

## **BRAZILIAN ETHANOL INDUSTRY – A NEW GROWTH CYCLE**

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In recent years, rapidly expanding sales of flex-fuel vehicles in Brazil has been a major driving force behind the accelerated growth in demand for ethanol from the sugarcane industry. Today, flex fuel cars account for over 45% of the total car fleet in the country and, since mid 2009, ethanol has surpassed gasoline in consumer preference and became a remarkable example of a successful effort to replace oil dependency and combat global warming. In the past three years, thanks to the expansion of ethanol production and competitive prices, combined with the recognized environmental value of the fuel, ethanol consumption grew 78% compared to only 3% for gasoline. One could argue that ethanol is today an example of well functioning market forces generating price adjustments. The main pillar of this system is the flex-fuel vehicle, which allows consumers to choose their fuel at the pump according to price and environmental benefits. No country in the world offers this choice in such broad and attractive terms for consumers. In making fuel choices, the drivers of flex-fuel vehicles lead markets to adjust. Therefore, the Brazilian experience is a national technological success, from the competitiveness of sugarcane as a feedstock for ethanol to the efficiency of flex-fuel engines that allow market-based price formation to produce economic, social, environmental and public health benefits. However, despite the fact that the scenario described above points in the right direction for the development of the energy sector in Brazil, Brazilian consumers were shaken up in recent weeks by the steep price of ethanol at pumps throughout the country. People wonder why this happened and if it will happen again in the future. The most radical critics even said we could be facing a potential fuel shortage and raised doubts about the very future of ethanol. All of this calls for a careful analysis of the issues. From 2000 to 2008, sugarcane production increased by 10.3% annually, driven by strong sales of flex-fuel vehicles. With about 20 new plants opened per year since 2005, the period was characterized by an abundance of cheap capital, new investors with limited experience in the sugarcane industry, and traditional businesses with limited access to modern financial tools. With prevailing low sugar prices, new investments were spurred on by the prospect of good profit margins for ethanol in Brazil and abroad. However, the 2008 global crisis came and impacted primarily the companies that invested the most. One third of the industry ran into difficulties and went through significant financial and corporate restructuring. New actors have emerged from the crisis: existing companies achieved solid growth while traditional agribusiness, oil

and chemical groups entered the sugarcane industry with full force. But investments were directed to the purchase of troubled companies, while expanding production grew at only 3% per year since 2008. The post-crisis scenario is dramatically different: over 70% of the cane industry is now comprised of groups with sizeable assets, capital structure and governance, operational performance and access to high quality capital. These are groups ready to invest. The problem is that today's market catalysts are very different from those observed in 2005. In the past six years, the cost of ethanol production increased more than 30%, hurting its competitiveness against gasoline, which has seen virtually no price fluctuation at the pump since 2005. Besides a significant reduction in margins, which currently do not justify heavy investments in new units, investors feel insecure about the lack of criteria in setting gasoline prices, a direct competitor of ethanol at the pumps with "managed" prices in Brazil, which do not follow the laws of supply and demand. Land availability, technology, or capable and motivated employees, are not factors that currently affect or hinder the efficient growth and expansion of the ethanol industry. Difficulties in management, governance, and capital have also been overcome. What's really lacking at this point is an adequate strategy to address structural factors that have reduced the competitiveness of ethanol. These are measures that require major efforts from both the public and private sectors: harmonization of federal and state taxes, incentives to bioelectricity, improved logistics and storage, a commitment to ensure the supply of the biofuel, increased productivity, cost reductions and improvements in flex-fuel engine efficiency. Brazil is currently the country with the greatest availability of natural resources and technology to simultaneously expand the production of both oil and biofuels. The challenge is to grow quickly and in an organized manner. We do not want to repeat the stop-and-start growth witnessed in 2006. Brazil has built one of the most diversified and clean energy matrixes on the planet, with sugarcane appearing as the country's number-two source of energy behind petroleum. Thanks to flex-fuel cars, Brazil is the only place where consumers can choose freely, at the pump, which fuel to use. If flex-fuel technology and ethanol did not exist, consumers would have spent an additional R\$ 20 billion over the last six years to fill their tanks only with gasoline. Not to mention the damage that society would have incurred in the form of higher greenhouse gas emissions, worse public health, lower job creation and income generation, all of that leading to less development away from major urban centers. The world recognizes that Brazil has taken bold and innovative decisions in its energy sector. We must now advance faster and better.

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