

## FOCUS: SUSTAINABLE PALM OIL POLICIES –



## EU biofuels trade restrictions & Indonesia's new national initiatives

### Palm Oil Strategic Analysis

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Issue 001

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## EU RED – will a trade complaint be made?

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- The EU RED excludes nearly all palm oil bio-diesel from its biofuel incentives system, from 5 Dec 2010
- A challenge could take 1 to 2 years, depending on the strategic option chosen?
- Indonesia steams ahead (on its own?) with announcement of 5 key initiatives to enhance its sustainability efforts

## EDITORIAL



Welcome to our very first issue of the Khor Reports on palm oil! For our inaugural issue, we are focusing on the upcoming EU Renewable Energy Directive (RED) and how Indonesia and Malaysia are dealing with it.

We shall do our best to always provide you with good strategy and analysis. Please bear with us as we learn the ropes of publishing. We are not very sure what the eventual format and frequency of our little venture will be. Hopefully, the next issue will not be too long coming.

On the surface, the Directive will only affect 1.5% of the global market for palm oil. The EU buys 15% of the total global market, of which it uses 10% for biofuels (under the purview of the new Directive). So there you have it, a mere 1.5%. So the question is: why is everyone so worked up about it?

Because it is the sign of things to come. I think that it is safe to say that when the EU takes a stance, it is usually the standard bearer. As such, the palm oil industry should be watchful, and it must engage positively on these issues. It should not pretend that there are no problems. It should not ignore emerging trends. Most make the excuse that India and China (the biggest buyers) care only for pricing, so why bother?

The strategy of denial has not worked so well. A handful of NGOs have played David to the palm oil Goliath. A startling outcome, for the key sector for the Indonesian and Malaysian economies and its corporate behemoths.

Indonesia and Malaysia ("The Big 2") and other wannabes, must engage the global environmental lobby. Unlike the 1980s anti-tropical oil campaigns which focused on health fears (disproved, and palm oil won) and allegedly funded by the US soybean lobby; this current crisis is a different animal. And that animal is the orang utan. Cute and cuddly. Highly emotive. This time, there will be no positive laboratory test result to defend palm oil, and take it back to the 'good old days'.

Yes, palm oil is the most sustainable oil crop in terms of efficient land usage. But the environmentalists are not concerned with palm oil per se. They are concerned with how it is developed. Is any sector perfect in this regard? Unlikely. Isn't there always room for improvements? We believe that there must be a middle ground.

Palm oil is a USD 30 billion industry. Its ownership is almost completely in local hands and dominated by a few mega corporations. We are surprised by the lack of coordinated initiatives to engage the problems. Come on guys, oil palm is the bedrock of your economies - a "do or die" attitude should be adopted.

In this issue of the Khor Reports, we highlight two well-known options for the industry to deal with the upcoming closure of the EU market to palm oil biodiesel (see pages 3 and 4). The Big 2 could engage with the EU to modify its methodology and data, so that the sustainability measures for palm oil biodiesel are improved. They could also challenge the EU via a trade complaint to the WTO (pages 5 and 6). However, this could take 1 to 2 years. We also propose a third option – could 'the best go first'?

But, we want to stress that these options are merely efforts to tinker with numbers, formulae, terminology, legal minutiae and timing. The core environmental and perception problems remain. These still need to be addressed. Consumers are being educated to be more concerned e.g. palm oil = killing orang utans. Fact is, as their incomes improve and their consumption increases, so does their awareness of these matters.

On this fundamental subject, we are rather impressed by the exemplary leadership shown by Indonesia to engage with environmental issues. We know that Indonesian practices could be inferior in many cases, and that implementation questions abound. But the arena for market acceptance and trade access is the highest level international stage. Indonesia's new initiatives hit the high notes and set the right tone. Its policy makers are trying to guide their palm oil industry into a new trajectory. Malaysia can learn a thing or two from SBY (page 7). USD 1 billion for a two-year moratorium on deforestation? Nice.

In almost the same breadth that the joint cooperation with Malaysia was signed, Indonesia went ahead with big progressive new policies for sustainable palm oil. Come on Malaysia, time to play catch up?

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## BACKGROUND

# The EU RED excludes palm oil biodiesel.

<p>5 Dec 2010, EU RED comes into force</p> <p>10% of CPO imports into the EU will be affected</p> <p>The EU imports 15% of global palm oil</p>	<p><b>The EU's policy, market and goals</b>                  The sustainability criteria in the European Union (EU) Renewable Energy Directive (RED), was issued on 23 April 2009, and it is due to come into force on 5 December 2010. That's a lead-time of nearly 20 months.</p> <p>The EU will not block any CPO imports with new tariffs, quotas, restrictions or conditions. However, imported CPO-based biodiesel will be at a disadvantage to various other biofuel competitors, as: a) it will not receive tax exemptions, subsidies or other incentives from EU member states, and b) it will not count towards the EU's objective of 10% of renewable energy in transport.</p> <p>90% of palm oil imports are used in consumer products, such as food and cosmetics. This will not be impacted by the EU RED Directive. The Directive is about trade in biofuels.</p> <p>The EU has ambitious targets in combating climate change: "20-20-20". The EU has a commitment to cut emissions by at least 20% of 1990 levels by 2020. It has a binding target to increase the share of renewable energy by 2020 with 20% renewable energy sources in EU total energy consumption and with 10% of transport fuels from renewable sources (i.e. biofuels).</p> <p>The EU argues that:</p> <ul style="list-style-type: none"> <li>• Companies need to cope with consumers demanding more environmentally friendly products.</li> </ul>	<ul style="list-style-type: none"> <li>• Good and clear certifications systems are needed.</li> </ul> <p><b>Sustainability criteria</b>                  The EU has three (3) key sustainability criteria for biofuels:</p> <ol style="list-style-type: none"> <li>1) No conversion of land with high biodiversity value</li> <li>2) No conversion of land with high carbon stock</li> <li>3) Minimum greenhouse gas (GHG) emission saving of 35%, increasing to 50% - 60% from 2017/18 onwards</li> </ol> <p>EU member states are responsible for the enforcement of the sustainability criteria, including adequate auditing .</p> <p><b>Regular palm oil biodiesel fails the EU threshold</b>                  The default value for palm oil biodiesel depends on processing techniques. The default value for GHG-emission savings from palm oil biodiesel is 19% (failing the EU's 35% threshold), and that for palm oil biodiesel with methane capture is 56% (meeting the threshold). However, as there is little of the latter, nearly all palm oil bio-diesel will not be eligible.</p> <p>Soybean oil biodiesel also fails, but rapeseed and sunflower biodiesel, plus sugar beet and sugarcane ethanol are acceptable.</p> <p style="text-align: right;"><i>Sources: EU 2010, EUDI 2010</i></p>
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## The headlines...



**35%**

EU RED threshold for GHG emissions savings, increasing to 50% - 60% from 2017/18 onwards.

**19%**

Default value for palm oil bio-diesel misses the threshold, but 56% value with methane capture is acceptable..

**No land conversion**

- of high biodiversity value areas
- of high carbon stock areas

## BACKGROUND

GHG savings criteria affects all growers

Biodiversity & high carbon stock criterias affect new plantations (established Jan 2008 onward).

### Final details due soon?

In April 2010, the EU reported that the final details for the RED implementation would be published soon.

An alternative may be available, as the EU can accredit 'voluntary schemes' (or international agreements) as sufficient proof.

Several practical details of the sustainability scheme noted as still pending included:

- » Details on emission saving calculation
- » Definitions on land use, degraded lands, biodiverse grasslands, reporting requirements
- » Recognition of voluntary schemes
- » Update/add default values

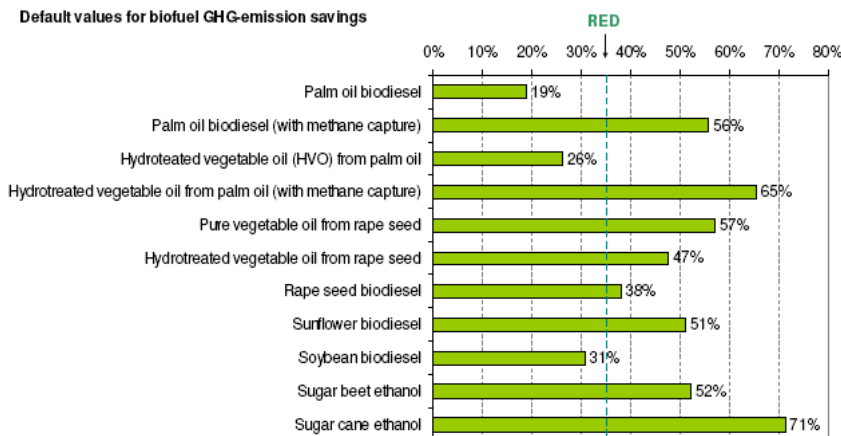
In May 2010, the EU trade officer for Malaysia reported that two (2) clarifications will be issued by June 2010 (on biodiversity and voluntary schemes e.g. RSPO). She said that there will also be a communication on default values - timing and process. There was ongoing analysis on indirect land use change (ILUC) and its results are due by end 2010. While the GHG criteria affects all growers, the biodiversity criteria and the high carbon stock criteria only affect new plantations set up Jan 2008 onward.

### National legislations

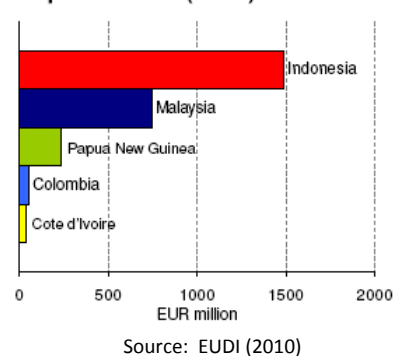
The EU RED will be implemented as national legislation EU members, by the end of 2010, most likely starting with Germany.

Sources: EUDI 2010, Bernama 2010, Khor 2010a

Default values for biofuel GHG-emission savings



EU top 5 sources for imports CPO\* (2009)



Source: EUDI (2010)

GHG-emission savings, for EU RED Directive	Typical case	Default case
Palm oil biodiesel	36%	19%
Palm oil biodiesel with full methane capture	62%	56%

Source: Highlighted in Pehnult 2010, and referred to in Khor 2010a

## STRATEGIC OPTIONS

### Challenging the EU RED?

#### Malaysia & Indonesia to boycott German cars & Aussie meats over EU RED?

– a trade complaint to the WTO is coming?

#### Challenge the EU RED's data and methodology?

– target end 2011 for market entry?

#### Indonesia and Malaysia to make a trade complaint to the WTO?

On 24 May 2010, Tan Sri Yusof Basiron, head of the Malaysian Palm Oil Council (MPOC), said that Indonesia and Malaysia will make a trade complaint to the WTO should EU RED be implemented as-is, as it automatically excludes most palm oil bio-diesel. If the EU or Australia legislates against acceptance of palm oil in biofuels for their countries, Malaysia and Indonesia may retaliate by boycotting German cars and Australia and New Zealand beef and lamb products.

*Source: Bernama 2010, Khor 2010a*

Fredrik Erixon, a trade specialist, argues that:

- These new standards discriminate against producers in Asia, Africa and Latin America, and make Europe's biofuel policy even more protectionist than it already is.
- The new standards will limit the importation of foreign biofuels.
- In an unintended irony, the global environment will also be a casualty of this protectionism as the main effect of Europe's new move will be to slow down the shift from fossil fuels to cleaner biofuels.
- The new rules are the result of pressure from a coalition of radical European environmental NGOs in Europe and their allies in the biofuels industry.
- Rather than retaliating by other means, it is better to solve disputes in a legal and structured form in the WTO.
- The EU target – the cut off point for market access – has not been chosen as much on scientific grounds as on industrial policy grounds. The target ensures that current biodiesel production in Europe (mainly rapeseed) will pass while its main competitors (especially palm oil) will fail.
- These are technical regulations that operate as a standard.

*Source: ECIPE 2009a, ECIPE 2010*

#### Option A: EU is open to scientific evidence, timeframe 2011?

The EU has said that it is open to review its scientific evidence. Producers can demonstrate that their actual emission reduction is higher than the default value annexed to RED.

- EU RED uses typical / higher value of GHG emission savings for EU members, and default / lower values for non-EU members. This is an immediate discrimination by assuming worst practice by all non-EU members.
- There is also criticism of the EU RED's methodology, which does not account for differences in usage of fertilizers and output of byproducts (on both counts, palm oil would be superior to many competitors). A more holistic, life-cycle analysis measure would benefit palm oil measured GHG savings.

On a fairer measure, palm oil for biodiesel is more efficient than other vegetable oils. Thus, the EU RED's methodology is called into question. The EU ought to recalculate default and typical values. However, such a recalculation is not likely to happen before 2011.

*Source: Pehnult 2010*

#### Option B: WTO trade complaint, timeframe late 2012?

- EU RED introduces a 'process and production method' (PPM) regulation that will considerably help EU producers. PPMs do not fit easily with core rules of the WTO. As they easily can be designed to discriminate against foreign producers and like products, WTO jurisprudence does not give them a free pass. On the contrary, there are stronger demands on them to be justifiable.

## STRATEGIC OPTIONS

### WTO complaint process could take 2 years?

– target end 2012 for  
market entry?

### The best go first?

– suggestion by Khor  
Reports

- GATT Article I: like products should be treated equally. Case law, offers interpretations. Products are not unlike just because there are differences in production methods, when these differences do not affect the physical characteristics of the final product.
- General Exception – Article XX. This article justifies exceptions if it can be established that an otherwise GATT-inconsistent regulation is necessary to – in this case – “protect human, animal or plant life and health” or if it relates to “the conservation of exhaustible natural resources”. The chapeau of Article XX disciplines the potential misuse of the Article. To that end, the Appellate Body has clarified in rulings that there must be a rational connection between the measure and the environmental goal in order to avoid ‘arbitrary and unjustifiable discrimination’.
- Panel reports have opined that the way to test this is to examine whether ‘the design, architecture and revealing structures’ indicate an intention to ‘conceal the pursuit of trade-restrictive objectives’. This will be a difficult test for the EU.

*Source: ECIPE 2009a, ECIPE 2009c*

**While taking up a WTO trade complaint against the EU RED sounds promising, this option could take up to two (2) years: the complaint first goes through the consultation stage, then a longer panel stage, and it is quite likely to be followed by an appellate stage. For example, the Taiwan electronics industry just won a trade complaint against the EU after a near 2-year process (2008-2010). Palm oil is a hotter topic than flat panels.**

*Source: Khor 2010b*

#### **Option C: The best go first?**

Both Option A and B assume that a national average approach is taken. But could some oil palm growers go it alone to achieve earlier market access? Could those that have best management and best agricultural practices be given the typical / higher value instead of the default / lower value?

**Perhaps each country could identify and rank and categorize their industry participants into fast, medium and slow track groups for market access. The entire country need not all be held back together? The typical value for palm oil biodiesel is 36%, which would make it eligible for the EU incentives schemes. Palm oil producers should find out how they can be assigned the typical value instead of the default / lower value.**

## NEWS WATCH

# National policies on sustainability – recent events

<p>Indonesia makes a slew of significant announcements since early May</p>	<p><b>Palm oil groups form coalition against critics, 5 May 2010</b></p> <ul style="list-style-type: none"> <li>The Indonesia-Malaysia Palm Oil Group brings together six organisations from the two countries, which account for 85 percent of global production. They said they had come together after being attacked by non-government organisations (NGOs) for causing deforestation and threatening the survival of endangered species. Palm oil, which is used extensively across the globe for biofuel, processed food and toiletries, is a key export for the two nations, earning them more than USD25 billion in total last year.</li> <li>The coalition includes the Malaysian Palm Oil Association (MPOA), the Indonesian Palm Oil Association, the Association of Plantation Investors of Malaysia in Indonesia, the Indonesia Oil Palm Smallholders Association, the Sarawak Oil Palm Plantation Owners Association and the Federal Land Development Authority.</li> </ul> <p style="text-align: right;"><i>Source: Bernama 2010</i></p>	
<p>Malaysia is slow off the blocks?</p>	<p><b>Indonesia's initiatives</b></p> <ol style="list-style-type: none"> <li>2-year moratorium on rainforest logging, will receive up to USD1bn in aid from Norway to help preserve forests.</li> <li>Moratorium on the issuance of new licenses for development of oil palm plantations on peat lands and primary forests.</li> <li>Introduction of mandatory Indonesia Sustainable Palm Oil (ISPO) standards nationwide.</li> <li>Restore 300,000 hectares of damaged forest per year to maintain biodiversity.</li> <li>Focus on enforcing the law on the illegal trade of species or illicit forest conversion in protected and conservation areas.</li> </ol> <p style="text-align: right;"><i>Source: Various news articles, May 2010</i></p>	<p><b>Malaysia's announcements</b></p> <ol style="list-style-type: none"> <li>Book launch – “The Best-Kept Secret for Reversing Global Warming”, highlights that the palm oil industry is a carbon sink.</li> <li>Signing of MOU for the establishment of the Sabah Wildlife Rescue Program; Sabah Wildlife Dept, MPOC and Shangri-la Rasa Ria resort.</li> </ol> <p>At MPOC's recent conference on sustainability, emphasis was on the fact that Malaysia still has 56% permanent forest cover, that deforestation is caused primarily by poverty and that peatlands should be developed for the sake of its poor communities.</p> <p style="text-align: right;"><i>Source: MPOC 2010, Khor 2010a</i></p>
<p>Joint initiatives – none so far</p>		

## The tally...

### 0 joint initiatives

No programs yet, since Indonesia-Malaysia coalition was announced, 5 May 2010.

### 5 Indonesia initiatives

Moratorium on forest logging with USD1 bill Norwegian aid; moratoria on peat land & primary forest dev't; mandatory ISPO standard; 300,000ha/yr forest restoration; better enforcement.

### 2 Malaysia launches

Book launch (palm oil as carbon sink); MOU for Sabah wildlife rescue program.

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