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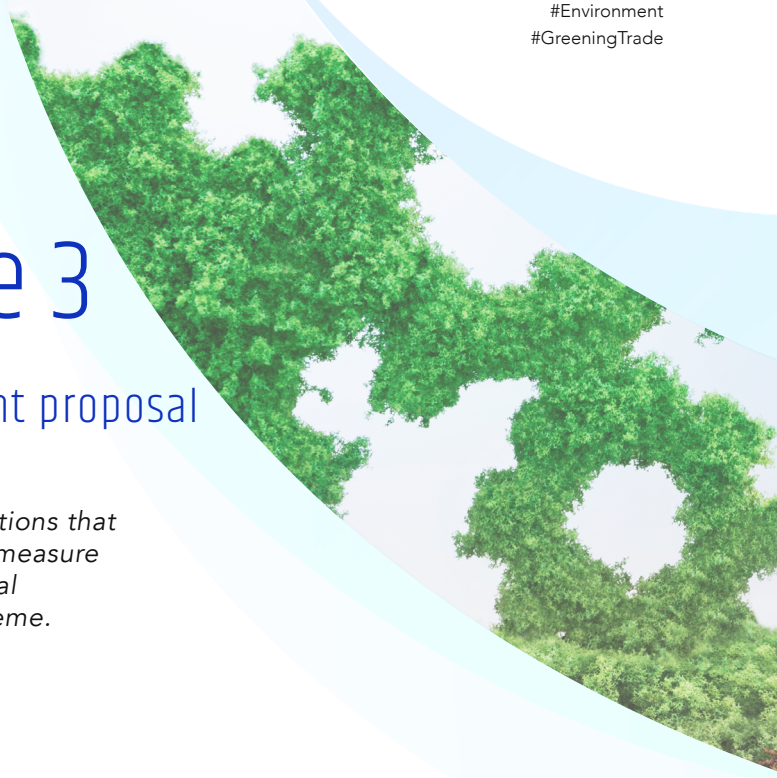

Greening EU trade 3

A European Border Carbon Adjustment proposal

> *In order to meet the more or less well-founded objections that it will inevitably raise, the border carbon adjustment measure will have to be thought of and designed as an external transposition of the European Emissions Trading Scheme.*

Pascal Lamy, Geneviève Pons & Pierre Leturcq, 2020

On 11 December 2019, Commission President Ursula Von der Leyen presented her European Green Deal package proposal to the European Parliament. Not surprisingly, it included an upcoming proposal for a "carbon adjustment mechanism at the Union's borders", an innovation designed to align the European Union's trade policy with its decarbonation objective. The communication that was published that very day specifies that the mechanism will target specific sectors and that it will replace measures designed to address the risk of carbon leakage in the European Union Emissions Trading Scheme (EU ETS)[1], i.e. free allocation of allowances.

The issue of border adjustment, which for the last ten years has regularly reappeared on the European political agenda, is making a strong comeback in a context where the EU has decided to move towards carbon neutrality by 2050, and where many industrial sectors are increasingly concerned regarding the impact that this objective will have on their competitiveness. In its Communication of 11 December 2019, the Commission proposed a response to address these concerns by targeting the sectors that emit the most CO2 and are therefore most likely to be affected by ambitious measures to reduce these emissions.

1. COM(2019) 640 final, 11 December 2019, p.6

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The COVID-crisis paves the way for a reconfiguration of the world economy, the extent of which remains, at this stage, uncertain. Production systems are likely to undergo relocation movements and see the diversification of value chains. The focus of international trade actors' attention on health and environmental issues - the linking of which appears to be more clear - should also accelerate the transition from protectionism to "*precautionism*"[1]. In the time that separates us from the post-crisis world, the promotion of greener trade becomes ever more urgent.

The European Commission's communication published on 27 May 2020[2] as part of the presentation of the "Next Generation EU" Recovery plan included an upcoming proposal for a Carbon Adjustment Mechanism at the Union's borders by 2021. The measure will, according to the terms of the communication, "be a new own resource for the EU budget and help repay funds raised for Next Generation EU in the future". The measure is also presented as a means of addressing the risk of carbon leakage, in compliance with WTO rules[3].

[1] Le Monde, Pascal Lamy : « Le Covid-19 va accélérer le passage du protectionnisme au précautionnisme », 9 avril 2020

[2] COM(2019) 640 final, 11 December 2019, p.6

[3] This confirms the European Commission's communication published on 11 December 2019 as part of the presentation of the European Green Deal.

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The issue of border adjustment, which for the last ten years has regularly reappeared on the European political agenda, has made a strong comeback in a context where the EU has decided to move towards carbon neutrality by 2050, and where many industrial sectors are increasingly concerned regarding the impact that this objective will have on their competitiveness. To achieve the climate objective, it will be necessary to achieve high levels of carbon pricing within the Union as a matter of priority. This will have to be done, for energy-intensive sectors, through the European Emissions Trading Scheme (ETS). According to a recent report of the Centre for Climate and Energy Analyses, the allocation price under the EU ETS should reach €52/tonne in 2030 if the new target is a 50% reduction in emissions compared to 1990 levels and €76 in 2030 with a target of 55% reduction[4].

However, via the rapid fall in the EUA price, the COVID-2019 crisis has revealed a major flaw in the system[5], the likes of which could be rectified by the introduction of a CO2 floor price.

The logic of the carbon adjustment mechanism is primarily linked to the will to avoid the carbon leakage that is likely to occur when carbon price differentials lead to a relocation of the most emitting activities to regions with more permissive legislation. With lower carbon prices, carbon leakage could be considered limited. As soon as we move towards a significant increase in carbon prices on the European market, the risk of carbon leakage can no longer be underestimated.

[4] Centre for Climate and Energy Analyses (CAKE), The European Green Deal Impact on the GHG's emission reduction target for 2030 and 2050 and on the EUA prices, March 2020, http://climatecake.pl/wp-content/uploads/2020/03/Impact-on-the-reduction-target-for-2030-and-on-the-EUA-prices.-Summary.pdf

[5] Carbon Brief, "Coronavirus set to cause largest ever annual fall in CO2 emissions", 9 April 2020 https://www.carbonbrief.org/analysis-coronavirus-set-to-cause-largest-ever-annual-fall-in-co2-emissions

The heightening of the carbon leakage phenomenon would pose a significant problem as it would counteract efforts to reduce CO2 emissions on a global scale.

As a net CO2 importing region wherein carbon emissions from imported products account for approximately 30% of domestic CO2 production, a border adjustment would prove to be relevant for the European Union's climate objectives, albeit potentially negative for some of its trading partners, those particularly affected being least developed countries and exporters of carbon-intensive products.

In developing its adjustment mechanism, the Commission will have to find its footing on two fronts – one political, the other, legal. On the political front, it will have to grapple with past experiences and various aborted proposals while also preserving a climate of consensus at the European level. Legally, the proposal will have to be carefully crafted to be compatible with the provisions of WTO rules to which the EU has subscribed.

This paper reviews the technical and political difficulties behind IMF Managing Director Kristalina Georgieva's position at the World Economic Forum in Davos on 23 January 20206, who publicly expressed concerns about the implementation of such a measure. With the support of the European Climate Foundation, this paper - the third in the series "Greening EU trade policy" - also takes stock of past attempts and reviews the legal and political criteria that need to be met for the adjustment mechanism to effectively meet its objectives. While recalling that an increase in the domestic price per tonne of carbon and the abolition of the free allocation system are necessary prerequisites for any corrective measures of a commercial nature, this note concludes that the

[6] WEF DAVOS Talk - Leadership Lessons: Building an Inclusive and Sustainable Financial System - Speakers: Kristalina Georgieva, Laurence D. Fink, Anil Menon, 23 January 2020

European Commission should work towards a progressive mechanism parallel and equivalent to the EU ETS. This mechanism should initially target electricity and cement and then be extended to additional products subject to carbon pricing in the EU, subsequently paving the way for carbon pricing system convergences among trading partners.

01.
History of previous proposals (2007 – 2019)

A. In the European Union

Since 2007, three adjustment proposals have been debated at the European level, none of which produced results. These adjustment proposals came within the scope of various projects to reform the EU ETS, which was implemented from 2005 in four steps.

In 2007, the conversion of the free emission allowance system into an auction system as part of the EU ETS reform led high-emitting industries to express their concerns regarding the risks of loss of competitiveness and carbon leakage. As part of the EU ETS reform for the third phase of the mechanism's implementation (2013-2020), the European Commission initiated an informal[7] proposal for an adjustment mechanism[8]. It sought to include pertinent sectors' imports in the EU ETS, and to remunerate European exporting industries by basing the equilibrium on the average level of emissions generated at the European level in accordance with the products concerned. The idea expressed in this informal proposal was eventually discarded in favour of an extension of the free allocation of emission allowances for the industries most exposed to international competition.

On two separate occasions, France initiated a proposal to put a border carbon adjustment mechanism in place. A non-paper from the French government in 2009 proposed the implementation of a "carbon inclusion" mechanism, obliging importers to purchase emission allowances under the EU ETS. The non-paper also set out criteria to ensure the mechanism's compliance with WTO rules, focusing the scope of the measure on countries that refused to take part in discussions on a future international climate agreement, and targeting only the emissions generated during production. This initiative was not followed up by a formal legislative proposal from the European Commission.

Following the signing of the Paris Agreement, France issued a new proposal in February 2016 explicitly targeting the cement industry. This proposal aimed to replace the free allowances granted to European industries with the implementation of a similar emission pricing mechanism for cement importers in Europe. After having raised unanimous upheaval among European cement manufacturers[9], the proposal was taken up by the European Parliament's Environment, Public Health and Food Safety Committee in December 2016 in an amendment to the draft reform of the EU ETS for the fourth phase of operation (2021-2030) and voted upon. In the end, it was rejected by the European Parliament in favour of once again maintaining free allowances for the cement industry. The lack of a legal basis to justify the measure (mainly under WTO rules) accompanied by the risk that the measure would be perceived as a disguised form of economic protectionism were the main reasons given for the rejection of France's proposal.

[7] Draft Commission Proposal for a Directive of the European Parliament and of the Council amending Directive 2003/87/EC (December 10, 2007).

[8] *Ibid*, Art 29 "Future Allowance Import Requirement".

[9] Carbon Pulse, "Comment: Why is the EU cement sector resisting a CO2 border measure?", 31 January 2017

B. In the United States of America

On the other side of the Atlantic, four key proposals have also made it more or less as far in the legislative process. Of the four, two have failed and one is awaiting Congress' vote. The first proposal in 2007 was invoked by the private sector. Together with the support of the International Brotherhood of Electric Workers, a powerful American union, American Electric Power suggested the implementation of an adjustment mechanism. The proposal was taken up the same year by two U.S. Senators and was included in the Low Carbon Economy Act. The legislative package was introduced on 11 July 2007, but was eventually rejected by the U.S. Senate.

The following year, the Climate Security Act provided for an allowance purchasing system parallel to the domestic system, albeit only for producers in countries that had not taken comparable action. Section 768 of the Waxman-Markey Bill (American Clean Energy and Security Act) of 2009 arranged for both a cap-and-trade system, as well as a border adjustment measure (International Reserve Allowance Program) that was not to take effect until 1 January 2020 and specifically targeted the iron and steel sectors (Section 769). Passed in the House of Representatives on 26 June 2009, the law was later rejected by the Senate in July 2010 following the push-back of industrial lobby groups.

In 2014, section 4695 of the "American Opportunity Carbon Fee Act" also explicitly arranged for the introduction of adjustment measures (Border Adjustments for Energy Intensive Manufactured Goods). These measures consisted of a refund of allowances paid for products intended for export on the one hand, and the imposition of an equivalent border tax on high-carbon foreign-made products on the other. Introduced in Congress on 19 November 2014, two months before the end of the 2013-2015 legislature, the law failed to be enacted on time. US laws that are not enacted before the end of the legislature are cleared from the books and must be reintroduced.

The Energy Innovation and Carbon Dividend Act 2019 was introduced in Congress on 1 January 2019 and is awaiting passage through the House of Representatives. It has provided for the implementation of a carbon tax and a border adjustment measure to discourage industries subject to carbon pricing from relocating their activities. The justification for the adjustment measure contained in Section 9908[106] explicitly emulates GATT Article XX paragraph (b) on exemptions. The bill, which is expected to be submitted to the U.S. Congress for a vote in the forthcoming months, also arranges for a social measure to redistribute the profits generated in dividends to individuals. It is nevertheless highly unlikely that this proposal, tabled by Democratic Representative Ted Deutch, will make it through the Republican-dominated Senate.

C. The "Nordhaus" option and the carbon club hypothesis

In 2015, the economist William Nordhaus[11] wrote an article[12] in which he presents the advantages of "climate clubs" to encourage the most reluctant countries to

[10] 6 Energy Innovation and Carbon Dividend Act (2019); Sec 9908 Carbon Border Fee Adjustment: (b) Purpose. —The purpose of the carbon border fee adjustment is to protect animal, plant, and human life and health, to conserve exhaustible natural resources by preventing carbon leakage, and to facilitate the creation of international agreements.

[11] Nobel Memorial Prize in Economic Sciences recipient, 2018.

[12] Nordhaus, W., Climate Clubs to Overcome Free-Riding, Issues in Sciences and Technology, n°4 summer 2015.

move faster towards a reduction in their CO2 emissions, therein avoiding progression of the phenomenon known as "environmental free riders". Based on a hypothesis of climate co-benefits the economist seeks to demonstrate States' interest in applying a single carbon price amongst themselves and arranging flat-rate penalties for those who refuse to do so. The publication of William Nordhaus' article consequently led to a renewed interest in the club hypothesis. Between 2015 and 2017, a large number of articles in economic and environmental sciences addressed the issue of climate clubs and, particularly after the Paris Agreement, the issue of Carbon Market Clubs. The "Carbon club" consists of an alliance of countries that are committed to reducing their CO2 emissions and have chosen to harmonize their domestic carbon pricing policies and/or open carbon markets to one another. The introduction of border adjustment measures for this common carbon market is often presented as a logical consequence of the club's creation to rebalance conditions of competition as well as to direct the club's trading partners to adopt the same pricing level. Though often mentioned, this initiative has not yet been realized, particularly due to internal difficulties in stabilising markets and existing taxation systems. In a way, though, the EU ETS joined by Switzerland, Liechtenstein, Iceland and Norway could be likened to a carbon club, an analogy to bear in mind when designing a European carbon adjustment mechanism. In addition, we will see that system linkages could be envisaged between those of the EU, Canada and New Zealand, for example. In certain regions of Canada, the carbon tax is already as high as $35 per tonne, a relatively similar price to that of an EU ETS allowance.

02.
Legal and political obstacles

The results of a survey published in January 2020 by Eurochambre highlight the measure's two main obstacles[13]: open to the principle of carbon adjustment, the vast majority of companies (from across the globe) that responded to the survey mention the need for compatibility with WTO rules, as well as the very real risk of a series of commercial reprisals if the European Union were to introduce such a measure unilaterally. In addition, although the European Commission expressed its preference of the term "adjustment measure" over "tax", the legal nature of this mechanism, as well as the reactions that its implementation could provoke in Europe and the international arena remains uncertain.

A. Compatibility of the adjustment measure with WTO rules

From the perspective of various experts in international trade law, an adjustment measure could be compatible with WTO rules under certain conditions. It is its legal nature (tax or customs duty) that will partly determine the relevant international legal bases on which to justify the measure.

A.1. Internal and external non-discrimination (GATT Art. I and III)

GATT Article I on General Most-Favoured-Nation Treatment prohibits measures which result in the granting of differential trade treatment to goods imported from different origins but considered to be similar. The

[13] Eurochambres – Global Chamber Platform, Report on the GCP Growth & Sustainability Survey 2020, January 2020

similarity of products is assessed on the basis of four criteria: the characteristics of the product, its end use, the qualification of the product in the Member States' schedule of concessions and, finally, consumer tastes and habits (whether the product attracts the same consumers). GATT Article III prohibits any regulatory and fiscal discrimination between imports and domestic products, but allows the imposition of a charge at the border amounting to the equivalent of a domestic tax directly levied on certain products. This implies that no differentiated direct or indirect charges may in principle be imposed between equivalent imported products, and that internal measures and taxes on domestic products and imports must not favor domestic production.

A.2. No less favorable treatment (GATT Article II)

Should the measure be considered as a customs duty calibrated to the average carbon intensity of European industries and the domestic price per tonne of CO2, Article II of the GATT would also have to be taken into consideration when assessing the measure's legality. Article II prohibits the unilateral introduction by a Party of less favourable trading conditions (Article II, 1-a.) and therefore of customs duties higher than those provided for in the Agreement (Article II, 1-b.).
GATT Article II (2) provides, however, that "nothing in this Article shall prevent a contracting party from imposing at any time, on the importation of any product, a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III*, " in respect of the like domestic product or in respect of an article from which the imported product has been manufactured or produced in whole or in part". Therefore, the strict correspondence of a customs duty measure with the domestic level of taxation would be a necessary prerequisite for WTO legality.

The fact that the EU ETS does not, strictly speaking, correspond to "domestic taxation levied directly on products" as envisaged by GATT Articles II and III adds to the climate of legal uncertainty.

A.3. Environmental exceptions (GATT Art. XX)

Article XX lists the exceptions that allow Parties to override the above principles. Among them, two in particular could form the legal basis for justifying the establishment of a border carbon adjustment mechanism. Paragraph b) of Article XX provides an exception for measures "necessary for the protection of human, animal or plant life or health" and paragraph g) for measures "necessary for the conservation of exhaustible natural resources". The chapeau of Article XX recalls that such measures must not, in any event, constitute arbitrary or unjustifiable discrimination between domestic products and imports, and between imports of equivalent products or a disguised restriction on international trade. On the issue of arbitrariness, the WTO Appellate Body in the *US-Shrimp case*[14] highlighted the importance of fairness and justice in the implementation of a measure. Implementation must therefore be transparent and predictable, and must allow targeted industries to exercise their rights and calculate the carbon content of their production. Nevertheless, in its assessment of the legitimacy of these exceptions, the Appellate Body stresses that sustainable development is now an objective of the WTO and that all its provisions must be interpreted with this principle in mind.

[14] WTO AB, *US-Shrimp case*, 1998.

B. Technical and political obstacles

B.1. Evaluation of the carbon intensity of EU imports

An initial observation stands out: at present, the instruments available do not render it possible to accurately measure the carbon content of products entering the European market. Value chain fragmentation further complicates the process of measuring the carbon content of production. Should the carbon intensity of the final production process alone be taken into account, or should it include the carbon intensity of inputs and energy consumption during the transport and processing of components? While the latter option simply seems unattainable, the measurement of certain primary goods' carbon content produced in Europe, such as cement or steel, is well known. Notably, this is thanks to the ISO 14060 standards and those following, as well as the EU ETS calculation and data collection methodology. On the latter point, however, there is still major uncertainty - in the current state of measurement technology - about the carbon intensity of the same type of goods produced in third countries that are imported into the European market.

Pricing based on the average intensity of equivalent goods produced in Europe would technically be possible, but would create a rift in the level playing field between industries in third countries, some of which would have the means to demonstrate the carbon footprint of their production (with potentially lower intensity levels than the European average), and others which, on the contrary, would have neither the means nor the instruments to do so. This last point will have to be answered: who bears the burden of measurement, and according to what criteria and methodological principles?

B.2. Absence of EU allowance floor price

The economic slowdown incited by lockdown measures taken by national governments to combat the spread of the virus has led to a sharp and sudden reduction in CO2 emissions in the Union and, consequently, a drop in the EU Allowance price. Although stable at the start of 2020, the price per tonne of carbon has been falling steadily since March 2020. From 25.7 euros/tonne on 19 February, the price of the emission allowance in the EU ETS fell to around 15 euros/tonne in April, only beginning to recover at around 22 euros/tonne on 17 April 2020.

Since the price signal per tonne of CO2 emitted in Europe will inevitably have to increase in order to accelerate the transition of the most carbon-intensive domestic industries, the introduction of a price floor per tonne of CO2 is essential. This measure should, as a matter of priority, be included among the reforms planned for Phase 4 of the EU ETS (2021-2030).

B.3. Internal and external political challenges

Since 2007, the various proposals raised at the European level have in turn come up against the reluctance of European decision-makers, the opposition of industries benefiting from free allocations of emission allowances, and more blatantly, the complexity of a measure that would nevertheless end up being denounced at the WTO and subsequently raise contentious issues. The new Commission seems to have assessed these difficulties and has already initiated an impact assessment process which will be responsible for determining the framework of a measure that the Commission plans to propose in the second half of 2021.

The term "adjustment mechanism", akin to customs duty and therefore decided by 'qualified majority' in the Council under the co-decision procedure with the Parliament, was logically preferred to "tax". The introduction of a uniform tax at the Union's borders

would indeed have required the unanimous agreement of all the Member States, far from being a foregone conclusion. Furthermore, a tax would fail to reflect the nature of the EU ETS. The only viable option available to the EU appears to be a tariff, the amount of which would be aligned with the carbon tariff of the EU ETS. In this respect, it is worthwhile to note that unless there is a bilateral agreement to recognise equivalent pricing on the other side of the Channel, imports from the UK could also be subject to the border adjustment measure if confirming its intention to leave the EU ETS.

Regarding the acceptability of the measure at the international level, the imposition of new customs duties is nevertheless likely to give rise to opposition from certain partners of the European Union. Least developed countries exporting to the European Union whose lack of access to greener technologies and production methods hampers the transition of their industries would have legitimate reasons to consider this measure a disproportionate burden on them, this said measure thus favouring the industries of the most developed countries. Countries such as India and China have repeatedly indicated that they would systematically take action at the WTO if any country were to introduce a carbon tax or border adjustment measure. Ensuring the compatibility of the measure with GATT/WTO rules would on the one hand ensure the diplomatic coherence of the EU, which has always defended multilateralism and made the case for upholding a binding dispute settlement mechanism, and on the other hand avoid escalation in a trading theatre already severely disrupted by the untimely initiatives of Mr Trump. Donald Trump's potential re-election in November 2020 renders new trade sanctions by the US a likely scenario if the EU unilaterally implements a carbon adjustment measure at its borders. In this regard, it should be recalled that the threat of trade retaliation was confirmed by US Secretary of Commerce Wilbur Ross at the end of January in Davos[15].

[15] Financial Times, "US threatens retaliation against EU over carbon tax", 26 January 2020

03.
Criteria for success

Once they are identified, the rules of international trade law can be considered not as an obstacle, but rather as the compass that the European Commission will have to follow when designing its carbon adjustment mechanism. The fundamental criteria to be respected are as follows:

A. Necessity and proportionality

In order to fit within the legal framework of exceptions (b) or (g) of GATT Article XX, the measure will have to be chiefly based on the climate objective of combating carbon leakage. The criterion of "necessity" referred to in exception (b) of GATT Article XX does not imply that the measure is unquestionably inexorable, but rather that there is a genuine relationship between the objectives pursued and the means employed[16]. On the European side, it will have to be argued that there is a real and quantifiable risk of significant carbon leakage as a result of increased climate ambitions at the EU level, and that the adjustment measure seeks to avoid such a chain of circumstances. To the extent that the proposal would constitute a de facto trade-restrictive measure, it will be up to countries wishing to denounce it to demonstrate that less trade-restrictive measures could be as effective in achieving tantamount objectives.

Over the years, free allowances, which are generally presented as this alternative, have demonstrated their ineffectiveness; they have neither led to efficiency gains, nor progress in energy transition for beneficiary industries. Moreover, they are considered subsidies under WTO rules. The impact assessment that the European Commission has started will have to emphasise these points, compare various scenarios, and quantify the volume of leakage that can be avoided compared to the current system of free allowances.

[16] WTO Appelate Body Report, Brazil – Retreated Tyres, 2007.

B. Fairness

The compliance of the measure under WTO rules will depend on the absence of any form of unjustifiable discrimination between domestic and import carbon pricing, or between areas of origin depending on whether or not they have equivalent domestic pricing. Where justified, exceptions should be granted to foreign producers in the sectors concerned and linkage systems with equivalent foreign emissions trading or carbon pricing schemes should be sought.

C. Transparency and predictability

The process of calculating the CO2 emissions contained in the targeted products will have to be transparent and allow producers the possibility of demonstrating better results. The system will have to include a default value for imports, which could, for example, correspond to the average carbon content of similar goods produced in Europe while also allowing foreign importing companies to pay less by proving that the carbon content of their production is lower than the average of European equivalents. For greater transparency, the evaluation of the carbon content of products could eventually be entrusted to an independent agency financed by the European Union by allocating some of the revenue from adjustment. This body would be responsible for adjudicating the carbon-content that producers in third countries would like to put forward.

04.
Fundamental characteristics of the European Border Carbon Adjustment mechanism and modalities of implementation

In order to ensure compatibility with WTO rules and although the measure may also be based on the need to preserve the competitiveness of European companies the fight against carbon leakage must be its main rationale. The risk of carbon leakage will increase as the European Union's domestic environmental and climate constraints are tightened, but will only surface in a limited number of highly energy consuming industrial sectors particularly exposed to trade.

A. A parallel system aligned with the EU ETS

Although criticized in the early stages of its implementation, since its last reform in November 2017, the EU ETS has succeeded in demonstrating both its effectiveness at the European level and the role model it can now be on the international stage. In the course of the reforms that preceded each phase of the system's implementation, as well as the integration of Switzerland, Iceland, Liechtenstein and Norway, the EU ETS has advanced towards progressive pricing per tonne of carbon that is currently between €25 and €30 and could reach €40 to €50 per tonne in the near future. In addition, the European Union has supported countries such as China in the design of their internal ETS system[17].

[17] For example, in 2018, nearly 8000 Chinese professionals had benefited from training programmes financed by the European Commission in the framework of a cooperation on the design of their ETS system. The EU and China have also renewed the principle of their cooperation in this field via the signing of the Memorandum of Understanding framework, Beijing 2018.

Because it would allow the carbon pricing of imports to be modelled on current domestic prices in force without disturbing the operating balance of the EU ETS, the mechanism for adjusting carbon at the European Union border will have to be thought of as an equivalent of the EU ETS with the implementation of a parallel allowance trading market. An indexation of the import quota price per tonne to the domestic price per tonne in the EU ETS the day before the product enters the territory of the European Union would also provide indispensable guarantees of non-discrimination vis-à-vis domestic production under GATT Article III.

B. Targeted launch on pilot products: electricity and cement

The set of procedural and formal requirements described in the previous sections should lead the European Commission to restrict the scope of the measure to a limited number of sectors, for which the implementation of a carbon adjustment will be the least complex. Technical reasons of readability, effectiveness and proportionality between the measure and its environmental objectives also justify focusing the adjustment on pilot products with a well-identified or identifiable carbon content, both within the Union and abroad.

The excellent traceability of the emissions for which its production is responsible both in the EU and in neighbouring countries connected to the European grid make electricity a designated product for the first implementation phase of the adjustment mechanism. Since 2013, European electricity producers no longer receive free allowances and are subject to increasing pricing of their CO2 emissions under the EU ETS. In addition, since 2015 there has been a steady increase in the volume of electricity imported into the EU from countries with zero or near-zero carbon pricing[18]. While the EU plans to increase the interconnection capacity of its electricity grid with its neighbours, new coal plants have been or will soon be built in the various countries already connected - or in the process of being connected - to the European grid. None of the five new countries that are expected to be connected to the EU electricity grid by 2025 (Tunisia, Egypt, Libya, Israel and Moldova) are currently applying carbon pricing.
Regarding modalities, the mechanism applied to electricity will necessarily have to take into account the variations in the carbon intensity of production from country to country and hour to hour, and will have to be configured as the corollary of the EU ETS applied to electricity entering the EU.

At the industrial level, the sectors to be targeted are those whose production is at the same time localised, highly energy-intensive and particularly exposed to international competition. Examples include cement, steel, aluminium and paper. For these products, the EU ETS has the advantage of having established reliable methods and databases to quantify CO2 emissions generated during production. As proposed by France in 2017, cement as the first pilot product of the European Border Carbon Adjustment Mechanism would make a good case in point. Cement meets all the criteria of a pilot product: high CO2-emitting production and well-identified carbon content on European territory. It is also subject to strong competitive pressure from countries bordering the European Union. Lastly, it has the advantage of being exposed to trade without being a good that the European Union imports or exports with China or the US. While China accounts for almost 60% of the world's cement production, Europe imports negligible amounts of Chinese cement, most of it destined for domestic consumption.

[18] Sandbag, The Path of Least Resistance – How Electricity generated from Coal is leaking into the EU, Report, January 2020.

C. Nature and use of the levy

This levy, which is not a tax, is comparable to a custom duty and could as such be considered as an own resource of the European Union. We propose to make it a resource assigned to two objectives in particular, necessary for the functioning of the whole process: the financing of an independent agency responsible for assessing the carbon content of imported products and the creation of an energy transition fund for the least developed countries, both of which are developed below.

D. Fairness ensured by an independent agency

An agency, independent under European law but open to non-European experts, will determine the outstanding balance for access to the EU market depending on the level of domestic CO2 pricing. In the case of a WTO challenge by the States of origin of the affected companies, this independent body should be consulted. Both the establishment of the levy and its characteristics and the independent evaluation mechanism will have to be notified to the WTO for examination by the Committee on Trade and Environment and/or the Committee on Technical Barriers to Trade.

E. Phasing out of free allowances

In order to avoid any form of trade distortion, in accordance with the GATT principles of non-discrimination, the Commission will have to ensure that the adjustment mechanism and the suppression of free allowances are introduced simultaneously. Designed to level the competitive playing field between certain domestic producers particularly exposed to international trade and their competitors in third countries, these free allowances are problematic in two respects: they are tantamount to subsidies under WTO rules, and have been completely ineffective in encouraging beneficiaries to decarbonize their production.

Since the EU ETS reform in 2017 and the coinciding reduction of free allowances volume, some European industries have complained of an overall lack of free allowances. This argument is questionable to the extent that the gradual reduction of free allowances during Phase 3 had mainly been used to correct the surplus of free allowances granted in Phase 2. The battle will continue in this respect for the European Commission, which in its announcement of 11 December logically evoked a system meant to replace free allowances.

F. A "test" period for negotiations and necessary exemptions (linking existing ETSs and offering preferential treatment for certain developing countries)

The European Union will have to indicate from the outset the temporary nature of the measure and allow for negotiations with its trading partners that may be affected by the adjustment before its implementation. Being first and foremost an environmental measure, it should dissolve as soon as the countries exporting to the European Union have themselves put in place an equivalent domestic carbon pricing system. It must also be subject to periodic review and adaptation, as was the case for the implementation of the EU ETS.

The EU should open a two-year "test" period to allow plurilateral "carbon club" alternatives to emerge. It could, for example, open discussions within the framework of the UNEP[19], while requesting the assistance of other international organisations such as the OECD. The adjustment would enter into force if negotiations were to fail at the end of the two-year test period.

[19] United Nations Environment Program

The EU could thus, under the non-discrimination principle of GATT Articles I and III, conclude agreements with States that have equivalent carbon pricing systems. While cooperation between the EU ETS and the ETSs of, for example, Canada-Quebec, California and New Zealand, seems feasible in the short term, caution must be exercised with regard to other major trading partners that are far less advanced in their carbon pricing systems. Targeting only the electricity generation sector, China's national ETS – despite its size[20] – is not mature enough for a system bridging but will be a privileged partner in the future.

Respect for the principle of common but differentiated responsibility contained in the preamble of the Paris Agreement, as well as alignment with the spirit of the WTO's preamble referring to sustainable development exceptions should lead the European decision-makers to plan to negotiate with developing countries during the two-years "test" period. This phase of negotiations could be used to identify the conditions under which some of these least advanced countries could be exempted from the adjustment mechanism.

In addition, as proposed above, part of the revenues of the mechanism could be used to accompany the energy transition of these countries by contributing to a dedicated fund which should find its place among the financing instruments for development aid.

This condition of exemption and special treatment for the benefit of developing countries comes not only from the provisions of GATT Article XX, but also from multilateral environmental agreements which call for special attention to be paid to them. To date, the language used in major multilateral environmental agreements concluded to date indicates that measures restricting international trade may be taken as a last resort, and only to the extent that they do not adversely affect the economic development of developing countries. The Kyoto Protocol states that Parties "…shall strive to implement policies and measures […] in such a way as to minimize adverse effects […] on international trade, […] especially [for] developing country Parties…"[21]. Lastly, Article 4 (15.) of the Paris Agreement[22] states: "Parties shall take into consideration in the implementation of this Agreement the concerns of Parties with economies most affected by the impacts of response measures, particularly developing country Parties".

Conclusion

In order to meet the more or less well-founded objections that it will inevitably raise, the border carbon adjustment measure will have to be thought of and designed as an external transposition of the European Emissions Trading Scheme. The ETS will also need internal reformation in order to provide an appropriate CO2 price floor while at the same time, avoiding another drop in the price per tonne of CO2, as experienced since the debut of the COVID-2019 crisis.

Based on two pilot products, electricity and cement, it should initially be implemented in a cooperative approach, aiming to build "carbon clubs" with partners and formalised by the opening of a two-year "test" negotiation period. Often roused, sometimes debated, but never implemented because of the many difficulties it raises, a border carbon adjustment will make sense as soon as the carbon pricing constraint is seriously imposed

[20] As of its implementation in 2020, it will be the largest ETS system in the world, covering between 3 and 4 gigatonnes of CO2 per year, while the EU system, which also includes the most emitting European industries, covers 2 Gt per year.

[21] Article 2 (3.), Kyoto Protocol, 1998

[22] Article 4 (15.), Paris Agreement on Climate Change, UNFCCC, 2015

on the European production system. That being said, we must not mistake the consequence with the cause: the need to change the speed at which the economy is decarbonising under fair conditions is the cause, the border measure representing the consequence. It is therefore in the credibility of this decarbonisation undertaking, which should progressively affect all sectors of the economy including areas hitherto seldom mentioned in the "green deal" such as agriculture, that the European Union will find the political response to the inevitable criticisms that such an innovation is bound to provoke. In other words, such a measure is only justifiable as an accompaniment to a gear shift that the Union will have to accomplish in the coming years; otherwise, rightly or wrongly, it will be suspected or even accused of hypocrisy by trading partners that are less committed than itself to ecological transformation. ●

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