EUROPEAN UNION

DELEGATION OF THE EUROPEAN COMMISSION

Head of Delegation

Washington, July 9, 2009
D/888

The Honorable Max Baucus
Chairman
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Subject: **Comments of the European Commission on the legislative staff draft proposal to prohibit alternative fuel mixture credit for Black Liquor**

Dear Senator Baucus:

Please find attached the comments of the European Commission on the above matter.

For any questions, your staff could contact Ms. Michaela Muranova at 202 862 9564.

Sincerely,

Angelos Pangratis
Chargé d'Affaires a.i.

Attachment

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Comments of the European Commission on the legislative staff draft proposal to prohibit alternative fuel mixture credit for Black Liquor

The European Commission would like to thank the United States for providing the opportunity to comment on the Senate Finance Committee legislative staff draft proposal of June 11 2009. The proposal intends to clarify the types of fuels that qualify for the Alternative Fuels Mixture Credit ("AFMC"), and to eliminate from eligibility fuel derived from the processing of paper or pulp.

The European Commission would like to confirm that it shares with the United States the objective of contributing to promoting renewable energy as a means to achieve carbon dioxide reduction and improved energy security. However, the European Commission is concerned that the unintended application of the AFMC to "black liquor" mixtures used by the U.S. pulp and paper industries undermines this objective.

U.S. companies that produce pulp through the kraft chemical process are currently mixing a small (0.1%) amount of taxable fuel (diesel) into the "black liquor", in order to qualify for the $0.50 per gallon tax credit for biomass-based fuel, under Section 6426 of the U.S. tax code. Some companies have thus claimed credits that amount to ca. USD 200 per ton of pulp, or approximately 30% of the selling price of pulp. Beneficiaries of the credit are thereby granted hundreds of millions of dollars of funding, that private-sector estimate up to $8.0 billion in 2009 alone.

Hence, while the tax credit is scheduled to expire at the end of 2009, it is already creating distortions and imbalances in the international market for pulp. The tax credit notably provides significant incentive for U.S. kraft chemical producers to overproduce pulp, because they are able to recover a significant portion (30-50%) of their production costs. This happens at a time when producers around the world are operating at substantially reduced capacity-utilization levels, as result of the economic downturn. The result is a significant downward pressure on pulp prices, leading to further depressed markets, and strong losses for companies present on those markets.

In addition, given the magnitude of the tax credit, companies in the United States can use this unintended cash injection to improve their long-term cost-competitiveness, and thereby gain an immediate, artificial competitive advantage over their foreign and domestic competitors. Thus, recent industry analysis suggest that the US incentive is also affecting markets and prices for products whose production process does not involve black liquor, such as newsprint. Since the tax credit is providing a straight cash injection to these companies with no strings attached on how it is spent, the US kraft producers can use the money to bolster other parts of their operations, and to undercut market prices for other wood products.

According to the information available to the European Commission, those negative effects are already perceptible. In the 2nd quarter of 2009, US newsprint prices have decreased to levels that are 24% lower than current average prices, and considered to be below cash cost. At the same time, US pulp and paper producers are reducing their production downtime, or re-starting idle mills, whilst simultaneously closing equivalent mills in other countries, such as Canada.

The impact on trade patterns is also visible by now, insofar as during the 1st quarter of 2009 *EU imports* of wood pulp from the US have increased by 2% with respect to the 4th quarter of 2008, at a time where all other main EU suppliers have seen their exports reduced. Similarly, *EU exports* to the US have significantly decreased during the same period (-39%), contrary to the trend on other main export markets.

The credit is also having unintended environmental effects, by promoting the use of fossil fuels in the United States, contrary to its original goal of encouraging the development and use of alternative fuels. Furthermore, the tax credit grants to kraft chemical pulp mills, which use virgin fibre, an advantage over recycled mills, which use recycled materials. Thus, during the last few months, some companies such as SFK have decided to switch part of their production from recycled de-inked pulp towards chemical pulp, because of the tax credit. These aspects are of particular concern to environmental groups in the United States.

From a legal perspective, it is clear that these credits amount to actionable subsidies (since they provide disproportionate benefits to a limited number of enterprises i.e. the US pulp and paper industry, the predominant user of such credits), and that any adverse effects caused by them could be subject to remedies in the WTO, or through domestic countervailing duty investigations.

As you are aware of, most of the largest pulp and paper producing EU Member States do not provide their respective industries with any financial support for biomass-based production. Where available, that support is usually linked to the deployment of new investments, and only granted under the strict conditions imposed by the EU subsidies rules. In addition, the amounts involved in those cases are not in the same order of magnitude than the ones considered under the AFMC programme, as they cover less than 3% of the average cash manufacturing cost of pulp.

In this light, the European Commission deeply regrets the subsidy race triggered by the AFMC scheme, as third countries have started responding to it by introducing new subsidies to their own industry. The adoption by Canada of the Pulp and Paper Green Transformation Programme, on June 17, may just be a first example of that escalation.

The present staff draft proposal seeks to ensure that the tax credit is used consistently with the Congress original intent, not through an unintended loophole. Likewise, the U.S. Administration included in its budget proposals, released on May 11, 2009, a proposal to exclude "black liquor" burned in kraft mills from eligibility under the scheme. The European Commission fully endorses both initiatives, and urges the United States to end the unintended and distortive application of the scheme without delay.

Therefore, we request that the unintended application of this tax credit to "black liquor" be terminated no later than the date of introduction of the legislation, or at a specific date which would be no later than July 31, in order to address the above concerns. We understand the difficulties related to choosing a specific date prior to the date of enactment, however, given the busy legislative calendar, we are extremely concerned about the likely delay of adoption of the legislation, which could slip to late fall and result in further deterioration of the already critical situation. We look forward to being able to support the overall initiative to promote alternative energy sources and reduce pollution, whilst preserving normal market stability for forest product industries.

Finally, the European Commission would note that the comments made in this document are without prejudice to the rights of the European Communities in the WTO.

Thank you in advance for your attention to our concerns.