European Commission services' Position Paper on the Sustainability Impact Assessment in support of negotiations of an Investment Agreement between the European Union and the People's Republic of China

May 2018

1. Introduction

This paper sets out the European Commission services' position on the Sustainability Impact Assessment ("SIA") on a Comprehensive Agreement on Investment ("CAI" or "Agreement") between the European Union ("EU") and the People's Republic of China ("China"). The SIA was commissioned by the European Commission's Directorate-General for Trade and was carried out by a consortium of independent consultancy companies comprising Ecorys Nederland, Oxford Intelligence, TNO and Reichwein China Consult ("consultant"). It was completed in December 2017.

SIAs are trade and investment specific assessments carried out by external consultants to support major trade negotiations. The Commission has been carrying out SIAs as part of the EU's trade and investment policymaking since 1999. They are designed to provide negotiators and policymakers with an evidence-based *ex ante* assessment of the potential sustainability impacts that may arise from a proposed agreement.[1]

[1] For more information about the tools the Commission uses to evaluate EU trade policies, please visit: http://ec.europa.eu/trade/policy/policy-making/analysis/policy-evaluation/.

SIAs assess how the trade and investment related provisions of the agreement under negotiation could affect economic, social, human rights and environmental issues in the EU and in the partner country/ies, but also in other relevant countries, and propose measures to maximise the possible benefits of the agreement or mitigate possible negative impacts. SIAs are also important tools for consultation and communication with stakeholders, contributing to the transparency of the negotiations.

The SIA of the EU-China CAI built on the Impact Assessment conducted by the Commission in 2013, which accompanied the process up to the formal opening of negotiations. It drew on the methodological framework set out in the Commission's Handbook for Sustainability Impact Assessment.[2]

The SIA complemented the existing analysis by updating and expanding the assessment of the potential impacts of the Agreement on social and labour aspects, human rights and the environment, but also on EU competitiveness (with a special focus on small and medium enterprises ("SMEs")), consumers and potentially significant impacts on third countries, notably least developed countries ("LDCs") and low income countries ("LICs"). It also examined the potential impacts on six key economic sectors comprising transport equipment, mining and energy extraction, chemicals, manufacture of food and beverages, finance and insurance, and communication and electronic equipment.

The SIA process included a wide consultation of interested parties in both the EU and in China, which enabled the consultant to take into account views from a broad base of actors from different sectors and to raise awareness about the proposed Agreement. In particular, the main outreach activities consisted of electronic consultation and dissemination (through a dedicated SIA website, electronic newsletters and social media), three Civil Society Dialogues for EU civil society, a SIA stakeholder workshop in Brussels held on 5 July 2016, personal interviews and online surveys.[3]

The EU-China CAI negotiations

The EU-China CAI negotiations were officially launched during the 16th EU-China Summit held on 21 November 2013 and the first round

[2] http://trade.ec.europa.eu/doclib/docs/2016/april/tradoc_154464.PDF.

[3] For details, see chapter 8 of the SIA and http://www.trade-sia.com/china/.

of negotiations took place in Beijing in January 2014. In January 2016 the parties reached clear conclusions on an ambitious and comprehensive scope of the Agreement.

CAI will be the first EU's stand-alone comprehensive investment agreement providing investors on both sides with both predictable, long-term access to the EU and Chinese markets and investment protection. Technically, it will replace the 26 bilateral investment protection agreements currently in place between China and 27 EU Member States (all but Ireland). On substance, it will improve market access opportunities by establishing a genuine right to invest and by protecting investors against discrimination, uncompensated expropriation and unfair treatment while preserving the host states' right to regulate. It will also address key challenges of the regulatory environment (including those related to transparency, licensing and authorisation procedures), sustainable development and dispute settlement. Regarding sustainable development, the future agreement will comprise rules on environmental and labour-related dimensions of foreign investment.

Following the agreement on scope in 2016, China and the EU moved into specific text-based negotiations. By May 2018, 16 rounds have taken place during which the parties discussed their respective proposals for the various articles of the Agreement. It follows that the provisions referred to in this position paper relate only to the EU's proposals and objectives, as the Agreement is not yet concluded.

As mentioned, the CAI SIA includes a quantitative and qualitative analysis of the Agreement's impacts on the EU and China in economic, social, human rights and environmental terms. The analysis was carried out in the context of wide reviews of academic literature, the EU's positions in the negotiations and a variety of stakeholders' perspectives. In particular, chapters 3 to 6 of the final report assess its potential economic, social, human rights and environmental impacts, chapter 7 focuses on the expected sustainability impacts for the abovementioned six key sectors whereas chapter 9 provides policy recommendations aimed at maximising the possible beneficial impacts of the Agreement and at mitigating its potential negative externalities. The final report is publicly available on DG Trade's website:

http://ec.europa.eu/trade/policy/policy-making/analysis/sustainability-impact-assessments/assessments/

This position paper constitutes the European Commission services' response to the SIA's findings and recommendations. Section 2 of the paper provides an overview of the consultant's findings, focusing on the expected impacts of the CAI. In Section 3, the Commission services examine the SIA recommendations and how they have fed into and will continue to feed into the negotiation process. As conclusion, Section 4 provides an overview on the results of the assessment and on the recommendations.

2. Overview of the consultant's findings

Overall, the final report finds that the EU-China Agreement is likely to have positive albeit moderate economic impact as better market access and investor protection are expected to result in an increase in investment flows. While some stakeholders expressed concerns regarding the influence of foreign investors on social, human rights and environmental standards, the SIA analysis mainly points at small but positive effects as a result of the Agreement. Effects on third countries, notably least developed countries ("LDCs") and low income countries ("LICs") are expected to be negligible.

2.1. Economic impacts

The SIA confirms the economic rationale for an EU-China comprehensive agreement on investment. It finds that an ambitious liberalisation agreement with significant market opening would potentially lead to an increase of 1.9% in the EU's existing foreign direct investment ("FDI") stock in China, whereas Chinese FDI stock in the EU would potentially increase by 0.9%. Enhanced regulatory transparency and legal certainty could also stimulate new EU and Chinese investors to enter both markets. This latter forecast led the consultant to affirm that the aforesaid quantitative findings are likely to underestimate the increase in bilateral investments.

Compared to the 2013 Impact Assessment, the SIA offers more insights into specific sectors. It predicts that all six key sectors[4] would benefit from the CAI as China would reduce its current restrictions and investment-barriers on a wide range of foreign products and services. The increase in EU output to China is expected to also lead to a rise of both low and high skilled employment in the EU.

[4] Transport equipment, mining and energy extraction, chemicals, manufacture of food and beverages, finance and insurance, and communication and electronic equipment.

With specific regard to the chemical sector, the consultant noticed that increased FDI from the EU could have positive indirect effects. The chemical sector is still one of the main contributors to soil and water pollution in China despite the adoption of more stringent environmental regulations over the last years. Thus, EU multinational enterprises could bring higher technological standards and compliance with international environmental regulations, enhancing a spill-over effect of responsible and sustainable practices into local companies in China.

On the other hand, the SIA cautions that the removal of investment-related barriers in the transport equipment sector could also go to the benefit of countries other than the EU. The Commission services highlight however that the spill-over effects related to increased regulatory transparency cannot be considered as a negative impact. Transparency of the regulatory process is a cornerstone of the Commission's initiatives so as to improve the quality of law making in the European Union. Transparency of trade negotiations is a key principle of the EU's trade policy, as set out in the *Trade for All*[5] strategy in 2015.

The SIA also notes that EU and Chinese SMEs can be expected to benefit from the Agreement as they typically face disproportionate costs from investment-related obstacles. Moreover, some positive market access and productivity spill-overs effects can be expected for local SMEs in both the EU and China. The CAI may in fact raise awareness of investment opportunities for such enterprises and contribute to other EU activities supporting SME investment in the country.

Additionally, labour productivity and income are expected to increase in the EU as a result of the CAI although the consultant sounds a note of caution about Chinese FDI into the EU. These concerns mainly relate to the fact that Chinese companies, either SOEs or private companies receiving preferential treatment from the Chinese government, seem to use acquisitions for obtaining expertise and advanced technologies from the EU.

2.2. Social impacts

[5] COM/2015/497 final.

The SIA concludes that economic gains would not come at the expense of social variables and interests. On the contrary, an increase in FDI from the EU operating in China could have the dual effect of exporting capital, know-how and corporate social responsibility ("CSR")/responsible business conduct ("RBC") practices into the country. By way of example, the consultant signalled that working conditions in China could improve as EU companies compensate workers for overtime and have lower employee turnover. Also industrial relations practices can be expected to benefit since, as the consultant highlights, well-run European companies allow for more consultations with employees.

The SIA also notes that consumer prices are expected to remain the same or witness a very limited drop because the scope of the Agreement is not to reduce or abolish tariffs. At the same time, surveys conducted during the SIA process revealed concerns over other types of impacts on consumers. Stakeholders fear that the threat of investor-to-state disputes permitted under the Agreement could lead to the erosion of national policy autonomy in the form of forced regulatory restraint, and hence ultimately impact on consumers who would not benefit from such new or stricter regulations. While acknowledging these concerns, the SIA points out that the EU's reformed approach on investment dispute settlement – the investment court system ("ICS") – and the explicit safeguards to the right to regulate therein significantly reduce the likelihood of constrained regulatory decision making.

2.3. Human rights impacts

At the outset, the SIA notes that the CAI’s impact on human rights – either positive or negative – will largely depend on the soundness of the domestic legal frameworks and their compliance with international standards. In addition, since the Agreement does not include specific human rights provisions as it is limited to investment protection and market access, the SIA notes that its overall impact on human rights would be mainly indirect.

Having clarified these two points, the SIA then estimates that such indirect effect is likely to be positive although minimal, and it would mainly derive from the increased engagement of the Parties on labour- and environment-related aspects of investment following from the sustainable development provisions. An increase in FDI from the EU could also promote economic stability and growth, increase employment and, as a result, lead to better living standards and less poverty. Additionally, EU investors would be expected to value and protect human rights, especially as they often include

CSR and RBC practices in their business operations. With an increase in Chinese investment in the EU, these investors are expected to observe EU human rights as implemented in various pieces of legislation and hence no negative impacts are expected in the EU.

The SIA also finds that an institutional mechanism under the CAI might provide an opportunity for participation of non-state stakeholders in discussions on labour and environment related aspects of investment. The obligation to ensure transparency and to promote public participation and public information might also positively impact the right of freedom of expression, especially in China.

Finally, as mentioned above, the SIA points to the CAI's potential litigation risk. It echoes stakeholders' calls for China and the EU to retain sufficient policy space under the Agreement to undertake the necessary reform process to promote social inclusion, labour rights and the protection of human rights. On the other hand, the SIA notes that the right to regulate will be embedded in the Agreement and hence the policy space will be preserved.

2.4. Environmental impacts

The SIA shows that the CAI is unlikely to cause any deterioration of environmental quality. On the contrary, the Agreement could contribute to greening the economy and to more sustainable production in China as EU companies perform higher internal environmental practices and supply more environmentally friendly technologies. This greening effect would determine a positive technological spill-over onto domestic firms in China. With regard to international environmental commitments, the SIA forecasts that the CAI could even further push China to reach its 2015 Paris Agreement target on carbon emissions.

On the other hand, the SIA mentions the risk of EU companies benefitting from less stringent environmental regulations in China than in the EU. In spite of considerable improvement in recent years, the Chinese environmental regulatory system is still considered to be inadequate, mainly due to poor implementation and enforcement capacity. Against this background, CAI commitments to effective implementation of the multilateral environmental agreements and encouraging governments to promote international guidelines and principles on CSR/RBC would address these concerns.

3. Commission services' views on the recommendations

The consultant lists a set of recommendations with the purpose of enhancing the positive impacts and preventing or mitigating the negative impacts identified in the SIA report. This section provides the Commission services' response.

3.1. Economic impacts

The SIA recommends the Commission to negotiate an ambitious agreement in terms of market opening, procedural fairness and transparency in order to achieve the maximum potential benefits for EU investors, particularly in the transport equipment, mining and energy extraction, finance and insurance sectors. The Commission services agree with the recommendation. The EU-China CAI negotiations are the main tool to address issues EU investors face in China, notably by improving market access, establishing a reliable and more transparent regulatory environment and an effective level playing field. To this end, the Commission services regularly consult EU industries to ensure that their interests and concerns are properly considered and reflected in the negotiation outcomes.

The Commission services also agree with the recommendation that increased investment in the mining and energy extraction sectors should not undermine the countries' right to regulate in these sectors. To this end, the EU's proposal on the right of governments to regulate in the public interest includes a full, effective and operational article. This article will guide in the interpretation of the provisions of the Agreement. These are ground-breaking improvements to the protection of the right to regulate compared to traditional investment agreements, and will ensure that the goal of protecting and encouraging investment does not affect the ability of the EU and its Member States to continue to pursue public policy objectives.

The SIA also emphasises the importance of increasing the level of awareness and information about the negotiations, especially in the chemicals, communication and electronic equipment sectors. The Commission services agree with the importance of informing European investors on the increased opportunities for investing in China. Since the launching of the negotiations and even more once the Agreement enters into force, the EU is committed to extensively communicate its benefits to all interested parties.

Lastly, the consultant recommends monitoring the development of investment flows from the EU and China to the poorest countries in the South-East Asian region, as well as their participation in value chains with China and the EU, especially in those sectors that will experience the highest degree of market opening by the agreement. The Commission accepts the recommendation. The report emphasises that the CAI's impacts on third countries appear to be limited. Nonetheless, during its regular contacts with countries in the South-East Asian region, the Commission will seek to address specific concerns raised about the CAI. The Commission will also use the *ex post* evaluation to look into the effects of the agreement in relation to the South-East Asian region.

3.2. Cross-cutting sustainable development impacts

As a general recommendation, the SIA emphasises that the EU-China CAI should include provisions on sustainable development to ensure EU and Chinese investors' compliance with core international labour, environmental and human rights standards, and encourage responsible behaviours by investors.

The Commission services agree with the importance of including a sustainable development chapter in the Agreement. Such provisions are derived from similar provisions of the EU Free Trade Agreements, and tailored to the specificities of an investment agreement. Against this background, in CAI the Commission services seek an ambitious chapter on investment and sustainable development, including commitments to high levels of environmental and labour protection as well as CSR/RBC. The chapter would also promote investment favouring sustainable development.

The SIA also calls for the establishment of an institutional mechanism that would allow discussing matters covered by the sustainable development chapter and promote transparency, consultation and participation of interested third parties.

The Commission services take due account of this recommendation and note that the EU proposal foresees the establishment of an institutional structure overseeing the agreement allowing for discussion between the parties on a whole range of matters covered by the agreement, including sustainable development issues.

Secondly, the Commission services point out that EU agreements foresee an institutional mechanism allowing the parties to submit any dispute with respect to the interpretation or the application of the sustainable development chapter to a panel of non-state experts, which may make recommendations for its solution. The Commission's aim is that the CAI would also commit the parties to review the impact of the agreement on sustainable development through their respective participative processes and institutions.

Thirdly, as mentioned above and in the SIA, the Commission is proposing to replace the existing EU Member States' investor-to-state dispute settlement mechanisms included in their bilateral investment agreements with an investment court system ("ICS"). The proposed new system envisages hearings open to the public and will allow interested third parties to submit *amicus curiae* briefs. Members of the tribunal will also have the ability to appoint non-state experts to report on any factual issue concerning environmental, labour, human rights or other matters raised in the dispute.

The SIA also advises EU-China CAI negotiators to include a commitment of the parties to promote investment in a way contributing to sustainable development, for instance, through enhanced coordination of their policies, dialogue and cooperation, and stakeholder consultation. This would in fact strengthen the parties' respective implementation and enforcement systems, notably with respect to ensuring international labour and environmental standards, and social inclusion. The Commission services agree with the importance of dialogue and cooperation between China and the EU on sustainable development and propose relevant provisions to achieve these objectives.

The SIA also recommends including in the Agreement CSR and RBC objectives so as to encourage European and Chinese companies to comply with international labour, environmental and human rights standards.

The Commission services agree with the recommendation. Recognising the important contribution of CSR/RBC practices to high level of labour and environmental protections, the sustainable development chapters in EU bilateral trade and investment agreements include commitments by the parties to promote the uptake by companies of CSR/RBC practices in line with the relevant internationally agreed principles and guidelines such as the United Nations Global Compact, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy and the OECD Guidelines on Multinational Enterprises.

Moreover, it is worth mentioning a recently launched pilot programme on "Responsible Supply Chains in Asia" funded by the EU, and which is being implemented by the ILO and the OECD that will promote CSR/RBC in all its dimensions such as the respect of the environment, the promotion of decent work and the respect of human rights. China will be one of the partner countries.

Additionally, the 2014 non-financial disclosure Directive[6] requires listed companies and other public-interest entities with more than 500 employees during the financial year, regardless of where these employees are located (i.e. approx. 6 000 large companies and groups across the EU) to disclose information on policies, results and risks concerning environmental aspects, social and employee-related matters, respect for human rights, anti-corruption and bribery issues. The first reports will be published this year.

The previous recommendation is accompanied by the suggestion to include in the Agreement monitoring mechanisms focusing on company behaviour such as the OECD National Contact Points ("NCPs") under the OECD Guidelines on Multinational Enterprises. The Commission services recognise the usefulness of the NCP mechanisms. As explained above, the EU proposes to its partners that the parties to an investment agreement promote the uptake by companies of CSR/RBC practices in line with the relevant international guidelines such as the OECD Guidelines on Multinational Enterprises. The National Contact Points constitute a useful tool to handle enquiries, and contribute to the resolution of issues that may arise from the alleged non-observance of the Guidelines by investors.

Finally, the SIA indicates that the parties should support business forums aiming at exchanging good practice on human resources policies and sustainable businesses. The EU Commission services agree on the central role that businesses and business forums can play at exchanging good practice on promoting responsible business practices, and as highlighted above has been actively promoting similar initiatives.

3.3. Social impacts

Focusing specifically on labour impacts, the SIA recommends that in order to ensure that domestic labour law and practices provide for effective protection, the Agreement should include commitments on respecting the core labour standards and to effectively implement the ILO Conventions each party ratified.

The Commission services agree with the importance of including labour provisions in the Agreement to ensure that the increased investment is mutually supportive to the protection of labour rights on both sides. To this end, the EU seeks, in line with its approach in other trade and investment agreements, that as members of ILO the EU and China commit to respect,

[6] https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

promote and realize the ILO's fundamental principles and rights at work, and to effectively implement the ratified ILO Conventions, and progress towards ratification of ILO fundamental conventions that have not been ratified yet. This would be complemented by a commitment between the parties to dialogue and cooperation on labour-related matters.

3.4. Environmental impacts

The Commission services have taken note of the consultant's recommendations in relation to the environmental impacts. In particular the Commission services agree with the importance of promoting investment that favours green growth and fostering cooperation to encourage these processes, in addition to the need for effective implementation of the key international environmental agreements.

In this context, in addition to the cross-cutting provisions in the sustainable development chapter such as promoting involvement of stakeholders and the roles and responsibilities of investors from both sides in line with the CSR/RBC practices, the Commission seeks ambitious environment related provisions, including commitments to pursuing high levels of environmental protection in domestic law and effective implementation of multilateral environmental agreements.

3.5 Human rights impacts

The SIA calls on the CAI to allow both parties to engage in legitimate regulatory actions to protect human rights without the risk of liability to investment dispute and compensation claims.

The Commission services share this concern and broadly agree with the recommendation. As the SIA itself notes, recent EU agreements such as the CETA and the EU-Vietnam FTA already set a very high benchmark with respect to the protection of the right to regulate, notably when compared with the approach taken in other investment agreements concluded by China.

The EU-China CAI will re-balance the context in which investment protection standards are interpreted by giving substantive guidance to the adjudicators of investment disputes. Besides a reference in the preamble to the right to regulate (a significant innovation as compared to the traditional approach to refer exclusively in the preamble to the economic imperative of promotion and protection of investments), the EU intends to pursue its practice of including a specific clause expressly preserving the right to regulate, in addition to clearly worded standards of protection.

The SIA also stresses the need to address private actors' potential abuse on human rights and to consider the full range of permissible preventative and remedial measures. According to the SIA report, the agreement should also recall the States' duty to protect and promote the rule of law.

The Commission services broadly agree with the recommendation. As noted above and in the SIA, the CAI will promote the uptake by companies of CSR/RBC practices, which also cover human rights standards, in line with relevant international guidelines such as the OECD Guidelines for Multinational Enterprises, the UN Global Compact, the UN Guiding Principles on Business and Human Rights.

Moreover, while the scope of the agreement is limited to investment protection and market access opening, it still contains preambular language reaffirming the parties' commitment to democracy and fundamental rights, recognising the importance of international security, human rights and the rule of law for the development of international cooperation. This preamble language does not by itself compel the EU and China and their investors but it provides interpretative guidance for the implementation of the agreement.

Finally, the SIA suggests establishing a body or mechanism with the participation of gender and human rights experts in the EU and China to assess the link between investment and gender and to propose policy measures to mitigate the potential differentiated impact of foreign investment on men and women. The Commission services acknowledge the need to monitor the link between investment and gender, noting however the need for more data and information on the CAI's potential impacts on gender balance.

4. Conclusion

The SIA confirmed the potential economic benefits, as well as the overall positive social, environmental and human rights impacts that the EU-China CAI could have on China and the EU. The consultant also identified specific risks associated with the Agreement and proposed a number of policy measures to maximise the benefits of CAI while mitigating potential risks.

The Commission services have taken note of the findings and recommendations of the SIA and as described above have already taken them into account as much as possible during the negotiating process that started in January 2014 and intend to continue doing so in the future.