

Governments must act to boost trade in biofuels

World Trade Organisation rules covering biofuels and feedstocks need updating, say **Jennifer Haverkamp and Leslie Parker**

High energy prices, concerns about climate change and air quality and energy security worries are all contributing to major growth in interest in biofuels. The result is steep increases in investment in biofuels around the world, partially because of considerable government support, major commitments to growing biofuel feedstock crops, including oil palm plantations, large new subsidy and mandate commitments in developed nations and government-supported biofuels programmes in the least developed countries, particularly in Africa.

Although most biofuels and feedstocks are currently produced and consumed in domestic markets, there is enormous potential for international trade. Despite valid concerns about the environmental and food security implications of biofuels, such trade, if done right, could generate significant economic, environmental and social benefits.

Uncertainty over biofuel classifications and government measures to protect domestic production – including tax incentives, high tariffs and subsidies – risks stunting growth in trade even as the global demand for biofuels rises. A web of separate technical and environmental standards also risks interfering with the potential for greater trade.

Therefore, the time has come for an examination of how World Trade Organisation (WTO) rules apply to this emerging market.

WHY CREATE AN INTERNATIONAL MARKET?

It is likely that domestic production of biofuels in the US and the European Union (EU) will remain constrained by high costs and limited availability of suitable agricultural land and, as a consequence, trade in biofuels and biofuel feedstocks is likely to increase. Other countries may also look for suppliers beyond their borders – because of limits on domestic supplies, cost pressures or environmental considerations.

Furthermore, the countries where biofuels can be produced most easily and cheaply and the countries with the greatest potential demand for biofuels are not one and the same. Tropical and sub-tropical developing nations have a comparative advantage in producing biofuels due to their long or year-round growing seasons, large areas of available arable land and low labour costs. Also, the production of ethanol from sugar cane is significantly more energy efficient and more environmentally sustainable than using maize as the feedstock.

As Peter Mandelson, the EU trade commissioner, told a conference on biofuels in July organised by the EU's executive arm, the European Commission: "We should certainly not

contemplate favouring EU production of biofuels with a weak carbon performance if we can import cheaper, cleaner, biofuels. Resource nationalism doesn't serve us particularly well in other areas of energy policy – biofuels are no different." (*Bioenergy Business* July/August 2007 page 14)

Developing countries sense that there are substantial opportunities for exports. For example, Malaysia, Thailand and Indonesia are planting large areas of oil palms, the Philippines is expanding coconut oil production and India wants to produce significant quantities of biodiesel from jatropha and other crops. Thailand has also been developing ethanol capacity since early this decade and has exported at least some ethanol to Japan.

However, most developing countries are not in a position to provide anywhere near the government support that the biofuels industry enjoys in developed countries. They will need to rely heavily on private investment to foster biofuels industries – and a transparent global trading regime can help to attract stable financing and investment capital.

CLARITY ON WTO RULES NEEDED

Biofuels are not classified uniformly and their unusual make-up — fuels produced through the transformation of agricultural feedstocks — makes examining biofuels and trade regulations a complex undertaking.

As often happens when rules are applied to new technologies, a debate is needed on whether the rules should be clarified or even changed. Essentially, three issues are relevant, both for countries that are providing significant support to their biofuel industries and for those interested in exporting biofuels.

- How should biofuels be classified?
- How should subsidies to promote the production or consumption of biofuels be considered from the WTO point of view?
- How consistent are domestic regulations and standards – for example, mandates requiring the use of biofuels – with WTO rules on regulations and technical barriers to trade?

A major function of the WTO is to provide a framework for its members to negotiate reductions of tariffs on goods. Different categories of products have different tariffs and the rates can vary widely.

The first challenge faced by policy-makers, and the industry, is to reach agreement on the classification of biofuels. The main problem is that biofuels do not enjoy consistent tariff classification, making it difficult to lower tariffs on biofuels and their feedstocks without also lowering tariffs on similar or identical products, which may be used for different purposes.

For example, ethanol is considered an agricultural good under the harmonised system of classification (HS) used by the WTO, while biodiesel is considered an industrial good (and, atypically, has its own tariff classification). This distinction can have significant implications regarding tariff rates and the treatment of subsidies.

Tariffs for fuel ethanol can vary widely according to classification criteria unrelated to its use for fuel (eg whether

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the ethanol is denatured and undrinkable or undenatured, pure alcohol).

The lack of classifications more precisely targeted at a substance's use makes it difficult to get precise biofuel trade flow statistics. It may also impede efforts to liberalise tariffs on biofuels. WTO members may have environmental and energy security reasons for wanting to reduce tariffs on these substances when used as fuels, but not when they are destined for other uses in competition with domestic products.

Further complicating the classification issue is the possibility (to the extent that the Doha Development Round may be revived) that some biofuels could be deemed 'environmental goods' and subject to special negotiations under the Doha mandate to reduce or eliminate tariffs and trade barriers for environmental goods and services.

The increasing recognition that biofuels' environmental benefits vary greatly, depending on the feedstocks and their production methods, the conversion processes and the transportation used, has, however, significantly complicated efforts to define biofuels as environmental goods.

A number of policy responses to the biofuels classification issues (besides the complex and time-consuming process of reclassifying the various biofuels) could be undertaken.

WTO members could negotiate the liberalisation of tariffs on biofuels in a way that circumvented the HS classification problems. WTO members or some subset of them could agree to limit tariffs on biofuels or allow them tariff-free entry regardless of the existing HS classification and existing domestic nomenclature.

Alternatively, any WTO member could unilaterally lower tariffs, as a matter of its own energy and environmental policy. WTO obligations do not prevent a WTO member from applying a lower rate of tariff, as long as it provides "most favoured nation" treatment to "like products".

Another option is preferential trading arrangements, under which a developed country admits products from developing countries at rates lower than its standard rate for those products.

An impediment to any of the approaches, however, is the political pressure on governments to protect their farmers, which leads them to resist tariff reductions in the first place. Especially noteworthy, therefore, is the call by US Senator Richard Lugar, from the farm state of Indiana, for removal of the \$0.54/gallon (\$0.14/litre) tariff on imported ethanol.

Given the large number of government support measures for the biofuels sector, a clarification of WTO rules on subsidies would also be desirable in order to increase the certainty surrounding WTO members' notification requirements and overall transparency in a sector that is heavily subsidised (see panel).

Expansion of biofuels will also lead to a considerable increase in the volume of byproducts, whether livestock feed or other products, which may lead to protectionist pressures, the distortion of world markets and the need to consider appropriate WTO disciplines.

TANGLE OF REGULATORY ISSUES

The WTO includes rules for domestic regulations and standards since these measures can sometimes undermine negotiated tariff reductions and efforts to tackle other 'border' measures (such as quotas or bans on the import and export of particular products).

For example, standards could restrict market access or alter the competitive relationship between domestic and imported products in favour of the former. Most of these standards serve legitimate governmental objectives, but they can be more trade-restrictive than needed to achieve the

SUBSIDIES RAISE DOUBTS OVER VALIDITY AND REPORTING

Government subsidisation has been crucial to the economic viability of the biofuels industry since its inception and will continue to be vital to further establish biofuels, given that they are in competition with an established – and often also subsidised – petrochemical industry. However, greater clarity about the degree to which these subsidies conflict with WTO rules and a closer look at potential cross-subsidisation of byproducts are needed.

The need to clarify how biofuels subsidies should be treated by the WTO has been given a new urgency by the WTO dispute filed in January 2007 by Canada against US subsidies for maize (corn). Canada has been joined by several countries, including the key biofuels producers Brazil and the European Union. Brazil explicitly cited the US's subsidies for maize-based ethanol as a reason for joining the dispute.

Subsidisation can have multiple purposes, which may sometimes be inconsistent with world trade law. A government may, for environmental or energy security reasons, subsidise consumers to switch from conventional fuels to biofuels. Or it may subsidise research and development (R&D) into more efficient production technologies. Neither type of subsidy needs affect the relative competitive positions of domestic and foreign producers or raise WTO concerns.

Subsidies for the domestic production of biofuels are a different story. While sometimes justified, as a policy matter, on 'infant industry' grounds, such subsidies may not be a cost-efficient way of providing an incentive for consumers to switch to biofuels, as the lowest-cost, most-efficient producers may be foreign. The subsidies can also, in some cases, be incompatible with WTO rules.

For example, the WTO's Subsidies and Countervailing Measures Agreement prohibits subsidies contingent upon use of domestic products over imported products. A dispute can also be brought if a subsidy entails a "financial contribution" by a government and a "benefit" which confers a competitive advantage on the recipient. Financial contributions explicitly include situations other than direct cash payments, such as provision of goods and services or tax breaks where the government foregoes revenue "otherwise due".

An additional issue is upstream and downstream subsidies. One firm or industry may receive the financial contribution but the benefit that flows to an upstream or downstream industry is the concern. For example, a subsidy paid to domestic feedstock producers might be challenged by foreign biofuels producers on the grounds that it results in a lower price of feedstock to domestic producers.

If biofuels fall within agricultural classifications, their 'amber box' subsidies are subject to annual caps on agricultural subsidies and must be notified to the WTO. An exception is for 'green box' subsidies – non- or minimally-trade distorting subsidies for public policy purposes, including R&D or environmental programmes. The extent to which biofuel subsidies could qualify for the green box needs further examination, as does whether WTO members are accurately reporting their amber box subsidies to the WTO.

government's policy objectives and in some cases they are intentionally designed to benefit domestic interests.

A wide range of internal regulations concerning biofuels could have an impact on trade:

- mandates to use particular percentages or quantities of biofuels either in fuel blends or for specific purposes (such as in bus or taxi fleets);
- restrictions or limits on the amount or kinds of biofuels that can be contained in blends with conventional fuels;
- specifications of the properties or performance characteristics of particular biofuels or the materials they must be derived from;
- labelling for consumer protection and information;
- health and safety regulations concerning the handling and transportation of particular biofuels or feedstocks and related specifications for processing plants; and
- broad environmental performance requirements related to the entire life-cycle of products, including the sustainability of the agriculture used to produce biofuel feedstocks.

A patchwork of national, state, provincial and non-governmental standards is emerging, which is likely to make it difficult for manufacturers to supply different national markets. The development of international standards would not only remove the need for manufacturers to produce multiple versions of products to meet different standards, but would also help with WTO compatibility, since the WTO

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rules give deference to international standards.

Particularly helpful would be internationally-agreed criteria for biofuels sustainability standards, which, initially prompted by concerns about tropical deforestation (and resultant carbon dioxide releases) from south-east Asian palm oil production, are currently under consideration by the EU, the UK, the Netherlands and Germany, among others.

In recognition of the significant variability associated with the environmental performance of biofuels and a desire to encourage advanced production, governments are developing policies that will favour fuels with greater benefits.

These policies often address the life-cycle impacts of biofuels, from feedstock production through to ultimate consumption, and may incorporate everything from greenhouse gas emissions and capture to soil and water quality, even taking into account human rights issues.

Support for sustainability criteria comes from Stavros Dimas, the EU's environment commissioner: "We must ... discourage the use of environmentally, socially and economically harmful biofuels. We must promote those that have a proven well-to-wheel sustainable and energy substitution performance ... And, as demand grows, a framework must be established in order to create a global market of sustainable biofuels."

Sustainability standards will enjoy wider acceptance by exporting countries (and the WTO) where they have been developed through broad consultation among diverse states, taking into account the different conditions in different countries. Even then, such standards may be challenged by countries that view them as a threat to their market access

and, while the WTO has been moving in a direction more favourable to such process-based standards, the rules in this area are not all that clear:

The stakes are high. The biofuels market needs to be developed in a way that does not distort trade, degrade the environment nor disadvantage developing countries. Many people believe and hope that this can be done.

The promotion of a robust international market for sustainable biofuels will require an examination and clarification of trade rules — the sooner the better. However, that alone is not enough.

Governments will need to step forward and find the political will to remove high tariffs and other trade barriers to biofuel imports. It is hoped that the potential benefits of opened borders for consumers, producers, developing countries and the global environment can outweigh narrower national interests and compel action.

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