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## What's In Store For Ethanol Trade?

*Law360, New York (September 24, 2009)* -- It was only last summer that ethanol was a central focus of news stories and debates in the halls of Washington. With gasoline prices hovering around \$5 per gallon, ethanol was being hailed both as a savior and a curse. To its supporters, U.S. corn ethanol offered a viable alternative fuel source, while critics linked it to rising food prices.

In the fall of 2008, an impending ethanol trade war seemed inevitable. But by spring of 2009, those heady days seemed long gone as the recession hit the ethanol industry hard. Large producers reported decreased profitability and production due to sinking gasoline prices, decline in demand and plant closings.

While the economic slowdown may have deflated some of the enthusiasm, perhaps bringing about more realistic expectations, the ethanol industry has seen signs of resurgence.

The Renewable Fuels Association reports June U.S. ethanol production has increased by 109,000 barrels a day from the same time last year. Yet while the domestic industry may be experiencing recent growth, what effect will ethanol trade have on this recovery?

The U.S. ethanol industry has maintained a steady and secure position in the domestic market. 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 on imported ethanol was introduced in 1980. The tariff served to "offset" the domestic blending credit, thereby preventing imported ethanol from benefiting from domestic subsidies.

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, partially due to insufficient CBI capacity.

Importers and refiners also relied on duty drawback 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 or on exports of merchandise that is commercially interchangeable with the import.

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 tariff 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. The drawback provision allowed refiners and others importing ethanol to recoup the tariff paid if they exported jet fuel within three years of importing the ethanol.

These elements remained unchanged until the passage of last year’s Farm Bill. The bill 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 54-cent-per-gallon import tariff until Dec. 31, 2010.

This disparity means that an ethanol importer now pays more tariff than he gets back in subsidy. The Farm Bill also eliminated 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 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.

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, and recently also by the Obama administration.

In July, Secretary of State Hillary Rodham Clinton and U.S. Trade Representative Ron Kirk affirmed the administration's support of the tariff.

In response, Brazil announced its plans to file an ethanol-specific case at the World Trade Organization against the U.S. based on what Brazil perceives to be these trade-distorting provisions of the Farm Bill.

Its rationale is 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, which would make it a violation of the WTO national treatment provisions.

A position taken by Sen. Charles Grassley, R-Iowa, a key supporter of the tariff, is 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 has not specifically addressed the gap between the tariff and the reduced blending credit but has also 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.

If Brazil proceeds with its case against the U.S. ethanol tariff at the WTO, it would have significant ramifications for the energy industries in both countries.

Should the U.S. defense of the tariff hold up, the U.S. and the European Union would be encouraged in their efforts to block Brazil's attempt to secure duty-free access for its ethanol as an “environmental good” to all WTO member markets under the framework of the Doha Development Round.

On the other hand, a win for Brazil would give it unfettered access to the U.S., its largest ethanol export market, and possibly prompt the EU to lower its own biofuel barriers, opening another large market.

Regardless of these implications, timing of such a case is also important. The domestic ethanol industry employs more than 200,000 workers, many in the economically weakened Midwest.

Increased competition to the industry would be perceived as a threat to those jobs and would induce a strong defense from the Obama administration and Congress given the recessionary conditions and congressional pressure to revoke Brazil's eligibility under the Generalised System of Preferences.

From Brazil's perspective, an open U.S. market would almost certainly benefit its ethanol producers, but may adversely affect Brazil's consumers as domestic supply is diverted and prices increase.

Finally, market forces may naturally lead to a more open U.S. market for imported ethanol.

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 (OFS) is approved by Congress and signed into law by President Obama.

The OFS would require an increase in the production of flex-fuel vehicles, thereby significantly increasing the domestic consumption of ethanol to a point where the 54 percent tariff would need to be reduced or dropped.

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