Renewable Fuels Association

THE IMPORTANCE OF PRESERVING THE SECONDARY TARIFF ON ETHANOL

I. Introduction

Ethanol is a renewable fuel produced from biomass, primarily corn. Ethanol's primary use in the U.S. is as an additive in gasoline, and today, nearly 70 percent of all gasoline in the United States is blended with ethanol. Ethanol serves as an octane booster to prevent early ignition, as an extender of gasoline, and as an oxygenate to promote more complete combustion of gasoline and to prevent air pollution from carbon monoxide and ozone.

Domestic ethanol production has numerous benefits including reducing the demand for imports, stimulating job growth in the United States, reducing air pollution, and decreasing farm program costs to the federal government. Farmer-owned ethanol plants comprise 40 percent of the ethanol industry. While 75 percent of ethanol production takes place in Illinois, Iowa, Nebraska, Minnesota, South Dakota and Indiana, the industry consists of over 140 biorefineries operating in 21 states and more growth is on the way.

The ethanol industry is single-handedly responsible for creating over 235,800 new jobs. In 2007 alone, the industry increased household income by $12.3 billion, generated $8.2 billion in federal, state and local tax revenue, and lowered federal program costs by $6-8 billion.

Imported ethanol is currently subject to two duties in the United States: (1) a 2.5% ad valorem tax, and (2) a secondary tariff of 54 cents a gallon (or 14.27 cents a liter). Although Brazil would like to see the U.S. secondary tariff eliminated, the secondary tariff is a key component of U.S. energy policy that must be preserved.

II. U.S. Ethanol Program

The secondary ethanol tariff is pivotal to longstanding U.S. energy and national security policy goals that were first established in the 1970s. After the Arab oil embargoes, the United States realized the strategic importance of decreasing dependence on foreign oil. Since then, it has sought to create a reliable domestic source of renewable fuel, and domestic ethanol production is a key part of this effort. Because U.S. national security is linked to having a

domestic energy supply Congress provided tax incentives to develop the domestic ethanol industry. These tax incentives have resulted in domestic ethanol production increasing from only 175 million gallons in 1980 to nearly 9 billion gallons this year.

Over the past two decades, Congress has repeatedly reaffirmed the need for economical alternative energy sources like ethanol. With the passage of the Energy Policy Acto of 2005 and the Energy Independence and Security Act of 2007, Congress has broadly expanded the use of ethanol in gasoline and created a Renewable Fuel Standard (RFS) that calls for significant increases in production levels for ethanol; 36 billion gallons by 2022. By establishing policies to support the continued growth of the ethanol industry, Congress has shown its commitment to ethanol as a means of reducing foreign oil dependence and boosting U.S. energy security.

Because Congress explicitly established the secondary tariff on ethanol to support the ethanol tax credit, unraveling the ethanol secondary tariff would effectively undo the entire U.S. ethanol program. In 1978, Congress partially exempted motor fuels blended with ethanol from the federal excise tax on gasoline as part of the Energy Tax Act of 1978. *See* Energy Tax Act of 1978, Pub. L. No. 95-618. In lieu of the partial exemption from the excise tax, a tax credit for ethanol could also be claimed. *See* Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223. Currently, all ethanol in the United States, both domestically produced and imported, receives a tax credit of 51 cents per gallon.[1] This tax credit, which will be available until December 31, 2010, was recently reduced under the Food, Conservation and Energy Act of 2008 to 45 cents for 2009, and thereafter. *See* Food, Conservation and Energy Act of 2008, Pub. L. No. 110-123. Imported ethanol receives the benefit of the tax credit due to an Internal Revenue Service ruling that the tax incentives applied to *all* ethanol. The IRS ruling effectively eliminated the special support that Congress provided to develop the *domestic* ethanol industry.

Congress reacted to the IRS ruling by amending the U.S. tariff schedule in 1980 to include an additional duty on ethanol. *See* Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499. Congress imposed the secondary tariff on ethanol to negate the benefit of the tax credit for imported ethanol and reestablish support for the domestic industry. *See* Cong. Rec. S19181 (daily ed. July 23, 1980) (statement of Sen. Hollings) ("This duty increase [for ethanol] would offset what amounts to a 40 cents per gallon subsidy now available to imported alcohol as a result of the excise tax exemption and the 40-cent tax credit").[2] The additional duty was not created as a barrier to entry, but to promote the domestic ethanol industry and strengthen national security. *See id.* (the tariff "would encourage U.S. alcohol production for fuel, aiding U.S.

[1] In 2004, Congress eliminated the partial exemption from the excise tax for ethanol. The tax credit, which was formerly 54 cents, was reduced to 51 cents per gallon. The tax credit has been further reduced to 45 cents per gallon for 2009, and thereafter, as part of the 2008 Farm Bill. The tax credit is taken by gasoline producers and marketers. It is not taken by ethanol producers.
[2] The duty has since been increased to 54 cents per gallon.

national security"). Therefore, the secondary tariff on ethanol simply counterbalances the tax credit for ethanol – a tax credit that is funded by U.S. taxpayers.

Renewable fuels are produced only in countries where programs have been created to assist in their production. Thus, any reduction in the U.S. secondary tariff on ethanol would result in U.S. taxpayers further subsidizing imported ethanol beyond the subsidies that are already being given in the country of production. U.S. taxpayers should not be required to subsidize imported ethanol because it is counter to the purpose and many benefits of the U.S. ethanol program – to foster the domestic production of a renewable fuel.

The U.S. market already allows for the importation of ethanol because at times when U.S. demand for ethanol has outpaced U.S. supply, ethanol is imported to meet the demand.

In 2007, U.S. domestic consumption of ethanol was approximately 6.91 billion gallons, while domestic production was only about 6.49 billion gallons. Thus, in 2007, approximately 426 million gallons of ethanol were imported to meet domestic demand, of which 189 million gallons came from Brazil.

Many other countries, including Brazil and EU Member States, have domestic biofuel support programs that include tax incentives. The existence of these programs demonstrates that, like the United States, other countries believe that the development of a domestic renewable fuel industry is an important policy goal. Brazil should not be allowed to force the U.S. ethanol program to be summarily dismantled while other programs are left intact. The EU may serve as a strategic ally in efforts to preserve the U.S. ethanol tariff because it has an interest in maintaining its own programs to develop its own industry. If the U.S. secondary tariff is eliminated, EU biofuel programs may be next on the chopping block. Details of the EU Member States biofuel programs, as well as those other countries, are provided below.

The ad valorem ethanol tariff in the United States is much lower than other countries. The U.S. 2.5% ad valorem tax equates to about 5.6 cents per gallon at ethanol's current wholesale price per gallon of $2.25. In contrast, the Canadian ad valorem ethanol tariff is 19 cents per gallon, Brazil's ad valorem tariff is 25 cents per gallon of ethanol, the European Union's ad valorem ethanol tariff is 65 cents per gallon, and in Japan, the ad valorem ethanol tariff is $1.35 per gallon.

III. Biofuel Programs in Other Countries

A. Brazil

Brazil, the world's largest ethanol producer and consumer, has had an ethanol program in place since the oil crises of the 1970s. Its program includes various incentives to support the domestic industry, such as tax and loan incentives to build ethanol facilities. Today, Brazil retains a blending requirement that all gasoline used in the country contain a minimum of 25%

anhydrous alcohol, such as ethanol. Diesel-powered personal vehicles are also banned in Brazil to boost the demand for ethanol powered vehicles, and government entities are required to purchase 100% hydrated alcohol fueled vehicles. Brazil's tax regime favors ethanol over gasoline, and it has a protective 20% ad valorem tariff on ethanol, among other programs to support the domestic industry.

B. The European Union

The EU has a specific directive intended to promote the use of biofuels and other renewable fuels. *See* Directive 2003/30/EC of the European Parliament and of the Council of 8 May 2003, on the promotion of the use of biofuels and other renewable fuels for transport. Pursuant to this directive, Member States must have a minimum proportion of biofuels and other renewable fuels on the market. The percentage of renewable fuels should increase 0.75% points annually, until it reaches the target of 5.75% in 2010. To achieve this objective, EU Member States may grant exemptions from the gasoline tax as long as these exemptions do not lead to an overcompensation of the difference in production costs relative to conventional fuels. *See* Council Directive 2003/96/EC of 27 Oct. 2003, restructuring the Community framework for the taxation of energy products and electricity. Art. 16.

1. EU Country Specific Programs

- Germany: The Biofuel Quota Act entered into force on 1 January 2007. It replaced the exemption from petroleum tax for biofuels with a legally prescribed minimum percentage (quota) of biofuels. A degressive tax incentive will be retained for a transitional period until the end of 2011 for pure vegetable oil and pure biodiesel outside the quota. Second-generation biofuels, biogas and pure bioethanol (E85) are granted a degressive tax incentive until 2015, having regard to the overcompensation arrangement. No tax is currently levied on such fuels.

- United Kingdom: The UK subsidizes both biodiesel and bioethanol. The subsidy amounts to 20 pence per liter of biodiesel or biofuel, which is the equivalent of approximately 15 cents or €.10 per liter. The subsidies will remain in place until at least 2010.

- France: Biodiesel and bio-ETBE are partially exempt from taxation. The amount of the exemption is adjusted each year. Bioethanol directly blended in gasoline is also partially exempt from taxes. The tax exemptions are subject to quotas, which are adjusted each year. In 2008, the quotas were 2,478,000 tons for biodiesel, 224,000 tons of bio-ETBE, and 717,000 tons of bioethanol. Per liter, France's exemption for biodiesel blends is worth up to €.25 or 37 cents and for ethanol it is worth up to €.33 or 49 cents.

- Austria: Pure biofuels are exempt from the mineral oil tax. For blends reaching certain targeted levels, Austria provides a refund of €.442 of the mineral oil duty for each liter of blended bioethanol.

- Spain: Biofuels are subject to a zero tariff. When biofuels are blended with other products, the zero tariff rate applies only to the volume of biofuel included in the blend. For biodiesel, the tax exemption is worth up to €.29 per liter or 43 cents.

- Czech Republic: Support for rapeseed methyl ester (RME) was discontinued December 31, 2006. Government Resolution No 1080 of 20 September 2006 provides for a minimum quantity of biofuels in the full range of motor-vehicle fuels without any subsidies or support from the state.

- Poland: Incentives in the form of exemptions from excise duty for fuels containing biocomponents, which were in effect from 1 May 2004 were reduced in order to bring national regulations into line with European Union law and resulted in weakening the support mechanism for biocomponents added to diesel (by reducing the level of exemption from excise duty for liquid fuels containing biocomponents and for liquid biofuels). Since 1 May 2007, the following rates apply: 1) For petrol products containing over 2% of biocomponents, the excise duty charged on the petrol (1,565 PLN/1000 liters) shall be reduced by 1.565 PLN (70 cents) for each liter of biocomponents added to the petrol, subject to the minimum excise duty payable being 10.00 PLN/1000 liters; 2) For products diesel blended with over 2% biocomponents, the excise duty charged on the diesel (1,048 PLN/1000 liters) shall be reduced by 1.048 PLN (47 cents) for each liter of biocomponents added to the diesel, subject to the minimum excise duty payable being 10.00 PLN/1000 liters; and 3) For biocomponents used as direct fuel in internal combustion engines the rate shall be 10 PLN($4.46)/1000 liters.

- Italy: Italy provides tax relief for ethanol. Per liter, the exemption for biodiesel blends is worth up to €.41 or 60 cents. Italy imposes a quota on the amount of biofuel eligible for tax relief. As part of an experimental program to encourage the use of ethanol, Italy provides for reduced rates of excise duty on bioethanol and products derived therefrom used as a fuel, whether alone or blended, up to a ceiling total of 73 million Euros.

- Portugal: Portugal provides a lower excise duty rate for fuel products containing at least 4.4% biofuels.

- Hungary: Hungary provides a lower excise duty rate for fuel products containing at least 4.4% biofuels.

- Lithuania: Lithuania exempts dehydrated ethanol from excise duties for use in the production of biofuels.

- Estonia: Estonia exempts biofuels used as motor fuel or heating fuel from its excise tax.

- Sweden: Sweden exempts biobased ethanol from both the carbon dioxide tax and the energy tax until 2009 if used as a motor fuel.

- Finland: Biogas used as a transport fuel is exempt from taxes. In 2007, Finland launched a new program to promote the development of second generation biofuels. The program will run through 2012 and it has a total budget of EUR 146 million. The program's specific objective is to significantly promote the development of second-generation biofuel production technology. The funding is being used to launch a special Tekes/Ministry of Trade and Industry development program, the main thrust of which involves new technology pilot and demonstration projects.

- Denmark: Denmark exempts biofuels from the carbon dioxide tax applied to ordinary petrol and diesel for transport.

- The Netherlands: Since 2006, the Netherlands has provided a reduction in excise duty to encourage the blending of a 2% biofuel component (bio-ethanol, bio-ETBE or biodiesel). For ethanol use, the reduction in excise duty amounted to €10.10 ($14.82) per 1000 liters. For biodiesel, the reduction in excise duty amounted to €6.10 ($8.95) per 1000 liters. For both ethanol and biodiesel, if less than 2% biofuel was added the reduction was lowered proportionately.

- Ireland: Ireland provides an excise tax relief program for biofuels, valued at over €200m. The scheme is being rolled out over a five-year period to 2010. For 2007, the excise relief on ethanol was valued at €.443 (65 cents) per liter up to 67,000 tons and for biodiesel, the exemption is valued at €.368 (54 cents) up to 52,800 tons.

- Greece: Greece provides an excise tax exemption for biodiesel. In 2007 the excise tax exemption was valued at €.26 (38 cents) per liter.

- Latvia: Latvia applies a reduced rate of excise duty depending on the biofuel content of the fuel/blend. For ethanol blends containing 5% by volume of dehydrated ethanol, the excise tax rate is reduced by 10 LVL (or €14.2) per 1000 liters. E85 blends receive a reduction of 177.5 LVL (or €253) per 1000 liters. Diesel blends with at least 30 % by volume of biofuels have an excise tax reduction of LVL 53 (or €75.6) per 1000 liters. Excise duties are eliminated on biodiesel completely derived from rapeseed oil.

- Cyprus: Cyprus offers excise tax reductions/eliminations for biofuels, but the rates are not known.

C. *Other Countries*

Canada and several South and Central American countries are increasing their ethanol production capacity. Canada has not taxed ethanol since 1992. Argentina has instituted an ethanol program requiring the use of 5% ethanol blends in the next five years, and it intends to provide tax breaks to biofuel producers. Asian countries having a growing focus on ethanol production as well. For instance, Thailand now requires that gasoline in Bangkok be blended with 10% ethanol, and it has created a support program to assist agricultural producers turn crops into ethanol. India has adopted a 5% ethanol requirement in all gasoline and has also created an ethanol program structured similarly to Brazil's program.