

ENVIRONMENTALLY HARMFUL AND TRADE DISTORTING MEASURES AND POLICIES IN ENERGY MARKETS

Communication from the European Communities

1. In its note WT/CTE/W/67 of 7 November 1997 the CTE Secretariat undertook a preliminary analysis of the environmental benefits of removing trade restrictions and distortions. The note addressed some general concerns regarding the relationship between removing trade restrictions and distortions (notably direct subsidies and some forms of direct taxation) and potential environmental benefits, as well as examining the potential positive impacts in certain sectors, including the energy sector. The part devoted to the energy sector (paragraphs 49-82), whilst duly noting the array of measures that have market trade and environment distortion effects, shied away from an analysis of all types of measures. The lack of information and reliable studies in many of the areas related to the energy sector was given as the explanation. One of the consequences is the note's concentration on the impact of direct subsidies to coal.
2. It should be noted that there has been a substantial evolution in the years since the reference period examined in WT/CTE/W/67 (which stopped at 1994) and that more recent figures could show a markedly different picture. Accordingly, this part of the note should be updated. Furthermore, the coal sector, as well as other energy sub-sectors, are the object of other types of distorting measures that should be included in any update of WT/CTE/W/67 (see below).
3. In addition, work undertaken in the ambit of the OECD (notably its Joint Working Party on Trade and Environment) and of the IEA now makes available a wealth of data on a larger range of instruments and policies used by many countries, including those beyond the OECD.
4. We therefore would like to request the Secretariat to produce a new section on energy as an addendum to WT/CTE/W/67. This revised section will, as the previous one, address the relationship between removing trade restrictions and distortions and environmental benefits, with a first part containing an overview of the main characteristics of the sector, a second part an analysis of the most prevalent trade restrictions and direct or indirect distortions, followed by an examination of the environmental benefits associated with the elimination of these trade barriers or distortions.
5. The specificity of energy is already widely recognized. It is an "intermediary good" i.e. an input to other industries and activities. Energy depends on the way it is treated in its various forms of production and trading. As a result, any analysis should take into account a larger range of policies and measures, as well as examining distorting effects and their potential redress. It should also be kept in mind that "market failures" in the energy area have an upstream consequence on the use of best available and environment-friendly technologies through unhindered procurement/sale of equipment, know-how and services (topics addressed in other WTO fora and on which the CTE might wish to give its advice in due time, since this could be the area for "win-win-win" negotiated decisions).

6. As a supplementary dimension, the need to ascertain the environment and climate change effects of present policies and measures as compared to possible changes in policies has now become part and parcel of all analyses in this area.

7. In other words, the price formation of energy as delivered to users is the results of many factors which may be deemed to have “distorting effects” on prices, trade and environment. A few examples brought to light in the aforementioned studies are:

- Local entities or local-state regulations or measures may help keep certain types of power plants in operation, therefore encouraging the use of certain primary sources in power generation. This may take place through various types of subsidies, investment control and procurement control, which raises questions of WTO rules compatibility and affects opportunity costs, also in relation to externalities and environmental cost.
- Absence of regulation or fiscal policies to internalize environmental costs can encourage profligate use of energy generally and reduce incentives to develop and invest in more energy efficient technologies. Artificially cheap energy, i.e. energy whose price does not reflect even an approximate environmental cost associated with its consumption, can also be equated to a subsidy. Industry which is able to enjoy such artificially cheap energy can benefit from a competitive advantage by offloading the real cost of its energy use on to society as a whole, including on to other generations and people living in other jurisdictions. This runs counter to the concept of sustainable development. This type of “non-action” by countries in which such energy pricing prevails is pernicious and is deemed by most analysts as having negative welfare and environment impact both on the local and on competitors’ markets.
- A package of such measures may create artificial competitive advantage, resulting in, *inter alia*, lower prices as compared to other energy sources. These in turn have a distorting competitive effect on high energy-intensity tradable products.

8. Climate Change concerns and work done under the implementation of the Kyoto Protocol are of clear relevance in this field.

9. Indeed, as long as cleaner and sustainable forms of energy are not generalized in production and use, this is an area where the interest of liberalization and apparent cost effectiveness might be mitigated by negative effects of increased consumption (use) and emission of GHG.

10. The progressive reductions or phasing out of market imperfections, fiscal incentives, tax and duty exemptions and subsidies in all greenhouse gas-emitting sources that run counter to the objective of the Convention on Climate Change and application of market instruments is fully embodied in the text of the Kyoto Protocol (Art.2.1 provides a non-exhaustive list of eight areas to be considered by industrialized countries to mitigate climate change). As far as subsidies are concerned, this also implies that well-targeted subsidies may constitute a valuable instrument to meet the climate change objective and that one should therefore not treat all subsidies in the same way nor conclude that they all have negative environmental implications..

11. Industrialized countries shall implement domestic policies and measures to mitigate climate change (i) compatible with sustainable development and (ii) which should minimise adverse effects, *inter alia* effects on international trade, and social, environmental and economic impacts on other Parties, especially developing countries.

12. These issues are currently debated in the context of the implementation of the Kyoto Protocol, and it a restructuring of industrialized countries' tax system has been suggested to reflect the carbon content of fossil fuel, from coal to gas, as the current rates of taxation are not applied in an harmonized way across all fossil fuel.¹ Overall, climate change matters should be taken into account where relevant to provide a better understanding for the analysis of energy trade and market distorting measures, but are not directly the object of the intended request.

13. As explained under 2, the European Community requests that the Secretariat produce a new section on energy as an addition to WT/CTE/W/67 as exposed above, on the basis of available reports and research. The importance of energy matters for trade and the environment make it necessary, in our opinion, for the CTE to devote some of its attention to these points on a regular basis.

¹**Gas:** 4.8% (UK) until 29% (FIN); **oil:** 39% (US) until 85% (UK); **coal:** 1.2% (CH) until 48% (FIN). These are IEA figures.