Changing the point of obligation in the RFS

Why biofuels advocates should care about it

by Joe Jobe

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One of the most talked about issues related to the Renewable Fuel Standard (RFS) in recent months is the debate over whether to change the point of obligation (PO). That is to say to change the point in the fuel supply chain in which a party becomes obligated to comply with the RFS requirements. This can be accomplished through a regulatory process by changing the definition of obligated party. When passing the Energy Independence and Security Act of 2007 (EISA) Congress left it to the EPA to define an obligated party. EPA defined an obligated party in its initial rulemaking as a refiner or importer and EPA explained then that they considered placing the PO at the terminal. The agency stated that this issue may need to be reconsidered in the future if experience informs us otherwise.

Well, that future is here and a growing coalition is asking EPA to reconsider the placement of the PO due to the emergence of disproportionate compliance burdens for some and windfall profits for others. In the last two months, articles and op-eds on this topic have appeared in publications such as *OPIS, Politico, The Hill, Forbes, Wall Street Journal,* and others. Biofuels advocates have mostly not weighed in on this debate. When they have, it has usually been out of an understandable concern that the discussion itself was generating unwanted criticism of the RFS. There has also been a suspicion that this was yet another tactic in the broader war by RFS opponents to point out the flaws in and therefore undermine the programme.

Many have been operating under a mistaken impression that the change would require congressional action and have resisted it based on the mantra of "Don't mess with the RFS." In fact, a change in the PO, does not require that we "mess with the RFS", is not overly-complicated to administer, is not a nefarious plot to weaken and ultimately repeal the RFS, it will not increase the number of obligated parties under the programme[1], and does not threaten the growth or stability of the RFS.

> *Anything that impedes the progress toward repeal of the RFS should be considered very carefully by biofuels advocates*

Biofuels producers by and large are not currently the recipients of either the windfall profits or the undue compliance burdens that are occurring. That fact combined with a general lack of awareness of the ramifications of changing or not changing the PO have led most biofuels supporters to conclude that "it is not our issue". As one of the longest serving advocates for biofuels in the United States, my purpose for writing this article is to make the case for why changing the PO is indeed our issue. Changing the PO to "rack seller" at the terminal is the right thing for the RFS programme and for the biofuels industries, which remain dependent on it functioning well. Most importantly, changing the PO will go to the heart of addressing the *real* reason that EPA proposed using its waiver authority in 2013, delayed finalising three years of rules, and ultimately set low volume obligations in all categories of biofuels moving forward (Hint: It's not really "the ethanol blend wall.") .

The great divide

"In all debates, let truth be thy aim, not victory or an unjust interest," said British-born real estate entrepreneur William Penn (1644-1718).

In the search for truth in the PO debate, it is instructive to observe who the debaters are, what their interests and what their arguments are. In full disclosure, as an independent consultant I have been asked to provide advise on this issue for an independent refiner, but the majority of my current consulting work is for biofuels groups, including advising on this issue. I have concluded that changing the PO would be beneficial to biofuels, as well as most other stakeholders, consumers, and the RFS in general.

While biofuels groups have been mostly agnostic, viewpoints from the oil industry have broken into two opposing sides. The two sides include merchant refiners (entities whose business is primarily that of purchasing crude oil and refining it into finished petroleum products) small independent retailers, and some pipeline companies on one side. Many in this group are members of the American Fuels and Petroleum Manufacturers Association (AFPM) who are advocating a change in the PO. And on the other side are large retailers, large truck stop operators, and large integrated oil companies (who are vertically integrated in the supply chain from extraction to retail). Many of these players are members of the American Petroleum Institute (API) who oppose a change in the PO.

Most of API's members fall in the camp of the entities who are reaping the windfall RIN profits. API has scolded AFPM for supporting the change in PO stating that it is a distraction from their efforts to repeal the RFS. While advocates of changing the PO have effectively argued that it would dramatically improve the programme by fixing an inherent flaw that is creating unintended consequences, API members have said that they don't want to do anything that fixes the programme because it would hinder their ability to repeal it. In a recent media call, an API spokesman stated that they have been making real progress in their long effort to repeal the RFS and all of the focus on changing the PO has been a distraction that is impeding that progress. In my view, anything that impedes the progress toward repeal of the RFS should be considered very carefully by biofuels advocates.

For many years and for reasons unrelated to the RFS, the large integrated oil majors have been reducing their emphasis on refining, focusing their businesses to an ever greater extent on upstream exploration and downstream distribution and retail. This now leaves them with a relatively small obligation under the RFS associated with their small refining footprints relative to their large distribution and retail activities. These downstream assets are key to enabling the blending of ethanol into petrol and biodiesel into diesel. With low compliance requirements and high blending capabilities, most integrated oil majors are generating large net RIN surpluses, which have become for them significant new profit centres. They also end up RIN-long on biodiesel, which disincentives them from making any infrastructure investments to expand their blending capability.

Merchant refiners, on the other hand, whose core business is refining, are the primary obligated parties under the programme. Yet because of where they reside in the supply chain, independent refiners have the most limited ability to actually blend biofuels in order to comply with their obligation. Refiners make finished products and originate them to the pipeline for their customers, who then ship them to downstream terminals. Pipelines though, have not traditionally been accessible to biofuels and have been almost exclusively the domain of pure petrol and pure diesel with nearly all biofuels blending being forced to occur at the terminal or retail levels rather than at the refinery or pipeline head.

Most integrated oil majors are generating large net RIN surpluses

Truck stop operators

As a result, independent refiners have limited ability to meet their blending obligations by actually blending biofuels. Their only other option then is to purchase RINs from the large integrated oil companies or large diesel retailers (truck stops). The oil majors end up with their RINs by blending E10 into their petrol like they had been doing before RFS2. Truck stop operators, who are not obligated parties, generate a large number of RINs to sell to obligated parties generating huge profits. For biodiesel, about a third of the RINs come from imported biodiesel, almost all of which is subsidised by foreign governments before entering the US. The imported biodiesel is advantaged over domestic biodiesel because the imports can also take the blender's tax credit, and the value of the RIN, creating a significant windfall for truck stop operators.

A recent *Wall Street Journal* article laid out the inequities under this system, with some parties becoming enriched, while other parties burdened to the point of pending potential insolvency.[2] These imbalances were never meant to be and they do not need to continue. For us in the biofuels community, they create significant market inefficiencies and are destabilising throughout the supply chain.

Thankfully, the solutions are easily available to us through an EPA administrative change in the PO. Similarly, a modest tweak in the biodiesel tax credit from one directed at blenders to one available to domestic producers will allow for a system in which the RFS requirements are filled to a much greater extent by domestically produced product. Neither of these solutions is beyond our collective reach, and producers of American fuels, both petroleum and renewable, should work together to achieve them.

Windfall RIN profits

One of the most potent arguments by the large integrated oil companies is that the advocates for a change in PO are simply parties who did not make the proper investments to comply with the RFS, and now they want to be bailed out by punishing those parties that did make the proper investments.

A closer look reveals a different picture. As I laid out before, this is not the case because the large integrated oil companies and truck stops did not make major infrastructure investments to receive their windfall RIN profits, at least not the types of investments that would be required of refiners to blend more biofuels. Since biofuels are almost exclusively blended at or below the rack, merchant refiners reside in the point of the supply chain that is most limited to blend biofuels.

In order to blend enough biofuels to meet their obligation, merchant refiners would not simply be required to invest in some additional tanks, pipes or pumps. If that were all that was required they would have done it already. No, in order to meet their obligations by actually blending biofuels, they would have to buy up whole new businesses at a different part of the supply chain which have little to do with their core business, and then invest in the additional tanks, pipes, and pumps. Specifically, they would have to buy up wholesale distributorships that are integrated or aligned with retail stations. That is the point in the supply chain where blending occurs, and RINs are separated and sold. Not surprisingly then, this has become the place where RFS value has been concentrated. And because of the current PO, these RINs are sold at an artificially high price back to the merchant refiners who have no choice but to buy them.

Think about this for a moment – because of one rather obscure ruling (definition of obligated party) in a large and very worthy government programme, regulated entities are expected not just to make modest investment upgrades in order to comply with the law, but

EPA defined an obligated party in its initial rulemaking as a refiner or importer would have to buy up entirely new integrated businesses that are not necessarily even for sale, and then make investment upgrades in order to comply with the law.

Effectively, if merchant refiners want to comply with the biofuel blending requirements by actually blending biofuels, which is the point of the law, they would need to vertically integrate. They would have to buy up integrated downstream assets, which would cause them to become an integrated oil company and compete with the oil majors in that business.

This is simply not a realistic option. Even if it was realistic, and even if the Federal Trade Commission were to allow it, it would not be a desirable goal for the programme, consumers, or the country. We don't want to disadvantage independent refiners and independent small retailers in favour of the big oil companies, who already have enough advantages going for them. It is an unintended consequence of setting the PO in the wrong place, a situation that can be corrected by the EPA without overhauling the programme or unfairly harming anyone, while realising significant benefits in reaching the worthwhile goals of the RFS.

We know the oil majors haven't made major investments in blending infrastructure because a) they say they haven't in their investor reports and other public documents[3], and b) because they are calling for a repeal of the RFS. If they had made major investments in biofuels or blending infrastructure, they would likely not want to strand those investments. Merchant refiners on the other hand have made investments in biofuels, and favour changing PO over repeal.[4] Also, merchant refiners are mostly publicly traded companies, who have been forced to report to their investors the harm that has been done because of their limited ability to comply with the RFS other than buying artificially high-priced RINs. Their stock prices have suffered from this.[5]

Regulations should aim to strengthen competition, not weaken it

But if all refineries share the cost of compliance proportional to their refinery capacity, aren't they all on a level playing field competitively? No, because independent refineries have to compete with the refineries of the majors, who have a smaller refinery footprint than they have a distribution and retail footprint. This is not because they designed their businesses this way to take advantage of and obscure definition in the RFS that was promulgated in 2011, this is the way they have been for many years. Because big oil companies are blending E10 anyway, they end up RIN-long, so they don't have to buy RINs, they are able to use their own RINs to comply with their obligation. Then they even get to sell their surplus RINs for a windfall profit back to their competitor merchant refiners.[6]

This contradicts two fundamental principles of good government regulation. First, regulations should aim to strengthen competition not weaken it. Second, effective regulation must be careful to place requirements on the proper parties who have the ability to comply, otherwise the incentives to accomplish the regulatory goals are misaligned.


Merchant refiners are the primary obligated parties under the RFS

Unintended consequences of inaction

The RFS2 is a good law and it is currently working to achieve the goal of drawing biofuels into the marketplace. But it would work much better if the PO was changed to the terminal, because it would not only address the flaws discussed above, it would benefit biofuel producers in the following six ways:

1. EPA has stated that the "ethanol blend wall" is the primary reason for delayed rules and lower proposed volumes in all categories. (See number 6 below.) The current point of obligation incentivises RIN-long parties (the oil majors and large retailers) to not invest in ways that push through the blend wall because it would reduce the value of their RIN inventory. To the extent that there is an ethanol blend wall, moving the PO to the rack would help push through it by incenting the promotion of higher blends by obligated parties who will need offtake for their blended wet gallons.

2. It would incentivise investment in biodiesel blending infrastructure at terminals. Rack sellers pulling diesel fuel off the pipeline would now have a proportional obligation attached to those diesel gallons. The most cost-effective way to meet that obligation would be to blend actual wet gallons right there at the terminal, incentivising rack seller obligated parties to collectively invest in biodiesel blending infrastructure. Available blending infrastructure at terminals across the country dramatically improve the logistics and economies of scale for biodiesel. It also has advantages for local and regional biodiesel producers over importers.

3. Aligning the point of obligation at the point where actual compliance (blending) occurs makes the burden of compliance more proportional so that no parties are overly burdened and no parties are overly enriched. This is the same way that federal excise tax is administered. This maximises the amount of compliance that occurs through the actual blending of wet gallons.

Ultimately, obligated parties' RIN activity could possibly be integrated into the ExSTARS system (Excise Summary Terminal Activity Reporting System) to marry up fuel excise taxes and RIN activity and reporting, further strengthening the efficiency of the programme. This will result in more transparency and less RIN speculation, increasing the demand for actual gallons of biofuels at terminals making biofuel prices higher while making RIN prices lower. Lower and more stable RIN prices will reduce the overall compliance cost of the programme – something OMB and EPA have indicated is one of their top considerations in setting RVOs.

4. The California Low Carbon Fuel Standard (LCFS) has the PO at the rack with obligated parties defined as Rack Sellers, the same as merchant refiners are proposing. None of the negative unintended consequences that opponents claim would occur with this change in PO in the RFS, have occurred with the LCFS.

5. RIN integrity would be improved. Robust measures to address RIN fraud by the biodiesel sector, the EPA, and the petroleum sector did much to address most of the RIN fraud that occurred in 2011-2013. However, based on some more isolated cased of fraud activity from 2014-2016, it has not been eliminated entirely. If the PO had been placed with the rack seller, much of the fraud would not have occurred.

This is because much more of the compliance by obligated parties would have taken place by blending actual wet gallons of biofuels at the terminal, separating the RIN and using that RIN to meet their obligation. The PO set at the refiner level forced more compliance by buying RINs in a then immature and opaque market, where the PO (refinery) was separated so far in the supply chain and the chain of custody from the point of compliance (below the rack). Changing PO to the rack will benefit RIN integrity for both biodiesel and new fuels that come on line in the future.

6. Earlier, I stated that I would explain how changing the PO would get to the heart of the real reason for the EPA's dramatic use of waivers, delays in the programme, and now a trend of finalising very modest, even tepid increases in annual volumes. I will close this article with that explanation. The ultimate unintended consequence of inaction is best illustrated by a drama that is predictable because we have seen it play out before. In 2013, RIN prices went from 5 cents to $1.50 in six months, a phenomenon referred to as "RIN-sanity".

Media leak

In October 2013, an excerpt of EPA's proposed volume obligations for 2014 was leaked to the media, which revealed the EPA's intention to cut ethanol volumes and to freeze biodiesel volumes. Biofuel advocates organised the largest and most intense campaign ever to fight this move. Yet in November of 2013 the cutbacks from the leaked proposal were published in the 2014 proposed rule. The 2014 volumes did not get finalised until November of 2015, two years later (three years behind the statutory deadline in the case of biodiesel), which left the biofuels industries in limbo for two and a half years, doing untold damage to biofuels businesses, many of which failed in that time period. It also cost the collective biofuels industries millions in advocacy costs.

This inexplicable move on the part of the administration would have remained a mystery were it not for two articles published by *Reuters* in May of 2014.[7] The articles documented in surprising detail how the administration was persuaded by two East Coast merchant refiners owned by the Carlyle Group and Delta Airlines that they were in serious danger of going bankrupt because of the high RIN prices. The administration was convinced of the financial threat these companies were facing.

The administration was convinced that the bankruptcy and shut-down of two refineries in close proximity in the Mid-Atlantic region was imminent without taking some action, and would create fuel shortages to the East Coast as well as the loss of hundreds of union jobs. I bring up this unpleasant story to point out that the most painful chapter in RFS history was more directly related to an unintentionally misaligned PO than it was an ethanol blend wall. Had the PO been placed at the terminal, making the burden of compliance proportional to every gallon of hydrocarbon pulled off the pipeline and eliminating the inequities that we have discussed here, the two refiners would not have been threatened with insolvency.

When talking to biofuels advocates I often hear, "point of obligation is not our issue". Isn't it? Or in response to the notion that if refiners cannot get PO changed, they will be forced to spend all of their resources repealing the RFS or lowering the RVOs: "Let them fight the RFS, it hasn't gotten them anything so far." Hasn't it?

Merchant refiners are suffering real financial harm by the sustained high RIN prices. It can be remedied by placing the point of obligation at the same place as fuel excise taxes, and ultimately perhaps folded into the ExSTARS system. Biofuel advocates have the opportunity to partner with merchant refiners, small retailers, and pipeline companies to make this common sense adjustment. It is an opportunity for biofuel advocates to align ourselves with a broader coalition of stakeholders, including the merchant refiners who generally favour improving the RFS over repealing it. If we don't do this, we have seen what happens from the political fallout from refineries being threatened with shutdown. Except this time, it is not two merchant refiners that are being harmed, it is all of them. We should join with them to support the solution. Otherwise the unintended consequences of inaction will be predictably significant.

About the author

Joe Jobe served for 19 years with the National Biodiesel Board, 17 years as the CEO. During Jobe's tenure, he helped lead the industry from about 200,000 gallons of production in 1999 to 2 billion gallons today. Jobe was instrumental in the development, passage and implementation of major federal and state biofuel policy initiatives including the biodiesel tax credit, RFS1 and RFS2. He is a recognised author and thought leader in energy, environmental, agricultural, and sustainability issues, and has given major speeches in ten countries.

For more information:
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References:

1 According to Attachment D of Valero Energy's Petition to open a rulemaking considering PO, an analysis was done to look at the number of rack sellers currently. The analysis looked at 1) OPIS terminal Price Posting, 2) OPIS Active Supplier List, 3) Valero's market research on bulk and rack activity, 4) Review of federal excise tax forms (637S), and 5) Market information received by Valero from others in the business. The analysis found the number of rack sellers to be 202, and if subsidiaries and joint ventures were combined, the number would be well below 200. The EPA has stated in various places that the current number of obligated parties is between 200-230. The analysis also showed that under a change in the point of obligation to rack seller, approximately 90% of the new obligated parties would be the same as the old obligated parties.

2 See Wall Street Journal article October 27, 2016 "Big Oil Companies Reap Windfall from Ethanol Rules."

3 In a September 9, 2016 letter to the EPA on the PO, Marathon indicates that they are not adding E15 infrastructure or other investments to increase their biofuel blending capabilities.

4 http://www.forbes.com/sites/realspin/2016/10/10/make-the-renewable-fuel-standard-more-fair-and-effective/#554cc4016455

5 A June 2016 Goldman Sachs report downgraded the stock of several merchant refiners because of their large RFS obligation, their limited ability to blend wet gallons, forcing them to buy RINs that have sustained a high price.

6 A September 2016 OPIS Carbon Market Report identified a broad range of RIN exposure among various refiners according to Barclays Capital.

7 http://www.reuters.com/article/us-oil-ethanol-lobby-timeline-idUSBREA4B01T20140512