House of Commons

European Scrutiny Committee

Thirty-sixth Report of Session 2017–19

Documents considered by the Committee on 18 July 2018

Report, together with formal minutes

Ordered by the House of Commons
to be printed 18 July 2018

HC 301-xxxv
Published on 24 July 2018
by authority of the House of Commons

Notes

Numbering of documents

Three separate numbering systems are used in this Report for European Union documents:

Numbers in brackets are the Committee's own reference numbers.

Numbers in the form "5467/05" are Council of Ministers reference numbers. This system is also used by UK Government Departments, by the House of Commons Vote Office and for proceedings in the House.

Numbers preceded by the letters COM or SEC or JOIN are Commission reference numbers.

Where only a Committee number is given, this usually indicates that no official text is available and the Government has submitted an "unnumbered Explanatory Memorandum" discussing what is likely to be included in the document or covering an unofficial text.

Abbreviations used in the headnotes and footnotes

AFSJ	Area of Freedom Security and Justice
CFSP	Common Foreign and Security Policy
CSDP	Common Security and Defence Policy
ECA	European Court of Auditors
ECB	European Central Bank
EEAS	European External Action Service
EM	Explanatory Memorandum (submitted by the Government to the Committee)*
EP	European Parliament
EU	European Union
JHA	Justice and Home Affairs
OJ	Official Journal of the European Communities
QMV	Qualified majority voting
SEM	Supplementary Explanatory Memorandum
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

Euros

Where figures in euros have been converted to pounds sterling, this is normally at the market rate for the last working day of the previous month.

Further information

Documents recommended by the Committee for debate, together with the times of forthcoming debates (where known), are listed in the European Union Documents list, which is published in the House of Commons Vote Bundle each Monday, and is also available on the parliamentary website. Documents awaiting consideration by the Committee are listed in "Remaining Business": www.parliament.uk/escom. The website also contains the Committee's Reports.

*Explanatory Memoranda (EMs) and letters issued by the Ministers can be downloaded from the Cabinet Office website: http://europeanmemoranda.cabinetoffice.gov.uk/.

Staff

The staff of the Committee are Dr Philip Aylett (Clerk), Kilian Bourke, Alistair Dillon, Leigh Gibson, Foeke Noppert, Sibel Taner and George Wilson (Clerk Advisers), Arnold Ridout (Counsel for European Legislation), Joanne Dee (Deputy Counsel for European Legislation), Jeanne Delebarre (Second Clerk), Daniel Moeller (Senior Committee Assistant), Sue Beeby, Rob Dinsdale and Beatrice Woods (Committee Assistants), Ravi Abhayaratne and Paula Saunderson (Office Support Assistants).

Contacts

All correspondence should be addressed to the Clerk of the European Scrutiny Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is (020) 7219 3292/5467. The Committee's email address is escom@parliament.uk.

Contents

Meeting Summary

The Committee looks at the significance of EU proposals and decides whether to clear the document from scrutiny or withhold clearance and ask questions of the Government. The Committee also has the power to recommend documents for debate.

Summary

Proposed Regulation on the 2021–2027 Rights and Values Programme

The proposed Rights and Values programme aims to protect and promote rights and values as enshrined in the EU Treaties and in the EU Charter of Fundamental Rights (the Charter). The specific objectives are to promote equality and rights, to encourage citizens' engagement and participation in the democratic life of the Union and to fight violence, particularly against children, young people and women. Activities envisaged are awareness-raising, mutual learning, analytical and monitoring activities, training, bringing people together and developing the capacity of European "Rights and Values" networks.

The Government is unsure yet whether it will participate in this 2021–27 Rights and Values programme as a third country after transition/the implementation period. We press the Government for an indication of the likely cost of such participation, whether the UK would be able to fulfil the qualifying criteria for participation, whether the benefits would outweigh both the costs and the inability to influence decision-making, what other legal or policy implications might flow from association and how it might fit with the UK not incorporating into UK law post Brexit/transition.

Not cleared from scrutiny; further information requested; drawn to the attention of the Justice Committee and the Joint Committee on Human Rights.

Documents drawn to the attention of select committees:

('NC' indicates document is 'not cleared' from scrutiny; 'C' indicates document is 'cleared')

Defence Committee: Cyprus: Brexit and UK Sovereign Base Areas [Council Regulation (C)]

Environmental Audit Committee: Green Finance: classification of investments, disclosures and low carbon benchmarks [Proposed Regulations (NC)]

Foreign Affairs Committee: Cyprus: Brexit and UK Sovereign Base Areas [Council Regulation (C)]; The EU emergency Travel Document [Proposed Council Directive (NC)]

International Trade Committee: EU countermeasures to US tariffs on steel and aluminium [Implemented Regulations (C)]

Joint Committee on Human Rights: Rights and Values Programme 2021–27 [Proposed Regulation (NC)]

Justice Committee: Rights and Values Programme 2021–27 [Proposed Regulation (NC)]

Public Accounts Committee: EU Budget 2019 [Estimates Statement (NC)]

Treasury Committee: Green Finance: classification of investments, disclosures and low carbon benchmarks [Proposed Regulations (NC)]; EU Budget 2019 [Estimates Statement (NC)]

1 A New Deal for Consumers

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; updates requested
Document details	(a) Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: A New Deal for Consumers; (b) Proposal for a Directive of the European Parliament and of the Council amending Council Directive 93/13/EEC of 5 April 1993, Directive 98/6/EC of the European Parliament and of the Council, Directive 2005/29/EC of the European Parliament and of the Council and Directive 2011/83/EU of the European Parliament and of the Council as regards better enforcement and modernisation of EU consumer protection rules; (c) Proposal for a Directive Of The European Parliament And Of The Council on representative actions for the protection of the collective interests of consumers, and repealing Directive 2009/22/EC
Legal base	(a) —; (b) (c) Article 114 TFEU, Ordinary legislative procedure; QMV
Department	Business, Energy and Industrial Strategy
Document Numbers	(a) (39619), 7875/18, COM(18) 183; (b) (39618), 7876/18 + ADDs 1–4, COM(18) 185; (c) (39617), 7877/18 + ADDs 1–5, COM(18) 184

Summary and Committee's conclusions

1.1 Following a regulatory fitness (REFIT) review of European consumer and marketing law, which found that action should be taken to improve enforcement of EU consumer protection rules as well as consumers' awareness of their rights, the European Commission has adopted a "New Deal for Consumers", which consists of two proposed directives and a communication.[1]

1.2 The first of the two proposals for a Directive (7876/18), would amend the four main consumer Directives: the Consumer Rights Directive (CRD),[2] the Unfair Contract Terms Directive (UCTD),[3] the Unfair Commercial Practices Directive (UCPD)[4] and the Price Indications Directive (PID).[5] This proposed Directive envisages the following key changes to the consumer protection acquis:

- To improve traders' compliance with EU consumer law through the introduction of penalties, including fines, for breaches of consumer law under each of the four

1 European Commission, A New Deal for Consumers: Commission strengthens EU consumer rights and enforcement (11 April 2018).
2 Directive (EU) 2011/83 of the European Parliament and of the Council of 25 October 2011 on consumer rights.
3 Directive (EC) 1993/13 on unfair terms in consumer contracts.
4 Directive (EC) 2005/29 concerning unfair business-to-consumer commercial practices in the internal market.
5 Directive (EC) 1998/6 on consumer protection in the indication of the prices of products offered to consumers.

cross-cutting Directives. Member States would be able to determine the level of the cap in their country, subject to a minimum 'floor' level of 4% of a trader's annual turnover. Member States would be required to take account of certain criteria when deciding whether to impose a penalty and at what level, although these criteria would be non-exhaustive. 13 out of 17 Member State authorities and all 16 consumer organisations surveyed supported the introduction of penalties and the establishment of common criteria across the EU for imposing fines.

- To improve transparency online and ensure that consumers are aware of their rights when purchasing goods from an online platform. This would be achieved through amendments to the CRD which would require online marketplaces to inform consumers about: how offers presented to them when using the online marketplace have been ranked; whether the contract would be concluded with a trader or not; whether EU consumer law applies to their transaction; and, where the contract is concluded with a trader, who is responsible for guaranteeing the EU consumer law rights related to their contract.

- To reduce the regulatory burden for business in relation to the consumer's right of withdrawal from distance sales through the removal of two obligations which have been found to be particularly burdensome: the requirements for the trader to accept the consumer's withdrawal from the contract when they have used the good more than necessary to establish their nature, characteristics and functioning, and for the trader to reimburse the consumer before they have had receipt of the returned good.

- To amend the CRD to extend its application to digital services, such as cloud storage or an email account, for which a consumer has paid using their personal data. Consumers would have the same right to pre-contractual information and to cancel the contract within a 14-day right-of-withdrawal period as with conventional paid-for services.

- To clarify the rules on misleading marketing of 'dual quality' products, amending the UCPD so that it is made explicit that a commercial practice involving the marketing of a product as being identical to the same product marketed in several other Member States, where those products have significantly different composition or characteristics causing or likely to cause the average consumer to take a transactional decision that he would not have taken otherwise, is a misleading commercial practice which competent authorities should assess and address.

1.3 The former Parliamentary Under Secretary of State and Minister for Small Business, Consumers and Corporate Responsibility at the Department of Business, Energy and Industrial Strategy (Andrew Griffiths) indicated in an explanatory memorandum[6] regarding the package that the Government had worked closely with the EU on its REFIT review of EU and consumer marketing law and its parallel review of the CRD, and supports EU efforts to ensure that consumers' rights are robust and that they can be enforced effectively.

6 Explanatory Memorandum from the Minister, BEIS (4 May 2018).

1.4 In the explanatory memorandum the Minister emphasises that the Member States retain significant levels of discretion under the proposal: regarding redress, for breaches of the UCPD, Member States would retain discretion as to which remedies they make available, subject only to the requirement to provide both contractual remedies (as a minimum, the right to termination) and non-contractual remedies (as a minimum, the right to compensation); for penalties, Member States would also retain discretion to set a higher cap than the 4% minimum, and the criteria to be used in deciding whether to impose a fine and at what level are non-exhaustive.

1.5 The Minister also notes that the package addresses many of the same themes which the UK is currently consulting on in the 'Consumer Green Paper: Modernising Consumer Markets'.[7] The Green Paper confirms the Government's intention to bring forward domestic legislation which will, according to the Minister:

- give civil courts the power to impose financial penalties on traders for breaches of consumer protection laws;
- enable all consumer law enforcers, including the CMA and Trading Standards, to ask the courts to impose fines either as a standalone remedy, or in conjunction with the existing civil remedies such as injunctive relief, enforcement orders or enhanced consumer measures; and
- the financial penalty proposed will go further than the current 'floor' level of 4% set out in the New Deal and be subject to a total cap of 10% of a firm's worldwide turnover.

1.6 The second element of the New Deal for Consumers is the proposed Directive (EU) 7877/18 which would replace the existing Injunctions Directive with an instrument for the protection of consumers' collective interests. The proposed Directive would cover both horizontal and sector-specific EU instruments which relate to the protection of consumers' collective interests across sectors including financial services, energy, the environment and telecommunications. It would enable 'qualified entities', designated by Member States, to bring forward representative actions on behalf of consumers seeking measures which would oblige the trader to provide the consumer with compensation, a repair, replacement, price reduction, contract termination or a reimbursement of the price they have paid, as appropriate.

1.7 In a separate explanatory memorandum submitted in relation to this proposal,[8] the Minister notes that the Commission has made clear that it intends to avoid the potential for abusive litigation under the instrument, and that the entities should, as a minimum, be not-for-profit and have a legitimate interest in protecting consumers' collective interests. The Minister states that the Government will work closely with the Ministry of Justice to ensure that any new rules introduced at EU level are proportionate to tackle consumer detriment and that the rules provide legal certainty.

1.8 As drafted, both proposals provide for an 18 month period for the Member States to transpose them into national law (once the proposal has been negotiated and adopted); Member States would have to apply the provisions after a further 6 month period. If the transitional arrangements in the current draft Withdrawal Agreement become applicable,

7 BEIS, Modernising consumer markets: Consumer Green Paper (11 April 2018).
8 Explanatory Memorandum submitted by the Minister, BEIS (4 May 2018).

whether or not the UK will have to implement these provisions in national law, and to apply the provisions, before the transitional period ends, will depend on whether the institutions can make significant progress on the proposals before European Parliament elections in 2019, and whether there is an extension to the transitional period.

1.9 The Communication[9] which accompanies the legislative proposals also signals the Commission's intention to agree bilateral or multilateral agreements for consumer-protection enforcement cooperation between the EU and third countries such as the USA, Canada and China. This cooperation would be facilitated by the stronger framework for the coordination of public enforcement authorities within the EU established by the revised CPC Regulation,[10] which can be used as a basis for seeking cooperation agreements with third countries.

1.10 On EU exit, the Minister states only that "the way consumer protections apply across the border with the EU in future is a matter for negotiations" and that it is not in either party's interest "for rogue traders to target citizens based in the UK or EU." On 12 July 2018 the Government published the White Paper "The Future Relationship between the United Kingdom and The European Union", which set out the Government's vision for the future economic partnership.[11] In relation to consumer protection, the report states that that the UK "is committed to maintaining high standards", and:

> "To ensure that open trade between the UK and EU economies is not at the expense of consumers, and in the context of the future economic partnership, the UK proposes to commit to maintain reciprocal high levels of consumer protection. There should be cooperation on enforcement, including provisions to allow mutual exchange of information and evidence, and a framework to work collectively on areas of wider consumer detriment."

1.11 **We have taken note of the Minister's assessment of the New Deal for Consumers. The Minister emphasises that the Government has worked closely with the EU on its REFIT review of EU and consumer marketing law and its parallel review of the CRD, and that the package addresses many of the same themes which the UK is currently consulting on in its green paper on modernising consumer protection—including consumer protection in digital markets, redress, and penalties. The Government identifies no significant concerns with either of the proposed Directives, both of which it accepts comply with the principle of subsidiarity.**

1.12 **The principal effect of the package is to strengthen enforcement of EU consumer protection rules. Enabling Member States' competent authorities to impose fines of 4% (or more, at Member State discretion) of a business's annual turnover for breaches of consumer law under each of the four cross-cutting consumer protection Directives will bring enforcement of consumer protection rules in line with the current data protection and competition enforcement in this respect. The proposed instrument that would replace the existing Injunctions Directive would enable consumer rights**

9 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: a New Deal for Consumers 7875/18.

10 Regulation (EU) 2017/2394 of the Council and European Parliament of 12 December 2017 on cooperation between national authorities responsible for the enforcement of consumer protection laws and repealing Regulation (EC) No 2006/2004.

11 HM Gov, The future relationship between the United Kingdom and the European Union (12 July 2018).

organisations to bring forward representative actions on behalf of consumers across the full range of horizontal and sector-specific EU consumer protection instruments. Taken together, these measures would significantly increase businesses' incentives to comply with EU consumer protection rules.

1.13 **A variety of further updates and clarifications are proposed to ensure that consumer protection rules adequately reflect recent market developments. The proposed adaptations to developments in the digital economy are modest in scope, and would provide consumers with greater transparency when transacting online and also extend protections to online transactions in which the consumer pays for a service with their data. The removal of two disproportionate regulatory obligations is based on the Commission's public consultation with SMEs and consumer associations. The provisions regarding the misleading marketing of 'dual quality' products will address widespread concerns about this practice in some Member States.**

1.14 **Although the Minister does not identify any specific concerns, he indicates that the Government intends to closely monitor the proportionality of a number of aspects of the proposals as they develop, to ensure that:**

- **the proposed transparency requirements for online marketplaces do not pose a disproportionate burden on business;**
- **the removal of certain obligations on traders in relation to the customer's right of withdrawal are fair for consumers; and**
- **any new rules regarding collective actions are proportionate to tackle consumer detriment and that the rules provide legal certainty.**

1.15 **On EU exit, the Minister states that "the way consumer protections apply across the border with the EU in future is a matter for negotiations" but that it is not in either party's interest "for rogue traders to target citizens based in the UK or EU." We note that the Government's White Paper "The Future Relationship between the United Kingdom and The European Union" published on 12 July 2018 states that, as part of the future economic partnership, "the UK proposes to commit to maintain reciprocal high levels of consumer protection" including "cooperation on enforcement, including provisions to allow mutual exchange of information and evidence, and a framework to work collectively on areas of wider consumer detriment."**

1.16 **We ask the Government to provide the Committee with an update regarding both proposed Directives when the shape of any anticipated General Approach or mandate becomes clearer. As part of this update, we particularly request that the Government clarify whether the text achieves satisfactory outcomes on the three points which the Minister identified as requiring further monitoring (see paragraph 14).**

1.17 **In the same update, we ask the Government to provide further clarification of how it envisions UK-EU consumer protection working in practice within the context of the future relationship. We particularly ask the Government to clarify:**

- **Whether any existing EU arrangement with a country outside the EEA, and not including Switzerland, currently provides a level of reciprocal consumer**

protection that the Government would consider to be adequate within the scope of the future economic partnership, and if so, to elaborate on this arrangement;

- **Whether any current EU agreements with third countries, other than the EEA and Switzerland, provide for a high level of participation in the intra-EU legal cooperation mechanisms and infrastructure that facilitate the protection of European consumers (e.g. RAPEX, the EU Rapid Alert System for dangerous non-food products; the European Consumer Centre Network, an EU-wide network of advice centres for consumers shopping across borders; cooperation facilitated by the Consumer Protection Cooperation Regulation)?**
- **How the Government envisages that consumer protection arrangements within the future UK-EU economic partnership would differ from, for example, the provisions of the EU-Ukraine Association Agreement[12] (see particularly Chapter 20 and Annex XXXIX)?**
- **Whether, assuming that a transitional period is agreed as part of a withdrawal agreement, the Government would continue to implement and apply the rules of the proposed Directives in this package if the deadline for full transposition of the Directives' provisions into national law were to fall within the transitional period, but the deadline for Member States to apply the Directive's provisions were to fall *after* the transitional period had ended?**

1.18 **We would also request the Government to clarify whether there is any overlap or conflict with the proposed Directive (b) and:**

i) **the proposed Directive concerning contracts for the supply of digital content[13] currently being negotiated;**

ii) **the UK's Consumer Rights Act 2015[14]**

both generally and in relation to the proposed extension of the existing Consumer Directive to digital services for which a consumer has paid using their personal data?

1.19 **We retain these proposals under scrutiny. In the meantime, we ask for a response to the above EU exit implications by 19 September 2018, and an update in relation to the two draft Directives when sufficient progress has been made in Council negotiations for the outline of any General Approach to be clear.**

Full details of the documents

(a) Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: A New Deal for Consumers: (39619), 7875/18, COM(18) 183; (b) Proposal for a Directive of the European Parliament and of

12 Association Agreement between the European Union and its Member States, of the one part, and Ukraine, of the other part OJ 29.5.2014 L 161/3.

13 See (37389), 15251/15 + ADDs 1–2, COM (15) 634: Proposal for a Directive of the European Parliament and of the Council on certain aspects concerning contracts for the supply of digital content. The Committee already has under scrutiny

14 We note that the Consumer Rights Act 2015 only applies to digital content/services supplied for money and not personal data.

the Council amending Council Directive 93/13/EEC of 5 April 1993, Directive 98/6/EC of the European Parliament and of the Council, Directive 2005/29/EC of the European Parliament and of the Council and Directive 2011/83/EU of the European Parliament and of the Council as regards better enforcement and modernisation of EU consumer protection rules: (39618), 7876/18 + ADDs 1–4, COM(18) 185; (c) Proposal for a Directive Of The European Parliament And Of The Council on representative actions for the protection of the collective interests of consumers, and repealing Directive 2009/22/EC: (39617), 7877/18 + ADDs 1–5, COM(18) 184.

Previous Committee Reports

None.

2 Online platforms

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested
Document details	Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services
Legal base	Article 114; OLP; QMV
Department	Business, Energy and Industrial Strategy
Document Number	(39665), 8413/18 + ADDs 1–3, COM(18) 238 final

Summary and Committee's conclusions

2.1 One of the more contentious strands of the European Commission's Digital Single Market Strategy, first outlined in a communication in May 2015,[15] was the proposal to develop "a fit for purpose regulatory environment for platforms and intermediaries" in response to concerns about the "growing market power of some platforms". The communication suggested that this market power, and "their strong bargaining power compared to that of their clients … may be reflected in their terms and conditions (particularly for SMEs), promotion of their own services to the disadvantage of competitors, and non-transparent pricing policies, or restrictions on pricing and sale conditions".

2.2 Following a lengthy process of consultation and development, on 26 April 2018 the European Commission brought forward draft Regulation 8413/18[16] (hereafter, "the Regulation") which seeks to promote fairness and transparency for business users of online intermediation services by establishing a range of regulatory requirements applicable, among other things, to multi-sided e-commerce market places, app stores, social media, and search engines. The proposal also includes provisions to facilitate out-of-court dispute resolution, and would establish an EU Observatory to monitor the implementation of the regulation and emerging currents in the digital economy.

2.3 In the text which precedes the content of the Regulation, the Commission states that online platforms are key enablers of online trade, and that, at present, more than a million EU enterprises trade through online platforms in order to reach their customers, and it is estimated that around 60% of private consumption and 30% of public consumption of goods and services related to the total digital economy are transacted via online intermediaries.

2.4 A central strand of the rationale for the proposal are the dynamics of the online markets in question. Due to their networked nature, online platforms, which typically operate in multisided or "platform" markets, benefit from "network effects"—an economic phenomenon which means that the value of the network to its users grows as it increases in size. These network effects may be direct (direct network effects refer to the way in which

15 A Digital Single Market Strategy for Europe COM(2015) 192 final.

16 Proposal for a Regulation on promoting fairness and transparency for business users of online intermediation services COM(2018) 238 final.

a social network becomes more valuable to its users the more users of the same kind there are) or indirect (indirect network effects refer to the increase in the value of the service to one group of users that results from an increase in the number of users of a different kind: for example, a marketplace platform becomes more valuable to buyers the more sellers there are on a platform; a search engine becomes more valuable to its advertisers the more users it has). Because network effects mean that the businesses which benefit from them become more valuable to their users the more users they have, this creates a tendency to high levels of market concentration, with one or a small number of operations often developing a high market share in particular sectors of the digital economy.

2.5 Although network effects are not inherently problematic—indeed, they are constitutive of the markets in which multi-sided businesses operate, and generate increased value and efficiency for users of the network—the market dynamics they foster, in which one or a small number of platforms tend to gain a high market share in a specific sector or sub-sector of the digital economy, may have a harmful effect on competition, as the presence of a strong network effect is likely to increase switching costs and raise entry barriers for a platforms' business users, making it harder for rival platforms to effectively compete.

2.6 These dynamics may also have effects on businesses that become dependent on a particular platform to reach the market, as they may have little scope to switch platform if they wish to reach the market—for example, if a business wishes to reach UK consumers using general search platforms, Google Search has 85% of the UK market.[17] In consequence, businesses which depend on a particular platform to reach their target market may have limited bargaining power vis-à-vis the platform, which may in some cases result in them having little choice but to accept onerous terms and conditions. The Commission states that this relationship of dependency is exacerbated by the fact that the supply-side of multi-sided platforms is inherently fragmented and consists of "thousands of small merchants".

2.7 The Commission's consultation identified the following harmful trading practices as recurrent, across a wide range of platforms:

- unexplained changes in terms and conditions without prior notice;
- the delisting of goods or services and the suspension of accounts without a clear statement of reasons;
- lack of transparency related to the ranking of goods and services and of the undertakings offering them;
- unclear conditions for access to, and use of, data collected by providers;
- dependency-related issues with respect to search ranking practices; and
- a lack of transparency regarding favouring of providers' own competing services and so-called Most-Favoured Nation (MFN) clauses which restrict undertakings' ability to offer more attractive conditions through other channels than the online intermediation services.

2.8 It is not within the scope of the present report to discuss each of these concerns in detail. However a particularly clear example of the issues which may arise as a result of

17 Statista, Market share held by the leading search engines in the United Kingdom (UK) as of January 2018 (January 2018).

the dynamics of online platform markets is provided by the online travel agent (OTA) sector's practice of including MFN clauses in its contracts with dependent businesses. A wide range of OTAs are known to have imposed MFN clauses on suppliers using their platforms, which effectively prohibited hotels and B&Bs from offering lower prices to consumers both to other rival OTA platforms as well as directly to consumers via their own websites—in some cases these clauses also prohibited hotels and B&Bs from offering consumers lower prices offline. The proliferation of such clauses in the OTA sector had a range of harmful effects, which included reducing the ability of hotels and B&Bs to compete on price with the OTAs (as they could not offer consumers a lower price, online or, in some cases, offline) as well as reducing the incentives for OTAs to compete with each other on levels of commission charged (as, if one OTA charged a higher commission, and a B&B increased its prices in order to offset this increase, the higher price would be passed on to all of the OTAs on which the B&B advertised, as different OTA's MFN clauses effectively required operators to offer them their best price). Although a significant number of competition authorities have taken action to address these concerns in the case of OTAs, they have done so in a fragmented manner over a long period of time, and there is evidence to suggest that, even when these clauses have been prohibited, their effects have persisted in practice, as OTAs can still remove businesses from their platforms if they do not offer them their lowest price even in the absence of an MFN clause in a contract.[18]

2.9 In response to the Commission's plans to develop proposals in this area, the House of Lords EU Internal Market Sub-Committee produced an extensive analysis of the competitive dynamics of these markets in a report titled "Online Platforms and the Digital Single Market" in April 2016. The report identified a wide range of ways in which existing regulatory frameworks (competition law, data protection, consumer protection) struggled to address the issues in these markets, and advocated a number of specific adaptations to these frameworks. The report expressed support, among other things, for the development of codes of practice, akin to the Groceries Supply Code of Practice (GSCP) that exists for the food supply chain in the UK,[19] and recommended that increased transparency of search results should be mandated.[20]

2.10 Under the Regulation, online intermediaries within scope of the definition, including multi-sided e-commerce marketplaces, app stores, social networks and search engines, would be regulated to ensure their relationships with their business users are open, fair and transparent. The Government's Explanatory Memorandum, submitted by the Parliamentary Under-Secretary of State for the Department for Business, Energy and Industrial Strategy (Lord Henley) on 5 June 2018, states that the proposal applies to online intermediation services provided to business users and corporate website users that have their place of establishment or residence in the European Union and that, through online intermediation services or online search engines, offer goods or services to consumers located in the Union, irrespective of the place of establishment or residence of the providers of those services.

2.11 The proposal has three main strands: transparency, redress, and monitoring.

18 House of Lords EU Committee, Online Platforms and the Digital Single Market, paras 117–122 (20 April 2016).
19 House of Lords EU Committee, Online Platforms and the Digital Single Market, paras 129–134 (20 April 2016).
20 House of Lords EU Committee, Online Platforms and the Digital Single Market, paras 276–286 (20 April 2016).

2.12 Regarding transparency, the Regulation would require online platforms to ensure that terms and conditions are accessible and that any changes to terms and conditions are announced with at least 15 days' notice. Additionally, these terms and conditions should clarify:

- when and how a business may be suspended or delisted from the platform;
- how businesses are ranked in search criteria;
- how and whether a business can access data generated on the platform;
- possible restrictions from offering different pricing elsewhere; and
- any differentiated treatment that applies to the platform itself and select business users.

2.13 Regarding redress, under this Regulation, online platforms would be required to:

- establish internal complaint-handling systems (platforms qualifying as small enterprises would be exempted);
- specify mediators with which they are willing to cooperate to facilitate out-of-court dispute resolution; and
- cover at least half of the costs of mediation.

2.14 The Commission would be obliged to encourage industry to set up specialised mediation bodies. The Commission would also be obliged to encourage online intermediation service providers to draw up codes of conduct. Organisations and associations that have certain defined interests in representing relevant users of online intermediation services will be empowered to take court action on behalf of businesses in relation to breaches of the regulation.

2.15 Regarding monitoring, the Regulation is accompanied by a Commission Decision to establish an EU Observatory (Annex C) to monitor emerging issues in the platform economy. The observatory would provide advice and analysis on the evolution of the online platform economy and the evolution of policy measures in this area. The Commission proposes that the Observatory will be formed of a group of independent experts and a dedicated team of Commission officials.

2.16 A fuller account of the provisions of the Regulation is provided in the Background section of this report.

2.17 In terms of policy analysis, the Government's Explanatory Memorandum is exceptionally brief and non-committal, given the wide-ranging nature of the proposal. The 'policy implications' section of the document merely notes that the Government recognises the benefits and opportunities that platforms can bring to both consumers and businesses, and states that the Government is committed to maintaining "the right environment to ensure both platforms and the businesses that use them can thrive", without specifying whether the proposal represents the right environment or not. The Minister also indicates that the Government is "keen that any action reflects the voice of businesses", including both business users of platforms as well as online platforms themselves.

2.18 The Government has not provided a subsidiarity assessment, merely repeating the Commission's view that the proposal cannot be sufficiently achieved by the Member States and that regulation at European Union level would avoid the negative effects of regulatory fragmentation caused by national level initiatives.

2.19 In terms of timescales, the Minister noted that, depending on the progress of negotiations, the file could be agreed by early 2019, and that, if the proposed six-month timescale for application were kept, the regulation's provisions would then be applicable during 2019. As such, it would apply to the Government during the transitional period contained within the draft Withdrawal Agreement, if it were agreed.

2.20 **The European Commission's proposal for a regulation regarding online intermediaries has proven to be one of the more contentious strands of the Digital Single Market Strategy from its inception, and is the result of an unusually protracted process of consultation and development.[21] We consider the high level of scrutiny to which the proposal has been subjected to be appropriate given the challenges inherent in making effective regulatory interventions in the digital economy.**

2.21 **The final proposal, which was modified following an opinion of the Regulatory Scrutiny Board, is more targeted and excludes B2B (business-to-business) and P2P (peer-to-peer) platforms, on the basis that asymmetries of bargaining power are less pronounced in these markets. The principal intermediaries captured by the proposed definition are social networks, app stores, and multi-sided e-commerce marketplaces, including online travel agents. Specific provisions also are made for search engines.**

2.22 **The rationale for targeting these categories of intermediary is provided by the features of these markets, which display strong network effects, which in turn tend to lead to high levels of market concentration and to successful platforms becoming almost unavoidable trading partners for businesses seeking to reach consumers. As the supply-side on these platforms are often highly fragmented, consisting of large numbers of small businesses, these markets also display significant asymmetries of bargaining power. The Commission notes that business users' dependency may lead to them having little choice but to accept unfair terms and conditions, and being reluctant to bring complaints forward for fear of retaliation. A 2016 House of Lords report on this issue identified widespread evidence of these concerns among dependent businesses in the UK, and called for a wide range of regulatory interventions.[22]**

2.23 **The level of intervention proposed is, for the most part, light-touch, with the focus being on improving transparency in these markets. Search engines would have to identify the main parameters determining their ranking of business users in search results and their relative importance, and to explain where ranking is influenced by remuneration, without having to divulge trade secrets. The proposal does not prohibit the use of Most Favoured Nation clauses by platforms, but would require them to provide a justification and description of their use. Platforms would have to specify when they discriminated in favour of their own services. Platforms would be required**

21 This process, its findings, and the opinion of the Regulatory Scrutiny Board referenced below are summarised in the Impact Assessment which accompanies the proposal: Commission Staff Working Document Impact Assessment Annexes accompanying the document Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services SWD(2018) 138 final.

22 House of Lords EU Committee, Online Platforms and the Digital Single Market (20 April 2016).

to provide clear explanations as to why businesses were de-listed, and to provide 15 days' notice in advance of changes to terms and conditions. Our initial assessment is that these transparency provisions are pro-competitive as they would facilitate increased differentiation and competition between rival platforms; they would also modestly strengthen smaller businesses in their dealings with online platforms.

2.24 **The second strand of the proposal seeks to provide more effective redress mechanisms, as the asymmetries of scale between platforms and the smaller businesses depend on them can make it difficult for dependent businesses to challenge unfair practices. The Commission proposes that platforms be required to establish internal complaint-handling systems and specify mediators with which they are willing to cooperate to facilitate out-of-court dispute resolution, with platforms obliged to cover at least half of the costs of mediation. Associations representing businesses would be granted the right to bring court proceedings on behalf of businesses to enforce the new transparency and dispute settlement rules. We note that there is strong evidence that smaller businesses in the UK may find it difficult to challenge the unfair trading practices of platforms they depend on and that there is support among these businesses for binding dispute resolution mechanisms.**[23]

2.25 **We are concerned that the Government's Explanatory Memorandum provides no serious analysis of the proposal's implications, and merely repeats the Commission's subsidiarity assessment without indicating whether it accepts this assessment or not. Our initial assessment is that subsidiarity concerns do not arise, as uncoordinated Member State approaches to these practices would result in a significant increase in market fragmentation, which would inhibit market scale, which is of paramount importance to the digital economy.**

2.26 **To assist us in reaching a view on the proposal we ask the Government to answer the following questions:**

- **What engagement has the Government undertaken, with regard to this proposal, with online platforms and their businesses users? What are the results of this engagement, and how did these views vary with respect to the different types of platform covered?**
- **Does the Government believe that the proposal strikes the right balance in terms of promoting innovation and protecting dependent businesses from having unfair practices imposed on them? If not, which specific provisions does the Government object to? What action is the Government taking in working parties to ensure that these are modified or excluded from any future General Approach?**
- **Were these rules to be agreed, would the Government envisage retaining them in law in the long-term (following the end of any transition period), or, given the Prime Minister's intention to leave the Digital Single Market, would the Government anticipate significant divergence from the EU platforms regime?**
- **Given that UK-based digital firms targeting the EU market would have to comply with the terms of the draft Regulation even after the UK had left**

23 See House of Lords EU Committee, Online Platforms and the Digital Single Market, paras 126–141 (20 April 2016) and evidence given by industry stakeholders to the same inquiry (2 December 2015).

the EU and any transition period had ended, where they were providing services to EU businesses, to what extent would it be possible for the UK to gain a significant competitive advantage vis-à-vis the EU27 by domestically adopting a lighter-touch regulatory approach in relation to online platforms than is proposed here?

- **As the Government intends to leave the Digital Single Market,[24] this will automatically reintroduce a degree of regulatory fragmentation between UK and EU digital markets: even in cases where the UK chooses to voluntarily align with EU law to minimise friction, the reciprocal provisions of EU law will cease to apply to the UK. The effects of the Digital Single Market Strategy, which sought to create a domestic market of 500 million consumers within which businesses could scale up their operations, will therefore be to a significant extent reversed. This represents a major policy change for the Government with respect to the digital economy. What is the Government's alternative strategy for the UK's digital market, given this loss of domestic market scale? Does the Government intend to prioritise unilateral regulatory action, even if this entails increased regulatory fragmentation, or does it intend to shadow EU policy to minimise fragmentation insofar as possible, despite the constraints identified above?**

2.27 **We ask the Government to provide answers to these questions, and an update on the anticipated progress of the file, by 17 August 2018. We retain the proposal under scrutiny.**

Background

2.28 The proposal applies to online e-commerce market places (i.e. multi-sided marketplaces which permit buyers and third-party sellers to transact, as opposed to conventional linear e-commerce suppliers), app stores, social media, and search engines. The effects of the principal provisions are summarised below:

- Article 2 clarifies that, to be within the scope of the regulation, online intermediation services must meet the following three requirements:
    - they constitute information society services within the meaning of Article 1(1)(b) of Directive (EU) 2015/1535 (the Information Society Services Directive);
    - they allow business users to offer goods or services to consumers, with a view to facilitating the initiating of direct transactions between those business users and consumers, irrespective of where those transactions are ultimately concluded; and
    - they are provided to business users on the basis of contractual relationships between, on the one hand, the provider of those services and, on the other hand, both those business users and the consumers to which those business users offer goods or services.

24 "On digital, the UK will not be part of the EU's Digital Single Market, which will continue to develop after our withdrawal from the EU," in "PM speech on our future economic partnership with the European Union" (2 March 2018).

- Article 3 of the draft Regulation establishes requirements for the clarity, accessibility and modifications of pre-defined, standard terms and conditions used by providers of online intermediation services. Providers must ensure that their terms and conditions:
    - are drafted in clear and unambiguous language;
    - are easily available for business users at all stages of their commercial relationship with the provider of online intermediation services, including in the pre-contractual stage; and
    - set out the objective grounds for decisions to suspend or terminate, in whole or in part, the provision of their online intermediation services to business users.

  Terms and conditions which do not comply with these requirements will not be binding on the business user concerned where such non-compliance is established by a competent court.

  Providers are also required to give business users at least 15 days notification of any envisaged modification to their terms and conditions. Modifications will be null and void where this does not happen.
- Article 4 requires a provider to give a statement of reasons if it suspends or terminates the use by a business user of its intermediation services, which should contain reference to the specific circumstances of the case.
- Article 5 establishes requirements for a description of the main parameters determining ranking of business users in search results and their relative importance, and a description where ranking is influenced by the business user giving direct or indirect remuneration to them, in the terms and conditions used by providers of online intermediation services. This applies to both search engines and search functions provided by the other types of intermediation platform.
- Article 6 establishes requirements for a description of any differentiated treatment given to goods and services offered by the provider of online intermediation services itself, or by business users which it controls, in their terms and conditions.
- Article 7 establishes a requirement to include a description of the access to personal data or other data which business users or consumers provide to online intermediation services or which are generated through those services, in the standard terms and conditions used by providers of online intermediation services.
- Article 8 establishes a requirement to provide and publish a description of the grounds for restricting the ability for business users to offer different conditions to consumers for obtaining goods or services through means other than the online intermediation services, in the providers' terms and conditions.
- Article 9 establishes a requirement for a provider of online intermediation services to provide for an internal system for handling complaints of business users together with requirements relating to the handling of such complaints, including obligations to duly consider complaints swiftly and effectively and communicate the outcome clearly and unambiguously to the business user. It also establishes the requirement to include certain information on the internal complaint-handling system in the

terms and conditions. In addition, it establishes an obligation on providers of online intermediation services to publish reports on the number of complaints lodged, the subject matter of the complaints, the time period needed to process the complaints and the decision taken on the complaints.

- Article 10 establishes a requirement for providers of online intermediation services to list in their terms and conditions one or more mediators with which the provider is willing to engage to reach an agreement out of court on a dispute, for instance where an issue has not been resolved by the internal complaint handling system (established under Article 9). In addition, it establishes certain requirements for the mediators, including impartiality, accessibility, competency and resources as well as an obligation for the providers of online intermediation services to engage in mediation in good faith. Providers of online intermediation services would be required to bear at least half of the total cost of mediation.
- Article 11 establishes a requirement for the Commission to encourage providers of online intermediation services to individually or jointly set up one or more independent mediator organisations to facilitate the settlement, out of court, of disputes that arise in the course of online intermediation services, particularly given their cross-border nature.
- Article 12 establishes a right for judicial proceedings to be brought by representative organisations, associations or public bodies to stop or prohibit any non-compliance by providers of online intermediation services with the requirements contained in the Regulation. In addition, it requires representative organisations and associations to meet certain requirements such as having a non-profit making character, establishment as a legal entity under the law of the relevant Member State, and pursue objectives that are in the collective interests of the business users they represent.
- Article 13 establishes a requirement for the Commission to encourage providers of online intermediation services as well as of online search engines, and organisations and associations representing them, to draw up codes of conduct.
- Article 14 establishes a requirement for the Commission to regularly evaluate the Regulation, for the first time three years after the date the Regulation enters into force.
- Article 15 suggests that the Regulation will apply six months from the date of publication, although this (as all of the above provisions) may be modified.

Full details of the documents

Proposal for a Regulation of the European Parliament and of the Council on promoting fairness and transparency for business users of online intermediation services: (39665), 8413/18, + ADDs 1–3, COM(18) 238 final.

Previous Committee Reports

None. However, see the Committee report on the communication on online platforms: Ninth Report HC 71–vii (2016–17) chapter 10 (20 July 2016). See also the Committee's report on the Digital Single Market Strategy: Fifth report HC 342–v (2015–16) chapter 4 (14 October 2015).

3 Rights and Values Programme 2021–27

Committee's assessment	Legally and politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Justice Committee and the Joint Committee on Human Rights
Document details	Proposed Regulation establishing the Rights and Values programme
Legal base	Articles 16(2), 19(2), 21(2), 24, 167(5) and 168 TFEU; ordinary legislative procedure; QMV
Department	Department for International Development (Government Equalities Office)
Document Number	(39814), 9605/18 + ADD 1, COM (18)838

Summary and Committee's conclusions

3.1 The Commission has proposed to introduce a Rights and Values programme with effect from 1 January 2021 to cover the period from 2021–27. This is one of two related programmes (the other being the Justice programme which we examined in our Report chapter of 27 June)[25] that comprise the Justice, Rights and Values Fund. The new programme will build on the Rights, Equality and Citizenship programme, which runs from 2014 to the end of 2020.

3.2 The proposed Rights and Values programme aims to protect and promote rights and values as enshrined in the EU Treaties and in the EU Charter of Fundamental Rights ("the Charter"). The specific objectives are to promote equality and rights, to encourage citizens' engagement and participation in the democratic life of the Union and to fight violence., particularly against children, young people and women. The European values[26] to be promoted include fundamental rights, non-discrimination and equality, anti-racism and tolerance, respect for human dignity, the rule of law and the independence of the judiciary, cultural diversity, a vibrant civil society, freedom of expression and citizen participation in democratic life. The sorts of activities anticipated are awareness-raising, mutual learning, analytical and monitoring activities, training, bringing people together and developing the capacity of European networks.

3.3 The Commission has conducted a mid-term analysis of the Rights, Equality and Citizenship programme and has consulted with stakeholders. It concludes that whilst the programme has been successful there is still a need to address the issues. In addition, an overarching Impact Assessment[27] examines not only the Rights and Values Programme

25 Thirty-third Report, HC 301–xxxi (2017–19), chapter 8 (27 June 2018).

26 For EU values see Article 2 TEU. This provides that "The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail".

27 9616/18 + ADD1: Commission Staff Working Document Impact Assessment: Accompanying the documents Proposal for a Regulation establishing the Rights and Values programme Proposal for a Regulation establishing the Justice programme Proposal for a Regulation establishing the Creative Europe programme.

but also the Justice and Creative Europe Programmes.[28] This has already been cleared from scrutiny in our last Report chapter on the Justice Programme.[29] The original intention of the Commission was to merge the Rights, Equality and Citizenship Programme, the Europe for Citizens programme, the Creative Europe programme and the Rights programme. However, as a result of the impact assessment the Commission decided to have a self-standing Creative Europe Fund and to create a separate Justice, Rights and Values Fund.

3.4 The combined Justice and Rights and Values fund (comprising this programme and the Justice programme) will have a budget for the period of the programmes of €947 million (£839 million).[30] The total budget for the Rights and Values programme for the 2021–2027 period is proposed to be €641,705,000 (approximately £567 million).[31] Of this €408,705,00 (approximately £362 million)[32] is allocated to the equality and rights, and violence strands and €233 million (approximately £206.45 million)[33] is allocated to the citizens engagement and participation strand.

3.5 The proposed Regulation would need to be adopted before its proposed date of application (1 January 2021) but adoption is likely to be earlier than that as part of the wider Multi-Annual Financial Framework (MFF). That date of application reflects the expected end of the UK's expected transition/implementation period[34] as currently drafted in the provisional Withdrawal Agreement.

3.6 In terms of Brexit implications, Article 7 is the most significant provision in the proposed Regulation. It sets out the basis of third country association with the programme. Aside from the provision for non-EU EEA (European Economic Area) states, acceding and candidate countries and European Neighbourhood countries, other third countries can participate subject to the conditions laid down in a specific participation agreement providing that agreement:

- ensures a fair balance as regards the contributions and benefits of the third country participating in the Union programmes;
- lays down the conditions of participation in the programmes, including the calculation of financial contributions to individual programmes and their administrative costs;
- does not confer any participation in decision-making for the third country; and
- protects the EU financial interests.

28 See our chapter on the Creative Europe programme: Thirty-third Report, HC 301–xxxi (2017–19), chapter 2 (27 June 2018).
29 Thirty-third Report, HC 301–xxxi (2017–19), chapter 8 (27 June 2018).
30 Applying an exchange rate of €1 = £0.88605.
31 As above.
32 As above.
33 As above.
34 In the Commission's EM states that the proposal provides for a date of application as of 1 January 2021 and is presented for a Union of 27 Member States, in line with the notification by the United Kingdom of its intention to withdraw from the European Union and Euratom based on Article 50 of the Treaty on European Union received by the European Council on 29 March 2017.

3.7 The Minister for Women and Equalities (Penny Mordaunt) says in her Explanatory Memorandum of 3 July 2018 that:

- There are no new policy implications arising from the proposed Regulation.
- There are no new financial implications for the UK at this stage as the UK will continue to pay its net contributions under the current EU budget plan that was signed in 2013 and which runs until the end of the expected transition/ implementation period.
- The UK will continue to participate in EU programmes under this budget plan, which will include the Rights, Equality and Citizenship programme (2014–2020): UK recipients will therefore continue to benefit from the existing programme until the end of 2020.
- Should the UK wish to participate in the Rights and Values programme as a third country in the next MFF, it would need to adhere to the criteria for third country participation as outlined in Article 7.
- It is not yet clear what the financial arrangements would be for the UK should it participate as a third country.
- The Government would continue to consider the UK's interests in future participation as a third country as negotiations on the proposal progress.

3.8 **We thank the Minister for her Explanatory Memorandum.**

3.9 **We would also welcome as early an indication as possible as to whether the UK would consider participating in the future programme after the end of the transition/ implementation period. Related to that we would be interested to learn in due course:**

- **To what extent does the Minister consider that the UK could meet the Article 7 conditions for participation?**
- **How much is that likely to cost?**
- **What would the benefits be for the UK of such participation, given that cost and the inability to influence any decision-making in respect of the programme: is there evidence as to how successful third country applicants are for grants available under the programme?**
- **What other implications (policy or legal) might arise from UK association as a third country?**
- **Since the programme advances values and rights in the EU Charter of Fundamental Rights, could UK participation be consistent with the exclusion of the Charter from "retained EU law" pursuant to the European Union (Withdrawal) Act 2018?**

3.10 **In the meantime, we retain the document under scrutiny but draw it and this chapter to the attention of the Justice Committee and the Joint Committee on Human Rights.**

Full details of the documents

Proposed for a Regulation of the European Parliament and the Council establishing the Rights and Values programme: (39814), 9605/18 + ADD 1, COM(18) 838.

Previous Committee Reports

None; though see (39815) 9616/18 +ADD1: Thirty-third Report, HC 301–xxxi (2017–19), chapter 8 (27 June 2018).

4 Green finance: classification of investments, disclosures and low carbon benchmarks

Committee's assessment	Legally and politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Environmental Audit Committee and the Treasury Committee
Document details	(a) Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment; (b) Proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341; (c) Proposal for a Regulation amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks
Legal base	Article 114 TFEU; ordinary legislative procedure; QMV
Department	Treasury
Document Numbers	(a) (39806), 9355/18, COM(18) 353; (b) (39805), 9357/18, COM(18) 354; (c) (39798), 9348/18, COM(18) 355

Summary and Committee's conclusions

4.1 In May 2018, the European Commission published three legislative proposals that aim to ensure the financial services industry plays its part in the fight against climate change. The Commission argues this would benefit the environment and lead to more sustainable economic growth (as well as being in the industry's own interest by reducing insurance claims related to environmental damage and ensuring the viability of long-term investments). We first discussed the proposed EU initiatives in this area in our May 2018 Report on the Commission's Action Plan on Sustainable Finance.

4.2 The overall aim of the proposals is to channel more investment into sustainable activities by incorporating 'Environmental, Social and Governance' (ESG) considerations into investment industry practices. Concretely, the Commission wants to achieve this objective by means of three proposals for new Regulations, and a proposed amendment to existing EU law on investment services. We have discussed the detail of the proposals in "Background" below, but in summary the Commission wants to:

- Set new EU-wide criteria (the 'Sustainability Taxonomy') to underpin assessments of whether an economic activity is environmentally sustainable (see paragraphs 4.15 to 4.24) and require investment advisors to use this Taxonomy to gauge the environmental and sustainable preferences of their clients before making investment recommendations (paragraph 4.18);

- Impose new ESG disclosure requirements on asset managers, institutional investors and investment advisors, requiring them to be transparent about the environmental footprint of their investment decision-making or advisory process (paragraphs 4.25 to 4.37); and

- Set minimum requirements for investment benchmarks that are marketed 'low carbon', to ensure investors can have confidence that the benchmarks accurately measure the sustainability performance of their investments against a broader pool of assets (paragraphs 4.38 to 4.48). However, the use of the new Sustainability Taxonomy would *not* be mandatory for such benchmarks.

4.3 The Economic Secretary to the Treasury (John Glen) submitted Explanatory Memoranda on all three proposals in June and July 2018. The Government appears broadly supportive of the objectives of the new Regulations, but has voiced concerns in particular about using a Regulation to set binding EU-wide disclosure requirements on sustainability (and will explore with other Member States the possibility of using non-binding guidance by the EU's Supervisory Authorities[35] for the financial sector instead).

4.4 The Minister also notes that the Low Carbon Benchmarks Regulation may take effect during the proposed transitional period (and therefore apply directly to the UK). With respect to the proposals on the taxonomy and ESG disclosures, the likely timetable for adoption and implementation would likely defer any practical impact until after end of the transitional arrangement (scheduled for 31 December 2020). While also emphasising the UK's strong current position in 'green finance', which the Minister says means it "stands to benefit from any increased export potential [to the EU] in this market". However, he does not refer to the implications of the UK's exit from the Single Market for financial services, which is likely to mean a drastic curtailment of cross-border access for UK asset managers and investment advisors into the EU (which may be mitigated by the use of 'delegation' of functions back to the UK by EU-based subsidiaries or parent companies).[36]

4.5 **We thank the Economic Secretary for his Explanatory Memoranda on the EU's sustainable finance proposals. While their aims are laudable, the exact methods chosen by the Commission to boost sustainable investment will clearly be the subject of further deliberations among the EU's Member States.**

4.6 **It is not entirely clear to us what the practical effect would be of the Sustainability Taxonomy, the central element of the Commission's Green Finance proposals. It appears the sustainability criteria it would establish would not be binding, but financial services providers would be encouraged to meet those criteria when offering 'green' investment products. It seems somewhat incoherent to us to propose a new Sustainability Taxonomy, but then not apply its substance to the parallel proposal on benchmarks that give an indication of the 'sustainability factor' of specific investments.**

35 The Supervisory Authorities are the European Securities & Markets Authority (ESMA); the European Banking Authority (EBA); and the European Insurance & Occupational Pensions Authority (EIOPA).

36 See our chapter on the European Systems of Financial Supervision: Fifth Report, HC 301-v (2017–19), chapter 9 (13 December 2017) for more information on delegation in financial services after Brexit.

4.7 **With respect to the practical implications of the Green Finance proposals, we ask the Minister to clarify:**

- **What specific obligations the Sustainability Taxonomy by itself would impose on market participants in the absence of any further EU or national legislation making use of the taxonomy mandatory for specific investment products or services;**
- **Whether there are any existing or planned UK regulatory initiatives on 'green finance' which would fall within the scope of the taxonomy, and may therefore have to be modified if the Regulation takes effect while the UK is still applying EU law;**
- **What support there is among the other Member States for issuing the ESG disclosure requirements for investors and advisors in the form of guidance rather than by means of a Regulation;**
- **If the new ESG disclosure requirements for institutional investors and investment advisors would affect the regulatory baseline against which any requests for equivalence decisions would be judged under the Alternative Investment Fund Managers Directive and the Markets in Financial Instruments Regulation; and**
- **Whether the Government is minded to support the supplementary draft Delegated Regulations published in parallel to the above proposals, which would require the incorporation of ESG considerations into the investment advisory process under the Insurance Distribution Directive and MiFID.**[37]

4.8 **We also note that all or some of the proposed Regulations may apply to the UK if they take effect during the post-Brexit transitional period, during which the Government would continue to apply EU law. Moreover, the future framework for flows of financial services between the UK and the EU is yet to be negotiated. Under either the mutual recognition model (until recently advocated by the Government and UK industry) or 'equivalence' (the EU's preferred approach and the basis for the Government's new position under the July 2018 White Paper),**[38] **these new pieces of legislation may have an impact on British financial services providers. The extent to which they may be applied to the UK investment industry will depend to a large degree on the depth of the trading relationship in financial services after the UK leaves the Single Market.**[39] **The Committee will also assess the Government's aspirations in this area in more detail in light of the recent White Paper on the future UK-EU relationship.**

4.9 **Given the continued uncertainty about the exact implications of the proposals for the UK, we retain the three Regulations under scrutiny and ask the Minister to keep us informed of any further developments in the legislative process. We also draw these proposals to the attention of the Environmental Audit Committee and the Treasury Committee.**

37 The draft Delegated Regulations are not yet formally subject to scrutiny as they would be deposited only when finalised and adopted by the Commission.

38 DExEU White Paper (July 2018), p. 30.

39 The Brexit implications of each of the three proposals is assessed in more detail in "Background".

Full details of the documents

(a) Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment: (39806), 9355/18, COM(18) 353; (b) Proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341: (39805), 9357/18, COM(18) 354; (c) Proposal for a Regulation amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks: (39798), 9348/18, COM(18) 355.

Background

4.10 In March 2018, the European Commission published a policy paper focussed on social and environmental sustainability, including the effects of climate change. In it, the Commission described how it wants the financial system to be part of "the solution towards a greener and more sustainable economy" by "reorienting private capital to more sustainable investments". The aim of EU policy in this area is to put 'Environmental, Social and Governance' (ESG) considerations at the heart of the financial system, with the wider aim of making the European economy 'greener'.

4.11 Based on the recommendations of its High-Level Expert Group (HLEG) on sustainable finance, which included seven UK members, the Commission's 'Sustainable Finance Action Plan' set out a number of initiatives to channel more investment into an "environmentally and socially sustainable economic system" in the EU; ensure social and environmental costs are integrated into the risk management processes of financial services providers such as insurers and banks; and increase transparency of corporate sustainability policies to allow investors to differentiate between companies based on their social and environmental approach. In its Memorandum on the policy paper, the UK Government urged the Commission, when considering legislative action in pursuit of these objectives, to "conduct rigorous quantitative and qualitative analysis before deciding to legislate for changes to prudential requirements on green assets and investments" and to be "mindful of domestic regimes that are working well (…) across the European green finance market".

4.12 We reported the Action Plan to the House on 2 May 2018,[40] noting that any regulatory measures proposed by the Commission as a result could apply to the UK under the terms of the post-Brexit transitional arrangement (a period scheduled to last 21 months after the UK ceases to be a Member State on 29 March 2019, during which it would continue to apply EU law and remain part of the Single Market).[41]

40 In his Explanatory Memorandum on the Sustainable Finance Action Plan, the Economic Secretary has "broadly welcomed" the Commission's policy agenda. He notes that the "UK was influential in the [High-Level Expert Group], with a third of its members drawn from UK institutions", and the aims outlined in this document are "aligned with the UK's interests in developing green finance". He calls this "an area in which the UK has significant expertise" and thus one where it "stands to benefit from any increased export potential in this market" (although he does not refer to the implications of the Government's decision to leave the Single Market in this regard, which is likely to end the ability of UK-based financial services providers to market their activities within the EU without the need to establish a separate business in one of the remaining Member States).

41 If the Withdrawal Agreement is ratified as currently drafted, it provides for a transitional arrangement lasting until 31 December 2020 during which the UK would continue to be under an obligation to apply EU law (including new legislation that only takes effect during that period).

4.13 Also in May, the Commission published three proposals for Regulations to achieve these objectives:

- New EU-wide criteria (the 'Sustainability Taxonomy') to judge whether an economic activity is environmentally sustainable (paragraphs 4.15 to 4.24), and consequential amendments to the Markets in Financial Instruments Directive requiring investment advisors to use this Taxonomy to gauge the environmental and sustainable preferences of their clients before making investment recommendations (paragraph 4.18);
- New disclosure requirements on asset managers and institutional investors, requiring them to be transparent about the environmental footprint of the way in which they invest their clients' money (paragraphs 4.25 to 4.37); and
- Minimum requirements for investment benchmarks which are marketed as 'low carbon', allowing investors to measure the sustainability performance of their investments against a broader pool of relevant assets (paragraphs 4.38 to 4.48).

4.14 The Economic Secretary submitted Explanatory Memoranda on the proposals in June 2018. We have drawn on these in our description of the practical implications of all proposed Regulations below. The Minister also emphasised that the new legislation, depending on the speed with which it is adopted, may apply to the UK during the post-Brexit transitional period and therefore UK engagement in the negotiations on the legislation remains important.

The 'Sustainability Taxonomy'

4.15 The first proposal in the package is a Regulation to establish a "framework to facilitate sustainable investment". This 'Sustainability Taxonomy' would, in essence, set criteria for determining whether an economic activity is environmentally sustainable (to establish, in turn, the degree to which *investment* in that activity could be considered sustainable).

4.16 The taxonomy is to be established in two phases:

- Firstly, the Member States and the European Parliament need to agree on the Regulation. This would establish the high-level conditions for identifying environmentally-sustainable activities in six areas (climate change mitigation and adaptation; sustainable use of water and marine resources; waste prevention and re-use; pollution prevention and control; and protection of ecosystems);[42]
- As a second step, the Commission would issue Delegated Acts to establish the qualitative and quantitative technical screening criteria[43] for the sustainability of economic activity for each of the six objectives. The substance of those measures will be based on the work of a technical expert group. The taxonomy

42 Three years after the Regulation takes effect, the European Commission would be required to produce a report on its impact (and to consider whether the taxonomy should be extended to social factors in addition to the original six environmental objectives).

43 For example, to qualify as 'environmentally sustainable' an economic activity would need to be "based on available and conclusive scientific evidence, be proportionate to the nature and the scale of the economic activity and build on existing taxonomies".

would gain legal force six months after the first Delegated Act covering the criteria for investments marketed as contributing to climate change mitigation or adaptation takes effect (foreseen for 2020).[44]

4.17 After the sustainability taxonomy takes effect, it would apply to EU institutions and Member States when they legislate in respect of investment products or bonds that are marketed as 'environmentally sustainable'. It would also apply directly to market participants marketing investment products that fall within the scope of the taxonomy; for them the Regulation would create an obligation to "disclose how and to what extent the criteria for environmentally sustainable economic activities are used to determine the […] sustainability of the investments" they offer.[45] As a result, the Commission says, they would be "incentivised to use the proposed taxonomy".[46]

4.18 In addition to the proposal for the Taxonomy itself, the Commission also published draft Delegated Regulations under the Insurance Distribution Directive and the Markets in Financial Instruments Directive. These, once formally adopted later in 2018, would require investment advisors in the EU to include ESG considerations when giving advice to individual clients. This would draw on the definition of 'environmentally sustainable investments' as contained in the Taxonomy Regulation.

4.19 In practice, it appears the Regulation as drafted would not restrict what types of investment products can be marketed as 'green' or 'sustainable', even if they do not meet the criteria for environmental sustainability developed by the Commission. Use of the Taxonomy would be obligatory only where required by future pieces of national or EU legislation. For example, the ESG suitability assessment as part of the investment advice process would rely on the taxonomy, whereas the proposal on 'low carbon benchmarks' (see paragraph 4.38) would not.

4.20 In the absence of any additional legalisation, it appears the Regulation would encourage but not require firms offering 'green' investment products to ensure that their products meet the criteria set out in article 3 of the proposed Regulation by:

- 'contributing substantially' to one or more of the six environmental objectives, and not 'significantly harming' any of them;
- complying with any additional technical screening criteria for the six environmental objectives as laid down in Delegated Acts after the Regulation is adopted; and
- respecting the minimum social safeguards set out in the "eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work".[47]

44 The Commission's High-Level Expert Group already made detailed recommendations for the technical screening criteria. For example, investment in wind and solar power would always meet the eligibility criteria for 'environmentally sustainable' climate change mitigation.

45 See Commission Impact Assessment SWD(2018) 264, p.101.

46 Idem.

47 These eight 'fundamental conventions' are: the right not to be subjected to forced labour, the freedom of association, workers' right to organise, the right to collective bargaining, equal remuneration for men and women for work of equal value, non-discrimination in opportunity and treatment with respect to employment and occupation, as well as the right not to be subjected to child labour.

4.21 The Minister's Explanatory Memorandum on the taxonomy proposal reiterates the Government's support for the 'green finance industry', and the aim of having a "clearer taxonomy" because it is an area where the UK "has significant expertise and thus stands to benefit from any increased export potential in this market". With respect to the substance of the Regulation, the Minister welcomes the "flexibility […] allowing national labelling schemes to work with the taxonomy", but added that "further work and clarity is needed to ensure that the new proposals adequately enable investors to take informed decisions when they make an assessment of how environmentally friendly an overall investment is, including the extent to which non-green elements are neutral or negative in terms of environmental impact".

Implications of Brexit

4.22 During the transition period after Brexit, it is foreseen that the UK will temporarily stay part of the Single Market and continue applying EU legislation. That would include the Sustainability Taxonomy if it takes effect while the transitional arrangement is still in operation. It is unclear if there are any 'green finance' initiatives in the UK run by the Treasury, Financial Conduct Authority or Bank of England that would be affected by the taxonomy and may need to be modified if it takes effect while the UK is still applying EU law.

4.23 The Minister's Memorandum also does not make any assessment of the impact of Brexit—and the UK's exit from the Single Market specifically — for any "export potential" that might result from clearer EU—wide sustainability standards for investments. In our view, as the Regulation does not establish any binding product criteria or a new Single Market 'passport' for financial services providers, it has no direct implications in the context of the UK's exit from the EU. However, it is conceivable that any future divergence by the UK from the EU's environmental or social standards could make it more difficult for sustainable investments into the UK to meet the criteria established by the taxonomy.

4.24 Given the practical impact of the taxonomy, and the wider uncertainty about the post-Brexit economic partnership with the EU in the area of financial services, it is impossible to judge at this stage what the long-term implications of this specific initiative on the UK's 'green finance' sector might be.

Institutional investors: ESG disclosures

4.25 The second proposal of the Sustainable Finance package is a new Disclosures Regulation to introduce clearer EU-wide requirements on how asset managers, institutional investors[48] and investment advisors should integrate ESG factors into their investment decision-making or advisory processes.[49] The Commission argues that financial market participants and financial advisors "lack regulatory incentives to disclose to end—investors how they integrate sustainability factors in their investment decision process" which in turn "makes it more difficult and costly for end-investors to make informed investment choices".

48 Institutional investors are typically asset managers, insurance companies and pension funds.

49 The new transparency obligations would apply, in whole or in part, to financial market participants (alternative investment funds and investment advisors engaging in portfolio management), insurance intermediaries which provide insurance advice on insurance-based investment products ('IBIPs') and investment firms which provide investment advice (financial advisors).

4.26 There would, broadly speaking, be four new disclosure requirements:

- Both asset managers and financial advisors would be required to publish written policies on the integration of sustainability risks into their investment or advisory processes (**Article 3 of the Regulation**)
- The same firms would also have to make certain statutory pre-contractual disclosures. These would explain to prospective investors how they incorporate sustainability risks into their investment decisions or investment advice, including how their company's remuneration policies are in line with the sustainability objectives of the product they offer or advise on and how sustainability risks could impact on the financial returns of a product offered or advised on (**Article 4**);
- For asset managers and other financial market participants, there would be additional pre-disclosure requirements about how their specific financial products[50] are designed to achieve their sustainability objectives. There would be specific disclosure requirements where a product is marketed as contributing to a reduction in carbon emissions, using the parallel Commission proposal for rules on 'low carbon' and 'carbon positive' benchmarks (see paragraphs 4.38 to 4.48 below) (**Article 5**); and
- Finally, financial market participants which market financial products designated as 'sustainable' would have to publish a periodic report describing the sustainability-related impact of that product (**Article 7**).

4.27 The proposed Regulation would establish these high-level requirements, but the practical way in which they would have to be implemented by financial market participants would depend on the adoption of further

4.28 The Economic Secretary submitted an Explanatory Memorandum on the new ESG disclosure requirements for investors and advisers with some considerable delay on 3 July 2018. In it, he explains the UK is "supportive of the aim to enhance the transparency of ESG considerations for the benefit of investors" but that the regulatory requirements sought by the Commission could entail "significant costs" for financial services providers.

4.29 As such, the Government is yet to be convinced of the merits of setting these transparency obligations at EU level and will "explore whether […] the objective could be achieved through guidance from the European Supervisory Authorities, which would be more flexible and easier to update as thinking on climate change and measures of sustainability develops". The Commission's proposed approach could, instead, "hinder innovation and competition" and potentially "discourage firms" from providing investment products or advice with sustainability targets.[51]

50 "Financial products" are defined as "a portfolio management, an AIF, an IBIP, a pension product, a pension scheme or a UCITS [fund]".

51 The Minister's Memorandum also notes that the Department of Work and Pensions is currently consulting on regulations to update ESG related disclosure requirements for the trustees of IORPs (occupational pension schemes) in line with recommendations from the Law Commission. The Minister says further updates "may be required as a result of this Regulation, depending on the final text of the technical standards".

Brexit implications of the Disclosure Regulation

4.30 In his Explanatory Memorandum, the Minister notes that it is "likely" that—if the Disclosures Regulation is agreed between the Member States and the European Parliament—the new legislation could come into force during the proposed post-Brexit transitional period (which is scheduled to end on 31 December 2020). However, the practical implementation of the new regulatory disclosures will require technical underpinnings by the European Supervisory Authorities that are due 18 months after formal entry into force. As such, the Minister says, "there is a significant risk the complete framework may not be agreed until after any [transition] period comes to an end". The exact implications of the new Regulation during the transitional period are therefore not yet known.

4.31 The Regulation, if adopted, would in any event cease to apply to British financial market participants when the UK leaves the Single Market (currently envisaged for the end of the transitional period on 31 December 2020), although they could be retained in domestic law under the terms of the EU Withdrawal Act 2018. However, even once the new Regulation no longer applies to the UK directly, it may still have an impact on institutional investors and investment advisors seeking to service EU-based clients as 'third country' operators.

4.32 The proposed Regulation would create new regulatory requirements for a range of financial services firms operating in sectors where, in some cases, 'equivalence' is available under EU law. This means that the Union can unilaterally recognise the regulatory regime of a non-EEA country[52] as delivering 'equivalent' outcomes to the EU's approach. If it does so, firms based in that country may find it easier to access the Single Market.[53]

4.33 However, equivalence is granted—and can be revoked—unilaterally by the European Commission.[54] Legislative efforts in Brussels to make it more difficult for the UK to obtain any hypothetical equivalence decisions more difficult are already underway,[55] and we have also heard that the French Government in particular is seeking to impose even stricter conditions in the future.[56] Given these drawbacks, the Government has repeatedly and emphatically rejected the notion of reliance on equivalence as it currently exists to secure preferential UK market access to the EU for financial services after the exit from the Single Market.[57] Having recently abandoned its initial proposals for a mutual recognition

52 'Equivalence' does not apply to Norway, Iceland and Liechtenstein because they apply EU financial services law as part of the EEA Agreement.

53 Equivalence benefits non-EU firms, for example by allowing them to provide services on a cross-border basis where this is not normally permitted (equivalence for investment advisors under the Markets in Financial Instruments Regulation allows provision of certain cross-border investment services from a non-EU country) or because EU-based firms that deal with them enjoy certain regulatory or prudential reliefs normally only reserved for transactions with other EU-based financial services providers (e.g. banks clearing derivatives transactions through an 'equivalent' third country Central Counterparty (CCP) do not face the higher capital requirements that using a non-EU CCP would normally trigger).

54 Equivalence decisions — and decisions to revoke them — require the support of a qualified majority

55 See for example our recent Reports on prudential requirements for investment firms and EU supervision of non-EU central counterparties.

56 Oral evidence by Mr. Barnabas Reynolds (6 June 2018), Q381.

57 As recently as 21 June 2018, the Chancellor dismissed equivalence as "piecemeal, unilateral and unpredictable" and unable to "provide the stability that a well-regulated market requires" https://www.gov.uk/government/speeches/mansion-house-2018-speech-by-the-chancellor-of-the-exchequer.

agreement on regulatory standards in financial services, [58] the Government in its July 2018 White Paper said that "the existing autonomous frameworks for equivalence would need to be expanded, to reflect the fact that equivalence as it exists today is not sufficient in scope for the breadth of the interconnectedness of UK-EU financial services provision. A new arrangement would need to encompass a broader range of cross-border activities that reflect global financial business models and the high degree of economic integration".

4.34 The Treasury has not confirmed whether the Government would seek equivalence decisions from the EU in specific areas under the existing legal frameworks if the ambition for "enhanced equivalence" does not materialise. Not seeking equivalence would reduce the risk that the UK would be constrained to follow future developments in EU financial services law (because there would be no immediate pressure for continued alignment to preserve market access, as such access would already have been lost). However, a lack of equivalence would also place British firms in a disadvantageous position compared to competitors from financial centres in the US, Hong Kong, Singapore and others (for whom equivalence decisions are already in place).

4.35 With respect to the implications of the new Disclosure Regulation for any future equivalence decisions specifically, it would appear to primarily affect Alternative Investment Fund Managers under the AIFM Directive[59] and investment firms providing portfolio management under the Markets in Financial Instruments Regulation (MiFIR).[60] Any decision by the UK to seek 'equivalence' where available after Brexit could require UK-based hedge fund managers and investment firms to apply the same ESG transparency requirements as their EU-based counterparts, although a literal reading of the draft legislation does not make this fully clear (as the new Regulation does not directly amend the AIFMD or MIFIR legislation on which equivalence would be based).[61] We have sought further clarification from the Minister on this point.

Low carbon benchmarks and positive carbon impact benchmarks

4.36 The final Regulation in the EU's 2018 Green Finance package relates to investment benchmarks. Following the LIBOR and EURIBOR manipulation scandals, the EU adopted

58 Previously, the Government was seeking a comprehensive mutual recognition agreement with the EU, where cross-border market access would be guaranteed across the spectrum of financial services (including areas where equivalence is not available under EU law). Such market access would have been be based on the UK's initial full alignment with EU financial services law—including, depending on the timetable for their formal adoption, these new disclosure requirements. Market access would remain in place unless and until a specific decision is taken by either party to suspend that access, triggered by a divergence of regulation or supervisory practice.

59 The AIFMD does not literally provide for 'equivalence', but instead creates the legal framework for the extension of the Single Market 'passport' to non-EU alternative investment fund managers. It has not been used in practice yet, but would require adherence to the full Directive by the non-EU fund manager in question.

60 Article 19 of MiFIR allows a third-country firm to provide investment services or perform investment activities to eligible counterparties and to professional clients in the EU without the establishment of a branch, if equivalence of its home country's regulatory regime has been established. Investment services, under MIFID II, include portfolio management.

61 For example, the MIFIR equivalence decision must state "that the legal and supervisory arrangements of that third country ensure that firms authorised in that third country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements set out in this Regulation, in Directive 2013/36/EU and in Directive 2014/65/EU and in the implementing measures adopted under this Regulation and under those Directives". A literal reading would therefore not include these new requirements in the equivalence assessment.

legislation to govern the accuracy and integrity of benchmarks (including indices)[62] used in financial contracts. Under Article 29 of the resulting Benchmarks Regulation,[63] supervised entities such as banks, investment firms and insurance companies can only use a benchmark if its administrator is registered with the European Securities & Markets Authority (ESMA), and fulfils requirements with respect to governance, transparency and conduct.

4.37 Where investors want to make environmentally sustainable investments, their asset managers can use low carbon or sustainability benchmarks to ascertain whether that objective is being achieved. The Treasury has explained that, at present, those are typically constructed by taking a standard benchmark (such as the S&P 500 or NASDAQ 100), and removing or underweighting the companies with relatively high carbon footprints. In that way, the return on specific investments can be compared to the performance of sustainable economic activities more broadly. However, the European Commission argues that:

- Low carbon benchmarks remain relatively insignificant in terms of their use in overall portfolio allocation by asset managers, despite a relatively wide range of them having been developed;
- The basic transparency requirements of the Benchmark Regulation notwithstanding, there are divergent levels of openness between administrators about the methodologies underpinning their low carbon benchmarks and as a result they are difficult to compare; and
- In the absence of a common regulatory framework, there is a risk that all low carbon benchmarks are perceived as being equally suitable to measure the sustainability performance of a given investment despite having different characteristics (potentially leading to 'green washing' where investments seen more environmentally-friendly than they are).

4.38 As it announced in its March 2018 Sustainable Finance Action Plan, the Commission has now proposed a Low Carbon Benchmarks Regulation to address these concerns. The legislation would define two new categories: 'low carbon' and 'positive carbon impact' benchmarks respectively. It would also introduce specific transparency requirements for their administrators, obliging hem to disclose the methodology underpinning those benchmarks.[64]

4.39 The Regulation would also empower the European Commission to establish—by means of Delegated Acts—the minimum criteria for the actual calculation of sustainability benchmarks.[65] These would cover the choice of the underlying assets against which an investment would be benchmarked; the method for the weighting of the underlying assets relative to each other; and the method for the calculation of carbon emissions and carbon

62 In financial services, the benchmark is the point of reference against which the performance of an investment is measured. Normally, the benchmark is an index, a hypothetical portfolio of stocks.

63 Regulation (EU) 2016/1011.

64 A 'low-carbon benchmark' must reflect underlying assets which have less carbon emissions when compared to the assets that comprise a standard capital-weighted benchmark. A 'positive carbon impact benchmark' must reflect underlying assets which have carbon emission savings which actually exceed their carbon footprint.

65 Delegated Acts are adopted by the European Commission but can be vetoed by either the European Parliament or a qualified majority of Member States in the Council.

savings associated with the underlying assets.[66] However, benchmark administrators will not be required to use the EU Sustainability Taxonomy (see paragraphs 4.15 to 4.24 above), to allow them the "necessary degree of flexibility" when designing their products.

4.40 The Minister's Explanatory Memorandum on the Low Carbon Benchmarks proposal explains that, if agreed, the Regulation is likely to become applicable during the post-Brexit transitional period and would therefore have force of law in the UK. With regards to the substance, he adds that the Government "are not opposed to the introduction of specific ones for sustainability benchmarks if it helps investors to make more informed decisions", reiterating that 'green finance' is an area where the UK has "significant expertise and thus stands to benefit from any increased export potential in this market".[67]

4.41 Nevertheless, the Minister raises some concerns. The Government is not convinced that the methodology for establishing sustainability benchmarks should be subject to minimum harmonising standards as proposed by the Commission:

> "There are various methods to calculating emissions data and we would need further convincing that prescribing this in the [Benchmarks Regulation] is appropriate. The Commission has cited data challenges as a 'con' of its preferred approach, which we would agree with.
>
> Thinking on climate change is developing very rapidly and any legislation would need to be fluid enough to keep pace with this change. An overly prescriptive approach could hinder innovation and competition in sustainability benchmarks. We would not want burdensome requirements to discourage firms from providing these benchmarks. […] Furthermore, if the criteria for choice of assets is too prescriptive, investment could be channelled into a much narrower range of firms than it is currently. Whilst we support the Commission's overall initiative on sustainable development, we do not believe that it is the role of the BMR to redirect investment."

Implications of Brexit

4.42 The Minister states in his Explanatory Memorandum that "if agreed, the [Regulation] and delegated acts would come into force during the implementation period under the draft Article 50 Withdrawal Agreement between the EU and the UK". As such, they would apply in the UK (but the extent to which the Government's views will be taken into account during the legislative process is unclear, given the UK has less than nine months of EU membership left).

4.43 The Minister also does not address the consequences of the UK's exit from the EU and the Single Market for the provision of benchmarks by UK-based administrators within the EU. The proposed Low Carbon Benchmarks Regulation itself has no immediate implications in the context of Brexit, as it regulates the use of benchmark in financial contracts within the EU. After the UK leaves the Single Market, the regulation of benchmarks for use domestically will be within the exclusive purview of the Treasury and the Financial Conduct Authority.

66 The Commission proposal originally would have introduced a fully harmonized regime for the methodology of calculating the low carbon and carbon positive benchmarks, including the use of the new EU Sustainability Taxonomy (see above). This approach was abandoned after a negative opinion by the Commission's Regulatory Standards Board.

67 The Minister made a similar observation with respect to the Sustainability Taxonomy proposal (see above).

4.44 However, the UK's exit from the Single Market *does* have implications for the use of UK-administered benchmarks by EU-based financial services providers and, by extension, for the use of any 'low carbon or 'carbon positive' benchmarks under this latest proposal. For benchmarks administered by organisations based in a non-EU country (e.g. the UK after it leaves the Single Market), use by counterparties based in the EU normally requires both the administrator and the benchmark to be registered with the European Securities & Markets Authority (ESMA).[68] That, in turn, requires a formal equivalence decision by the European Commission which recognises the regulatory regime of the third country in question as equivalent to the Benchmarks Regulation, and for the competent authority of that country to have concluded a cooperation agreement with ESMA.[69]

4.45 Given the widespread use of third country benchmarks on EU markets, Article 32 of the Regulation allows specific third country administrators to ask for "prior recognition" by the competent financial regulator of an EU Member State. If such recognition is granted, which is conditional on compliance with the Regulation (including, if adopted, these proposed amendments), its benchmarks can be used by supervised entities in the EU without the need for a formal equivalence decision and registration with ESMA. Recognition in the absence of an equivalence decision will also require UK benchmark administrators to appoint a legal representative in an EU Member State.[70]

4.46 However, as part of a wider (and controversial) proposed overhaul of the European System of Financial Supervision, the European Commission wants to make the European Securities & Markets Authority (ESMA) in Paris responsible for the supervision of all benchmarks which are administered from outside the EU, but used within it. This includes responsibility for granting recognition or endorsement to third country administrators in the absence of an equivalence decision. As a result, individual national authorities would lose the ability to grant such recognition. The Committee has retained the ESFS reform proposals under scrutiny, and given the level of opposition among Member States it appears unlikely they will be adopted in the near future. However, when they do take effect they may entail changes for the way in which UK benchmarks could be used in the EU.

4.47 The European Scrutiny Committee has retained the different elements of the Green Finance package under scrutiny until there is more clarity about the practical impact they may have in the UK, especially in the context of the Government's evolving position on the future economic partnership with the European Union.

Previous Committee Reports

None. These are new proposals for legislation. The Committee reported on the Sustainable Finance Action Plan in May 2018, see: Twenty-Sixth Report HC 301–xxv (2017–19), chapter 12 (2 May 2018).

68 Article 30 of the Benchmark Regulation. For more information on 'equivalence', see paragraphs 4.31 to 4.33 above.

69 Third country benchmarks which were already in use in June 2016 (when the Regulation took effect) can be used until June 2020 as a transitional measure without having to go through either the equivalence or prior recognition process.

70 Under article 32 of the Regulation, administrator's legal representative in the EU acts on behalf of the administrator vis-à-vis the authorities and any other person in the EU with regard to the administrator's obligations under the Benchmarks Regulation.

5 EU Budget 2019

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Treasury Committee and the Public Accounts Committee
Document details	Statement of Estimates of the European Commission for the financial year 2019
Legal base	Article 314 TFEU; special legislative procedure; QMV
Department	Treasury
Document Number	(39886), 10365/18, COM(18) 600

Summary and Committee's conclusions

5.1 In June 2018 the European Commission presented its draft budget for the European Union for the 2019 calendar year. As proposed, the budget would allow the EU to make €166 billion (£147 billion)[71] of spending commitments next year (a three per cent increase compared to the 2018 budget).[72]

5.2 The Commission describes its priorities for the 2019 budget as "investing in a stronger and more resilient European economy" and—given the continued political controversy around inflows of people via the EU's southern and eastern borders—"promoting solidarity and security on both sides of the EU's borders".[73] For the latter, proposed spending in 2019 exceeds the initial limit for that year set by the Member States back in 2013[74] by nearly a billion euros, resulting in extensive use of the Flexibility Instrument to make up the shortfall.[75] The Commission also estimates that the UK's rebate for 2018 will be €5 billion (£4.4 billion). We have described some of the most politically relevant areas of spending in "Background" below.

5.3 The draft budget is now subject to negotiations between the Member States and the European Parliament, which must agree on the total amounts and detailed spending priorities before the end of the year.[76] The 2019 budget is also the last general EU budget over which the Government is likely to have a vote in Council, as it will lose its institutional representation when the UK ceases to be a Member State of the EU on 29 March 2019.

71 Currency exchange rate as per HMRC on 29 June 2018: €1 = £0.88605 or £1 = €1.12860.

72 Commitments cover the cost of all financial obligations the EU budget could be used for in a given financial year, such as contracts or grant decisions. Payments cover actual expenditure to be made from the budget that year, to cover commitments made previously.

73 See European Commission press release 18/3870.

74 In 2013, the Member States agreed the 2014–2020 Multiannual Financial Framework (MFF). This sets the expenditure limits for the six broad policy headings of each annual budget within that period. For 'security and citizenship', the MFF limit for 2019 was €2.8 billion (at current prices), whereas the Commission now proposes spending of €3.7 billion.

75 The Flexibility Instrument is established by the MFF Regulation (Article 11). Its base amount per year is €600 million in 2011 prices, but since 2017 this is increased by the unused funding of the EU Solidarity Fund and the European Globalisation Adjustment Fund the previous year.

76 If the two institutions do not come to an agreement by the end of November, the European Commission will propose a new draft budget to break the deadlock. If there is no agreement by the end of the year, the 2018 budget will automatically "roll over" in monthly instalments until a new budget is adopted.

5.4 However, under the terms of the draft Withdrawal Agreement, it would nonetheless remain a contributor to the EU budget as if it were still a Member State until the end of 2020. The reason provided by the Government is that none of the remaining Member States should receive less or contribute more over the lifetime of the current Multiannual Financial Framework (MFF), which runs from 2014 until 2020 and was adopted unanimously— i.e. with the UK's agreement—in 2013.[77] Controversially, this financial settlement means the UK would also pay towards the EU's own preparations for Brexit. In the 2019 financial year, that may include a new project to create a shipping route between Ireland and the continent by-passing the UK, and the opening of a €10 million EU delegation in London to replace the much smaller current 'representation' that the European Commission maintains in all Member States.

5.5 The UK's exit from the EU also does not, by the Government's own admission, mean that there will be no further UK payments to the EU budget in addition to the Brexit financial settlement as described above.[78] Beyond the transitional period, the Government wants to stay involved in various EU programmes (and, more controversially, EU agencies), which would require a continued financial contribution that could run into billions of pounds annually.[79] As we explored in more detail in our Report of 4 July 2018, there would be additional financial implications from the Government's proposals to avoid border controls on goods being moved between the UK and the EU, or any extension of the transitional period beyond 31 December 2020 (as that would take it into the EU's next Multiannual Financial Framework).

5.6 **The European Commission has proposed a €166 billion (£147 billion) EU budget for 2019, which is likely to be reduced by the Member States. Nevertheless, the 2019 budget will have significant financial implications for the UK despite Brexit, as the draft Withdrawal Agreement requires the Treasury to pay for a share of all EU expenditure to be committed under the Union's general budgets up to and including 2020. The Chief Secretary to the Treasury (Elizabeth Truss) has explained the UK's financing share for 2019 is expected to be 11.4 per cent, which—under the Commission proposal—would result in a gross contribution towards EU expenditure commitments in 2019 in due course of €19 billion (£17 billion). The net contribution would be lessened by EU investment in the UK and the application of the UK rebate.**

5.7 **The Chief Secretary has also said that, during transition, the UK will get a "fair share of receipts" from the EU budget. However, we are concerned that the uncertainty about the UK's long-term relationship with the EU's primary investment vehicles—notably the Framework Programme for Research—is already leading to a reduction in private sector receipts for the UK. The statistics in the Annex to this chapter show that the UK's share of new EU research funding has decreased noticeably since early 2016.**

77 If the Withdrawal Agreement is not ratified, the UK will cease to be under a legal obligation to make contributions to the EU budget on 30 March 2019. However, it would also not benefit from the transitional arrangement sought by the Government to create more time for the UK (and EU) to prepare for the regulatory and customs changes that will result from the UK becoming a 'third country' vis-à-vis the EU.

78 Speech by the Prime Minister at Mansion House (2 March 2018): "The UK is also committed to establishing a far-reaching science and innovation pact with the EU, facilitating the exchange of ideas and researchers. This would enable the UK to participate in key programmes alongside our EU partners. And we want to take a similar approach to educational and cultural programmes, to promote our shared values and enhance our intellectual strength in the world — again making an ongoing contribution to cover our fair share of the costs involved."

79 Based on the indicative budgets of the EU programmes in which the Government has expressed an interest for participation after Brexit, we estimated that the gross UK contribution could be between £2 and £4 billion pounds annually. The net contribution would depend on the flow of receipts back to the UK.

5.8 **Similarly, the Commission has also started proposing the use of EU funding for projects directly related to Brexit. For example, it is planning EU investment in a new shipping route between Ireland and the continent that would allow some freight transports to by-pass the UK more easily.[80] It is difficult to see how that is a good use of UK public funds, given that the Treasury would effectively part-finance any projects which start before the end of the transitional period in December 2020. The Commission has also earmarked €10 million for the creation of an EU 'delegation' to the UK following the closure of the current EU 'representations' in London, Cardiff, Edinburgh and Belfast (which will result in much smaller savings of €700,000). Under the Withdrawal Agreement, the UK would therefore pay towards the establishment of a new EU diplomatic mission in London.**

5.9 **We will continue to monitor developments in the Brexit process—and the costs of the EU's own preparations for the UK's exit—to evaluate the value for money offered by the EU budget for the UK taxpayer (although the net impact of a reduction in UK receipts from the EU budget is cushioned by the UK rebate, which is roughly inversely proportional to the amount of EU funding the UK receives).**

5.10 **The Council and the European Parliament are due to enter into their customary negotiations over the final size and priorities for the annual budget after the 2018 summer recess, aiming for formal adoption by November. We retain the draft budget under scrutiny, and ask the Chief Secretary to keep us informed in due course of the outcome of the negotiations before the budget is formally adopted. We also draw the Commission proposal to the attention of the Treasury and Public Accounts Committees, given its financial and political implications for the UK.**

Full details of the documents

Statement of Estimates of the European Commission for the financial year 2019: (39886), 10365/18, COM(18) 600.

Background

5.11 The European Commission presented the draft EU budget (DB) for 2019 in June 2018. It sets out the Commission's priorities for the 2019 Budget; how the Commission intends to ensure proper implementation; how its fits with the 2014–2020 Multiannual Financial Framework (MFF); and detailed figures of proposed payments and commitments.

5.12 The draft budget, which is now subject to negotiations between the Member States and the European Parliament, would allow the EU to make €166 billion (£147 billion) of spending commitments (a three per cent increase compared to the 2018 budget). Payment appropriations, which cover actual disbursement towards payment commitments, would amount to €149 billion (£135 billion).[81]

80 The European Commission's note of 12 June 2018 on "pending and planned legislative proposals for the purposes of Brexit preparedness" includes an "amendment of […] Regulation (EU) No 1316/2013 establishing the Connecting Europe Facility [to] design a new maritime route to link Ireland with the continental part of the North Sea-Mediterranean corridor".

81 Commitments cover the cost of all financial obligations the EU budget could be used for in a given financial year, such as contracts or grant decisions. Payments cover actual expenditure to be made from the budget that year, to cover commitments made previously.

5.13 In terms of specific expenditure plans,[82] the Commission describes its priorities for the 2019 budget as "investing in a stronger and more resilient European economy" and— given the continued political controversy around inflows of people via the EU's southern and eastern borders—"promoting solidarity and security on both sides of the EU's borders".[83]

Economic investment

5.14 The largest areas of EU spend would remain the Agricultural Guarantee Fund under the Common Agricultural Policy (which covers farming subsidies) at €44 billion, and the three Structural and Investment Funds[84]—which invest in the EU's economic development (especially its lower-income regions)—with a budget of €54 billion. The Commission also wants to set the annual budget for Horizon 2020—the EU's investment vehicle for scientific research—at €12.5 billion (an increase of over eight per cent on the current year). EU investment in cross-border transport, energy and telecommunications infrastructure— via the Connecting Europe Facility—would amount to €3.8 billion in 2019, an increase of roughly a third on the current annual budget. Potentially controversial here is the use of the Facility, and by extension a UK contribution, to finance infrastructure for a proposed new shipping route between Ireland and the "continental part of the North Sea-Mediterranean corridor" to allow freight to by-pass the UK after Brexit.[85]

5.15 For the EU's space programmes, the UK's main interest is in Galileo—the EU's satellite navigation programme. In late 2016, the programme moved from the testing phase to the provision of live services. Completion is due in 2020, but may be delayed due to the exclusion of the UK from bidding for certain contracts.[86]

5.16 In its latest draft budget, the Commission has proposed that commitments for Galileo should be decreased from €805 million in 2018 to €672 million in 2019. This reduction reflects the fact that most of the infrastructure contracts for the programme were signed in the first few years of the current MFF. Conversely, payment appropriations are to be increased year-on-year from €710 million to €920 million, to enable the EU to pay for the "intense activity on the ground" now that Galileo is partially operational. The draft budget also earmarks expenditure commitments of €874 million for Copernicus (the EU's earth observation programme) and the EU's contribution to the international ITER nuclear fusion energy project. These are both programmes in which the Government wants to stay involved after Brexit.

Security and border control

5.17 With respect to "solidarity and security" at the EU's borders, the Commission estimates that "€2.3 billion [from the EU budget] will be required in 2019 under heading 3

82 The figures given in this section refer to commitment appropriations.

83 European Commission press release 18/3870.

84 The three largest ESIFs under the 2019 budget are the European Regional Development Fund (€31 billion), the European Social Fund (€14 billion) and the Cohesion Fund (€10 billion). The other two ESIFs — the Agricultural Fund for Rural Development and the Maritime & Fisheries Fund—have proposed budgets of €15 billion and €942 million respectively.

85 This new maritime route, to receive EU funding, will need to be added to the Connecting Europe Facility Regulation. The European Commission is expected to table a formal legislative proposal to that effect later in 2018.

86 See the Committee's Report of 18 April 2018 for more information on Galileo and Brexit.

to address the challenges of migration and security issues". Because of sustained pressure under the 'Security and Citizenship' heading of the EU budget in recent years, the overall allocation would—again[87]—exceed the expenditure ceiling established by the 2014–2020 Multiannual Financial Framework (the long-term planning for the EU budget, endorsed by all Member States in 2013). The 2019 ceiling for 'Security and Citizenship' agreed in 2013 was €2.8 billion, but the Commission proposal would exceed this by nearly a billion euros (€930 million). This will be funded from the EU's Flexibility Instrument, which is used to fund EU operations for "clearly identified expenses" which could not be covered by the relevant heading of the EU budget in a given year without breaching its MFF expenditure ceiling.

5.18 Specific EU security-related spending in 2019 would include notably €1.1 billion for the Asylum, Migration & Integration Fund under the proposed reforms to the Dublin Regulation on the reception of asylum-seekers, supporting Greece and Italy in particular.[88] The Commission has also proposed €529 million for the Internal Security Fund, which is used to facilitate a common EU approach to border control. The European Border and Coast Guard Agency and eu-LISA, the agency which oversees the EU's three information systems dealing with asylum, border management and law enforcement, would get budgets of €293 million and €291 million respectively. The Turkey Refugee Facility, which funds facilities for refugee communities in Turkey, and is funded jointly by the EU and the Member States, would get €1.45 billion from the 2019 budget.

Funding for new initiatives

5.19 The Commission has also noted that (smaller) financial allocations would be made available for a number of new EU initiatives in 2019, including:

- The European Defence Fund, including the Preparatory Action on Defence Research and the new European Defence Industrial Development Programme (€245 million);[89]
- The European Solidarity Corps, which creates a framework for young people from across the EU to volunteer or work in projects in their own country or abroad (€103 million);
- The establishment of the proposed new European Labour Authority, which will help coordinate the implementation of EU rules to ensure the free movement of workers is not used to undercut local employment conditions (€11 million);[90] and
- The creation of the new European Public Prosecutor's Office, in which the UK does not participate (€5 million).[91]

87 Under the 2018 EU budget, the Commission proposed commitments under 'Security and citizenship' exceeding that year's MFF ceiling by €817 million.

88 Under the 2018 EU budget, there was a sharp reduction in funding for ASIF because of the delays in the adoption of the proposed reforms of the Dublin Regulation. Its 2018 budget was €719 million (compared to the proposed €1.1 billion for 2019).

89 Over 2019 and 2020 combined, the European Defence Fund will be funded by diverting planned funding from other EU projects as follows: €116.1 million (£101.7 million) from the Connecting Europe Facility; €108 million (£94.7 million) from the Galileo and EGNOS satellite navigation projects; €63.9 million (£56 million) from the ITER nuclear fusion project; €12 million (£10.5 million) from the Copernic earth observation project; and €200 million (£175.3 million) from the unallocated margin.

90 The Committee considered the proposal for a European Labour Authority in its Report of 25 April 2018.

91 See for more information on the EPPO the Committee's Report of 13 December 2017.

Brexit-related expenditure from the EU budget

5.20 The European Commission has announced several areas of proposed expenditure (and some cuts) related directly to the UK's exit from the EU. If the Withdrawal Agreement is ratified, the Treasury will co-finance this expenditure as it will remain a contributor to the EU budget for all spending commitments made before 31 December 2020:

- The 2019 budget sets aside €9.8 million for the European External Action Service to staff a 'UK division in Headquarters' and open a formal delegation in London. The money will primarily go towards 25 additional posts "relating to the UK withdrawal from the EU";
- There is a parallel reduction in staffing costs of €702,500 related to the closure of the current EU 'representation' in London and its Regional Offices in Cardiff, Edinburgh and Belfast;
- The Commission estimates that the relocation of the European Medicines Agency and the European Banking Authority from London to Amsterdam and Paris respectively will result in additional costs of €1.9 million in 2019; and
- Although not directly the result of Brexit, the Commission has asked for resources to finance 66 new posts with the European Securities and Markets Authority (ESMA) related to the supervision of non-EU Central Counterparties and increased supervisory responsibility in other areas, some of which are linked to Brexit and the significant level of activity of UK financial services firms in the Single Market. Accordingly, the Authority's budget would balloon from €11.6 million in 2018 to €38.2 million in 2019.

The Government's position

5.21 The Chief Secretary to the Treasury (Elizabeth Truss) submitted an Explanatory Memorandum on the 2019 budget proposal on 29 June 2018. This reiterates the basic principles of the financial settlement under the UK's draft Withdrawal Agreement. Should this treaty be ratified, the Minister says:

> "The UK will participate in the EU's annual budgets in 2019 and 2020, covering the implementation period and the remainder of the [2014–2020] Multiannual Financial Framework (MFF). As part of this, the UK will continue to participate in, and get its fair share of receipts from, programmes under the MFF. The agreement also includes a number of protections, for example through the limits to how much the EU can commit and spend under the MFF ceilings."

5.22 The Explanatory Memorandum also repeats the Government well-established position that "it wants to see real budgetary restraint in the EU" and is "committed to continue to work hard to limit EU spending, reduce waste and inefficiency, and ensure that where EU funds are spent they deliver the best possible value for money for taxpayers". The Minister does not identify any specific areas of the 2019 proposed budget where the Government believes reductions should, or could, be made.

Our assessment: Implications of the 2019 EU budget for the UK

5.23 The EU budget is mostly funded by contributions from the Member States, with the UK currently providing approximately 12.5 per cent of total funding each year.[92]

5.24 As the UK notified its intention to leave the EU in March 2017, it will by operation of law cease to be a Member State on 29 March 2019. Beyond that date, it would in principle have no further legal obligations to contribute towards the EU budget bar any agreement with the Union to the contrary. However, as noted by the Chief Secretary, the draft Withdrawal Agreement (WA) would require the UK would pay into the EU budget in 2019 and 2020—the last years of the current Multiannual Financial Framework—as if it were still a Member State. This would be part of a wider transitional arrangement during which the UK and UK-based natural and legal persons would largely remain eligible for EU funding on the same terms as they do now.

5.25 In addition, the settlement requires further (but decreasing) UK contributions *after* 2020 to account for a share of the '*reste à liquider*' or RAL, the outstanding expenditure commitments made before 31 December 2020 but due for payment after. That will include expenditure commitments made under the 2019 EU budget, but not yet paid out by the end of 2020. The Office for Budget Responsibility estimates that UK payments towards RAL between 2021 and 2028 will amount to €20.2 billion (£18.2 billion). However, as we have set out in some detail in our recent Report on the EU's next Multiannual Financial Framework for 2021–2027, the UK would likely be making additional contributions during that period to pay towards in its continued participation in various EU programmes after 2020 like the Framework Programme for Research or the European Defence Fund.[93]

5.26 There have been calls for the UK's financial contribution (after its formal withdrawal from the EU) to be linked via a conditionality clause to the future UK-EU trade agreement. This would, effectively, allow the Government to suspend payments unless it was satisfied with the substance of (the negotiations on) that trade agreement. The current draft of the Withdrawal Agreement does not provide for any such mechanism, as the EU sees the financial settlement as a way of ensuring the settlement of existing obligations to which the UK consented when it approved the 2014–2020 Multiannual Financial Framework, not a 'down payment' on the future relationship. It is also not clear how it would operate in practice given the UK has not yet clearly defined its own proposition for the future UK-EU partnership, so the objectives against which the conditionality would be benchmarked does not yet exist.

5.27 The existence of the financial settlement relies entirely on the ratification of the UK's Withdrawal Agreement by both Parliament and the EU. In light of the current text of the WA, the Commission has noted specifically that its proposal for the 2019 budget "is based on the premise that the United Kingdom […] will continue to contribute to and participate in the implementation of EU budgets until the end of 2020 as if it were a Member State". This implies that, should the Agreement not be ratified for whatever reason—for example due to the dispute over the 'backstop' for the Irish border—the budget would have to be

92 HM Treasury estimates the UK financing share over recent years to be 12.7 per cent, while the Office for Budget Responsibility has a slightly lower estimate at 12.4 per cent.

93 We estimated in July 2018 that, if the Government achieves its ambitions for participation in the various EU programmes in which it has expressed an interest, the UK gross contribution per year in 2021 to 2027 could amount to approximately £4 billion. See for more information our Report of 4 July 2018.

readjusted to account for the loss of the UK's contributions after March 2019. This could be achieved by combination of increased contributions by the remaining Member States and a reduction of new spending commitments.[94]

5.28 If the Withdrawal Agreement *is* ratified, there would nevertheless still be some changes to UK eligibility for EU funding during the transitional period, after the UK formally ceases to be a Member State. As has been widely reported, the European Commission has already effectively excluded UK companies from bidding for the most sensitive contracts under the Galileo satellite navigation programme for "security-related" reasons.[95] In addition, we remain in correspondence with the Ministry of Defence about the extent to which the UK defence industry will be eligible for funding under the new European Defence Industrial Development Programme (EDIDP), a precursor to the European Defence Fund (the latter of which is due to become operational in 2021).[96] Given these programmes are among the EU's smaller areas of expenditure, the losses to the UK are political—a loss of influence in security-related EU programmes—more so than financial.

5.29 The Chief Secretary's Explanatory Memorandum argues that, for EU programmes where the UK would remain fully involved during the transition, it will "get its fair share of receipts from, programmes under the MFF". However, it appears that even in those cases (such as the Framework Programme for Research), receipts flowing back to the UK may decrease due to the continued uncertainty over our long-term participation in successor programmes under the post-2020 Multiannual Financial Framework. For example, the UK's share of new EU research funding awarded since the referendum has noticeably declined: it received 15 per cent of new funding between October 2016 and March 2017, but only 10.4 per cent over roughly the same period a year later (even if the UK remains the second-largest beneficiary of funding—after Germany—overall). We have shown the full figures in the Annex to this Report.[97] While this may have the effect of reducing the UK's contribution to the EU budget due to the rebate, it also reduces funding for British researchers until domestic alternatives are available.

5.30 The Minister also notes that the Government's expected financing share of the 2019 EU budget—provided the Withdrawal Agreement is ratified—would amount to 11.4 per cent (roughly a percentage point lower than the recent annual average). The Office for Budget Responsibility estimates that the UK's contribution to the EU budget in 2019 will be €19.4 billion (gross) and €9.2 billion (net),[98] although this is not directly related to the size of EU budget for 2019 because payments made in that calendar year will largely relate to spending commitments undertaken in 2018 or before.

5.31 The Council and Parliament are expected to formally adopt the draft budget in late November 2018, provided they reach an agreement on all proposed expenditure. If the two sides do not come to an agreement by the end of November, the European Commission

94 While a lack of agreement would absolve the UK from legal responsibility to make contributions to the EU budget after 2019, the economic shock of a disorderly withdrawal would dwarf any gains to the public purse.
95 See our Report of 18 April 2018 on the EU's space programmes in the context of Brexit.
96 See our Report of 20 June 2018 for more information on the European Defence Fund and the UK's eligibility to receive funding from it during the transitional period.
97 Based on statistics on UK participation in Horizon 2020 published by the Government.
98 The net contribution is calculated by subtracting both public and private sector receipts from the EU budget from the gross contribution.

will propose a new draft budget to break the deadlock. If there is no agreement by the end of the year, the 2018 budget will automatically "roll over" in monthly instalments until a new budget is adopted.

Previous Committee Reports

None on the 2019 EU budget. However, we considered the EU's next long-term budget on 4 July 2018. See Thirty-fourth Report HC 301–xxxiii (2017–19), chapter 6 (4 July 2018).

Annex: UK share of EU research funding since the referendum

The tables below show the UK's share of participation in, and funding from, 'Horizon 2020', the EU's Framework Programme for Research.

The figures are based on statistics published several times a year by the Department for Business, Energy & Industrial Strategy. These show that the UK remains the second largest nation in terms of overall 'participations' and funding received, but the share of new funding awarded to the UK has decreased from 15.6 per cent between February—September 2016 to 10.4 per cent between October 2017—March 2018. Since around the time Article 50 was triggered, the UK has persistently attracted funding at a lower rate than the increase in funding across all participating countries.

Table 1: UK share of Horizon 2020 participations (February 2016-March 2018)

Period	Total Horizon 2020 participations[99] (incl. non-EU countries)	UK cumulative share of participations	UK share of new participations since previous period	Overall UK rank
1 October 2017 — 6 March 2018	71,449	12.4%	10.5%	2nd
1 June 2017 — 30 September 2017	63,685	12.6%	11.6%	2nd
1 March 2017 — 31 May 2017	57,705	12.8%	12.2%	1st
1 October 2016 — 28 February 2017	50,528	12.8%	11%	1st
24 February 2016 — 30 September 2016	40,938	13.3%	14.1%	1st
As at 23 February 2016	30,535	13%	-	2nd

99 'Participations' refers to individual participations by an organisation as part of a Horizon 2020, based on signed grant agreements. There can be multiple participations to a single project.

Table 2: UK share of Horizon 2020 funding (February 2016-March 2018)

Period	Total Horizon 2020 funding[100]	UK cumulative share of total funding	UK share of new funding since previous period	Overall UK rank
1 October 2017 — 6 March 2018	€29.2 billion	14.5%	10.4%	2nd
1 June 2017 — 30 September 2017	€26.7 billion	14.9%	11.6%	2nd
1 March 2017 — 31 May 2017	€24.1 billion	15.3%	14%	2nd
1 October 2016 — 28 February 2017	€21.2 billion	15.4%	16.1%	2nd
24 February 2016 — 30 September 2016	€17.2 billion	15.3%	15.6%	2nd
As at 23 February 2016	€12.4 billion	15.1%	-	2nd

100 'Funding' refers to the agreed financial contribution from the European Commission to the project participant, based on signed grant agreements.

6 The EU Emergency Travel Document

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Foreign Affairs Committee
Document details	Proposal for a Council Directive establishing an EU Emergency Travel Document and repealing Decision 96/409/CFSP
Legal base	Article 23(2) TFEU, special legislative procedure, QMV, EP consultation
Department	Home Office
Document Number	(39850), 9643/18 + ADDs 1–4, COM(18) 358

Summary and Committee's conclusions

6.1 One of the rights associated with EU citizenship is the right to diplomatic and consular protection outside the EU. EU citizens who are stranded in a third country are entitled to seek diplomatic or consular assistance from the authorities of any EU Member State if their own Member State of nationality is not represented (through an embassy or consulate). The assistance provided may include the issuing of an Emergency Travel Document ("ETD") to enable an EU citizen whose passport or travel documents have been lost, stolen or destroyed to return home. The current rules on the issuing of emergency travel documents are set out in an intergovernmental Decision adopted in 1996.[101] They prescribe a uniform format and security features for an EU Emergency Travel Document, but do not make its use mandatory — Member States remain free to issue their own (national) emergency travel documents to EU citizens who seek their assistance.

6.2 The European Commission considers that the continued use of national ETDs creates a risk of fragmentation and "forum shopping", as unrepresented EU citizens may request assistance from a Member State whose emergency travel documents are more widely recognised, or are cheaper or easier to obtain.[102] It has therefore proposed a Directive establishing an EU Emergency Travel Document which would repeal the 1996 Decision and make it *mandatory* for Member States to issue an EU ETD instead of a national ETD to unrepresented EU citizens seeking diplomatic or consular assistance outside the EU. The proposal also envisages that an EU ETD may be issued in a wider range of circumstances, though the decision to issue an EU (rather than a national) ETD would rest with each Member State.[103] In addition, the proposed Directive would:

- strengthen the security features of the EU ETD to reduce the risk of fraud and counterfeiting and support the fight against terrorism and organised crime;
- streamline procedures and introduce time limits for the issuing of EU ETDs to unrepresented EU citizens; and

101 See Decision 96/409/CFSP on the establishment of an emergency travel document.

102 See p.4 of the Commission's explanatory memorandum accompanying the proposed Directive.

103 For example, an EU ETD could be issued to accompanying (non-EU) family members of an EU citizen, to a Member State's own nationals or residents, to represented citizens of another Member State and to EU citizens and their family members within the EU.

- ensure that the rules are fully aligned with a 2015 Directive on consular protection.[104]

6.3 The Commission recognises that the number of EU ETDs is likely to remain low (around 1,000 are issued each year to unrepresented EU citizens) but underlines their importance as "a visible demonstration of the value of EU citizenship and solidarity between Member States".[105] It anticipates that the changes it has proposed to the EU ETD might make it a more cost-efficient alternative to national ETDs for some Member States and, by increasing the use of EU ETDs, make it more likely that they will be recognised and accepted by third countries.

6.4 Member States would have twelve months from the adoption and entry into force of the Directive to adapt their own laws and administrative practices to its provisions, and a further twelve months before the changes would take effect. If the Directive is adopted later this year, it would apply towards the end of 2020 — after the UK's exit from the EU but during the transition/implementation period (ending on 31 December 2020) envisaged in the draft EU/UK Withdrawal Agreement.

6.5 In her Explanatory Memorandum of 4 July 2018, the Immigration Minister (Caroline Nokes) says that there are 49 countries in which the UK has no embassy, consulate or High Commission and depends on other EU Member States (or Australia, New Zealand or Canada) to issue an ETD to a stranded UK national. In 2017, the UK issued a national ETD to 123 unrepresented EU citizens in third countries — the UK is one of three Member States (the others are France and Germany) that does not use the current EU ETD "as it is a lower integrity document" than their national ETDs. Whilst the Government supports the introduction of "a higher integrity" EU ETD and clearer processes for obtaining it, the Minister does not accept that Member States should be required to issue unrepresented EU citizens with an EU ETD rather than a national ETD. Even with the changes proposed by the Commission, the EU ETD would be less secure than the current UK ETD which "significantly exceeds" the minimum standards set by the International Civil Aviation Organisation (ICAO) and is widely accepted. The Minister is unaware of any delays or refusals of entry at borders for EU citizens travelling on a UK ETD and considers that the costs of introducing a mandatory EU ETD would be disproportionate, given the small number issued. She will therefore seek in negotiations to "maintain the right to opt out of issuing EU ETDs".

6.6 In the longer term, the Minister reiterates the Government's commitment to "continue cooperating with the EU on consular affairs", including through the provision of consular assistance to unrepresented EU citizens in third countries on a reciprocal basis.[106] She anticipates that cooperation in this area will form part of negotiations on the future EU/UK security partnership.

104 See Council Directive (EU) 2015/637 on the coordination and cooperation of measures to facilitate consular protection for unrepresented citizens of the EU in third countries. Member States were require to comply with its provisions by 1 May 2018.

105 See p.1 of ADD 3 — Executive Summary of the Impact Assessment.

106 The Government's Framework for UK-EU Security Partnership published in May 2018 calls for "continued cooperation on consular provision and protection".

Our Conclusions

6.7 **We can see the benefit in making the EU Emergency Travel Document more secure and less susceptible to fraud, streamlining procedures to avoid unnecessary delay for unrepresented EU citizens stranded aboard without travel documents, and ensuring more consistent application and enforcement of the rules on EU ETDs. The Minister nonetheless considers that making it compulsory for Member States to issue EU ETDs is unjustified, given the lack of evidence to indicate that national ETDs issued by the UK (and, we assume, France and Germany) to unrepresented EU citizens are inadequate in terms of their security features or their acceptance by third countries. We share her concern but invite her to comment on the Commission's view that greater use of the EU ETD — including by Member States with the largest global reach and representation outside the EU — would increase the recognition and acceptance of the EU ETD by third countries and border control authorities, ensuring greater benefits for more EU citizens. We also ask the Minister:**

- whether British citizens issued with an EU ETD by another Member State have experienced difficulties or delays; and
- whether she is aware of a lower acceptance and recognition rate of EU ETDs than UK ETDs.

6.8 As it seems that most Member States do issue EU ETDs, we would welcome further information on:

- the prospects for successfully opposing the Commission's proposal to make the use of EU ETDs mandatory for unrepresented EU citizens in third countries;
- the pace of negotiations and how soon the Minister expects the proposed Directive to be agreed by the Council; and
- how the Government intends to approach implementation of the Directive, given that the deadline for Member States to transpose it into their national laws will most likely fall within the transition/implementation period envisaged in the draft EU/UK Withdrawal Agreement.

6.9 Pending further information, we are holding the proposed Directive under scrutiny. We draw to the attention of the Foreign Affairs Committee the Minister's observations on the Government's intention to continue diplomatic and consular cooperation with the EU post-exit (and post-transition).

Full details of the documents

Proposal for a Council Directive establishing an EU Emergency Travel Document and repealing Decision 96/409/CFSP: (39850), 9643/18 + ADDs 1–4, COM(18) 358.

Background

6.10 The proposed Directive is based on Article 23 of the Treaty on the Functioning of the European Union (TFEU) which provides:

> "Every citizen of the Union shall, in the territory of a third country in which the Member State of which he is a national is not represented, be entitled to protection by the diplomatic or consular authorities of any Member State, on the same conditions as the nationals of that State. Member States shall adopt the necessary provisions and start the international negotiations required to secure this protection.
>
> "The Council, acting in accordance with a special legislative procedure and after consulting the European Parliament, may adopt directives establishing the coordination and cooperation measures necessary to facilitate such protection."

Previous Committee Reports

None.

7 EU countermeasures to US tariffs on steel and aluminium

Committee's assessment	Legally and politically important
Committee's decision	(a) Cleared from scrutiny; further information requested
	(b) Cleared from scrutiny; further information requested
Document details	(a) OTNYR — Commission Implementing Regulation (EU) …/… of XXX on certain commercial policy measures concerning certain products originating
	in the United States of America pursuant to Article 4(1) of Regulation (EU) No 654/2014;
	(b) OTNYR — Commission Implementing Regulation (EU) …/… of XXX on certain commercial policy measures concerning certain products originating
	in the United States of America and amending Implementing Regulation (EU) 2018/724
Legal base	Regulation (EU) No 654/2014
Department	International Trade
Document Numbers	(a) (39698), —; (b) (39923), —

Summary and Committee's conclusions

7.1 On 8 March 2018, the US announced its intention to impose additional 25% tariffs on steel imports and 10% duties on aluminium imports to protect US national security. It granted the EU a time-limited exemption from these tariffs, initially until 1 May 2018 and subsequently extended to 1 June 2018. The EU pressed the US for a permanent exemption, but on 1 June 2018 the US applied the extra steel and aluminium duties on EU imports.

7.2 While the US argues that the tariffs fall outside the remit of the World Trade Organisation (WTO), on the basis that they have been imposed in the interests of US national security, the EU is treating them as safeguard measures that are intended to protect US industry from foreign competition for commercial reasons. The WTO Agreement on Safeguards allows for the imposition of countermeasures to the equivalent value of the damage caused by safeguards. The Commission estimates that the US tariffs would have affected at least €6.41 billion (£5.62 billion)[107] worth of EU imports into the US in 2017.

7.3 Two different Commission Implementing Regulations are required for the EU to apply countermeasures to US tariffs on steel and aluminium:

- The first notifies the WTO of the scope of potential countermeasures (the tariff lines/products and the maximum level of those tariffs) — a precondition for the

107 €1 = £0.88605 or £1 = €1.12860 as at 29 June 2018.

eventual imposition of additional duties. Commission Implementing Regulation (EU) 2018/724 was adopted on 18 May 2018 (the first Commission Implementing Regulation) ,[108] and

- The second brings into effect the proposed countermeasures that have been notified to the WTO. Commission Implementing Regulation (EU) 2018/886 was adopted on 20 June 2018 (the second Commission Implementing Regulation).[109]

7.4 In its consideration of the first Commission Implementing Regulation at its meeting on 6 June 2018, the Committee:

- noted the Government's support for notifying the WTO of the list of potential countermeasures and that the Government had yet "to determine its position" on whether to support their implementation;
- asked the then Minister of State for Trade Policy (Greg Hands) to set out what criteria the Government would use to assess whether such countermeasures are necessary and proportionate (in determining whether to support their implementation);
- asked the then Minister to share the Government's analysis on the legality of these retaliatory measures under WTO law; and
- noting the lack of any analysis on the Brexit implications of these potential measures, asked the then Minister to set out the legal and policy framework for the UK in its application and enforcement of international trade rules a) during the transition/implementation period (scheduled between 29 March 2019 and 31 December 2020); b) in the event of a 'no deal' exit and no transition/implementation period; and c) after any transition/implementation period (scheduled to end on 31 December 2020).

7.5 On 12 June 2018, the then Minister responded in part (as set out below under 'Our Conclusions') to the list of questions raised by the Committee[110] on 6 June 2018.

7.6 On 20 June 2018, the then Minister provided an Explanatory Memorandum on the second Commission Implementing Regulation (the day that these measures were adopted by the Commission, as noted above). He notes that there are no substantial differences between the first and second Commission Implementing Regulations regarding the US products affected or the additional customs duties. The second Implementing Regulation does, however, allow the Commission to amend the countermeasures to reflect any exemptions that the US may apply (further to any successful US importers' applications to the US Department for Commerce for specific products to be excluded from the tariffs). He states that the Government supports the proposal, as it considers the countermeasures are "measured and proportionate", work "within the boundaries of the rules-based international trading system" and may act as a potential deterrent against similar future actions.

108 The then Minister of State for Trade Policy (Greg Hands) shared an "official text not yet received" version of the proposed countermeasures with the Committee in his Explanatory Memorandum of 8 May 2018.

109 The first set of countermeasures on US products valued up to €2.8 billion came into force on 22 June 2018. The second set of extra duties valued at €3.6 billion will take place a later stage — in three years' time or after a positive finding in WTO dispute settlement, if arrived at sooner.

110 Letter from the then Minister of State for Trade Policy (Greg Hands) to Sir William Cash of 12 June 2018.

7.7 **We note that the proposed countermeasures were adopted by the Commission on 20 June 2018 (following unanimous support for their implementation by all Member States, including the UK, at the Trade Barriers Committee meeting of 14 June 2018)[111] — the date that the Government issued its Explanatory Memorandum on the second Commission Implementing Regulation. While the Scrutiny Reserve Resolution does not apply to Commission Implementing Acts, we remind the Minister of the benefit of sharing information with the Committee in a timely manner, given its clear political importance.**

7.8 Further to the then Minister's responses to the Committee's questions of 6 June 2018 on whether these countermeasures will continue after UK exit on 29 March 2019 (as set out in his letter of 12 June 2018 and reiterated in his Explanatory Memorandum of 20 June 2018), we draw the House's attention to the following:

- during the transition/implementation period (scheduled between 29 March 2019 and 31 December 2020), the UK will apply the countermeasures in accordance with the draft Withdrawal Agreement, which requires the UK to apply the EU's Common Customs Tariff;
- in the event of a 'no deal' exit (no Withdrawal Agreement and no transition/implementation period), the Government considers that the powers it is seeking in the proposed Taxation (Cross-Border Trade) Bill would enable the UK "to apply its own countermeasures, in accordance with international law" and that no formal decision has yet been made on their continuation or otherwise; and
- post-transition/implementation period (scheduled from 1 January 2021), the continued application of the first set of countermeasures or implementation of the second set of countermeasures "would depend on the customs arrangements to be agreed with the EU".

7.9 We now clear these documents from scrutiny, but ask the Minister of State for Trade Policy (George Hollingbery) to respond to the following outstanding questions (which were not addressed by your predecessor):

- What is the Government's analysis on the legality of these retaliatory measures under WTO law? and
- What would be the possible impacts on the UK if it were to a) effectively 'rollover', b) diverge from, or c) not continue to implement the EU list of countermeasures, either in the event of a no-deal scenario or post-transition period (noting from your predecessor's Explanatory Memorandum of 20 June 2018 that the UK share of EU imports affected by US tariffs is roughly 20 per cent)?

7.10 **Furthermore, following publication of the Government's White Paper** The future relationship between the United Kingdom and the European Union**, we ask the Government for its assessment on how the UK's proposed facilitated customs arrangement with the EU (if it were to be agreed by the EU) would impact the UK's continued application of the first set of countermeasures or implementation of the**

111 EU Trade Policy update to the Committee of 4 July 2018.

second set of countermeasures post-transition period. We also ask the Minister to outline the UK decision-making process for imposing such countermeasures in the event of a no-deal scenario or post-transition period.[112]

7.11 **We also take this opportunity to remind the Minister that we expect deposit of, and timely updates on, any related documents dealing with the EU's response to US steel and aluminium tariffs (for example, on steel safeguard measures) and in relation to potential US tariffs in other areas (for example, on EU cars and car parts further to the US S232 investigation of 23 May 2018).**

7.12 **We draw the documents and our conclusions to the attention of the International Trade Committee.**

Full details of the documents

(a) OTNYR — Commission Implementing Regulation (EU) …/… of XXX on certain commercial policy measures concerning certain products originating in the United States of America pursuant to Article 4(1) of Regulation (EU) No 654/2014: (39698), —; (b) OTNYR — Commission Implementing Regulation (EU) …/… of XXX on certain commercial policy measures concerning certain products originating in the United States of America and amending Implementing Regulation (EU) 2018/724: (39923), —.

Background

7.13 The details of the first Commission Implementing Regulation and the Government's position on it can be found in the Committee's Report chapter listed at the end of this chapter.

7.14 The imposition of countermeasures is one part of the EU's three-pronged response to US steel and aluminium tariffs. The second is possible safeguard measures to protect EU producers from excessive steel imports due to trade diverted from the US (a safeguard investigation into the EU's imports of 26 steel products was launched on 26 March 2018). The third is a WTO dispute case against the US, which was launched on 1 June 2018. The Minister provides a short update on the progress of these investigations in his EU Trade Policy update to the Committee of 4 July 2018. He states that provisional safeguards may be imposed in July 2018.

7.15 On 23 May 2018, the US launched a Section 232 investigation into automobiles and automotive parts. The Commission has coordinated the EU's response to the investigation's call for public comment.

Previous Committee Reports

Thirtieth Report HC 301–xxix (2017–2019), chapter 12 (6 June 2017).

112 In a letter to Lord Boswell of Aynho (Chairman of the Lords' European Union Committee) of 11 June 2018, the then Minister states that the "Trade Remedies Authority, which will be an independent, arms-length body, will not be responsible for deciding whether to impose these countermeasures."

8 Cyprus: Brexit and UK Sovereign Base Areas

Committee's assessment	Politically important
Committee's decision	Cleared from scrutiny; drawn to the attention of the Defence and Foreign Affairs Committees
Document details	Fourteenth report on the implementation of Council Regulation (EC) No 866/2004 of 29 April 2004 and the situation resulting from its application covering the period 1 January until 31 December 2017
Legal base	Council Regulation (EC) No 866/2004
Department	Foreign and Commonwealth Office
Document Number	(39931), 10435/18, COM(18) 488

Summary and Committee's conclusions

8.1 When Cyprus joined the EU in 2004, its accession covered the entire island even though the Republic of Cyprus — recognised internationally as its sovereign authority — only controls part of the country. The northern half, invaded by Turkey in 1974, is not under its effective control.

8.2 To reflect this political reality, the application of EU law in Northern Cyprus is suspended but a special regime applies to facilitate trade between the two parts of the island — across a UN buffer zone known as the 'Green Line'. Under the so-called 'Green Line Regulation', entry of goods from Northern Cyprus is subject to a more permissive regime than for formal 'third countries' outside the Single Market, as there are no tariffs or quotas. However, regulatory controls for food and plant safety apply, and trade in agricultural products is severely restricted in practice.

8.3 The situation on Cyprus is further complicated by the existence of two Sovereign Base Areas (SBAs) on the island, remnants of its pre-1960 status as a UK Crown Colony. The Bases are British Overseas Territories administered by the Ministry of Defence, which are not part of the European Union. Dhekelia — also known as the Eastern Sovereign Base Area or ESBA — straddles the Green Line and contains two crossing points for movements of goods and people between the two parts of Cyprus.

8.4 In line with the UK's commitment "not to create customs posts or other frontier barriers between the Sovereign Base Areas and the Republic of Cyprus", Protocols 3 and 10 to Cyprus' 2004 Act of Accession refer specifically to the SBAs. These seek to ensure free movement of goods between the Republic of Cyprus (the area effectively controlled from Nicosia) and the Base Areas, by requiring the latter apply EU law in a number of areas, including customs, VAT, excise and food safety, and performing checks on goods entering from Northern Cyprus. The Common Agricultural Policy also covers farms

within the territory of the Bases. **We have described the current trade regimes that govern movements of goods and people between the EU (including Cyprus), Northern Cyprus and the SBAs in more detail in "Background" below.**

8.5 **The UK's decision to leave the EU complicates the situation for both Cyprus and the Bases, as goods will no longer be able to flow freely between the two once the SBAs leave the customs territory of the EU and cease to be bound by EU law on the safety of animal and plant products. Instead, EU law will require Cyprus to apply customs and regulatory controls on crossing between the two for the first time.**[113] **This would also disrupt any movements between the Republic of Cyprus and the northern half of the island via the border crossings within the Dhekelia base. There has been no suggestion that Cyprus is seeking to formally regain sovereignty over the SBAs.**

8.6 **To mitigate the impact of Brexit, the UK, Cyprus and the European Commission have been negotiating a** specific Protocol **on the Sovereign Base Areas to be annexed to the Withdrawal Agreement on the UK's exit from the EU. Its purpose would be to** "protect the interests of Cypriots who live and work in the SBAs following the UK's withdrawal from the Union", **and in June 2018 the Government** said **that it had** "made progress in agreeing the text of the Protocol". **However, it has not made any public statement about the likely substance of the SBA Protocol, or the extent to which the current situation — in which the Bases are part of the EU's customs territory and apply EU law on animal and plant health — could be maintained even when the UK itself becomes a 'third country' vis-à-vis the EU.**

8.7 The Commission reports annually on the implementation of the Green Line Regulation, and its latest report was submitted for scrutiny by the Foreign & Commonwealth Office in July 2018. In his Explanatory Memorandum on the document, the Minister for Europe (Sir Alan Duncan) explains that "no decisions have been taken yet with regard to the UK's future role in implementing the [Green Line Regulation]".

8.8 **The Government has not discussed the implications of Brexit for the Sovereign Base Areas on Cyprus in any detail. Although we now clear the Green Line Report from scrutiny, we note that there has been unspecified "progress" on agreeing a Protocol on the SBAs as part of the Brexit negotiations. We ask the Minister to clarify as soon as possible what the substance of the Protocol on the Sovereign Base Areas is likely to be, and in particular whether it will in effect maintain Protocols 3 and 10 of the 2004 Act of Accession (meaning the bases would stay part of the EU's customs territory; apply EU law on sanitary and phytosanitary measures; and remain covered by the Common Agricultural Policy).**

8.9 **We also draw this Report to the attention of the Defence and Foreign Affairs Committees, given the potential implications of Brexit for the Sovereign Area Bases.**

Full details of the documents

Fourteenth report on the implementation of Council Regulation (EC) No 866/2004 of 29 April 2004 and the situation resulting from its application covering the period 1 January until 31 December 2017: (39931), 10435/18, COM(18) 488.

113 The absence of customs and regulatory controls between Cyprus and the SBAs was strictly a bilateral matter prior to Cyprus' accession in 2004, as the Bases are not part of the EU under the UK's own 1973 Act of Accession. The UK's exit from the EU, however, turns the borders between the SBAs and Cyprus into an external border of the European Union where a whole range of EU legislation on trade in goods applies.

Background

8.10 In 1974, the Cypriot National Guard — with the backing of the Greek military junta in its dying days — overthrew Cyprus' government, with the ultimate aim of the island's political annexation to Greece. This prompted Turkey to invade, and occupy the northern part of the island. It has styled itself as the independent Turkish Republic of Northern Cyprus since 1983, although it is only recognised as a sovereign country by Turkey.[114]

8.11 The Republic of Cyprus (which is recognised internationally as the sole sovereign authority over the entire island, despite only effectively controlling the southern part of Cyprus) joined the EU in 2004. The situation is further complicated by the fact that the UK also maintains two "Sovereign Base Areas" (SBAs) on the island, which are British Overseas Territories administered by the Ministry of Defence. These are remnants of Cyprus' status as a British protectorate — and later Crown Colony — until it achieved independence in 1960.[115] The Eastern Sovereign Area Base (ESBA), also known as Dhekelia, straddles the line between southern and northern Cyprus.

8.12 The links between the government-controlled areas of Cyprus (and the wider European Union) on the one hand and the SBAs and Northern Cyprus on the other hand are established through two Protocols to the island's 2004 Act of Accession, supplemented by more detailed secondary EU legislation. In particular, Protocol 10 to the Act of Accession[116] provides that the application of the EU's *acquis* to northern Cyprus is suspended, but the line between the two sides is not formally considered an external border of the EU.[117]

8.13 Separately, Protocol 3 to the Act of Accession clarifies the status of the Sovereign Base Areas in relation to Cyprus as a Member State of the EU. As the House of Commons Library has noted, the purpose of this Protocol is to ensure that "those resident or working in the Sovereign Base Areas […] should have, to the extent possible, the same treatment as those resident or working in the Republic of Cyprus" and to give effect to the UK's commitment "not to create customs posts or other frontier barriers between the Sovereign Base Areas and the Republic of Cyprus".[118] To that end, even though the SBAs are not part of the EU, the Treaty on the Functioning of the EU applies there "to the extent necessary to ensure the implementation of the arrangements set out in the Protocol".

8.14 Under secondary legislation adopted by the Council, the 2004 Green Line Regulation[119] (named for the "green line" buffer zone between the island's two halves) and a supplementary Commission Regulation,[120] the law provides more detail how this complex regime is to operate in practice. In essence, it defines the terms under which the provisions of EU law apply to the movement of persons, good and services crossing between Cyprus' two sides. Under Article 4 of the Council Regulation, goods may be introduced from Northern

114 The Cypriot question is also one of many stumbling blocks to Turkey's prospective accession to the EU. Both Cyprus and Greece would veto its accession until the situation is resolved (although accession negotiations are now effectively suspended in any event because of the political situation in Turkey).

115 See for more information the Treaty of Establishment (1960), article 1.

116 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12003T%2FPRO%2F10.

117 See Protocol 10 of Cyprus' Act of Accession.

118 This commitment also extends to the safeguarding of the "arrangements made pursuant to the Treaty of Establishment [of the Sovereign Base Areas] whereby the authorities of the Republic of Cyprus administer a wide range of public services in the Sovereign Base Areas, including in the fields of agriculture, customs and taxation".

119 Council Regulation 866/2004.

120 Commission Regulation 1480/2004.

Cyprus into the government-controlled areas and the Sovereign Area Bases, provided that they meet certain criteria and undergo the necessary regulatory controls at the Green Line.

8.15 Cumulatively, under these Protocols and Regulations:

- The **Republic of Cyprus**, in areas effectively controlled by its Government, is fully in the European Union, Single Market and Customs Union;
- The **Sovereign Base Areas** are not in the EU or the Single Market, but are part of of the EU's Customs Territory (including for the purposes of Value Added Tax and excise duty).[121] It applies Cyprus' transposition of EU legislation in those areas.[122] To ensure free movement of agricultural goods produced by farmers within the SBAs to Cyprus and the wider EU, the Bases are covered by the Common Agricultural Policy[123] and they must also apply EU law "in the veterinary and phytosanitary fields which have as their direct objective the protection of public health". The SBAs also use the euro as their currency;[124] and
- **Northern Cyprus** is formally considered part of the EU, but the application of EU law is suspended there. A special regime applies to movement of goods and people between the two halves of the island. Goods mostly or wholly manufactured in Northern Cyprus can enter the EU's customs territory tariff- and quota-free but are subject to certain regulatory checks to ensure conformity with EU product regulations, such as food safety controls. As such, there are border controls on goods moving between the two halves of the island of Cyprus.[125]

8.16 In the ESBA, the crossing points with Northern Cyprus are operated by the SBA customs authority, who have primary responsibility for implementing the provisions of the Green Line Regulation. They carry out any required checks on people and goods crossing the Line (especially regulatory controls on goods entering from Northern Cyprus). However, the UK's decision to leave the EU has put the status of the Sovereign Area Bases in relation to Cyprus back into question, as the Protocols to the Act of Accession will cease to apply when the UK leaves the European Union.

8.17 The European Commission published its latest Annual Report on the implementation of the Green Line Regulation in June 2018.[126] It concludes that the Regulation "continues to provide a workable basis for allowing the passage of persons and goods" between the

121 VAT and excise duty normally require import controls when entering a country to ensure the correct amount of tax is paid. Within the EU, the abolition of border controls has led to the creation of separate legal regimes — underpinned by shared IT systems — that allow goods to be moved between Member States without the need for VAT and excise duty to be checked when crossing intra-EU borders. See for more information our recent Reports on VAT and Brexit and on excise duty and Brexit.

122 The SBA Administration says: "Some laws of the Republic of Cyprus, primarily those relating to agriculture, excise duty and VAT are "adopted" as made by the Republic of Cyprus. Adopted laws form part of the law of the Sovereign Base Areas without the need for new SBA legislation to be made when the law of the Republic of Cyprus changes".

123 Under article 3 of Protocol 3, Title II of Part Three of the EC Treaty, on agriculture, and provisions adopted on that basis and measures adopted under Article 152(4)(b) of the EC Treaty, apply to the SABs.

124 The UK Court of Appeal recently decided that the UN Refugee Convention extends to the SBAs. The Home Office has appealed the decision in the Supreme Court. The Foreign Office says that, although there has not been "a substantial increase in levels of irregular migration to […] the SBAs", it "will continue to monitor the situation".

125 As a result of the non-application of EU law in Northern Cyprus, significant barriers persist; for example, trade in live animals and animal products is prohibited, and the Cypriot authorities do not allow processed foods from Northern Cyprus to cross the Green Line out of concern over sanitary practices.

126 See Commission document COM(2018) 488.

two parts of Cyprus. While not focused on the Brexit implications for the Bases, it does note that the Eastern Sovereign Area Base (Dhekelia) is an important crossing point for traffic between the two parts of Cyprus, with over 200,000 crossing of Cypriots and their vehicles (and over 700,000 crossings by Turkish Cypriots and their vehicles) in 2017.

8.18 The Minister for Europe (Sir Alan Duncan) submitted an Explanatory Memorandum on the document on 5 July 2018. It mainly summarises the Commission's findings.

Implications of Brexit for the UK Sovereign Base Areas on Cyprus

8.19 The Minister's Explanatory Memorandum also refers to the implications of Brexit for the UK's Sovereign Base Areas. When the UK leaves the European Union, Protocols 3 and 10 will cease to apply. As a result, the EU's border for the purposes of unfettered trade in goods would shift — from the boundaries of the SBAs with the sea or Northern Cyprus, to the frontier between the Republic of Cyprus and the Bases. This will be the default situation because the latter would no longer be part of the EU's customs, VAT and excise territory, or apply EU law on agricultural goods. As such, goods entering Cyprus from the Bases would be subject to customs controls — including payment of Value Added Tax — and full regulatory controls on agricultural goods. Agricultural production within the SBAs would also no longer be covered by the Common Agricultural Policy. There is also the uncertain impact of the ability of Cypriots who live work within the territory of the Base Areas to cross freely between them and the Republic.

8.20 The status of goods from Northern Cyprus would not be affected as such, as the relevant elements of Protocol 10 remain in effect irrespective of Brexit. However, goods may not be able to move through Dhekelia to or from the part of the Republic of Cyprus under effective control without undergoing UK checks on entry and exit from the Sovereign Base Area; and when entering Cyprus they would also need to be checked by Cypriot authorities to ensure the goods originated in Northern Cyprus (a function currently carried out within the Base itself), in addition to the normal regulatory border controls that apply to goods from the occupied territory.[127]

A Protocol on the Sovereign Base Areas in the Withdrawal Agreement

8.21 The potential ramifications of Brexit are clearly of major concern to the Cypriot and UK authorities. In summer 2017, the Foreign Office told us that the Government is in discussions with both Nicosia and the EU on how to adapt the bilateral and EU arrangements governing the status of the Sovereign Base Areas "to take account of UK exit", including how the Green Line Regulation will operate in Dhekelia, which straddles the green line between the Republic of Cyprus and Turkish Cyprus but currently applies EU law on customs, VAT, excise and food safety to allow for smooth passage of goods between the two.

8.22 The draft Withdrawal Agreement on the UK's exit from the EU, published in March 2018, contains a Protocol "relating to the Sovereign Base Areas in Cyprus". The text of this section is yet to be agreed between the Government and the EU. The Commission's placeholder for the Protocol reads:

127 Cypriot farmers who produce within the SABs would also not qualify for assistance from the Common Agricultural Policy as they would, in effect, be 'third country' (i.e. non-EU) businesses.

> "Since the arrangements applicable to relations between the Union and the Sovereign Base Areas in Cyprus will continue to be defined within the context of the Republic of Cyprus' membership of the Union, appropriate arrangements have been determined to achieve, after the withdrawal of the United Kingdom from the Union, the objectives of the arrangements set out in Protocol 3 to the Act of Accession of the Republic of Cyprus to the Union. Those arrangements should ensure the proper implementation of the applicable Union law in relation to the Sovereign Base Areas in Cyprus following the withdrawal of the United Kingdom from the Union."

8.23 That implies the EU is seeking an arrangement under which the UK would continue to apply EU law at the bases as it does at present to prevent them from becoming regulatory and customs enclaves that would impede the movement of goods and people (especially when crossing to and from Northern Cyprus via Dekhelia). On 19 June 2018, the Government and the European Commission published a Joint Statement on progress to date in the Brexit negotiations. With respect to Cyprus, this states:

> "On the Sovereign Base Areas in Cyprus, both Parties have confirmed their commitment to establish appropriate arrangements for the SBAs, in particular with the aim to protect the interests of Cypriots who live and work in the SBAs following the UK's withdrawal from the Union, in full respect of the rights and obligations under the Treaty of Establishment. The Parties have made progress in agreeing the text of the Protocol that will give effect to this."

8.24 The draft Withdrawal Agreement would also establish a specialised committee composed of UK and EU officials on the Sovereign Base Areas to oversee implementation of the Protocol as and when agreed, and following ratification of the overall Agreement. However, it remains unclear what the substance of the Protocol will be even though there has been "progress in agreeing the text".

8.25 The Government's Memorandum on the Commission's latest Green Line Report, submitted by the Minister for Europe (Sir Alan Duncan) on 5 July, states that "no decisions have been taken yet with regard to the UK's future role in implementing the [Green Line Regulation]. We will keep the Committees informed as and when these decisions are taken". The Minister does not refer to the substance of the "progress in agreeing the text of the Protocol" that was reported in June 2018. In light of this, we have asked the Minister to provide further information on the likely substance of the Withdrawal Agreement in relation to the SBAs, in particular as regards any continued alignment of the Base with EU law in the areas covered by the current Protocols, as soon as he is able.

Previous Committee Reports

None.

Documents not raising questions of sufficient legal or political importance to warrant a substantive report to the House

Department for Exiting the European Union

(39925) 10268/18 COM(18) 377	Report from the Commission to the European Parliament and the Council pursuant to Article 27 of the Staff Regulations of Officials and to Article 12 of the Conditions of Employment of Other Servants of the European Union (Geographical balance).

Foreign and Commonwealth Office

(39924) 10135/18 JOIN(18) 14	Joint Report to the European Parliament, the European Council and the Council on the implementation of the Joint Framework on countering hybrid threats from July 2017 to June 2018.
(39927) 10242/18 JOIN(18) 16	Joint Communication to the European Parliament, the European Council and the Council Increasing resilience and bolstering capabilities to address hybrid threats.
(39949) — —	Council decision establishing a common set of governance rules for PESCO projects.
(39952) — —	Council Decision on a no-cost technical extension of Council Decision 2012/392/CFSP on establishing a European Union CSDP mission in Niger (EUCAP Sahel Niger).

HM Treasury

(39802) 9476/18 +ADD 1–2 COM(18) 339	Proposal for a Regulation of the European Parliament and of the Council on sovereign bond-backed securities.

Home Office

(39716) 9072/18 + ADD 1 COM(18) 301	Communication from the Commission Progress report on the Implementation of the European Agenda on Migration.
(39783) — —	Special report No. 13/2018: Tackling radicalisation that leads to terrorism: the Commission addressed the needs of Member States, but with some shortfalls in coordination and evaluation.
(39901) 10160/18 + ADD 1 COM(18) 458	Proposal for a Council Decision on the conclusion of the status agreement between the European Union and the Republic of Albania on actions carried out by the European Border and Coast Guard Agency in the Republic of Albania.
(39902) 10161/18 + ADD 1 COM(18) 459	Proposal for a Council Decision on the signing, on behalf of the Union, of the status agreement between the European Union and the Republic of Albania on actions carried out by the European Border and Coast Guard Agency in the Republic of Albania.
(39919) 10206/18 + ADD 1 COM(18) 470	Communication from the Commission to the European Parliament, the European Council and the Council Fifteenth Progress Report towards an effective and genuine Security Union.

Formal Minutes

Wednesday 18 July 2018

Members present:

Sir William Cash, in the Chair

Martyn Day	Kelvin Hopkins
Geraint Davies	Stephen Kinnock
Steve Double	Andrew Lewer
Richard Drax	Michael Tomlinson
Mr Marcus Fysh	Dr Philippa Whitford
Kate Green	

Scrutiny Report

Draft Report, proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1.1 to 9 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Thirty-sixth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

[Adjourned till Wednesday 5 September at 1.45pm.

Standing Order and membership

The European Scrutiny Committee is appointed under Standing Order No.143 to examine European Union documents and—

a) to report its opinion on the legal and political importance of each such document and, where it considers appropriate, to report also on the reasons for its opinion and on any matters of principle, policy or law which may be affected;

b) to make recommendations for the further consideration of any such document pursuant to Standing Order No. 119 (European Committees); and

c) to consider any issue arising upon any such document or group of documents, or related matters.

The expression "European Union document" covers —

i) any proposal under the Community Treaties for legislation by the Council or the Council acting jointly with the European Parliament;

ii) any document which is published for submission to the European Council, the Council or the European Central Bank;

iii) any proposal for a common strategy, a joint action or a common position under Title V of the Treaty on European Union which is prepared for submission to the Council or to the European Council;

iv) any proposal for a common position, framework decision, decision or a convention under Title VI of the Treaty on European Union which is prepared for submission to the Council;

v) any document (not falling within (ii), (iii) or (iv) above) which is published by one Union institution for or with a view to submission to another Union institution and which does not relate exclusively to consideration of any proposal for legislation;

vi) any other document relating to European Union matters deposited in the House by a Minister of the Crown.

The Committee's powers are set out in Standing Order No. 143.

The scrutiny reserve resolution, passed by the House, provides that Ministers should not give agreement to EU proposals which have not been cleared by the European Scrutiny Committee, or on which, when they have been recommended by the Committee for debate, the House has not yet agreed a resolution. The scrutiny reserve resolution is printed with the House's Standing Orders, which are available at www.parliament.uk.

Current membership

Sir William Cash MP (*Conservative, Stone*) (Chair)

Geraint Davies MP (*Labour/Cooperative, Swansea West*)

Martyn Day MP (*Scottish National Party, Linlithgow and East Falkirk*)

Steve Double MP (*Conservative, St Austell and Newquay*)

Richard Drax MP (*Conservative, South Dorset*)

Mr Marcus Fysh MP (*Conservative, Yeovil*)

Kate Green MP (*Labour, Stretford and Urmston*)

Kate Hoey MP (*Labour, Vauxhall*)

Kelvin Hopkins MP (*Independent, Luton North*)

Darren Jones MP (*Labour, Bristol North West*)

Mr David Jones MP (*Conservative, Clwyd West*)

Stephen Kinnock MP (*Labour, Aberavon*)

Andrew Lewer MP (*Conservative, Northampton South*)

Michael Tomlinson MP (*Conservative, Mid Dorset and North Poole*)

David Warburton MP (*Conservative, Somerton and Frome*)

Dr Philippa Whitford MP (*Scottish National Party, Central Ayrshire*)