

WTO Members, Not the Appellate Body, Need to Clarify Boundaries in Renewable Energy Support

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What constitutes appropriate state measures for incentivizing renewable energy development and deployment? This key question has been posed by the sustainable development community, and even more so by governments and investors around the world. On May 6, 2013, all eyes were focused on the Appellate Body (AB) of the World Trade Organization (WTO),¹ which gave its first ruling on measures affecting the renewable energy generation sector as part of a dispute brought by Japan and the European Union against Canada.² It was expected that the ruling would provide legal clarification and interpretation of WTO rules on trade, investment measures and subsidies related to sustainable energy.³

Our key question, however, remains largely unanswered. While the AB—the highest WTO court—ruled that local content requirements (LCRs) are unacceptable, the status of renewable energy support measures remains unclear.

It is likely that a WTO Dispute Settlement Panel and potentially the AB will soon again be confronted with the question of whether a feed-in tariff (FIT) is a subsidy. WTO disputes similar to Canada - Renewable Energy include:

- In November 2012, China requested consultations with the European Union on Italian and Greek FITs with attached LCRs. Besides GATT and TRIMs, China also cited the ASCM, under which the determination of whether the LCR is a prohibited subsidy requires a determination of whether the FIT without LCR provisions would constitute a subsidy (see Box 1).
- In February 2013, the United States filed a request for consultations with India concerning certain measures relating to solar cells and solar modules. Again the dispute concerns incentive programs with attached LCRs and the complainant cited GATT, TRIMs and ASCM.

¹ A short description of key concepts can be found in the terminology box at the end of this commentary.

² Appellate Body. (2013). Canada - Certain Measures Affecting the Renewable Energy Generation Sector. Appellate Body Report WT/DS412/AB/R / WT/DS426/AB/R, adopted 6 May 2013. Hereafter, this report will be referred to as "Canada - Renewable Energy."

³ Rules on trade are mainly found in the General Agreement on Tariffs and Trade (GATT); rules on investment measures are found in the Agreement on Trade Related Investment Measures (TRIMs); and rules on subsidies are found in the Agreement on Subsidies and Countervailing Measures (ASCM).

- In response, India submitted a report to the WTO's Subsidy and Countervailing Measures Committee in April concerning state-level incentive programs with attached LCRs in the United States.

This commentary observes that the AB seemingly wanted to avoid ruling on whether an FIT constitutes a subsidy, thereby creating uncertainty for investors in renewables and governments designing their renewable energy policies. As of 2013, 99 jurisdictions in the world use FITs to foster renewable energy deployment (REN21, 2013), most of which do not use LCRs. Potential investors need to have clear instructions about the implications of support mechanisms without LCRs in the development and deployment of renewables.

BOX 1: THE DETERMINATION OF AN ACTIONABLE SUBSIDY IN THE WTO

Panels and the AB have to address three questions to determine whether or not a measure constitutes an actionable subsidy: (1) Is the measure a financial contribution? (2) Does the measure confer a benefit? (3) Is the measure specific?

If a measure is found to be an actionable subsidy, the analysis then continues to determine whether the actionable subsidy caused adverse effects to the interests of another WTO member. Only if such adverse effects are found is the subsidy in violation of WTO law. An actionable subsidy is in itself not illegal.

In the Canada - Renewable Energy case, the question of whether the FIT conferred a benefit was key to determining whether an FIT in itself was a subsidy (not yet actionable) or not. To find that a benefit is conferred, the panel and AB ask whether the disputed measure makes firms better off than they would be under competitive market conditions. The issue in the Canada - Renewable Energy case was: where should these prevailing market conditions be found? Or, put differently, what was the benchmark market price to compare to electricity generated from wind and solar energy?

BOX 2: THE LOCAL CONTENT QUESTION

Japan's main complaint in this case is not the existence of an FIT in and of itself, but rather the local content requirements attached to it. The fact that neither Japan nor the European Union argued that the subsidy was specific (a necessary step to find an actionable subsidy in absence of local content requirements) is indicative of their willingness not to scrutinize FITs without LCRs under WTO law.

Governments seek local benefits when setting up public financing programs for renewable energy. This is particularly the case in times of financial and job crises, and when public programs are expensive and involve a high level of investment. While FITs with LCRs clearly constitute prohibited subsidies, one could ask whether renewable energy development would be significant without LCRs in place. LCRs will generate short-term costs and inflate retail power prices, but there may be medium-term benefits through having more mature companies on the market that can compete, innovate and drive down technology costs.

Medium-term benefits remain a largely unproven possibility that has not been convincingly demonstrated in a large number of cases. Whether LCRs could be effective in terms of medium-term innovation is a useful question to address, in particular given the frequent use of LCRs in renewable energy policy. What can be observed with regards to LCRs used today, however, is that many are too restrictive to generate such benefits, that they sometimes focus on non-infant industries with a low learning-by-doing potential, and that policy often overly focuses on upstream manufacturing and ignores value in the downstream services sector (Kuntze & Moerenhout, 2013).

It is curious that the AB seemingly wanted to avoid ruling on the matter of whether or not an FIT is a subsidy, since the issue is likely to return in WTO adjudication. Criticism of the AB report springs from that issue and its reasoning on market creation and benchmark markets to determine a subsidy—two issues discussed in more detail below.

When we examine these elements, we reach the same conclusion as when renewable energy equipment trade competition touches WTO discipline. Within a dispute settlement, the AB is constrained by subject matter and process. Instead, WTO members should provide clarity on appropriate policy measures to encourage the renewable energy sector. Given the importance of renewable energy in the transition to a green economy, the current set of WTO rules needs new guidance, and perhaps even interpretations or additions. This is the primary responsibility of WTO members, not of the AB.

The Canada - Renewable Energy Dispute in Brief⁴

Japan and the European Union claimed that the 2009 Ontario FIT program violated WTO law. The Ontario regulation was accused of (1) violating the provisions on national treatment under GATT III: 4 and TRIMs 2.1 and (2) constituting a prohibited subsidy under ASCM Art 3.1(b) because of the presence of LCRs in the FIT program. Ontario's FIT program was found in violation of its national treatment obligation under the TRIMs and GATT agreement because of its LCRs. One of the main questions that remained unanswered, however, was the status of FITs within the WTO subsidy agreement.

The AB's analysis of the ASCM was controversial—specifically the benefit analysis necessary to establish the existence of a subsidy. The majority of the panel declined to give any conclusion on whether a benefit was conferred and therefore whether a subsidy existed. It rejected all benchmarks suggested by the complainants, arguing that they were distorted, and concluded that the wholesale electricity market should not be the focus of the analysis. However, it also rejected Canada's argument that the market for wind and solar photovoltaic (PV)-generated electricity is the relevant benchmark market.

The dissenting opinion—rather unusual in WTO adjudication—by one panelist on this issue reflects this controversy. The dissenting panelist argued that the wholesale market is the benchmark market and that, since FITs offer a premium over that market's price, it is clear that a benefit is conferred and that the FIT program constitutes a subsidy.

The AB criticized the panel's majority opinion analysis, in particular the determination of the relevant market. First, the AB held that the relevant market should be defined. Second, the benchmarks for the benefit analysis have to be identified in that market. To determine the relevant market, the AB emphasized that it is not sufficient to only take demand-side factors of the market into account. The ruling argued that supply-side factors should also be considered—in this particular case, the different cost structures of renewables. The AB subsequently found the market for wind and solar PV-generated electricity to be the relevant market, not the wholesale electricity market. Two elements were argued to support this finding:

1. The AB agreed with the panel's finding that there would be no market for electricity from wind and solar PV if there were no government intervention. Because the differences in costs for conventional and renewable electricity are so significant, a government has to interfere to create a market for renewable electricity because it would otherwise not exist. The AB—somewhat surprisingly given the demand-side substitutability of

⁴ See the WTO's website for further details: http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds412_e.htm

renewable and non-renewable electricity—explained that “the creation of markets by a government does not in and of itself give rise to subsidies within the meaning of the SCM Agreement” (AB, 2013, para 5.188).

2. The AB relied on the sovereignty of governments to create their own supply mix of energy to reflect different policies of the government, such as long-term energy security and addressing negative externalities (e.g., emissions from conventional electricity production). Also in this regard, the AB stated that this definition of a “certain supply-mix by the government cannot in and of itself be considered as conferring a benefit” (AB, 2013, para 5.175).

BOX 3: MARKET CREATION AND SECURITY OF SUPPLY: WHERE WAS SUSTAINABLE DEVELOPMENT?

One of the problems with the AB’s reasoning in this case is the definition of the relevant market. The creation of a market by the government does not automatically lead to the finding of a benefit and consequently a subsidy. However, the AB seems to have opened the door for governmental support measures for a like product whose cost structures are so significantly different that it cannot compete without government support.

The ASCM used to have exceptions under Article 8 for environmental subsidies that were seen as good and therefore not subject to dispute (non-actionable). The provision lapsed in 1999 after a failure to renegotiate its application; however, in its five years of existence, the provision had never been used. It seems that, by being reluctant to determine that an FIT can be deemed a subsidy under the ASCM, the AB has attempted to indicate that certain support measures are permissible.

However, in doing so, it may have created a carve-out of the subsidy agreement that was a little too broad. For example, does this ruling imply, as Lester (2013) questioned on the International Economic Law and Policy blog (IELP), that when a government creates a market for shale oil, this does not in and of itself amount to a subsidy? And thus, if no benefit can be found, is it consistent with WTO law? It would have been preferable if the members had created a safe haven for subsidies that contribute to sustainable development, which would have been in line with the Preamble of the WTO Agreement. Now, however, the AB focused its analysis more on energy security of supply and created a broad, and potentially problematic, carve-out.

Though it disagreed with the panel on what the benchmark market should be, eventually the AB came to the same conclusion as the panel had: there is not enough evidence to conclude whether a benefit is conferred and, subsequently, whether a subsidy exists.

The Wholesale Electricity Market Should be the Benchmark Market for Renewable Electricity

The AB thus ruled that (1) supply-side factors such as the cost structures between different electricity generating technologies and (2) the supply mix reflecting a government’s policy for energy security have to be taken into account for the determination of the relevant market. Based on these, the AB concluded that “benefit benchmarks for wind- and solar PV-generated electricity should be found in the markets for wind-and solar PV-generated electricity that result from the supply-mix definition” (AB, 2013, para 5.190).

We find this benchmark analysis problematic. As Marc Benitah (2013) pointed out in his commentary on IELP, the AB came to its conclusions without referencing market theories or expert opinions by energy economists. In the

opinion of the authors of this commentary, the AB started off its analysis well by rightly arguing that renewable energy and conventional energy are substitutes within the retail electricity market. We believe this element is key. Without government intervention, renewable electricity markets would often be unable to compete with electricity from conventional energy sources on a purely financial basis. When the cost structures of a like product are different, can we talk about a different market?

Clearly not. Whether a new market is created or whether the discussion concerns national governmental objectives such as security of supply does not change the nature of the electricity market. Achieving global public benefits such as greenhouse gas reduction or environmental preservation will not proceed optimally without government investments into, and adjustments of, existing markets. To a significant degree, that is what the transition to the green economy is about. We do not believe the AB should try to avoid the determination of a subsidy in order to have a “green reading” of WTO law—if that was one of its objectives in the first place. An FIT should be recognized as a subsidy by the AB, and WTO members should guarantee that appropriate policies that encourage a shift to the green economy are safeguarded under WTO law. This is particularly the case as long as carbon is not properly accounted for in electricity generation. The lack of carbon pricing remains the principal obstruction to the uptake of renewable energy and should be addressed as such.

What Are the Implications of a Wholesale Market Benchmark for an FIT Without LCR?

Clearly, LCRs attached to an FIT are illegal under GATT and TRIMs, as found by the panel and confirmed by the AB. If the FIT would have been found a subsidy under the ASCM, it is likely that the panel would have then found a breach of the ASCM as well, because subsidies contingent on LCRs are illegal under ASCM Art. 3. But the interesting question is: what would be the implications for FITs without local content requirements if, as we argue above, we take the wholesale electricity market as a benchmark? How would a panel rule on (1) financial contribution, (2) benefit and (3) specificity?

First, a financial contribution through an FIT is not hard to identify, since the instrument is used specifically to set prices above conventional retail electricity prices in order to achieve cost competitiveness. For example, in the Canada - Renewable Energy case, both the panel and the AB found that an FIT is a financial contribution to the electricity generator receiving the support. Second, if the wholesale electricity market were the benchmark market, as we argue it should be, it is also relatively easy to establish that a benefit has been conferred, because the FIT, by definition, gives the producer a higher price than what could generally be obtained on the wholesale market. Before being able to conclude that the subsidy is an actionable subsidy, specificity would need to be found. Only when a subsidy is found to be specific to an enterprise, industry or group of enterprises or industries, can it be considered an actionable subsidy.

To find that a subsidy is specific is not as easy as it might seem. Intuitively, one could think that in the wholesale electricity market, a subsidy to solar PV is specific, as other generation technologies are not eligible. This seems to be the case when reading Article 2.1(a) of the ASCM: “Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such a subsidy shall be specific.” In US-Aircraft, the panel explained that to find specificity under this article, a certain limitation in the legislation needed to be demonstrated, which “expressly and unambiguously restricts the availability of the subsidy to certain enterprises and as a result does not make the subsidy sufficiently broadly available throughout an economy.” This seems to be the case for FITs.

However, Article 2.1(b) of the ASCM states that when legislation establishes objective criteria and conditions for the eligibility and amount of the subsidy, and when those conditions are automatically and strictly applied, then specificity does not exist. These provisions are not further specified and, in particular, the interpretation of Article 2.1(b) through WTO case law is limited given the low number of cases on actionable subsidies (most subsidy cases are on prohibited subsidies). Hence, we advise caution in assuming a *prima facie* case for specificity.

The legal uncertainty continues when one asks what would happen if the AB would find specificity and therefore the existence of an actionable subsidy. In that case, only when it could be proven that an FIT causes adverse effects to the interests of another WTO member would the FIT violate WTO subsidy rules. Like specificity, “adverse effects” is a concept that is limitedly developed in WTO case law. What is certain is that establishing adverse effects is always dependent on the data a complainant can put forth in front of a panel, which may make the finding of adverse effects more difficult because there might not be sufficient data available. While an in-depth analysis of adverse effects and their potential applicability to an FIT is beyond the scope of this commentary, we believe that it is neither impossible nor assumable that FITs would cause adverse effects. When taking the wholesale electricity market as the benchmark market, FITs could be found to be specific and causing adverse effects.

What Are the Options to Address Renewable Energy Support Measures?

The AB ruling in Canada - Renewable Energy again opened the debate for a renegotiation of exceptions under the ASCM, whether it is in the form of general exceptions or a revival and renegotiation of the expired non-actionable category of subsidies in Article 8.

Renegotiating the ASCM is something that, in the current stage of the Doha negotiations, is not very likely to happen. The negotiating history of Article 8 indicates that there was an ideologically loaded negotiation on whether subsidies are per se good or bad and whether they should be used to correct certain market failures. Also, the opposing points of view between certain developed and developing countries are very apparent in this debate: while developed countries might want exceptions for environmentally “good” subsidies, developing countries want to see subsidies for economic development being clarified as non-actionable in the ASCM.

We do not see sufficient debate on renewable energy incentives taking place in the relevant committees in the WTO. Nonetheless, there are several existing committees whose portfolios could host parts of the debate:

- The Committee on Subsidies and Countervailing Measures is the committee that members notify to discuss subsidy programs and has already worked on problems related to completeness of notifications in the past.
- The Trade Policy Review Body undertakes trade policy reviews of members, which could address renewable energy-related trade aspects.
- The Committee on Trade and Environment has a broad portfolio explicitly to discuss the relationship between trade and sustainable development.

We believe FITs are a good springboard to start a constructive dialogue on renewable energy support measures that are capable of building trust among the WTO members. In the abstract, FIT programs are very common policies to support renewable energy development and deployment. Given that they are used by many jurisdictions around the world, and since the specificity question was not invoked by Japan or the European Union, it is questionable but still

uncertain whether an FIT without LCRs would ever face a complaint. Debating FITs therefore does not seem divisive, but is still necessary and a useful first measure to start a dialogue on renewable energy support mechanisms. However, discussions between members should go beyond FITs to also address more difficult questions, such as how local value can be created in late-moving countries that want to set up public financing mechanisms for renewable energy development and deployment, and how those objectives relate to local content requirements.

Even if members have an implicit understanding of the necessity of renewable energy support measures and have therefore not notified or discussed such support measures in the relevant committees, the AB report in the Canada - Renewable Energy case shows that clarification on measures like FITs would be useful and necessary. The aforementioned potential carve-out of the subsidy definition created by the AB in its reasoning could very well affect other markets and lead to an increase in inefficient state support for other non-green markets. One method for members to start a discussion is to ask the Secretariat for a background paper. This would not only feed the discussion from the Secretariat out, but also build its expertise in the issue and could prove useful in future negotiations.

Increasing the transparency of subsidy notifications in the WTO could be a useful action to facilitate the discussions and help members and the committee discuss the subsidies before they reach the dispute settlement process. That said, discussions within the WTO should go beyond FITs to also address other renewable energy support mechanisms. We strongly advise that these debates be inspired by expert opinions from diverse fields, including trade and subsidy specialists and energy economists.

Legal uncertainties are negatively affecting the investment environment for renewables. Any guidance by WTO members should ultimately be about facilitating attaining global public benefits in the most cost-effective manner.

Terminology Box

Appellate Body: Both the complainant and the respondent have the right to appeal a panel's decision and report. In that case, three members of a permanent seven-member Appellate Body (AB) will either uphold, modify or reverse the panel's legal findings and conclusions.

Dispute Settlement Body: A member government can file a complaint before the Dispute Settlement Body (DSB) against another member government that is believed to have violated WTO provisions. First, a consultation phase will try to settle the dispute without having to involve the judiciary. Only when consultations fail will the case formally go to the judiciary for a ruling.

Feed-in tariff: Feed-in tariffs (FITs) are set rates at which renewably generated electricity will be purchased, typically offered in long-term contracts, and typically constituting a premium over the tariffs set for conventionally generated electricity.

Local content requirement: Local content requirements (LCRs) are policy measures that require foreign or domestic investors to source a certain percentage of intermediate goods from local manufacturers or producers. These local producers can be either domestic firms or localized foreign-owned enterprises.

National treatment: National treatment is a core principle of the WTO and in WTO law that establishes that, once they have entered the market, imported products, services, trademarks, patents and copyrights should be treated no less favourably than "like" products that are locally produced.

Panel: When consultations fail, the complainant can request for the appointment of a panel. This panel is composed ad hoc for every dispute and will rule in first instance. When their report is not appealed, the DSB will adopt it and it becomes an official ruling, unless the DSB decides anonymously not to do so.

Wholesale electricity market: A wholesale electricity market is a market where electricity is (non-physically) traded between parties before it is eventually consumed by a final consumer.

World Trade Organization: The WTO is a rules-based, member-driven international organization that promotes trade liberalization. The political component of the organization attempts to further develop trade rules by negotiating among WTO members. The judicial component of the organization provides for a mandatory dispute settlement system through which members can peacefully settle trade-related disputes.

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