Tackling Fossil Fuel Subsidies through Trade Agreements

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The idea of reforming fossil fuel subsidies has recently attracted attention as a way to meet the objectives of both the Paris Agreement on climate change and the 2030 Agenda for Sustainable Development.

These subsidies start at a low-range estimate of several hundred billion dollars a year, and have a range of negative socio-economic and environmental effects. But tackling them has remained challenging, in spite of high-level commitments to do so.

G20 commitment in September 2009:
“phase out and rationalise over the medium term inefficient fossil fuel subsidies”, a pledge echoed by the Asia Pacific Economic Cooperation (APEC) group.

Given its wide membership, its central role in disciplining trade-distorting measures across sectors and its well-established dispute settlement system, the World Trade Organization (WTO) is well suited to take the fossil fuel subsidy reform agenda forward. To date, however, its involvement in this issue has been limited. In fact, while a range of challenges to renewable energy support measures have been launched at the WTO over the past decade, no fossil fuel subsidies have been disputed thus far.

WTO agreements relevant to energy support measures:
- General Agreement on Tariffs and Trade (GATT)
- Agreement on Trade-Related Investment Measures (TRIMs Agreement)
- Agreement on Subsidies and Countervailing Measures (ASCM), of particular relevance as it is the WTO’s dedicated treaty on subsidies.

For a measure to be incompatible with the ASCM, it must:
- meet the ASCM’s definition of a subsidy; and
- be contingent on export performance or on the use of domestic over foreign products (“prohibited subsidy”), or;
- be specific and cause adverse effects to another Member (“actionable subsidy” with adverse effects).
Why have fossil fuel subsidies escaped a WTO challenge?

There are several explanations for why fossil fuel subsidies have evaded a WTO challenge. Domestic pressure groups have played a role. Furthermore, newer subsidies – such as those to renewable energy – are more likely to be challenged than long-standing support measures – such as those to fossil fuels – already built into investor decisions. However, most explanations for the absence of fossil fuel subsidy disputes at the WTO stress legal considerations. WTO law tends to “undercapture” fossil fuel support measures compared with renewable energy ones, allowing the former to escape litigation. To test this, we have examined the compatibility of five fossil fuel subsidies provided by G20 countries with the ASCM.

ASCM compatibility of five G20 fossil fuel support measures

<table>
<thead>
<tr>
<th>G20 Member</th>
<th>Name of Measure</th>
<th>Description</th>
<th>ASCM Compatibility</th>
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<tbody>
<tr>
<td>United States</td>
<td>Expensing of intangible drilling costs – Producer support</td>
<td>Tax concession allowing independent oil and gas producers to expense the intangible drilling costs associated with successful investments in domestic oil and gas wells in the year in which they are incurred. It means a deduction of up to 70% of such costs at once and the recovery of the remaining 30% over a 5-year period for large, vertically-integrated producers.</td>
<td>Inconclusive. More information needed to ascertain whether the measure: 1. would pass the three-part analysis to determine “government revenue that is otherwise due is foregone or not collected” (and therefore confers a benefit); 2. represents a prohibited subsidy; and 3. causes adverse effects.</td>
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<td>Indonesia</td>
<td>Compensation for below-market prices for fuels – Consumer support</td>
<td>Retail prices for certain brands of petroleum set below market price. State-owned energy company Pertamina received direct financial compensation from the government for the losses it incurred as a result. This subsidy was eliminated in 2015, although diesel and kerosene are still subsidised at lower rates.</td>
<td>Likely. The measure appears to lack specificity. As such, it falls outside the Agreement’s scope.</td>
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<td>Germany</td>
<td>Manufacturer privilege – Producer support</td>
<td>Exemption from energy tax for coal, natural gas and petroleum products that manufacturers of energy products (e.g. refineries) use as process energy.</td>
<td>Inconclusive, as above.</td>
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<td>Mexico</td>
<td>Fuel tax credit for agriculture, forestry and fisheries – Consumer support</td>
<td>Fuel-tax credit for these sectors on the purchases of diesel for final use in general machinery, with the exception of vehicles.</td>
<td>Likely, as above.</td>
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<td>Australia</td>
<td>Support to Queensland Rail’s coal and freight services – Producer support</td>
<td>AUD 94m to upgrade and acquire rolling stock such as diesel locomotives allocated for the fiscal year 2003/2004.</td>
<td>Inconclusive. More information is needed to ascertain whether the measure: 1. represents a prohibited subsidy; 2. is specific; and 3. causes adverse effects.</td>
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Source: Based on analysis by Cleo Verkuijl, Harro van Asselt, Tom Moerenhout, Liesbeth Casier and Peter Wooders. Full descriptions of measures via the Organisation for Economic Cooperation and Development (OECD), at http://www.oecd.org/site/tadffss/data/

Though preliminary, the results highlight the difficulty of litigating fossil fuel subsidies through the ASCM. This applies in particular to fossil fuel consumption subsidies, and to demonstrating adverse trade effects. When it comes to fossil fuel producer subsidies, however, there is potential to further explore litigation on a case-by-case basis.
Beyond litigation, we identify five avenues for reform of international trade policy to better address fossil fuel subsidies.

1. **Technical assistance and capacity building**
   - Lesson-sharing on fossil fuel subsidy reform and technical cooperation with existing initiatives (e.g. the Enhanced Integrated Framework for Least Developed Countries), in coordination with other international organisations, such as the World Bank, the International Monetary Fund and the Global Subsidies Initiative.

2. **Improved Transparency**
   - Voluntary commitments by Members to notify fossil fuel subsidies under the ASCM according to a common template. Also, commitment to include fossil fuel subsidies in Trade Policy Reviews under the Trade Policy Review Mechanism, and strengthened enforceability of notification obligations.

3. **Pledges and follow-up through reporting and review**
   - Pledges by Members to eliminate or reduce their fossil fuel subsidies, building on the ASCM and linking to other voluntary commitments and review processes (e.g. the G20 and APEC), extending the system to Members that do not participate in these forums.

4. **Political declaration**
   - Negotiated interpretation of the scope of the ASCM, clarification of the mandate of the Committee on Trade and Environment to discuss fossil fuel subsidies, or a more general affirmation that the WTO is an appropriate venue for intergovernmental dialogue on fossil fuel subsidies.

5. **Expansion of category of prohibited subsidies (with possible exemptions)**
   - Inclusion of fossil fuel subsidies in the ASCM’s category of prohibited subsidies, for instance those with particular trade or environment-related effects. Prohibitions could be tailored to specific needs, e.g. special and differential treatment, subsidies aimed at the poor, and allow for a more flexible timeline.

Options could be pioneered by one or several WTO Members, or through regional, mega-regional and plurilateral trade agreements. They should address the special circumstances of developing countries and complement ongoing efforts.

With the WTO’s 11th biennial Ministerial Conference coming up in Buenos Aires in December 2017, creative thinking, constructive debate, and further research on the various options is needed to ensure that the promises of the Paris Agreement and the 2030 Agenda are fulfilled.