



# FOSTERING CLIMATE ACTION THROUGH TRADE-RELATED POLICY INSTRUMENTS FINAL REPORT: DELIVERY STRATEGIES AND SUPPORT TOOLS

Final report

July – 2016



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# Fostering Climate Action through Trade-Related Policy Instruments

**Final report: Delivery  
strategies and support tools**

Fostering Climate Action through Trade-Related Policy Instruments for European Commission, DG Climate Action

July 2016

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# Acronyms

AfT	Aid for Trade
AFOLU	Agriculture, Forestry and other Land Use
APEC	Asia-Pacific Economic Cooperation
BCA	Border Carbon Adjustment
BITs	Bilateral Investment Treaties
BV	Business Visitors
CARIFORUM	Caribbean Forum
CBA	Cost-Benefit and Achievability analysis
CSS	Contractual Services Suppliers
CPC	Customs Procedures Code
DDA	Doha Development Agenda
DR	Domestic Regulation
DG Trade	Directorate General for Trade
EC	European Commission
EG	Environmental Good
ETS	Emissions Trading Scheme
EU	European Union
EUR	Euro
EGA	Environmental Goods Agreement
EPAs	Economic Partnership Agreements
FLEGT	Forest Law Enforcement, Governance and Trade
FTA	Free Trade Agreements
FFS	Fossil Fuel Subsidies
G20	Group of 20
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GHG	Greenhouse Gas Emissions
GSP	Generalised Scheme of Preferences
GSI	Global Studies Initiative
ICT	Intra-corporate Transferees
IEA	International Energy Agency

INDC	Intended Nationally Determined Contribution
IPR	Intellectual Property Rights
ISIC	International Standard Industrial Classification
ISO	International Organization for Standardization
IMF	Internationally Monetary Fund
MEPS	Minimum Energy Performance Standards
MFN	Most Favoured Nation
MtCO <sub>2e</sub>	Mega tonnes of Carbon Dioxide Equivalent
NAFTA	North American Free Trade Agreement
NAPAs	National Adaptation Programmes of Actions
NDC	Nationally Determined Contribution
NGO	Non-Governmental Organization
NT	National Treatment
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
R&D	Research and Development
RED	Renewable Energy Directive
REDD+	Reduced Emissions from Deforestation and Forest Degradation, plus the role of conservation, sustainable management of forests, and the enhancement of forest carbon stocks
SMEs	Subject and Medium-sized Entities
SCM	Subsidies and Countervailing Measures
SOE	State-owned Enterprises
TISA	Trade in Services Agreement
TBT	Technical Barriers to Trade
TSD	Trade & Sustainable Development
TPR	Trade and Policy Reviews
UN	United Nations
UNEP	United Nations Environment Programme
UNFCCC	United Nations Framework Convention on Climate Change
VAT	Value Added Tax
VPA	Voluntary Partnership Agreement
WTO	World Trade Organization

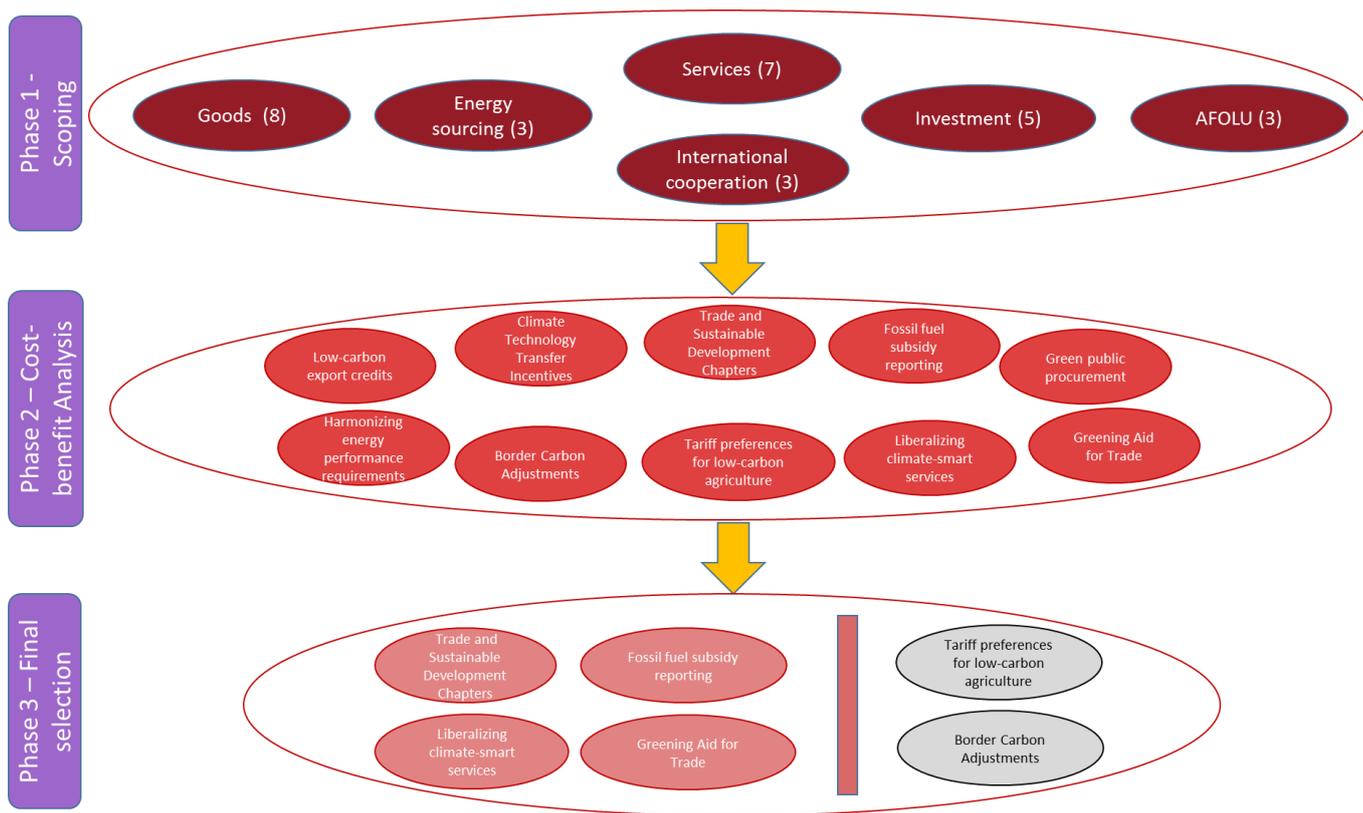
# Executive summary

## Introduction

Carbon-intensive and low-carbon goods and services alike are traded across borders in massive numbers daily. Changes in international trade rules have the potential to significantly alter the balance of these flows in one way or the other, while policy measures to reduce greenhouse gas emissions can act as catalysts for increased trade in one area and to decrease or even eliminate trade in another. The extent to which the two are aligned, therefore, has a great influence on the success of each. While much attention has been paid to the potential conflicts and challenges between the two regimes, there is increasing political interest in finding ways in which they can support each other's objectives and work in complement.

This goal of this study project, 'Fostering climate action through trade-related policy instruments', was to identify concrete opportunities to make this happen. Specifically, it sought to identify ways in which the European Union (EU) can use trade-related instruments – at a unilateral, bilateral or multilateral level – to further the achievement of long-term mitigation and adaptation goals. It focused on ambitious and innovative strategies to align EU trade and climate objectives that were at the same time realistic and achievable. Casting the net widely, it considered opportunities across a broad range of sectors and looked not only at classic trade instruments such as treaties and tariff adjustments, but also at less obviously trade-related measures that nonetheless have important trade impacts, including in the area of international cooperation.

This report represents the final report of the study project. It presents the final measures that have been selected based on a three stage consultative process led by the advisory team – consisting of experts from Climate Focus, WTI Advisers, Atlas Environmental Law and Ecofys – in close coordination with the EU Commission and other stakeholders from international organizations, civil society and the private sector (Figure 1). From an initial scoping of 31 measures across six different sectors and areas, four measures have been recommended for action (shaded in light red in Figure 1). For each of four selected measures the report presents technical tools – principally legal and policy text suitable for use in EU trade instruments – and policy tools, comprising political argumentation and strategy. We further developed an assessment of feasibility and economic, political and legal implications for two additional measures that were not considered feasible in the current political climate but nonetheless worthy of additional analysis (shaded in grey in Figure 1).



## Strategic considerations

Although the purpose of the study was to identify and develop concrete trade-related measures that the EU can use to advance its climate change objectives, this process has generated a number of general considerations that can be useful in informing the further integration of climate change objectives within EU trade projects. Here we present the most important of these.

**Wide range of opportunities.** The project identified a wide range of potential trade-related measures that could be used to pursue climate action, covering all principle types of trade and incorporating a broad range of sectors and instruments (see Figure 1). While not all measures were deemed feasible in current political contexts – for example Border Carbon Adjustments – were considered to go against the cooperative spirit that dominates the post-Paris paradigm – the process shows that measures that can be identified and designed to fit a broad range of policy directions and political contexts. Notably, several measures that we recommend respond to opportunities presented by ongoing developments, such as the revision of the EU Aid for Trade (AfT) Strategy or the conclusion of the Environmental Goods Agreement, indicating that where political opportunities arise, technical measures can be developed.

**Main constraints are political.** While there are important legal constraints imposed by WTO agreements and EU law, among others, and in some cases technical constraints in terms of data or monitoring, the biggest constraints to adopting climate-smart trade (and trade-related) measures are political. Potential constraints lie both with trade partners and with the EU itself. For instance, progress on fossil fuel subsidies remains subject to high sensitivities how the G20 commitment to eliminate “inefficient” fossil fuel subsidies is defined. At the EU level, there may for example be reluctance to push action of fossil fuel subsidies in a bilateral context due to the potential that this may incite demands from partners for reductions in other subsidies that are important for the EU economy. Successful measures will need to navigate and adapt to these political constraints, finding points of common interest and identifying where parties may be open to push the boundaries a little further.

**Build on existing efforts.** The EU is already making significant efforts to integrate environmental and sustainability concerns into its trade policy. The Trade for All strategy places a strong focus on sustainable development, and the EU has initiatives to integrate environmental considerations (including climate) into various areas, including public procurement, green goods, Aid for Trade and through Trade and

Sustainable Development chapters. Additional efforts to pursue climate action should build upon and extend these efforts with further potential synergies.

**Employ multi-pronged strategies.** The EU is a large organization that engages on trade on multiple levels and through a huge variety of bilateral and multilateral fora. Different fora will lend themselves to different approaches, and so overall strategies should be nuanced. The measures developed show that more ambitious agreements will often be possible in bilateral contexts, and these can be used to both test different approaches and to gradually build support for future plurilateral or multilateral agreements.

**Engaging with civil society and the public.** Free trade agreements are increasingly received, by civil society and the wider public, with caution, reservations, and sometimes open hostility. The agreements are often understood as undermining social, labour and environmental standards, lowering legal protection, and making public engagement more difficult. By contrast, the fact that free trade agreements increasingly include an ambitious environmental — since recently also climate change focused — agenda is little known. There are few indications, if any, that free trade agreements had lowered environmental standards; the North American Free Trade Agreement, in fact, is an example for strong cross-country environmental performance. Trade negotiators are advised to portray better positive environmental agendas of negotiations, while the involvement of stakeholders and civil society at large in the implementation of such agendas deserves to be made a priority.

## Recommended measures

This section presents the four measures that were selected as the most promising and for which the advisory team has developed a range of technical and political tools.

### Fossil fuel subsidies

#### Background and Rationale

Fossil fuel subsidies (FFS) are a major contributor to GHG emissions. Though the G20 has committed to phase out “inefficient” FFS and other bodies such as APEC are pursuing similar goals, practical efforts to act on these commitments have had mixed results. There is a strong case for strengthening these efforts using available international institutions and mechanisms.

Existing international cooperation has largely focused on reporting of FFS as a first step, but even these efforts remain far from complete. The absence of uniform templates, unclear definitions of key concepts such as “inefficient FFS” and a lack of monitoring and enforcement systems contribute to this status quo. The WTO and other trade agreements in many cases already address subsidies, and provide for related transparency processes and institutional arrangements. As such they are well placed to play a role in enhancing reporting on FFS.

#### The Measure

The proposed measure aims at enhancing reporting on FFS in the WTO, in Free Trade Agreements (FTAs) and under the G20, building on the existing structures and mechanisms of each. Its objective is to provide for broader, more coherent and more transparency reporting on existing fossil fuel subsidies and measures to phase them out. This will provide much-needed transparency and enable greater tracking of progress towards the political goal to phase out inefficient fossil fuels subsidies. It would ideally be complemented by the development of substantive subsidy disciplines – agreement on rules addressing the use of FFS, as opposed to just reporting on them – and enhanced transparency processes such as peer reviews where possible. The measure proposes four distinct but inter-related components.

- *Common reporting template for FFS reporting.* Establish a common template for reporting on fossil fuel subsidies in the WTO, the G20 and FTAs. This master template would be used based on a deliberately inclusive definition of FFS, covering any form of support – not necessarily being limited by the definitions adopted by the G20 or WTO – for fossil fuel subsidies and their related services.
- *Advocacy Strategy for Increasing and Harmonizing FFS Reporting and Monitoring in the WTO.* EU strategy to systematically practice and advocate increased, harmonized and inclusive FFS reporting in

the WTO and G20 based on this common template and inclusive definition, including through 'leading by example'. The strategy would include the following main points:

- Systematically advocate *and* practice the extensive and fully inclusive notification of all FFS programmes in existing reporting under the Subsidies and Countervailing Measures (SCM) Agreement and the General Agreement on Tariffs and Trade.
  - Promote use of the master template and checklist.
  - Use third-party notifications the Subsidies and Countervailing Measures Agreement to highlight – in a non-confrontation manner – the FFS programmes of other Members.
  - Follow up on FFS in the SCM Committee.
  - Systematically advocate and practice a discussion of FFS in Trade Policy Reviews.
- *Increase FFS Reporting and Monitoring and FFS Substantive Disciplines in EU FTAs.* Enhanced action on FFS in its Free Trade Agreements, capitalizing on the greater negotiating power of the EU in these settings to provide for both enhanced transparency and substantive disciplines on FFS (i.e., obligations to eliminate, avoid or reduce certain subsidies). The EU would further aim to avoid certain undesirable provisions, such as exemptions of FFS from otherwise applicable rules on the prohibition of subsidies.
- *Promote Extensive and Inclusive FFS Reporting at the G-20 Level.* EU action to seek G20 agreement to systematically apply and promote an extensive and inclusive definition of FFS for purposes of G-20 FFS reporting, ideally using the master template, with the EU leading by example.

### **Strategic Considerations**

This measure tackles FFS reporting on multiple levels, taking advantage of the different opportunities presented across various fora. Though designed as an integrated, comprehensive strategy, it can also be 'sliced' and employed flexibly on an opportunistic basis.

A standardized, inclusive common template will increase overall transparency and usability of FFS information, as a first step toward further action. A deliberately over- inclusive definition (compared with the more limited WTO or G20 focus) seeks to side-step any limitations in terms of scope that arise in these frameworks. The broad definition and inclusive approach to reporting on the one hand arguably goes beyond what is strictly required in the context of existing commitments, but on the other hand does so by equally explicitly acknowledging that substantive obligations remain unaltered. This is meant to de-link reporting / transparency – where many agree that more is better – from substantive obligations, where countries will disagree as to how much is desirable.

Resistance can be expected from defenders of specific subsidy programmes, both within the EU and in partner countries, and from governments articulating systemic concerns about preserving the more limited trade focus of WTO/FTA subsidy disciplines. Some FTA partners, or prospective FTA partners, may resist proposals to include substantive subsidy disciplines on a bilateral level, and refer to the WTO level instead. Some may have concerns over specific FFS programmes in existence, and may hence resist efforts to curb them through an FTA. Some G20 members may also resist further administrative burdens, as well as increased ambition, in the G20 context. All these concerns can be overcome through compelling and consistent argumentation, spelled out in some detail here, and equally consequent action, including leadership by example.

## **Services ancillary to environmental goods**

### **Background and rationale**

The effective trade in, and use of, climate-smart goods is heavily reliant on services, including those involved directly in their deployment and also ancillary services provided in the context of their acquisition, sale, installation, maintenance and use. Trade in these 'services ancillary to climate-smart goods' is often restricted through market access rules and/or regulatory hurdles. This can affect trade in climate-smart goods themselves, and may often affect big projects and sophisticated technologies as these rely on installation, maintenance, training and other services to be delivered together with the product. Liberalization of such services trade is highly desirable.

Different fora offer different and complementary opportunities for liberalising trade in services ancillary to climate-smart goods. The multilateral (WTO) level offers the possibility to use the momentum of the Environmental Goods Agreement (EGA) to attempt narrow, targeted liberalisation. Plurilateral negotiations on the Trade in Services Agreement (TISA) offer the potential for a more ambitious approach, although the window for comprehensive new and ambitious initiatives may be closing as a result of the dynamics of the negotiations. FTAs offer the chance to go further in terms of both the goods referenced and types of services covered.

### The Measure

This measure proposes to formulate and implement a comprehensive strategy to seek liberalisation and facilitation of trade in services ancillary to climate-smart goods on the multilateral (WTO), plurilateral (TISA) and bilateral (FTA) trade agreement levels. It would be undertaken in a context of a broader agenda of pro-climate liberalization of trade in services and nested within the EU's existing strategy of liberalizing environmental goods and services.

It further proposes to implement it by systematically introducing ambitious and targeted agreement text, proposed specific commitments – both horizontal and sector-specific –, and proposed regulatory disciplines on matters such as the licensing of service providers. The following components are elaborated here:

- *Formulation of a strategy to seek liberalisation and facilitation of trade in services ancillary to climate-smart goods. Explicit strategy statement for internal and public consumption outlining the approach to be taken by the EU, namely:*
  - Systematically seek targeted liberalization of services relevant to climate change mitigation and adaptation;
  - As a 'pilot project', seek liberalization of services (including installation, maintenance and training) ancillary to climate-smart goods, especially those covered by the future Environmental Goods Agreement; and
  - Pursue liberalization systematically and on all levels, namely the multilateral (WTO and EGA), the plurilateral (TISA) and the bilateral and regional level (FTAs).
- *General and specific requests for market access openings for services ancillary to climate-smart goods. Toolbox for EU trade negotiations, designed to advance the above strategy, including:*
  - Negotiating text for WTO, TISA and FTA negotiations, including for the main agreement text, text on specific commitments and draft sample elements for a "master" model schedule and check list covering key services and modes of supply targeted.
  - Additional negotiating text and tools for use at WTO, TISA and FTA levels, respectively.
- *Proposals for regulatory disciplines relating to services ancillary to climate-smart goods.* Identification of key areas of domestic regulation that are relevant to trade in services related to climate-smart goods. Examples include facilitated recognition of professional qualifications and waiver of qualification requirements, for example for engineers and architects performing services relating to the installation of climate-smart goods; or facilitated licensing, for instance of construction operators assembling renewable energy installations.

### Strategic considerations

Trade in services is a timely and low-hanging fruit, but also potentially controversial as it needs to be advanced in the context of specific frameworks and negotiating contexts, each with its own challenges. The proposed targeted, narrow approach clearly tailored to fast-track liberalization of an overall small – but highly climate-relevant – subsection of all services is designed attract overall broad support and help overcome possible hesitations on the technical level, timing challenges (esp. EGA and TISA) and some principled opposition to further services liberalization. The proposed strategy would directly address concerns, and make a compelling case for the proposed targeted and comprehensive approach. The measure provides further political tools in the form of clear arguments to address any such concerns.

The concerted parallel approach on all three levels – WTO, TISA, FTAs – makes eminent sense and does not increase complexity; progress on either front will support efforts on the others. The same logic applies everywhere, and there is no downside to a universal approach.

The main tools needed on the three levels are largely the same and can be easily replicated/adapted to each forum, complemented by specific tools made available here to respond to the specific negotiating opportunities and challenges present on the respective levels. As negotiating outcomes depend on adequate opportunities, the strategy, approach and tools are designed to be applied flexibly, and to advance the overall agenda wherever and whenever possible.

## Aid for Trade

### Background and Rationale

The EU (together with its Member States) is the largest global provider of Aid for Trade (AfT). It also the leading provider of climate finance, though meeting international climate finance needs remains an ongoing challenge. The EU has, meanwhile, committed to mainstream climate change in its development aid, and in 2016 updated its Guidelines on 'Integrating the environment and climate change into EU international cooperation and development' (the "Mainstreaming Guidelines"), which guide EU delegations in integrating climate considerations in country programmes. This approach explicitly supports the 2030 Agenda for Sustainable Development, which is also integrated within EU trade policy through the Trade for All Strategy.

The existing EU Aid for Trade Strategy, adopted in 2007, does not make explicit reference to mainstreaming climate change in AfT, limiting itself to general support for 'environmental sustainability'. This arguably makes it out of step with the more ambitious approach adopted in more recent instruments. The AfT Strategy is however currently being updated, creating an opportunity for a more ambitious approach.

### The Measure

This measure proposes a more concerted commitment and pathway to integrating climate change within EU AfT. It contains two related components:

- *Revision of Aid for Trade Strategy.* This component proposes greater integration of climate objectives within the revised AfT Strategy, in the context of the overall commitment to the SDGs. This includes the specific commitment to integrate climate change considerations within all AfT provided by the EU and its Member States, within the overall framework of the Mainstreaming Guidelines. The EU and its Member States would also commit to strive for coherence between AfT and climate finance, taking into account both the national trade and development strategies and climate mitigation and adaptation policies of partner countries.
- *Specific guidance in Strategic Approach on International Cooperation and Green Economy.* Here the team proposes the inclusion of a dedicated discussion of potential opportunities for integrating green economy goals within EU cooperation on trade within the forthcoming Strategic Approach on International Cooperation and Green Economy, in particular:
  1. Discussion of the role that Free Trade Agreements (FTAs), including Economic Partnership Agreements (EPAs), can play in promoting EU green economy objectives;
  2. Discussion of the role of Aid for Trade in promoting green economy objectives, and identification of potential opportunities for integrating these objectives in Aid for Trade through specific actions and approaches.

### Strategic Considerations

- The timing of this measure is opportune as the EU Aid for Trade Strategy is currently under review and climate change is among the topics being considered for integration. Moreover, following the SDGs and the Paris Agreement, support for climate change action is at a high.
- Scepticism and some resistance is to be expected from some developing country partners who will be concerned about dilution of AfT, climate finance double-counting / additionality, and generally political

conditionalities. Engaging with partner countries at an early stage will be important for effectively communicating its purpose and avoiding misunderstandings. It will also be key to ensure that climate mainstreaming does not result in the diversion of aid resources from other areas and that EU delegations are able to make an economic case for climate-smart trade action in discussions with partner countries.

- Providing clarity for EU delegations on the relationship of the Strategic Approach with the Mainstreaming Guidelines, sector notes and sector scripts will help avoid confusion that may stem from the various different documents that guide the work of delegations. Providing training can also help delegations better understand how this guidance can be translated in concrete AfT actions.

## Trade and sustainable development chapters

### Background and Rationale

Countries across the globe are increasingly seeking greater coherence between applicable trade regimes and international law on the environment and climate change. As part of this trend, there is a growing practice among countries and supranational bodies such as the EU to use operative legal texts in FTAs as platforms and conduits for discussions, processes and sometimes substantive law – hard or soft – to manage interfaces between trade and aspects of sustainable development from environmental protection to protecting labour rights. This practice is increasingly centred on the inclusion of Trade and Sustainable Development (TSD) Chapters in EU FTAs, which enshrine joint commitments and provide for cooperation between the EU and partner countries on a broad range of sustainable development issues, including climate change and related areas such as sustainable forest management.

While it is too early to assess the effectiveness and efficiency of the use of TSD Chapters given they remain a relatively new instrument, they appear to provide a suitable format for advancing both substantial and procedural sustainability and, in particular, climate change goals. A standard feature in all modern EU FTAs, these chapters can provide for both substantive agreements and procedural cooperation not only on climate change generally but also on specific areas of interest in the context of a given bilateral relationship. The recent adoption of the Paris Agreement, moreover, offers the opportunity to enhance the linkages between international climate policymaking and bilateral trade.

### The Measure

To advance the aims set out above, this measure – ambitious in its design – attempts to expand and consolidate the general matrix of TSD chapters, integrating a number of issues relevant in a wide range of trade negotiations, including:

- *Commitment to ambitious climate change concepts.* This includes concepts and goals embraced at the global level (notably the Paris Agreement), but may also advance notions long championed by frontrunner countries, but not yet accepted at the global level (e.g. the decarbonisation goal).
- *Creation of an interface with a number of provisions in the Paris Agreement (PA).* The FTA can create a procedural platform to identify cooperative opportunities related to trade under Article 6 PA on cooperative approaches, Article 5 PA on REDD+ and coastal ecosystem preservation, Article 7 PA on adaptation and the enhancement of resilience, as well as the transparency framework and future stocktake exercises (Articles 13 and 14 PA).
- *Special focus on a number of high impact trade-cum-climate change instruments.* The TSD chapter can incorporate a range of active work programmes to advance rules on green public procurement, the phase-out of fossil fuels, and harmonised rules on minimum energy performance standards.
- *Strengthening of the institutional framework.* The TSD, more programmatic than prescriptive in nature, will require special resources in terms of funds, staffing, information-gathering, powers, and logistics in order to be able to meaningfully fulfil its mandate of identifying and developing joint cooperation on climate change and sustainable development. The Specialised Committee on Trade and Sustainable Development – mandated with the implementation in practice of the joint goals and work programmes agreed in the TSD Chapter – will also work in close interaction with stakeholders, which participate through enhanced stakeholder engagement formats, and receives institutional support through a Joint Forum.

## Strategic Considerations

The practice and function of TSD chapters remain little known in the wider public. It does not help that the chapters' relevance and impact has been hardly researched (in particular in Europe), even though research from elsewhere (including concerning the work of the Commission for Environmental Cooperation (NAFTA)) suggests that concerning environmental norms, FTAs may have a clearly positive record.

Making the TSD chapters operational – linking bilateral trade and investment with the Paris Agreement and advancing on a number of programmatic concepts (green public procurement, fossil fuel phase out, etc.) – will be decisive for their success. The Specialised Committee, in particular, will have to become a body not of protocol and general discussion, but of function and focus.

TSD chapter negotiations should be used to engage in a transparent process with the public, to explain the TSD process, the risks it is meant to mitigate, and the opportunities it is tapping into, in particular with respect to international climate change cooperation. The discussions are too often too focused on risk-containment (“our standards will not be lowered”) and special interests (e.g. of the EU export industry). Instead, negotiators should set positive agendas on ambitious cooperation in various field of trade and investment, and the opportunity for the bilateral implementation of green high impact instruments, which remain blocked at the international level.

## Measures for further consideration

This section presents analysis on two measures that have not been recommended for action, but have been considered worthy of additional analysis, with a view to informing future political decisions.

## Addressing land-use change through agriculture tariff preferences

### Rationale and description of measure

Deforestation embedded in EU imports is a significant source of global emissions, and the EU has previously sought to identify strategies to reduce the impacts of its imports on emissions.<sup>1</sup> This measure would address these embedded emissions by providing tariff preferences for agricultural or forestry products whose production has not led to deforestation or peatland oxidation. The tariff preferences would be set at a level that is sufficient to provide a compelling disincentive to clear forest for the production of agricultural goods destined for the EU. The focus would be on EU imports with the greatest effects on land-use change emissions and where tariff preferences can be expected to make a discernible difference, with the initial priority being on soya and palm oil. Preferences would be offered to imports that have been certified under certification standards recognised by the EU or originating in countries that have entered into agreements with the EU that reduce emissions from the supply chain in question.

### Technical feasibility

The main technical challenge in adopting this measure surrounds the establishment and monitoring of criteria on land-use change from EU imports, which would differ for direct and indirect land-use change. Criteria to address direct land-use change have already been developed and implemented for biofuels through the EU's Renewable Energy Directive (RED), and so could in principle be adapted for this purpose, but would need to address perceived weaknesses, in particular the varying quality of the voluntary certification schemes under which the majority of biofuels are certified under RED. This approach also carries leakage risks through shifting supply of 'non-sustainable' products to markets that do not differentiate products based on their deforestation impact.

In the case of indirect drivers there are no existing criteria in EU law or elsewhere that are sufficiently robust to adequately differentiate products that based on indirect contribution to land-use change. An alternative option to address these imports could lie in the use of bilateral or multilateral agreements with

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<sup>1</sup> In 2013 the EU published a report assessing the impact of EU consumption on deforestation and assessing potential strategies to reduce this impact. Nathalie Devriendt et al., 'The impact of EU consumption on deforestation: Comprehensive analysis of the impact of EU consumption and deforestation', report for the European Commission, 2013

producer countries, already provided for under the RED but to-date not operationalized. These agreements would address land-use change from agricultural production at national level, and so avoid issues of domestic leakage, if not international leakage. This approach would arguably also be equally or more successful in addressing direct drivers. Nonetheless, negotiating such agreements would likely be time and resource intensive, and would face technical challenges in defining appropriate criteria and monitoring mechanism suited to each country. They would also risk unfairly discriminating against sustainable products in jurisdictions with overall high-levels of commodity-related deforestation, and vice-versa.

### **Economic and emissions implications**

The effects that this measure would vary across different agricultural imports. Soy and palm oil are assessed here, since they account for the largest share of deforestation embedded in EU imports.

In the case of soy, Brazil would be the most relevant country, since the other major exporters to the EU – Bolivia and Paraguay – are already eligible for zero tariffs under the EU's GSP+ arrangement. Soy in Brazil is primarily an indirect driver of deforestation, and so only a scheme that incorporates these emissions would have impact. Brazilian firms pay tariffs of approximately USD 65 million each year on soy bean imports into the EU,<sup>2</sup> which could provide an incentive to negotiate a bilateral agreement in conjunction with other incentives. In this case, the potential emission reductions in Brazil from this measure are significant.

In the case of palm oil, EU imports from Indonesia and Malaysia were between 1990 and 2008 responsible for emissions of around 800 MtCO<sub>2e</sub>.<sup>3</sup> A large share of palm oil production in Indonesia and Malaysia acts as a direct driver of deforestation. Indonesian and Malaysian firms pay approximately USD 135 million and USD 107 million in tariffs on palm oil exports to the EU imports each year, respectively, so the measure could potentially provide an incentive for action. However, leakage of emissions in such a scheme would present a significant risk.

For Member States the measure would result in a potential loss of tariff revenue, in the order of up to USD 65 million for Brazilian soy and USD 240 million for Indonesian and Malaysian palm oil, based on the amount of tariffs currently paid on these products.

### **Legal considerations**

Some aspects of the measure's technical design are considered quite achievable, while others raise greater technical challenges: A WTO challenge would be a possibility, in particular under the most-favoured nation principle of the General Agreement on Tariffs and Trade (GATT), which requires equal treatment of like products from different foreign countries. Though the EU could argue that products associated with deforestation are different from those that are not based on the principle that they are based on different 'processes or production methods', WTO case law on this question does not provide clear guidance, and so the success of the argument could not be guaranteed.

The violation of the most-favoured nation principle could in principle be justified under the General Exceptions clause in GATT Article XX if the measure is designed in such a way as to fulfil the various criteria of Article XX. This would require that the measure provide for full recognition of local conditions in other countries in determining eligibility for the tariff preference, and ensure effective equal access for countries to the negotiation of qualifying agreements; countries willing to negotiate would have to be treated equally. While designing the measure in this way is possible, it is challenging, and completely protecting against the risk of WTO legal challenge will be difficult.

### **Political considerations**

At EU level this measure is potentially politically opportune as it supports overall EU objectives and builds upon existing policies. On the other hand, require significant political capital, and it is not clear that there is currently sufficient political support for such an approach. In particular, there appears to be little political

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<sup>2</sup> Based on analysis of UN COMTRADE data 2010-2013

<sup>3</sup> Based on hectare data from (EC, 2013) and average emissions per hectare deforestation from (Bellassen et al, 2008).

appetite in the EU for negotiating bilateral agreements with tropical forest countries. Reactions from partner countries would likely be mixed. While countries that could benefit from reduced tariffs could be expected to be positive, there may be negative reactions from competitor countries that already enjoy tariff preferences under the GSP and GSP+.

### **Overall assessment**

This measure presents an interesting opportunity to build upon existing initiatives to address the EU's deforestation impact through trade measures and forward the EU's goal to halt tropical deforestation. At the same time, it would face significant technical challenges, and existing initiatives only provide an incomplete and not fully satisfactory infrastructure to build upon. There are also important legal challenges, and it is unclear whether there is currently sufficient political appetite to advance the measure.

## **Border carbon adjustments**

### **Rationale and description of measure**

Border Carbon Adjustments (BCAs) address the issue of carbon embedded in international trade. Theoretically they enable the protection of industry competitiveness in the abating countries, higher environmental effectiveness or cost-effectiveness of climate policy and the sanctioning of countries considered to be not contributing to an international abatement regime.

It is interesting for the EU to consider the impacts of BCAs. However, two immediate concerns are flagged. Firstly, BCAs have not yet been implemented anywhere globally and so there is no experience that could be drawn upon in their implementation. Secondly, there is currently little or no evidence of carbon leakage within the EU-ETS. Some theoretical studies have predicted that leakage could occur in the future, but there is no empirical evidence of it occurring to-date, placing doubt on whether BCAs are really needed as a solution.

An EU BCA would fully or partially replace current carbon leakage arrangements in the EU-ETS and would require affected products from countries without climate policy measures equivalent to the EU-ETS to face a carbon adjustment levy derived from appropriate product or industry benchmarks.

### **Economic and emissions implications**

This measure could be anticipated to have the following economics and emissions implications:

1. *Positive:* impact on climate mitigation, could act as a trigger for all countries and industrial players to modernise their industries to qualify for adjustment exemptions and could generate additional revenues for EU Member States.
2. *Negative:* can lead to higher costs for EU industry and therefore market prices, add at-border-costs and challenge free-trade agreements, lead to increased administrative costs, fail to address the issue of windfall profits for (EU-) industry, reduce overall economic welfare and still lead to EU producers facing higher production costs when exporting.

### **Political considerations**

An EU BCA would be damaging to the recent successes in international climate policy, and would likely go against the positive and cooperative spirit that has followed the successful Paris climate negotiations. Moreover, perceived border measures in aviation have already attracted strong international lobbying and resulted in diplomatic challenges for the EU. In addition, unlike aviation a 'kick-start' to the international process is not needed as carbon pricing is already being increasingly implemented globally. Additionally, the political climate in EU is not conducive to BCA.

### **Legal considerations**

This measure raises multiple questions of WTO compatibility, in particular under the non-discrimination principles of National Treatment (NT) and Most-Favoured Nation (MFN) treatment. While legal justification is in principle possible, it implies complex design requirements whose implementation in practice would be

very complex. It also cannot co-exist with free allocation, the currently preferred method of leakage prevention under the EU ETS.

In any case WTO dispute settlement is likely. While there are good reasons to believe that the WTO Appellate Body would ultimately uphold a BCA measure that is designed to respect all parameters and applied in good faith, the sheer complexity of doing so means that virtually in any case a significant risk would remain that the measure would be found to violate WTO law.

### **Overall assessment**

While BCAs may have theoretical advantages, they have not yet been successfully implemented anywhere. Moreover, they primarily seek to address carbon leakage, for which there has to-date been little or no evidence. BCA economic impacts would be broadly negative, although BCA mitigation impacts would be positive.

BCAs would, moreover, go against the current international climate policy thrusts, i.e. the Paris agreement and could provoke a large international response. They also run counter to EU climate policy thrusts. For all these reasons an EU BCA is very likely politically unacceptable.

If it was still decided to proceed, there would be legal complications, due to international trade law and while good design could deal with legal issues, there is no guarantee of successful defence.

# ***Part I: Background***

# 1.

# Introduction

## 1.1 Project background and process

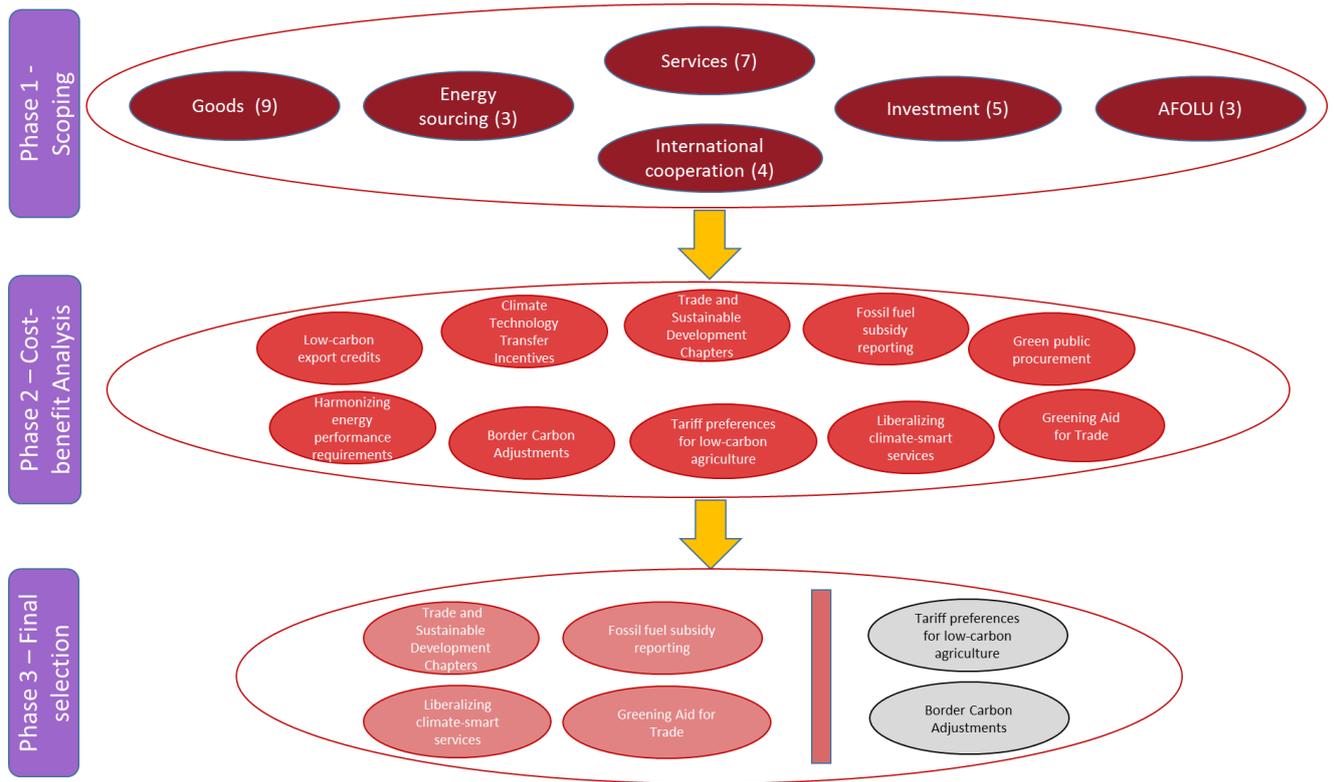
The European Commission, DG Climate Action contracted Climate Focus, WTI Advisers, Atlas Environmental Law and Ecofys (the Consortium) to carry out a study project on ‘Fostering climate action through trade-related policy instruments’. The objective of the study is to provide elements for the development of a positive climate agenda for the EU’s trade engagements, to provide synergies between the EU’s climate, trade and investment agendas, and to make practical recommendations on shaping relevant trade policy instruments.

The study project was organized in three phases. The first phase began with developing a long list of potential trade-related measures available to the EU that could advance the its climate change objectives. In total 31 measures were identified, covering six broad areas of trade policy, as depicted in Figure 1. In addition to representing a range of policy areas, the measures covered variety of types of instruments, from multilateral, plurilateral and bilateral treaties to unilateral instruments and ‘soft’ measures such as international cooperation strategies.

Based on this initial scoping, the study team undertook a preliminary analysis of the strengths and weaknesses of the basket of measures, with a view to identifying the most promising measures to develop further in the following phase. Based on this initial assessment the study team and the EU Commission (DG CLIMA and DG Trade) together chose the ten most promising measures and, in the second phase, developed these further and undertook a cost, benefit and achievability analysis for each of them. These measures and their assessment were presented in a stakeholder workshop in Geneva in October 2015, which included trade and climate experts from international organizations, civil society and the private sector. They were additionally discussed between the study team and experts from DG Trade in meetings in Brussels in February 2016.

Building on the cost-benefit and achievability analysis and the feedback provided by stakeholders and DG Trade experts, the study team and the Commission decided on four measures for which technical tools – principally legal and policy text suitable for use in EU trade instruments – and policy tools, comprising political argumentation and strategy, would be developed in the third phase. In addition, they chose two measures that were not considered feasible in the current political climate but nonetheless worthy of additional analysis, with a view to informing future political decision. For these two measures an assessment of feasibility and economic, political and legal implications was developed.

Figure 1. Caption



## 1.2 Report purpose and structure

The present report comprises the final report of the study. It presents concrete recommendations on trade-related measures to further the EU's climate objectives, and includes a varied 'toolbox' of legal and political tools that the EU can draw upon in furthering these objectives. The recommendations include a combination of different types of trade-related measures, as well as a mix of short, medium and long term action that target a range of the Union's key trading partners.

The report is structured as follows. Part II sets out the recommendations for action. This comprises four measures that have been selected through a consultation process with DG CLIMA, DG Trade and a range of public sector, private sector and civil society representatives. Each measure can be considered as an independent course of action, and as such each chapter is designed to also exist and be reproduced independently for use by relevant EU policy makers. In each case an overall description of the recommended measure is provided, followed by a set of practical technical and political tools focused on key elements of the measure (including draft text and political argumentation) designed to support EU policy makers in pursuing the measure.

Finally, Part III provides additional analysis on two measures that were not selected for inclusion within the recommendations, but regarding which it was considered worthwhile providing an analysis of its value, benefits and drawbacks and to provide considerations on whether and how they may become viable in the future.

## 1.3 Strategic considerations

Although the purpose of the study was to identify and develop concrete trade-related measures that the EU can use to advance its climate change objectives, this process has generated a number of general considerations that can be useful in informing the further integration of climate change objectives within EU trade projects. Here we present the most important of these.

**Wide range of opportunities.** The project identified a wide range of potential trade-related measures that could be used to pursue climate action, covering all principle types of trade and incorporating a broad range of sectors and instruments (see Figure 1). While not all measures were deemed feasible in current political contexts – for example Border Carbon Adjustments – were considered to go against the cooperative spirit that dominates the post-Paris paradigm – the process shows that measures that can be identified and designed to fit a broad range of policy directions and political contexts. Notably, several measures that we recommend respond to opportunities presented by ongoing developments, such as the revision of the EU Aid for Trade (AfT) Strategy or the conclusion of the Environmental Goods Agreement, indicating that where political opportunities arise, technical measures can be developed.

**Main constraints are political.** While there are important legal constraints imposed by WTO agreements and EU law, among others, and in some cases technical constraints in terms of data or monitoring, the biggest constraints to adopting climate-smart trade (and trade-related) measures are political. Potential constraints lie both with trade partners and with the EU itself. For instance, progress on fossil fuel subsidies remains subject to high sensitivities how the G20 commitment to eliminate “inefficient” fossil fuel subsidies is defined. At the EU level, there may for example be reluctance to push action of fossil fuel subsidies in a bilateral context due to the potential that this may incite demands from partners for reductions in other subsidies that are important for the EU economy. Successful measures will need to navigate and adapt to these political constraints, finding points of common interest and identifying where parties may be open to push the boundaries a little further.

**Build on existing efforts.** The EU is already making significant efforts to integrate environmental and sustainability concerns into its trade policy. The Trade for All strategy places a strong focus on sustainable development, and the EU has initiatives to integrate environmental considerations (including climate) into various areas, including public procurement, green goods, Aid for Trade and through Trade and Sustainable Development chapters. Additional efforts to pursue climate action should build upon and extend these efforts with further potential synergies.

**Employ multi-pronged strategies.** The EU is a large organization that engages on trade on multiple levels and through a huge variety of bilateral and multilateral fora. Different fora will lend themselves to different approaches, and so overall strategies should be nuanced. The measures developed show that more ambitious agreements will often be possible in bilateral contexts, and these can be used to both test different approaches and to gradually build support for future plurilateral or multilateral agreements.

**Engaging with civil society and the public.** Free trade agreements are increasingly received, by civil society and the wider public, with caution, reservations, and sometimes open hostility. The agreements are often understood as undermining social, labour and environmental standards, lowering legal protection, and making public engagement more difficult. By contrast, the fact that free trade agreements increasingly include an ambitious environmental — since recently also climate change focused — agenda is little known. There are few indications, if any, that free trade agreements had lowered environmental standards; the North American Free Trade Agreement, in fact, is an example for strong cross-country environmental performance. Trade negotiators are advised to portray better positive environmental agendas of negotiations, while the involvement of stakeholders and civil society at large in the implementation of such agendas deserves to be made a priority.

***Part II:***  
***Recommendations***  
***for action***

# 2 ■

## Improve and harmonise reporting on fossil fuel subsidies

### Summary and Key Points

#### Measure rationale

- Fossil fuel subsidies (FFS) are a major contributor to GHG emissions. Though there is increasing political commitment to inefficient FFS phase out in the G20 and other fora, practical efforts to act on this commitment have had mixed results.
- Existing international cooperation has largely focused on reporting of FFS as a first step, but even these efforts suffer from an absence of uniform templates, unclear definitions of key concepts such as “inefficient FFS” and a lack of monitoring/enforcement frameworks.
- The WTO and other trade agreements in many cases already address subsidies, and provide for related transparency processes and institutional arrangements. As such they are well placed to play a role in enhancing reporting on FFS.

#### Summary of measure

To advance the aims set out above, this measure proposes an integrated strategy to promote greater and more consistent reporting on FFS, based on the following four actions.

1. *Common reporting template for FFS reporting.* Development of common reporting template for FFS reporting, for systematic use by the EU in a variety of contexts (WTO, G20, FTAs). The template would include a broad definition of FFS, covering any form of support, thereby side-stepping any limitations in scope that arise in different fora. It would also include an illustrative checklist of FFS that helps assure consistency in reporting.
2. *Advocacy Strategy on FFS Reporting and Monitoring in the WTO.* Consistent EU strategy to lead by example through using the template in its own subsidy reporting, both under the Subsidies (SCM) Agreement and in the more general Trade Policy Reviews, and promote the same approach in other WTO Members.
3. *Increase FFS Reporting and Substantive Disciplines in EU FTAs.* Use of FTA negotiations to both provide for enhanced transparency on FFS through bilateral reporting, peer review and/or agreement on a common approach in the WTO; and agree on substantive disciplines on FFS (i.e., rules that restrict or prohibit the use of subsidies) and avoid undesirable provisions, such as an exemption of certain FFS from otherwise applicable disciplines.
4. *Promote FFS Reporting at the G-20 Level.* Draft EU communication to G20 seeking agreement to systematically apply an extensive and inclusive definition of FFS for purposes of G-20 FFS reporting, ideally using the master template. The EU would again lead by example.

#### Strategy Considerations

- This measure tackles FFS reporting on multiple levels, taking advantage of the different opportunities presented across various fora. Though designed as an integrated strategy, it can also be ‘sliced’ and employed flexibly on an opportunistic basis.
- Resistance can be expected from defenders of specific subsidy programmes, in the EU and partner countries, and from governments articulating systemic concerns about preserving the focus of WTO/FTA subsidy disciplines. Both can be overcome through compelling and consistent argumentation, and this measure sets out key arguments for this purpose.

## 2.1 Background and measure overview

FFS are a major contributor to GHG emissions. Estimates vary depending on definitions, methodology and focus, but overall global FFS are likely to be well above USD 600 billion per year. FFS set harmful incentives to produce and consume fossil fuels, and thereby both directly increase emissions and distort competition in disfavour of renewable energy. Moreover, for downstream (energy consumption) FFS, studies consistently show that mostly the richer segments of the society benefit from such subsidies.

Current international disciplines on subsidies provide only a sub-optimal basis for action. Article 5 of the WTO's SCM Agreement – which restricts the use of subsidies that have 'adverse effects' on the (trade) interests of other Members – or Article 25 of the SCM Agreement, which requires WTO Members to provide detailed information on their subsidy programmes, are among the most relevant provisions, but are focused on trade rather than the effects of FFSs themselves. FTA provisions tend to add little. In addition, there is some lack of clarity as to what constitute WTO-relevant subsidies in the area of energy sourcing and consumption, and reporting often lacks data and comprehensive economic analysis.

While effective tackling of the issue will eventually require further steps – possibly including hard law agreements on controlled phasing out of subsidies – increased transparency will be a key element of any effective strategy. FFS reporting, in particular self-reporting, remains overall suboptimal and tentative. Notwithstanding their deficiencies, trade-related instruments, including the WTO and FTAs, can be used as platforms to advance transparency, complementing efforts by the G-20 and by various organizations such as the OECD, the IEA and the IMF. Pilots on better FFS transparency are also arguably promising. A recent review of fossil fuel subsidies in Peru under an APEC voluntary peer review initiative led to the assessment of three FFSs provided in Peru and identified how two of these were ripe for reform with significant potential for fiscal, social, climate and environmental benefits (APEC, 2014).

Existing efforts to achieve transparency face several problems. Crucially, methodologies to assess and report on FFS differ,<sup>4</sup> making follow-up action difficult. The OECD, the IEA and the IMF use partly complementary, partly overlapping methodologies. While full harmonization may not be an immediate possibility, improved overall transparency which applies inclusive definitions will support that goal and make a significant contribution to any attempts at FFS Reform. A consistent methodology for reporting on and measuring subsidies is therefore useful for comparability, not only among the EU member states, but as well among the G20 and in the context of North-South relationships.

For purposes of FFS reporting within the context of trade agreements in particular, but also within the G20, an inventory approach in principle appears best-suited because it would ensure coverage of the first key element of the SCM Article 1.1 definition of a subsidy – “financial contribution by a government or any public body...” or “any form of income or price support.” A comprehensive inventory based on an over-inclusive definition of FFS will serve the trade purpose while providing the comprehensive input needed for the larger aim of controlling FFS for climate purposes.

The proposed measure aims at establishing a common template for FFS reporting in the WTO, the G20 and FTAs. This template would ideally be used based on a deliberately over-inclusive definition of FFS, covering any form of support (not necessarily strictly limited to subsidies defined as such in SCM Article 1.1), and consider any such support to both goods and services. It further suggests to systematically advocate improved (increased, harmonized and over-inclusive) FFS reporting, including through proliferation of disciplines (e.g. in EU FTAs) and advocating improved practices under existing disciplines (esp. in WTO and G20), including through 'leading by example'. In FTAs, meanwhile, this should ideally be combined with a further promotion of improved substantive disciplines covering FFS.

## 2.2 Detailed measure description and technical tools

### Component 1: Establish common reporting template(s) for FFS reporting

#### *Description of measure*

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<sup>4</sup> An excellent short summary can be found here [https://www.iisd.org/gsi/sites/default/files/ffs\\_methods\\_estimationcomparison.pdf](https://www.iisd.org/gsi/sites/default/files/ffs_methods_estimationcomparison.pdf)

Establish a common reporting template for FFS reporting in the context of trade agreements and related contexts, in particular G-20 reporting on FFS.

This template would ideally be based around a deliberately over-inclusive definition of FFS, covering any form of support (not necessarily strictly limited to subsidies defined as such in SCM Article 1.1), and consider any such support to both goods and services. This implies a conscious choice – *for purposes of reporting and transparency, not implying an extension of substantive disciplines* – to side-step any limitations in terms of scope that currently exist under specific frameworks (e.g. limitation under G20 to “inefficient” FFS; under WTO/SCM subsidies falling under definition in Article 1.1 of SCM).

This component comprises two sub-components: (i) a draft standard working definition of FFS; and (ii) Draft ‘master’ template for use in FFS reporting.

#### *Technical tools*

#### **Sub-component I - Draft standard working definition of FFS for purposes of reporting in trade/G-20 context**

The following definition is proposed:

*Fossil fuel subsidies [for purposes of reporting and transparency [under this agreement]] are all “financial contributions by a government or a public body” or “income or prices support” in the sense of Article 1.1 (a) of the SCM Agreement, whether or not an identifiable benefit is thereby conferred (but excluding procurement at market rates for governmental use or commercial resale), and whether or not any such contribution or support is specific to an enterprise or industry or group of enterprises or industries, relating directly or indirectly to the exploration, extraction, production, processing, transport, provision (through sale or otherwise), consumption or other use of fossil fuels, including but not limited to coal, oil, natural gas, lignite, peat and their derivatives. This shall include related investments in State-Owned Enterprises, except those that a private investor would have undertaken.*

*The Parties agree that in case of doubt measures shall be included rather than excluded from reporting and other transparency measures.*

*This definition applies exclusively for purposes of transparency. It is without prejudice to, and has no interpretative value whatsoever for the interpretation of, the scope of other disciplines [under this agreement].*

#### **Sub-component II – Draft ‘master’ template for use in FFS reporting in the context of trade agreements and related contexts (G 20)**

Under the auspices of the Global Subsidies Initiative GSI reporting templates have been proposed that could – we propose: in modified form – be used as a standard format for FFS reporting in all fora, including in the WTO under SCM Article 25.2 and GATT Article XVI. It would consist of two parts – a summary table and an annex containing relevant information in text format – and be complemented by an illustrative checklist that could be used as an annex. The purpose of the checklist would be to assist notifying countries in ensuring that no relevant programmes are missed. The checklist would serve as an illustration for types of programmes and measures meant to be addressed and notified, but not imply separate obligations.

The summary table could be used for all subsidies notified, but would be recommended to cover at least all FFS. Ideally FFS would be compiled together in a separate section of the notification, or at least a separate part of the table. The table would ideally be compiled in Excel or another widely-used spreadsheet or database software to allow for easy analytics (such as grouping by fuel).

A. Template for Part 1: Summary Table<sup>5</sup>

1	2	3	4	5	6	7	8	9	10
ISIC / CPC Code (Goods / Services)	Title / Description	Beneficiaries	Subsidy Type	FFS (Y/N)	Fuel Concerned	Gov't Level	Regional Designation	Duration	Amount

B. Template for Part 2: Annex

One (Sub-)Annex to be filled out per programme. This will, for each programme, have to satisfy the minimum requirements enumerated in the WTO questionnaire for notifications under SCM Article 25.<sup>6</sup>

<b>Title and/or brief description</b>		
<b>Period covered</b>		
<b>Policy objective</b>		
<b>Background and authority (especially: legal basis)</b>		
	<i>Level of government (central, state/regional, local)</i>	
<b>Type/form of subsidy (grant, loan, tax concession, fuel vouchers, etc.)</b>		
<b>Target beneficiaries</b>		
	<i>Enterprises or industries</i>	
	<i>Products/sectors</i>	
	<i>Regional designation</i>	
<b>Relating to fossil fuels (production, processing, transport, consumption, other)?</b>		
	<i>Which fossil fuel?</i>	
	<i>Quantity of fossil fuel affected?</i>	
<b>Amounts</b>	Overall amount (period covered)	
	Subsidy per unit, if possible	
<b>Duration / time limits</b>		
<b>Statistical data permitting an assessment of trade effects</b>		

C. Illustrative checklist of FFS (possibly use as annex to template)

- Approach: Bottom-up inventory of all measures fitting the above definition, including all measures attributable directly or indirectly to the governments and involving the investment of societal resources but excluding purely private initiatives. Measures should be listed individually to satisfy WTO needs, but also as a means to ensure completeness. Any checklist can only be illustrative as subsidies can take virtually infinite forms. All measures that fit the FFS definition provided previously should be reported.

<sup>5</sup> Adapted from Steenblik, R./Simón, J., A New Template for Notifying Subsidies to the WTO, GSI/IISD 2011; and Casier, L. et al., Shining a Light on Fossil Fuel Subsidies at the WTO, IISD 2013.

<sup>6</sup> WTO, Committee on Subsidies and Countervailing Measures, *Questionnaire Format for Subsidy Notifications under Article 25 of the Agreement on Subsidies and Countervailing Measures and under Article XVI of GATT 1994*, WTO Doc. G/SCM/6/Rev.1, 11 November 2003. The proposed outline is adapted from that questionnaire.

- Checklist (The following broad categorisations adapted from GSI<sup>7</sup> could be used. Users should however consult in addition, for further inspiration and reference, the OECD fossil fuel subsidy inventory which contains more than 800 different specific subsidy mechanisms.)
  - i. 'public subsidies', such as direct spending by government agencies and tax breaks to companies; These could be distinguished (aligned with OECD) into:
    1. (direct) producer support
    2. (direct) consumer support
    3. (indirect) general services support
  - ii. 'investment by State Owned Enterprises (SOEs) both domestically and internationally, to majority state owned utilities and/or fossil fuel concerns through government transfers to support enterprises in investments or to cover losses; and
  - iii. 'public finance' including support from domestic, bilateral and multilateral international agencies through partially or majority owned agencies or banks and the provision of grants, loans, equity and guarantees (export credits, risk guarantees, high credit ratings).
  - iv. The above could include specific items such as:
    1. Support to production (infrastructure provision, energy quotas, support schemes, free allocation of emission allowances, production tax incentives, royalty exemptions, support to stranded assets, support to SOEs, capacity payments, support for decommissioning and disposal, (fuel) tax exemptions, support with social costs, other support to cover externality costs, etc.).
    2. Support for investment (direct transfers to SOEs, grants, soft loans, tax incentives, accelerated depreciation, tax abatement, differentiated charging structures)
    3. Support to R&D (tax incentives, grants, use of public facilities/IPR)
    4. Support to energy demand (consumption), including: interruptible load schemes, exemptions from VAT, exemptions from energy taxes and levies, price guarantees.
    5. Further forms of coverage of externality costs attributable to fossil fuels. (This is already included in IMF estimates and others including the European Commission<sup>8</sup> have also investigated and reported on these costs).

## **Component 2: Advocacy Strategy for Increasing and Harmonizing FFS Reporting and Monitoring in the WTO**

### *Description of measure*

This component proposes an advocacy strategy for the EU – either publicly communicated as such or used internally to support systematic and concerted action – to increase and harmonize FFS reporting and monitoring within the WTO. The strategy would use existing reporting mechanisms for subsidies under the relevant WTO agreements as a vehicle. It would do so by explicitly employing extensive interpretations for purposes of reporting (through the use of the wide definition and of the master template set out above) to cover all FFS to achieve the desired comprehensive transparency. By doing so explicitly only for purposes of reporting, and without prejudice to existing legal obligations which remain untouched, this will avoid any risk of compromising EU legal positions in the WTO (e.g. generally on subsidies disciplines, reporting requirements, etc.). This would include the following elements:

- Systematically advocate *and* practice (EU as notifying Member, leading by example) the extensive and fully inclusive notification under Article 25 of the SCM Agreement and Article XVI:1 of the GATT of all subsidy programmes related to fossil fuel production, trade or consumption,

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<sup>7</sup> OCI International (2015) Empty Promises: G20 subsidies to oil, gas and coal production

<sup>8</sup> <http://ec.europa.eu/energy/en/content/final-report-ecofys>

including subsidies that Members might consider not to fall within the scope of these agreements, i.e. subsidies considered to be not specific or without trade effect, or where they may have doubts as to whether a relevant benefit is conferred.

- Specifically advocate and practice the use of the master template<sup>9</sup> (or a variation thereof) for this purpose, including the illustrative checklist to facilitate Members' reporting efforts.
- Use the possibility of third-party notification under SCM Article 25.10 to raise FFS programmes of other Members that these have not notified.
- In meetings of the SCM Committee systematically follow up on notifications of other Members that relate to FFS.
- Systematically advocate and practice (EU as reviewed Member) a discussion of FFS in Trade Policy Reviews (TPR) of WTO Members; work towards making FFS a standing item in TPR report templates.

### *Technical tools*

#### **Sub-component I – Formulation of the strategy**

The following presents key elements that are broadly formulated for use in strategy statements and in communications with WTO Members in the SCM Committee and the Trade Policy Review Body (TPRB), but are equally useful in internal and/or background communication.

- “The EU has long expressed its grave concerns about the harmful effects of fossil fuel subsidies (FFS), including on the climate, and has joined partners worldwide in working towards their reduction or elimination. It is recognized that any such efforts rely significantly on increased transparency with regard to FFS.”
- “The WTO is the foremost international forum to review, discuss and discipline subsidies and their use. The EU believes that established WTO transparency mechanisms within the WTO can and should be used in a targeted and systematic manner to increase transparency with regard to FFS.”
- “The EU advocates the extensive and fully inclusive notification under Article 25 of the SCM Agreement and Article XVI:1 of the GATT of all subsidy programmes related to the exploration, extraction, production, processing, transport, use or consumption of fossil fuels, including subsidies that Members might consider to be not specific or without trade effect, where they may have doubts as to whether a relevant benefit is conferred, or where the nexus to trade in goods is unclear. The EU believes that for FFS in particular it is desirable for Members to systematically err on the side of caution.”
- “The EU proposes that – for purposes of the desired inclusive reporting of FFS and without prejudice to the interpretation of substantive or procedural legal obligations under WTO agreements – a deliberately over-inclusive working definition of FFS is used to identify measures to be notified. The EU further proposes that WTO Members use a master template (or a variation thereof) for this purpose, including the illustrative checklist to facilitate Members' reporting efforts.
- “The EU will lead by example and [do XYZ from DATE onwards].”
- “In the spirit of cooperation and transparency the EU will further use the possibility of third-party notification under SCM Article 25.10 pro-actively to raise in particular FFS programmes [of other Members] that have not yet been notified, and encourages other Members to do the same.”
- “The EU will pay special attention to FFS in the context of the work of the SCM Committee, and will systematically follow up on notifications of other Members that relate to FFS.”

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<sup>9</sup> See Component 1, Sub-component II above.

- “The EU will systematically advocate – and practice as reviewed Member – a discussion of FFS in Trade Policy Reviews (TPR) of WTO Members where such FFS are relevant. The EU will work with other Members towards making FFS a standing item in TPR report templates.”
- “The EU will continue to work proactively with other Members on matters relating to fossil fuels and FFS in the context of other WTO bodies, in particular the Committee on Trade and Environment.”

### **Sub-component II – Notes on WTO-specific aspects in using the proposed definition, template and checklist in notifications under the SCM Agreement and the GATT, and in Trade Policy Reviews**

The proposed definition, template and checklist can be effectively used in countries’ notifications of their subsidies under the SCM and the GATT, as well as in the context of Trade Policy Reviews. The following notes aim to clarify certain specifics of the different WTO situations where these tools may be used.

*When used in notifications of subsidies under SCM Art. 25, GATT Art. XVI*

- Definition: No specific issues. The definition if used as intended will lead to some notifications containing elements that are not strictly required to be notified under WTO law. However, the system already today favours over-inclusive notifications over under-inclusive ones, and no harm will ensue. Should Members (incl. the EU) worry about the optical effect of inflated overall subsidy numbers they could without much effort include a note indicating the amount of subsidies notified but considered likely not to be covered by the SCM definition of a subsidy (Art. 1) and/or not to be “specific” (Ar. 2).
- Template: The template works for all subsidies. Its use however could also be limited to FFS only.
- Checklist: The checklist is illustrative, and can be used as such in WTO notifications. WTO Members are unlikely to accept any agreement, explicit, implied or insinuated, that the list has any bearing on their legal positions as to what constitutes a subsidy and/or what has to be notified.

*When used in third-party notifications (SCM Art. 25.10)*

- Definition: The definition can be used to identify suitable FFS. As third-party notifications are mildly adversarial acts (one Member pro-actively highlighting another Member’s subsidies) it would be important, however, to acknowledge both at the moment of initial consultations with the Member concerned and at the time of notification that a potentially over-exclusive definition has been used, and share that definition, to preserve legal credibility and as an act of fairness and transparency.
- Template: Both parts of the template can be used, but elements can be left empty as appropriate or convenient. There is no obligation for a third-party notification to be comprehensive.
- Checklist: Directly usable.

*When used in TPRs (TPRM) (Government report; WTO Secretariat report; Q&A)*

- Government report: Definition, template and checklist can usefully be employed as they are to identify FFS for purposes of inclusion in government reports. The form of the eventual reports would speak to the use of compilation tables which could be identical to or a simplified version of the template tables. What matters in TORs is to allow for general transparency, not to replicate SCM notifications.
- The same applies to WTO Secretariat reports. The Secretariat, however, at present does not have an explicit mandate to specifically look at FFS. However, as it is reasonably free in its reporting, it would also not be inappropriate for it to reflect on FFS in its reports. A systematic approach to FFS reporting would be desirable, and could be proposed by the EU.
- In Q&A sessions during TPRs Members are largely free to raise any aspect or issue, but will usually do so with some diplomatic restraint, reflecting the specific TPR context. All three tools can be usefully used as ‘checklist’ and reference material.

### **Component 3: Increase FFS Reporting and Monitoring and FFS Substantive Disciplines in EU FTAs**

### *Description of measure*

This measure proposes to systematically move towards FFS reporting and monitoring in FTAs, where possible both in the context of the TSD chapter and its mechanisms (see related recommendation in Chapter 5) *and* as part of substantive subsidy disciplines and related mechanisms (described here). It further proposes to increase the coverage and depth of substantive disciplines vis-à-vis classical trade agreement rules on subsidies with a view to better capturing FFS.

The technical tools below contain two sub-components. In the first, we set out a selection of draft standard provisions relating to reporting and transparency on FFS, as well as peer review. Addressing these issues will often be more politically feasible than establishing substantive disciplines. Here we also identify areas where ancillary references to FFS could be added to support these core provisions.

In the second sub-component, we identify possible areas where FFS could be addressed through *substantive subsidies disciplines*, focusing both on positive action to reduce FFS and on the avoidance of negative actions, such as excluding FFS from general provisions limiting subsidy use.

### *Technical tools*

#### **Sub-component I – Draft standard provisions on FFS transparency for inclusion in FTAs, and identification of potential supporting actions in FTAs**

##### A. Draft standard provision on FFS reporting for inclusion in FTAs

The provision would be most naturally placed with any subsidies disciplines the FTA would contain. This could be within the competition, trade remedies, or another chapter. In all cases it should be cross-referenced to the TSD chapter. If the FTA has no substantive disciplines on subsidies the provision would be best placed in the TSD chapter.

#### **Transparency of Fossil Fuel Subsidies**

1. The Parties shall notify to [each other / the Specialised Committee] on a [yearly] basis all fossil fuel subsidies as defined in paragraph 2, using the template attached in [Annex X (include template provided under Component 2)].

2. Fossil fuel subsidies [for purposes of reporting and transparency [under this agreement] are all financial contributions by a government or a public body or income or prices support in the sense of Article 1.1 (a) of the SCM Agreement, whether or not an identifiable benefit is thereby conferred (but excluding procurement at market rates for governmental use or commercial resale), and whether or not any such contribution or support is specific to an enterprise or industry or group of enterprises or industries, relating directly or indirectly to the exploration, extraction, production, processing, transport or consumption or other use of fossil fuels, including but not limited to coal, oil, natural gas, lignite, peat and their derivatives. [This definition applies exclusively for purposes of transparency. It is without prejudice to, and has no interpretative value whatsoever for the interpretation of, the scope of other disciplines [under this agreement].]

3. The Parties agree that in case of doubt measures shall be included rather than excluded from reporting and other transparency measures.

5. The Parties will synchronize notifications with those to the WTO SCM Committee. They will practice and promote the use of a standardized approach and template in both fora, as well as [to the extent practicable] in agreements with third parties.

##### B. Sub-component III – Draft standard provision on Committee review

This provision would preferably be positioned in the TSD chapter, but should follow the position of the main transparency provision.

The Specialised Committee shall periodically review the notifications. It may consult with relevant stakeholders. Where appropriate it shall adopt relevant proposals for implementation by the Parties and submit them as recommendations to the Trade Committee.

The Specialised Committee, on the basis of the template provided in [Annex X], may prepare supplementary good reporting guidelines to be used by both Parties.

C. Sub-component IV – Draft standard provision on Peer Review

This provision would preferably be positioned in the TSD chapter, but should follow the position of the main provision on Committee review.

Further to discussions in the Specialized Committee [and, upon request of either Party, but not more often than every [X] years,] OR [on a voluntary basis] the Parties may engage in a Peer Review of fossil fuel subsidies granted by a Party.

The Specialized Committee shall agree on guidelines, taking the *APEC Energy Working Group Guidelines on a Voluntary Peer Review for Reform of Inefficient Fossil Fuel Subsidies that Encourage Wasteful Consumption (VPR/IFFSR)* as a basis, and building on experiences gained within APEC. The Specialized Committee may provide for the inclusion of a third party and/or external experts in the review.

D. Sub-component V – Draft standard provision on Agreement to Cooperate on FFS in the WTO and elsewhere

This provision as well would preferably be positioned in the TSD chapter, but should follow the position of the main provision on Committee review and that on peer review, if applicable.

The Parties agree to individually and jointly, as appropriate, promote a comprehensive approach to fossil fuel subsidy transparency in all suitable fora, including the WTO and their respective FTAs with third parties.

The Parties will advance the use of the inclusive definition of fossil fuel subsidies set out in [Article X] and the reporting template set out in [Annex Y], or tools as closely as possibly resembling these, wherever possible and suitable.

They further agree to cooperate and coordinate fossil fuel subsidy-related action in the WTO and other fora.

E. Identification of additional potential supporting references to FFS in FTAs

Section of FTA	Nature of provision
Preamble or TSD Chapter	Agreement on undesirability of FFS
Chapters on Energy, Renewables, Environment	Cross-references to fossil fuels, FFS and FFS disciplines as appropriate

**Sub-component II – Negative/positive list of undesirable / desirable substantive disciplines relating to FFS**

Substantive subsidies disciplines in FTAs exist, but are rare. Because subsidies are usually not targeted towards trade with a particular country (the FTA partner), or have effects limited to the partner concerned, subsidies as a *trade issue* are in principle better addressed on the multilateral level (WTO). However, provided there is a political will to adopt substantive disciplines, either narrowly considering subsidies affecting bilateral trade, or with a broader scope, this is not inconceivable, and some FTAs do contain such disciplines.

Given the climate change-related underpinnings of this measure, it does make sense to consider substantive disciplines in FTAs with partners who share the overall strategic goal to progressively contain FFS generally. This can be a credible way to ‘spread the gospel’, not least with a view to bringing it to the WTO (see above).

The following list sets out, in the first place, positive (“desirable”) ways in which substantive disciplines on FFS could be included in an FTA and, secondly, a list of “undesirable” provisions that would negatively affect the goal of FFS reduction and should therefore be avoided. The adoption of any of these positive disciplines assumes *arguendo* a positive willingness to engage. Some are deliberately designed to ‘push the envelope’ of legal concepts and disciplines. It is also worth noting in this context that some EU MS themselves currently maintain FFS.

#### Desirable disciplines

- General substantive subsidies disciplines covering inter alia FFS
- Soft/hard law commitment to eliminate / phase out / reduce specifically-identified FFS
- Soft/hard law obligation to eliminate or reduce by at least X% of all FFS (note: some EU MS currently maintain FFS)
- Exclusion of FFS from a peace clause otherwise applicable to subsidies (note: the *opposite* may be desirable for tactical reasons in cases where substantive obligations can only be obtained for the price of peace clause coverage)
- Soft/hard law agreement on an extensive definition of FFS (akin to the one proposed in Sub-component 1 above) for purposes not only of reporting but also substantive disciplines)
- Agreement on facilitated countervailing of FFS (e.g. facilitated inclusion of FFS subsidies for input materials in subsidy calculations, including economy-wide non-specific FFS)
- Exemption of renewable energy subsidies from subsidy prohibitions (see proposed peace clause in Component 7 of Section 5.2 (TSD Chapter)).

#### Undesirable disciplines

- Exemption of specific FFS from substantive disciplines limiting subsidy use
- Exemption of specific FFS from review, enforcement or countervailing actions regarding subsidy use
- Placement of equal or greater limitations on renewable energy subsidies than on FFS

### **Component 4: Promote Extensive and Inclusive FFS Reporting at the G-20 Level**

#### *Description of measure*

This component seeks to foster agreement to systematically apply and promote an extensive and inclusive definition of FFS for purposes of G-20 FFS reporting, ideally using the master template. The EU would promote this use by leading by example. It consists of a set of key points that could be incorporated into a communication of the EU to G-20 Members, advocating for the adoption and/or use of an extensive definition of FFS when reporting under the G-20. These key points are complemented by an *Argumentaire* that can complement the arguments laid out under Component 2 when presenting and promoting this communication.

#### *Technical tools*

#### **Key points for a draft communication to G-20 Members on a proposed extensive and inclusive definition of FFS to be used in FFS reporting within the G-20**

- In its September 2009 summit in Pittsburgh, the G20 undertook a historic commitment to “rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption,” and to “adopt policies that will phase out such subsidies worldwide.”

G20 leaders further committed to report annually on their inefficient fossil fuel subsidies, as well as their actions to reform them.

- The 2009 commitment, reaffirmed multiple times by the G20 in its subsequent meetings, represents a key avenue of global action on climate change. The elimination of inefficient fossil fuel subsidies has consistently been recognized by experts and leaders as among the priority actions in the fight against global climate change. As the foremost body representing the world's major economies, including major energy producers and consumers, the G20 has a pivotal role to play in driving this effort.
- Important progress has been made since the adoption of the 2009 commitment. Since 2010, G20 members and several observers report annually on their inefficient fossil fuel subsidies, while since 2013 a voluntary peer review process has also been underway. These represent important first steps in the move to encourage fossil fuel subsidy reform. The IEA estimates that, without reforms enacted since 2009, the level of global fossil fuel subsidies would be USD 120 billion higher than it is today.
- Despite these achievements, the reporting and peer review process has not been without its challenges. The absence of an agreed definition on the scope of inefficient fossil fuel subsidies, or even fossil fuel subsidies themselves, has resulted in members using often widely varying definitions in their reports. As a result, reports are difficult to compare, and the overall transparency benefit that is at the heart of the G20 work on fossil fuel subsidies is severely diminished.
- The ambitious agreement adopted by world leaders in Paris in December 2015 to limit climate change to well below 2 and pursue efforts to limit warming to 1.5°C makes achieving progress on fossil fuel subsidy reform all the more urgent, while also creating the conditions to renew and enhance efforts through the G20.
- Responding to this renewed urgency and with a view to enhancing the effectiveness of the G20 initiative and further realizing its enormous potential, the EU proposes the agreement of members on a common definition of fossil fuel subsidies, together with a commitment by member and observers to use this definition as a basis for all voluntary reporting of fossil fuel subsidies. The EU further proposes the use of a common reporting template for use by members and observers, which would support the achievement of consistency in reports and facilitate a more effective peer review process.
- Significant work has been done by leading international organizations to develop definitions of fossil fuel subsidies, and the EU proposes that the definition adopted by the G20 draw on the work of these organizations. In the interests of transparency, and noting that the reporting of fossil fuel subsidies in no way commits any G20 member to specific reform actions, the EU proposes to adopt an inclusive definition that incorporates the full range of government support to producers and consumers of fossil fuel subsidies. As a starting point, the EU proposes [the attached definition and reporting template], and looks forward to engaging in a constructive discussion and development on this with other members.
- As a first step toward adopting a common definition and reporting template, the EU and its Member States commit to the consistent use of [the attached definition and template] in all their reporting to the G20, subject to any future changes in a definition and/or template that may be agreed by members.

## 2.3 Political tools

For this measure we have developed a separate set of political tools for each of the four components. They are set out below.

### Component 1: Establish common reporting template(s) for FFS reporting

The following present arguments/justification that can be used by the EU to support the introduction of this measure.

- This measure is an opportune 'soft law' step into the right direction for harmonization. The WTO and FTAs offer both a logical conceptual framework for FFS transparency, as subsidies as such

are a classical trade concern covered by trade agreements, and these agreements provide a sufficiently robust institutional framework to foster discipline, regularity and harmonization.

- While the proposed toolset (inclusive definition, template and illustrative list) will not solve all challenges (and complementary work on the basis of price gaps in particular will remain essential for some purposes), a concerted effort to improve and harmonize will make a significant contribution to both trade and climate-related aims.
- In the longer term, this will allow/support negotiations on substantive disciplines, i.e. obligations to eliminate or reduce FFS, possibly within the WTO, akin to those on fisheries subsidies. The latter – though not yet concluded – set a precedent for negotiations on subsidies disciplines that explicitly target policy concerns beyond trade, “enhancing the mutual supportiveness of trade and environment”.<sup>10</sup>
- The fisheries approach also provides inspiration in terms of design. Explicit recognition of an obligation not to stimulate the extraction and exploitation of particularly carbon-intensive fossil fuels through subsidies could be followed by stricter rules on subsidies for fossil fuel sourcing, trading and consumption as a whole. This could happen as part of a larger agreement on trade and energy, or on a stand-alone basis focusing only on energy subsidies, possibly including also energy subsidies other than FFS.

## Component 2: Advocacy Strategy for Increasing and Harmonizing FFS Reporting and Monitoring in the WTO

For this component we present arguments supporting the approach in the WTO, addressing concerns other WTO Members (as well as other stakeholders) may raise.

Concern	Response
<b><i>The strategy amounts to a ‘hijacking’ of the WTO for non-trade purposes</i></b>	FFS subsidies are already today covered by the notification requirements in the SCM Agreement and the GATT, and existing guidelines already advocate an inclusive (expansive) approach to notifications. The present strategy aims to capitalize on these bases to achieve an obviously worthwhile dual-purpose outcome on which all WTO Members should be able to agree [not least as no new or expanded legal obligations are implied].
<b><i>The working definition is too broad and unclear</i></b>	The working definition is designed to support a deliberately over-inclusive approach. It aims to facilitate Members’ good faith search for measures that could possibly be FFS and to stimulate their reporting discipline. However, because the definition does not imply any expansion of legal disciplines, it does not have any effect on Members’ legal obligations. That said, any improvements on the working definition proposed are welcome.

## Component 3: Increase FFS Reporting and Monitoring and FFS Substantive Disciplines in EU FTAs

The main overall political tool for this measure is the Strategy set out in Component 2. While this is presented as a technical tool due to its proposed status as an (semi-) formal EU document, its content should also inform the EU’s political strategy in this respect.

In addition, the following presents arguments specifically supporting the inclusion of FFS disciplines in FTAs (substantive, reporting, review/peer review), which could be used by the EU with respect to prospective FTA partners.

- FTAs serve bilateral trade interests, but are also tools to build broader international consensus and momentum.

<sup>10</sup> WTO, Hong Kong Ministerial Declaration “Doha Work Programme”, Annex D.I. para. 9, WTO Doc. WT/MIN(05)/DEC/1, 22 December 2005 (recalling the 2001 Doha Declaration).

- FFS are subsidies, and as such necessarily of trade/commercial interest. There is a specific and systemic EU *trade* interest in including subsidies disciplines in FTAs. The EU is generally a high performer in terms of subsidy disciplines, thanks to its State Aid law and practice, and is therefore well-positioned to advance this general cause.
- FFS have a recognizably detrimental effect on the climate, and as such run diametrically counter to agreed overall goals shared by all, not least after the overwhelming support gathered by the Paris Agreement. It is therefore logical for the EU to include CC elements systematically in its common commercial policy, of which FTAs are a vital component. Combined with the systemic interest in advanced subsidies disciplines, including as a first step better transparency, a focus specifically on FFS in FTAs is a legitimate and logical approach.
- Due to their cooperative nature FTAs lend themselves specifically to elements such as enhanced committee review and peer review.
- FTAs also provide a generally fertile climate for advancing good practice. FFS reporting on the basis of an enhanced, ambitious approach as proposed here appears to be a suitable case for this.

#### **Component 4: Promote Extensive and Inclusive FFS Reporting at the G-20 Level**

Most arguments supporting this component are contained in Component 2. In addition to these the following can further support this component.

##### A. To G20 members

- G20 members must lead by example. They have agreed on the principle that FFS can be wasteful and negatively affect the climate, and counteract globally agreed climate change policies, but the transparency tools agreed have not yet had the desired effect.
- The proposed approach is entirely in line with past G20 decisions and action on transparency, but aims to increase their effectiveness and compatibility with transparency mechanisms elsewhere, in particular the WTO. A harmonized and ambitious approach is highly desirable.
- It is recognized that the proposed over-inclusive approach reaches beyond the G20 focus on inefficient and wasteful FFS. However, there is not only no harm in over-inclusive *transparency*, but a clear gain as it enables G20 members to gain a better overview and hence will support any efforts to further clarify and focus action in the future.

##### B. To others

- Including the G20 in the overall strategy links both the trade-related logic and the opportunities inherent in trade instruments because of the logic to the wider strategic and political context globally.
- Conversely, the G20 has always considered trade as one of its tools and a forum for action. Given its existing clear positioning on FFS and FFS transparency, it is logical and promising to extend an initiative focused on the better and systematic use of trade instruments also to the G20 itself, to the greatest extent possible.

## **2.4 Delivery strategy**

- The overall strategic considerations are spelled out in some detail in Component 2 above. It is proposed to formulate and advance the strategy as an immediate and concerted comprehensive effort on all levels. There are no obvious (major) technical obstacles to doing so. Key political tools/arguments have been identified above under the respective components.
- It appears both desirable and feasible to engage in a concerted and comprehensive 'push' on all levels – especially G20, WTO and FTAs. This should be done in full openness and in cooperation and coordination with those who have extensive experience in monitoring and measuring FFS, in particular the OECD, the IMF, the IEA, the World Bank and the GSI. Refinements to the tools proposed here should be considered as part of such cooperation/coordination.

- While designed as a comprehensive and concerted effort on all levels, the proposed strategy can also be 'sliced' and employed flexibly on an opportunistic basis, advancing the cause incrementally wherever possible. Transparency is a relative exercise lending itself to such flexibility, if needed.
- At the domestic level, the opposition camp is likely to include, among others, the coal industry. Perhaps the sharpest tool – to move forward domestically – at the disposal of the European Commission is competition law (state aid law). The Commission has indeed cautiously moved towards the goal of phasing out state aid to uncompetitive coal mines beyond 2018 (Council Decision 2010/787/EU). This is a good basis for formulating and implementing an overall strategy as proposed, ostensibly anchored in the EU's trade policy.

# 3 ■

## Liberalisation of trade in services ancillary to environmental goods

### Summary and Key Points

#### Measure rationale

- The effective trade in, and use of, climate-smart goods is heavily reliant on services, including those involved directly in their deployment and also ancillary services provided in the context of acquisition/sale, installation, maintenance, use, etc.
- Trade in these ‘services ancillary to climate-smart goods’ is often restricted through market access rules and/or regulatory hurdles. This can affect trade in climate-smart goods themselves, and may often affect big projects and sophisticated technologies as these rely on installation, maintenance, training and other services to be delivered together with the product. Liberalization of such services trade is highly desirable.
- Different fora offer different and complementary opportunities for liberalising trade in services ancillary to climate-smart goods. The multilateral (WTO) level offers the possibility to use the momentum of the EGA to attempt narrow, targeted liberalisation. TISA negotiations offer the potential for a more ambitious approach. FTAs offer the chance to go further in terms of both the goods referenced and types of services covered.

#### Summary of measure

This measure proposes a comprehensive strategy to seek liberalisation and facilitation of trade in services ancillary to climate-smart goods on the multilateral (WTO), plurilateral (TISA) and bilateral (FTA) levels. The strategy would have horizontal linkages to a broader agenda of pro-climate liberalization of trade in services, and vertical linkages to the EU’s existing strategy of liberalizing environmental goods and services. The measure contains three components:

- *Strategy formulation.* Formulation of a strategy to seek liberalisation and facilitation of trade in services ancillary to climate-smart goods.
- *Requests for market access.* General and specific requests for market access openings for services ancillary to climate-smart goods. This component provides the EU with a toolbox of specific elements for its requests, designed to advance the above strategy, to be used on all three levels. Includes draft sample elements for a “master” model schedule and check list covering key services/modes.
- *Domestic regulation.* Proposals for key areas of domestic regulation important for services ancillary to climate-smart goods, that could progressively be addressed in trade agreements.

#### Strategy Considerations

- Trade in services is both a timely and low-hanging fruit and potentially controversial. The proposed targeted, narrow approach, clearly tailored to fast-track a worthwhile cause should, however, attract overall broad support. It will need to content with some hesitation on the technical level, timing challenges (especially EGA and TISA) and some principled opposition to services liberalization remaining entrenched in some parties.
- The concerted parallel approach on three levels – WTO, TISA, FTAs – provides an integrated strategy without increase complexity; progress on either front will support efforts on the others.

### 3.1 Background and measure overview

The effective trade in, and use of, climate-smart goods<sup>11</sup> is heavily reliant on services, including those involved directly in their deployment and also ancillary services provided in the context of the acquisition/sale, installation, maintenance use, etc.<sup>12</sup> Such services can together be considered as 'services ancillary to climate-smart goods'.

Currently, trade in services ancillary to climate-smart goods is restricted in many countries through various measures relating to market access (i.e. exclusion of foreign firms or professionals from certain services or certain modes of delivery, e.g. physical presence or establishment of firms, including through onerous visa regimes) or to domestic regulation (including e.g. licensing requirements for services such as engineering or construction, as well as qualification requirements for professionals such as engineers). These issues are particularly relevant for large projects and/or sophisticated technologies, which can require regular, highly qualified on-the-ground technical support. Such barriers are understood to be common, based on both anecdotal evidence and some documented cases, for example regarding Swedish firms in the wind energy and wastewater treatment industries.<sup>13</sup>

To-date there has been little progress in international efforts to liberalise trade in services ancillary to climate-smart goods. The efforts of the EU to include services related to environmental goods in a future EGA have so far not borne much fruit. Taking action to liberalise trade in services ancillary to climate-smart goods has the potential to open the door to broader action to liberalise trade in climate-relevant services (e.g. any services provided with a relevant low-carbon impact). It also provides a logical starting point as it builds on the current momentum to liberalise trade in environmental goods and adopts a simple approach with potentially high political acceptability.

Different fora offer different and potentially complementary opportunities for liberalising trade in services ancillary to climate-smart goods. The multilateral (WTO) level offers the possibility to use the momentum of the EGA to attempt narrow, targeted liberalisation, while negotiations under TISA offer the potential for a more ambitious approach, although among a more limited group of participating countries. FTAs, in turn, offer the chance to go potentially much further in terms of both the goods referenced and types of services covered, potentially providing momentum for the TISA and WTO levels. It is understood that concrete opportunities in the immediate EGA and TISA contexts may be elusive as time windows for new or renewed proposals may close as results have to be consolidated to achieve overall progress. However, keeping the issue on the agenda for future upgrades in these fora, e.g. under general or specific *rendez-vous* clauses, seems advisable in any case.

We propose to formulate and implement a comprehensive strategy to seek liberalisation and facilitation of trade in services ancillary to climate-smart goods on the multilateral, plurilateral and bilateral trade agreement levels, with horizontal linkages to a broader agenda of pro-climate liberalization of trade in services and pro-climate trade generally, and vertical linkages to the EU's existing strategy of liberalizing environmental goods and services. Key tools for implementation will be general and specific requests for market access openings (specific commitments from other countries), based on a model schedule/checklist of desired market access commitments, and proposals for related regulatory disciplines (chapters/provisions on domestic regulation) relating specifically to services ancillary to climate-smart environmental goods, on three levels: multilateral/WTO/EGA; plurilateral/TISA; bilateral-regional/FTAs.

#### *WTO level*

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<sup>11</sup> We define these – for purposes of this paper – as the following goods which are included under the negotiations on the Environmental Goods Agreement and have a significant climate impact: Parts of biomass boilers; gas turbines that burn natural gas or for electrical generation from recovered landfill gas; wind turbines; waste incinerators and heat or catalytic incinerators; solar water heaters; biogas reactors; digestion tanks; biogas refinement equipment; PV cell coaters; apparatus for landfill gas monitoring, anaerobic digesters for organic waste; AC generators (alternator) of an output exceeding 750 kVA for renewable energy plants (e.g. biomass); amorphous transformers for electricity production from wind, combined heat and power systems using biomass and/or biogas; Portable solar power generation equipment; solar power electric generating sets; small hydro powered generating plant; wave power generating plant; and gas turbine sets for biomass plants and for waste heat applications; parts for electrical transformers, static converters and inductors to convert DC current from renewable energy generating sets into conventional AC electricity; parts of solar heliostats (for CSP), .OR IN SHORT: services related to namely products related to cleaner and renewable energy; energy and resources efficiency.

<sup>12</sup> See Kommerskollegium (2014) Making Green Trade Happen – Environmental Goods and Indispensable Services, p.5.

<sup>13</sup> Ibid.

- Follow-up on existing EU proposal to extend EGA to goods-related services, specifically seeking agreement on climate-smart goods. Clearly articulate demands/ambition for post-EGA follow-up/*rendez-vous* negotiations.
- Renewed/revised market access requests in general services negotiations, if and when revived under Doha Development Agenda (DDA) or otherwise.
- Domestic regulation (DR): Pursuit of concluding agreement on general disciplines on DR *and/or* proposal of sectoral disciplines of relevance to services ancillary to climate-smart environmental goods.

*TISA (plurilateral) level. (In view of advanced negotiations and the ambition to conclude TISA, largely precluding new initiatives at this stage)*

- Specific market access request(s) to TISA participants (to the extent politically possible). Close follow-up on market access offers received from other TISA participants with a view to ensuring maximum coverage of services ancillary to climate-smart environmental goods.
- Pursuit of domestic regulation disciplines of relevance to services ancillary to climate-smart environmental goods as part of general and sectoral regulatory disciplines (assuming a separate chapter is not an option)

*FTA (bilateral/regional) level*

- Specific market access requests to FTA partners, based on broader (EGA plus) list of climate-smart goods.
- Pursuit of strong general disciplines on domestic regulation, and where possible sectoral disciplines of relevance to services ancillary to climate-smart environmental goods

## 3.2 Detailed measure description and technical tools

### Component 1 – Strategy to seek liberalisation and facilitation of trade in services ancillary to climate-smart goods

#### *Description of measure*

Explicit strategy statement for internal and public consumption outlining the fundamental strategic approach taken by the EU, namely:

- (1) to systematically seek targeted liberalization of services relevant to climate change mitigation and adaptation, recognizing the significant contribution that efficient services can make to the global efforts under way, not least in developing countries
- (2) to specifically, and as a ‘pilot project’, seek liberalization of services ancillary to climate-smart goods, especially those covered by the future Environmental Goods Agreement (EGA); these services should include in particular installation, maintenance, training and the like to facilitate the effective deployment and operation of such goods
- (3) to pursue such liberalization systematically and on all levels where the EU engages trading partners, including on the multilateral level (WTO, including through the EGA), the plurilateral level (TISA negotiations) and the bilateral and regional level (FTAs)

This strategy statement could be issued separately, in the form of elements inserted into other, broader strategy statements (Trade, Climate), in the form of “interpretations” of relevant elements of existing strategy statements, in speeches, and combinations of the above.

#### *Technical tools*

Proposed/possible text elements for one or more strategy statement(s) *accompanying the articulation of the approach itself* (see above *narrative*; elements not re-elaborated here):

*Reference to “Trade for All” and previous/existing initiatives on trade:*

- “The 2015 Communication “Trade for all” has underscored the European Union’s commitment to a trade policy that also advances climate change goals. The fight against climate change for effective adaptation is also part and parcel of the pursuit of a mutually reinforcing relationship between trade and sustainable development,<sup>14</sup> and the Commission has made it clear that it is increasing the priority given to the sustainable management of natural resources and the fight against climate change through the EU’s trade agreements.<sup>15</sup>”
- “The EU is committed to the successful conclusion of the Environmental Goods Agreement with WTO Members. The logic behind this dual-benefit approach for trade and the environment should further extend to services that are needed to put these goods to use. The EU has therefore tabled a proposal on the liberalization of services ancillary to environmental goods.”
- “Out of this broader goal the liberalization of *services ancillary to climate-smart goods* should be made a priority within the priority. Climate-smart technology relies on climate-smart services to put it to use. It is the combination of green technology and green services, which makes the long-term difference.”

*Reference to Climate-/Energy-related policies*

- “The EU is strongly committed to supporting the growth of renewable energy beyond its borders and ensuring access to sustainable energy for all. This is one of the four pillars of its strategy ‘The EU Energy Policy: Engaging with Partners beyond Our Borders ‘ and a consistent thread in its cooperation with international partners, including through the Sustainable Energy for All initiative, the Africa-EU Energy Partnership and the European Investment Bank’s Global Energy Efficiency & Renewable Energy Fund. The free movement of services that support the installation and operation of renewable energies in partner countries is key to the success of these efforts.”

*Horizontal and vertical linkages clearly articulated, but pilot-approach (specifically these services first) equally clearly established (to allow partners to agree to narrow “concessions” without compromising resistance to services liberalization otherwise)*

- “The liberalization of services linked to climate-smart goods is a logical extension and element of the EU’s broad approach to achieving better and more effective market access for services, especially in those sectors where EU providers can make great contributions to customers in markets worldwide. These include services linked to exported goods, including in particular technology and investment goods.”
- “The EU has for a long time been a proponent of broader and deeper market access for environmental services, a concept that should be understood broadly. The win-win potential is significant. Market access for services linked to environmental goods supports this approach.”
- “The link to climate-smart goods as a priority sub-group of environmental goods is logical and a powerful incentive for all to advance this cause. If these goods are worth being treated as a priority, the services that put them to use should as well.”

<sup>14</sup> Trade for All, p. 23.

<sup>15</sup> Trade for All, p. 24.

- “The liberalization of services ancillary to climate-smart goods is highly desirable for all, and in its own right. Trading partners should find it easy to agree and – where necessary – carve out the necessary flexibility in their approach in FTAs, plurilateral initiatives such as TISA, and the WTO. Where necessary it makes sense to isolate this specific and narrow target from any disagreements that may prevail over broader items on the trade agenda between partners. This is good, and everyone can do it.”
- “At the same time the Commission believes that the liberalization of services ancillary to climate-smart goods can also act as a “trial” run, and hence as a “pilot” for possibly more efforts in future: For more liberalization of services that are of particular relevance to climate change, including ‘dual use’ services such as professional services rendered to climate-smart projects; for more market access for environmental services, including ‘dual use’ services; for better market access for services linked to (other) environmental goods; also for increased liberalization of services trade that is logically linked to traded goods generally; and for better market access for high-quality services generally.”

## **Component 2: General and specific requests for market access openings for services ancillary to climate-smart goods**

### *Description of measure*

Agreements on trade in services classically rely on a combination of general cross-cutting provisions and specific commitments, often broken down by sub-sector and mode of supply,<sup>16</sup> and enshrined in schedules of commitments. Both general clauses and specific commitments, which determine absolute market access rights (as opposed to relative non-discrimination rights), and – in the GATS and many other agreements – also National Treatment rights, are usually negotiated on the basis of requests.

This component provides the EU with a toolbox of specific elements for its requests on services, designed to advance the above strategy, to be used on all three levels (multilateral/WTO, plurilateral/TISA and bilateral/regional/FTA).

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<sup>16</sup> The GATS classically distinguishes four modes of supply: (1) cross-border supply (only service crosses the border), (2) consumption abroad (service consumer or his assets cross the border to consume the service abroad), (3) commercial presence (provider sets up branch, subsidiary etc. abroad to provide services from there) and (4) presence of natural persons (natural persons as service providers or employees of service providers cross the border to provide service abroad). The EU and some others now usually advocate a modified classification, grouping modes (1) and (2) together, usually referred-to as „cross-border supply“. The differences in classification are of limited relevance here..

Technical tools

**Sub-component I – Elements suggested for all levels (WTO, TISA/plurilateral and FTA)**

A. Draft main agreement text

The proposed draft agreement text is based on the EU’s existing proposal text on services ancillary to environmental goods submitted in the EGA negotiations. The original text is reproduced in Annex 1 to this measure. It is worth keeping in mind that that text was developed to fit a particular context (EGA) and a particular juncture (EGA negotiations in July 2015), which has informed certain choices. In the proposed text below we build on the EGA negotiations text to propose a refined text that is more closely tailored to the needs of climate-smart goods...

The table below sets out the text we propose to be used as the standard negotiating text by the EU, together with explanatory commentary, explaining both the rationale for the proposals and, where relevant, in which negotiation context they are most relevant. The lighter text represents the existing text of the EU EGA proposal text, which the regular text represents our proposed additions.

Title	Proposed Text	Commentary
<b>[Scope / Definition]</b>	<p>For the purposes of this Agreement, services ancillary to climate-smart goods means services that are supplied to manufacture, adapt, transport, assemble, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good listed in Annex X or a good consisting thereof, or are supplied to supervise the foregoing activities.</p>	<p>(Darker elements are additional to the EU EGA proposal text (Article 4).)</p> <p>The EU EGA proposal text aims to cover services <i>ancillary to trade in environmental goods</i>. While we propose to cover services <i>ancillary to climate-smart goods</i>. This means a modification in two significant ways here:</p> <ul style="list-style-type: none"> <li>- Instead of services incidental to <i>trade</i> in goods this would expand coverage to services that are ancillary to the goods themselves, hence not necessarily presupposing a trade (in goods) context.</li> <li>- The proposed text ‘zeroes in’ on climate-smart goods, as opposed to generally environmental goods.</li> </ul> <p>The EU EGA proposal contains two additional elements (qualifications) which we propose to avoid to the extent possible:</p> <ul style="list-style-type: none"> <li>- <b>Text EGA Proposal:</b> “are supplied as part of a seller’s contractual obligation pursuant to a warranty or any other services contract incidental to the sale of the environmental good...”</li> </ul>

		<ul style="list-style-type: none"> <li>• <b>Comment:</b> While this captures the classical case (a seller of an EG also offers and sells the ancillary services), it would be unnecessarily restrictive to exclude alternative contractual arrangements or even cases where the seller of the goods has nothing to do with the servicing, but both seller and buyer work on the basis of the assumption that such services will be available from high quality, competitive suppliers. This ‘disentanglement’ will be of particular interest for SME producers (or buyers) who need to limit their exposure to contractual risk. Many producers of climate-smart goods are SMEs. In view of the need to cater for dynamic innovation, this aspect will remain important throughout.</li> </ul> <p>- <b>Text EGA proposal:</b> “... either by the signatory of the contract or by a juridical person that is subcontracted by the signatory of the contract”</p> <ul style="list-style-type: none"> <li>• <b>Comment:</b> Again, this seems unnecessarily restrictive as to the contractual construction chosen by the parties involved. Especially when smaller companies are involved both buyer and seller may find it beneficial if the buyer contracts a third party provider of the services independently, without the seller being drawn into contractual matters.</li> </ul> <p>- <b>Text EGA proposal:</b> “and...are classified under the headings listed in Annex [X]”</p> <ul style="list-style-type: none"> <li>• <b>Comment:</b> A listing of services sectors/subsectors will provide orientation, but will also act as a restriction. We suggest to avoid it, or only provide it as a non-exhaustive illustrative list.</li> </ul>
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<p><b>Market Access and National Treatment</b></p>	<p>1. With respect to measures affecting any of the modes of supply defined in Articles I.2 (a) and (b) of the General Agreement on Trade in Services (“GATS”), each Party shall accord to the services ancillary to climate-smart goods and to the suppliers of those services market access and national treatment [within the meaning of Articles XVI and XVII of the GATS] [as defined in Article X].</p> <p>2. Any conditions, limitations and qualifications to the commitments described in paragraph 1 [with respect to Modes 1 and 2], including their duration, shall be limited to existing non-conforming measures listed in Annex [X] to this [Agreement], on any level of government, or their continuation or prompt renewal, or an amendment to any such measure that does not decrease the conformity of the measure with paragraph 1.</p> <p>3. Parties shall eliminate the non-conforming measures referred to in paragraph 2 no later than [X].</p> <p>4. [For modes other than those referred to in paragraph 2, the Parties shall accord each other’s services and service suppliers treatment no less favourable than provided for under the terms, limitations and commitments agreed and specified in its schedule of commitments.]</p>	<p>(Darker elements are additional to the EU EGA proposal text (Article 6).)</p> <p>Paragraph 1 is purely technical. It extends the EU EGA proposal, which only includes Modes 1 and 2 here (cross-border supply; consumption abroad) to all four modes of supply.</p> <p>Paragraphs 2 and 3 – which will be most suitable in FTAs and TISA but can also work under the EGA – establish the status quo of existing non-conforming measures as a maximum ceiling. Ideally this would be achieved for all four modes of supply. However, as a minimum / fall back demand it should be requested for Modes 1 and 2 (see square-bracketed text).</p> <p>Paragraph 4 serves as the fall back option for Modes of supply that cannot be covered by the more stringent option in paragraphs 2 and 3.</p>
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<p><b>Presence of Natural Persons</b></p>	<p>1. [The Parties shall allow the entry and temporary stay of natural persons supplying services ancillary to climate-smart goods in all forms, namely as Independent Professionals (IP), Contractual Services Suppliers (CSS) or Intra-Corporate Transferees (ICT), including Graduate Trainees, as well as of related Business Visitors (BV).]</p> <p>2. CSS for purposes of services ancillary to climate-smart goods shall include all employees of a provider that are required in the <i>bona fide</i> execution of a relevant contract, including non-specialists. <i>[Add clarifications/expansions for IP and ICT where existing definitions are not sufficient.]</i></p> <p>3. Unless otherwise specified in their schedules the Parties shall allow the entry and temporary stay of natural persons supplying services ancillary to climate-smart goods as IPs or CSS without the requirement of a work permit or any other prior approval procedures of similar intent.</p> <p>4. For [others/ICT] the issuance of a work permit, or completion of another approval procedure, shall normally be automatic and in any case be completed without delay</p> <p>5. <i>[Maximum durations of stay to be defined if existing horizontal commitments are not sufficient].</i></p>	<p>The EU EGA proposal on Mode 4 (Article 7) is phrased as an enriched mandate to negotiate, not as a substantive discipline, owing to the specific context in which it was proposed. The proposed text takes elements from that provision but rearranges and modifies them significantly.</p> <p>Paragraph 1 clarifies coverage to include all forms of provision of services through natural persons. The EU EGA proposal appears to limit itself to CSS and IP, as it leaves Mode 3 out altogether.</p> <p>Paragraph 2 aims to preclude the otherwise likely restriction to specialists (EU EGA proposal: “persons...possessing specialized knowledge essential to the seller’s contractual obligation”). The restriction to specialists stands in the tradition of CSS, IP and Mode 4 commitments generally. However, especially in a context where providers efficiently would send entire teams (including lower-skilled or generalist staff) to get the job done, these limitations can cause significant disruption. This applies generally. Given the very narrow focus here on services related to climate-smart goods, and the overarching non-trade motivation to fast-track this particular liberalization step for the greater good, it appears feasible and largely painless to broaden the coverage in this specific context. The EU itself is among those exercising restraint on Mode 4 generally and CSS in particular, but given its own emphasis on installers and servicers and the said narrow focus here could credibly propose this without compromising its overall position.)</p>
<p><b>Link to GATS schedules (EGA only)</b></p>	<p>Each Party shall incorporate the commitments described in [Article X], including any related conditions, limitations and qualifications listed [in their schedules/corresponding lists under this agreement], into its Schedule of Commitments under the General Agreement on Trade in Services (“GATS Schedule of Commitments”).</p>	<p>(Corresponds to Article 5.1 of the EU EGA proposal).          Needed if separate agreement within the WTO (e.g. EGA) aimed to apply on an MFN basis (e.g. EGA, services sectoral, early harvest on services in DDA, etc.): Commitments undertaken on services ancillary to climate-smart goods need to be incorporated into GATS schedules.</p>
<p><b>Regular review / progressive liberalization</b></p>	<p>The [Committee / Parties] shall regularly, at least every X years, review the list of services and commitments with a view to further liberalizing trade in services ancillary to climate-smart goods, including by expanding the list of relevant goods.</p>	<p>(Corresponds to Article 5.3 of the EU EGA proposal; darker elements are additional to the EU EGA proposal text.)</p> <p>Where a general review clause exists the clause should be adapted as</p>

		appropriate and necessary to reflect (i) the special attention to be given to services ancillary to climate-smart goods and (ii) the proposed high-frequency rhythm of review.
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B. Draft general request for specific commitments:

The EU requests [Party X / other Parties / other Members] to make full, comprehensive and deep commitments, covering all modes of supply, with respect to services ancillary to climate-smart goods. These include services that are supplied to manufacture, adapt, transport, assemble, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good listed in Annex [X] or a good consisting thereof, or are supplied to supervise the foregoing activities. [This includes, but is not limited to, services in the following sectors and subsectors...]

C. Draft sample elements for a “master” model schedule and check list covering key services and modes of supply targeted

Note: The draft schedules below are devised assuming that the proposed ‘lock in’ of existing market access and national treatment as proposed above (Subsection A: Draft main agreement text, under “Market Access and National Treatment”, paragraphs 2 and 3) is not agreed. If it is, non-conforming measures will have to be listed separately. The draft schedules below can act as a checklist for this purpose.

*Option 1: General cross-cutting commitment*

Note: The proposed cross-cutting commitment is a (pluri-)sectoral commitment rather than a horizontal one. It therefore belongs to the sector-specific commitments section rather than the horizontal section. It could be positioned at its beginning.

Modes of supply: 1) Cross-Border supply 2) Consumption abroad 3) Commercial presence 4) Presence of natural persons			
Sector/Subsector	Limitations on Market Access	Limitations on National Treatment	Additional Commitments
<b>General Cross-Cutting Commitment</b>			
<b>Services ancillary to climate-smart goods</b>  Within all services sectors, except where provided otherwise with specific reference to this commitment:  Services that are supplied to manufacture, adapt, transport,	1) None  2) None  3) None  4) <i>[Full market access commitments for IP, CSS, ICT and BV, with CSS including non-specialists; the</i>	1) None  2) None  3) None  4) <i>[Full NT commitment for IP, CSS, ICT and BV; formulation depends on</i>	[The Party/Member] undertakes commitments as follows:  [regulatory principles]  OR  [The Party/Member] undertakes commitments in the [Reference Paper

<p>assemble, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good or a good consisting thereof, or are supplied to supervise the foregoing activities.</p> <p>Climate-smart goods for purposes of this commitment comprise are [add list or reference, ideally dynamic reference to list that may develop progressively over time.]</p>	<p><i>formulation depends on the Member's/Party's schedule's horizontal section. Where IP, CSS, ICT and BV are generally defined and committed: see below. Where not, positive commitments to be added here or in horizontal section.</i></p> <p>Unbound, except as provided in the horizontal section.</p> <p>[CSS for purposes of services ancillary to climate-smart goods shall include all employees of a provider who are required in the <i>bona fide</i> execution of a relevant contract, including non-specialists.]</p>	<p><i>schedule. Usually the following will apply:]</i></p> <p>Unbound, except for measures concerning the categories of natural persons referred to and committed in the Market Access column.</p> <p>Limitations reflected under specific subsectors shall [not] apply[, except as specifically provided there.]</p>	<p>on Services Ancillary to Climate-Smart Goods]</p>
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*Option 2: Sector-specific commitments.*

The below is a sample commitment. Similarly designed commitments would be adapted to each sub-sector of relevance.

Modes of supply: 1) Cross-Border supply 2) Consumption abroad 3) Commercial presence 4) Presence of natural persons			
<b>Sector/Subsector</b>	<b>Limitations on Market Access</b>	<b>Limitations on National Treatment</b>	<b>Additional Commitments</b>
<b>1. Business Services</b>			
A. Professional Services	1) None	1) None	<p>[The Party/Member] undertakes commitments as follows:</p> <p>[regulatory principles especially relating to</p> <ul style="list-style-type: none"> <li>- Qualification requirements: Waiver of requirements or fast-track recognition on the basis of 'best available procedure'</li> </ul>
d. Architectural Services	2) None	2) None	
e. Engineering services	3) None	3) None	
f. Integrated engineering services	4) [Full MA commitments for IP, CSS, ICT and BV, with CSS including non-specialists; the formulation depends on the Member's/Party's schedule's horizontal section. Where IP, CSS, ICT and BV are generally defined and	4) [Full NT commitment for IP, CSS, ICT and BV; formulation depends on schedule. Usually the following will apply:]	
g. Urban planning and landscape architectural services			
k. other			

<p>supplied to manufacture, adapt, transport, assemble, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good or a good consisting thereof, or are supplied to supervise the foregoing activities.</p> <p>Climate-smart goods for purposes to this commitment a goods are [add list or reference, ideally dynamic reference to list that may develop progressively over time.]</p>	<p><i>committed: see below. Where not, positive commitments to be added here or in horizontal section.</i></p> <p>Unbound, except as provided in the horizontal section. [</p> <p>CSS for purposes of services ancillary to climate-smart goods shall include all employees of a provider who are required in the <i>bona fide</i> execution of a relevant contract, including non-specialists.]</p>	<p>Unbound, except for measures concerning the categories of natural persons referred to and committed in the Market Access column.</p> <p>Limitations reflected under specific subsectors shall [not] apply[, except as specifically provided there][except as follows:....].</p>	<ul style="list-style-type: none"> <li>- Membership in professional bodies: Waiver or automatic membership</li> <li>- etc.]</li> </ul> <p>OR</p> <p>[The Party/Member] undertakes commitments in the [Reference Paper on Services Ancillary to Climate-Smart Goods]</p>
<p>B. Computer and Related services</p> <p>supplied to manufacture, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good or a good consisting thereof, or are supplied to supervise the foregoing activities.</p> <p>Climate-smart goods for purposes to this commitment a goods are [add list or reference, ideally dynamic reference to list that may develop progressively over time.]</p>	<p>1) None</p> <p>2) None</p> <p>3) None</p> <p>4) <i>[Full market access commitments for IP, CSS, ICT and BV, with CSS including non-specialists; the formulation depends on the Member's/Party's schedule's horizontal section. Where IP, CSS, ICT and BV are generally defined and committed: see below. Where not, positive commitments to be added here or in horizontal section.]</i></p> <p>Unbound, except as provided in the horizontal section. [</p>	<p>1) None</p> <p>2) None</p> <p>3) None</p> <p>4) <i>[Full NT commitment for IP, CSS, ICT and BV; formulation depends on schedule. Usually the following will apply:]</i></p> <p>Unbound, except for measures concerning the categories of natural persons referred to and committed in the Market Access column.</p>	<p>[The Party/Member] undertakes commitments as follows:</p> <p>[regulatory principles especially relating to</p> <ul style="list-style-type: none"> <li>- Data security incl. data localization: (,,)</li> <li>- etc.]</li> </ul> <p>OR</p> <p>[The Party/Member] undertakes commitments in the [Reference Paper on Services Ancillary to Climate-Smart Goods]</p>

	CSS for purposes of services ancillary to climate-smart goods shall include all employees of a provider who are required in the <i>bona fide</i> execution of a relevant contract, including non-specialists.]		
<b>Other sectors / subsectors<sup>17</sup> e.g.:</b>			
E. Rental/Leasing Services without Operators  c. Relating to other transport equipment d. Relating to other machinery and equipment	(as above)	(as above)	(as above)
F. Other Business Services  c. Management consulting services d. Services related to management consulting e. Technical testing and analysis services h. Services incidental to mining i. Services incidental to manufacturing j. Services incidental to energy distribution n. Maintenance and repair of equipment	(as above)	(as above)	(as above)
<b>3. Construction and Related Engineering Services</b>			

<sup>17</sup> The following list of sub-sectors of potential relevance is extensive, but not necessarily exhaustive..

A. General construction work for buildings	(as above)	(as above)	(as above)
B. General construction work for civil engineering	(as above)	(as above)	(as above)
C. Installation and assembly work	(as above)	(as above)	(as above)
<b>5. Educational Services</b>			
D. Adult education	(as above)	(as above)	(as above)
E. Other education services	(as above)	(as above)	(as above)
<b>6. Environmental Services</b>	(as above)	(as above)	(as above)
<b>11. Transport Services</b>			
A.-C., E.-F. Maritime, Internal Waterways, Air Transport, Rail, Road Transport Services  Especially: b. Freight transportation d. Maintenance and repair	(as above)	(as above)	(as above)

## Sub-component II – Elements suggested for use at WTO level

- A. Proposed approach to ongoing EGA negotiations:
- i. Propose a narrow pilot agreement only on services ancillary to climate-smart goods, as opposed to all environmental goods, as a compromise vis-à-vis original July 2015 EGA proposal;
  - ii. Propose text akin to draft agreement text above, in the form of a modified EU EGA proposal text;
  - iii. If necessary to achieve agreement, offer a limitation to services incidental to *trade* in climate-smart goods (as opposed to services ancillary to climate-smart goods) (i.e. replace references to “services ancillary to climate-smart goods” by “services incidental to climate-smart goods”);
  - iv. Consider narrow request, possibly even on a ‘critical mass basis *within a sub-group of EGA participants*, covering only selected sub-sectors – as a way to generate within the WTO a pilot agreement, establishing the idea of priority liberalization of services ancillary to climate-smart goods.
- B. Draft text for *rendez-vous* clause for EGA (articulating possibility of priority treatment / fast-tracking for services related to climate smart goods):

The Parties agree to enter into further negotiations on the liberalization of services ancillary to environmental goods, beginning not later than [insert date].

They agree that these will cover, as a minimum, services ancillary to climate-smart goods, namely services supplied to manufacture, adapt, transport, assemble, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good or a good consisting thereof, or are supplied to supervise the foregoing activities.

The Parties agree that climate-smart goods for purposes of this clause include, but are not necessarily limited to, XYZ [subset of agreed EGs].

## Sub-component III - Elements suggested for use at TISA level

- A. Draft request for specific commitments, for use as request and/or checklist, depending on TISA context/progress (elements for the main text may or may not be needed, depending on the main text otherwise):

The EU requests other Parties to make full, comprehensive and deep commitments, covering all modes of supply, with respect to services ancillary to climate-smart goods. These include services that are supplied to manufacture, adapt, transport, assemble, install, analyse, test, repair, maintain, operate and train employees or third party providers to operate a climate-smart good listed below or a good consisting thereof, or are supplied to supervise the foregoing activities.

Climate-smart goods include: [list or reference]

[This includes, but is not limited to, services in the following sectors and subsectors

### 1. Business Services

#### A. Professional Services

- d. Architectural Services
- e. Engineering services
- f. Integrated engineering services
- g. Urban planning and landscape architectural services
- k. other

#### B. Computer and Related Services

#### E. Rental/Leasing Services without Operators

- c. Relating to other transport equipment
- d. Relating to other machinery and equipment

**F. Other Business Services**

- c. Management consulting services
- d. Services related to management consulting
- e. Technical testing and analysis services
- h. Services incidental to mining
- i. Services incidental to manufacturing
- j. Services incidental to energy distribution
- n. Maintenance and repair of equipment

**3. Construction and Related Engineering Services**

- A. General construction work for buildings
- B. General construction work for civil engineering
- C. Installation and assembly work

**5. Educational Services**

- D. Adult education
- E. Other education services

**6. Environmental Services**

**11. Transport Services**

A.-C., E.-F. Maritime, Internal Waterways, Air Transport, Rail, Road Transport Services

Especially:

- b. Freight transportation
- d. Maintenance and repair]

The EU proposes that Parties use the attached model schedule[s], or elements thereof as appropriate, to reflect their commitments. [attach draft schedules above].

**Sub-component IV - Elements suggested for use at FTA level**

- A. Standard Request: Same as for TISA above, extended to cover additional goods and/or services below, as appropriate.
- B. Checklist of possible 'extensions' *vis-à-vis* WTO/TISA levels to be considered when negotiating FTAs
  - i. Inclusion of additional "anchor" goods (beyond EGA) within definition of 'climate-smart goods':
    - Current EGA list of climate-smart goods would include, for example (tentative): Parts of biomass boilers; gas turbines that burn natural gas or for electrical generation from recovered landfill gas; wind turbines; waste incinerators and heat or catalytic incinerators; solar water heaters; biogas reactors; digestion tanks; biogas refinement equipment; PV cell coaters; apparatus for landfill gas monitoring, anaerobic digesters for organic waste; AC generators (alternator) of an output exceeding 750 kVA for renewable energy plants (e.g. biomass); amorphous transformers for electricity production from wind, combined heat and power systems using biomass and/or biogas; Portable solar power generation equipment; solar power electric generating sets; small hydro powered generating plant; wave power generating plant; and gas turbine sets for biomass plants and for waste heat applications; parts for electrical transformers, static converters and inductors to convert DC current from renewable energy generating sets into conventional AC electricity; parts of solar heliostats (for CSP).
    - Possible additional goods could include, for example: hydropower or geothermal power products; carbon capture and storage relevant products; or electric vehicles.
  - ii. Additional services sub-sectors (to be added to list of sectors for which commitments are sought)
    - 1. Business services: Legal services relating to climate-smart goods
    - 4. Distribution services: Distribution of climate-smart goods
    - 7. Financial services: Financial services relating to climate-smart goods

- iii. Suggestions on additional creative tools only possibly on FTA level:
  - Where partners do not agree to a comprehensive extension of Mode 4 commitments to non-specialist personnel of CSS, propose enhanced market access for Contractual Services Suppliers (CSS) (Mode 4) to include non-specialist personnel;
  - Protocol akin to the “Cultural Protocol” of the EU-CARIFORUM EPA providing ‘soft’ market access for all staff of CSS teams deployed to provide services ancillary to climate-smart goods.

### **Component 3: Proposals for regulatory disciplines relating to services ancillary to climate-smart goods**

#### *Description of measure*

Effective trade in services depends – often crucially – on the absence or containment of obstacles in the realm of domestic regulation. Some of the services ancillary to climate-smart goods covered here are covered by, sometimes onerous, domestic regulation. This includes, for example, professional services such as architectural and engineering services; construction services; environmental services; and transportation services.

Trade agreements offer certain possibilities to agree on disciplines on domestic regulation, especially qualification requirements and procedures, licensing requirements and procedures, and technical standards (for services). Possible elements for such disciplines are proposed here.

#### *Technical tools*

*Checklist of key domestic regulation disciplines of relevance to trade in services related to climate-smart goods*

- (Facilitated) recognition of professional qualifications / waiver of qualification requirements (e.g. for engineers, architects performing services relating to the installation of climate-smart goods); recognition of practical experience in lieu of formal qualifications, where appropriate
- (Efficient, speedy and cheap) recognition / qualification procedures
- (Facilitated) licensing (e.g. of transport operators – possibly specialized – transporting sensitive machinery equipment; of construction operators assembling installations) (licensing requirements, licensing procedures)

*Examples of possible sector-specific disciplines (these could be agreed separately or included in schedules of commitments within the fourth column (“additional commitments”))*

- Exemption from requirement of membership in local professional bodies for engineers and architects
- Automatic/fast track recognition of national qualifications for engineers/architects
- Exemption from localization requirements for IT-based remote maintenance or operation of climate-smart equipment
- Automatic/fast track licensing of specialized transport operators
- Automatic/fast track licensing of specialized construction operators

## **3.3 Political tools**

Arguments for strategy and approach, formulated to fit into possible ‘background note’ or similar briefing materials for stakeholders such as trading partners and civil society

*[Note: The articulations of salient points proposed above as possible text elements for strategy statements equally fit here. They are not repeated here. The below are additional points that may be worth explaining or highlighting vis-à-vis stakeholders]*

- The strategy is squarely based on a win-win-win-win perspective:
  - Win for the climate;

- Win for trade and exports;
- Win for climate policy and compliance with international commitments (Paris) in importing countries, and the low-carbon trajectory;
- Win for consumers in export markets who will gain better access to energy, and at cheaper prices.
- Services are a generally a 'low-hanging fruit' because much liberalization that does not raise any concerns (outside the few controversial sectors) has simply not happened yet, amidst a backlog of reform and limited understanding among decision makers. The potential gains are disproportionately high, the downsides limited (no loss of tariff revenue) – leaving aside those few sectors especially 'public services' where possible scenarios involving abuse by rogue players raise concerns.
- Because the "climate first" approach is narrow in terms of coverage and very targeted, its overall acceptance is expected to be high, even among those [trading partners and stakeholders] who are generally restrained when it comes to trade liberalization generally and service liberalization in particular. The desired market access for services related to climate-smart goods can be designed in a way that other interests remain untouched.
- The approach should be advanced in all possible trade fora – multilaterally, plurilaterally and bilaterally/regionally. The same logic applies everywhere, and there is no downside to a universal approach. The tools needed are the same and can be easily replicated/adapted to each forum.
- The approach is dynamic. As more goods are recognized as useful for climate change mitigation or adaptation, related services will be either automatically covered, if so agreed, or benefit from an accepted philosophy when their liberalization is negotiated.

### 3.4 Delivery strategy

#### *Overall strategic considerations*

- Some key considerations are reflected in the arguments spelled out under Component 1 and in the political considerations above.
- Trade in services is both a timely and low-hanging fruit and potentially controversial (as many misunderstand even the basics, and even more the specifics). The proposed targeted, narrow approach clearly tailored to fast-track a worthwhile cause should however attract overall broad support, with some hesitation on the technical level, timing challenges (esp. EGA and TISA) and some principled opposition to services liberalization remaining entrenched.
- The concerted parallel approach on all three levels – WTO, TISA, FTAs – makes eminent sense and does not increase complexity; progress on either front will support efforts on the others. However, in view of the different negotiating dynamics at play the specific opportunities and obstacles vary from forum to forum, and also from FTA to FTA. As a result the flexibility to be applied will likely lead to different compromises in each context. That is unproblematic on the technical level as long as the EU's own commitments remain (largely) the same.
  - In EGA the current dynamics point towards the need to conclude the negotiations soon, albeit likely with (a) rendez-vous clause(s) in place, raising the prospect of further rounds. The EU's proposal on services incidental to trade in environmental goods has reportedly not gained sufficient traction. However, given the much narrower scope in terms of goods to which the covered services are to relate (climate-smart as opposed to all environmental goods), a renewed attempt now proposing a more narrowly focused "pilot project" would not be inappropriate. It would be useful however to do so fast as the current window is closing. However, it would be unwise to pin high hopes to the EGA process during this round; there may simply not be enough traction to branch out into services, even if narrowly focused. But a credible attempt would as a minimum mark the spot for the future and send a signal to partners in the other fora.
  - In TISA a similar dynamic is at play. TISA participants are somewhat anxious to advance the project to generate a credible outcome, and there is reportedly little desire for new chapters and

concepts at this stage. However, this would in no way stop the EU from systematically seeking meaningful commitments for services ancillary to climate-smart goods from TISA partners, nor to have a declared policy of doing so. TISA's overall declared ambition, in fact, lends itself to a creative offensive push for commitments; the climate change context provides legitimacy, including potentially for TISA itself.

- In FTAs there is the greatest room for creativity, and the EU's relative weight is usually greater. It would be desirable to seek an ambitious outcome with a willing partner to establish a precedent for future reference in other fora. A possibly promising forum for doing so could be the the EU-Japan FTA as mutual interests could be sufficiently aligned in this area. TTIP would in principle be another promising forum, for the same reason; while as in the EGA and TISA time is not on the side of creative new proposals, TTIP's need for fresh and renewed legitimacy could in fact provide an interesting backdrop for a targeted push for an ostensibly good cause.

#### *Main stakeholders*

- Key counterpart countries are:
  - EGA participants – and to some extent the wider WTO membership, as EGA results will be multilateralized under the MFN clause, and additional Members may join the effort in future rounds – for purposes of the EGA approach;
  - TISA participants for purposes of the TISA approach;
  - FTA partners, in particular future ones including India, Japan, Indonesia, Mercosur and others, and those whose FTAs are likely to be upgraded in the future to cover services, such as various EuroMed and EPA partners.
- Key business stakeholders in the EU are exporters of the relevant services as well as exporters of the relevant climate-smart goods.
- Parts of the development community as well as general services and trade sceptics

#### *Approach for engaging interested stakeholders, possibly points of resistance identified*

- All stakeholders should ideally be engaged broadly through a clear strategy statement setting out the ambition, the focus and the proposed tools.
- For EGA and TISA partners there is/will be both principled receptiveness to the idea and process-related hesitation or resistance to engage at this stage, given the specific stages in which the two negotiations find themselves. Both are moving towards finalization, with limited appetite for 'opening new drawers'. However, gradual progress can in any case still be achieved and should be sought as such, such as an ideally specific rendez-vous clause in EGA and specific commitments, across the board or under specific sectors, within TISA.
- Some FTA partners as well as EGA and TISA partners may hesitate to engage in what they may perceive as unusual mechanics, namely the proposed cross-cutting commitments and/or the definition of sub-sectoral carve-outs by reference to a list of goods, dynamic or static, and specific activities relating to these goods. These partners should be approached pro-actively on the technical and reassured of the technical feasibility of the approach, in particular regarding scheduling. Questions and answers could be anticipated and compiled in a Q&A document.
- Building on prior Commission efforts within the EGA context, in particular EU business stakeholders – producers/suppliers and traders of relevant goods and services – need to be engaged pro-actively, possibly through formal consultations, and encouraged to supply further specific substance and evidence to support the overall 'case' underpinning the logic of the present approach. Available evidence generated by Kommerskollegium and others points clearly and unmistakably towards the relevance of the cause, but is overall still thin and will benefit from enhancement.
- Some from the development community and from among the general services and trade sceptics may raise general concerns about displacement of service providers in third countries as well as within the EU. While not leaving aside the need to engage these critics on the principles, it appears advisable to focus primarily on the specifics of this approach: very narrow, low effort/risk combined with high benefits for a greater good, significant long-term benefits for humanity, often with positive

## **Liberalisation of trade in services ancillary to environmental goods**

local environmental effects (local emissions), all very distinct from general services liberalization approaches.

## **3.5 Annex 1: July 2015 EU Proposal on Ancillary Services – EGA Negotiations**

### **Section II**

#### **Services Incidental to Trade in Environmental Goods**

##### **Article 4**

###### **Scope**

For the purposes of this [Declaration/Agreement], services incidental to trade in environmental goods means services that:

- a. are supplied to adapt, assemble, install, analyze, test, repair, maintain and train employees to operate an environmental good listed in Annex I or a good consisting thereof, or are supplied to supervise the foregoing activities, and
- b. are supplied as part of a seller's contractual obligation pursuant to a warranty or any other services contract incidental to the sale of the environmental good, either by the signatory of the contract or by a juridical person that is subcontracted by the signatory of the contract, and
- c. are classified under the headings listed in Annex [X].

##### **Article 5**

###### **General provisions**

1. Each Party shall incorporate the commitments described in Article 6, including any related conditions, limitations and qualifications listed under Annex III to this Declaration and their duration, into its Schedule of Commitments under the General Agreement on Trade in Services ("GATS Schedule of Commitments").
2. Paragraph 2 to paragraph 5 of Article 2 shall apply *mutatis mutandis* with respect to the modification of the GATS Schedules of Commitments and to the implementation of the commitments referred to in Article 6.
3. The Committee shall regularly review the list of services and commitments with a view to further liberalizing trade in services incidental to trade in environmental goods subject to this [Declaration/Agreement] in accordance with the procedure set out in Article 3.

##### **Article 6**

###### **Modes 1 and 2 (cross-border supply and consumption abroad)**

1. With respect to measures affecting the cross-border supply and consumption abroad of services as defined in Articles I.2 (a) and (b) of the General Agreement on Trade in Services ("GATS"), each Party shall accord to the services incidental to trade in environmental goods and to the suppliers of those services market access and national treatment within the meaning of Articles XVI and XVII of the GATS.
2. Any conditions, limitations and qualifications to the commitments described in paragraph 1, including their duration, shall be limited to existing non-conforming measures listed in Annex [X] to this [Declaration/Agreement].
3. Parties shall eliminate the non-conforming measures referred to in paragraph 2 no later than [X].

##### **Article 7**

###### **Mode 4 (temporary movement of natural persons)**

1. With respect to measures affecting trade in services as defined in Article I.2 (d) of the GATS, Parties shall, no later than [X] initiate consultations with a view to allowing the entry and temporary stay of natural persons supplying services incidental to trade in environmental goods and possessing specialized knowledge essential to the seller's contractual obligation in its territory, without the requirement of a work permit or any other prior approval procedures of similar intent.
2. As part of the consultations referred to in paragraph 1, Parties shall consider:
  - a. allowing the temporary stay for the duration of the contract up to a maximum period of 90 days in any 12 months period;listing, notwithstanding paragraph 1, any conditions, limitations and qualifications relating to a requirement of a work permit or other prior approval procedures under Annex [X] to this [Declaration/Agreement].

# 4.

## Alignment of Aid-for-Trade with climate change objectives

### Summary and Key Points

#### Measure rationale

- The EU has committed to mainstream climate change in its development aid, and has adopted guidelines for EU delegations to use to integrate climate considerations in the country programmes, in line with the overall commitment to the Sustainable Development Goals
- The existing EU Aid for Trade (AfT) Strategy does not make explicit reference to mainstreaming climate change in AfT, limiting itself to general support for 'environmental sustainability'. The current revision of the Strategy provides an opportunity for a stronger commitment to be adopted.
- While specific sector guidance have recently been updated for other sectors, the Sector Script on integrating climate change within Trade and Investment is not currently up for update. The development of an EU Strategic Approach to International Cooperation on Green Economy provides an opportunity to provide additional practical guidance to help EU delegations identify opportunities for climate-smart AfT.

#### Summary of measure

This measure aims to strengthen the overall commitment to mainstreaming climate change in EU AfT and to provide practical guidance on how to achieve this. It comprises the following two components:

- *Revision of Aid for Trade Strategy.* Greater integration of climate objectives within revised AfT Strategy, in the context of the overall commitment to the SDGs, including the specific commitment to integrate climate change considerations within all AfT provided by the EU and its Member States.
- *Specific guidance in Strategic Approach on International Cooperation and Green Economy.* Discussion of the role that Free Trade Agreements (FTAs) and AfT can play in promoting EU green economy objectives and identification of potential opportunities for integrating these objectives in AfT through specific actions and approaches.;

#### Strategy Considerations

- The timing of this measure is opportune as the EU Aid for Trade Strategy is currently under review and climate change is among the topics being considered for integration. Moreover, following the SDGs and the Paris Agreement, support for climate change action is at a high.
- Engaging with partner countries at an early stage will be important for effectively communicating its purpose and avoiding misunderstandings. It will also be key to ensure that climate mainstreaming does not result in the diversion of aid resources from other areas.
- Providing clarity for EU delegations on the relationship of the Strategic Approach with the Mainstreaming Guidelines, sector notes and sector scripts will help avoid confusion that may stem from the various different documents that guide the work of delegations. Providing training can also help delegations better understand how this guidance can be translated in concrete AfT actions.

## 4.1 Background and measure overview

The EU (together with its Member States) is the largest global provider of Aid for Trade (AfT). It also the leading provider of climate finance, though meeting the levels considered necessary to meet international mitigation goals remains an ongoing challenge. Meanwhile, the EU has also committed to mainstream climate change throughout its internal and external policies, and has committed to ensure that at least 20% of its budget for 2014-2020 is spent on climate change-related action. The Agenda for Change, which provides the guiding framework for EU international development policy, emphasizes that EU development aid cannot be sustainable if it damages the environment, and should promote low-carbon development.

Against this background, the EU in 2016 updated its Guidelines on 'Integrating the environment and climate change into EU international cooperation and development' (the "Mainstreaming Guidelines"). The updated guidelines provide a framework for integrating climate change within all areas and stages of EU development cooperation. This policy aligns with the EU commitment to the global development agenda agreed through the Sustainable Development Goals (SDGs) in 2015. Specifically, the revised Mainstreaming Guidelines emphasize that mainstreaming climate change in development cooperation is key to successfully meeting the SDGs, given the adverse effects of climate volatility on issues ranging from food security and poverty to health, security and biodiversity.

EU trade policy also integrates the new global agenda within its framework. The Trade for All Strategy, adopted in October 2015, puts particular emphasis on trade and sustainable development – including climate change – and commits the EU to using its trade policies to commit to the SDGs. The 2012 Trade, Growth and Development Policy similarly commits the EU to promoting sustainable development in its trade policy, including through AfT measures.

Current EU AfT is guided, in addition to the frameworks set out above, by the Aid for Trade Strategy 2007. While this Strategy broadly refers to the promotion of environmental sustainability, there are no explicit provisions seeking to mainstream climate goals. This arguably makes it out of step with the more ambitious approach adopted in more recent instruments, in particular the 2016 Mainstreaming Guidelines. The EU Commission is, however, currently in the process of updating the AfT Strategy and considering how climate change and other objectives could be more effectively integrated within the new strategy.

Against this backdrop, this measure proposes, in the first place, to include a more explicit commitment to integrate climate change objectives within AfT as part of the new AfT Strategy's anticipated dimension on sustainable development. This approach recognises that AfT is fundamentally centred on cooperation in the trade sphere and driven by partner country needs, while at the same time acknowledging that integrating climate change mitigation and adaptation within all areas of EU development cooperation is essential ensuring the sustainability of that cooperation and ultimately achieving the SDGs. Secondly, the measure proposes to provide more specific guidance on integrating climate change within one important area of trade-related cooperation, namely cooperation on the green economy. This would be included within the EU Strategic Approach to International Cooperation on Green Economy (the "Strategic Approach"), which is currently being developed by the European Commission, DG DEVCO.

## 4.2 Detailed measure description and technical tools

### Component 1 – Revision of Aid for Trade Strategy

#### *Overview*

This measure places greater emphasis on the integration of sustainable development, and in particular climate change, considerations within the text of the revised EU Aid for Trade Strategy. This includes, in the first place, incorporating a general aim to mainstream sustainable development and climate change within AfT and, secondly, more specific text on mainstreaming climate change within AfT, including through the use of the Mainstreaming Guidelines, and through avoiding directing AfT to vulnerable and emissions-intensive activities. It also makes reference to the specific guidance to be integrated within the EU Strategic Approach to International Cooperation on Green Economy.

As the development of the revised strategy remains in initial stages and no public text is yet available, we take the 2007 strategy as the starting point and propose a number of additions or modifications in order to incorporate climate change mitigation and adaptation objectives. We include the relevant section of the current strategy in lighter text and include, in **regular black text**, the proposed modifications.

The current EU Aid for Trade Strategy is divided into six chapters, of which we propose additions to three under this measure:

1. Overall aims
2. Quantitative ambitions
3. Enhancing pro-poor focus and quality
4. Increasing EU-wide and Member State donors' capacity
5. Building upon, fostering and supporting ACP regional integration processes with an ACP-specific angle of EU AfT
6. Monitoring, Reporting and Evaluation

### *Technical tools*

#### *Chapter 1 – Overall aims*

##### **Sample text (lighter sections stem from the 2007 EU Aid for Trade Strategy)**

The EU AfT Strategy aims at delivering an effective response to countries own trade-related priorities in the context of their poverty reduction strategies. It will help the EU achieve better policy coherence in the areas of trade and sustainable development, including climate change.

[...]

The Strategy is composed of actions organised under the following pillars:

- [...]
- Enhancing the pro-poor focus, quality and sustainable development orientation of EU AfT, ensuring support is climate-resilient and contributes to low-emission development;

[...]

#### *Chapter 2 – Quantitative ambitions*

**Sample text (lighter sections stem from the 2007 EU Aid for Trade Strategy)**

(c) The EU will promote an effective response to the wider AfT agenda (i.e. AfT beyond TRA) by continuing and strengthening Member States' and EC support for demand-driven, pro-poor **sustainable** development strategies, which incorporate building productive capacities, trade-related infrastructure and trade-related adjustment and by encouraging enhanced participation of other international donors and the private sector.

(d) The EU will encourage partner countries to increase, with Member States' and EC support as required, their parallel efforts to include AfT in their poverty reduction and national development strategies, implementation plans and national budgets in ways which ensure the demand-driven, pro-poor character of their national trade development strategies **and which are aligned with national climate change adaptation and mitigation priorities**. To support this, the EU will:

- Seek to broaden significantly the inclusion of trade and AfT in poverty reduction and national sustainable development strategies by 20xx **in a manner consistent with climate change adaptation and mitigation goals and plans**, through
  - enhanced joint policy dialogue;
  - supporting partner countries' use of participatory processes, including local civil societies and trade actors (e.g. private sector, consumer organizations, producer organizations) when establishing poverty reduction and national development strategies;
  - engagement with other donors and international financial institutions to that end.
  - [...]

*Chapter 3 - Enhancing the pro-poor focus, quality of EU AfT*

**Sample text (lighter sections stem from the 2007 EU Aid for Trade Strategy)**

**Chapter 3 - Enhancing the pro-poor focus, quality and sustainable development orientation of EU AfT**

The EU will intensify its activities in a range of areas in order to ensure the quality of its AfT and its alignment with other strategic policy objectives, in particular the achievement of the SDGs and the collective goal to limit the increase in the global average temperature to well below 2 °C above pre-industrial levels. In particular, in response to partner countries' own trade-related priorities, in the context of poverty reduction and sustainable development strategies, it will help facilitate, implement and adjust to trade reform and liberalization paying specific attention to their impact on poverty reduction and low-carbon, climate-resilient growth.

[...]

(b) To promote the environmental, social and economic sustainability of AfT, the EU will:

- [...];
- Integrate sustainable development and climate change considerations within all AfT provided by the EU and its Member States, including through applying the framework set out in the EU Guidelines 'Integrating the environment and climate change into EU international cooperation and development: Towards sustainable development'. The EU will strive to increase the climate resilience of AfT and to avoid directing AfT to emission-intensive or vulnerable activities, and seek to enhance AfT directed toward climate-smart trade development. It will, in addition, seek to ensure complementarity between EU AfT and climate finance, in accordance with partner countries development and trade strategies, National Adaptation Plans, Nationally Determined Contributions, and other relevant policies and strategies. These actions will be guided, where relevant, by the EU Strategic Approach to International Cooperation on Green Economy.

[...]

**Component 2 – Integrating guidance on Aid for Trade within the EU Strategic Approach to International Cooperation on Green Economy**

*Overview*

While overall guidance on integrating climate change considerations within EU development aid are provided by the Mainstreaming Guidelines, additional practical guidance on the implementation of these guidelines in specific sectors or areas are provided in a series of “sector notes” and “sector scripts”, as well as in internal EU communications such as thematic strategy papers. While a Sector Script was prepared for Trade and Investment in 2009, this has not been updated since and it is understood there are no immediate plans to do so. However, the European Commission, DG DEVCO, is currently preparing an EU Strategic Approach to International Cooperation on Green Economy (the “Strategic Approach”), which offers a timely opportunity for integrating broad guidance on the integration of green economy goals – including those focused on climate change mitigation and adaptation – within EU AfT.

This measure proposes the inclusion of a dedicated discussion of potential opportunities for integrating green economy goals within EU cooperation on trade within the Strategic Approach. It is based on the review by the advisory team of a draft version of the Strategic Approach, pursuant to which a number of suggestions were provided to DG DEVCO. The core of this suggested text is located in section 4 of the Strategic Approach, on ‘Key Principles’ under the sub-heading of ‘Promoting the green economy in partner countries through policy coherence’, and includes the following principal elements:

1. Discussion of the role that Free Trade Agreements (FTAs), including Economic Partnership Agreements (EPAs), can play in promoting EU green economy objectives;
2. Discussion of the role of Aid for Trade in promoting green economy objectives, and identification of potential opportunities for integrating these objectives in Aid for Trade through specific actions and approaches.

The suggested text that has been provided to DG DEVCO on these points is reproduced under 'Technical Tools' below. In addition, the advisory team has made a number of minor suggestions to DG DEVCO regarding specific areas in other parts of the Strategic Approach where AfT-relevant examples can be integrated within the broader guidance provided on the integration of green economy objectives in development cooperation. Since these examples are dispersed throughout the document and should be read in the context of the sections in which they are integrated, they are not reproduced here.

### *Technical tools*

#### **Sub-component I – Discussion of the role that FTAs) can play in promoting EU green economy objectives**

##### **Suggested text**

An increasingly relevant platform for the EU and developing partner countries to facilitate and promote bilateral cooperation on the green economy are Free Trade Agreements (FTAs), including Economic Partnership Agreements (EPAs), which can provide specific opportunities for removing barriers to trade in goods (e.g. tariffs, technical regulations, standards and conformity assessment procedures) and services (e.g. quantitative restrictions, licensing and qualification requirements), developing joint strategies for investment (e.g. through green public procurement), and engaging in capacity-building (e.g. on implementing multilateral environmental agreements including the recently adopted Paris Agreement). In dedicated Trade and Sustainable Development (TSD) chapters FTAs increasingly also provide umbrella provisions on sustainable development, which formulate work programmes, create an institutional framework for implementation, and aim at addressing cross-cutting green development issues that are relevant throughout different trade and investment chapters. FTAs and their TSDs represent useful instruments to integrate and further bilateral development cooperation and, at the same time, to benefit from its agenda and its impact.

## Sub-component II – Discussion of the role of AfT in promoting green economy objectives and identification of opportunities

### Suggested text (lighter sections stem from draft Strategic Approach shared with advisory team)

Another trade instrument of key relevance is the Aid for Trade (AfT) initiative, which the EU defines as assistance to support developing countries' efforts to expand their trade as a tool to stimulate growth and reduce poverty. It is meant to help identify and maximise green economy opportunities arising from partner countries' trade with the EU and other consumer markets. The majority of EU AfT<sup>1</sup> is focused on building trade-related infrastructure – in particular transport and energy infrastructure – and building productive capacity for export products, in particular agricultural products.<sup>1</sup> Further enhancing the focus of this support on green infrastructure (e.g. public transport, renewable energy and related grid infrastructure) and SCP (e.g. sustainable agriculture) – in line with the relevant Sector Notes for the Integration of Environment and Climate Change<sup>1</sup> – is an important part of fostering the green economy through AfT.

A smaller but nonetheless significant amount of EU AfT is focused on supporting domestic trade policy and regulation and participation in bilateral, regional and multilateral trade agreements. This support can similarly support green economic development, for example through:

- Integration of green economy within Trade Needs Assessments, focusing on the identification of barriers and needs for trade in green goods and services;
- Regulatory support to streamline access for green goods and services, and related investment;
- Facilitating compliance with EU and third country technical standards for green products, such as energy performance and emission standards;
- Support in acceding to and complying with green trade agreements (e.g. environmental goods agreement) and integrating provisions to support green trade in bilateral and regional agreements;

Policy dialogue with a cross-section of public institutions – including trade, development, environment, agriculture, energy and climate change – as well as the business community and civil society groups in partner countries is key to identify these opportunities and to develop synergies. Policy documents in the trade and environment spheres – such as Trades Needs Assessments and WTO Trade Policy Reviews, on the one hand, and national green growth, environment and/or climate change policies and strategies, on the other – can be jointly analysed to identify synergies.

## 4.3 Political tools

As the two components of this measure outlined above are closely linked and intended to go hand in hand we present one single set of political tools to support them. We focus here on the development of lines of argument to support the integration of climate change objectives within EU AfT, both in terms of strategy and implementation. The following bullets outline the key threads of argument we propose to support the measure.

- The EU has also committed to mainstream climate change throughout its internal and external policies, and has committed to ensure that at least 20% of its budget for 2014-2020 is spent on climate change-related action. Such mainstreaming provides the opportunity to make efficient use of EU finances through ensuring consistency between policies and actions, both avoiding finance flowing to actions that work at cross purposes and finding opportunities to achieve multiple goals simultaneously. The EU already uses the Rio markers to track financial contributions to climate change and other environmental goals and in 2016 updated its Guidelines on 'Integrating the environment and climate change into EU international cooperation and development' (the "Mainstreaming Guidelines"), providing a concrete framework for integrating climate change within all areas and stages of EU development cooperation. The current Aid for Trade Strategy, nonetheless, does not explicitly integrate climate change objectives.
- While the EU and its Member States are the largest providers of climate finance globally, by most estimates there remains a substantial gap that needs to be filled in order for developed countries

to meet their collective commitment to provide a minimum of USD 100 billion of climate finance to developing countries per year from 2020. In the context of scarce public resources, it is important that the EU ensure that its overseas development aid is used effectively. Further integrating climate change as part of sustainable development within AfT can help to achieve efficiency by ensuring AfT does not work at cross purposes with climate finance and finding opportunities through which AfT can have a net positive climate impact.

- A substantial portion of the EU Aid for Trade is directed at sectors that are sensitive to the effects of climate change, such as transportation and agriculture (which together constituted 44% of AfT from EU Institutions in 2013).<sup>18</sup> To ensure long term effectiveness in meeting trade objectives, these risks should be taken into account in order to 'climate proof' AfT programming.
- A substantial portion of EU Aid for Trade is also currently directed at sectors and sub-sectors that directly or indirectly are associated with GHG-intensive development. Six of the ten subsectors to have received the most AfT from EU Institutions in 2013 fall into that category, with 21% directed at road transport alone.<sup>19</sup>
- EU development cooperation on the green economy is an important component of the EU's goals to leverage private sector investment in climate change. Integrating climate change within cooperation on trade is a crucial aspect of this strategy. Previous EU sectoral scripts have considered the topics of trade, investment and private sector development as a whole, and the Strategic Approach continues to take this approach. It is therefore logical that the Strategic Approach identify opportunities for integrating climate change within AfT and related international cooperation on trade.

## 4.4 Delivery strategy

- The timing of this measure is highly opportune as the EU Aid for Trade Strategy is currently under review and it is understood that sustainable development, including climate change, is among the topics being considered for integration in the new strategy. Following the successful adoption of the SDGs and the outcome of the Paris climate conference in late 2015 and the strong momentum that has followed this, moreover, support for climate change action is arguably at an all-time high. This provides a unique window of opportunity for integrating climate change within the EU Aid for Trade Strategy as part of the current revisions.
- Scepticism and some resistance is to be expected from some developing country partners who will be concerned about dilution of AfT, climate finance double-counting / additionality, and generally political conditionalities. To counter this, it is recommended to:
  - Engage with developing country partners at bilateral level through EU delegations at an early stage to explain the consequences of the new strategy and understand concerns they may have and relay their feedback;
  - Explain the relationship of the climate-relevant parts of the AfT Strategy and relevant parts of the Strategic Approach with the Mainstreaming Guidelines and other relevant documents guiding the development of national programmes and strategies. Explain that these document only provide additional guidance for implementation of the Mainstreaming Guidelines, and do not entail new requirements or conditionalities;
  - Ensure that finance directed to climate-smart AfT is additional to or at least does not divert existing or planned climate finance flows. Focus on opportunities that will have similar or greater economic benefits for partner countries as existing AfT.
  - Strive for an even balance between the integration of mitigation and adaptation considerations in climate-smart AfT opportunities.

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<sup>18</sup> Figures taken from the OECD Query Wizard for International Development Statistics (QWIDS).

<sup>19</sup> From QWIDS query. The six emissions intense subsectors are road transport, power generation (non-renewable energy), energy policy and administrative management, electrical transmission/distribution, agricultural development, and agricultural policy and administrative management.

- The Strategic Approach operates in parallel to the Mainstreaming Guidelines and the various sectoral notes that guide their implementation in specific sectors. Since it comprises a different type of document in terms of both formal status and content, it will be important to provide clarity to EU delegations on the relationship between the different documents and how they are to be used.
- Complementing the guidance on integrating climate change within AfT in the Strategic Approach with training for EU delegations and other relevant parties would help to enhance understanding of how the guidance provided can be used in practice. These could be linked with the training provided by DEVCO Unit C2 on the Mainstreaming Guidelines.

# 5.

## Strengthening Trade and Sustainable Development Chapters in FTAs

### Summary and Key Points

#### Measure rationale

- There is a growing practice among countries and supranational bodies such as the EU to use operative legal texts in FTAs as platforms and conduits for discussions, processes and sometimes substantive law – hard or soft – to manage interfaces between trade and aspects of/factors for sustainable development.
- While it is too early to assess the effectiveness and efficiency of the early TSD practice, the instrument appears to be a suitable format for advancing both substantial and procedural sustainability and, in particular, climate change goals.
- The recent adoption of the Paris Agreement offers the opportunity to enhance the linkages between international climate policymaking and bilateral trade.

#### Summary of measure

- To advance the aims set out above, this measure – ambitious in its design – attempts to expand and consolidate the general matrix of TSD chapters, adding a number of components, including:
- Commitment to ambitious climate change concepts. This includes concepts and goals embraced at the global level (notably the Paris Agreement), but may also advance notions not yet accepted fully at the global level (e.g. the decarbonisation goal).
- Creation of an interface with a number of provisions in the Paris Agreement. These include Article 6 on cooperative approaches, Article 5 on REDD+ and coastal ecosystem preservation, Article 7 on adaptation and the enhancement of resilience, as well as the transparency framework and future stocktake exercises (Articles 13 and 14).
- Special focus on a number of high impact trade-cum-climate change instruments. Incorporate active work programmes to advance rules on green public procurement, fossil fuel phase-out and harmonization of minimum energy performance standards.
- Strengthening of the institutional framework. Provide for specific resources in terms of funds, staffing, information-gathering, powers, and logistics. The Specialised Committee work in close interaction with stakeholders, organised in different formats.

#### Strategy Considerations

- While impact research for EU FTAs is not yet available, case studies from other FTAs suggest that FTAs may have an overall positive impact on environmental issues. Such research should be encouraged within the EU and communicated to the public.
- Making the TSD chapters operational – linking bilateral trade and investment with the Paris Agreement and advancing on a number of programmatic concepts (green public procurement, fossil fuel phase out, etc.) – will be decisive for their success.

### 5.1 Background / Objective

Countries are increasingly seeking greater coherence between applicable trade regimes and international

law on the environment and climate change. As part of this trend, there is a growing practice among countries and supranational bodies such as the EU to use operative legal texts in FTAs as platforms and conduits for discussions, processes and sometimes substantive law – hard or soft – to manage interfaces between trade and aspects of/factors for sustainable development. These are often grouped (partly) in so-called “Trade and Sustainable Development” (TSD) chapters, which operate as a catch-all, and default, for often rather diverse provisions.

The EU’s TSD chapters, while distinct in each case, generally follow the same logic. They typically start with a formulation of general objectives and principles (in particular on recognizing core environmental agreements, minimum environmental standards and autonomous environmental regulation). This is then followed by (differing) specific commitments on priority areas of cooperation (e.g. frontloading the liberalization of environmental goods and services), policies (e.g. phase-out of fossil fuel subsidies, voluntary eco-labels, etc.), and the protection of ecosystems and the sustainable use of natural resources. These provisions are, finally, accompanied by a framework of implementation, based on good governance, transparency and consultation, some form of monitoring, participation of civil society, and joint work programmes.

While it is too early to assess the effectiveness and efficiency of the early TSD practice, the instrument appears to be a suitable format for advancing both substantial and procedural sustainability and, in particular, climate change goals. Furthermore, the recent adoption of the Paris Agreement offers the opportunity to enhance the linkages between international climate policymaking and bilateral trade.

The measure proposed below – ambitious in its design – attempts to expand and consolidate the general matrix of TSD chapters, integrating a number of issues relevant in a wide range of trade negotiations. Though the economies and political priorities of EU trade partners vary considerably, meaning that there is not one TSD model that would fit all, a number of details, in particular on process, are of general concern, and some aspects of both process and substance will be of relevance for negotiations with a wide range of trade partners. This measure seeks to propose elements that could be integrated into a range of TSD Chapters with different partners. The measure, while operational as a whole, may well be used selectively, informing certain aspects found to be of particular relevance in any particular trade negotiations rather than requiring comprehensive implementation across the board.

The measure is also composed as an umbrella tool to cluster and structure a range of different instruments, all of which have strong climate change impacts but which eventually may not be jointly arranged within one single (TSD) Chapter. Some instruments will likely be placed in specific chapters (MEPS in energy or TBT, for instance). Nonetheless, the umbrella composition chosen here has the advantage of highlighting the network and interface character of the TSD Chapter and the need for adopting a cross-cutting approach, when aligning climate change goals with trade tools and targets.

## 5.2 Detailed measure description and technical tools

The measure updates and upgrades the TSD with respect to climate change (labour aspects and other environmental areas such as biodiversity are beyond the scope of this measure), both seeking strategic and programmatic interfaces with the newly adopted Paris Agreement and responding to a number of priority areas that – in the view of the authors – are of particular relevance in the context of bilateral trade and climate change cooperation. These incorporate some of the proposals from other measures made in deliverables 1 and 2 (see section 1).

The specific order of the different components below (“Components”), and their headings, are closely informed by the recently adopted Free Trade Agreement between the EU and Vietnam.

### **Component 1 – Context, Objective and Scope (§ 1)**

#### *Description of measure*

- Climate change aspects are specifically referenced and key principles and objectives, notably the objective to hold global average temperature to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C.
- The clause also references terminological details and certain nuances from the Paris Agreement but also from (slightly more ambitious) statements made by global leaders on the negotiation path to Paris (“decarbonised economy”).
- At the same time, the clause links to trade-related themes not expressly mentioned in the Paris Agreement (in particular “fossil fuels”).

- The clause also takes into its view, for the first time, a key element of the Paris Agreement, the nationally determined contributions (NDCs), which may reflect on and impact the bilateral trade relations, just as, in reverse, it may receive guidance from the Parties' trade and investment policies.

#### *Technical tools*

##### **Sample text (new language)**

- (1) ...
- (2) The Parties recognise that climate change is a cross-cutting and persistent crisis and express their concern that the scale and gravity of the negative impacts of climate change affect all countries and undermine the ability of all countries, in particular developing countries, to achieve sustainable development, stressing the need to hold the increase in the global average temperature to well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5°C above pre-industrial levels.
- (3) The Parties reaffirm their commitment to combat climate change through following a low-carbon and adaptation-focused development pathway towards a decarbonised and climate-change-resilient economy, and to pursue sustainable development, whose pillars – economic development, social development and environmental protection – are inter-dependent, mutually reinforcing and include the sustainability of supply chains and resource management.
- (4) The Parties stress the need to combat the harmful effects of fossil fuel subsidies, particularly with respect to climate change, and their mutual commitment to work towards their transparent reduction and ultimate elimination.
- (5) ...
- (6) ...
- (7) It is the intention of the Parties to create within the framework of this Chapter and using the procedures laid out herein a number of trade tools and instruments to advance the commitments made under the United Nations Framework Convention on Climate Change (UNFCCC) and with a view to coordinating with each other the implementation of the Paris Agreement and their nationally determined contributions.

## **Component 2 – Right to regulate and levels of protection (§ 2)**

### *Description of measure*

- The precautionary principle and the polluter pays principle are introduced as general principles for regulatory action.
- The clause mandates bilateral (and multilateral) cooperation on minimum energy performance standards (MEPS), standardized test methodologies and harmonized energy and environmental labels. Depending on the overall architecture and the details of the agreement in question, this mandate may be moved into one or more of the specific sections. In any case, the strong role of a specialised committee should be maintained.

#### *Technical tools*

### **Sample text (new language)**

- (1) The Parties underline the importance to base regulatory action on the precautionary principle and on the principles that preventive action should be taken, that environmental damage should as a priority be rectified at source and that the polluter should pay.
- (2) ...
- (3) ...
- (4) The Parties shall cooperate on minimum energy performance standards (MEPS) as well as on environmental labelling of products and appliances, so as to facilitate increased trade in goods and services between the Parties, while enhancing energy and resource sufficiency and contributing to mitigating the effects of climate change. To that purpose, the Specialised Committee, at its earliest convenience, shall identify priority sectors for mutual recognition and/or harmonisation, analyse commonalities and differences, explore possibilities for increased mutual recognition and joint accreditation of laboratories, and work towards a joint definition of performance standards and a plan for implementation, taking into account the important role of voluntary labelling programs and relevant international developments including the G20 Energy Efficiency Action Plan. The scope of cooperation may develop over time at different levels, including at the level of harmonized and mutually standardized test methodologies, common definition of product categories, fixed efficiency metrics, and shared performance thresholds.
- (5) The Specialised Committee may prepare standards for implementation and submit them as recommendations to the Parties.

## **Component 3 – Climate change (§ 5)**

### *Description of measure*

- Key provision to link bilateral trade policy and international climate change policy.
- The aim is to reach a mutually responsive and ideally interactive relationship between the two policies.
- On the assumption that the ratification of the Paris Agreement (PA) is on its way, the provision focuses on a commitment to the swift and full implementation of the Paris Agreement.
- Specific attention is given to Article 6 PA, which opens the door for bilateral mitigation actions, and which allows for trade and investment focused cooperation, including with a view to mitigating higher trade related GHG exposure.
- Other than Article 6 PA, the TSD climate change provision may give rise to specific engagement with respect to the following PA elements: REDD+ and coastal ecosystems with a focus on results-based payments (Article 5 PA), adaptation (Article 7 PA), the technology mechanism (Article 10 PA), the transparency framework (Article 13 PA), and the global stocktake exercise (Article 14 PA).

### *Technical tools*

**Sample text (new language; “[...]” indicating options dependent on the specific context and specific bilateral trade relation)**

- (1) The Parties reaffirm their commitment to reaching the ultimate objective of the United Nations Framework Convention on Climate Change (UNFCCC), and they will work closely together to promote the swift and full implementation of the Paris Agreement.
- (2) The Parties commit to the development and implementation of ever more ambitious nationally determined contributions (NDCs) in line with Article 4 of the Paris Agreement and consistent with global temperature goals.
- (3) The Parties shall develop through the Specialised Committee – in consultation with relevant stakeholders, including institutional investors, development banks, export agencies and civil society of both Parties – proposals for enhanced cooperation of both Parties in the following areas:
  - a. Identification of trade and/or investment areas with a specific exposure to high GHG emissions (“Hotspots”), whether due to increased levels of traded goods and services, the risk of carbon-intensive lock-in investments, or other;
  - b. Trade- and investment-based measures to respond to such Hotspots, including through voluntary cooperation in the formulation and the implementation of NDCs *[ultimately]* on the basis of fixed economy wide emissions pathways;
  - c. Use of cooperative approaches, including sectoral approaches targeting Hotspots and other areas with a particular trade and investment impact, with a view to preparing a comprehensive, methodologically robust and transparent carbon pricing framework;
  - d. Bilateral engagement on the basis of internationally transferred mitigation outcomes to strengthen the Parties’ NDCs and to enhance their ambition over time on the most cost-efficient and effective terms;
  - e. As part of such bilateral engagement, consideration of mitigation and adaptation-focused investment in third countries, specifically those that prove particularly vulnerable to the adverse effects of climate change, *[including through the use of the mechanism to contribute to the mitigation of greenhouse gas emissions and support sustainable development and through addressing non-market instruments in relation with such third countries]*;
  - f. Trade- and investment based approaches – including public and/or private sector-driven initiatives to promote sustainable supply chains – to reduce emissions from deforestation and forest degradation and to promote the role of conservation, sustainable management of forests and the enhancement of forest carbon stocks (REDD+) as well as to preserve and restore coastal ecosystems, in accordance with Article 5 of the Paris Agreement;
  - g. Identification of trade and investment priorities to enhance the adaptive capacity and resilience of the Parties as well as third countries, specifically those that prove particularly vulnerable to the adverse effects of climate change;
  - h. Coordination of the Parties’ national and international climate finance strategies, including with respect to the promotion of a sustainable development mechanism as foreseen under Article 6 (4) Paris Agreement;
- (4) The Parties commit to closely coordinate with respect to the continuous enhancing of technical capacities to GHG reporting across all economic sectors, including land use, land-use change and forestry, the development of a robust inventory and monitoring and verification functions in line with the principles and requirements of the Paris Agreement.
- (5) The Parties shall closely coordinate mutual efforts in preparing the global stocktake cycle, as foreseen under Article 14 of the Paris Agreement; they may, to that effect, coordinate their submissions to the Conference of the Parties serving as the meeting of the Parties to the Paris Agreement.
- (6) The Parties further commit to coordinate their work with and towards the bodies, working groups and institutions set-up under the UNFCCC and the Paris Agreement whose mandates include technology-related aspects, namely the Technology Mechanism established under the UNFCCC, the Technology Executive Committee and the Climate Technology Centre Network. Supported by the Specialised Committee and an advisory group dedicated to technology transfer, which shall consist of representatives of business associations and civil society of both Parties, the Parties shall identify a roadmap for enhanced climate technology development and transfer as well as facilitative trade instruments in existence between the Parties or to be created.
- (7) The Specialised Committee shall regularly report on its work under this Article and shall collect data on international practice concerning the implementation of the Paris Agreement. Where appropriate, it shall adopt relevant proposals for implementation by the Parties and submit them as recommendation.

## Component 4 – Sustainable forest management (§ 7)

### *Description of measure*

- The article is expanded to cover forest products (not only timber) in general as well as products which are fully or partially sourced from agriculture, forestry, or agro-forestry.
- The Parties shall promote the trade in certified sustainable products with verifiable supply chains in sectors that directly or indirectly are significant drivers of deforestation, natural habitat depletion, and wetland loss.

### *Technical tools*

#### **Sample text (lighter sections stem from the TSD EU/Vietnam example)**

- (1) The Parties recognise the importance of ensuring the conservation, sustainable restoration and management of forests resources in contributing to the Parties' economic, environmental and social objectives.
- (2) To this end, the Parties commit to:
  - a. Encourage the promotion of trade in forest products from sustainably managed forests and harvested in accordance with the domestic legislation of the country of harvest; this **should** include the conclusion of a Forest Law Enforcement Governance and Trade (“FLEGT”) Voluntary Partnership Agreement.
  - b. Encourage the promotion of trade in products with a verifiable supply chain that has not given rise, directly or indirectly, to deforestation, the depletion of natural habitats, or the drainage of wetlands.
  - c. Exchange information on measures to promote consumption of timber and **other** forest products from sustainably managed forests and, where relevant, cooperate to develop such measures.

## Component 5 – Marine resources (§ 8)

### *Description of measure*

- A specification is made regarding sustainable aquaculture aimed at reducing the clearance of mangroves and introducing mandatory certification schemes.

### *Technical tools*

### **Sample text (lighter sections stem from the TSD EU/Vietnam example)**

- (1) The Parties recognise the importance of ensuring the conservation and sustainable management of living marine resources and marine ecosystems as well as the promotion of responsible and sustainable aquaculture.
- (2) To this end, the Parties commit to:
  - a. Comply with long-term conservation and management measures and sustainable exploitation of marine living resources as defined in the UN Convention on the Law of the Sea of 1982 (UNCLOS), encourage compliance with the objectives of the United Nations Agreement for the Implementation of the Provisions of UNCLOS relating to the Conservation and Management of Straddling Fish Stocks and Highly Migratory Fish Stocks, the FAO Agreement to Promote Compliance with International Conservation and Management Measures by Fishing Vessels on the High Seas, and the FAO Agreement on Port State Measures to Prevent, Deter and Eliminate IUU, and adhere to the principles of the FAO Code of Conduct for Responsible Fisheries of 1995.
  - b. Cooperate, as appropriate, with and within Regional Fisheries Management Organisations to which they are members, observers, or cooperating non-contracting parties, including through effective application of their Monitoring, Control and Surveillance and enforcement of management measures and, where applicable, implement their Catch Documentation or Certification Schemes.
  - c. Cooperate in and actively engage in the fight against illegal, unreported and unregulated (IUU) fishing and fishing related activities with comprehensive, effective and transparent measures to combat IUU. The Parties shall also facilitate the exchange of information on IUU activities and implement policies and measures to exclude IUU products from trade flows.
  - d. Promote the development of sustainable aquaculture with a view to halting the clearing of mangrove areas, closing and restoring unlawful installations, and establishing a robust mandatory aquaculture certification scheme.
  - e. Exchange at the meetings of the Specialised Committee on Trade and Sustainable Development and, as appropriate, in other occasions, information on all new measures of management of living marine resources, fishery and aquaculture products and relevant certification schemes that may impact on trade between the Parties.

## **Component 6 – Trade and Investment (§ 9)**

### *Description of measure*

- A mandate to develop a joint green public procurement scheme and to work on the phase out of subsidies for fossil fuels (mandatory: for conventional coal-fired power plants) is added. Either may be moved into a specific chapter, depending on the overall architecture and the specifics of the negotiation at hand.

### *Technical tools*

### Sample text (lighter sections stem from the TSD EU/Vietnam example)

The Parties confirm their commitment to enhance the contribution of trade and investment to the goal of sustainable development in its economic, social and environmental dimensions. Accordingly:

- a) The Parties recognise the beneficial role that decent work may have for economic efficiency, innovation and productivity, and they shall encourage greater policy coherence between trade policies, on the one hand, and labour policies on the other.
- b) Each Party shall strive to facilitate and promote trade and investment in environmental goods and services, in a manner consistent with this Agreement.
- c) The Parties shall strive to facilitate trade and investment in goods and services of particular relevance for climate change mitigation, including through the development of policy frameworks conducive to the deployment of best available technologies.
- d) The Parties shall closely coordinate efforts to establish common procurement rules, which integrate consideration of climate change mitigation and adaptation policies and targets for priority sectors such as buildings and transport vehicles as well as services, including with respect to procurement eligibility and selection criteria, pre- and post-purchase energy consumption, mandatory life-cycle costing, and “green labelling” requirements. The Specialised Committee shall consult with relevant stakeholders regarding these efforts and present recommendations to the Parties.
- e) The Parties commit not to use public financing to support the construction or extension of conventional coal-fired power plants domestically or abroad.
- f) The Parties further commit to comprehensively report all instances of public financial support for fossil fuel sourcing (including financing) and consumption, on the basis of a mutually agreed reporting template, with a view to achieving the complete elimination of all forms of inefficient subsidies by 2025; from that year, each Parties shall include in its reports, for any subsidy that remains in place, the grounds why it deems its use efficient, as well as a roadmap for its eventual phase-out. The Specialised Committee shall collect and analyse the reported data and make it publicly available together with its findings. It shall additionally explore options for gradual phase out including a timeline.
- g) ...
- h) ...

### Component 7 – Upholding levels of protection (§ 10)

#### *Description of measure*

- The Parties commit to applying a peace clause vis-à-vis domestic support for renewable energy sourcing and distribution.

#### *Technical tools*

**Sample text (lighter sections stem from the TSD EU/Vietnam example)**

- (1) The Parties stress that weakening the levels of protection in the environmental or labour areas is detrimental to the objectives of this Chapter and the Agreement as a whole. Accordingly, they recognize that it is inappropriate to encourage trade or investment by weakening the levels of protection afforded in domestic environmental or labour laws.
- (2) A Party shall not waive or derogate from, or offer to waive or derogate from, its environmental or labour laws, in a manner affecting trade or investment between the Parties.
- (3) A Party shall not, through a sustained or recurring course of action or inaction, fail to effectively enforce its environmental and labour laws, as an encouragement for trade or investment.
- (4) A Party shall not apply labour or environmental laws in a manner that would constitute a disguised restriction on trade or unjustifiable discrimination between the Parties.
- (5) The Parties acknowledge that domestic measures to support renewable energy sourcing and distribution which conform fully with the provisions of [Annex ## of the Agreement]<sup>1</sup> shall be exempt from legal action under this Agreement. The Parties further commit not to pursue legal or other action concerning such support measures in the WTO under the provisions of GATT 1994 or the Agreement on Subsidies and Countervailing Measures.

**Component 8 – Scientific information (§ 11)**

*Description of measure*

A commitment to apply the most recent IPCC guidance and IPCC reports (including the 2018 report) is added.

*Technical tools*

**Sample text (lighter sections stem from the TSD EU/Vietnam example)**

When preparing and implementing measures aimed at protecting the environment or labour conditions that may affect trade or investment, each Party shall apply the precautionary principle, and shall take reasonable account of relevant available scientific, technical and innovation-related information, and relevant international standards, guidelines or recommendations if they exist, including the most recent guidelines of the Intergovernmental Panel on Climate Change (IPCC) on national greenhouse gas inventories as well as relevant reports, including the report on the impacts of global warming of 1.5 °C above pre-industrial levels and related global greenhouse gas emission pathways.

**Component 9 – Review of sustainability impacts (§ 13)**

*Description of measure*

The Parties will apply regular review cycles linked, where appropriate, to the global stocktake exercises under Article 14 of the Paris Agreement, focusing on measuring the climate change-related impact with respect to the year before the FTA and with respect to the NDCs in place.

*Technical tools*

**Sample text (lighter sections stem from the TSD EU/Vietnam example)**

The Parties will, both independently and jointly, review, monitor and assess the impact of the implementation of this Agreement on sustainable development through their respective policies, practices, participative processes and institutions. With respect to climate change mitigation and adaptation impacts, they shall do so in five-year-intervals, which may, if the Parties so agree, anticipate and prepare the five-yearly global stocktake exercise, as laid out in Article 14 of the Paris Agreement. The Parties shall develop mutually agreed metrics to measure the impact of implementation of this Agreement against the year that preceded the entry into force of the Agreement as well as against both Parties' nationally determined contributions as prepared and regularly updated in accordance with Article 4 of the Paris Agreement.

**Component 10 – Institutional set-up (§ 15)**

*Description of measure*

In order for the ambitious agenda of the TSD Chapter to be implemented, the Specialised Committee must be given the resources needed in terms of funds, staffing, information-gathering, powers, and logistics. The Specialised Committee is therefore given a heightened status, potentially being put on par with, rather than below, the Trade Committee.

Public consultation is strengthened and should be, as a rule, led jointly. There are three different consultation procedures: those specifically foreseen under the relevant articles (e.g. Article 5, involving development banks, institutional investors, etc.); the default consultations (an option only for the Parties); and regular joint consultations (with rules to be laid out during the first meeting of the Specialised Committee).

The Specialised Committee should not only discuss and deliberate, but provide output (adopt recommendations) in a range of trade-related fields as foreseen under the TSD chapter and potentially elsewhere in the FTA (cf. the measure on fossil fuel subsidy reporting – Chapter 2).

*Technical tools*

### Sample text (lighter sections stem from the TSD EU/Vietnam example)

- (1) Each Party shall designate a Contact Point within its administration for the purposes of implementing this chapter.
- (2) The Parties shall establish a Specialised Committee on Trade and Sustainable Development (the “Specialized Committee”). The Specialised Committee shall comprise senior officials from the relevant administrations of each Party or officials they designate. It shall cooperate with the Trade Committee to achieve the sustainability goals of the Agreement.
- (3) The Specialised Committee on Trade and Sustainable Development shall meet within the first year after the date this Agreement enters into force, and thereafter as necessary, to review the implementation of this chapter, including its Article 2 [Right to regulate], its Article 5 [Climate Change] and its Article 9 [Trade and Investment], and of other chapters in the Agreement which include a specific mandate for the Specialised Committee. The Specialised Committee shall establish its own rules of procedure, and adopt its decisions by mutual agreement.
- (4) The Specialised Committee may establish working groups and may seek the advice of non-governmental organisations or persons, including independent experts. The Specialised Committee may also request information from international organisations and bodies.
- (5) The Specialised Committee shall be assisted by a secretariat, led by an executive director. The secretariat shall provide technical, administrative and operational support.
- (6) The Specialised Committee shall adopt recommendations, as foreseen under this chapter and elsewhere in the Agreement, and take other decisions as appropriate. All decisions shall be taken by consensus.
- (7) The Parties shall undertake joint public consultations as foreseen in this Chapter. For all other matters, the Parties may consult separately or, to the extent possible, jointly, with stakeholders and interested parties, including representatives from academia, think-tanks, non-governmental organisations, businesses, consumer and other organisations, including social and environmental groups, in order to gain non-governmental perspectives on matters that relate to the implementation of this Chapter. These consultations shall be conducted in an open and transparent way.
- (8) The Parties shall establish a joint forum of governmental and non-governmental representatives of different stakeholder groups (“Joint Forum”) to discuss matters related to sustainable development. The Joint Forum shall take place alongside or immediately preceding the Specialised Committee meetings. Joint Forum meetings shall be open to the public. The rules of convocation shall be defined at the first meeting of the Specialised Committee.

## 5.3 Political tools

The instrument of Trade and Sustainable Development Chapters is still relatively new, and it is hard to gauge its relevance and effectiveness as a trade tool in FTAs. The attention the TSD chapters receive in negotiations may serve as an indicator that Parties are prepared for real impact. The following considerations support a pro-active use of the TSD chapter and the integration of a dedicated climate-change focus:

- An FTA is a complex treaty, covering a wide range of sectors and activities. At the same time, it is the highly specialised expression of strictly bilateral interests in a multipolar world. A TSD chapter allows that all chapters and sections are accountable against targets and objectives supported by the international community at large.
- A TSD chapter allows for the concentration of sustainability-oriented policy development across sectors and sections of the FTA, as well as institutional responsibility (Specialised Committee); it also helps mainstream trade and investment policy against certain principles of paradigmatic importance (e.g. precautionary principle).
- A TSD chapter is the appropriate format for wide, transparent and balanced public consultation. The Joint Forum may assume a visible and relevant platform for the engagement of the public and the private sector.

- A climate-change focused TSD can serve as the functional link between international trade and investment law and the climate change architecture (the latter does indeed avoid all references to trade). The Paris Agreement sets an ambitious framework and quantitative targets, which cannot be reached without focused support from the areas of trade and investment. Through an FTA, countries can become frontrunners in terms of bilateral cooperation on climate change. The format also helps remove, certainly over time, the relevance of the (albeit already fading) “firewall” assumption, i.e. the binary separation in developed and developing countries.
- The adoption of the Paris Agreement with its ambitious approach to both multilateral but also regional and bilateral cooperation gives momentum to the negotiation of climate-change enhanced TSDs.
- The chapter should assume a prominent role throughout the negotiation of a trade agreement and when communicating the opportunities and risks to the wider public. The chapter can act as safeguard against the lowering of environmental (and social) standards, and it can do even more. It can set a positive agenda of ‘greening’ trade flows, avoiding high-carbon lock-ins, and collaborating on climate change mitigation and adaptation.
- TSD chapters have, indeed, quickly developed into comprehensive instruments to integrate a wide range of sustainability aspects ranging from standards to biodiversity, natural resources, and detailed suggestions on climate change and trade tools. Yet, their existence is little known in the wider public. It does not help that the chapters’ relevance and impact has been hardly researched (in particular in Europe), even though research from elsewhere (including concerning the work of the Commission for Environmental Cooperation (NAFTA)) suggests that concerning environmental norms, FTAs may have a clearly positive record.

## 5.4 Delivery strategy

- Negotiations of the TSD chapter, including its climate change focus, will be specific from country to country. Depending on the partner country and its economic composition, some details will be more important than others. The preferences for harmonised standards will be different in a country with high levels of (competing) manufacturing to a country that focuses on services or natural resource production. Developing an emissions trading scheme, or linking existing systems, will be a viable option among industrialised (or emerging) countries, though not with less developed ones. For tropical countries, the provisions on forestry and forest products may be highly important, for others not. Any specific TSD negotiations will have to take these factors – of development, geography, economic profile, etc. – into account. For developing countries, in particular, complementary measures – ranging from Aid-for-Trade support to dedicated climate finance interventions from the EU and its Member States – offer a flexible tool for strengthening the sustainability goals as a whole. At the same time, close alignment with internationally agreed treaties, namely the Paris Agreement, will provide strong incentives to base every TSD chapter on commonly shared standards and minimum thresholds.
- It will be important to make comprehensive use of the TSD chapter (in terms of implementation). This requires (a) that the Specialised Committee become a body not of protocol and general discussion, but of function and focus; and b) that non-governmental organisations and the public as a whole become engaged.
- Without appropriate levels of resources, the Specialised Committee risks being overburdened and dysfunctional. Trade negotiators point out that there is a risk for TSD engagement to become too broad and wide, at the cost of substantial impact and added value, and with too few resources to secure a robust follow-up. Placing the committee next to, rather than below, the Trade Committee, providing it with substantial funds and, through the Secretariat, continuous human resources, and giving it a face in public communication will help avert this risk. A powerful example for an overall functional environmental committee – though from a different continent – can be found in the Commission for Environmental Cooperation under the North American Free Trade Agreement (NAFTA). The contributions of the Commission to research and policymaking is notable. Resources, of course, may be difficult to procure, in particular in FTAs with small countries. Grouping of TSD institutions among the EU and partner countries, though not discussed within this study, may be a way forward in the future
- Even if equipped with sufficient resources to assume its tasks, the Specialised Committee will have little or no institutional history and relevance to assist it with delivering meaningful outputs. The transformation from protocol and deliberation to developing concrete action points will be particularly

challenging. Two procedural concepts will help in this respect. One concerns joint deliberation. The TSD chapters in the EU's free trade agreements stress that each party must apply the procedures foreseen. This is an important commitment. However, they also place many of these processes and procedures under the sole responsibility of each party (both parties then going about in parallel, cf. the rules on stakeholder consultation). This removes control and slows down the process of future standardisation and rulemaking. As a rule, the actions and deliberations under the TSD chapter should be defined as joint activities. Exceptions may be in order, but they need special justification, rather than be the rule. The other relates to the range of output instruments foreseen for the Specialised Committee. Recently adopted FTAs give a wide mandate to the Specialised Committee to "discuss" issues, but they are more hesitant to include, in the mandate, obligations – such as that the Specialised Committee take certain actions – or powers, such as adopt decisions and/or recommendations. This should be amended to give the Specialised Committee a bigger role.

- Research on the impact of concrete TSD chapters should become a high priority for EU decision makers.
- At the same time, the TSD chapter negotiations should be used to engage in a transparent process with the public, to explain the TSD process, the risks it is meant to mitigate, and the opportunities it is tapping into, in particular with respect to international climate change cooperation. The discussions are too often too focused on risk-containment ("our standards will not be lowered") and special interests (e.g. of the EU export industry). Instead, it would be worthwhile organising, at the Member State and at the EU level, communication and enhanced public engagement cycles (with stakeholders and interested parties, including representatives from academia, think-tanks, non-governmental organisations, businesses, consumer and other organisations, including social and environmental groups, see § 15) on the topic of "Trade and Climate Change" with concrete action windows on green technology, public procurement, MEPS, etc. In the long run, the Joint Forum will secure public acceptance and democratic transparency.

# *Part III: Measures for further consideration*

**Note:** This section presents analysis on two measures that have not been recommended for action, but have been considered worthy of additional analysis, with a view to informing future political decisions. It therefore presents an analysis of the respective strengths and drawbacks of these measures, and puts forward considerations to help determine the circumstances in which they may be advantageous.

# 6 ■

## Addressing land-use change through agriculture tariff preferences

### Summary and Key Points

#### Measure rationale

- Deforestation embedded in EU imports is a significant source of global emissions, and the EU has previously sought to identify strategies to reduce the impacts of its imports on emissions.
- Existing EU initiatives including the FLEGT Action Plan and the sustainability criteria for biofuels under the Renewable Energy Directive (RED) provide a potential basis upon which to expand incentives to reduce deforestation associated with EU imports.

#### Summary of measure

- Provide tariff preferences for agricultural or forestry products whose production has not led to deforestation or peatland oxidation.
- Tariff preferences would be offered either to specific imports that have been certified under certification standards recognised by the EU or originating in countries that have concluded and implemented agreements with the EU that reduce emissions from the supply chain in question.

#### Assessment of impacts and feasibility

- Likely to be technically feasible, but face significant challenges and would need to address a number of weaknesses in the system established for biofuel sustainability under the RED.
- Where existing systems are relied upon, only direct land-use change could be addressed, since RED does not address indirect land-use change.
- Bilateral agreements would be better equipped to address indirect land-use change, but there appears to be little political appetite for their conclusion.
- Reactions from partner countries would likely be mixed. While countries that could benefit from reduced tariffs could be expected to be positive, there may be negative reactions from competitor countries that already enjoy tariff preferences under the GSP and GSP+.
- A WTO challenge would be a possibility, with the outcome uncertain. While a carefully-designed system would with some likelihood survive such a challenge in principle, getting the design right may prove difficult.

### 6.1 Background and measure overview

Emissions from tropical deforestation comprise 6-17% of global emissions.<sup>20</sup> The conversion of tropical forests for commercial agriculture accounts for about half of this deforestation, making it the largest driver of global deforestation, while subsistence agriculture accounts for a further 30% (Rautner, 2013). Forestry and agricultural products traded into the EU, in particular soya and palm oil, together account for 10% of deforestation caused by agricultural expansion.

<sup>20</sup> Van Der Werf, G. R. et al. CO2 emissions from forest loss. *Nature Geosci.* 2, 737–738 (2009)

This measure would address the embedded emissions in EU agricultural imports by providing tariff preferences for agricultural or forestry products whose production has not led to deforestation or peatland oxidisation. The tariff preferences would be set at a level that is sufficient to provide a compelling disincentive to clear forest for the production of agricultural goods destined for the EU. The focus would be on EU imports with the greatest effects on land-use change carbon emissions and where tariff preferences can be expected to make a discernible difference, with the initial priority being on soya and palm oil. Tariff preferences would be offered either to specific imports that have been certified under certification standards recognised by the EU or originating in countries that have entered into and are implementing agreements with the EU that reduce emissions from the supply chain in question (see discussion in section 6.2).

This policy option builds upon existing EU initiatives addressing deforestation, most notably the EU Timber Regulation and FLEGT Action Plan,<sup>21</sup> which work in complement to restrict the import of illegally harvested timber and facilitate the generation of systems to ensure legality, and the Renewable Energy Directive's (RED) provisions to ensure the sustainability of EU biofuels imports. It drawn in particular on the approach set out in the latter, including the both the sustainability criteria adopted by RED and the potential mechanisms it sets out for providing compliance, most notably the use of voluntary sustainability standards and bilateral agreements with producer countries. These criteria are discussed in greater detail in the following section, on technical feasibility.

## 6.2 Analysis of the measure

### 6.2.1 Technical feasibility

The main technical challenge in adopting this measure surrounds the establishment and monitoring of criteria for determining whether imports qualify for the tariff preferences adopted. To be effective, these criteria need to adequately address the factors through which the selected agricultural imports drive deforestation. The following describes, firstly, the two main categories of these factors ('deforestation drivers'), and then considers the technical feasibility of addressing each through EU tariff preferences.

#### *Distinguishing direct and indirect drivers*

Among the most important factors in determining the appropriate design of such a measure is whether the imports targeted are for the most part *direct* or *indirect* drivers of deforestation.

- *Direct drivers of deforestation* are activities that directly and proximately lead to the deforestation of a given area. Where an area of land is deforested in order to provide room for an agricultural development, that development becomes a direct driver of deforestation. A large proportion of oil palm expansion in Southeast Asia in the past decade is, for example, considered to have directly resulted in deforestation,<sup>22</sup> and expected future expansion is expected to have a similar effect.<sup>23</sup> Direct drivers are relatively easier to measure than indirect drivers since there is a clear relation between the activity and the deforestation.
- *Indirect drivers of deforestation* refer to activities or circumstances that influence direct deforestation drivers. Indirect drivers may include weak governance or high international demand for the product, but agricultural expansion itself can also be an indirect driver. Expansion of soy production in Brazil, for instance, typically takes place in existing agricultural land, and so is for the most part not a direct driver of deforestation. However, it often displaces pasture land, which can lead to the conversion of forests to create new pasture lands to replace these.<sup>24</sup> Certified

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<sup>21</sup> 'Forest Law Enforcement, Governance and Trade (FLEGT), Proposal for an EU Action Plan', Communication from the Commission to the Council and the European Parliament, 21 May 2003, COM (2003) 251 final.

<sup>22</sup> Will McFarland, Shelagh Whitley and Gabrielle Kissinger, Subsidies to key commodities driving forest loss: Implications for private climate finance, ODI Working Paper, March 2015. Lian Pin Koh et al., "Remotely sensed evidence of tropical peatland conversion to oil palm", 108 *Proc. Nat. Ac. of Sci.* 5127 (2011).

<sup>23</sup> Jo Villanueva, Oil palm expansion in the Philippines: Analysis of land rights, environment and food security issues, in *Oil Palm Expansion in South East Asia: Trends and Implications for Local Communities and Indigenous Peoples* (FPP & SawitWatch 2011); Hugo Valin et al., The land use change impact of biofuels consumed in the EU: Quantification of area and greenhouse gas impacts, Ecofys, IIASA and E4tech Study for EU Commission, 2015.

<sup>24</sup> Will McFarland, Shelagh Whitley and Gabrielle Kissinger, Subsidies to key commodities driving forest loss: Implications for private climate finance, ODI Working Paper, March 2015.

sustainable palm oil can also have a similar effect, leading to an increase in demand for land for non-sustainable palm oil that is directed to less sensitive markets. The impacts of indirect drivers of deforestation are harder to monitor with precision, due to the multiple steps between the activity and the deforestation.

To act as an effective incentive to reduce deforestation, tariff preferences would need to be provide incentives to shift from practices leading to deforestation to those that do not. As such, they need to be able to define and monitor activities or results that achieve this goal.

### *Addressing direct drivers*

Developing and implementing criteria to apply differentiated tariffs to address direct drivers is considered to be more feasible than addressing indirect drivers, though challenges do exist. The relatively greater feasibility arises since similar criteria already exist and have been implemented through EU legislation for several years, namely through the sustainability criteria for biofuels adopted under the Renewable Energy Directive (RED).<sup>25</sup>

Specifically, the RED sets out criteria for identifying materials (or products that originate from materials) from land that was, at a given date (in this case January 2008) of very high carbon value. Under RED, this applies to wetlands, peatlands (where they have subsequently been drained) and “continuously forested” areas.<sup>26</sup> In addition, RED sets out a second set of criteria for products or materials originating from land that has moderate forest cover<sup>27</sup> and sets out a methodology to determine whether the carbon stock change arising from the extraction of materials is minimized to a level defined by the directive.<sup>28</sup>

In terms of verification, the processes and infrastructure established under the RED also provide a potentially workable basis for the implementation of a tariff preference system. Verification under RED is performed either by independent auditing of the information submitted by economic operators, which is checked by Member States, or through the use of voluntary certification schemes approved by the European Commission. The RED also makes provision for concluding agreements with third countries to reduce deforestation from biofuels, which would serve to render all imports from those countries compliant. As of 2016, however, no such agreements have been concluded or are being negotiated.

In practice, the vast majority of biofuel importers have made use of voluntary certification schemes to prove compliance with the sustainability criteria.<sup>29</sup> To-date, the EU has approved 19 voluntary schemes, several of which cover raw agricultural imports linked to deforestation such as palm oil and soya (such as RSPO-REDD and RTRS). This system could therefore potentially be adapted for use under a system of differentiated tariffs.

It is important to note, however, that there has been criticism of the use of voluntary schemes, including their environmental effectiveness and their high costs, which can make compliance difficult for smaller operators.<sup>30</sup> Some have argued that the voluntary schemes that have been recognized vary widely in quality, and that since there is no price premium associated with different standards, there is a built-in

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<sup>25</sup> Directive 2009/28/EC of the European Parliament and of the Council of 23 April 2009 on the promotion of the use of energy from renewable sources and amending and subsequently repealing Directives 2001/77/EC and 2003/30/EC.

<sup>26</sup> This is defined as land spanning more than one hectare with trees higher than five metres and a canopy cover of more than 30 %, or trees able to reach those thresholds *in situ*. See RED, *ibid* Article 17 (4)(b).

<sup>27</sup> This is defined as land spanning more than one hectare with trees higher than five metres and a canopy cover of between 10 % and 30 %, or trees able to reach those thresholds *in situ*. See RED, *ibid* Article 17 (4)(c).

<sup>28</sup> In the context of RED, which aims to reduce emissions by replacing conventional fuels with biofuels, this carbon stock change is measured by comparing the emissions from the carbon stock change to the emissions savings from the replacement of conventional fuels with biofuels. While the specifics of this approach are clearly particular to the context of RED, the basic principle of keeping carbon stock changes below a certain threshold is applicable to a broader range of approaches.

<sup>29</sup> Taking the example of biofuels in the UK, more than 99% were sourced from voluntarily certified suppliers in 2014. Department for Transport (2015) Renewable Transport Fuel Obligation statistics: obligation period 6, 2013/14, report 6.

<sup>30</sup> C. Johan Westberg and Francis X. Johnson, *The Path Not Yet Taken: Bilateral Agreements to Promote Sustainable Biofuels under the EU Renewable Energy Directive*, Stockholm Environment Institute, 2013; Client Earth, *Achieving credible EU- wide verification of biofuel sustainability*, November 2013.

incentive to use the cheapest schemes.<sup>31</sup> Others have questioned their capacity for monitoring compliance with complex criteria around land-use change.<sup>32</sup> These concerns could take on additional relevance where there are added incentives to use voluntary schemes through the introduction of tariff preferences. The EU has in 2015 introduced new rules to strengthen oversight over voluntary schemes,<sup>33</sup> though it has yet to be seen how successful these will be in addressing the environmental concerns associated with voluntary schemes.

Another issue regarding the use of the sustainability criteria approach is that it creates the risk of leakage. This could arise through re-directing a greater share of crops produced on non-deforested land to the EU, thereby reducing supply to other markets. Since the EU only accounts for a relatively small share of global demand, this could result in sustainably-produced crops being directed to the EU while non-sustainably produced crops are directed to less sensitive markets. An approach focused on implementing sustainability measures across entire countries (see below) may be more effective in promoting an overall move to sustainable production, at least at the country level.

### *Addressing indirect drivers*

In the case of imports that are indirect drivers, it is not the land from which the agriculture products in question are sourced that is deforested, therefore criteria relating to the status of that land are not relevant. As such, different criteria would need to be developed in order to apply differentiated tariffs to such products.

At present, no such criteria exist in EU law, nor are any criteria considered to exist globally that would appear sufficiently robust to adequately differentiate products that have (or have not) indirectly led to land-use change. Indeed, the absence of such criteria was central to the EU's recent revision of the provisions of the RED related to biofuels.<sup>34</sup> This legislation seeks to address the indirect land-use change impacts of EU biofuels policy. Given the lack of available criteria to ensure that biofuels feedstocks do not result in indirect land-use change, however, the new legislation instead takes the approach of placing restrictions on the use of biofuels originating from agricultural crops ("first generation biofuels") toward EU renewable energy targets, and seeks to promote biofuels produced from waste material ("second generation biofuels") as an alternative.

The amendment to the RED does provide for the Commission to, by December 2017, make a proposal for integrating indirect land-use change emissions factors into the biofuels sustainability criteria.<sup>35</sup> Thus far the Commission has not made public any initial proposals, and it is not known when a first draft is expected. Once this proposal is developed and approved, however, applying differentiated tariffs to imports associated with indirect land-use change could become more feasible.

In the absence of criteria for differentiating specific imports on the basis of their effects on indirect land-use change, an alternative option to address these imports lies in the use of bilateral or multilateral agreements with producer countries. Such agreements are already provided for under RED. They could be stand-alone or take the form of provisions within broader agreements,<sup>36</sup> and would set out country-specific sustainability criteria that correspond to EU criteria. The conclusion and proper implementation of those agreements could be accepted as prima facie proof that imports from that country qualify for tariff preferences.

Bilateral agreements offer a more flexible approach to applying sustainability criteria that could potentially also address indirect drivers. These agreements could take a number of forms, but the basic focus would

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<sup>31</sup> Client Earth, *Ibid.*

<sup>32</sup> R. Ackrill and A. Kay, *EU Biofuels Sustainability Standards and Certification Systems – How to Seek WTO-Compatibility*. *Journal of Agricultural Economics*, 62(3). 551–64 (2011).

<sup>33</sup> Directive (EU) 2015/1513 amending Directive 98/70/EC relating to the quality of petrol and diesel fuels and amending Directive 2009/28/EC on the promotion of the use of energy from renewable sources.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*, Article 3(2).

<sup>36</sup> Potential agreements that it has been suggested could include provisions on sustainability criteria are FLEGT VPAs and Economic Partnership Agreements. C. Johan Westberg and Francis X. Johnson, *The Path Not Yet Taken: Bilateral Agreements to Promote Sustainable Biofuels under the EU Renewable Energy Directive*. Stockholm Environment Institute, 2013.

be on strengthening national policies and actions to address land-use change from agricultural expansion or from specific supply chains. This could be based around, for instance, an (ambitious) intended nationally determined contribution (INDC) under the UNFCCC process that covers the forest and land-use sector; the adoption and implementation of a national REDD+ strategy that meets certain criteria; or the adoption of specific measures or action plans addressing deforestation associated with the specific supply chain in question. Lessons could be drawn from the similar process of concluding Voluntary Partnership Agreements (VPAs) under the FLEGT initiative, under which all timber stemming from countries implementing these agreements is presumed to meet EU legality requirements.

This broader, more encompassing approach, would be better equipped to address indirect drivers of deforestation than an approach focused on certifying a specific batch of commodities or area of land. They would also arguably be equally or more successful in addressing direct drivers, since they would address the risk the leakage risks discussed above. However, there would still be a risk of international leakage taking place.

The conclusion of bilateral agreements does present several challenges. To-date no such agreements have been concluded under RED and so this approach would require significant investment in both resources and political capital. Technically, careful consideration would need to be given to develop suitable criteria in each partner country, with no notable precedents currently existing for such national-level certification. Moreover, to-date there has been little appetite within the EU to negotiate bilateral agreements under the biofuels criteria, seemingly due to the high time/resources investment needed,<sup>37</sup> and so substantial political commitment would likely be required to make this a feasible option for a differentiated tariffs system. Finally, the effectiveness of bilateral agreements would naturally depend on the country they are negotiated with and its relevance in terms of emissions from agricultural commodity production. Priority countries in terms of EU imports of palm oil and soy would be Indonesia, Malaysia, Brazil, Argentina and Paraguay.

## 6.2.2 Emission potential and economic implications

### *Emission reduction potential*

The effects that this measure are likely to have on emissions and both EU and partner country economies varies across different agricultural imports. The following assesses likely implications for the two EU imports with the highest share of embedded deforestation: soy beans and palm oil.

#### *Soy beans*

The three biggest exporters of soy beans (and oil) to the EU (>60% of the total) are Brazil, Paraguay and Bolivia.<sup>38</sup> Between 1990 and 2008 deforestation in Brazil and Paraguay caused by EU imports of soybeans and soybean cake can be estimated<sup>39</sup> to have been responsible for emissions of around 3,300 MtCO<sub>2</sub>e.<sup>40</sup> Paraguay and Bolivia are already eligible for zero tariffs under GSP+; as such, this measure would not be relevant for those countries. Brazil, on the other hand, has no special trade preferences and therefore its products typically face the 4.5% MFN import tariff when they enter the EU,<sup>41</sup> hence in principle this measure could work to incentivise reduced deforestation from soy products in Brazil.

Nevertheless, the majority of soybean expansion in Brazil is not in forested areas. Rather, soy acts as an indirect driver of deforestation, with soy often displacing (and providing an input to) beef production, which

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<sup>37</sup> Ibid.

<sup>38</sup> Based on UN COMTRADE data. The EU also has significant soy imports from the US, Canada, Uruguay and Ukraine, but these are less relevant to the deforestation and climate goals of this measure.

<sup>39</sup> Based on hectare data from (EC, 2013) and average emissions per hectare deforestation from (Bellassen et al, 2008).

<sup>40</sup> Ibid.

<sup>41</sup> For reference for agricultural products the EU applies an average tariff rate of 14.8% to imports from countries without specific preferences, see <http://capreform.eu/wto-eu-trade-policy-review-2013/>

in turn moves into forested areas. As discussed above, existing EU criteria do not assess effects on indirect land-use change, and so in the absence of new criteria or bilateral agreements this measure would not have significant effects on the soy market. Brazilian firms pay tariffs of approximately USD 65 million each year on soy bean imports into the EU,<sup>42</sup> and so the elimination of these tariffs might act as an incentive to negotiate a bilateral agreement in conjunction with other incentives such as REDD+ payments. In this case, the potential emission reductions in Brazil from this measure are significant.

### *Palm oil*

By far the two biggest palm oil exporters to the EU are Indonesia and Malaysia, from whom the EU sources approximately 80% of its palm oil imports. Between 1990 and 2008 deforestation in Indonesia and Malaysia caused by EU imports of palm oil can be estimated to be responsible for emissions of around 800 MtCO<sub>2e</sub>.<sup>43</sup> Importantly, as noted above a large share of palm oil production in Indonesia and Malaysia acts as a direct driver of deforestation. Future expansion in other South-east Asian countries is expected to similarly directly drive deforestation. Palm oil imports from both countries attract MFN tariffs from 3.8 to 12.8% when they enter the EU, while Indonesian and Malaysian firms pay approximately USD 135 million and USD 107 million in tariffs on palm oil exports to the EU imports each year, respectively.

The high direct emissions from palm oil imports from Indonesia and Malaysia together indicate that there are significant potential emission reductions that could be achieved through offering reduced or eliminated tariffs for sustainable imports. Existing tariffs are sufficiently high that individual operators would have a reasonably strong incentive to seek certification, and the overall annual tariffs are potentially large enough to (together with other benefits from, e.g., REDD+) incentivize the governments of Indonesia and Malaysia to negotiate bilateral agreements.

Despite this potential, leakage of emissions in such a scheme would present a significant risk. Given that the EU only accounts for a limited percentage of demand for palm oil from Indonesia and Malaysia, it has been estimated in the context of the biofuels criteria that global effects are limited due to unsustainable palm oil simply being redirected to other markets. As discussed above, this risk would be mitigated through the conclusion of bilateral agreements with exporting countries.

### *Economic considerations*

The economic impact of the measure would be a factor of the extent to which tariff reduction was passed on to consumers in the form of lower prices, set against the additional effort and costs incurred by producers. The relative cost of certification is low, but the actions required to achieve certification can be more costly. For example, using only specified land types for which supply is lower and demand higher (due to certification requirements) will lead to higher costs, as would employing more sustainable production practices (EC, 2013). For Member States there would also be a potential loss of tariff revenue, as stated above this would be in the order of up to USD 65 million for Brazilian soy and USD 240 million for Indonesian and Malaysian palm oil.

## **6.2.3 Legal considerations**

### *Designing Tests*

Some aspects of the measure's technical design are considered quite achievable, while others raise greater technical challenges:

The adoption of specific tests raises relatively fewer challenges, at least in the case of oil crops (e.g. oil palm and soy), since a fully functioning system is already in place at EU level for ensuring that certain oil crop imports (i.e. biofuels) do not originate from land that has been deforested. This system already

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<sup>42</sup> Based on analysis of UN COMTRADE data 2010-2013

<sup>43</sup> Based on hectare data from (EC, 2013) and average emissions per hectare deforestation from (Bellassen et al, 2008).

recognises the main certification schemes for oil palm and soy and is currently in the process of being strengthened pursuant to the recent amendment of the Renewable Energy Directive.<sup>44</sup>

The adoption of general tests raises more challenges since no existing system is in place, and since any test that assesses progress in a country overall is likely to be politically sensitive. A test based on ambitious INDCs covering the forest and land-use sector would face the particular challenge of defining ambition, while a test based on a national REDD+ strategy would also raise challenges in defining relevant criteria and determining satisfactory implementation in heterogeneous circumstances. A test based on acceptable measures specifically targeting the supply chain in question – similar to the approach for aviation emission under the EU ETS whereby partner country airlines could be exempted from ETS requirements through adopting ‘equivalent measures’ approved by the EU – could be more workable, though this approach could be resource intensive.

### *WTO compatibility*

A WTO legal challenge based on discrimination claims – violation of the MFN principle in GATT Article I – would be a possibility. While a carefully-designed system would with some likelihood survive such a challenge in principle, getting the design right may prove difficult.

GATT Article I requires equal treatment of like products from different foreign countries. WTO Members have a right to see their products treated at least as favourably as a like product from any other country. This is the so-called MFN – Most-Favoured Nation –principle. The proposed measure consists of a differential tariff treatment of otherwise identical products (commodities) based on aspects of their production, in two variations: Differentiation between products with sustainability certification and products without; and between products from countries with which the EU has concluded corresponding agreements, and countries where that is not the case.

The second differentiation would appear to amount to a straightforward *de jure* discrimination based on origin. The first could, depending on how the measure applies in practice, lead to claims of a *de facto* discrimination whereby products from one country as a group *de facto* find themselves disadvantaged vis-à-vis competing products from another country where producers find it easier to comply, or are just more successful in doing so. Both differentiations, however, would only amount to a violation of the MFN principle if the products were deemed ‘like’. This could be in doubt if ‘processes or production methods’ (PPMs) relating to the product could be valid criteria to differentiate products, making them ‘unlike’ even if no physical or other differences between the products exist. This question is almost as old as the GATT, and its interpretation is arguably not yet settled, with some recent case law interpreted by some to indicate that PPMs provide valid grounds for differentiation. This would, if accepted, more easily support a differentiation based on sustainability certification linked to the actual production of the product at hand; it would seem more difficult to maintain for differentiations based on recognition-type agreements with countries as this would appear to differentiate not on the basis of actual PPMs, but place of production. A credible counterargument however can be made that the differentiation proposed here amounts to a legitimate grouping by proxy because qualifying countries would be those where producers would be under the requisite amount of supervision and pressure, making their origin akin to a certification of adherence to sustainability criteria.

While we believe that an interpretation considering otherwise ‘like’ products ‘unlike’ based on PPMs, in particular where those differences in PPMs actually affect the consumer (or broader societal) perceptions of the product – which would here be the case, as society legitimately cares about the carbon effect of deforestation – is to be favoured, there is a significant risk that the WTO Appellate Body would reject this view. And while we further believe that also the proposed differentiation based on a country’s directly relevant policy and regulatory framework could be accepted as a legitimate proxy for such a differentiation, this view would likely attract even less support. It would thus be prudent to assume that while the EU could credibly advance the above interpretations, a violation of GATT Article I may be found.

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<sup>44</sup> Directive on fuels and energy from renewable sources: transition to biofuels to deliver greenhouse gas savings, amending Directive 98/70/EC relating to the quality of petrol and diesel fuels and amending Directive 2009/28/EC on the promotion of the use of energy from renewable sources, OJEU, 15.09.2015, L 239/1 (adopted by the Council on 13 July 2015).

## Exceptions

The violation of GATT Article I could in principle be justified under the General Exceptions clause in GATT Art. XX, in particular under its paragraph (g) (“relating to the conservation of exhaustible natural resources”). The climate and/or the atmosphere would very likely qualify as a ‘natural resource’ for purposes of this provision; so would forests themselves.

However, “relating to” requires a material contribution of the measure to the conservation goal. This could be in doubt to the extent that the measure would simply lead to a reshuffling of distribution lines, with an allocation of ‘clean’ production outputs to the EU market while ‘unclean’ production goes to unregulated markets. This effect would be somewhat less likely in the case of general (country-level) tests, since these would influence the overall production in the country rather than just a segment. Moreover, as long as that effect is not so strong that it would render the measure entirely ineffective it would seem legitimate to assume that a contribution in fact follows from the potentially significant incentive/disincentive effect of differential taxation. That said, it would further arguably be necessary to continuously assess this vis-à-vis effects generated by other means, in particular the Paris Agreement, and include possible counterproductive effects of the measure for effective mitigation, such as political fallout that may negatively affect adherence to / implementation of Paris Agreement.

Paragraph (g) requires such measures to be “made effective in conjunction with restrictions on domestic production or consumption.” This requirement of “even-handedness” would require that the EU and its Member States have equivalent laws and policies in place to avoid the conversion of forest to agriculture in the EU.

Further, the *chapeau* of GATT Article XX requires that measures must not be applied in a way that leads to “arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade.” The comparison of countries extends to both the EU itself and third countries (MFN and NT).

This translates into the following requirements for the design of the measure (*recalling that the Art. XX justification is not needed and these requirements thus do not have to be fulfilled if a violation of Art. I is avoided in the first place – see above*):

- Full recognition of local conditions in other countries. This will require careful and consequent implementation of the approach to offer practicable paths towards preferential treatment for products that have in fact been sustainably produced.
- Effective equal access for countries to the negotiation of qualifying agreements; countries willing to negotiate would have to be treated equally.

## 6.2.4 Political considerations

At EU level this measure is potentially politically opportune as it supports the EU’s objective to halt global forest loss by 2030 and reduce gross tropical deforestation by at least 50% by 2020.<sup>45</sup> In addition, it builds upon existing EU studies on how to reduce the deforestation impact of EU consumption,<sup>46</sup> while also offering a means to mobilize private sector finance, a key objective of the EU’s strategy on climate finance.<sup>47</sup> The measure has the potential to be effectively combined with the REDD+ funding efforts of both the EU and its Member States, providing additional traction to these efforts.

At the same time, taking the route of concluding bilateral agreements, while having the potential to strengthen existing efforts, would require significant political capital and would need to be approached sensitively. Careful design and political tact would be needed to avoid these efforts being seen as the EU interfering with established processes under the UNFCCC, such as those for determining INDCs (which are, by definition, nationally determined). Experience with VPA negotiations under FLEGT highlight the difficulties that can arise in negotiating on sensitive issues such as governance. Indeed, the lack of

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<sup>45</sup> See <http://ec.europa.eu/environment/forests/deforestation.htm>.

<sup>46</sup> See [http://ec.europa.eu/environment/forests/impact\\_deforestation.htm](http://ec.europa.eu/environment/forests/impact_deforestation.htm).

<sup>47</sup> See, e.g., submission to the UNFCCC by Italy and the European Commission on Behalf of the European Union and its Member States, EU submission 2014 on strategies and approaches for scaling up climate finance, Rome, 29 September 2014, available: [http://ec.europa.eu/clima/policies/finance/docs/eu\\_strategies\\_and\\_approaches\\_en.pdf](http://ec.europa.eu/clima/policies/finance/docs/eu_strategies_and_approaches_en.pdf).

interest of the Commission in pursuing bilateral agreements despite the clear mandate under RED may indicate a general lack of appetite for pursuing this approach.

Outside the EU it can be expected that the measure would be welcomed by many countries that export agricultural products eligible for the reduced tariffs, particularly those whose exports are currently subject to high tariffs. It would be especially welcome by the various developing countries who were disappointed at the exclusion of agricultural products from the Environmental Goods Agreement. However, opposition may be expected from countries already benefiting from GSP+ that would be subject to greater competition due to their competitors having their tariffs reduced under this measure, for example Bolivia and Paraguay in the case of soybean oil. Combination with targeted Aid-for-Trade instruments that assist with the achievement of sustainability standards would also help enhance acceptability.

One potential effect of the measure could be to create a precedent for countries (unilaterally) establishing differentiated tariffs based on emissions generated through process and production methods associated with imports. Were this to happen, it could potentially have either positive or negative effects on EU exports, depending on how emission-intensive EU production of the products in question is compared to competitors.

Finally, it is worth noting that this measure received generally favourable feedback in stakeholder consultations undertaken for this project, while similar concepts developed under other projects also scored highly compared with other measures to reduce deforestation associated with EU consumption<sup>48</sup> and have received positive stakeholder feedback among government and non-government representatives alike.<sup>49</sup>

## 6.2.5 Conclusion

**Applying differentiated tariffs based on the deforestation impacts of imports is likely to be technically feasible, but face significant challenges.** Existing systems under the Renewable Energy Directive can be built upon, but these systems have a number of weaknesses that would need to be addressed to ensure the measure's environmental effectiveness.

**Where existing systems are relied upon, only direct land-use change could be addressed.** The criteria established by the RED and the voluntary standards that primarily monitor compliance with them do not address emissions from indirect land-use change, and in a recent revision of the issue the EU decided not to adopt a separate set of criteria to cover these emissions.

**Bilateral agreements would be better equipped to address indirect land-use change, but there appears to be little political appetite for their conclusion.** Despite having the mandate since 2009 to negotiate bilateral agreements that would implement the sustainable criteria in the RED, the Commission has not taken steps to negotiate any in this period. Experience under FLEGT shows that such negotiations can be complex and resource-intensive, particularly where they address sensitive issues around governance of land-use change.

**Reactions from partner countries would likely be mixed.** While countries that could benefit from reduced tariffs could be expected to be positive, there may be negative reactions from competitor countries that already enjoy tariff preferences under the GSP and GSP+.

**A WTO challenge would be a possibility, with the outcome uncertain.** While a carefully-designed system would with some likelihood survive such a challenge in principle, getting the design right may prove difficult. Equal treatment of partner countries and full recognition of local conditions would be important factors in ensuring WTO compatibility.

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<sup>48</sup> EC, 2013.

<sup>49</sup> Darragh Conway, Charlotte Streck and Moritz von Unger, REDD+ Finance in The European Union: Options for scaling-up near term support, Climate Focus and The Nature Conservancy, 2014.

# 7

## Border carbon adjustments

### Summary and Key Points

#### Measure rationale

- Border Carbon Adjustments (BCAs) address the issue of carbon embedded in international trade.
- Theoretically they enable the protection of industry competitiveness in the abating countries, higher environmental effectiveness or cost-effectiveness of climate policy and the sanctioning of countries considered to be not contributing to an international abatement regime.
- It is interesting for the EU to consider the impacts of BCAs, although two immediate concerns are flagged, that BCAs have not yet been implemented anywhere globally and that there is currently little or no evidence of carbon leakage within the EU ETS requiring BCA as a solution.

#### Summary of measure

An EU BCA would fully or partially replace current carbon leakage arrangements in the EU ETS and would require affected products from countries without climate policy measures equivalent to the EU ETS to face a carbon adjustment levy derived from appropriate product or industry benchmarks.

#### Assessment of impacts and feasibility

- Potential positive impacts on climate mitigation, acting as a trigger for industrial countries and to modernise their industries to qualify for adjustment exemptions. Could also generate additional revenues for EU Member States.
- May lead to higher costs for EU industry and therefore market prices, add at-border and administrative costs and reduce overall economic welfare while still leading to EU producers facing higher production costs when exporting.
- Would likely be damaging to the recent successes in international climate policy, and is out of step with current EU climate policy thrusts, and is likely to be politically unacceptable.
- Multiple questions of WTO compatibility exist and, while legal justification is in principle possible, it implies complex design requirements, and cannot co-exist with free allocation. In any case WTO dispute settlement is likely, with an unpredictable outcome.

## 7.2 Background and measure overview

### Justification and overall rationale

Border carbon adjustments (BCAs) address the issue of carbon embedded in international trade, and in more general terms, are in line with the ideas behind consumption-based emissions accounting. Although not implemented in practice to date, BCAs can theoretically serve multiple purposes enabling the:

- **Protection of the competitiveness of industry in abating countries.** By taxing emissions embodied in trade at the same level as those in domestic products, BCAs “level the playing field”

between domestic and foreign producers.<sup>50</sup> They take away the competitive advantage that foreign producers would have in countries without a, or with a lower, carbon price.

- **Higher environmental effectiveness or cost-effectiveness of a climate policy.**<sup>51</sup> By taxing 'dirty' imported products, BCAs could lead to reduced carbon leakage and lower consumption of these carbon-intensive products. Overall cost-effectiveness can be increased in a scenario where abatement costs in industries producing these 'dirty' products are relatively low.
- **Sanctioning of countries considered to be not contributing to an international abatement regime.** Learning from game-theory, non-participants might be deterred from free-riding behaviour in the international abatement regime. This argument holds under the assumption that non-participants would experience increased costs due to BCAs.

For the EU, in particular, which represents 16% of the world's imports and exports, it is of interest to explore both the gains and the costs of BCAs. The evaluation of BCAs set out below is made against the backdrop of the EU Emissions Trading Scheme (EU ETS), which for a number of industries located within the EU – current mitigation tools not taken into account – creates higher emissions costs than those of global competitors,<sup>52</sup> which some claim creates a risk of carbon leakage.<sup>53</sup>

Looking at the existing literature on carbon leakage, ex-ante studies, e.g. several theoretical modelling studies, generally identify that in theory EU-ETS is likely to lead to a dislocation of emissions outside the EU, rather than a long-term reduction of emissions or a low-carbon transformation of the industry.<sup>54</sup> Yet, empirical evidence demonstrating carbon leakage is very limited.<sup>55</sup> Indeed, a number of reputable studies find little or no evidence of these effects,<sup>56</sup> at least to the end of phase II of the EU-ETS in 2012.<sup>57</sup>

In addition to being subject to carbon costs through the EU-ETS industries also benefit from a number of instruments to address the risk of carbon leakage, including ex-ante free allocation of allowances as well as in some cases ex post-support (e.g. national compensation mechanisms for the increased costs of electricity due to EU-ETS); these measures may have effectively avoided leakage. For the time being, with an EU ETS still suffering from oversupply and low prices, there are no clear indications that a significant leakage risks exists.

### Overview of the proposed measure

BCAs can serve as a stand-alone or complementary measure to free allocation in order to reduce the risk of carbon leakage. Key features of a BCA regime could include:

- Full or partial replacement of the current carbon leakage free allocation arrangement;
- Selection of affected industries and products in line with the current carbon leakage process and criteria;
- EU-imported products from countries without measures equivalent to the EU-ETS to be subjected to a carbon adjustment levy, expressed in tCO<sub>2</sub>e, according to industry or production benchmark values;

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<sup>50</sup> Clapp (2010). Levelling the playing field in a fragmented carbon market: do carbon-based border tax adjustments work? Climate Science Policy. Available at <http://www.climatescienceandpolicy.eu/2010/09/levelling-the-playing-field-in-a-fragmented-carbon-market-do-carbon-based-border-tax-adjustments-work/>. Accessed 3 June 2016.

<sup>51</sup> Lininger (2015). Consumption-based approaches in international climate policy. Springer Climate.

<sup>52</sup> Apart from a handful, although increasing, of countries or regions globally that require industries to pay for their emissions at similar levels to EU ETS.

<sup>53</sup> E.g. Branger et al. (2014). EU ETS, free allocations and activity level thresholds, the devil lies in the details. Centre for Climate Change Economics and Policy Working Paper No. 190 / Grantham Research Institute on Climate Change and the Environment Working Paper No. 169, October 2014, available: <http://www.cccep.ac.uk/Publications/Working-papers/Papers/190-199/WP-190---Branger-et-al-2014.pdf>; Ralf Martin et al., On the empirical content of carbon leakage criteria in the EU Emissions Trading Scheme, *Ecological Economics* 105 (2014) 78–88.

<sup>54</sup> E.g. Branger et al. (2014), see footnote 3.

<sup>55</sup> E.g. Arlinghaus (2015), "Impacts of Carbon Prices on Indicators of Competitiveness: A Review of Empirical Findings", OECD Environment Working Papers, No. 87, OECD Publishing, Paris.

<sup>56</sup> World Bank (2015) Partnership for Market Readiness: Carbon Leakage – theory, evidence and policy design

<sup>57</sup> Ecorys et al (2013) Carbon leakage evidence project

- Allocating the institutional responsibilities of implementation and enforcement to an existing or newly created agency (assisted by Member States customs authorities).
- Encouraging additional allowance proceeds of Member States to be made available for international climate finance, research and development and similar ends.

## 7.3 Analysis of the measure

### 7.3.1 Economic and emissions implications

Much work has been carried out to model and compare the effects of ETS systems and BCA on both emissions and the economy. Estimates of impacts remain largely hypothetical and subject to modelling assumptions, with different studies pointing to different results and drawing different conclusions. Nevertheless, summarising the main potential positive and negative impacts of a BCA regime within, or instead of, the EU-ETS.

#### Expected positive impacts of BCA

- BCAs can have an **overall positive mitigation impact**. Studies show that replacing the current system with a well-designed border carbon adjustment measure can reduce overall leakage compared to the existing free allocation regime for selected energy intensive sectors.<sup>58</sup> When replacing the free allocation regime BCAs would also be likely to have an impact on allowance prices, leading to an increase, and increasing the incentives for industry to increase mitigation efforts. A side benefit of this is that low emitters would experience the greatest benefit.
- BCAs could act as a **trigger for all countries and industrial players to modernise** their industries and to qualify for adjustment exemption. This in turn will have positive indirect social and environmental consequences, particularly the potential for lowering other emissions to land, air and water from industrial production processes.
- BCAs could **generate additional revenues** for EU Member States. Currently under the EU ETS and according to Article 10(3) of the EU ETS Directive, at least 50% of the revenues from the auctioning of emissions allowances should be used to support climate and energy objectives. Depending on how the BCA revenue is used, this spending could be higher or lower. By replacing free allocation all allowances would be auctioned, increasing the total revenues generated.

#### Expected negative impacts of BCA

- BCAs can lead to **higher costs for EU industry and therefore market prices** due to increased prices of CO<sub>2</sub>-intensive intermediate goods imported into the EU and used by EU industry. Modelling work shows that the costs for EU firms from BCA would increase by more than for non-EU firms, negatively impacting upon competitiveness.<sup>59</sup> This could also perpetuate the risk of carbon leakage, although a reverse border adjustment for exports could mitigate it.<sup>60</sup> A reverse border adjustment could be drawn from the revenues generated by the BCAs.
- BCAs **add at-border-costs and challenge free-trade agreements**. By placing further requirements upon customs staff to potentially carry out manual interventions, and monitor more products and assess by the supplying company the costs at-border can increase. Additionally on top of the direct costs that may be applied to imports, such checks can be perceived as a (non-tariff) barrier to trade which could come into conflict with existing free trade agreements.

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<sup>58</sup> Monjon & Quirion (2012). A border adjustment for the EU ETS: Reconciling WTO rules and capacity to tackle carbon leakage. Available at <https://www.gtap.agecon.purdue.edu/resources/download/5558.pdf>. Accessed 1 June 2016.

<sup>59</sup> Monjon & Quirion (2012), see footnote 6.

<sup>60</sup> Böhringer, Balistreri & Rutherford (2012), The Role of Carbon Border in Unilateral Climate Policy, Results from EMF 29, 34 Energy Economics 79-110.

- BCAs can lead to **increased administrative costs**. Currently, there are already considerable difficulties to monitor and verify emissions in EU. These difficulties could be multiplied under a BCA which would also need to consider international producers.<sup>61</sup> Additional institutional efforts would be needed to define the products to be included under the BCAs, and to set-up industry benchmarks. Also, especially for SMEs, the registration costs could be a significant trade barrier. Lastly, if a carbon crediting mechanism were to be used as part of a BCA regime, it could lead to a debate on the acceptability of different carbon credit types.
- BCAs may not produce a robust answer to **windfall profits for (EU-) industry** as BCAs do not necessarily replace free allocation, but in theory could co-exist with free allocation method, if associated complexities could be addressed. Only full auctioning can mitigate the risk of windfall profits.
- BCAs can **reduce overall economic welfare** due to increased cost-pass through to domestic consumers, resulting from the higher costs experienced by EU industry (see bullet 1).
- BCAs would still lead to **EU producers facing higher production costs when exporting**. As BCAs create competitiveness and an equal playing field only with respect to products consumed within the EU; producers with markets outside the EU would still face the market risk of higher production costs. This could lead to leakage from EU based industries moving their high emission, export-market focused production outside of the EU.

### 7.3.2 Political considerations

For the other measures we have presented legal considerations before political considerations, but recent political and contextual developments have such a strong bearing on the feasibility of this measure we present these first.

**An EU BCA would be damaging to the recent successes in international climate policy.** The Paris agreement in December 2015 has ushered in a period of international cooperation and hope for stronger commitment to climate mitigation. If the EU was to unilaterally impose a BCA regime, this would effectively undermine any trust in the commitments made by other countries and the Paris process.

**Perceived border measures in aviation have already attracted strong international lobbying.** The fierce international response and non-cooperation of many non-EU airlines (for up to four years) with their inclusion, even for intra-European flights, in the EU-ETS provides a signal on the likely international response to a BCA. Indeed, China and India have already registered their concerns and opposition to using trade measures for climate action.

**Unlike aviation a kick-start to the international process is not needed.** It has been argued that the EU inclusion of aviation in the EU-ETS has kick-started a previously glacial international process on aviation emissions,<sup>62</sup> and that a similar kick-start could be achieved for mitigation in industry production. Yet the two sectors are very different, and referring back to the first point, the international process has gained momentum following Paris, the kick-start is not needed and would likely prove counterproductive, risking retaliation in other areas unrelated to climate action.

**Carbon pricing is already being increasingly implemented globally.** The Paris agreement signalled a preference for market based mechanisms, such as EU-ETS, to reduce emissions and global momentum is already strongly towards this. Carbon markets and taxes are being increasingly implemented globally, across states in the USA and Canada, in pilot provinces in China that are planned to become national, and existing or planned schemes in other countries such as Brazil, Chile, Mexico, Turkey, Ukraine,

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<sup>61</sup> Convery, Ellerman, and Kelly (2015). EU Climate Policy – Insights and Interactions, EnvEcon Decision Support Series 2015/2. Available at [http://entracte-project.eu/uploads/media/ENTRACTE\\_Second\\_Policy\\_Brief.pdf](http://entracte-project.eu/uploads/media/ENTRACTE_Second_Policy_Brief.pdf) . Accessed at 3 June 2016.

<sup>62</sup> Condon, M. and A. Ignaciuk (2013), "Border Carbon Adjustment and International Trade: A Literature Review", OECD Trade and Environment Working Papers, 2013/06, OECD Publishing

Kazakhstan, Japan, India, South Korea and New Zealand.<sup>63</sup> Every additional country implementing some form of carbon pricing reduces the need and effectiveness of a BCA regime.

**The political climate in EU is not conducive to BCA.** The fact that the benefits remain largely theoretical at this point, with no large scale proven implementation of BCAs, means they are not very attractive politically. In addition, practically speaking the political process relating to EU-ETS reform is already complex and difficult, pushing through such a radical change as BCA would likely be impossible even if there was demand for it. Industry is already adapted to work within the existing EU-ETS regime – while this has its flaws, correcting these through reform of the current system is the focus of political efforts. Reflecting this, outside academic circles, there is little or no interest in replacing the EU-ETS with BCA. Only if a 'best-of-both-worlds' option, free allocation plus BCA were proposed would this pique the interest of industry, but this would be unacceptable for environmental groups and civil society and face higher legal hurdles.

### 7.3.3 Legal considerations

Keeping the previous reflections in mind, if it was decided to pursue a BCA approach in any case then there are also various international trade law considerations. The following sections outline the various legal hurdles and how these could be overcome through careful design.

#### *Key Messages*

**Multiple questions of WTO compatibility.** Border Carbon Adjustments (BCA) in the form of allowance requirements for carbon-intensive products (products whose production is carbon-intensive) raise multiple questions of compatibility with WTO law, in particular under the non-discrimination principles of National Treatment (NT) and Most-Favoured Nation (MFN) treatment.

**Legal justification is in principle possible, but implies complex design requirements, and cannot co-exist with free allocation.** While it is arguably and in principle possible to avoid violations of the relevant GATT provisions and/or justify them under the general environmental exceptions provisions through careful design and provided certain legal interpretations are upheld, implementation in practice of the design requirements will in any case be very complex. It also appears clear that an allowance-based BCA could not coexist with free allocation unless a fully equivalent rebate is granted to/for imported goods.

**WTO dispute settlement is likely, with outcome not predictable.** Both the WTO legal interpretations supporting a BCA and their effective application through appropriate design would likely be tested rigorously through formal dispute settlement cases that WTO Members affected by the measure would be very likely to pursue before WTO panels and the Appellate Body. While there are good reasons to believe that the Appellate Body would ultimately uphold a BCA measure that is designed to respect all parameters and applied in good faith, the sheer complexity of doing so means that virtually in any case a significant risk would remain that the measure would be found to violate WTO law. That said, because WTO law requires compliance in the future but does not foresee the payment of damages or other remedies for past violations, from a purely legal perspective "testing the limits" does not carry much risk. That is obviously very different from a political perspective.

#### *Compatibility with WTO Law and Summary of Resulting Design Requirements*

It is in principle conceivable to design an allowance-based BCA that satisfies WTO law. However, the demands on the design are significant and difficult to meet.

A BCA in the form of a requirement to purchase/surrender allowances upon importation would probably not be assessed under the strict GATT Article XI, but rather only under the non-discrimination clauses under GATT Articles I and III.

Where the BCA is assessed under **Article I (MFN)** a violation could be contested on the basis of likeness, i.e. that the products from both types of countries are not alike because the amount of internalised carbon

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<sup>63</sup> Ecofys and World Bank (2015) State and Trends of Carbon Pricing 2015

costs differs, but existing case law is inconclusive on the likelihood of this being successful. Violation of Article I could only be securely avoided if there was:

- no differentiation between countries of origin based on their carbon policies; **and**
- no differentiation between more and less carbon-intensive production methods.

Where the BCA is assessed under **Article III (National Treatment)** a violation would most likely be avoided if:

- there was no free allocation to EU producers of competing (like) products, unless a fully equivalent rebate is granted to/for imported goods;
- the allowance requirements on foreign products would be calculated using a best available technology (BAT) benchmark; and,
- To the extent that better performances than under BAT are in fact possible importers would have to be granted a reasonable opportunity to prove less carbon emissions than BAT; and correspondingly less allowances would have to be required.

Violations of Art. I or Art. III could in principle be **justified under the General Exceptions clause in GATT Art. XX**, in particular under its **paragraph (g)** (“relating to the conservation of exhaustible natural resources”). The climate and/or the atmosphere would very likely qualify as a ‘natural resource’ for purposes of this provision, but with space for debate over the question and measurement of conservation (mitigation).

Using the exemption clause would require “even-handedness” in the treatment of domestic and imported goods and that any measures avoid arbitrarily discriminating against countries with similar measures or act as a disguised restriction on international trade. This would likely mean for the design of the BCA:

- No free allocation of allowances in the EU, unless a fully equivalent rebate is granted for imported goods.
- Comparable ease of access to accepted allowances for imported products / their importers as compared to domestic products/their producers.
- Full recognition of local conditions in other countries, i.e. exemption from allowance requirements of products produced in countries with comparable climate policies, and possibly also partial exemptions in proportion to partially comparable efforts.
- Partial to full exemption of products from developing countries based on the principle of historical responsibility / CBDR.
- De minimis exemptions for the importation of smaller quantities in view of otherwise disproportionate administrative burdens on small importers.

## 7.4 Conclusion

Summarising the main messages presented above we can conclude that:

**While BCAs may have theoretical advantages, they have not yet been successfully implemented anywhere.** Potential advantages include the protection of the competitiveness of industry in the BCA area, high climate mitigation effectiveness and attaching a price to inaction for other countries.

**BCAs help prevent carbon leakage in principle, but there is little or no evidence of leakage taking place.** While there may be risk of carbon leakage within an emission trading system, there is to date very little or no empirical evidence of carbon leakage taking place within EU ETS. This suggests that free allocation is addressing this risk, and that BCA is unnecessary.

**BCA economic impacts would be broadly negative.** Due to the increased costs of imported intermediate inputs for EU industry, leading to higher product prices and reduced consumer welfare. In addition the administrative costs associated with BCA are likely higher than the existing regime.

**Although BCA mitigation impacts would be positive.** A BCA should have high climate mitigation integrity and provide an incentive for producers outside the EU to reduce their emissions.

**BCAs would go against the current international climate policy thrusts.** The Paris agreement and the momentum it has generated would be significantly undermined by a BCA. Carbon pricing is already increasingly widespread globally and is likely to become more so in the coming years, reducing the need for BCA.

**And could provoke a large international response.** If the EU implemented BCAs unilaterally they would not only undermine the international process from Paris but would also lead to a strong response, a host of legal challenges, likely long periods of non-compliance and potential retaliatory measures in other areas.

**And also run counter to the EU climate policy thrusts.** The EU policy process for EU-ETS is already complex and difficult, an EU-ETS revision proposal is already in the co-decision process with intense discussions on many issues. A radical proposal such as BCA is most likely a non-starter given the existing issues. There is also little appetite for BCA among the main EU stakeholders.

**For all these reasons an EU BCA is very likely politically unacceptable.** If there were large scale backsliding on international commitments and no further momentum on global carbon pricing, then it is foreseeable that BCA could bear further consideration and be more politically attractive in future.

**If it was still decided to proceed, there would be legal complications, due to international trade law.** Multiple questions apply, in particular under the non-discrimination principles of National Treatment (NT) and Most-Favoured Nation (MFN) treatment.

**Good design could deal with legal issues, though there is no guarantee of successful defence.** We outlined above the different steps that could be taken to comply with WTO rules and align with EU law, including that the current free allocation system would need to be removed to ensure compatibility. The design changes appear to be theoretically achievable. Nevertheless legal challenge is almost inevitable, and would result in a long and expensive process, with no guarantee of success for the EU.

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