

Policy Notes

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Codifying Border Carbon Adjustments? Climate Clauses in EU Trade and Investment Agreements

Introduction

Trade and investment agreements currently negotiated by the EU, including the EU-Australia free trade agreement (FTA), embed 'climate clauses'. This policy note briefly reviews the lawfulness of border carbon adjustments (BCAs), a key element of the environmental policy currently proposed by the EU Commission. Arguably, climate clauses embedded in trade and investment agreements codify and make explicit a consistent jurisprudence of the WTO dispute settlement bodies establishing the lawfulness of environmental exceptions to free trade. In this context, if adequately framed, BCAs afford an effective legal mechanism to implement sustainable policies.

EU trade and investment agreements and climate clauses

Trade and investment agreements, recently concluded or currently negotiated by the EU, encompass 'climate clauses'. Among the treaties already concluded, this is the case for the EU-Singapore Free Trade Agreement,¹ EU-Japan Economic Partnership Agreement,² EU-Vietnam Trade and Investment Agreement,³ and EU-Mexico Trade Agreement.⁴ Among treaties currently being negotiated by the EU, this is the case for the EU-Australia FTA,⁵ EU-Mercosur Association Agreement,⁶ and EU New-Zealand Trade and Investment Agreement.⁷

The EU-Australia FTA recognises the importance of taking 'urgent action to combat climate change and its impacts' as well as 'the role of trade in pursuing this objective', consistent with the United Nations Framework Convention on Climate Change (UNFCCC), Kyoto Protocol, Paris Agreement and other multilateral instruments in the area of climate change. The Parties are thus invited to: (a) effectively implement nationally determined contributions under the UNFCCC and Paris Agreement; (b) promote trade and climate policies contributing to the transition to a low greenhouse gas (GHG) emission, resource-efficient economy and climate-resilient development; and (c) facilitate trade and investment in goods and services, such as renewable energy, that have particular relevance to climate change mitigation and adaptation. These policies should lead to the definition of carbon pricing via a cooperative approach.

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Although the formulation of climate clauses varies between treaties, all the provisions essentially require cooperation between the parties to implement GHG reduction targets established under the UNFCCC, Kyoto Protocol and Paris Agreement. The EU-Canada Comprehensive Economic and Trade Agreement embeds a more general clause requiring the implementation of multilateral environmental agreements.⁸

The EU climate policy, 'carbon leakage' and border carbon adjustments

The European Union (EU) has embraced an advanced sustainability policy since at least the 1970s. In the matter of climate change, Directive 2003/87/EC created the EU Emissions Trading System (ETS) and provides that industries in EU Member States are restricted in the amount of GHG they are permitted to emit, in accordance with national allocation plans.⁹ The EU Member States have to ensure that industries operating in the energy sector, or processing ferrous metal and minerals or fibrous materials, can undertake activities resulting in GHG emissions only if they hold a permit issued by a competent national authority (Article 5). The permit specifies the obligation of industries to surrender auctioned allowances equal to the total emissions for each calendar year (Article 6).

Costs related to GHG allowances might prompt high-intensive energy industries, particularly in the cement and fertilizer sectors,¹⁰ to transfer production to other countries with laxer emission constraints (see Figure). This is known as 'carbon leakage'.¹¹

To prevent this, Directive 2018/410 provides that EU Member States must partially compensate industries in sectors or subsectors that are exposed to 'a significant risk of carbon leakage', by using no more than 25 per cent of the revenues generated from the auctioning of allowances under the EU ETS.¹² The EU thus subsidises industries that are exposed to a significant risk of carbon leakage to prevent them from relocating outside the Union.

Subsidies are not absolutely prohibited by the World Trade Organisation (WTO). For instance, Article XVI of the General Agreement on Tariffs and Trade (GATT) provides a notification obligation for a contracting party that grants or maintains any subsidy on exports or imports. However, in the EU the experience has been that subsidies have resulted in windfall profits for subsidised industries.¹³ Subsidies also affect non-subsidised businesses and have prompted them to transfer industries outside the EU so as to enjoy a more favourable regulatory regime. Thus, in order to discourage and prevent carbon leakage, the EU Commission envisages a new strategy, expanding BCAs targeting products imported from countries with lower GHG emission constraints as part of a 'green deal' aiming to achieve EU climate neutrality by 2050.¹⁴

BCAs broadly encompass import tariffs and taxes.¹⁵ Reliance on BCAs is all the more important in light of the fact that provisions on dispute resolution procedures included in sustainable development chapters of trade and investment agreements concluded or negotiated by the EU only include non-binding measures, notably consultation.¹⁶

The economic viability of BCAs is debated, as recent studies on the adoption of border climate measures in Australia demonstrate.¹⁷ Furthermore, the adoption of BCAs triggers the risk of trade wars and raises the question as to what extent BCAs are consistent with international regulation, particularly the WTO regime, which aims to abolish barriers to cross-border trade.¹⁸

The lawfulness of border carbon adjustments within the WTO regime: an essential assessment

Concerning trade in goods, Article XX of the General Agreement on Tariffs and Trade (GATT) allows exceptions to trade liberalisation, notably when they are 'necessary to protect human, animal or plant life or health', specifically under sub-section XX(b). GATT Article XX does not explicitly mention environmental protection and climate change as a valid reason for exceptions to free trade, notably BCAs. A critical question is therefore whether an implicit derogation is allowed.

In *United States (US)—Shrimp*, India, Malaysia, Pakistan and Thailand challenged US regulations prohibiting the import of shrimp from countries not certifying harvesting through turtle excluder devices.¹⁹ The complainants successfully alleged to a WTO Panel and Appellate Body that the import ban was not justified as an environmental exception to free trade based on GATT Article XX. The WTO Panel and Appellate Body considered that shrimp caught using methods identical to those employed in the US were excluded from the US market only because they had been caught in waters of countries not certified by the US, without considering different conditions.²⁰ Furthermore, according to the WTO Appellate Body, the US failed to engage in negotiations to conclude an environmental agreement aiming to protect sea turtles before adopting a

unilateral trade ban.²¹ It therefore considered that the US applied a disguised protectionist measure.

Since *US—Shrimp*, GATT Article XX(b) has been interpreted as allowing trade restrictive measures to the extent that these genuinely aim to protect the environment and do not afford disguised protection for a country's economy.²²

The condition of engaging negotiations prior to the imposition of BCAs has been confirmed by practice subsequent to the decision in *US—Shrimp*. Notably, in 2008 the EU sought to extend unilaterally its ETS to foreign aviation companies operating aircraft taking-off from EU territory or landing in EU territory, via Directive 2008/101/EC.²³ This prompted US and Canadian aviation companies to challenge the extension of the EU ETS in UK courts, triggering a request for a preliminary ruling by the Court of Justice of the EU (CJEU).²⁴ The CJEU upheld the validity of the extension; however, the opposition of states such as China, Russia and the US prompted a suspension of the EU ETS extension until 2024²⁵ and triggered negotiations for an international regulatory framework of GHG emissions in the aviation sector within the International Civil Aviation Organisation.²⁶

Provisions similar to GATT Article XX are embedded in other WTO agreements, for instance, Article XIV(b) of the General Agreement on Trade in Services (GATS).

In light of these developments, it is arguable that climate clauses embedded in trade and investment agreements already concluded or currently being negotiated by the EU, such as the EU-Singapore FTA, EU-Australia FTA and EU-Mercosur Association Agreement, explicitly codify the environmental approach that is implicit in the jurisprudence of the WTO dispute settlement bodies with respect to climate change. In other words, trade and investment agreements might explicitly legitimate climate exceptions to free trade, including BCAs and the new EU policy on carbon leakage.

Implications

BCAs aim to provide legally effective enforcement mechanisms to achieve sustainability on a global basis by avoiding carbon leakage. The inclusion of climate clauses in EU trade and investment agreements seems to legitimise the practice of BCAs. Within the EU-Australia FTA, this means that both the EU and Australia can adopt BCAs on imports to compensate a difference in cost for GHG externalities under EU and Australian climate policies.

This analysis of key WTO provisions suggests that BCAs are legally viable, provided they are adequately framed:

- (1) BCAs should not discriminate among trading countries (most-favoured-nation treatment) and between foreign and domestic products (national treatment): they should be exclusively and genuinely based on carbon footprints;
- (2) BCAs must be adopted through a process that ensures transparency and impartiality: it is essential to try and negotiate a solution to compensate the different costs of carbon policies first.

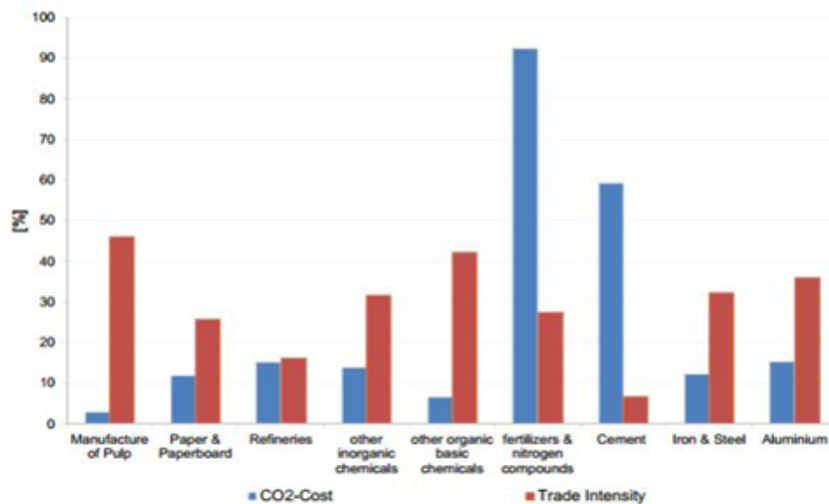


Figure: Quantitative assessments of the main sectors at risk of carbon leakage

Source: Marcu, A., C. Egenhofer, S. Roth and W. Stoefs, 'Carbon Leakage: An Overview', Centre of European Policy Studies (CEPS) Special Report No. 79 (2013): 12 (from European Commission Staff Working Document Impact Assessment accompanying Commission Decision C(2009)10251 final, Brussels, 24.12.2009).

Note: Column on the left denotes CO2 cost and the column on the right, trade intensity.

1 Signed on 19 October 2018, Chapter on Trade and Sustainable Development, Article 12(6), [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:22019A1114\(01\)&from=EN#page=96](https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:22019A1114(01)&from=EN#page=96).

2 Entered into force 1 February 2019, Chapter on Trade and Sustainable Development, Article 16(4), http://trade.ec.europa.eu/doclib/docs/2018/august/tradoc_157228.pdf#page=440.

3 Signed 30 June 2019, Chapter 13 (Trade and Sustainable Development), Article 13(6), https://trade.ec.europa.eu/doclib/docs/2018/september/tradoc_157373.pdf.

4 Agreement in Principle, Chapter on Trade and Sustainable Development, Article 5, https://trade.ec.europa.eu/doclib/docs/2018/april/tradoc_156822.pdf.

5 EU-Australia Trade Agreement Negotiations, Chapter on Trade and Sustainable Development, Article X(5), https://trade.ec.europa.eu/doclib/docs/2019/april/tradoc_157865.pdf.

6 Latest Round Reports and EU Proposals for the Trade Agreement with Mercosur, Chapter on Trade and Sustainable Development, Article 5, <https://trade.ec.europa.eu/doclib/press/index.cfm?id=1769>.

7 EU-New Zealand Trade Agreement Negotiations, Chapter on Trade and Sustainable Development, Article X(5), https://trade.ec.europa.eu/doclib/docs/2019/april/tradoc_157866.pdf.

8 Entered into force provisionally on 21 September 2017, Chapter on Trade and Environment, Article 24(4), <https://ec.europa.eu/trade/policy/in-focus/ceta/ceta-chapter-by-chapter>.

9 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, Articles 4 and 8.

10 A Marcu, C Egenhofer, S Roth and W Stoefs, 'Carbon Leakage: An Overview', Centre of European Policy Studies (CEPS) Special Report No. 79 (2013) 12; H Sigurd Næss-Schmidt, M Bo Hansen, M la Cour Sonne and C Haag Theilga, Carbon Leakage in the Nitrogen Fertilizer Industry (2015).

11 See, eg, European Commission, Carbon Leakage, https://ec.europa.eu/clima/policies/ets/allowances/leakage_en.

12 Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC to Enhance Cost-Effective Emission Reductions and Low-Carbon Investments, and Decision (EU) 2015/1814, s 13.

13 M Mehling, H von Asselt, K Das, S Droege and C Vekujil, Designing Border Carbon Adjustments for Enhanced Climate Action' (2017) 28, https://climatestrategies.org/wp-content/uploads/2017/12/CS_report-Dec-2017-4.pdf.

14 European Council, Climate Change, Conclusions – 12 December 2019, EUCO 29/19, para 7: 'The climate neutrality objective needs to be achieved in a way that preserves the EU's competitiveness, including by developing effective measures to tackle carbon leakage in a WTO compatible way. In this context, the European Council takes note of the Commission's intention to propose a carbon border adjustment mechanism concerning carbon-intensive sectors. Facilities in third countries need to adhere to the highest international environmental and safety standards.'

15 J Bueb, L Richieri Hanania and A Le Clézio, Border Adjustment Mechanisms: Elements for Economic, Legal, and Political Analysis (2016) 5, <https://www.wider.unu.edu/sites/default/files/wp2016-20.pdf>.

16 P Draper, N Khumalo and F Tigere, Sustainability Provisions in Regional Trade Agreements: Can They Be Multilateralised? (2017) 23-28, <http://e15initiative.org/wp-content/uploads/2015/09/RTA-Exchange-Sustainability-Provisions-Draper-Khumalo-Tigere-Final.pdf>.

17 For example, M Siriwardana, S Meng and J McNeill, 'Border Adjustments under Unilateral Carbon Pricing: The Case of Australian Carbon Tax' (2017) 6:34 Journal of Economic Structures 1.

18 S Fleming and C Giles, 'EU Risks Trade Fight over Carbon Border Tax Plans', 16 October 2019.

19 United States - Import Prohibition of Certain Shrimp and Shrimp Products, Request for Consultations by India, Malaysia, Pakistan and Thailand, WT/DS58/1G/L/116, 14 October 1996.

20 Id, WT/DS58/R (1998); WT/DS58/AB/R (1998) [164].

21 Id, WT/DS58/AB/R (1998) [166].

22 See, for instance, US – Restrictions on Import of Tuna II, WT/DS381R (2011) and WT/DS381/AB/R (2012).

23 Directive 2008/101/EC of the European Parliament and of the Council of 19 November 2008 amending Directive 2003/87/EC so as to Include Aviation Activities in the Scheme for Greenhouse Gas Emission Allowance Trading within the Community.

24 Air Transport Association of America, Case C-366/10, Judgment of 21 December 2011.

25 EU Commission, Reducing Emissions from Aviation, https://ec.europa.eu/clima/policies/transport/aviation_en.

26 ICAO, Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) <https://www.icao.int/environmental-protection/CORSIA/Pages/default.aspx>.



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Third Country Engagement with EU Trade Policy

This project seeks to explore and improve understanding of the EU's evolving trade policy and its implications for third countries, including Australia and countries in the Asia-Pacific region. It boosts existing knowledge of the EU among third country partners and spreads EU trade policy content across third country institutions.

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