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# THE REFORM OF THE EU SUGAR SECTOR: IMPLICATIONS FOR ACP COUNTRIES AND EPA NEGOTIATIONS


**SYNOPSIS**

This note is to provide comprehensive account of the legal and political background of the current reform of the EU sugar sector and of the implications of the reform and related EU policies for ACP countries. An assessment of the impact of the EU reform on sugar imports from ACP countries is provided against the background of the ongoing negotiations of EU-ACP Economic Partnership Agreements.



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**EXECUTIVE SUMMARY**

Since more than three decades, the EU upholds an extremely costly supply management scheme for its domestic sugar market which insulates domestic farmers and producers from international market forces by means of strong price support and import-prohibitive tariffs. This market regime has resulted in domestic prices three times higher than world market prices as well as a production surplus which can only be exported by means of large amounts of subsidies. At the same time, the EU has granted duty free market access for guaranteed quantities to some of its member states' former colonies at guaranteed prices. The Sugar Protocol, which provides for these preferences to 18 African, Caribbean, and Pacific countries, has proven to be highly remunerative for ACP producers. In some cases, the preferences have allowed high cost sugar producers to stay in business despite their lack of competitiveness. However, they enabled ACP policy-makers to invest extra revenue derived from the sugar sector into economic diversification and other development activities.

In 2003, three of the most efficient sugar producers which do not have access to the highly protected EU market, namely Brazil, Australia, and Thailand, filed a complaint against the EU, claiming that the EU subsidized sugar exports beyond the levels agreed to in Uruguay Round world trade negotiations. The challenged measures included the subsidization of the export of 1.6 million tons of ACP and Indian origin which the EU used to export at subsidized rates due to the oversupply of its domestic market. A WTO panel and the Appellate Body ruled in favor of the complainants, finding that the EU exceeded its export subsidy commitment level by the exported quantity of 2.8 million tons. In turn, the EU was obliged to bring its domestic market regulation into conformity with its WTO obligations.

In response, in February 2006, the EU adopted a radical reform programme for the period 2006/07 to 2009/10. The reform primarily aims at the significant reduction of domestic production, from about 20 million tons to 12 million tons, in order to render the necessity to export over-supply quantities obsolete and, thereby, to comply with the WTO dispute settlement decision. To achieve this objective, the reform provides for the reduction of the domestic price by 36% over four years, in order to reduce production incentives. Moreover, the legislation offers strong financial incentives to EU producers who are willing to renounce production rights and cease production. The price reductions, however, stand in stark contradiction to the interests of ACP beneficiaries of the Sugar Protocol, since the guaranteed price under the protocol has traditionally resembled the EU domestic price.

But the EU sugar market reform has yielded even more severe consequences for the signatories of the Sugar Protocol. In September 2007, the EU denounced the Sugar Protocol, providing for the termination of preferences by October 2009. The denunciation has two main reasons. First, EU policy-makers take pressure off the over-supplied domestic market which has proven to be relatively resistant to the initial reform efforts. The elimination of guaranteed imports hence complements efforts to reduce domestic over-supply. Secondly, it is more than questionable whether the Sugar Protocol, if upheld for indefinite duration, would withstand a legal challenge under WTO law. This is because the Sugar Protocol preferences generally violate non-discrimination obligations contained in the GATT 1994. The EU had received a 'waiver' with regard to these obligations from WTO members, which allowed it to grant trade preferences under the Cotonou Agreement, of which the Sugar Protocol is

an integral part. The WTO waiver expires by the end of 2007. By 2008, the preferences would seem to be highly vulnerable to legal challenge from other WTO members. The denunciation of the Sugar Protocol remedies this vulnerability with effect from October 2009.

Both the EU reform and the denunciation of the Sugar Protocol exert severe effects on sugar trade with the ACP beneficiaries of the protocol. Some ACP high cost producers are highly likely to cease sugar production due to the price reductions. Others will face a strong reduction of their export earnings derived from sugar exports to the EU. Only a small group of competitive LDCs will be comfortable in further supplying the EU market after the price reductions have been implemented and the preferences have been terminated. Those countries are also likely to be able to offset losses in export earnings by expanding exports under the EU's Everything but Arms (EBA) initiative.

In order to mitigate the adverse effects of the reform on ACP sugar producers, the EU has made available €1.284 billion of adjustment assistance. The funds are to finance Multi-Annual Adjustment Strategy (MAAS) plans of the 18 ACP Sugar Protocol states over eight years. They aim at enhanced competitiveness, diversification, and the financing of broader adjustment needs of individual states. The availability, however, is dependant on a low degree of competitiveness of the respective state and the degree of reliance on the preferences. The EU measures give rise to concern in two respects. First, the adjustment assistance appears to be inadequately funded, given the fact that several sugar producing states will be forced to cease production completely. Secondly, the eligibility criteria seem to put competitive sugar producers, for which exports to the EU account for a comparatively small share of production, in an unfavorable position. This would be highly unjustified since the foreign exchange revenue derived from sugar exports to the EU embodies an important source of income for almost every Sugar Protocol country, not only for 'less reliant' or 'less competitive' ones.

On a parallel track, the EU has made ACP countries a market access offer on sugar as part of the EU–ACP negotiations of Economic Partnership Agreements (EPAs). The EPAs are supposed to succeed the unilateral, non-reciprocal trade preferences of the Cotonou Agreement for which the WTO waiver expires by the end of 2007. The new trading arrangements are sought to resemble free trade areas, in compliance with Article XXIV of the GATT 1994. The EU market access offer on sugar, however, is disappointing in several respects and leaves most Sugar Protocol beneficiaries worse off. First, the EU seeks to make non-LDC sugar exports subject to a safeguard clause which might render it impossible for these states to offset losses due to price reductions by expanding their exports to the EU. Secondly, not even the new domestic reference price would be guaranteed to ACP exporters. In other words: ACP and EBA exporters, resembling the most vulnerable economies world wide, would find themselves in price competition for access to the EU market – exerting downward pressure on prices and hence adverse effects on export earnings. In the worst case, one or more ACP countries could be driven out of the supply market. In consequence, previously made investments in the sugar sector would be lost.

This scenario contradicts the EU obligation under the Cotonou Agreement to provide ACP countries with benefits similar to the pre-EPA situation. Therefore, ACP countries need to stand firm in EPA negotiations in order to prevent an unacceptably restrictive safeguard clause, to receive guaranteed export prices, and to receive initial quotas which are large enough to offset losses due to price reductions.

## I. INTRODUCTION

1. Triggered by the results of recent WTO dispute settlement, the Council of Ministers of the European Union, in February 2006, passed legislation which radically reforms the EU sugar sector within the subsequent four years, yielding significant effects on EU sugar production, exportation, and importation. The reform and the scope of accompanying EU measures are of critical importance for ACP sugar exporters to the EU which have benefitted from highly lucrative preferential market access under the Sugar Protocol for the last 30 years.

2. The reform of the EU sugar market coincides with the requirement to bring the non-reciprocal ACP trade preferences granted by the EU into conformity with WTO law by the end of 2007. Compliance with WTO law requires the replacement of the non-reciprocal and exclusive preferences by reciprocal free trade agreements which are currently negotiated within the framework of Economic Partnership Agreements (EPA) between the EU and the different ACP regions. These negotiations include the review of the preferences granted under the Sugar Protocol which has been denounced on behalf of the EU with effect from October 2009.

3. The combined effect of the EU domestic reform, the denunciation of the Sugar Protocol as well as the negotiation of reciprocal ACP-EU trade arrangements implies that ACP sugar exporters to the EU face a dramatic change of their long-lasting sugar trade relations with the EU, which has accounted for a stable and substantial income for their small and vulnerable economies. As shall be demonstrated, the EU sugar sector reform and the loss of exclusive ACP market access preferences significantly alters ACP exporters' competitive environment and, in some instances, poses a credible threat not only to their sugar producing sectors but to their economies as a whole.

4. Against this background, an assessment of the value of the new EU market access offer for ACP sugar, which was announced within the context of the current negotiations of the EPAs, is of crucial importance. The EU has the moral and legal obligation to provide the small and vulnerable ACP economies with market access for sugar that is worth no less than the previous trade arrangement and that continues to contribute to the realisation of ACP countries' economic development and poverty reduction.

5. Given this context, this note is to provide a comprehensive account of the legal and political background of the current reform of the EU sugar sector and the implications of the reform and related EU policies for ACP countries. An assessment of the impact of the reform on sugar imports from ACP countries shall be provided in light of WTO legal requirements and the substance of ongoing negotiations of EU-ACP Economic Partnership Agreements.

6. The following chapter provides an overview of the status quo of the EU Common Sugar Market Organisation (CMO) and the preferential market access that is granted to certain ACP countries under the Sugar Protocol. Moreover, the importance of these preferences for ACP economies is highlighted.

7. Subsequently, Chapter III sheds light on the international and domestic factors which have pressurized EU policy-makers to design and implement a radical reform of the EU Common Sugar Market Organisation, namely the need to comply with the results of recent WTO dispute settlement and to prepare the implementation of concessions regarding export subsidization within the WTO framework. Secondly, the chapter shall shed light on the WTO legal status of the preferences granted by the EU under the Sugar Protocol. As shall be demonstrated, the uncertainty regarding the legality of the Sugar Protocol under WTO law adds to the forces which have pressurized the EU to terminate the sugar preferences by October 2009. Moreover, this decision complements the efforts of the EU to reform its domestic sugar sector and transform from a net sugar exporter to a net importer by 2010.

8. Chapter IV outlines the substance of the current EU reform of the CMO and further elaborates on how the domestic reform effort matches up with the termination of preferential treatment of ACP sugar exports under the Sugar Protocol. Additionally, the chapter highlights the scope of EU measures which are designed to assist ACP Sugar Protocol states in coping with the adverse effects of the EU domestic reform on their earnings derived from sugar exports to the EU. A final section points out the short term effects of the reform and the termination of preferences on ACP Sugar Protocol states.

9. Chapter V then compares the losses and adverse effects faced by ACP Sugar Protocol states to potential gains derived from the implementation of the EU market access offer on sugar, which was made in the course of the current ACP – EU negotiations of EPAs. This comparison shall provide an indicative answer the question whether the new EU market access offer has the potential to safeguard ACP countries' benefits under the Sugar Protocol, in accordance with the EU's obligations under Article 36(4) of the Cotonou Agreement. Finally, the paper provides recommendations with regard to the negotiation of new ACP – EU trade arrangements in particular regard to sugar trade.

## II. THE EU COMMON SUGAR MARKET ORGANIZATION AND PREFERENCES GRANTED TO ACP COUNTRIES UNDER THE SUGAR PROTOCOL

### A. The EU Common Sugar Market Organisation (CMO) – The Pre-Reform Scenario

10. Council Regulation (EC) No.1260/2001 "on the common organization of the markets in the sugar sector" (CMO) comprises the main rules which were applicable to the EU sugar market since 1968 and accounted for the EU sugar policy for marketing years 2001/2002 up until 2005/2006.[1] Under this regime, EU sugar production, importation, and exportation remained subject to a complex and costly supply management scheme, involving high levels of domestic price support, export subsidization, and high tariff barriers.

[1] *Council Regulation (EC) No. 1260/2001* of June 10, 2001

11. The regulation provides for two main sugar production quotas. Under the current regime, both 'A' sugar (14.3 million tons) and 'B' sugar (3.1 million tons) are eligible for domestic price support which is to secure a 'fair income' to EU sugar processors and beet farmers. The administered domestic price is ensured by national intervention agencies, which buy 'A' or 'B' sugar if its price falls below a certain minimum target price. The target intervention prices for white sugar (631.9€ per ton) and raw sugar (523.7€ per ton) were set at levels approximately three times higher than the respective world market prices during the marketing years 2001/2002 to 2005/2006.

12. Furthermore, 'B' quota sugar qualifies for direct export subsidies, so-called 'refunds', which are supposed to "stabilize the Community market" by means of subsidized exports of surplus production. The subsidy amounts to the difference between the domestic intervention price and the world market price, rendering the export of EU sugar competitive on the world market. In order to channel a share of sugar processors' benefits from price support and export subsidies to beet growers, minimum prices are established for 'A beet' (46.72€ per ton) and 'B beet' (32.42€ per ton).

13. 'A' and 'B' sugar production quotas are allocated to member states, which, in turn, grant production licenses to sugar producers on the basis of historical production quantities. The quota allocations do not limit total sugar production quantities. However, production which exceeds 'A' and 'B' production quotas, so-called 'C' sugar, is not eligible for price support and export subsidies. Moreover, 'C beet', i.e. sugar beet which is processed into over-quota sugar, does not qualify for the minimum beet prices. Additionally, the diversion of 'C' sugar into the domestic market is subject to financial penalties. In other words, 'C' sugar production quantities must be "carried forward" to the next marketing year in order to benefit from 'A' or 'B' quota inclusion or must be exported at world market prices.

14. EU domestic sugar production is further protected by a practically prohibitive specific MFN tariff duty of 339€ per ton of raw sugar and 419€ per ton of white sugar, whereas world market prices fluctuate around 150€ for the former and 200€ for the latter. EU imports, which average slightly above 2 million tons per annum, are only viable under preferential trade arrangements which shall be discussed below.

15. In summary, the EU sugar regime sets, by means of highly lucrative administered prices and export subsidies, high production incentives for farmers and processors in the EU and insulates domestic production and consumption from world price impacts. As a result, EU-25 sugar production remains at high levels of around 19 to 20 million tons, comparing to an overall production quota of 17.4 million tons ('A' + 'B' sugar quotas) and consumption of about 16 million tons. Given additional amounts of 2 million tons of guaranteed preferential imports from certain trading partners, the EU market quantities are balanced out by means of roughly 5 million tons of exports (15% of world exports), which rendered the EU one of the major exporters among Brazil, Thailand, and Australia. This is despite the fact that field and factory production costs of sugar in the EU are about three times higher than in these highly competitive sugar producing economies. The explanation of

nevertheless high EU exports is found in the provision of high amounts of export subsidies to EU producers for export.

16. The CMO proves to be extremely expensive for EU taxpayers and consumers. In 2004, the budget foreseen for the sugar sector accounted for no less than €1.721 billion of which 1.285 billion were spent on export refunds, including €802 million on the export of the equivalent of 1.6 million tons of sugar imported from ACP countries. Consumers, in addition, pay for the difference between the world market price and the EU domestic administered price, which is upheld by potential purchases on behalf of the intervention agencies as well as by means of the import prohibitive MFN tariff.

17. Through protection of its sugar farmers and processors by means of prohibitively high tariffs and administered prices, as well as through dumping of large quantities of highly subsidized surplus production on the world market, the EU sugar policy has yielded strong distortions of world sugar trade in the last 30 years. In effect, the EU has continued to deprive developing and least-developed economies, which hold a comparative advantage in sugar production, of their export opportunities, precluded additional export earnings, and thereby impeded the realization of economic development and poverty reduction strategies in these countries.

18. In stark contrast to the importance of sugar production for employment and income of the rural population in many developing and least-developed countries, employment in the EU-15 sugar sector is marginal and further decreasing. In 2002, roughly 20,000 jobs were provided by the sector. Job numbers, not accounting for the impact of the current regulatory reform of the sector, are predicted to fall below 15,000 by 2012 due to further rationalization and increasing productivity.

19. The main EU sugar producers, and therefore the main beneficiaries of the CMO, resemble the largest and most powerful EU members, such as France, Germany, the United Kingdom, Italy, and Spain. Large production quota shares are also held by the Netherlands and Belgium.[2]

B. Preferential Market Access for ACP Countries – The Sugar Protocol

20. As noted above, the EU imports sugar under preferential market access arrangements only. In 1996, the EU opened a tariff rate quota of 85,000 tons, mainly for Brazil and Cuba, with an applicable duty rate of 98€ per ton. In 2005/06 western Balkan countries obtained a duty free tariff rate quota of 373,000 tons. Moreover, in 2001 the EU Council of Ministers amended the EU Generalized System of Preferences (GSP)[3] so as to provide duty and quota free market access for goods originating in least-developed countries (LDC) from 2001 on under the so-called 'Everything but Arms' (EBA) initiative.[4] However, the amendment provides for particular treatment of bananas and sugar. Duty free access for these politically 'sensitive' commodities

[2] EU Press Release: *EU Sugar Sector: Facts and Figures*, MEMO/04/177, Brussels, 14 July 2004.
[3] *Council Regulation (EC) 2820/98 of 21 December 1998*
[4] *Council Regulation (EC) 416/2001 of 26 February 2001*

only applies from July 2009 on. Until then, the EBA initiative provides for an increasing duty free tariff rate quota of 74,185 tons in marketing year 2001/02 up to 197,335 tons in 2008/09.[5]

21. Most importantly for the scope of this note, the EU, since 1975, upholds a preferential market access arrangement for sugar with 18 African, Caribbean, and Pacific (ACP) countries. The arrangement incorporates preferences granted by the United Kingdom to former colonies, preceding its accession to the European Communities (EC) in 1973.[6] The Sugar Protocol (SP), providing for these preferences, was originally annexed to the first preferential trade agreement between 79 ACP countries and the EC, i.e. the 1975 Lomé Convention, and was later attached to its successor, the 2001 ACP-EU Cotonou Agreement.

22. The underlying objectives of the provision of unilateral, non-reciprocal trade preferences to ACP countries by means of the sugar and other commodity protocols under the Lomé Conventions and the Cotonou Agreement are unambiguously codified in the preamble of the Cotonou Agreement. Namely, the EU finds itself committed to contribute to "poverty eradication, sustainable development and the gradual integration of the ACP countries into the world economy."

23. Despite the fact that the Sugar Protocol forms an integral part of the Cotonou Agreement, in accordance with Article 100 of the Agreement, the SP is a legally distinct commodity agreement between the EU and certain ACP countries. In contrast to the Lomé Conventions and the Cotonou Agreement, it is of 'indefinite duration'.[7] However, the Protocol may be denounced by the EU with regard to every ACP state or by any ACP state with respect to the EU, subject to two years notice.[8] The provisions of the SP, in accordance with its Article 1(2), are carried out under the provisions of the EU's CMO.

24. The SP guarantees ACP signatories duty free market access quotas which amount to 1.3 million tons of raw or white cane sugar in total. The beneficiaries are Barbados (42,000 tons), Belize (40,300), Republic of Congo (10,200), Cote d'Ivoire (10,200), Fiji Islands (165,300), Guyana (159,400), Jamaica (118,700), Kenya (10,000), Madagascar (10,800), Malawi (20,800), Mauritius (491,000), Mozambique (6,000), Saint Kitts and Nevis (15,600), Swaziland (120,000), Tanzania (10,000), Trinidad and Tobago (43,700), Zambia (10.000), and Zimbabwe (30,000).[9] Importantly, the price paid for these guaranteed quantities is linked to the EU's domestic administered price which is highly lucrative for ACP sugar exporters.[10] In practice, the preferential price equals the EU domestic price. The EU maintains an agreement similar to the SP with India (10,000 tons). Additionally, the EU allows for duty free market access for

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[5] European Commission: *Sugar*, Product Brief, TRADE Directorate General, available at: http://trade.ec.europa.eu/doclib/docs/2006/june/tradoc_120339.pdf, last visited: November 19th 2007.
[6] Although 20 ACP countries signed the agreement, only 18 countries now have a quota.
[7] Articles 1(1) and 10, Protocol 3 of Annex V to the 2001 Cotonou Agreement, as appearing in the ACP – EEC 1975 Convention of Lomé (hereinafter referred to as Sugar Protocol (SP))
[8] Article 10 SP
[9] The quantities which are specified in the Sugar Protocol have been adjusted in recent years. The quantities listed here reflect the updated quotas.
[10] Article 5(4) SP

annually fixed quantities from SP beneficiaries and India, labeled Special Preferential Sugar (SPS) of about 300,000 tons on average. The current SPS agreement has expired in June 2006, which coincides with the expiration of the 2001 CMO.

C. ACP Sugar Exports to the EU and their Importance for ACP Economies

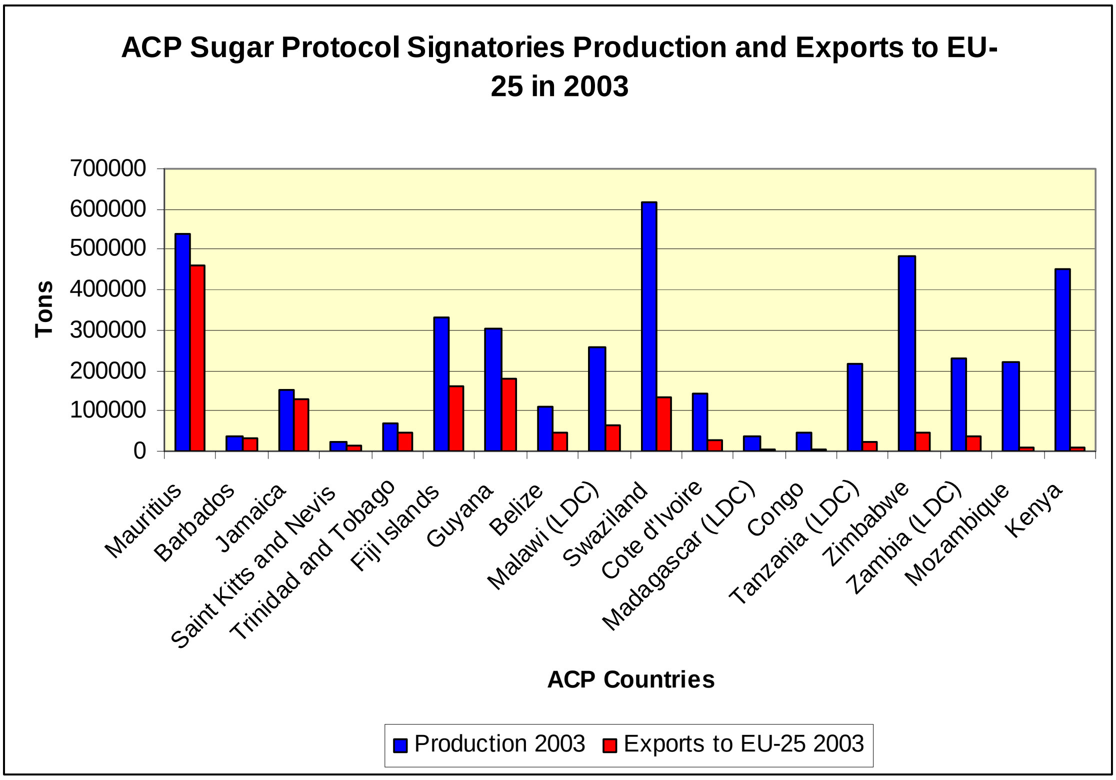
25. Most generally, earnings from exports of agricultural commodities are of crucial importance for many developing countries and least developed countries where agriculture still accounts for a major share of economic activity. Profitable exports provide for much needed foreign exchange which can be spent on imports of investment goods, aiming at domestic economic growth through economic diversification. Moreover, income changes in the agricultural sector of economies have typically strong effects on the realization of poverty reduction and development strategies with regard to rural areas from which the sector gains its workforce. In this sense, market access preferences provide a viable alternative to mere financial assistance in order to promote long-term self sustained development.

26. For ACP Sugar Protocol signatories, the EU sugar preferences have created a stable and important source of export earnings. The significance of preferential market access for the sugar sectors of SP beneficiaries is indicated by a comparison of sugar exports to the EU and total annual sugar production in these economies (see Chart 1). For 14 of 18 beneficiaries, sugar exports to the EU accounted for more than 10% of national sugar production in 2003. For eight countries, the share exceeded 40%, while five small island economies exported more than 60% of their 2003 sugar production to the EU at preferential price rates.

27. For 14 out of 16 countries, for which 2003 data is available, the sugar sector accounted for more than 1% of national income (see Table 1). Eight countries' sectors range between 1% and 5% of GDP, while in Mauritius (8%), Fiji Islands (8.1%), Belize (9.5%), Guyana (15.8%), Swaziland (24%), and Saint Kitts and Nevis (28%), the sector alone makes up for a major share of national economic activity.

28. Also, the sugar sectors in these economies hold a high share of the total agricultural GDP in 2003. For 9 out of 13 countries, for which data is available, sugar provided for more than 20% of national income from agriculture. Moreover, agriculture sectors in Swaziland (51%), Belize (61.9%), Mauritius (70%), Saint Kitts and Nevis (74%), and Fiji Islands (93%) are largely dominated by sugar production. Employment figures are similarly significant. Overall, sugar production provided for no less than 723,500 jobs in 16 economies.

**Chart 1: ACP SP Countries Sugar Production and Exports to EU**




(Source: ACP Sugar Group / EU Commission TRADE DG: Market Access Database)

**Table 1: Sugar Sector Share of GDP and Employment 2003**

| Sugar Protocol Beneficiaries | Sugar as % of 2003 GDP | Sugar as % of 2003 Agriculture | Sugar Sector Employment 2003 |
|---|---|---|---|
| Saint Kitts and Nevis | 28 | 74 | 9,400 |
| Swaziland | 24 | 51 | 93,000 |
| Guyana | 15.8 | 30 | 33,100 |
| Belize | 9.5 | 61.9 | 10,600 |
| Fiji Islands | 8.1 | 93 | 101,600 |
| Mauritius | 8 | 70 | 51,600 |
| Malawi (LDC) | 4.9 | N.A. | 21,800 |
| Madagascar (LDC) | 3.9 | N.A. | 18,000 |
| Tanzania (LDC) | 3.1 | 5 | 52,000 |
| Zimbabwe | 2.3 | 17.2 | 162,000 |
| Zambia (LDC) | 2.3 | 15 | 62,000 |
| Barbados | 1.8 | 41.4 | 9,500 |
| Jamaica | 1 | 13.9 | 51,500 |
| Republic of Congo | 1 | N.A. | 1,000 |
| Cote d'Ivoire | 0.9 | 3.3 | 5,000 |
| Trinidad and Tobago | 0.6 | 27.8 | 41,400 |
| Mozambique (LDC) | N.A. | N.A. | N.A |
| Kenya | N.A. | N.A. | N.A. |
| **Total** | | | **723,500** |

(Source: ACP Sugar Group)

## III. Factors Triggering EU Domestic Reform and the Denunciation of the Sugar Protocol

29. On February 20th 2006, the EU Council of Ministers adopted Council Regulation (EC) No 318/2006 on the common organization of the markets in the sugar sector; Council Regulation (EC) No 320/2006 establishing a temporary scheme for the restructuring of the sugar industry in the Community; and Council Regulation (EC) No 319/2006 establishing common rules for direct support schemes for sugar beet farmers. In their entirety, the legislation provide for a radical reform of the EU sugar sector, to be implemented within the four subsequent years, from marketing year 2006/07 to 2009/10.

30. Moreover, on September 28th 2007, the EU Council adopted the Council Decision 2007/627/EC, whereby it made use of its right under Article 10 of the Sugar Protocol to notify ACP beneficiaries of the SP that it denounces the Protocol with effect from October 1st 2009. In other words, the EU Council announced unilaterally that the preferential market access under the Sugar Protocol will be terminated on the latter date.

31. As shall be demonstrated in this chapter, the denunciation of the Sugar Protocol on behalf of the EU in September 2007, as well as the overall reform of the EU sugar sector stem from the EU's effort to comply with its obligations under WTO law. While both the reform and the denunciation are required in order to conform to distinct legal obligations, the termination of the sugar market access preferences largely complements the reform efforts, which are outlined in the subsequent chapter. The present chapter provides an overview of these legal requirements, which pressurized the EU to alter the regulatory environment of its domestic sugar sector and arguably led to the recent denunciation of the Sugar Protocol.

### A. WTO Dispute Settlement on *EC – Export Subsidies on Sugar*

32. The EU sugar sector has been a thorn in the eye of several competitive low-cost exporters of sugar for a long time. As noted above, the EU retains a major share of world exports despite the fact that EU production costs are about three times higher than the production costs in the economies of its most efficient export competitors and also about three times higher than the world market price.

33. Thus, the only way to export EU sugar at the world market price is export subsidization at levels which account for at least the difference between domestic production costs and the world market price. This is provided for, to some extent, by the payment of 'export refunds' for exported 'B' quota sugar, i.e. the direct export subsidy formally provided for under the CMO. However, up until recent clarification through WTO dispute settlement, it remained questionable whether EU sugar processors were additionally, by means of the receipt of extraordinary high amounts of domestic price support for quota production, enabled to export large quantities of 'C' sugar quota-surplus at the world market price price, and therefore prices below EU costs of production.

34. The excessive use of export subsidies by the EU had already been challenged by Brazil and Australia at the end of the 1970ies under Article XVI:3 of the GATT 1947. However, this legal challenge yielded limited effects on EC policies at the time.[11] In 2004, a WTO panel ruled on a similar challenge brought by Australia, Brazil, and Thailand under the 1995 Agreement on Agriculture (AoA).[12] In the proceedings of the recent dispute, the complainants claimed that the EU had by far exceeded its export subsidy reduction commitment on sugar under the AoA, in violation of Article 3.3 and 8 of the Agreement.

35. The EU commitment schedule, which is annexed to the AoA, lays down an export subsidy commitment for sugar of maximum €499.1 million in terms of budgetary outlays and close to 1.3 million tons in terms of quantity. Additionally, a footnote to the EU commitment states: "Does not include exports of sugar of ACP and Indian origin on which the Community is not making any reduction commitments. The average of export in the period 1986 to 1990 amounted to 1.6 mio t." According to the EU, this footnote allowed for the provision of export subsidies on 1.6 million tons of sugar additional to its original commitment of 1.3 million tons.

36. First, Australia, Brazil and Thailand claimed that the footnote is not in conformity with the AoA's provisions on export competition and would hence not enlarge or modify the original commitment level of 1.3 million tons. The panel agreed and reasoned that Article 9 of the AoA stipulates percentage reductions of *all* export subsidies of a respective WTO member which fall within the scope of Article 9.1 of the Agreement. The parties to the dispute had agreed that the export refunds in question, as provided for 1.6 million tons of 'ACP Indian equivalent' sugar, constituted direct export subsidies within the meaning of Article 9.1(a) AoA.

37. The panel found a conflict between the exclusion of an export subsidy from the general reduction requirement by means of a statement in a footnote to a member's commitment schedule, and Article 9.2 AoA which provides for this very reduction requirement. Moreover, the panel noted that reduction commitments, expressed as maximum quantities and budgetary outlays after reduction, are subject to scheduling requirements provided for in Article 3.3. As such, the commitments must be specified in terms of budgetary outlay and quantities in member's commitment schedules.

38. The panel, and subsequently the Appellate Body, essentially held that there is "no provision under the [AoA] that authorizes Members to depart, in their Schedules, from their obligations under that Agreement." As such, a member's statement in its commitment schedule that a certain quantity of exports is *not* subject to the reductions, which are generally required by Article 9 AoA, has no legal effect. Moreover, even if the footnote statement would be considered to have legal effect, it

[11] GATT Panel Report, *European Communities – Refunds on Exports of Sugar*, L/4833, adopted 6 November 1979, BISD 26S/290 ; GATT Panel Report, *European Communities – Refunds on Exports of Sugar – Complaint by Brazil*, L/5011, adopted 10 November 1980, BISD 27S/69

[12] Panel Report, *European Communities – Export Subsidies on Sugar, Complaint by Australia*, WT/DS265/R, adopted 19 May 2005, modified by Appellate Body Report, WT/DS265/AB/R, WT/DS266/AB/R, WT/DS283/AB/R

would not comply with the scheduling requirements of the AoA, as it does not provide for the specification of budgetary outlays, in violation of Article 3.3 AoA. Therefore, the panel held, and the Appellate Body upheld, that the EU, through the provision of export refunds for 1.6 million tons of 'ACP/India equivalent' sugar in excess of its commitment level of 1.3 million tons, exceeded its reduction commitment under the AoA by 1.6 million tons, in violation of Article 8 and 3.3.[13]

39. Secondly, recalling that over-quota 'C' sugar production is not eligible for price support and must be exported under the CMO, the complainants argued that the EU's comprehensive supply management scheme, providing for high fixed minimum prices for 'A' and 'B' sugar beet, had enabled sugar beet growers to sell over-quota 'C' sugar beet to processors at below average total cost of production. This discounted price would provide processors with an indirect subsidy on the export of 'C' sugar by virtue of government action - within the meaning of Article 9.1(c) of the AoA. Moreover, it was argued that processors of 'C' sugar had been enabled, by virtue of the highly remunerative subsidization of 'A' and 'B' sugar production, to cross-subsidize their exports of 'C' sugar quantities and to export 'C' sugar at below total average cost of production. In other words, the complainents argued that extraordinarily high domestic production subsidies for sugar provided for spill-over effects on export performance, rendering EU producers competitive on the world market.

40. The claims were largely based on the precedential *Canada – Dairy* dispute. In this dispute, the Appellate Body had issued a clarification with regard to the determination of the existence of export subsidies under the circumstances of a domestic supply management regime which grants high domestic price support for quota production and requires the exportation of over-quota production quantities. The Appellate Body, in this case, had established that such over-quota exports *at prices below the average total cost of production* are deemed to receive export subsidies within the meaning of Article 9.1(c) AoA.[14] Such 'payments on the export of an agricultural product by virtue of government action' are then subject to reduction commitments, as required by the *chapeau* language of Article 9 AoA.

41. In a landmark ruling, the panel found, and the Appellate Body upheld, that the EU, by virtue of high domestic minimum prices and price support as well as the CMO's requirement to export over-quota production, had provided producers with export subsidies within the meaning of Article 9.1(c) of the AoA, since 'C' sugar beet sales to processors for export as well as 'C' sugar exports occurred at prices way below average total cost of production. Therefore, such export subsidies would be subject to the reduction commitment as specified in the EU's commitment schedule.

42. In other words: all sugar quantities exported by the EU were found to be, directly or indirectly, subsidized. Given exports of about 4.1 million tons in

[13] Appellate Body Report, *European Communities – Export Subsidies on Sugar*, WT/DS265/AB/R, WT/DS266/AB/R, WT/DS283/AB/R, adopted 19 May 2005
[14] Appellate Body Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Recourse to Article 21.5 of the DSU by New Zealand and the United States*, WT/DS103/AB/RW, WT/DS113/AB/RW, adopted 18 December 2001, DSR 2001:XIII, 6829.

marketing year 2000/01 and a commitment level of 1.3 million tons, the panel found that the EU exceeded its commitment level by no less than 2.8 million tons and requested the WTO Dispute Settlement Body (DSB) to recommend to the EU to bring its sugar regime in conformity with its obligations under the AoA. Recalling the binding nature of DSB decisions, the EU would have to fear retaliatory actions, to be taken by the complainant parties, if it was found not to comply with these recommendations. As such, the EU is obliged not to exceed an export subsidization level of 1.3 million tons in the future. Since the world market price for sugar lies far below EU production costs, EU exports would generally be limited to this amount.

43. The WTO dispute settlement body adopted the reports of the panel and the Appellate Body on May 19th 2005. The reasonable period of time for the EU to comply with the ruling was agreed to expire on May 22nd 2006. In response to the ruling, the EU's Council of Ministers, on February 20nd 2000, adopted a radical reform program of the CMO, the substance of which shall be outlined in the subsequent chapter.

44. Possibly being a partial result of the obligations arising under the sugar dispute, the EU, at the WTO Hong Kong Ministerial Conference in December 2005, conceeded to eliminate all subsidies on exports of agricultural goods by 2013. If the Doha Round should result in a successful outcome and this concession is subsequently implemented, EU sugar exports would no longer be viable by the year 2013, providing for an additional impetus to the regulatory reform of the sugar sector.

45. Additional to its direct effect on the CMO, the DSB decision yields strong implications for the ability of the EU to uphold sugar preferences for ACP countries in the current form. As noted in chapter II, EU domestic consumption of about 16 million tons compared to domestic production of 19 to 20 million tons and additional guaranteed imports of about 2 million tons. Thus, the EU sugar market faces an annual surplus of 5 to 6 million tons, whereas producers are prohibited to dump more than 1.3 million tons of subsidized sugar on the world market in accordance with current trade rules. After WTO conform exports of 1.3 million tons of market surplus, the EU market is left with 3.7 to 4.7 million tons of residual sugar quantities which are prohibited to be exported under WTO law and can not be absorbed by domestic consumption.

46. The removal of these residual 3.7 to 4.7 million tons requires a) a reduction of export refunds to the level committed to by the EU in its schedule; b) a significant reduction of quota production quantities; and c) the significant reduction of domestic price incentives. The reduction of the domestic administered sugar price, being one of the cornerstones of the current reform, in turn, affects the preferential rates received by ACP countries under the Sugar Protocol as the former has traditionally equalled the latter. In other words, price preferences for ACP countries under the Sugar Protocol would be eroded by reductions of the administered price in the EU.

<u>B. Triggering the Negotiations of Economic Partnership (Free Trade) Agreements: The expiration of the WTO Waiver for Preferences under the Cotonou Agreement</u>

47. The 2000 Cotonou Agreement between the EU and ACP states, and the commodity protocols attached to Annex V of the agreement in particular, provide non-reciprocal trade preferences to ACP states, but not to other developing or least-developed countries. In this respect, the agreement mirrors the special political relations of the EU with the former colonies of its member states.

48. Generally speaking, Article I of the GATT 1994 on Most-Favoured-Nation Treatment (MFN) outlaws such accordance of exclusive trade benefits to WTO members with regard to trade in goods. The MFN clause stipulates that "any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."

49. WTO case law, which has a quasi-precedential character with regard to future DSB decisions, is unambiguous with regard to this issue. In the well-known *EC – Bananas III* dispute, the panel found, and the Appellate Body upheld, that the EU contradicted the GATT MFN Clause by granting certain trade preferences to ACP countries while excluding others.[15] Therefore, the exclusive and non-reciprocal trade preferences granted by the EU under the Cotonou Agreement and its protocols require a legal justification or exception under WTO law which remedies the violation of the MFN clause by this trade agreement.

50. One option to provide legal shelter for preferences granted to developing countries is the so-called Enabling Clause. The Enabling Clause is a Decision of the GATT Council, dated November 28th 1979, which authorizes developed GATT Contracting Parties, and now WTO member states, to "accord differential and more favorable treatment to developing countries, without according such treatment to other Contracting Parties."[16] The GATT Council, and now the WTO General Council or the WTO Ministerial Conference, hold the authority to issue legally binding decisions, which allow member states to deviate from their legal obligations on a timely restricted or permanent basis.[17] As such, under the Enabling Clause, developed countries are authorized, on a permanent basis, to grant preferences to developing and least-developing countries without applying these preferences on an MFN basis. In accordance with this decision of the GATT Council, developed countries have established individual generalized systems of preferences (GSP) which grant preferential market access to developing and least-developed countries' exports.

51. However, drawing from existing WTO case law, the ACP preferences under the Sugar Protocol would not be compatible with the provisions of the Enabling

[15] Appellate Body Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, adopted 25 September 1997, DSR 1997:II, 591
[16] Enabling Clause, GATT Council Decision of 28 November 1979, on *Differential And More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries* (L/4903).
[17] See Article XXV:5 GATT; Article IX (2) – (4) WTO Agreement

Clause. In the *EC – Tariff Preferences* dispute, the Appellate Body clarified that the provision of preferences to developing and least-developed countries under the Enabling Clause must be accorded on an MFN basis with regard to such countries.[18] In other words, third developing or least-developed countries must not be excluded from the eligibility for and receipt of such preferences in an arbitrary manner.

52. The Appellate Body in this dispute held that "preference-granting countries are required, by virtue of the term 'non-discriminatory,' to ensure that identical treatment is available to all similarly-situated GSP beneficiaries, that is, to all GSP beneficiaries that have the 'development, financial and trade needs' to which the treatment in question is intended to respond." Since the Cotonou Agreement and its protocols grant preferences to ACP countries exclusively, this arrangement would not conform to the non-discrimination requirement of the Enabling Clause, as interpreted by the Appellate Body.

53. A second and more viable option to remedy an MFN clause violation is the receipt of a specific waiver with regard to the EU's MFN obligations in respect of the preferences granted to ACP countries. Such a waiver can only be issued by the WTO General Council in accordance with Article XXV:5 of the GATT 1994 or by the WTO Ministerial Conference in line with Article IX (3)-(4) of the WTO Agreement. In fact, the EU and ACP countries had sought and received waivers for the exclusive trade preferences granted under the earlier Lomé Conventions and had similarly done so in respect of the Cotonou Agreement. The MFN waiver, sheltering the exclusive preferences under the Cotonou Agreement and its protocols, was issued by the WTO Ministerial Conference in Doha, Qatar, on November 14th 2001.

54. However, the path to the issuance of the waiver was a thorny one as the respective request on behalf of the EU and the ACP countries in April 2000 faced severe opposition by several WTO members at the time. This was despite the fact that the EU and ACP countries committed themselves to render their trade arrangements WTO compatible by the end of 2007 the latest. Article 36(1) of the Cotonou Agreement manifests this intent: "In view of the objectives and principles set out above, the Parties agree to *conclude new World Trade Organization (WTO) compatible trading arrangements*, removing progressively barriers to trade between them and enhancing cooperation in all areas relevant to trade [emphasis added]."

55. Following the signature of the Cotonou agreement in June 2000, it took no less than 18 months of intense negotiations with objecting WTO members (namely Thailand, the Philippines, and several Latin American banana exporting countries) until the MFN waiver was finally issued by the WTO Ministerial Conference in Doha, Qatar, on November 14th 2001.[19] Opposition was mainly sparked by low cost and competitive exporters of sugar and bananas which deem themselves to be deprived of export opportunities to the EU market, partly by means of EU preferential market access for ACP countries.

[18] Appellate Body Report, *European Communities – Conditions for the Granting of Tariff Preferences to Developing Countries*, WT/DS246/AB/R, adopted 20 April 2004, DSR 2004:III, 925

[19] *European Communities – The ACP-EC Partnership Agreement*, Decision of the Ministerial Conference of 14 November 2001, WT/MIN(01)/1, Fourth Session, Doha, 9-14 November 2001.

56. For instance, Thailand ranks among the world's largest and most competitive sugar exporters and could easily supply the EU sugar market at prices much lower than most of the ACP SP beneficiaries. However, Thailand and other large scale low cost producers such as Australia and Brazil are denied EU market access by a prohibitively high MFN tariff. The effect of EU sugar market access preferences for ACP countries is hence the diversion of sugar trade from the most competitive exporters to the small and vulnerable ACP economies. Therefore, the world's most competitive sugar exporters hold a strong interest to invoke their legal rights under WTO law, for example in terms of MFN treatment, in order to gain access to the EU market.

57. The eventual Decision of the Doha Ministerial Conference stipulates the following: "Subject to the terms and conditions set out here under, *Article I, paragraph 1 of the General Agreement shall be waived, until 31 December 2007,* to the extent necessary to permit the European Communities to provide preferential tariff treatment for products originating in ACP States as required by Article 36.3, Annex V and its Protocols of the ACP-EC Partnership Agreement, without being required to extend the same preferential treatment to like products of any other member [emphasis added]."

58. As such, the Cotonou Agreement and its protocols, including the Sugar Protocol, are legally sheltered by the quoted Doha MFN Waiver, up until its expiry on December 31st 2007. In the meantime, which is labeled 'preparatory period' by Article 36 of the Cotonou Agreement, parties to the agreement are mandated to negotiate WTO compatible trade agreements.

59. The replacement of the unilateral, non-reciprocal Cotonou Agreement by WTO compatible trade arrangements would render the renewal of the current waiver obsolete - a matter which would be difficult to achieve anyways due to the continuing opposition of several WTO members.

60. The preparatory period, in coincidence with the expiration of the Doha MFN Waiver, ends on December 31st 2007, as stipulated in Article 37(1) of the Cotonou Agreement. The new WTO compatible trade agreements between the EU and ACP countries, which are distinguished by regions for the purpose of the negotiations, are supposed to enter into force on January 1st 2008.

61. The negotiations of these Economic Partnership Agreements with different ACP regions essentially aim at the establishment of free trade agreements (FTA) which comply with Article XXIV of the GATT 1994, as indicated by Articles 36(1) and 37(7) of the Cotonou Agreement. The substance of the agreements would thus reach a completely different level than the unilateral and non-reciprocal Cotonou preferences, since GATT Article XXIV agreements are required to be reciprocal and, in effect, must liberalize 'substantially all trade' between the parties. This implies that ACP countries, if such agreements actually come into force, would be required to gradually open a large majority of their sectors to EU exports, with potential serious adverse effects on their vulnerable economies.

62. The negotiation of the Economic Partnership Agreement between ACP countries and the EU, as mandated by Article 37(1) of the Cotonou Agreement, is hence dictated by the expiration of the Doha MFN Waiver on December 31st 2007 and the formally expressed intent of the parties to elevate their trade relations to higher level, as manifested in the Cotonou Agreement.

C. Triggering the Denunciation of the Sugar Protocol: The questionable legality of the Sugar Protocol under WTO law

63. The Sugar Protocol, however, as noted in chapter II, is legally distinct from the Cotonou Agreement with regard to its duration. The non-reciprocal trade preferences under the Cotonou Agreement are terminated by the end of the preparatory period, in accordance with paragraphs (1) and (2) of Articles 36 and 37. In contrast, Article 1(1) of the Sugar Protocol provides for the 'indefinite duration' of the agreement. However, Article 10 stipulates that "the Protocol may be denounced by the Community with respect to each ACP State and by each ACP State with respect to the Community, subject to two years' notice." The EU made use of this right and notified ACP beneficiaries on September 28th 2007 that it denounces the Sugar Protocol with effect from October 1st 2009. In other words: sugar market access preferences granted to Sugar Protocol signatories are terminated by that date.

64. In the relevant Council Decision (2007/672/EC), the Council of the European Union states that "the arrangements of the Sugar Protocol can no longer be maintained. In the context of a reformed Community sugar market, the Community will cease to guarantee prices to European sugar producers as the former mechanism of intervention is being phased out. (…) In the context of a transition towards liberalization of ACP-EC trade, unlimited quantities cannot coexist with the price and volume guarantees of the Sugar Protocol."

65. First, as noted in section A of this chapter and as further discussed in the subsequent chapter, the termination of guaranteed import quantities at guaranteed prices from ACP countries appears to be complementary to the EU sugar sector reform program. As outlined above, the DSB decision in the *EC – Sugar* case pressurized the EU to reduce its direct export subsidies, as well as its administered domestic prices in order to reduce its subsidized exports to a WTO compatible level. ACP sugar exports to the EU are critical in this respect, since the EU used to re-export such quantities (up to 1.6 million tons) with the help of export refunds, which were found to be WTO incompatible in the *EC – Sugar* dispute. If not re-exported, ACP sugar contributes to a significant supply surplus on the EU sugar market which the EU seeks to reduce significantly within the context of its reform efforts. In other words, in the reformed scenario, ACP exports would need to be absorbed by the EU domestic market in order to respect the EU's WTO commitments. Furthermore, the EU effort to reduce its domestic prices in order to curb illegally cross-subsidized exports would go hand in hand with the reduction of prices received by ACP countries and substantially erode these price preferences up until the preference termination in 2009.

66. Secondly, in light of the expiry of the Doha MFN waiver by the end of 2007 and the fact that the EU would be unlikely to succeed in convincing the WTO membership to extend the waiver for the purposes of the Sugar Protocol, the notification of the denunciation may, in fact, be delayed. The notification of the denunciation, terminating the ACP duty free quotas by October 1st 2009, seems to imply that the EU, at least technically, may find itself in violation of its MFN obligation with regard to market access for sugar, for the time period between the expiry of the waiver and the date when the denunciation becomes effective.

67. This *could* be the case, despite the fact that the EU has included the ACP quota commitments in its schedule of commitments. The EU, upon challenge, would be likely to argue that its schedules are part of the Uruguay Round single undertaking, and as such agreed upon by the WTO membership. However, the findings of the panel and the Appellate Body in *EC – Sugar*, on the issue of a footnote in the EU commitment schedule which contradicted the text of the applicable treaty, held that member's schedules cannot modify the obligations of a member under the applicable agreements.

68. As such, the EU commitment schedule may not only lack compliance with Article I of GATT 1994, but also with the obligations contained in Article XIII, for which the EU has never even received a waiver. Article XIII, on the non-discriminatory administration of quantitative restrictions, stipulates that "[N]o prohibition or restriction shall be applied by any contracting party on the importation of any product of the territory of any other contracting party (…) unless the importation of the like product of all third countries or the exportation of the like product to all third countries is similarly prohibited or restricted." The EU, in regard of the Sugar Protocol, would appear to be in violation of this provision.

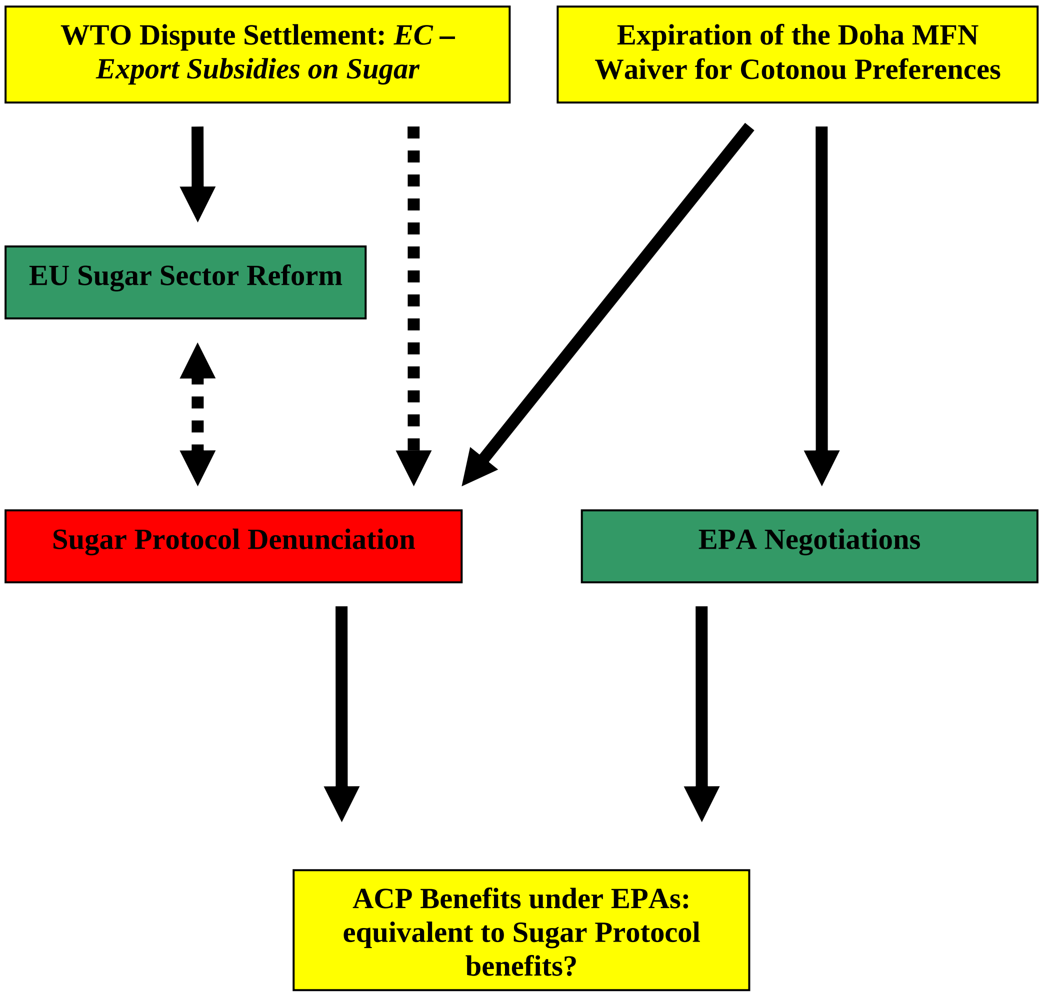
69. To be sure, the potential violation of these obligations on behalf of the EU does not necessarily mean that a challenge of the SP by a third WTO member would materialize. WTO members' trade measures are considered to be legal, unless successfully challenged in the context of the WTO dispute settlement mechanism. However, rumors about a challenge of the SP by Brazil have been persistent. To say the least, such a challenge has the potential to be successful. The critical issue seems to be whether a panel would find that the inclusion of the SP preferences in the EU schedule remedies an MFN and/or Article XIII violation.

70. In summary (see Chart 2) , the EU reform of its sugar sector, as outlined in the next chapter, is necessitated by the landmark ruling of the panel and the Appellate Body in the *EC – Sugar* dispute. Moreover, the termination of ACP sugar preferences is indirectly catalyzed by the DSB decision in the *EC - Sugar* dispute, since the decision requires a fundamental reform of the EU sugar sector which broadly affects ACP export prices as well as the EU exports of previously imported ACP sugar. Additionally, in light of the expiration of the Doha MFN Waiver by the end of 2007, the denunciation of the Sugar Protocol on behalf of the EU may be a legally necessary step in order to prevent the EU's vulnerability to legal challenge.

71. Finally, the denunciation of the Sugar Protocol coincides with EU – ACP negotiations on free trade / Economic Partnership Agreements. In the context of

these negotiations, the EU is morally and legally obliged to offer benefits to ACP sugar exporters which are equivalent to those accruing to them under the Sugar Protocol. In light of these requirements, the EU market access offer on sugar is assessed in chapter V.

**Chart 2: Factors influencing the EU Sugar Sector Reform, the Denunciation of the Sugar Protocol, and the EPA negotiations**




72. The subsequent chapter elaborates on the precise extent of the EU reform, the complementary character of the denunciation of the Sugar Protocol with regard to the EU's reform program, as well as EU policies which accompany the termination of the sugar preferences in order to mitigate adverse effects on ACP countries. Chapter V then presents and discusses the implications of the denunciation of the SP for ACP countries' economies. An assessment of the economic impacts is provided against the background of the EU preferential market access offer in the context of the current negotiations on EU - ACP Economic Partnership Agreements.

## IV. THE REFORM OF THE EU SUGAR SECTOR AND THE DENUNCIATION OF THE SUGAR PROTOCOL: HOW DO THEY MATCH UP?

A. The Reform of the EU Sugar Sector

73. On February 20th 2006 the EU Council of Ministers adopted Council Regulation (EC) No 318/2006 on the common organization of the markets in the sugar sector; Council Regulation (EC) No 320/2006, establishing a temporary scheme for the restructuring of the sugar industry in the Community; and Council Regulation (EC) No 319/2006, establishing common rules for direct support schemes for sugar beet farmers. As demonstrated in the following, the regulations provide for a radical reform of the EU sugar sector, to be implemented within the four subsequent years, from marketing year 2006/07 to 2009/10.

74. The reform program, as set out in this legislation, directly and explicitly aims at the achievement of EU compliance with the DSB decision in the *EC – Export Subsidies on Sugar* dispute. The content of the preambles of the regulations suggests that "due to developments within the Community and internationally, it is necessary to adjust the production system in order to provide for new arrangements and reductions of the quotas." Moreover, "to bring the Community system of sugar production and trading in line with international requirements and ensure its competitiveness in the future it is necessary to launch a profound restructuring process leading a significant reduction of unprofitable production capacity in the Community."

75. It was noted above that the DSB decision requires that the EU limits its subsidized exports of sugar to a maximum of 1.3 million tons by May 22nd 2006. EU domestic consumption amounts to 16 million tons compared to domestic production of 19 to 20 million tons and additional guaranteed imports of about 2 million tons. Given the EU processors' inability to export at the world market price and an annual EU market supply surplus of between 5 to 6 million tons, the EU reform would have to result in the reduction of domestic production quantities of roughly 4 to 5 million tons of sugar in the very short term in order to create a WTO compatible market balance of domestic production, consumption, guaranteed imports, and legally limited exports. Moreover, given the EU's long-term commitment to eliminate export subsidies on agricultural products by 2013, in case of a successful Doha Round deal, the required long-term reduction of production quantities would even increase to 5 to 6 million tons. Further reductions of domestic production quantities would be necessary in order to accommodate imports from least-developed countries under the EBA initiative or to increase ACP market access under the EPAs.

76. Upon adoption of the reform program the EU announced that domestic production is exptected to fall by between 6 and 7 million tons as a result of the full implementation of the reform.[20] Moreover, the reform would, in the long run, drastically reduce EU spending on the CMO since the provision of export refunds would be obsolete by 2010, when the EU has transformed to a net sugar importer. Export refunds accounted for €1.285 billion in 2004, comparing to an overall CMO

[20] EU Press Release: *CAP Reform: EU agriculture ministers adopt groundbreaking sugar reform*, IP/06/194, Brussels, 20 February 2006.

budget of €1.721 billion. Although some of the savings are to finance costly short-term and mid-term reform adaptation measures, the reform would still accommodate EU budget pressures and therefore the interests of several EU member states who would like to see the overall spending on the EU Common Agricultural Policy to be significantly reduced. These overall objectives of WTO compliance, market liberalization, and reductions of CMO spending are sought to be achieved by means of a basket of measures which is outlined in the following.

77. First, the original 'A' and 'B' sugar quotas are merged into one single sugar production quota which formally remains at 17.4 million tons. The 'intervention price' for quota production is abolished and re-introduced as the sugar 'reference price'. From the base level of the earlier intervention prices, as fixed by the 2001 CMO regulation up until marketing year 2005/06, the reference prices for both raw and white sugar are gradually reduced by 36% over four years (MY 2006/07-2009/10) in order to decrease production incentives. With regard to the price for raw sugar, which is highly relevant for ACP guaranteed export quantities under the Sugar Protocol, the strongest price reductions only kick in in marketing year 2008/09. This is later than under the initial June 2005 proposal of the European Commission and provides ACP countries with slightly more 'breathing space' in order to adapt to the price reductions. Moreover, overall reductions are slightly lower than initially proposed (see Tables 2a and 2b).

78. Second, the national intervention agencies are maintained during the four year reform implementation period and are obliged to buy sugar quantities up to a newly introduced maximum of 600,000 tons, at a price which must not exceed 80% of the reference price of the following marketing year. The provisions which are summarized here indicate the qualitative change from a strict intervention price mechanism to a reference price system which allows prices to fall, although only within a margin of appreciation, below the annual target price.

**Table 2a: Changes in price for white sugar**

| Year | Price per ton | % change (cumulative) |
|---|---|---|
| 2001 CMO | 631,90 € | 0 |
| 2006/07 | 631,90 € | 0 |
| 2007/08 | 631,90 € | 0 |
| 2008/09 | 541,50 € | -14,3 |
| 2009/10 | 404,40 € | -36,0 |

**Table 2b: Changes in price for raw sugar**

| Year | Price per ton | % change (cumulative) |
|---|---|---|
| 2001 CMO | 523,70 € | 0 |
| 2006/07 | 496,80 € | -5,1 |
| 2007/08 | 496,80 € | -5,1 |
| 2008/09 | 448,80 € | -14,3 |
| 2009/10 | 335,20 € | -36,0 |

79. Another major cornerstone of the 2006 reform is the provision of strong financial incentives to sugar processors in order to move them to voluntarily renounce their quota share in any one of the four years during the implementation period. Depending on the marketing year and the extent to which processors are willing not to use, to close, or to dismantle their production facilities in connection with the quota renounciation, they receive restructuring aid of between 750€ per ton and 182€ per ton of renounced quota. The renounciation of quota tons in the first years is rendered more lucrative than later, commensurate with the decreasing reference price for sugar. Ten percent of the funds are reserved for beet growers and machinery contractors. The aid is financed through a newly established temporary

restructuring fund. The measure clearly aims at a significant reduction of production quantities on a voluntary basis. It mainly targets the most inefficient producers which are expected to respond to the financial incentives earlier than more cost-efficient ones.

80. Fourth, the minimum price for sugar beet is gradually but significantly reduced during the implementation period. Counted against the base level of the minimum 'A' beet price under the 2001 CMO, the new unitary price is reduced by no less than 44% by 2009/10. Counted against the earlier 'B' beet minimum price, reductions amount to 20%.

81. Fifth, compliance with the EU's WTO export subsidy reduction commitment is ensured on the basis of the issuance of export licences for quantities which do not exceed the WTO commitment. Moreover, out-of-quota production, formerly 'C' sugar, is now allowed to be used for domestic processing of bioethanol and certain other products. This adds to the options of carrying such production forward to the next marketing year (for quota inclusion) and at below cost of production exportation. Exportation of out-of-quota production is explicitly limited to amounts which respect WTO commitments.

82. Finally, the 2006 CMO allows for the 'withdrawal' of a percentage of quota sugar production, which is common to all member states, from the domestic market.[21] This option provides the EU with the possibility to react flexibly to a lower than exptected decrease in production quantities and quota renounciations. Unexpectedly high production levels, due to a lack of response of producers and farmers to the reform measures, would be likely to pose a threat to the fixed reference price and/or could lead to cross-subsidized exports of surplus production in violation of the EU's WTO export subsidy reduction commitment. In this sense, the withdrawal of quota sugar provides the EU with an ad-hoc instrument to prevent such consequences of an over-supply situation.

83. Apart from measures which solely aim at the reduction of production and exportation, the reform program generously provides for compensation for sugar beet farmers and processors. Council Regulation (EC) No 319/2006 amends the single payment scheme for EU farmers and, in substance, compensates sugar beet growers with a direct payment which is decoupled from production and, on average, amounts to 64% of the respective price cuts. Additionally, the regulation introduces a coupled payment for a transitional period of five years which amounts to 30% of price cuts.

84. Moreover, Council Regulation (EC) No 320/2006 stipulates the provision of aid for diversification to member states in relation to the amount of sugar quota tons that are renounced by processors in the respective member state during the implementation period. Such aid amounts to between €109,5 (2006/07) and €78 (2009/10) per ton of rencounced quota. Additional aid for diversification is made available for member states where more than 50%, 75% or equal to 100% of the

[21] The withdrawn quantities must be stored by processors at their own expense and are counted against the allocated quota of the following year.

national sugar quota have been renounced. In case of full quota renounciation, a member state can increase such aid receipts by 100%.

85. Despite these comprehensive reform measures, the first impacts of the reform, in terms of reduction of production quantities, is not to be felt before the second year of the four year implementation period. Therefore, only 13 days after the adoption of the reform package in February 2006, the EU jump started the reform by reducing the sugar quota by 13.6% for marketing year 2006/07, i.e. 2.37 million tons.[22]

86. However, the effects of the structural elements of the reform have proved to be insufficient to reduce EU sugar production to sustainable levels to date. In March 2007, the European Commission, in a move to prevent a further production surplus, withdrew 2 million tons from the 2007/08 market, which indicates the highly tense market conditions.

87. Furthermore, in September 2007 the European Council adopted an amended sugar restructuring scheme which significantly increases financial incentives offered to sugar processors and beet growers if they cease production. Up until the adoption of the amendment, only 2.2 million quota tons had been renounced in response to incentives set by the original restructuring fund. The European Commission expects that the availability of additional restructuring funds, as conditional upon quota renunciation, will account for another 3.8 million tons of renounced quota. Moreover, Commission representatives emphasized that compulsory quota reductions are introduced without compensation after 2010, if insufficient quota has been renounced by that year.[23]

**Table 3: Estimation of the Impact of Reform on the EU Sugar Market[24]**

| | **2001 CMO Base Year** (in million tons) | **2012/13 Post-Reform Scenario** (in million tons) |
|---|---|---|
| **Total EU–25 Production** | **19.7** | **12.2** |
| Quota | 17.4 | 12.2 (12.9) |
| Production under Quota | 16.7 | 12.2 |
| Out-of-Quota Production | 3 | 0 (0.7) |
| **Consumption** | **15.9** | **16** |
| **Total Imports** | **2.3** | **3.9 (3.1)** |
| **Total Exports** | **3.1** | **0.4** |

(Sources: EU Commission / Napier Brown).

88. Given the difficulties on behalf of the EU to reduce domestic production, the denunciation of the Sugar Protocol further relieves the EU domestic market of pressure. Moreover, as voiced by the EU, guaranteed prices and quantities would not match up with the EBA initiative and the EU market access offer to ACP countries

[22] EU Press Release: *EU Member States agree to on-year cut in sugar production*, IP/06/261, Brussels, 3 March 2006.
[23] EU Press Release: *Sugar Reform: Council backs improved sugar restructuring scheme*, IP/07/1401, Brussels, 26 September 2007.
[24] The EU Commission's estimations are based on a 39% domestic price cut. Napier Brown bases its estimations on the 36% cut, as decided by the EU Council. Napier and Brown deviations from the EU estimations are shown in brackets.

under potential Economic Partnership Agreements. In both instances, the EU promises duty free market access for 'unlimited quantities', after the expiration of a respective transition period. Both scenarios are further discussed in chapter V.

89. In other words, for EU policy-makers the guaranteed prices and quantities under the SP do not match up with the vision of a largely liberalized market that is, in terms of imports, supplied by LDCs and ACP countries on a duty free but competitive basis. However, it may be doubted that these rather conceptual considerations were critical for the decision to denounce the SP. It should be recalled that the decision was made and adopted by the Council in the middle of the process of reform, right after the Council had modified its restructuring scheme in reaction to an insufficient level of voluntary quota renounciations on behalf of EU producers. As such, the decision to denounce the SP appears to have met the need for an ad-hoc measure aiming at a additional and complementary supply reduction, at the expense of the export earnings of the most vulnerable economies in the world.

B. Short-term effects of Price Reductions (2006-09) and Protocol Denunciation (2009) on Sugar Protocol Beneficiaries

90. Up until the termination of the sugar preferences for ACP states on October 1st 2009, SP beneficiaries continue to receive the EU domestic market price for guaranteed quantities. In the meantime, however, as shown in table 2b, the EU domestic price for raw sugar is subject to three reduction steps which significantly decrease the value of the quotas allocated to ACP countries and therefore exert severe adverse effects on ACP export earnings derived from sugar exports to the EU.

91. Table 4 summarizes the annual and total value losses faced by these countries due to EU price reductions. The figures do not take account of the fact that some of the SP beneficiaries, which are high cost producers and/or face high transport costs, will drop out of the EU supply market in response to actual and anticipated price reductions.

92. In nominal terms, countries holding the highest quota rights naturally face the highest losses. Mauritius, Fiji, Guyana, Swaziland, and Jamaica lose between €15 million and €62 million of quota value over three years. Another six countries, namely Trinidad & Tobago, Barbados, Belize, Zimbabwe, Malawi, as well as St. Kitts & Nevis, are confronted with total losses of between €2 million and €5.5 million. Moreover, three LDCs lose more than €1 million until the termination of preferences in October 2009. In relative terms, however, countries' losses due to price reductions need to be related to the significance of sugar exports and production for the individual economies (see Table 1).

**Table 4: ACP Countries' Annual and Total Quota Value Losses due reductions of the EU domestic price for raw sugar in €**

| Sugar Protocol Beneficiary | Current Quota (tons) | Quota Value (2001 CMO) | Quota Value Loss 2006/07 & 2007/08 | Quota Value Loss 2008/09 | Total Quota Value Loss 2006-09 |
|---|---|---|---|---|---|
| Mauritius | 491.000 | 257.136.700 | 13.113.972 | 36.770.548 | 62.998.492 |
| Fiji Islands | 163.600 | 85.677.320 | 4.369.543 | 12.251.856 | 20.990.942 |
| Guyana | 159.400 | 83.477.780 | 4.257.367 | 11.937.322 | 20.452.056 |
| Swaziland | 120.000 | 62.844.000 | 3.205.044 | 8.986.692 | 15.396.780 |
| Jamaica | 118.700 | 62.163.190 | 3.170.323 | 8.889.336 | 15.229.982 |
| Trinidad & Tobago | 43.700 | 22.885.690 | 1.167.170 | 3.272.654 | 5.560.994 |
| Barbados | 42.000 | 21.995.400 | 1.121.765 | 3.145.342 | 5.388.872 |
| Belize | 40.300 | 21.105.110 | 1.076.361 | 3.018.030 | 5.170.752 |
| Zimbabwe | 30.000 | 15.711.000 | 801.261 | 2.246.673 | 3.849.195 |
| Malawi (LDC) | 20.800 | 10.997.700 | 560.883 | 1.572.671 | 2.694.437 |
| St. Kitts & Nevis | 15.600 | 8.274.460 | 421.997 | 1.183.247 | 2.027.242 |
| Madagascar (LDC) | 10.800 | 5.760.700 | 293.796 | 823.780 | 1.411.372 |
| Republic of Congo | 10.200 | 5.341.740 | 272.429 | 763.868 | 1.308.726 |
| Cote d'Ivoire | 10.200 | 5.341.740 | 272.429 | 763.868 | 1.308.726 |
| Tanzania (LDC) | 10.000 | 5.237.000 | 267.087 | 748.891 | 1.283.065 |
| Zambia (LDC) | 10.000 | 5.237.000 | 267.087 | 748.891 | 1.283.065 |
| Mozambique (LDC) | 6.000 | 3.142.200 | 160.252 | 449.334 | 769.838 |
| Total | 1.302.300 | 682.328.730 | 16.264.651 | 97.573.008 | 165.069.340 |

93. From October 1st 2009 on, the market situation for ACP suppliers will further deteriorate. This assessment ignores for now, and for the sake of analysis, the potential loss of duty free market access, due to the denunciation of the Sugar Protocol, on that date as well as potential increases in duty free market access due to EBA access and/or the conclusion of EPAs.[25] What is certain is that, on October 1st 2009, the termination of the SP preferences coincides with the implementation of the full 36% domestic price cut for raw sugar, which will be reduced to 335.2€ per ton by then.

94. At this price, several earlier SP beneficiaries will no longer be able to supply the EU market. Table 5 presents ACP production and transport costs for shipment to the EU in relation to the fully reduced EU domestic price for raw sugar. Given these figures, Trinidad & Tobago, St. Kitts & Nevis, Barbados, Madagascar, Kenya, and Cote d'Ivoire will most definetly not have the capacity to make profits under the new price regime, and would cease to export raw sugar to the EU. Profits for Tanzania, Congo, and Jamaica will be marginal. Fiji, Belize, Mauritius, and Guyana face significant profitability losses. Zambia and Swaziland, moreover, are deprived of high profit margins. Zimbabwe, Malawi, and Mozambique will remain comfortable in supplying the EU market at the reduced price rate.

[25] As shall be further discussed in Chapter V, the EU offers increasing quota access for non-LDCs for the implementation period of the EPAs. ACP LDCs will benefit from quota free and duty free market access from July 2009 on.

**Table 5: 2009/10 Estimated Costs of Production and Transport (€/ton) and EU sugar prices (in €)**

| SP Beneficiaries | Production Cost 2009 (€/ton) | Transport Costs 2009 (€/ton) | Total Cost (€/ton) | Pre-Reform EU Price (€/ton) | EU price 2009/10 |
|---|---|---|---|---|---|
| Trinidad & Tobago | 440 | 80 | 520 | 523.7 | 335.2 |
| St. Kitts & Nevis | 440 | 80 | 520 | 523.7 | 335.2 |
| Barbados | 352 | 60 | 412 | 523.7 | 335.2 |
| Madagascar (LDC) | 317 | 80 | 397 | 523.7 | 335.2 |
| Kenya | 264 | 120 | 384 | 523.7 | 335.2 |
| Cote d'Ivoire | 264 | 112 | 376 | 523.7 | 335.2 |
| Tanzania (LDC) | 211 | 120 | 331 | 523.7 | 335.2 |
| Republic of Congo | 229 | 104 | 333 | 523.7 | 335.2 |
| Jamaica | 264 | 56 | 320 | 523.7 | 335.2 |
| Fiji | 229 | 80 | 309 | 523.7 | 335.2 |
| Belize | 211 | 92 | 303 | 523.7 | 335.2 |
| Mauritius | 229 | 64 | 293 | 523.7 | 335.2 |
| Guyana | 211 | 76 | 287 | 523.7 | 335.2 |
| Zambia (LDC) | 141 | 116 | 257 | 523.7 | 335.2 |
| Swaziland | 176 | 76 | 252 | 523.7 | 335.2 |
| Zimbabwe | 158 | 84 | 242 | 523.7 | 335.2 |
| Malawi (LDC) | 141 | 92 | 233 | 523.7 | 335.2 |
| Mozambique (LDC) | 141 | 68 | 209 | 523.7 | 335.2 |

(Source: CTA/Agritrade)

95. This does not take into account further potential EU price reductions as part of the 2013 review of the EU Common Agricultural Policy. A further reduction, e.g. down to 50% of the price fixed under the 2001 CMO, would be likely to jeopardize returns on currently made investments in the production capacities of comparatively low cost sugar producers, such as Mozambique, Malawi or Zambia.

96. ACP countries which manage to uphold exports after the price cuts, will find themselves in competition with LDCs which gain full duty free market access under the EBA initiative by July 2009. Moreover, traditional ACP exporters will have to find EU buyers on their own. Finally, the new EU domestic reference price will be more flexible than the earlier intervention price. Increased competition among suppliers could lead to downward pressure on the EU import price beyond the reference price applicable from October 2009 on.

97. Essentially, APC countries, which have benefitted from secure and stable export earnings on the basis of sugar exports to the EU for three decades, are confronted with the fallout of their preferences to which they have to adapt within three years in order to avoid the worst adverse effects on their economies.

98. However, the impacts of the reform and of the denunciation of the SP on ACP countries differ with regard to individual countries. For the purpose of discussing these impacts, SP beneficiaries can be categorized into three different groups, namely ACP LDCs, ACP non-LDCs with available alternatives, and ACP non-LDCs without such alternatives.

99. First, some ACP LDCs are likely to be able to compensate their losses due to EU price reductions by increasing their export volumes under the EBA initiative. Low-cost producers such as Malawi, Zambia, and Mozambique could significantly gain by the expansion of their exports under the EBA. Moreover, for these countries, as well as for Kenya, exports to the EU under the SP have so far only accounted for a small portion of overall sugar exports. The same accounts for Tanzania. However, Tanzania may have difficulties to gain from additional EBA market access due to relatively high production costs and extraordinarily high transport costs.

100. Also, countries in this group might gain from potential impacts of the EU sugar reform in third country markets. As EU exports diminish, export competition could decrease and result in world market price increases. World market price developments are, however, largely dependant on whether Australia, Brazil or Thailand, being the most efficient producers of sugar with a highly flexible supply capacity, will step in to supply the volumes which were formerly exported by the EU. In this case, world market prices are unlikely to increase.

101. Secondly, even under a post-2009 duty-free access / EPA scenario, the reform will seriously affect sugar revenues of ACP non-LDCs. An impact assessment authored by the European Commission predicts that raw sugar exports from Mauritius and Guyana would also come to a halt.[26] Others conclude that exports from Guyana may continue.[27] In fact, Guyana has recently invested in a new sugar mill, which may allow it to compensate losses by expanded production. Guyana may also benefit from the market exit of other ACP suppliers, such as Mauritius.

102. Mauritius, the largest SP beneficiary, is currently restructuring its sugar sector in order to produce value-added sugar products, such as 30 million litres of ethanol. According to Mauritius agro-industry minister, the "reforms will not only enable the Mauritian sugar cane industry to sail safely in the future. It will also enable [Mauritius] to continue cultivating a crop which is an invaluable asset as a renewable, environmentally friendly energy source."[28] Additionally, the country seeks to reduce its reliance on sugar by further developing its tourism and financial services sectors. Nevertheless, the loss from earnings of close to 500,000 tons of exports is likely to render adjustment difficult.

103. For Fiji, moreover, tourism has replaced sugar exports as the major source of foreign exchange influx and is far less reliant on sugar export to the EU than Mauritius is. Also, the sugar sector in Fiji has undergone reform which may provide it with enhanced competiveness in the future. However, small scale farmers in rural areas are likely to be affected by drops in export quantities and/or revenue.

104. Being an exception in this country group, Swaziland is a low cost producer which could benefit from increased exports to the EU. In the short-term, however,

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[26] EC : *Reforming the European Union's sugar policy: Summary of impact assessment work*. Brussels, Belgium: European Commission, 2003.
[27] Gillson, I., Hewitt, A., and Page, S.: *Forthcoming Changes in the EU banana/sugar markets: A menu of options for an effective EU transitional package*. London: Overseas Development Institute, 2005.
[28] IPS Daily Journal: *Mauritius: EU assists revamp of sugar cane industry*, 28 March 2007.

the adaptation to the new market reality should be particularly burdensome for this country, where the sugar sector makes up for about 23% of GDP. Additional investments are critical in order to increase production and export capacities, as necessary to compensate for revenue losses by means of enhanced exports. However, in comparison to recent EBA access driven private investments in several LDCs, such as Mozambique, Zambia, Malawi, Sudan and even Tanzania or Ethopia, Swaziland is, as a non-LDC, reportedly missing out on additional capital influx.[29]

105. Third, most concern arises with regard to countries in cyclonic regions where sugar is the only crop that can be grown and where agricultural diversification is hence not an option. Agricultural incomes and exports of these countries are not only highly dependent on the exportation of sugar to the EU, but they are also high-cost producers. For Jamaica, Barbados, Trinidad and Tobago and St. Kitts and Nevis, average production costs lie even above EU average cost of production.[30] Here, traditional raw sugar exports to the EU will most definitely be terminated by October 2009, whereas St. Kitts and Nevis has already ceased sugar production in 2005.

106. In this country group, Trinidad and Tobago appears to be the least affected due to its natural resources of gas and oil which provide for export revenue. Barbados has announced investments into the production of high quality sugars, which could be profitably exported to the EU and other countries, as well as the production of bio-ethanol in order to substitute costly fuel imports. Moreover, in Barbados as well as in St. Kitts and Nevis, tourism has replaced sugar exports as the main source of foreign exchange revenue.[31] Jamaica's economy, furthermore, is diversified to a comparatively high degree, but unemployment and debt levels remain extraordinarily high. The termination of sugar production is likely to add to these problems.

107. Having benefitted from the highly remunerative Sugar Protocol export quotas over the course of more than 30 years, several SP beneficiaries are now faced with the need to reform, restructure and diversify their industry within three years in order to prevent major economic shocks.

## C. Mitigating adverse effects of the EU reform? The EU Adjustment Assistance

108. Accompanying the adoption of the reform of the EU sugar sector, the EU Council, in February 2006, agreed on initial measures, applying to marketing year 2006/07, to assist ACP sugar exporters to the EU in the adaptation to the new market realities. For that year, the EU allocated €40 million to fund ACP countries' national strategies which are formally required to be aimed at a) the improvement of the competitiveness of national sugar sectors; b) the promotion of economic diversification and c) meeting broader adaptation needs with respect to concerns

[29] European Research Office: *The Link between Access to the EU Market and Investment Flows The Case of the Southern and Eastern African Sugar Sector*. March 2007.
[30] Kerkela, L., and Huan-Niemi, E.: *Trade Preferences in the EU sugar sector: Winners and losers.* 358 Vatt Discussion Papers, Government Institute for Economic Research, Helsinki 2005.
[31] Chaplin, H. and Matthews, A.: *Coping with the Fallout for Preference-receiving Countries from EU Sugar Reform*, 7(1) Estey Centre Journal of International Law and Trade Policy 15(2006).

arising over poverty and employment effects of the reform. The allocation of funds, and their amount was announced to be allocated depending on the importance of the national sugar sectors for the individual economies and the overall impact of the EU reform on the respective countries.[32]

109. The 2006 measures are part of multi-annual EU assistance to ACP countries which are affected by the sugar sector reform. As suggested by the European Commission, the EU will allocate up to €1.284 billion to fund ACP SP countries' Multi-Annual Adjustment Strategies (MAAS) over 8 years, from 2006 to 2013. The funds are financed by resources from the 10th EU Economic Development Fund, all existing ACP funds, the European Investment Bank, as well as support from other international donors, the private sector and loans. The allocation of funds to national governments occurs in response to an application by the respective government which includes a detailed Adjustment Strategy Plan. The final and continueing transfer of resources is made dependent on the strict adherence to conditionalities set out by the EU.

110. Thirteen ACP SP countries concluded MAAS plans in 2006, while the remaining five were finalized this year. For instance, for 2006/07, the EU allocated €2.332 million of budget support to Barbados and €2.845 million to St. Kitts and Nevis. For 2007-10, the European Commission agreed, in response to Barbados' MAAS plan, to provide development assistance of the value of €34.6 million. Barbados' adjustment plan focuses on economic diversification and restructuring of its sugar sector, i.e. the transformation of the sector from low value, raw sugar producing to a high value, multi-product industry. As such, Barbados seeks to complete the construction of a multi-purpose plant which produces 27,000 tons of high quality sugars, 30 megawatts of electricity and 24 million litres of ethanol to replace imported fuel.[33]

111. Providing for additional indicators for the extent and nature of the EU adjustment assistance, the Carribean ACP SP states were announced to receive an overall support of €325.46 million for the 2007-2010 period, including individual allocations for Guyana (€84.17 million), Jamaica (€77.547 million), Belize (€45.147million), St. Kitts and Nevis (€42.286 million), and Trinidad and Tobago (€41.643 million). The highest amounts are currently underway to support the adjustment efforts of Mauritius (€301 million for 2007-2010) which follows an enhanced competitiveness and diversification strategy similar to Barbados.[34]

112. However, the EU adjustment scheme is worrying in two respects. First, ACP ministers and civil society organisations (NGO's) have continiously claimed that the allocated amounts are insufficient in order to prevent the expected external economic shocks. At the upper end, Oxfam and WWF jointly demanded annual adjustment

[32] *Council Regulation (EC) 266/2006 of 15 February 2006*
[33] EU Commission Delegation in Barbados, Press Release: *EU allocates EC$124M to Barbados for 2007-2010 Sugar Reform Assistance*, Bridgetown, 23 May 2007.
[34] IPS Daily Journal: *Mauritius: EU assists revamp of sugar cane industry*, 28 March 2007.

funding of at least €500 million.[35] On the political level, ACP SP ministers urged the "Commission to supplement the accompanying measures funding with de-committed 9th EDF funds, to at least 200 million euros per year, and to accelerate disbursements, so as to enable the effective implementation of the ACP multi-annual adaptation strategies (MAAS)."[36] Moreover, ministers urged the Commission to provide flexibility to adapt the MAAS to changing circumstances. In fact, this is highly likely to be required in the context of the termination of sugar preferences by October 2009, a step that was only announced after the drafting of the MAAS.

113. The demands seem to be highly justified. EU farmers receive a generous 64% compensation for price reductions. Compensation is expected to amount to €1.54 billion once the full reduction has been implemented in 2010.[37] The availability of €1.284 billion over 8 years for the mere adjustment to EU domestic policy changes, in contrast, does not seem to match up with the EU's verbal commitment to the promotion of economic development and poverty reduction.

114. Secondly, the eligibility requirements of the EU adjustment scheme give rise to concern. On behalf of the EU, emphasis has been placed on the intention to provide funding to those countries "which need it." Following the wording of the 2006/07 Council Regulation providing for MAAS funding, countries with competitive sugar sectors and a lower degree of reliance on sugar exports to the EU would receive lower amounts. This rationale appears to misjudge the economic consequences of the EU price reductions on ACP economies.

115. For instance, Swaziland is a highly competitive sugar producer and exports about 20% of its production to the EU. A comparatively low allocation of funds to Swaziland, on the basis of high competitiveness and comparatively low reliance on exports to the EU, would ignore the fact that a €15.4 million quota value reduction over three years, and further major losses due to price reductions in 2009, constitute a profound economic shock which is likely to exert severe consequences for the achievement of national poverty reduction and development strategies.

116. What is necessary is a strong political commitment on behalf of the EU that it will step up to its responsibility to ensure that ACP SP countries' national economic development and poverty reduction strategies are by no means impeded by the 2006 reform of the EU sugar sector and the 2009 termination of preferences. This entails the commitment to provide adjustment assistance beyond the amounts offered so far. Funds should be adequate in amount to compensate competitive exporters for their losses. Such a commitment is even more necessary in light of the uncertainties created by the recent denunciation of the Sugar Protocol and preference erosion due to the market entry of LDCs.

[35] WWF and Oxfam: *Critique of the EC's Action Plan for ACP countries affected by EU sugar reform*, WWF and Oxfam Briefing Paper, June 2005.
[36] ACP Secretariat: *The Fiji Communiqué on Sugar*, adopted at the 10th ACP Special Ministerial Conference on Sugar, 30th April – 3rd May 2007, Nadi, Fiji.
[37] Chaplin, H. and Matthews, A. (2006)

117. A strong EU financial commitment to the promotion of economic development and poverty reduction in ACP SP countries, particularly in the context of the EU sugar reform, is an imperative. In fact, in the course of the reform, the EU ultimately saves around €800 million annually which it used to spend on export refunds in order to export 1.6 million tons of ACP/Indian sugar. The EU is morally and politically obliged to ensure that such savings are not made at the expense of the poorest and most vulnerable economies in the world. The fact that the saved amounts, due to the elimination of export refunds for ACP sugar, are now spent on the compensation of comparatively affluent EU farmers, does by no means justify the EU to provide less than adequate adjustment assistance to ACP SP states. To the contrary, the spending on ACP sugar export refunds have never benefitted EU farmers and should rightly be used as part of EU adjustment assistance to ACP states.

## V. THE EU MARKET ACCESS OFFER ON SUGAR IN THE CONTEXT OF EPA NEGOTIATIONS: SAFEGUARDING THE BENEFITS OF THE SUGAR PROTOCOL?

118. As indicated in chapter III, section B, the Cotonou Agreement explicitly provides for the negotiation of WTO compatible trading arrangements between ACP states and the EU, i.e. trade agreements which comply with Article XXIV of the GATT 1994, and therefore provide for the liberalisation of 'substantially all trade' between the parties.[38] These free trade agreements, labeled Economic Partnership Agreements, would be concluded and come into force by January 1st 2008, and succeed the current unilateral, non-reciprocal trade preferences granted by the EU to ACP states under the Cotonou Agreement and its commodity protocols.

119. It has been mentioned above that the conclusion of a free trade agreement bears great risks for developing and least-developed countries and require detailed impact studies. FTA's may deprive these countries, vis-à-vis the EU, of future policy space which they may need in order to develop competitive agricultural, industrial and services sectors on a sustainable basis.

120. Taking account of the possibility that some countries may come to the conclusion that they are not in the position to conclude an FTA with the EU, Article 37(6) of the Cotonou Agreement provides that the EU "will assess the situation of the non-LDC which, after consultations with the Community decide that they are not in a position to enter into economic partnership agreements and will examine all *alternative possibilities, in order to provide these countries with a new framework for trade which is equivalent to their existing situation and in conformity with WTO rules*."

121. Moreover, Article 36(4) of the Cotonou Agreement stipulates that "the Parties reaffirm the importance of the commodity protocols, attached to Annex V of this Agreement. They agree on the need to review them in the context of the new trading arrangements, in particular as regards their compatibility with WTO rules, with a

[38] Article 36(1) Cotonou Agreement

view to safeguarding the benefits derived therefrom, bearing in mind the special legal status of the Sugar Protocol."

122. The current status of EPA negotiations, in particular regard to the EU market access offer on sugar, has to be viewed and assessed against the background of these two provisions. The provisions impose, in principle, a legal obligation upon the EU to provide ACP SP countries with trade arrangments which safeguard the benefits under the Sugar Protocol *whether or not they decide to become party to an EPA*.

A. The EU Market Access Offer on Sugar in the Context of EPA Negotiations

123. In April 2007, the EU tabled an overall market access offer which would grant duty free and quota free market access to all ACP countries' products once the EPAs come into force - with transitional arrangements for bananas and sugar. For sugar, duty free and quota free market access would be phased in in three stages over 7 years. Ultimately, ACP developing countries would be granted the same market access conditions as those granted to LDCs under the EBA initiative - apart from the application of a safeguard clause to ACP non-LDC imports.[39]

124. In the first stage, lasting from January 1st 2008 until September 30th 2009, the Sugar Protocol continues to apply. ACP LDCs are offered a substantial quantitative improvement of market access for marketing year 2008/09, additional to the quota guaranteed under the EBA initiative for that year (197,335 tons). Non-LDC parties to the SP are offered market access additional to their SP quota. Non-LDCs not party to the SP would receive an initial quota. With regard to additional market access, the EU offer leaves much room for speculations and renders an evaluation of the offer almost impossible. It remains unclear how much market access is provided in addition to the SP quotas. On the positive side, this implies that the quantities remain subject to negotiation. As such, ACP SP countries, which are able to benefit from economies of scale, as their exports are still profitable under new EU domestic prices, are well advised to quantify the losses they face due to EU price reductions and demand quotas large enough to offset these losses.

125. The second phase lasts from October 1st 2009 to September 30th 2015. At this stage, the EU would grant free market access for ACP sugar. That this market access offer is, in fact, not as 'free' as proclaimed is made clear by rendering imports from ACP non–LDCs subject to an automatic volume safeguard clause. It remains unclear which import quantity level would trigger the application of the safeguard. Also, it might be difficult to grasp the conceptual difference between an automatic safeguard based on volumes and a mere quota limitation. To be sure, ACP non-LDC exports would remain limited. If this continues to be the EU position, guaranteed minimum market access for profitable non-LDC SP exporters *significantly above the levels of the Sugar Protocol quotas* would be crucial in order to enable them to offset the losses suffered in the course of the EU domestic price reductions.

126. Furthermore, until 2012, the offer provides that EU importers of ACP sugar would be required to pay a price above a certain level. After 2012, a price

[39] Fautrel, V. and Makhan, D.: *EU-ACP sugar trade and the EPAs: taking the sweet with the sour*, 6(6) Trade Negotiation Insights, IDCSD/ECDPM, October 2007.

information system would provide for market transparency. This feature of the EU market access offer is particularly worrying. What the EU is proposing here is to leave the post-2012 EU market deficit of three to four million tons up for competitive supply by LDCs under the EBA and ACP LDCs and developing countries under the EPAs – without providing for a guaranteed import price.

127. Under such circumstances of largely unrestricted competition for market access, large suppliers frequently tend to drive small-scale competitors, by means of low or even below-cost price competition, out of the supply market. As these conditions would apply to the most vulnerable economies in the world, such a scenario can only be deemed to be the worst case. The uncertainties associated with the drastic change from guaranteed prices to free market competition would jeopardize the sustainability and security of investments made, and to be made, in the sugar sectors of these countries. A price competition scenario appears to be the opposite of what attracts much needed investments. ACP non-LDCs would be particularly vulnerable to such price competition, since the safeguard clause would limit their exports and deprive them of the opportunity to compensate already low prices by selling higher quantities. Therefore, the EU must guarantee, beyond 2012, the payment of a minimum price for imports, which should equal the EU domestic price as indicated by the price information system and the domestic reference price.

128. Furthermore, in the second stage, several high-value, processed agricultural products with high sugar content would be subject to a surveillance mechanism in order to prevent evasion of the sugar-import regime. In this respect, it should be of particular concern of ACP countries, whether their high quality sugar products, which they have just recently sought to diversify into with assistance from the EU, would now be subject to import restrictions by the EU.

129. In the third stage, from October 2015 on, sugar originating from any ACP country would be granted quota and duty free access – subject to a safeguard clause which is based on the EPA safeguard, but takes account of the 'sensitivity' of sugar for the EU. Here, again, the details are left unspecified and appear to be open for negotiation.

<u>B...safeguarding the Benefits of the Sugar Protocol?</u>

130. For several high cost ACP SP producers, the question, whether their benefits under the Sugar Protocol are safeguarded, can only be answered in context of the adjustment assistance received from the EU. This is because these states have already ceased or will cease sugar production due to dramatically reduced EU sugar prices. The (in)adequacy of the amounts of the EU adjustment assistance has been addressed in chapter IV, section C.

131. However, for some high-cost producers whose economies are heavily dependent on sugar production, adjustment measures may not be implemented fast enough in order to prevent severe adverse effects on employment and poverty, especially in rural areas. Under such circumstances, it would be necessary to uphold production and exports to the EU at preferential rates for a transitional period of

time beyond the 2009 termination of sugar preferences, in order to ensure a smooth economic adaptation to the new reality.

132. Within the framework of a free trade agreement with the EU, this seems to be a WTO compatible and viable option. For instance, to be provided for in a potential EPA, the SP sugar quotas for high cost and sugar reliant ACP countries could be gradually phased out until 2015. Until then the EU would, for gradually reduced quota quantities, provide these suppliers with a per ton deficiency payment which enables them to uphold exportation at reduced EU domestic prices for the transition period, i.e. the deficiency payment would merely cover the difference between the reduced EU domestic price and production and transport costs on behalf the high-cost ACP producer, including a slight profit margin. Such a practice would be likely to conform to a GATT Article XXIV free trade EPA since sugar trade would be fully liberalized after the end of the transition period. In fact, the gradual phase out of quota quantities would effectively complement EU adjustment assistance provided for domestic efforts to enhance competitiveness and/or to diversify. As such, the per ton deficiency payments would have to be provided additionally to the MAAS funds.

133. The remaining ACP SP states, which are generally able to supply the EU market with raw sugar at a price of €335.2 per ton, will, from July 2009 on, face the competition of LDCs which gain duty free and quota free market access to the EU on that date under the EBA. The erosion of the SP preferences will, at this point, materialize by means of the market entry of countries such as Sudan, Ethiopia, and others. Both Sudan and Ethiopia have recently announced that they plan to increase their production up to one million tons.

134. The erosion of SP preferences will be particularly felt by non-LDC SP states which formerly held large SP quotas, such as Swaziland, Guyana, and Fiji. While these states would seek to significantly increase exports to the EU in order to compensate for losses due to price reductions, their exports would now be subject to a volume safeguard clause. The same applies to Zimbabwe and Belize, which, however, held significantly smaller quotas under the SP.

135. In terms of the erosion of preferences as formerly granted under the SP, this ACP country group accounts for the main losers of a non-SP EPA scenario – at least among those SP ACP states which can manage to uphold exports to the EU under the new conditions at all. Apart from Zimbabwe, all of these states are highly dependent on sugar production as a source of national income, with exports to the EU accounting for a major share of production. If these countries should not sign a free trade agreement with the EU, they would fall back to EU GSP or GSP+ preferences, which are by far not as beneficial as the non-reciprocal preferences under the Cotonou Agreement or the overall market access offer made by the EU in the EPA context.

136. This is particularly the case for sugar. The EU GSP and GSP+ schemes do not even offer any preferential access for sugar exports from developing countries. Therefore, EPA non-signatories would be confronted with the EU's MFN tariff for sugar which is set at the import-prohibitive level of €339 per ton of raw sugar.

Essentially, this would imply that highly competitive but small and vulnerable sugar producing non-LDC economies would be deprived of all export earnings formerly derived from sugar exports to the EU.

137. This worst-case scenario would become reality if the EU should not to step up to its legal obligation, provided for in Article 37(6) of the Cotonou Agreement, to provide ACP non-LDC countries with trading arrangements equal to their current situation, in case these ACP countries decide that they are not in the position to sign an EPA. Therefore, despite the fact that the new market reality would do everything but 'safeguard' the benefits derived under the SP, in violation of Article 36(4) of the Cotonou Agreement, these countries have a strong incentive to sign EPAs with the EU in order to safeguard whatever is left of their SP preferences.

138. Among ACP SP countries, the main beneficiaries of the altered market reality are low-cost competitive LDC producers which held small quotas under the SP. This country group includes Mozambique, Malawi, Zambia, and even Tanzania. Recently, these states have enjoyed a strong influx of investment in their sugar production capacity and will increase tonnage as much as possible in order to gain from free market access granted under the EBA initiative by July 2009. Typical for this group, Zambia plans to expand its sugar production from 186,000 tons in 1999 over 250,000 tons in 2006 to 434,000 tons in 2010. Exports to the EU are expected to increase from current 38,000 tons to 229,000 tons by 2010.[40]

139. Most generally, ACP LDCs have the lowest incentives to sign EPAs, since they already receive, under the EBA initiative, what ACP non-LDCs have to pay for with free market access to be granted to EU exports after a certain transition period. Moreover, they are likely to provide ACP non-LDC sugar exporters with strong competition with regard to sugar. As such, the distinguished treatment of LDCs and non-LDCs in an EPA framework seems likely to undermine ACP SP countries solidarity in the course of current EPA negotiations.

140. After all, a more precise assessment of the gains and losses is not feasible at this point, since the EU market access offer requires further specification. What is clear is that the new market reality, under the circumstances of drastically reduced and potentially flexible prices, is hardly comparable to the former market conditions of high guaranteed prices and guaranteed quantities. The main losers of the altered scenario are ACP developing non-LDCs that are highly dependent on foreign exchange revenue as derived from sugar exports to the EU. These countries are under heavy pressure to sign EPAs in order to secure some of their export revenue from sugar trade with the EU. In contrast, some ACP LDCs may anticipate compensating their losses due to EU reform price reductions, by expansion of production and unlimited exports at zero duty.

[40] European Research Office: *The Link between Access to the EU Market and Investment Flows The Case of the Southern and Eastern African Sugar Sector*, March 2007.

C. Safeguarding the Benefits of the Sugar Protocol in ACP-EU Negotiations: Conclusions and Recommendations

141. With regard to ACP SP countries which are currently engaging in negotiations with the EU over EPAs, the bottom line is to safeguard the benefits derived under the Sugar Protocol, in a WTO compatible manner. Seeking to achieve this objective on the expense of ACP states, as the EU market access offer on sugar seems to imply, contradicts the EU obligations under the Cotonou Agreement.

142. The adequacy of measures to safeguard ACP countries' benefits under the Sugar Protocol is highly dependent on the individual economic situation of the respective beneficiaries. Three main country groups can be identified to which partly distinct recommendations apply.

143. First, for several uncompetitive ACP countries sugar production and exportation under the new EU price regime is not sustainable. This group has to seek to make maximum use of the adjustment assistance provided by the EU in order to diversify into other economic sectors and to meet broader adaptation needs. The EU funds for the MAAS appear to be inadequate to address these countries' diversification and adaptation needs. Therefore, the main aim of this group would be to negotiate additional funding for the 2010-2012 period, on the basis of comprehensive Adjustment Strategy Plans, as individually submitted to the EU.

144. Moreover, for some countries in this group, the long-lasting reliance on sugar exports to the EU will render ad-hoc adjustment measures insufficient to cope with what turns out to be a major overall economic reform. In order to avoid short and mid-term adverse effects on employment and poverty and to complement the implementation of diversification strategies, such states would be eager to stress the need to establish a transition period beyond 2009. During this extended transition period, the guaranteed EU import quota under the SP would be gradually phased out until they are eventually terminated, e.g. by October 2015. To ensure the viability of these exports, the EU would provide a per ton deficiency payment which covers the difference between the EU import price and the production and transport costs of the respective supplier - plus a minimum profit margin. In an EPA/GATT Article XXIV scenario, such a transition arrangement would be WTO compatible and would therefore meet the EU bottom line.

145. Finally, countries in this group would feel inclined to pay particular attention to EU plans to set up a surveillance mechanism with regard to several high-value processed agricultural products with high sugar content. Depending on the functions of this mechanism, it could undermine the sustainability of ACP high-value sugar exports to the EU market. Since several ACP SP states are currently engaging in diversification efforts which aim at the production and exportation of high-value sugar products, the mechanism could be a potential threat to ACP SP states' diversification strategies.

146. Secondly, several highly competitive LDC sugar producers, holding small quota rights under the SP, have the opportunity to significantly increase their sugar exports to the EU under a potential EPA and/or under the EBA initiative. However,

the EU market access offer for sugar suggests that minimum prices for these exports will only be guaranteed until 2012. Under the circumstances of flexible prices, the profitability and sustainability of ACP LDC and ACP non-LDC exports may be endangered by increasing price competition and resulting downward pressure on EU import prices. This represents an unbearable risk and uncertainty and additionally discourages additional investments in the respective national sugar sectors. Therefore, competitive ACP-LDCs and ACP non-LDCs share the strong interest to negotiate the maintenance of a minimum EU import price beyond 2015.

147. Also, the offer of duty-free market access for unlimited sugar quantities can only materialize in ACP market access gains if the EU import capacity, i.e. its domestic supply deficit, allows for a significant increase of import quantities. Currently, it is expected that the EU will import between 3 and 4 million tons of raw sugar by 2010. Due to the reluctance of EU producers to voluntarily renounce their quotas so far, these estimations may only become reality if the European Commission will authoritatively reduce quota allocations from 2010 on, without compensating producers for the quota losses. This will be politically difficult to achieve. Thus, competitive ACP LDCs and ACP non-LDCs would be likely to emphasize the need for a minimum overall market access guarantee and, potentially, the need to enlarge the EU's import capacity beyond the currently estimated 3 to 4 million tons.

148. Thirdly, a group of competitive ACP non-LDC sugar producers, which hold large quotas under the SP and are highly reliant on sugar production, appear to be significantly worse off if the EU market access offer would be implemented. Facing the need to expand production and exports to the EU to compensate for losses due to price reductions, the safeguard clause proposed by the EU would place a de facto cap on ACP non-LDC exports and potentially deprive them of compensation for losses based on their own economic capacity. In order to prevent such a scenario, these countries hold a strong interest in the abolishment of the safeguard clause and/or an EU guarantee of minimum import quantities which would provide for the necessary economic compensation for price reductions. Such guaranteed quantities, as provided for in an EPA, would conform to GATT Article XXIV if the arrangement is transitory in nature, e.g. upheld for eight to fifteen years only.

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