



Client Briefing



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FIT for purpose?

A REVIEW OF THE ECONOMICS OF A WTO PANEL RULING ON FEED-IN TARIFFS AND LOCAL CONTENT REQUIREMENTS

Like many jurisdictions around the world, the Canadian state of Ontario operates a Feed-in Tariff (FIT) scheme to stimulate the generation of electricity from a range of renewable sources. A Feed-in Tariff offers a guaranteed rate for electricity generated over a specified period of time (20 to 40 years in the case of Ontario) in exchange for delivery of that energy into the grid. But there is a sting in the tail.

In order to benefit from the scheme, producers of renewable energy in Ontario must source at least a certain proportion of their equipment and other material inputs from domestic producers. It is this provision that was challenged by the complainants in the World Trade Organisation (WTO). The complainants argued that:

- such local content rules violated rules requiring that like products not be discriminated against on the grounds of their origin
- they violated rules that prohibit investment measures predicated on meeting use of local content requirements

- they violated rules that prohibit subsidy schemes that require the substitution of imported goods by domestic ones.

In the event, the panel found against the scheme on the first two grounds. Once the panel had established that the scheme fell under the scope of the relevant trade rules, it had little difficulty in establishing that the local content measures were in violation of trade law.

The panel, however, did not find against the scheme on the last of these grounds i.e. that it constituted a prohibited subsidy. This was because it could not establish that the FIT scheme constituted a subsidy as defined under WTO law, and more specifically Article 1.1 of the Agreement on Subsidies and Countervailing Measures (SCM). The latter requires, amongst other things, that the measure provide a benefit to one or more parties, and the panel concluded that the complainants had not demonstrated that the FIT scheme met this test.

The panel's decisions on the claims regarding subsidisation are from an economic point of view, of greatest interest.

- As already observed, the SCM provides a particular definition to the concept of “subsidy”, and it is interesting to consider how this concept can be applied in a field – renewables – in which governments usually intervene through various forms of support mechanisms. In general, energy and environmental policymakers outside the WTO would consider FIT schemes as one of a range of subsidy mechanisms (the others include tradable renewable energy certificate scheme and direct payments) that may be used to promote renewable energy.
- For the first time in WTO jurisprudence, extensive consideration was given to the operation of energy markets. This offers observers the opportunity to assess how well trade law specialists deal with a field that is relatively new to them, but which is likely to become of increasing relevance as the trade-related aspects of emissions reductions policies come under scrutiny.
- Finally, though the panel was at pains to emphasise that the dispute was one about certain investment measures, and not about greenhouse gas policy, the fact that it provided such extensive treatment of the FIT scheme, and the stationary energy sector (which accounts for the bulk of greenhouse gas emissions), naturally leads to questions as to implications of the findings for the nexus between trade rules and the environment.

IF FIT LOOKS, WALKS AND QUACKS ...

In reaching its conclusions as to whether the FIT scheme was indeed a subsidy under WTO law, the panel appears to have set great store by the idea that wholesale electricity markets in general, and Ontario's in particular, were unlikely to work like more traditional product markets. It appealed to a notion of “missing money” – that is, the contention that price signals emanating from wholesale markets would be insufficient to stimulate investment in generation capacity required to meet load. Government intervention was therefore needed to ensure the correct mix of plant to ensure supply adequacy.

The panel saw corroboration for its views in Ontario's abortive experience with electricity market reform in 2002. That involved unbundling the previously vertically integrated Ontario Hydro, and deregulating the wholesale market. Following an initial 30% increase in wholesale prices, an absence of new investment, and continued upward pressure on prices because of record temperatures in the summer of 2002, the government intervened to freeze prices. It subsequently created the Ontario Power Authority (OPA), which combined market planning functions with power procurement functions (and, as of 2012, system operation).

The panel's understanding of the factors constraining the operation of competitive energy markets in Ontario led it to a number of propositions. First, it took the view that the FIT scheme was one part of a wider set of contractual arrangements implemented by the OPA to ensure appropriate capacity and mix of plant technology to meet demand conditions, something the panel did not think could be achieved through a competitive wholesale market.

In the panel's view, the FIT scheme was designed to ensure that providers of renewable energy received an appropriate rate of return, just as contractual arrangements with other types of plant sought to guarantee those plant a reasonable rate of return. On that basis, payments under the FIT scheme could not be deemed to confer a benefit to its recipients, unless these were shown to offer to investors in renewables an overly generous rate of return.

Second, the panel rejected the proposals put forward by the complainants that it would be possible to establish subsidisation, by comparing the price paid under the FIT scheme, on one hand, and spot prices. The panel's view was that the spot price, and various other price measures based on it, were unreliable indicators of actual remuneration to generators since this was largely determined by contractual and/ or regulatory arrangements. The panel further rejected comparisons based on benchmark measures in other, more competitive markets in Canada and overseas, on the grounds of the differences between these markets and Ontario.

FAILURE BY DESIGN

Setting aside matters of law, there are several difficulties with the economic reasoning followed by the panel. The first of these lies in the argument that pervasive market failures made government intervention essential to stimulate investment. In fact, the difficulties in attracting private investment following the 2002 reform experience were less a reflection of a so-called "missing money" and market failure than it was of poor market design and policy failure.

The reforms of 2002 left 90% of installed capacity with the government owned incumbent, OPG. Investors are usually very reluctant to sink funds into long-lived assets in the presence of a large government-owned incumbent with a history of making uneconomic investment decisions, for fear that similar decisions in the future will strand their investments. Moreover, by acting to freeze prices within a few months of the reform, the government in effect neutered such incentives to invest that may have existed.

It is naive to think private investment would have been forthcoming in the circumstances, and therefore mistaken to believe that the absence of such investment is a sign of market failure. The observation is important given the panel's belief that the arrangements implemented in the wake of the abortive reforms were a necessary response to inherent problems with wholesale electricity markets which, in the context of Ontario, were seen to justify a suite of power purchasing arrangements managed by the OPA, of which the FIT was one.

The second difficulty is that even if it is accepted that government intervention is necessary through a system of centralised purchasing contracts to ensure adequate capacity, it does not follow that FIT schemes were a necessary part of such arrangements. Setting aside their specific design characteristics, electricity wholesale arrangements that seek to ensure reliable and affordable supply typically rely on supply on a least-cost basis. Indeed, the panel describes the operation of these arrangements in considerable detail. Under these arrangements, renewable sources of energy would typically be uncompetitive when set against conventional energy sources, and there would be few incentives for investment in renewables.

BRIGHT, GREEN AND SQUEAKY CLEAN

The reason governments choose to support the development of renewables is not primarily because of concerns regarding the adequacy and affordability of supply. Rather it is because lower emissions sources of energy, such as renewables, confer a positive benefit to society that is not normally captured by market arrangements absent some specific form of government intervention. In such circumstances, economists speak of market failure as a result of externalities. One way to address this externality is by subsidising the production of energy from renewable sources. FIT schemes are one example of such subsidies. The benefit of the subsidy accrues to the producers of energy from renewable sources. In the absence of such a benefit there would be no incentive for them to invest. The public benefit to society from lower emissions is entirely predicated on there being a private benefit to the producers of energy from renewable sources. These private benefits take the form of fixed prices over a lengthy period of time representing a significant mitigation of investment risk – more so than would likely be available on commercial terms, and more than made available under contracts between government and private investors.

In its reasoning, the panel did not keep a sufficiently clear view of the specific factors preventing the effective operation of the wholesale market. As observed before, the reason the wholesale market in Ontario did not provide sufficient investment incentives is largely attributable to a legacy of policy intervention and poor market design. The system of contractual arrangements developed by the government was thus largely a response to this legacy, and the unwillingness or inability of the government to pursue the type of reforms pursued in other jurisdictions.

By contrast, FIT schemes seek to address a market failure in the technical sense of the term i.e. in this case a positive externality. Regardless of how well a wholesale market may operate in terms of incentivising investment in conventional energy sources, some specific form of government intervention would be required regardless to stimulate investment in renewables. This is borne out by experience internationally across jurisdictions, and explains why subsidies for renewables (whether in the form of FIT schemes or some other mechanisms) are so widely used regardless of the underlying characteristics of the wholesale market.

POWERFUL FAILURES

The findings of the panel could undeniably have been strengthened by a better understanding of energy markets. However, without downplaying the complexity of energy markets, the difficulties with the panel's reasoning stem as much from its uncertain grasp of the operation of energy markets as it does from its uncertain grasp of more basic economic concepts, such as the distinction between the failure of a market to operate, because of poor design properties, and market failure in the technical economic sense of the word. It is the latter that forms the specific basis for government intervention in renewables. Had the panel kept this distinction in view, it would have come to a conclusion that met the definition of a subsidy under WTO law, and that was consistent with mainstream economics, namely that FIT schemes are a form of production subsidy intended to correct an externality.

Had the panel found that the FIT scheme was indeed a subsidy, this would have given greater teeth to its adverse findings concerning the issue at hand, namely the local content requirements of the FIT scheme. As observed, the panel found against these requirements on other grounds.

In coming to such findings the panel made a positive contribution to the coherence between environmental policy and trade policy. This is because local content requirements in green subsidies increase the resource cost of emissions abatement. FIT schemes are generally considered some of the least cost effective forms of green subsidies; imposing local content requirements on them compounds that resource cost. Because stable concentrations of greenhouse gases are a global public good, the world as a whole is better off if abatement is conducted internationally on a least cost basis. Trade rules that clamp down on practices that violate this principle are desirable both on a trade and on an environmental basis.

Throughout the course of the case, Canada devoted much effort to convincing the panel that the FIT scheme ought to be classified as government procurement, and hence that it was exempt from the various rules governing local content that the scheme was alleged to have violated. Canada will follow the same strategy in appealing the panel's ruling. From an economic point of view, the debate as to whether or not the FIT scheme should be classified as government procurement rather than, say, a financial contribution through a governmental purchase of goods, is an exercise in pure sophistry. It has no bearing on the economic damage arising from the local content measures.

That a great deal of effort has been directed to this question simply illustrates a long standing principle in trade policy. That is, countries will seek out the weakest link in trade rules in order to continue protectionist practices. WTO members passed over an opportunity a few years ago, in much more favourable economic circumstances, to secure stricter rules on government procurement. In a political climate that favours providing protectionism and government intervention with a green veneer, this failure appears all the more regrettable given the high cost in environmental, as well as purely commercial, terms of these measures.

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