alternative to the State aid (and other measures) under the EU-ETS to limit the risk of carbon leakage, the carbon border adjustment mechanism will leave less scope for such measures after it is introduced. In light of the carbon border adjustment mechanism's complex and controversial nature, the possibility cannot be ruled out that the mechanism will initially only be applied to a small number of products, with steel and cement mentioned frequently. That would leave scope, at least in other sectors where a risk of carbon leakage has been established, for the continued application of State aid and other measures to limit that risk. However, a more precise estimate and analysis of the implications will need to wait until the Commission presents its detailed proposal for designing the carbon border adjustment mechanism, which is expected to be in mid-2021.

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