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**INTERNATIONAL TRADE & CUSTOMS:  
REVIEW OF RECENT DEVELOPMENTS**

*On a periodic basis, Thompson Hine's International Trade & Customs group issues bulletins to clients and friends of the firm on new developments affecting their international trade activities. To augment these bulletins, we are providing a series of in-depth reports that will chronicle and explore recent key issues of a specific area of international trade law. The following is a roundup of developments affecting climate change policy, both at home and abroad.*

**Climate Change Policies to Affect Conduct of Business Worldwide**

In recent years, the policy arguments about climate change have shifted from questions about its validity to proposals over the best economically sustainable solutions for it. International trade and climate change issues are increasingly converging as climate change becomes a key issue for policy-makers worldwide. In the near future, companies can expect to conduct business under a new set of expectations and rules.

**U.S. CLIMATE CHANGE LEGISLATION**

In a significant switch from the previous Congresses, the Democratic Party leadership placed climate change legislation high on its list of priorities for the most recent session. An unprecedented number of bills were presented to combat climate change and achieve U.S. energy independence. As of July 2008, lawmakers had introduced more than 235 bills, resolutions and amendments specifically addressing global climate change and greenhouse gas (GHG) emissions – compared with only 106 pieces of legislation the entire previous Congressional session. Invariably, these proposals would have an impact on international trade in goods and services, from emissions permit trading systems to financial incentives for renewable sources of energy.

While it appears that no legislation will be finalized until the 2009 Congressional session, the convergence of the climate change and trade agendas in the U.S. has been particularly evident in two policies driving all of these proposals:

- A desired reduction in U.S. carbon emissions through a cap-and-trade regime and/or a tax on carbon; and
- An increase in the production and use of alternative fuels.

Under a cap-and-trade system, companies are issued permits for their emissions of carbon dioxide and other GHGs and then allowed to buy and sell their excess or deficit emissions with one another through a newly created carbon market in order to achieve reductions at the lowest possible cost. Proponents of the cap-and-trade system believe it has several advantages over the carbon tax:



- It yields more certainty in the environmental outcome than the carbon tax because it includes specific caps on GHGs;
- It is more politically sustainable over the long term because emissions permits can be banked from one year to the next, ensuring that companies have a vested stake in the continuity of the program; and
- It is more flexible than a carbon tax by incorporating various features to accommodate for changes in technology and other factors.

By comparison, a carbon tax is a fee placed on each ton of carbon dioxide emitted from fossil fuels. Its supporters cite several factors that they believe make a carbon tax a more attractive alternative to cap-and-trade:

- It is a substantial new revenue stream for the government that can be used to spur research and development of renewable energy;
- The price of emissions is more predictable long term than a cap-and-trade system with potential price volatility; and
- The tax is relatively easier to administer than a cap-and-trade system, which would need to create a new administrative infrastructure – a carbon market.

The most high-profile bill addressing these policies so far has been the Lieberman-Warner Climate Security Act of 2008 (*i.e.*, S. 3036). Viewed as a pilot bill to coax Congress to conduct hearings and debates on climate change policy, the Lieberman-Warner legislation proposed an economy-wide cap-and-trade program to reduce GHG emissions in the U.S. Key provisions of the bill sought to ensure that imports of energy-intensive products do not enter U.S. commerce without GHG regulation. If such imports were not regulated by their country of origin, importers of the product would be required to accompany their entries with certificates demonstrating the purchase of a requisite quantity of carbon credits.

The Lieberman-Warner proposal was the first climate change bill to be approved by a Congressional committee – the U.S. Senate Environment and Public Works Committee – by a vote of 11 to eight. The bill, however, failed this past June after less than a week of Senate floor debate – a debate that sidestepped any substantive discussion and consisted instead of procedural motions that stymied its progress.

It is generally assumed that any national climate change legislation passed by the next Congress would bear some similarities to the Lieberman-Warner bill; however, both the fallout from the financial crisis and the proper approach to adopt – a cap-and-trade system, carbon tax or a combination of the two – will continue to generate debate in 2009.



## **FUTURE EU CARBON TARIFF**

On January 23, 2008, the European Commission published a draft law aimed at energy sector reform and GHG emissions reduction, stepping back from its original proposal that included a carbon tariff on energy-intensive imports. The current proposal includes no carbon tariff but would require the EU to revisit this issue by 2011.

One of the key components of the draft legislation is strengthening and expanding the Emissions Trading System (ETS) by which participating companies in the EU can buy or sell carbon emission allowances. The legislation proposes transitioning to an auction-based system from 2013 to 2020 whereby companies will be required to buy all allowances for emissions that exceed quotas. So far, the great majority of allowances has been allocated free of charge to EU companies. The scope of the ETS has also been broadened beyond carbon to include emissions of perfluorocarbons and nitrous oxide.

In addition, the proposal considers potential exposure of the EU's energy-intensive industries to competition from countries that fail to implement comparable emissions legislation. According to the proposal, the EU will consider by 2011 two options designed to minimize potential loss of market share for its energy-intensive industries:

- Granting emission allowances free of charge to EU industries that are particularly exposed to global competition; or
- Imposing an emissions tariff on energy-intensive imports from countries that lack comparable climate change measures.

Whether either of these options is adopted will be of concern to U.S. energy-intensive industries, including aluminum, chemicals, cement, glass, metal casting, steel, petroleum, coal, paper and wood. How these industries are affected may ultimately depend on the several U.S. climate change bills previously mentioned that are currently under consideration in the U.S. Congress. If any become law, the EU would have to determine whether emission tariffs on those U.S. imports would be necessary. This would mean, however, that U.S. industries could be faced with the burden of paying for emissions one way or the other – either at home or in the EU.

Given the significant effect the EU climate and energy proposal will have on the European market and beyond, U.S. energy-intensive businesses will want to consider this proposal in the context of their own export targets and pending U.S. climate change legislation.



## MULTILATERAL NEGOTIATIONS

### *Bali Climate Summit*

At a December 2007 climate change conference in Bali, Indonesia, sponsored by the United Nations and organized under the UN Framework Convention on Climate Change, delegates from more than 187 countries agreed to a roadmap for establishing negotiations on a new global warming pact to be finalized by 2009. The pact would replace the current Kyoto Protocol, the multinational treaty binding countries to cut their emissions, which expires in 2012.

During the Bali summit, debate centered on two questions: how to define emissions reduction targets for developed nations and how to identify specific obligations for poorer countries. At the end, no clear binding targets were set – the U.S. made it known that it would not accept them – but developed countries pledged to consider specific objectives to mitigate climate change, including quantified emission reductions, and the agreement provided for a timetable to negotiate targets in 2009. Developing countries, including China and India, agreed to take actions to curb emissions and consider mitigation measures, without any mention of set targets, but also made it known that they regard economic progress as more important than carbon mitigation.

The breakthrough achieved in Bali is considered a significant development because the U.S. before the Bali summit was not willing to even begin serious discussions on a replacement for the Kyoto Protocol. While the Bali roadmap does not set specific obligations, it does not let countries off the hook either. It challenges all governments to confront the issue of climate change and establishes for the first time a path to comprehensive negotiations of post-Kyoto commitments.

The Bali roadmap was adopted after the U.S. delegation dropped its opposition to a proposal by the main developing nation bloc, the G-77, for increased developed nation support to fight rising GHG emissions in the developing world. Under this compromise, developing countries would commit to curbs on the growth of their emissions, for which they might receive financial incentives, rather than accept obligations to make absolute cuts in their GHG output. When such incentives are implemented, they may present potential opportunities for U.S. companies to export clean technologies and related services to developing countries.

The outcome of the Bali summit also presents opportunities for discussions on global sectoral agreements to tackle climate change. For instance, energy-intensive industries, such as the steel and paper industries, can work together on sectoral agreements befitting their particular needs, delivering GHG reductions and effectively stopping companies in those industries from relocating to countries with lower or no emissions requirements. Without such agreements in place, companies and even entire industries may be more inclined to move their facilities.

The 2009 deadline to draft a new treaty is intended to allow ratification by 2012. The next climate summit is scheduled for December 2008 in Poznan, Poland.



Continuing UN climate change discussions will be made more difficult by any further setbacks in the ongoing Doha Development Agenda negotiations of the World Trade Organization (WTO), which would exacerbate tensions between developed and developing countries. It is expected that the UN climate change negotiations will collapse in the same way the Doha trade talks have so far if China and India do not agree to proposed emissions targets.

### *Doha Negotiations*

The July 2008 collapse of the latest round of the WTO Doha negotiations – largely due to the failure of the U.S., India and China to agree on how to protect farmers from surges in agricultural imports – obscured the progress achieved beforehand by the Office of the U.S. Trade Representative (USTR) and the EU on a proposal to increase global trade in and use of environmental goods and services. The initiative, the Environmental Goods and Services Agreement (EGSA), is designed to promote technologies that address climate change and energy security.

The proposal would attempt to eliminate tariff and non-tariff barriers to environmental technologies and services<sup>1</sup> through a two-tiered approach:

- An agreement to eliminate tariffs worldwide on certain climate-friendly technologies recently identified by the World Bank; and
- A deeper commitment by developed and the most advanced developing countries to eliminate trade barriers against a broader range of other environmental technologies and environment-friendly services.

This proposal has already received some criticism, notably from developing countries like Brazil and India. This is largely because the proposal favors the U.S., which produces and exports many of the listed environmentally friendly goods; developing countries, in contrast, produce “low-tech” environmental goods like biofuels and organic crops that are not on the list. Brazil would like the proposal to include biofuels, which face high import tariffs in the U.S. India objected to the EGSA’s reliance on a list and instead proposed that environmental goods be defined according to individual environmental projects. India’s proposal would include a requirement that countries must notify the WTO’s Committee on Trade and Environment in advance of a project. This notification would identify which environmental goods and services the country deems necessary for the project.

While the Doha negotiations have been put on hold for now, the EGSA proposal may serve as the impetus to revive the talks since it focuses on a key sector with broad interest among WTO members. Alternatively, the EGSA proposal may sustain enough of its own momentum to be considered as a stand-alone agreement. In late summer, the National Association of Manufacturers (NAM) announced that it was seeking to form a coalition to back EGSA at the WTO and would be

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<sup>1</sup> These include air pollution and climate control services, technical testing and analysis, energy-related services, and architecture and construction services for energy-efficient buildings.



soliciting all major U.S. business groups and their counterparts in Canada, the EU, Japan, Korea, Australia, New Zealand, Brazil and India to reach a consensus on the mix of products the EGSA should cover.

### **LOOMING ETHANOL TRADE WAR**

In recent months, the production of ethanol for use as a biofuel has received increased attention worldwide as countries seek to diversify their sources of energy. In the U.S., corn ethanol production has been hailed by supporters as a viable alternative fuel source, while critics have linked it to rising food prices. Abroad, Brazil has threatened to file a WTO case largely in response to a new U.S. law – the Food, Conservation and Energy Act of 2008, also known as the 2007 Farm Bill – that continued tariffs on ethanol imports but markedly reduced fuel-blending subsidies to U.S. ethanol blenders. Brazil claims that the difference between the ethanol import tariffs and the lower blending subsidy will create distortive trade effects that will increase the use of domestic ethanol over imported ethanol.

For years, U.S. ethanol blenders have received a blending credit of 51 cents per gallon. This credit applied whether the blend used domestic or imported ethanol. To protect U.S. producers of corn-based ethanol from international competitors shipping cheaper sugar cane-based ethanol, a tariff of 54 cents per gallon was introduced in 1980 on imported ethanol. The tariff served to offset any benefit from blending imported ethanol.

U.S. importers have been able to avoid the tariff to some extent by sourcing sugar cane ethanol from countries in the Caribbean. Under the Caribbean Basin Initiative (CBI), ethanol can be imported duty-free if it is produced from sugar cane grown in CBI beneficiary countries. Further, up to 7 percent of the U.S. market can be supplied duty-free by CBI-sourced ethanol containing no locally grown sugar cane. This resulted in the shipments of hydrous (“wet”) ethanol produced in other countries, historically Brazil or EU countries, for dehydration in CBI-based facilities and subsequent importation duty-free into the U.S., up to the 7 percent quota. Historically, the CBI ethanol quota has never reached its cap.

Until the passage of the 2007 Farm Bill, importers and refiners also relied on a unique “duty drawback” provision to minimize the impact of the ethanol tariff. Drawback entitles companies to claim refunds of import duties on raw materials and components used in the production of finished goods that are then exported. The exportation must be of the imported merchandise, merchandise commercially interchangeable with the imported merchandise, articles produced with the imported merchandise or articles produced with merchandise that is the same kind and quality as the imported merchandise. In other words, drawback is permitted even if the imported merchandise is not actually used in the production of the exported goods – the imported and exported merchandise



simply need to be commercially interchangeable substitutes, which meant that the export of other kinds of fuel would be eligible for drawback of duties paid on imported biofuels.<sup>2</sup>

These elements remained unchanged until passage in late spring of the 2007 U.S. Farm Bill. The new law increases spending on various U.S. food programs and encourages the production of advanced biofuels, such as corn-based ethanol; the 2007 Farm Bill, however, also cuts the ethanol blending credit to 45 cents per gallon once production reaches 7.5 billion gallons in the U.S. (estimated for 2010), while extending the import tariff until December 31, 2010. Further, the law eliminates duty drawback on re-exports that do not contain ethanol. These changes are likely to restrict U.S. imports of ethanol and increase the significance and the use of the CBI duty exemption.

For major sugar cane ethanol exporters such as Brazil, the 2007 Farm Bill has been particularly troubling. Generally, a decrease in a domestic production credit or subsidy is welcomed by foreign producers because it makes their same or similar product more competitive in that market; Brazil claims, however, that the reduction in the U.S. ethanol blending credit – without a commensurate reduction in the tariff – will hurt Brazilian producers because it will make the price of imported ethanol (*e.g.*, Brazilian sugar cane ethanol) less attractive than that of domestically produced corn-based ethanol because the 45-cent credit will be inadequate to cover the 54-cent tariff. As such, U.S. blenders are more likely to choose domestic corn-based ethanol over Brazilian sugar cane ethanol. (As the leading global ethanol producer, Brazil is more vocal in its criticism than other trading partners.)

In response, Brazil has announced plans to file an ethanol-specific case at the WTO against the U.S. based on what Brazil perceives to be these trade-distorting provisions of the 2007 Farm Bill. It will argue that the reduction in the blending credit places U.S. production in a better competitive position in the U.S. market than production from WTO member states, a clear violation of the WTO national treatment provisions.

Not surprisingly, the ethanol tariff has been solidly backed by the U.S. ethanol industry and defended by members of Congress from ethanol-producing states. Sen. Charles Grassley, R-Iowa, in an August letter to U.S. Trade Representative Susan Schwab, stated that the U.S. is expressly allowed under the WTO rules to impose this tariff per Schedule XX – United States of America, annexed to the Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994, as a permitted “other duty or charge.” Sen. Grassley did not specifically address the gap between the tariff and the reduced blending credit but defended the tariff on the grounds that Brazil has not taken full advantage of the duty-free access available for ethanol through the CBI duty-free quota.

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<sup>2</sup> For example, jet fuel was a perfect petroleum commodity for U.S. refiners to use to obtain the ethanol duty drawback because it is commercially interchangeable with gasoline based on its HTS classification. For drawback, jet fuel was deemed to be exported by merely filling the fuel tanks of an aircraft in the U.S. destined for an international route. Drawback allowed refiners and others importing ethanol to recoup the paid tariff if they exported jet fuel within three years of importing the ethanol.



Despite Sen. Grassley's defense, the pressure to eliminate or reduce the ethanol tariff has been mounting in Congress. Sens. Dianne Feinstein, D-Calif., and Judd Gregg, R-N.H., introduced the Imported Ethanol Parity Act (S. 3080), which would lower the 54-cent tariff to a level at or below the blender credit. The bill, which has 12 co-sponsors, has stalled, however, in the Senate Finance Committee because Sen. Grassley, the committee's ranking Republican, opposes it.

Brazil is expected to press for the tariff's removal during the final months of the Bush administration. President-elect Barack Obama has indicated that he will support both the credit and the tariff; however, the biggest impact on the tariff may come from the U.S. market itself. The U.S. auto industry has made a commitment to make half its cars and trucks capable of running on alternative fuels by 2012 if enough E85 (fuel blend containing up to 85 percent ethanol) is available on the market. This pledge may become a requirement if the Open Fuel Standards Act<sup>3</sup> (OFS) is approved by the new Congress and signed into law by President-elect Obama. The OFS would require an increase in flex-fuel vehicle production, which would significantly increase domestic ethanol consumption to a level where the 54 percent tariff would need to be reduced or dropped. The movement toward flex-fuel vehicles has not gone unnoticed by U.S. ethanol producers. Archer Daniels Midland (ADM), a large corn-based ethanol producer, recently announced that it has entered a joint venture for the construction of two sugar cane ethanol plants in Brazil. This venture by ADM may signal a wane in support for the tariff as more U.S. producers will become motivated to invest in sugar cane ethanol production abroad to meet growing demand.

#### FOR MORE INFORMATION

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<sup>3</sup> Senate bill S.3303. Co-sponsors: Sens. Sam Brownback (R-Kan.), Ken Salazar (D-Colo.), Joseph Lieberman (Ind-Conn.), Susan Collins (R-Maine) and John Thune (R-S.D.). House bill H.R. 6559. Co-sponsors: Reps. Eliot Engel (D-N.J.), Jack Kingston (R-Ga.), Steve Israel (D-N.Y.) and Bob Inglis (R-S.C.). The OFS requires that starting in 2012, 50 percent of new automobiles, and starting in 2015, 80 percent of new automobiles, be flex-fuel vehicles warranted to operate on gasoline, ethanol and methanol, or on biodiesel.