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The system of gas dual pricing in Russia: compatibility with WTO rules

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Abstract: The gas dual-pricing system in Russia has been a highly contentious issue in the context of the ongoing negotiations on the accession of Russia to the WTO. At present the domestic price for gas in Russia is set by the Government at a level several times lower than the freely negotiated export price. In the view of the European Union and other WTO Members such a policy is not permitted under WTO disciplines, while Russia persists in viewing the existing dual-pricing system as WTO consistent. The article pursues a legal assessment of the issue, demonstrating that although the Russian gas pricing system can be considered a subsidy, this subsidy is non-actionable under the WTO rules. This means that Russia has merit in its attempt to keep the gas pricing system in place after it accedes to the WTO.

1. Introduction and overview

After the accession of China to the WTO Russia remains the last big player in international trade, which is still not a WTO member. The negotiations on the accession of Russia to the WTO commenced in 1993. Since then, substantial progress has been made, especially during the last several years. On 21 May 2004 Russia made another big step on the road to the WTO signing the accession protocol with the European Union, by far Russia's main trading partner. The agreement covers the commitments that Russia will undertake in goods and services, once it accedes to the WTO and reflects agreed positions of the parties on previously outstanding issues. Amongst these issues, the Russian policy of gas dual pricing had been perhaps the most contentious one. This issue is the subject matter of the present article.

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By virtue of the system of gas price regulation in Russia, the price of gas is dependent on whether the gas is supplied domestically or for export. In the domestic market gas has to be sold at a price fixed by the Government whereas the price of exported gas is freely negotiated between a seller and a buyer. The disparity between domestic and export prices is great (for the figures see Section 2 below). The export gas market is operated by a monopoly, a state controlled company Gazprom.

In the course of negotiations on the WTO entry terms for Russia, the European Union and some other Members have been continuously raising serious concerns with regard to the gas dual-pricing practice demanding its phase-out. EU experts argued that the domestic price for gas was being kept artificially low in comparison with the world market price and that this 'non-market' pricing contributed to an indirect subsidization of Russian industrial producers (US$5 billion annually, according to the EU's evaluation), as they do not have to pay a full market price for their energy inputs. This situation allegedly had implications for the ability of imported goods to compete on the Russian market and could also lead to a displacement of member products from third country markets.

Russia maintained that there was no 'world market price' for gas (even within the European Union itself prices varied substantially) and that dual pricing would not follow under the tests established by the WTO Agreement on Subsidies and Countervailing Measures for determining the existence of an 'actionable' subsidy. Russian negotiators asserted that domestic gas prices were set at a level that permitted gas producers to recoup economically justified expenses and sufficient profit. Russia argued that cheap energy was the country's *natural* comparative advantage and since the WTO rules did not expressly prohibit that practice it must be deemed compatible with them.

Quite naturally, the EU wished to solve this problem before Russia joins the WTO without requesting a dispute settlement panel to rule on the issue. Initially, in the course of negotiations, the EU demanded that the Russian domestic price be raised to the world market level. Russian negotiators were firm in rejecting this demand. After the EU–Russia meeting in April 2003 it was reported that the EU had withdrew its demand to raise the internal gas price and insisted instead on liquidation of Gazprom's export monopoly, on phasing-out of export duties on gas and on liberalization of gas sector. Evidently, these demands aimed at a decrease in the gas export price, as opposed to the previously demanded increase in domestic price. But both ways seemed to lead to one desired result – bridging the gap between domestic and export gas prices.

In the EU–Russia protocol on WTO accession signed on 21 May 2004, the European Union reportedly dropped its demands to change Russia's gas dual-pricing policy. In return, Russia agreed to raise the regulated domestic price from the current US$27–28 to between US$37–42 by 2006 and US$49–57 by 2010. Obviously a political compromise, the issue did not receive a clear legal resolution. Now, that the political heat over the matter is over (at least, as far as the EU is concerned), a legal analysis of the consistency of the gas dual-pricing system with WTO rules would seem interesting and, at the same time, less sensitive for the parties concerned. The analysis might also have systemic value as similar issues can arise in future.[1] Finally, the EU could still countervail the alleged subsidy in case it considers the subsidy actionable.

2. Economic perspective

Before turning to the analysis itself, it appears useful to provide a general picture of the role of gas in the Russian economy and of the way the Russian gas market functions.[2]

Russia possesses an estimated one-third of world's natural gas reserves and is the largest producer and exporter of gas in the world. In 2002 Russia produced 595 Billion cubic meters (Bcm) and exported 190 Bcm of gas, Europe being its main destination (128 Bcm in 2002,[3] projected 200 Bcm in 2008). Russia is responsible for 66 % of the European gas imports (including Turkey). Surprising as it may sound, Russia itself also imports gas (31 Bcm in 2001 from Central Asian and Caspian countries).

Gas is the main source of energy in Russia. About 382 Bcm of gas is consumed domestically each year, 60 % of which is transformed into electricity (in the European Russia, 70 % of all electric energy is generated from gas). Around 50 Bcm a year is consumed by industrial producers directly.

Russian gas industry is dominated by OAO 'Gazprom', the world's largest gas company. It is a privatised company, in which the Russian Government maintains a major share. Gazprom produces about 90 % of total Russian gas output, controls all gas exports to Europe and all transportation of gas through high-pressure pipelines. The fact that Gazprom provides for around 20 % of the Russian federal

1 The energy pricing policy of Saudi Arabia discussed in the context of this country's current negotiations on the WTO accession and sometimes compared with the Russian system is not a good example because in Saudi Arabia the difference between domestic and export price is solely due to the difference in transportation costs and, accordingly, there is no 'dual pricing' in the sense of the term used to describe the Russian system.

2 Data used in this section come from: *Key World Energy Statistics 2003*, a publication of the International Energy Agency, <http://library.iea.org/dbtw-wpd/Textbase/nppdf/free/2003/key2003.pdf>; *Russia Energy Survey 2002*, a publication of the International Energy Agency, <http://library.iea.org/dbtw-wpd/Textbase/nppdf/stud/02/russia2002.pdf>; *International Energy Annual 2002*, a publication of the United States Energy Information Administration (Table 4.2, World Dry Natural Gas Supply and Disposition, 2001), <http://www.eia.doe.gov/pub/international/iea2002/table42.xls>; D. Tarr and P. Thomson (World bank), *The Merits of Dual pricing of Russian Natural Gas*, <http://www.worldbank.org.ru/ECA/Russia.nsf/0/d538d7635d046decc3256e230031ac47/$FILE/russian_natural_gas_eng.pdf>; Annual Reports of the Ministry of Energy of the Russian Federation for 2002 and 2001, <http://www.mte.gov.ru/docs/94/978.html>; *Revised Draft Report of the Working party on the Accession of the Russian Federation to the WTO*, WT/ACC/SPEC/RUS/25/Rev.2, 26 May 2003, <http://www.insidetrade.com/secure/pdf4/wto2003_4945.pdf> (all documents last accessed on 15 March 2004).

3 Including Turkey.

budget revenues is an indicator of the scale of its business and of its importance to the country.

Domestically, gas is supplied at a price set by the Federal Energy Commission. The domestic price has been steadily increasing over the last few years, and in 2004 it reached US$27–28 per thousand cubic meters on average (in fact, a different price is fixed for each of the seven price-belts, which reflects different transportation costs). Although this is twice as much compared with US$14.5 in 2001, the disparity between the domestic and the export price (the latter amounting to approximately US$120) remains more than material.[4] As noted earlier, in its accession deal with the EU Russia agreed to raise the domestic price to between US$37–42 by 2006 and US$49–57 by 2010.[5]

The economic survey undertaken by the World Bank reveals that, from Russia's perspective, there is no economic rationale to unify the price of natural gas it sells domestically and abroad. The survey suggests, however, that the domestic gas price should be raised from its current level to the full long-run marginal costs[6] (about US$35–40 per thousand cubic meters), which is a well-established principle of efficient market pricing and would lead to a more efficient use of gas, maintenance of production levels, and increase of investments. If Russia were to sell its gas to Europe at only full long-run marginal cost plus transportation costs, Russia would lose between US$5 billion and US$7.5 billion per year. If, instead, Russia were to raise its domestic prices to the prices it charges in Europe, Russian industry would incur very large adjustment costs as the gas cost increases would adversely impact on investment and unemployment in the short run. The World Bank economists conclude that there is no world market price for gas and that with a 27 % market share of gas sales in Europe, it is optimal for Gazprom to exploit this market power and to sell natural gas in its exports market at a price higher than domestically.

3. Subject-matter of the analysis

According to the 'Revised Draft Report of the Working party on the Accession of the Russian Federation to the WTO', the members of the Working Party that allege the unacceptability of the system of gas price regulation in Russia[7]

4 It has to be noted that in addition to higher transportation costs, the export price also includes a 30 % export duty.

5 Note, in this connection, that the Russian Energy Strategy to 2020 (adopted by the Government in 2003) also envisages domestic price increases to the level of US$40–41 in 2006 and US$59–64 in 2010. Apparently, this policy seeks to provide an ample incentive for investments in the gas industry and to promote energy efficiency measures.

6 Includes environmental costs in addition to the full cost of doing business.

7 The Report does not name these members but from the information surrounding the negotiations it is clear that the European Union has been the main, yet not the only, opponent to the Russian gas pricing system.

substantiate their position by (1) WTO rules on subsidies,[8] and (2) WTO rules on state trading enterprises.[9]

Taking into account that Article XVII of the GATT 'State Trading Enterprises' has not been properly tested in the WTO dispute settlement and that the existing jurisprudence lacks consistency,[10] analysis of this issue would hardly be of value. Therefore, this article focuses exclusively on the issue of subsidization. In particular, it seeks to establish whether the Russian dual pricing system constitutes a subsidy within the meaning of the WTO law; and, if so, what kind of subsidy is this (prohibited, actionable, non-actionable).

4. Analysis

The analysis of the alleged 'gas subsidy' is carried out as to its consistency with the relevant rules of WTO law, as interpreted and applied by panels and the Appellate Body in previous disputes.

As a result of the Uruguay Round, the meaning of the term 'subsidy' was circumscribed in order to draw a difference between all governmental activities that could potentially result in some sort of benefit to domestic producers, on the one hand, and measures that should be outlawed as subsidies under the Agreement on Subsidies and Countervailing Measures (SCM Agreement), on the other. Thus, two important concepts were introduced to the text of the SCM Agreement to constrain the meaning of the term 'subsidy', the first of them being a definition of a subsidy and the second being the criterion of 'specificity'. They are examined in turn with relation to the measure at issue.

Definition of a subsidy

According to Article 1 of the SCM Agreement, any subsidy consists of two elements: (1) a financial contribution (or price or income support) and (2) a benefit. The Appellate Body emphasized in *Brazil–Aircraft* that financial contribution and benefit are 'separate legal elements in Article 1.1 … which *together* determine whether a "subsidy" exists'.[11] The Panel in *United States – Measures Treating Export Restraints as Subsidies* (*US–Export Restraints*), in analysing the negotiating

8 See *Revised Draft Report of the Working party on the Accession of the Russian Federation to the WTO*, *supra*, footnote 2, para. 76. An 'indirect subsidization of Russian industrial producers' is alleged while no reference is made to specific WTO disciplines on subsidies.

9 See *Revised Draft Report of the Working party on the Accession of the Russian Federation to the WTO*, *supra*, footnote 2, para. 388.

10 Article XVII has been addressed in one GATT case (*Canada – Administration of the Foreign Investment Review Act*) and two WTO cases (*Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef* and the very recent *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain*). The *Wheat* Panel chose not to rule on issues that would be necessary for the purposes of the present analysis. The relevant Article XVII findings of the *FIRA* and *Beef* Panels appear contradictory.

11 Appellate Body Report, *Brazil – Export Financing Programme for Aircraft*, WT/DS46/AB/R, adopted 20 August 1999, para. 157 (original emphasis).

history of Article 1, concluded that the requirement of a financial contribution was intended to ensure that *not all* government measures that conferred benefits could be deemed to be subsidies and that only government actions constituting financial contributions, as set forth in the exhaustive list, should be subject to the multilateral rules on subsidies and countervailing measures.[12] Therefore, the analysis of any measure alleged to be a subsidy should start with the first element of any subsidy in the sense of the SCM Agreement, that is with whether a measure constitutes 'financial contribution' or 'any form of income or price support in the sense of Article XVI of GATT 1994'. I will start with the second of these two options and then proceed to the first.

Income or price support

Article 1.1(a)(2) of the SCM Agreement refers to 'any form of income or price support in the sense of Article XVI of GATT 1994'. The concept of income or price support has not received much attention.[13] WTO 'case law' so far does not give much useful or definitive guidance on this issue.[14] The GATT Analytical Index refers in the relevant section to Interpretative Note 2 *ad* paragraph 3 of Article XVI, which concerns '[a] system for the stabilization of the domestic price or of the return to domestic producers of a primary product independently of the movements of export prices, which results at times in the sale of the product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market'.[15]

Although this definition relates only to primary products, which are defined in Interpretative Note 2 *ad* Section B of Article XVI and do not include gas, the features of the concept remain the same. The quoted part appears to suggest that 'income or price support' in the sense of Article XVI of the GATT implies government involvement undertaken to ensure that the price of a certain product or an income derived from a certain economic activity would not go lower than a certain level. The apparent concern underlying the concept of 'income or price support' is that by maintaining higher domestic prices (or ensuring a certain level of producers' income) the government is cross subsidizing domestic producers, which receive an opportunity to export their goods at lower prices and, thus, obtain a more than equitable share of world export trade in that product. By introducing this concept into the definition of a subsidy in the SCM Agreement, Members sought to prevent such practices not only with respect to primary goods but to apply it across the board to any product or economic activity.

12 Panel Report, WT/DS194//R, adopted 29 June 2001, paras. 8.65–8.69.

13 E. McGovern, *International Trade Regulation* (loose-leaf) (Globefield Press), Issue 12, p. 11.31–5.

14 M. G. Desta, *The Law of International Trade in Agricultural Products* (Kluwer Law International, 2002), p. 157.

15 See *GATT, Analytical Index: Guide to GATT Law and Practice*, Updated 6th Edition (WTO, 1995), pp. 445–446.

One might allege that the gas dual pricing provides an above-described support – not to Russian gas producers, but to domestic producers of industrial goods, who would use cheap energy inputs to obtain a price advantage and, thus, receive some sort of 'support' in terms of prices of their downstream products. However, although it is doubtless that cheap energy input gives some sort of eventual price advantage to domestic industrial producers and does, at the end of the day, assist them in making their businesses profitable, the contention that gas dual pricing is a form of an 'income or price support' in the sense of Article XVI of the GATT would not seem plausible. The gas dual pricing system does not operate to *maintain* a certain level of income or price; in other words, it does not ensure that a price of an industrial product or an income of a respective producer would not go lower than the given level – this is neither the system's objective, nor its actual effect. Furthermore, this system does not result in domestic industrial goods prices that would be higher than export price, and, therefore, does not constitute unfair cross subsidization. For these reasons, the gas dual pricing system is unlikely to fall within the meaning of 'income or price support' in the sense of Article XVI of the GATT.

Financial contribution

Types of 'financial contribution' are listed in sub-paragraph 1.1(a)(1) of Article 1. The gas dual-pricing system may possibly be considered under items (iii) or (iv) of this sub-paragraph.

Item (iii) provides:

> a government provides goods or services other than general infrastructure, or purchases goods.

In our case, it is Gazprom who supplies gas to industrial producers. As the word government in Article 1.1(a)(1)(iii) includes also 'any public body within the territory of a Member', it is necessary to determine whether Gazprom may be considered a 'public body'. To date, there has been no WTO jurisprudence as to what is understood by a 'public body' in the SCM Agreement. However, one could suggest that two main approaches appear to present themselves here. The first is that a 'public body' means public entity (public corporation); the second is that it means a body controlled by the government. The first option stems from the legal distinction between public and private companies; the second from an actual possibility of a *de jure* private company to be *de facto* the same as a public entity, if it is controlled by the government.

The Civil Code of the Russian Federation draws an explicit distinction between private and public legal entities, making the 'legal disctinction' test applicable to the Russian legal environment. However, it appears that such an approach would allow a rather easy circumvention of WTO disciplines on subsidies – it would be enough for a government to simply form a 100 % controlled private company to escape from the ambit of Article 1.1(a)(1)(iii). The second approach seems to be more logical as it would prevent an easy circumvention of the provision in question.

Accordingly, a legal entity could be considered a 'public body' if it is controlled by the government, irrespective of the legal status of the entity. Sometimes, the practical application of the 'control' test would present difficulties, namely where a government controls less than 50 % of all shares – in these cases an analysis would be necessary as to whether the number of shares directly or indirectly owned by the government allows it to control a company. However, in my opinion, given the absence of the exact definition of a 'public body' in the text of the SCM Agreement and in order to preclude possible circumvention of the SCM disciplines, the second – 'control', or *de facto* – approach would prevail.

As noted above, Gazprom is a private company. Russian Government owns about 40 % of Gazprom's shares, which, given the shareholders' structure, allows to the Government exercise effective control over the enterprise. Gazprom's total *de facto* control by the Government is also evidenced by the fact that Gazprom has never attempted to challenge or, at least, to officially express its dissatisfaction with governmental resolutions fixing domestic gas prices below the cost-of-production level, which would be the most natural thing to do for a classic private entity driven by profit-maximizing considerations.

The foregoing suggests that, if the first of the two identified approaches applies then there is no Article 1.1(a)(1)(iii) case here; if the second approach applies then there is a provision of a good by a public body in the sense of Article 1.1(a)(1)(iii) and, accordingly, there is a financial contribution.

Despite the inclination towards the 'control' approach, it is not completely clear which of the two approaches would apply. Therefore, it is useful to proceed to the analysis under Article 1.1(a)(1)(iv) of the SCM Agreement, which provides:

> a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

Assuming for the purpose of the present argument that Gazprom is a private body, one has to look at whether other conditions of Article 1.1(a)(1)(iv) are met. In particular, three issues need to be addressed here.

The first question would be whether the Government, by setting a domestic price for gas, '*entrusts or directs*' Gazprom to carry out a function illustrated in Article 1.1(a)(1)(iii); that is, to provide gas domestically. The words 'entrusts or directs' were interpreted by the WTO Panel in *US–Export Restraints* to require an explicit and affirmative action of delegation or command.[16] Russian laws do not impose on gas producers an express obligation to provide gas domestically, with the exception of the provision to organizations funded from the federal budget and a limited number of consumers for which a minimum defined level of gas supply must be maintained. Aside from that, the governmental intervention is confined to the

16 Panel Report, *supra*, footnote 12, para. 8.44.

matter of fixing a price at which gas must be sold; the sales themselves are effected on a contractual basis.

In these circumstances if Gazprom were a usual profit-maximizing enterprise it would then make sense for it to decrease domestic supplies and to build additional transportation capacities in order to increase the volume of exported gas. However, again, as a result of control of the Government over Gazprom, the latter does not follow this market-dictated scenario, but acts to satisfy the whole of domestic demand, despite the low price. In my view, this type of action can be characterized as a direction, though of a *de facto* kind, when there is no express legal requirement to provide but when the private body is, in fact, directed, by means of the governmental control over the enterprise, to follow the governmental policy of satisfying the domestic demand for gas without taking into consideration the price factor.

One might argue that the Panel in *US–Export Restraints* ruled out the possibility of *de facto* direction. Such a view would not seem plausible. In *US–Export Restraints* the United States was arguing that the restraints set for export of the goods induce producers to provide the goods domestically. Here, the situation is quite different and must be distinguished from the one in *US–Export Restraints*. There is no indirect incentive; instead, the direction is positive, though not by virtue of setting a legal requirement but by means of exercising a control over the monopolist provider of the good. The interpretation given to 'entrusts or directs' in *US–Export Restraints* does not suggest that 'an explicit and affirmative action of delegation or command' needs to be in a legislative form. Therefore, in my view, the type of direction exercised on Gazprom by the Russian Government is likely to survive the test established by the *US–Export Restraints* Panel.

The second question concerns the issue of whether Gazprom is directed *to provide* gas domestically and, accordingly, depends on the meaning of the term 'to provide' in Article 1.1(a)(1)(iv). Examining this issue in *United States – Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada* (*US–Softwood Lumber IV*), the Appellate Body did not accept Canada's argument that 'to provide' means something more than 'to make available' or 'put at the disposal of', namely that it implies in fact 'giving'. The Appellate Body found that Canadian stumpage programs, which gave tenure holders a right to enter on to government lands, cut standing timber, and enjoy exclusive rights over the timber that is harvested, constituted the provision of standing timber by putting it at the disposal of timber harvesters and allowing those enterprises, exclusively, to make use of those resources.[17] In the case at hand the Government does not 'give' gas to downstream producers, it only fixes the selling price. However, this act of the Government is in effect equivalent to making gas 'available' to domestic producers at the fixed price. The governmental control over Gazprom ensures, *de facto*, that gas *will* be provided at this price. In the

17 Appellate Body Report, *US–Softwood Lumber IV*, WT/DS257/AB/R, adopted 17 February 2004, para. 75.

mentioned Report the Appellate Body emphasized that it is not required that elements of the subsidy definition are fulfilled *simultaneously*.[18] This is very true for the system of Russian gas pricing where the act of price fixing and the fact of gas availability might be not simultaneous. Finally, it is enough to look at the rate of the domestic gas consumption for any doubts to be dispelled as to whether there is a provision of gas at the fixed price.

The third question concerns a requirement in Article 1.1(a)(1)(iv) that a private body must be entrusted or directed to carry out one or more type 'of functions illustrated in (i) to (iii) above, which would *normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments*' (emphasis added). This phrase was to some extent explored in the Panel Report on *US–Export Restraints*. The Panel noted that reference to 'practice … in no real sense different from those normally followed by governments' was a general reference to the *delegation* to private parties of the particular government functions of taxation and expenditure of revenue, and *not* a reference to government market interventions in the general sense, or the effects thereof (original emphasis).[19] This means that, in the case where the government entrusts or directs a private body to carry out one of the functions listed in subparagraphs (i)–(iii), the function must be one that would normally be vested in the government, and must not differ in any real sense from practices normally followed by governments. While there might be different views on this issue, I would suggest that it is not uncommon for governments to control the provision of natural resources within its territory, either directly or by medium of public bodies. Therefore, it would be plausible to say that the provision of energy, although not being a governmental function of taxation or expenditure of revenue, is still a practice normally followed by governments in the sense of Article 1.1(a)(1)(iv).

The foregoing reasoning leads to the conclusion that, depending on the interpretative approaches, the system of gas dual pricing falls either under Article 1.1(a)(1)(iii) or under Article 1.1(a)(1)(iv) of the SCM Agreement. In any case, the dual-pricing system appears to constitute 'financial contribution' in the sense of Article 1.1(a)(1) of the SCM Agreement and, therefore, the first of the two elements of the subsidy definition is fulfilled.

Benefit

According to Article 1 of the SCM Agreement, a 'financial contribution' becomes a subsidy only if 'a benefit is thereby conferred'. Therefore, it is necessary to determine whether the gas dual-pricing system confers a benefit on producers using gas as a source of energy.

The SCM Agreement itself does not define the term 'benefit' but in the WTO jurisprudence the meaning of this term has been addressed on several occasions. In

18 Appellate Body Report, *supra*, footnote 17, para. 73.
19 Panel Report, *supra*, footnote 12, para. 8.72.

Canada – Measures Affecting the Export of Civilian Aircraft ('*Canada–Aircraft*'), the Panel pointed out that the ordinary meaning of 'benefit' clearly encompasses some form of advantage.[20] The Appellate Body in the same case observed that '[t]he dictionary meaning of "benefit" is "advantage", "good", "gift", "profit", or, more generally, "a favourable or helpful factor or circumstance". Each of these alternative words or phrases gives flavour to the term "benefit" and helps to convey some of the essence of that term.'[21] The benefit requirement is thus met as soon as the 'financial contribution' results in creating some form of 'competitive advantage in trade' in the export market for the product concerned in favour of the recipient.[22] The *Canada–Aircraft* Panel summarized the essence of this requirement as follows: '[i]n order to determine whether a financial contribution (in the sense of Article 1.1(a)(1)) confers a "benefit", i.e., an advantage, it is necessary to determine whether the financial contribution places the recipient in a more advantageous position than would have been the case but for the financial contribution'.[23]

Thus understood, a benefit 'involves the concept of comparison'[24] and, consequently, requires a benchmark, against which to compare the situation. Article 14 points to the marketplace as an appropriate basis for comparison. As the Appellate Body stated in *Canada–Aircraft*, '[t]he guidelines set forth in Article 14 relate to equity investments, loans, loan guarantees, the provision of goods or services by a government, and the purchase of goods by a government. A 'benefit' arises under each of the guidelines if the recipient has received a 'financial contribution' *on terms more favourable than those available to the recipient in the market*' (emphasis added).[25]

The exact language of Article 14(d) of the SCM Agreement is as follows:

> the provision of goods or services or purchase of goods by a government shall not be considered as conferring a benefit unless the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration. The adequacy of remuneration shall be determined in relation to prevailing market conditions for the good or service in question in the country of provision or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale).

Thus, Article 14(d) provides that, first, to confer a benefit a good has to be provided at a *less than adequate remuneration* and, second, that the adequacy of remuneration shall be determined *in relation to prevailing market conditions in the country of provision*. For the purpose of the present analysis it is, therefore,

20 Panel Report, WT/DS70/R, adopted 20 August 1999, para. 9.112.

21 Appellate Body Report, *Canada–Aircraft*, WT/DS70/AB/R, adopted 20 August 1999, para. 153.

22 Panel Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* ('*Canada–Dairy*'), WT/DS103/R, WT/DS113/R, adopted 27 October 1999, para. 4.368.

23 Panel Report, *Canada–Aircraft*, *supra*, footnote 20, para. 9.112.

24 Appellate Body Report, *Canada–Aircraft*, *supra*, footnote 21, para. 157.

25 Appellate Body Report, *supra*, footnote 21, para. 158.

necessary to determine whether Gazprom provides gas domestically at a less than adequate remuneration as suggested by Article 14(d).

The Russian Government fixes the prices for gas supplied by Gazprom. Gazprom, being a predominant gas supplier in Russia, is not, however, the only one. The economic Section 2 above indicates that producers other than Gazprom account for 10 % of the total domestic gas output (however, it has been impossible to obtain statistics as to what share of this 10 % is provided domestically). Russia also imports the volume of gas equal to about 5 % of the total domestic output. For independent gas producers the selling price is not fixed and the import price is freely negotiated as well. In these circumstances, in order to determine a benefit, the language of Article 14(d) would suggest looking at private prices in the market of provision. Although the exact rate of private prices has been impossible to obtain, one would think that it cannot be significantly higher than the price fixed for Gazprom, given the latter's predominant position on the market. Accordingly, this method would demonstrate a rather small benefit or even no benefit to Russian downstream producers.

In *US–Softwood Lumber IV* the Panel and Appellate Body faced a similar situation. Canadian provincial governments were predominant suppliers of standing timber and the private market was relatively small. Considering the issue under Article 14(d), the Appellate Body held that private prices in the market of provision would *generally* represent an appropriate measure of the 'adequacy of remuneration' for the provision of goods and thus such private prices were the *primary* benchmark for the adequacy of remuneration determination. However, contrary to the view of the Panel, the Appellate Body took a position that Article 14(d) did *not* require the use of private prices in the market of the country of provision *in every situation*.[26] According to the Appellate Body, private prices in the country of provision can be distorted because of the government's predominant role in that market. The Appellate Body reasoned that '[w]henever the government is the predominant provider of certain goods, even if not the sole provider, it is likely that it can affect through its own pricing strategy the prices of private providers for those goods, inducing the latter to align their prices to the point where there may be little difference, if any, between the government price and the private prices.'[27] In such a situation it will not be possible to calculate a benefit having regard exclusively to private prices and an investigating authorities may use a benchmark other than private prices in the country of provision.[28]

Although the Appellate Body emphasized that 'an allegation that a government is a significant supplier would not, on its own, prove distortion' and that each situation must be approached 'on a case-by-case basis', the interpretation given by

26 Appellate Body Report, *US–Softwood Lumber IV*, *supra*, footnote 17, paras. 90, 96.
27 Ibid., para. 100.
28 Ibid., paras. 101, 103.

the Appellate Body in *US–Softwood Lumber IV* to the rule of Article 14(d) has apparent implications for similar situations in general and the situation in the Russian gas market in particular.

As noted earlier, Gazprom is the predominant gas provider in Russia and this undoubtedly affects prices of other private providers of gas, inducing the latter to align their prices with the prices fixed by the Government for Gazprom. Should these circumstances be established, they would be sufficient to authorize the determination of benefit using the benchmark different from the private prices in the country of provision. A natural question arises as to what would serve as a proper benchmark in such a case. The Appellate Body did not answer that question in *US–Softwood Lumber IV*. However, it agreed that alternative methods for determining the adequacy of remuneration could include proxies that take into account prices for similar goods quoted on world markets, or proxies constructed on the basis of production costs. The Appellate Body further emphasized that it has to be ensured that the chosen benchmark 'relates or refers to, or is connected with, prevailing market conditions in the country of provision, and must reflect price, quality, availability, marketability, transportation and other conditions of purchase or sale, as required by Article 14(d)'.[29]

With respect to the Russian gas market, the application of either of the two mentioned proxies would result in a finding of a benefit to domestic producers using gas as a source of energy since they receive their energy inputs at a less than adequate remuneration (if the fixed gas price is lower than the cost of production). Relying on the World Bank's proposition that there is no world price for gas, the use of the cost-of-production proxy would probably be more appropriate as closer connected with 'market conditions in the country of provision'. Therefore, the second obligatory element of the subsidy, as defined in Article 1.1 of the SCM Agreement, appears to be satisfied, which suggests that the gas dual-pricing system constitutes a subsidy to domestic producers of industrial goods.

Conclusion

By fixing the low domestic price for gas and ensuring that the gas is provided at this price to domestic downstream producers, the Russian Government makes a 'financial contribution' in the sense of Article 1.1(a)(1) of the SCM Agreement, which results in a benefit to domestic downstream producers, who obtain their energy inputs at a less than adequate remuneration. Such price fixing would appear to constitute a subsidy as defined in Article 1.1 of the SCM Agreement.

Type of the gas subsidy

Even if a given measure meets the definition of a subsidy in Article 1.1 of the SCM Agreement, it nevertheless is not automatically subject to its disciplines. Article 1.2

29 Ibid., para. 106.

suggests that this would only be the case if the subsidy is specific.[30] Thus, the requirement of 'specificity' is a second hurdle on the way to subjecting any given measure to the disciplines of the SCM Agreement.

The 'non-specific' subsidies fall in the so-called 'non-actionable' subsidies category of Part IV of the SCM Agreement. Specific subsidies may be either 'prohibited' or 'actionable'. Article 2.3 provides that '[a]ny subsidy falling under the provisions of Article 3 [which defines prohibited subsidies] shall be deemed to be specific'. Therefore, if a measure satisfies the Article 3 definition of prohibited subsidies, no specificity analysis is required. In all other cases such analysis would be in order. I start the examination with a look at prohibited subsidies and then proceed to the specificity analysis.

Prohibited subsidy

Article 3 lists two categories of prohibited subsidies, the first being 'export subsidies', that is, subsidies contingent upon export performance, and the second encompassing 'import substitution' subsidies, that is, subsidies contingent upon the use of domestic over imported goods.

It is obvious that the Russian gas subsidy does not belong to the first category, since among the industrial consumers of gas there are many who do not export their production at all. The second category deserves some more discussion. For example, addressing, in the Doha Round negotiations, the issue of the dual natural resource pricing the United States suggested that '[s]imply put, there is no difference between the government provision of a natural resource at less than fair market value and the government provision of a cash grant allowing the purchase of a natural resource at less than fair market value'.[31] Continuing this logic, one could reason that if a producer wants to receive this 'cash grant' it has 'to undertake' to spend it only on domestic gas, otherwise it will receive no benefit. Accordingly, under this approach, the benefit resulting from the financial contribution is accessible only to those producers who use domestic, but not imported gas. The conclusion would be that gas subsidy is 'contingent' upon the use of domestic gas and, for this reason, is prohibited under Article 3.1(b) of the SCM Agreement.

It would be unreasonable to deny that the gas dual-pricing system gives an incentive to Russian industrial producers to consume domestic gas rather than imported. However, such an incentive alone is insufficient to establish an 'import substitution' subsidy. The 'contingency' relationship is required, which is something different from an incentive. In *Canada–Aircraft* the Appellate Body stated that the common understanding of 'contingent' as 'conditional' or 'dependent for

30 Article 1.2 of the SCM Agreement provides that '[a] subsidy as defined in paragraph 1 shall be subject to the provisions of Part II [Prohibited Subsidies] or shall be subject to the provisions of Part III [Actionable Subsidies] or V [Countervailing Measures] only if such a subsidy is specific in accordance with the provisions of Article 2'.

31 Subsidies Disciplines Requiring Clarification and Improvement, Communication from the United States, 18 March 2003, available on-line at <http://www.ustr.gov/releases/2003/03/2003-03-18-wto-subsidies.PDF>.

its existence on something else' 'is borne out by the text of Article 3.1(a), which makes an explicit link between "contingency" and "conditionality" in stating that export contingency can be the sole or "one of several other *conditions*"' (original emphasis).[32] Article 3.1(b) is phrased, in the relevant part, using the same language as Article 3.1(a), which makes the cited analysis of the Appellate Body also applicable to 'import substitution' subsidies.

Under Article 3.1(b), the subsidy must be contingent 'upon the use of domestic over imported goods'. In other words, the use of domestic over imported goods must be a *condition* for receiving a subsidy. In terms of the provision-of-goods-by-government subsidy, such a condition would mean that a government would provide goods to a producer only under the condition that this producer uses certain *other* domestic (not imported) goods. Only in this instance the contingency requirement would be met. By contrast, in our situation the use of domestic gas is not a condition for receiving a subsidy but is a subsidy itself (a good provided by virtue of government involvement). Therefore, the 'contingency' test is not satisfied.

Adoption of a different approach would mean that the provision of *any* good by a government at a less than adequate remuneration would constitute a prohibited – as opposed to actionable – subsidy (unless this good is imported by a government). Had the negotiators intended this to be a result, they would have expressly put it in the text. In the absence of clear language to that effect, the interpretation of Article 3.1(b) as encompassing all Article 1.1(a)(1)(iii) situations, where the good in question is of domestic origin, would become overly stretched.

For the foregoing reasons, the gas subsidy does not appear to satisfy the definition of the 'import substitution' subsidy as defined in Article 3.1(b) of the SCM Agreement.

Specificity analysis

Having determined that the gas subsidy is not a 'prohibited' subsidy under the WTO rules, I proceed to the specificity analysis to determine whether it may be considered an 'actionable' subsidy.

Stated in general terms, specificity is a requirement to the effect that access to the subsidy must be limited, either in law or in fact, to 'an enterprise or industry or group of enterprises or industries'. The economic argument underlying the specificity test is that a subsidy equally available to all spheres of the economy does not as such distort trade or the allocation of resources, or distortions are quite minimal. Further, in light of the need to eliminate from actionable subsidies the general activities undertaken by governments (such as societal infrastructure like police, fire protection, roads, schools, etc.), the specificity test can offer a very useful method for doing so.[33]

32 Appellate Body Report, *Canada–Aircraft*, *supra*, footnote 21, para. 166.

33 See J. Jackson, The World Trading System: Law and Policy of International Economic Relations, 2nd edition (MIT Press, 1997), pp. 296–297.

The criteria for specificity are set forth in Article 2 of the SCM Agreement, which distinguishes between two forms of specific subsidies – *de jure* specific and *de facto* specific. There is no doubt that the Russian gas subsidy is not *de jure* specific, since neither the granting authority nor the legislation explicitly limit access to the subsidy. The question here is about *de facto* specificity.

According to Article 2.1(c): '[I]f, notwithstanding any appearance of non-specificity … there are reasons to believe that the subsidy may in fact be specific, other factors may be considered.' The factors set out in Article 2.1(c) include:

(a) use of a subsidy program by a limited number of certain enterprises;
(b) predominant use by certain enterprises;
(c) the granting of disproportionately large amounts of subsidy to certain enterprises; and,
(d) the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy.

Finally, Article 2.1(c) provides: 'In applying this subparagraph, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.'

In the United States, where the *de facto* specificity had been several times established by the authorities and then reviewed by the courts,[34] prior to the Uruguay Round it was determined that the investigation authority must consider all four factors for *de facto* specificity when making a respective determination.[35] In the post-Uruguay Round US case law and in the WTO dispute settlement the matter has been approached differently. The WTO Panel in *US–Softwood Lumber IV*, in the finding not reviewed by the Appellate Body, held contrary to Canada's argument that the US Department of Commerce had not been required to examine all four factors listed in Article 2.1(c) and that a determination made on the basis of only one of those factors was not inconsistent with Article 2.1(c).[36]

Factors (a) and (d) should be dismissed from the outset as obviously inapplicable to the Russian gas subsidy. Factor (c), 'the granting of disproportionately large amounts of subsidy to certain enterprises', does not appear to apply either because

34 See, for example, *Cabot Corporation* v. *United States, PPG Industries, Inc.* v. *United States*, *Roses, Inc.* v. *United States, Armco, Inc.* v. *United States Comeau Seafoods Ltd.* v. *United States.* A brief account of the US administrative practice and case law concerning the *de facto* specificity test is set out in two decisions of the panels established pursuant to Article 1904 of the United States–Canada Free Trade Agreement – see the Panel Decision on *Certain Softwood Lumber Products from Canada*, U.S.A.-92-1904-01, adopted 6 May 1993, pp. 29–35, and the Panel Decision on *Pure an Alloy Magnesium from Canada*, U.S.A.-92-1904-03, adopted 16 August 1993, pp. 19–24.

35 See the Decision of the Panel, *Certain Softwood Lumber Products from Canada*, U.S.A.-92-1904-01, adopted 6 May 1993, pp. 35–39, referring to *PPG Industries, Inc.* v. *United States* and *Roses, Inc.* v. *United States*.

36 Panel Report, *US–Softwood Lumber IV*, WT/DS257/R and Corr.1, adopted 17 February 2004, para. 7.123.

this factor implies the *granting* of different amounts of subsidy to different enterprises (industries), while the gas subsidy is granted generally to all enterprises and industries equally and it is for the enterprise (industry) itself to decide to what extent to use the subsidy.

The only factor that remains is factor (b) 'predominant use [of a subsidy] by certain enterprises'. This factor ought to be given more careful consideration. It is evident, that some enterprises use by far more energy than others, as different industrial processes require different levels of energy inputs. Gas subsidy may be said to confer most benefits on enterprises engaged in manufacturing energy-intensive products (such as fertilizers, chemical products, or metals), because the energy constituent in the price of those products is very significant. Accordingly, access to 'artificially cheap energy' makes the cost of an end product substantially lower, which allegedly leads to trade distortion. Therefore, the gas subsidy may be alleged to be 'predominantly used' by described enterprises.

According to the first paragraph of Article 2.1, the word 'enterprise' encompasses, in the context of the SCM Agreement, 'an enterprise or industry or group of enterprises or industries'. Therefore, the range of recipients of a *de facto* specific subsidy may be as broad as 'group of industries', in this case – energy-intensive industries.

However, it appears that the logic offered above would not stand because of the meaning, which has to be attached to the concept of 'predominant use' in the context of Article 2 of the SCM Agreement. The Panel in *US–Softwood Lumber IV* noted that Article 2 'is concerned with the distortion that is created by a subsidy which either in law or in fact is *not broadly available*' (emphasis added).[37] Or, one might add, even a broadly available subsidy may be specific if, despite its nominal broad availability, the subsidy is predominantly used by certain enterprises or industries. As noted by the Panel, the *de facto* specificity is all the more likely to occur if a subsidy takes the form of a *good* that is provided by a government – and not just money, which is fungible – because most goods have utility only for certain enterprises (because of the inherent characteristics of the good). It was exactly the case in *US–Softwood Lumber IV* where the Panel examined stumpage programs, which nominally were available generally but could in fact be used only by industries consuming standing timber. However, the Panel specifically emphasized that its proposition would not imply that any provision of a good automatically would be specific, 'because in some cases, the goods provided (such as for example oil, gas, water, etc.) may be used by an indefinite number of industries'.[38]

Indeed, the range of subsidy recipients must be a deciding factor. If a subsidy offered generally is in fact used, although to a different extent, by a very large number of industries, such subsidy cannot be held specific. Otherwise the concept of specificity looses its meaning. In every classic non-specific subsidy such as roads

37 Panel Report, *supra*, footnote 36, para. 7.116.
38 Panel Report, *supra*, footnote 36, para. 7.116.

or education there are economic operators, which make more use of the subsidy. An enterprise with an extensive network of suppliers benefits from roads to a greater extent than an enterprise which produces its goods from raw materials at the place of their extraction. A government offer of tax credit for one year to all enterprises (a 'foregone revenue' subsidy) would be more advantageous to profitable enterprises than to low or no-profit enterprises or industries. In the case of a government offer of a loan to all economic sectors at an interest rate lower than the market level, capital-intensive industries would make more use of this subsidy than other industries. However, the finding of a *de facto* specificity in all these examples would be absurd precisely because the number of potential and actual users would be extremely broad.

It appears, therefore, that the concept of 'predominant use' should be understood as encompassing situations where a lot of enterprises/industries have access to a subsidy but only a few in fact use it ('predominant' users) but not as a concept requiring to estimate a *degree* of subsidy usage in a broad range of enterprises/industries which use it. Applying this interpretation of 'predominant use' to the Russian gas subsidy, it appears that the subsidy cannot be considered *de facto* specific. It is offered across the board to the whole of economy, is used by a very large number and wide variety of industrial consumers, representing a wide cross section of the national economy. The range of subsidy recipients is so broad that it cannot be asserted that the subsidy is predominantly used by certain enterprises or industries.

Lastly, Article 2.1(c) mandates to take into account the extent of diversification of economic activities within the jurisdiction of the granting authority. This guideline was included for the cases where the whole economy is dominated by one or few industries, so that, even if application of the above factors indicates specificity, it could not be established. This requirement, therefore, has to be considered in case of a positive finding of *de facto* specificity on the basis of the preceding factors. In our case the finding should be negative, so there is no need to consider the diversification test.

Accordingly, the Russian gas subsidy does not appear to meet the *de facto* specificity test in Article 2.1(c) of the SCM Agreement.

5. Concluding remarks

The undertaken analysis of the Russian gas pricing system under the WTO rules on subsidies demonstrated that the provision, through governmental involvement, of gas at a less than adequate remuneration constitutes a subsidy as defined in Article 1.1 of the SCM Agreement. However, the analysis also demonstrated that this subsidy is neither prohibited nor actionable under the applicable WTO disciplines. Even if it were actionable, this would not give the WTO Members a legal ground to demand its phase-out, because actionable subsidies, though subject to the possible countervailing measures, are not prohibited in the WTO as such.

Thus, the demand to phase out the gas pricing system does not seem to have sufficient legal foundation and, probably, has been made in the context of the Russia's accession process, because the affected WTO Members have realized that it would be difficult to deal with the system through the regular dispute settlement procedures. This conclusion is further supported by the terms of the agreement reached, after several years of struggle, between Russia and the European Union, which does not require either the equation between the domestic and export gas prices or the withdrawal of the Government from the price regulation. If the approach of the EU–Russia agreement finds support of other WTO Members and will not be substantially changed in Russia's WTO accession protocol, this will mean that Russia will rightly succeed in preserving its important comparative advantage.