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HAS GERMANY'S BOOMING BIODIESEL MARKET REACHED ITS PEAK?

by Dieter Bockey*

The changes to the law on the mineral oil tax which contained new tax incentives for biofuels came into effect in January 2004. The new rules triggered a wave of investment in the biodiesel industry so that, by the end of 2005, an additional 740,000 tonnes of production capacity will have come online bringing the total to around 2 mln tonnes. Further industrial-scale facilities are either being built or in the concrete planning stage with the result that total capacity by the end of 2006, or 2007 at the latest, could rise to approximately 3 mln tonnes a year. If all the plants currently being constructed or in the planning stage were to be built by 2006/07, the share of biodiesel in the conventional diesel market would reach as much as 9%. Taking account of current German fuel ethanol production capacity of around 500,000 tonnes, the overall market share of biofuels could reach 5.75% by the end of 2006, four years ahead of the timetable laid down in the European Union's (EU) Biofuel Directive. These figures confirm that Germany is the leading producer and user of biodiesel in the EU by a large margin.

Booming biodiesel sales in Germany

Biodiesel sales in 2005 are forecast to rise to between 400,000 and 500,000 tonnes to reach a total 1.5 mln tonnes, a new record.

The distribution of biodiesel in Germany is via three channels:

- blending with conventional diesel EN 590 (up to a maximum of 5%)
- sales to captive fleets
- sales of B-100 (pure biodiesel) through 1,900 gasoline stations with dedicated pumps.

It is impossible to determine the exact split between the various channels due to the lack of statistical data. However, it is estimated that the mineral oil industry will use a total of 500,000 tonnes of biodiesel for blending in 2005. Of the 1,900 gasoline stations offering pure biodiesel (B-100), around 1,400 are taking part in the Quality Assurance System of the Arbeitsgemeinschaft Qualitätsmanagement Biodiesel e.V. (AGQM). In 2004, the AGQM performed an analysis of biodiesel sales differentiating between passenger vehicles and commercial vehicles. According to this survey, total biodiesel sales in 2004 were up 100,000 tonnes at 420,000 tonnes, a rise of 32% year-on-year. Federal states with a particularly high sales volume

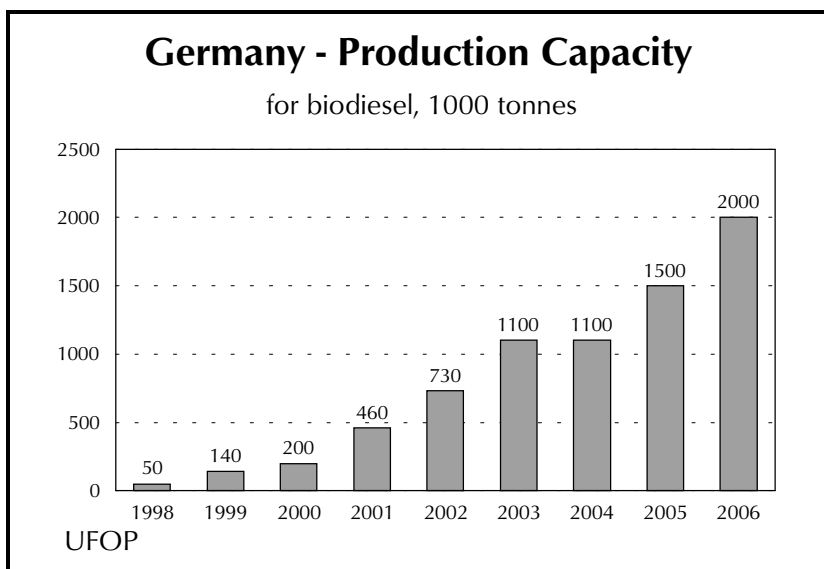
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through dedicated pumps were Bavaria, Nordrhein-Westfalia, Baden-Württemberg and Lower Saxony. The increase in sales was primarily the result of take up by new customers in the transport business (40% of total sales).

Overcompensation

Given the rapid increase in capacity, the risks associated with a possible change in the current beneficial tax regime have to be analysed. The present tax incentives are due to expire by the end of 2009. However, there is the option for them to be extended for a maximum of a further six years. In addition, these incentives have to be reviewed annually in order to establish whether or not there is overcompensation. Under this rule, the incentives must not be more than the additional costs of the production of biofuels compared with conventional fuels. Investors in the sector have to be aware of this risk because the 'overcompensation rule' can result in a situation where the advantages of cheaper feedstocks supplies can be completely eaten up by higher tax payments. This dilemma can only be avoided if the biofuel industry primarily processes domestic feedstocks.

At end of June 2005, the Finance Ministry sent its first report on the issue of overcompensation to the German Bundestag. The report only covered biodiesel because the quantities of bioethanol being used were too small. However, given the rising importance of biofuels on the market, it may well be that the next report, due on March 31, 2006, will also investigate this



question as it relates to bioethanol and rapeseed oil fuel.

The basis for this review process is a comparison between the average ex-works prices for conventional diesel/biodiesel and the costs of production. For the year 2005, the German government has calculated the overcompensation for B-100 at 5 euro cents a litre and for biodiesel in blends at 10 cents per litre.

Partial taxation at this time has been rejected as a solution for a number of reasons.

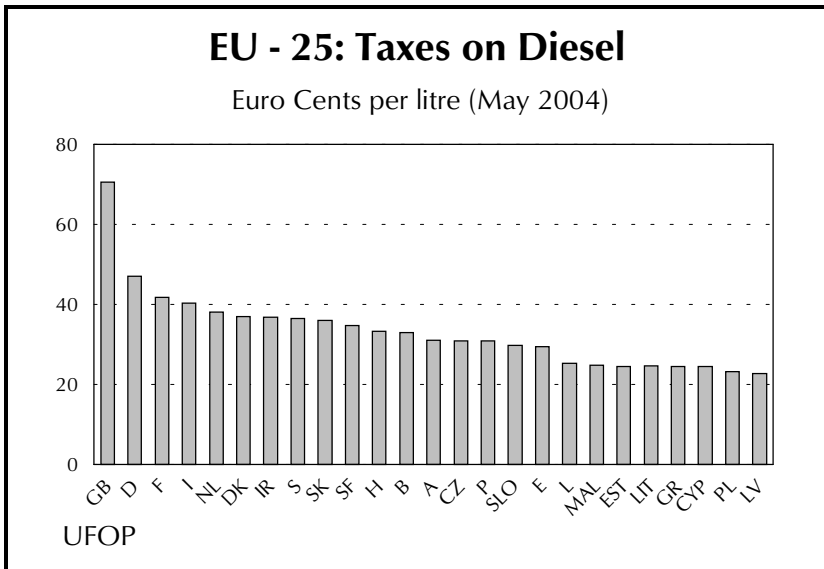
1. The production of biofuels from domestic feedstocks contributes to a lower dependence on imports and lower emissions of greenhouse gases.
2. The increase in the area under rapeseed reduces surplus production in grains and helps to lower grain intervention stocks.
3. Partial taxation would boost costs for biodiesel manufacturers and

would result in higher producer prices, which could lead to a higher incorporation of imported vegetable oils. In turn, this would undermine efforts at reducing dependency on imports and at creating alternative outlets for the agricultural sector.

4. The biodiesel industry is a very young sector which faces enormous challenges in both the feedstock market and the fuel market where it sells its end products. The producers have to invest heavily in research and development in order to be able to sell biodiesel in its pure form. The sale of B-100 in particular offers the opportunity to pass on the cost savings made possible by the beneficial tax regime to the final customer. The current price differential between biodiesel and conventional diesel is proof of that. Rising sales of B-100 will also help to raise the profile and the acceptance of biodiesel in general.
5. For many independent fuel retailers, biodiesel has become an important alternative source of income in the fiercely competitive fuel market.
6. Only the marketing of B-100 offers the opportunity to run feedstock-related advertising campaigns which help raise the environmental awareness of consumers.

Calculation of Overcompensation		
The table below refers to the report of the Federal Government. It lists all factors which have to be checked in the case of biodiesel		
	Biodiesel	
Prices (Euro Cents/l)	B-100	in blends
Rape seed oil (ex mill)	49	49
Refining	4	4
Esterification minus glycerine credits	7	7
Blending costs	0	3
Logistics	8	8
Additional technical costs	3	0
Higher consumption	5	0
Total (excl. VAT)	76	71
Average Diesel price (2004)	81	81
Overcompensation	5	10

Source: Deutscher Bundestag Drucksache 15/5816



Action is needed

Given the fact that production capacities for both biodiesel and bioethanol are rising rapidly, there is a growing need to discuss future fiscal policies and strategies. This debate is becoming even more urgent as there are rising imports from third countries such as Brazil, the US or Malaysia of either finished products or feedstocks for the production of biofuels. Such developments are placing the national tax rules for biofuels under increasing scrutiny.

At a Community level, the volume target laid down in the EU Biofuels Directive is not binding. Therefore, the political will to boost biofuel usage is being reflected in national tax laws. In addition to the differing reduced excise regimes, there are also disparities between member states regarding the blending targets for 2005, which the national governments have reported to the EU Commission. Since much is left to the discretion of the governments of the member states, there is a wide range of policies in the individual countries. A common market for biofuels does not exist; there must therefore be concern that the finance ministers of the member states will focus primarily on the harmonisation of the various legal frameworks.

Diverging tax policies have resulted in higher biodiesel imports into Germany and, as a result, some quality problems. The Union zur Förderung von Öl- und Proteinpflanzen (UFOP)

and the Deutscher Bauernverband (DBV) are therefore recommending that biodiesel purchases be made solely from members of the Working Group on Quality Management Biodiesel (AGQM). In the event of engine damage due to faulty products, the one necessary prerequisite for filing claims is traceability.

Need for action - WTO

It has been necessary to list biofuels as a sensitive product in the WTO negotiations and the MERCOSUR talks in relation to import quotas for fuel ethanol have highlighted the need for action. Fuel ethanol is being imported duty-free from countries which are not party to the preferential trade agreements via third countries and through "carousel" trades. The directive on energy taxes already provides for a differentiation of incentives on the basis of the feedstocks use. The General Directorate "Tax" which the EU Commission is already proposing calls for the introduction of a basic level of tax reductions coupled with additional incentives depending on which feedstocks are being used for the manufacturer of the biofuels.

The effects of this proposal would be basically positive because it would help achieve all the targets associated with the market introduction of biofuels (such as the minimisation of import dependence, reduction of greenhouse gases and creation of alternative outlets for agriculture) at the same time. Imports from third countries, no matter

EU-25: Volume targets according to directive 2003/30/EU	
EU member state	Market share %
Belgium	2.0 a)
Denmark	0.0
Germany	2.0
Finland	0.1
France	2.0
Greece	0.7
United Kingdom	0.3
Ireland	0.1
Italy	n.a. a)
Netherlands	1.2
Austria	2.5
Portugal	1.2
Sweden	3.0
Spain	2.0
Estonia	0.0
Latvia	2.0
Lithuania	2.0
Malta	0.2
Poland	n.a. a)
Czech Republic	2.6*
Hungary	0.6
Slovenia	n.a. a)
Slovakia	2.0
Cyprus	n.a.
Luxembourg	n.a. a)
EU-25	1.4

a) No official report to the Commission yet
 * Increase until 2009 2.9%
 Source: EU-Commission, 03/2005

whether in the form of biofuels or feedstocks for production, would undermine at least some of these targets.

Need for action at national level

The board of the German Farmers' Union has asked the Federal Government for a permanent exemption from the mineral oil tax for both the agricultural and public transport use of biodiesel and rape oil fuel. After all, it would be absurd if German farmers had to pay a higher mineral oil tax for biofuels than their competitors pay for their purchases of conventional diesel. Public transport plays an important role in the promotion of biofuels as it offers an alternative for mobility, particularly in times of rising fuel prices.

Biofuel production in Germany at the crossroads?

The announcement by the 'Grand Coalition' of the replacement of the tax exemption for biofuels by mandatory blending targets sent shock waves through the entire biofuel sector in-

cluding agriculture, the oil producers and biodiesel manufacturers and traders. However, very shortly after the publication of the agreement setting up the Coalition, the vice president of the German Farmers' Union and member of the budget commission of the German Bundestag, Norbert Schindler, was able at least partly to allay these fears by pointing out that the new policy would only apply to biofuels in blends. Nevertheless, the debate on this topic between the coalition partners is clearly not yet over. It is obvious that the Federal Government has to make deep cuts in its budget and therefore tax incentives for various sectors, including biofuels, have to be reduced. The discussion of where the axe should fall is currently in full swing and as yet, the biofuel sector cannot be given a final 'all-clear'.

UFOP is therefore recommending that no further investments be made in biodiesel in Germany given that capacity will rise to over 3 mln tonnes of biodiesel in 2007 with bioethanol contributing another 500,000 tonnes. On the basis of a full tax exemption, these quantities would be equivalent to a gross tax revenue loss to the Federal Government of over EUR2 bln. Given the precarious state of the federal budget, this is an untenable situation. Under the Federal Government's consolidation programme, biofuels are seen helping to reduce the budget deficit in the years 2007 and 2008 to the tune of at least EUR1.7-1.8 bln.

The introduction of a biofuel mandate is an important political signal which underlines the fact that the strategic direction of energy supply in the fuel sector cannot be left solely to the mineral oil industry.

This policy provides agriculture with the opportunity to produce renewable, value-added feedstocks for biofuel producers. However, as a study by the

IFO Institute (www.ufop.de) has shown, the tax incentives and the financial loss to state coffers are being substantially compensated for, something which the Federal Government is not taking into account. This compensation effect is not a factor in the case of imported biofuels or imported feedstocks used for biofuel production. On the contrary, there is the risk that national incentives may result in a considerable distortion of competition with negative consequences for the environment and society.

The following proposals are currently being discussed:

1. Introduction of a biofuel mandate without tax incentives for 'green fuels' at the refinery stage i.e. the mineral oil industry, in line with the volume targets of the EU Biofuel Directive.
2. Revision of the tax incentives for biofuels in accordance with the rules relating to "overcompensation".
3. Introduction of a minimum tax rate which could offset revenue losses from the mineral oil tax and could calm markets particularly in respect of biofuel imports. Conversely, the introduction of a national minimum tax rate would result in a "harmonisation" of the tax incentives at Community level. The expectation is that the export of biofuels to other member states may become an interesting alternative, particularly given the substantial growth in Germany's biodiesel capacity.
4. Introduction of a permanent tax incentive for agriculture to compensate for rising fuel prices and to alleviate the competitive disadvantages with regard to the tax rates for conventional diesel applied in other member states.

5. In order to create a level playing field, biofuels producers have to report feedstocks and quantities used. On the basis of the different feedstocks and their prices, the level of overcompensation is worked out. The calculation is therefore based on the feedstocks actually utilised and their values. The prices used in the first report on overcompensation for the Federal Government will result in distortions in the case of mixed feedstock usage. This will be to the detriment of those companies which exclusively use rapeseed oil as a raw material. The additional costs of administering the scheme are considered relatively minor. Imports may be treated in the same way and, in the case of biodiesel, this can easily be done using the composition of fatty acids.

The result is that feedstock-related distortions can be avoided. (NB: The US Energy Bill states that the tax incentive for biodiesel produced from waste cooking oil is only half the rate of biodiesel produced from virgin soyabean oil).

In addition, the continued calculation of overcompensation on the basis of more expensive rapeseed oil cannot be justified when, in fact, a rising share of the feedstock market is being taken by cheap vegetable oil imports.

Fixing the overcompensation level has to be done very carefully, because fuel markets are highly volatile. In the event of falling fossil fuel prices, partial taxation (as a result of the overcompensation revision) may make the use of biofuels in blends or in their pure form uneconomic. Mandatory blending as well as the continuing usage of biodiesel as a pure fuel in agriculture provide a safety net for national and EU biofuel production.