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VIA ELECTRONIC MAIL

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**Re: Petition for Rulemaking: Renewable Fuel Standard Definition of Obligated Party –
40 C.F.R §80.1406**

Dear Administrator McCarthy:

The Renewable Fuel Standard (“RFS”) was implemented through two statutes. The first (“RFS1”) was included in the Energy Policy Act of 2005 (“EPACT”). RFS1 required the Environmental Protection Agency (“EPA”) to promulgate regulations to ensure that gasoline contained, on an annual average basis, an “applicable volume” of renewable fuel. RFS1 requirements began in 2006 at a level of 4.0 billion gallons and EPACT specified annual increases until the applicable volume reached 7.5 billion gallons in 2012.¹

Two years later, Congress enacted the Energy Independence and Security Act of 2007 (“EISA”), which significantly expanded the RFS (“RFS2”) by adding diesel to the obligation and extending requirements related to renewable fuel to 36 billion gallons in 2022.² Proponents of the law cited a desire to move the United States towards greater energy independence and to reduce greenhouse gas emissions from the transportation sector.

More than a decade after enactment, however, U.S. domestic energy production is near an all-time high, with little or no assistance from the RFS, and the notion that the RFS is better for the environment is at best debatable, and questioned by many.³ In other words, some of the basic assumptions and the overall policy context of the RFS2 no longer hold true today.

¹ Energy Policy Act of 2005, Pub. L. No. 109-58 (2005).

² Energy Independence and Security Act of 2007, Pub. L. No. 110-140 (2007), codified at 42 U.S.C. §7545(o).

³ See e.g., House Comm. on Science, Space, and Technology Subcommittee on Environment and Subcommittee on Committee on Oversight, *Renewable Fuel Standard: A Ten Year Review of Costs and Benefits*, 114 Cong. (Nov. 3, 2015) (testimony of John M. DiCiccio, Research Professor, University of Michigan Energy Institute) (“The program has resulted in higher cumulative CO2 emissions than otherwise would have occurred and has also damaged the environment in many other ways. In summary, careful scientific analysis indicates that the lifecycle studies used to justify the RFS were flawed.”); National Research Council Comm. on Economic and Environmental Impacts of Increasing Biofuels Production, *Renewable Fuel Standard: Potential Economic and Environmental Effects of U.S. Biofuels Policy* (National Academies 2011); Government Accountability Office, *Environmental Regulation: EPA Should Improve Adherence to Guidance for Selected Elements of Regulatory Impact Analysis*, GAO-14-519 (July 2014).



The RFS2 included four “nested” mandates. Of the 36 billion gallons in total renewable fuel specified for 2022, 21 billion gallons were intended to be comprised of advanced biofuel. Of this amount, EISA further specified that 16 billion gallons of advanced biofuel should be comprised of cellulosic biofuel. EISA also established a specific mandate for biomass-based diesel and specified that a minimum of 1 billion gallons be used in 2012 and thereafter. EISA allowed the remaining applicable volume of renewable fuel – 15 billion gallons out of the total 36 billion gallons – to be satisfied using any qualifying renewable fuel, including “conventional biofuel,” or renewable fuel that is ethanol derived from corn starch. Although use of conventional biofuel is not explicitly required, this aspect of the RFS is often referred to as the “corn ethanol mandate” since such fuel has been used to fulfill the vast majority of RFS requirements to date.

It is clear that the RFS2 has not met the basic statutory goals. EPA has been required to waive nearly all of the applicable volume of cellulosic biofuel since a requirement for this fuel began in 2010. For each of the RFS compliance years 2014 through 2016, additional waivers have been required for total renewable fuel and advanced biofuel. A total of 1.87 billion gallons was waived in 2014, 3.57 billion gallons in 2015 and 4.14 billion gallons in 2016. In addition, there have been numerous other implementation issues which are presented in further detail below. Collectively, this imbalance requires EPA to take action to better align the RFS with market realities and to move towards greater efficiency by moving the RFS point of obligation.

A. EPA Designed RFS “RIN System” to Promote Flexibility and to Lower Costs

Each year, the EPA must translate RFS-mandated volumes into percentage standards that obligated parties use to determine their individual compliance obligations, or renewable volume obligations (“RVOs”). EPA created the Renewable Identification Number (“RIN”) system as the mechanism for obligated parties to demonstrate compliance with their RVOs. In general, obligated parties must acquire a sufficient amount of RINs each year to address their RFS compliance obligations (*i.e.*, their individual RVOs multiplied by their production of gasoline and diesel in a given year). Obligated parties can acquire RINs through various means, including through the blending of renewable fuel into transportation fuel or the purchase of RINs from other parties.

In the RFS1 rulemaking, EPA identified several advantages to having a RIN-based system, including verification of renewable fuel production, real-time RIN trading to provide compliance certainty, ensuring the ability of renewable fuel to be produced, distributed, and blended “*where economic to do so*” (emphasis added), and reduction in double-counting of renewable fuel claimed for compliance.⁴ EPA described the RIN-based trading program as “an essential component of the RFS program, ensuring that every obligated party can comply with the standard while providing the flexibility for each obligated party to use renewable fuel in the most economical ways possible.”⁵ The RIN-based system was recognition that some refiners would have access to terminal blending facilities (allowing them to acquire RINs in this fashion) and that other refiners would not have such access.

⁴ Regulation of Fuels and Fuel Additives: Renewable Fuel Standard Program 72 Fed. Reg. 23900, 23908 (May 1, 2007) [hereinafter “RFS1 Final Rule”].

⁵ *Id.*



RINs also allowed for trading that would ensure the RFS volume standards could be met without requiring wholesale changes to the fuel distribution infrastructure. In promulgating the RFS2 implementation rules, EPA reiterated its reasoning for utilizing the RIN-based system, emphasizing yet again that the RFS was not intended to change the existing system of fuel distribution and blending, despite claims to the contrary. EPA discussed its adoption of a RIN-based system as:

[f]or compliance and credit purposes as the one which met our goals of being straightforward, maximizing flexibility, ensuring that volumes are verifiable, and *maintaining the existing system of fuel distribution and blending*. RINs represent the basic framework for ensuring that the statutorily required volumes of renewable fuel are used as transportation fuel in the U.S. *Since the RIN-based system generally has been successful in meeting the statutory goals, we are maintaining much of its structure under RFS2*” (emphasis added).⁶

Throughout its implementation of the RFS, EPA has continually reaffirmed its⁷ interpretation of the statute that the intent of Congress was to minimize costs, ensure flexibility, and maintain the existing system of fuel distribution and blending. EPA noted that its approach in RFS1 was predicated on the belief “that there would be an excess of RINs at low cost” and that the “ability of RINs to be traded freely between any parties once separated from renewable fuel would provide ample opportunity for parties who were in need of RINs to acquire them from parties who had excess.”⁸ RINs were designed to serve as the compliance mechanism for the RFS;⁹ there is no evidence in the legislative and regulatory history of the RFS that RINs were intended to function as a tool to spur investment or to compel refining companies to subsidize gasoline marketers and retailers for mid-level ethanol blends or E85 sales.

B. EPA Must Make Further Changes to RFS to Address New Conditions

Despite the enormous incentive the RFS provides, commercially available advanced and cellulosic biofuels, specifically drop-in biofuel that is compatible with existing engines and infrastructure, have failed to materialize in significant volumes. This has required EPA to waive or propose to waive cellulosic biofuel levels by nearly 100 percent in every year since promulgating RFS2. A lack of other advanced biofuels and the ability to use such fuels has also required EPA to waive such requirements for the last three years.¹⁰

During a Senate Environment and Public Works Committee hearing in February 2016, the Energy Information Administration (“EIA”) testified that the RFS2 volume targets also will not be met by 2022, when the statutory schedule for three of the four renewable fuel categories ends. The shortfall between the statute and projected volumes is projected to be 18 billion

⁶ Regulation of Fuels and Fuel Additives: Changes to Renewable Fuel Standard Program 75 Fed. Reg. 14670, 14684 (March 26, 2010) [hereinafter “RFS2 Final Rule”].

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⁸ Regulation of Fuels and Fuel Additives: Changes to Renewable Fuel Standard Program 74 Fed. Reg. 24904, 24963 (proposed May 26, 2009) [hereinafter “RFS2 Proposed Rule”].

⁹ See 40 C.F.R. §80.1427.

¹⁰ EPA waived advanced biofuel requirements in each of the compliance years 2014-2016. Renewable Fuel Standard Program: Standards for 2014, 2015, and 2016 and Biomass-Based Diesel Volume for 2017, 80 Fed. Reg. 77,420 (Dec. 14, 2015).



credits, with virtually the entire amount of this shortfall occurring within the advanced biofuels category.¹¹

Thus, whatever initial expectations may have existed for the RFS program in 2007 regarding advanced and cellulosic biofuel, those expectations have failed to materialize. Last year, corn ethanol accounted for 80 percent of the renewable fuel utilized in the RFS program. The balance was filled primarily by biomass-based diesel and renewable diesel. In fact, only 2.2 *million* gallons of liquid cellulosic biofuels were produced in the U.S. last year. Corn ethanol and biodiesel are currently the only viable options to comply with growing mandates, and each have significant market barriers that EPA is underestimating.

In addition to the program's reliance on corn ethanol and biodiesel brought on by the failure of drop-in biofuels to materialize, the gasoline market has also changed. More specifically, the U.S. is using less gasoline than Congress envisioned when it enacted the RFS program and EIA projects that domestic gasoline demand will drop further in the coming years. When Congress debated and enacted RFS2, EIA projected gasoline demand would continue to rise each year. However, a number of factors have reversed that trend, including increased new vehicle efficiency standards and changes in Americans' driving habits. In 2007, EIA projected that the U.S. would consume 159 billion gallons of gasoline in 2016. It now forecasts demand of 143 billion gallons for 2016—a 10 percent decrease.¹² EIA has similarly reduced its demand projection for 2022 by 23 percent¹³ compared to its 2007 forecast (from 172 billion gallons to 132 billion gallons). For obligated parties, this means there is an increasingly smaller gasoline pool into which to blend increasing volumes of mandated biofuels. As discussed below, this conflict has led to the onset of the E10 blend wall.¹⁴

The U.S. has also undergone a dramatic shift in domestic energy production since 2007 undermining one of the main objectives of RFS proponents. Indeed, the U.S. produced 9.4 million barrels per day of crude oil in 2015, the highest domestic production since 1972. As a result of increased domestic crude oil production, gross U.S. crude oil imports have dropped by 30 percent since 2007. Additionally, in contrast to popular belief, of U.S. crude oil imports, only 30 percent come from OPEC countries—the rest comes from non-OPEC nations, mostly Canada and Mexico. In fact, Canada alone accounted for nearly 40 percent of U.S. crude oil imports in 2015. The fact is that the conversation of energy security has gone from one of energy scarcity in 2007 to one of abundance in 2016. According to EIA, the RFS played only a small part in this shift.¹⁵ Instead, it is the innovations in domestic crude oil production techniques that have enhanced U.S. energy security.

For these reasons, AFPM supports full legislative repeal of the RFS. In the interim; however, EPA has an ongoing responsibility to implement the statute responsibly and to

¹¹ *Oversight of the Renewable Fuel Standard: Hearing before S. Comm. on Environment and Public Works*, 114th Cong. (2016) (Testimony of Howard Gruenspect, Deputy Administrator, Energy Information Administration) [hereinafter "EIA Testimony"].

¹² EIA Short Term Energy Outlook (June 2016).

¹³ EIA Annual Energy Outlook, Reference Case (2016).

The E10 blend wall is reached when all gasoline contains 10% ethanol.

¹⁵ EIA Testimony at 5-6 ("biofuels volumes in response to the RFS program have played only a small part in reducing projected net import dependence given the expectation of continued use of ethanol as an octane and volume source independent of RFS program requirements.").



minimize economic damage that can arise from a RIN market. As noted, RINs were intended to provide compliance flexibility and allow the then-existing system of blending and distribution to continue. RINs were not intended to serve other purposes or to provide an investment mechanism for speculation (and in some instances, fraud). This limited scope and purpose was well established during the RFS1 and RFS2 rulemakings.

As detailed below, the existing point of obligation for RFS compliance exacerbates the implementation and compliance issues with the RFS. More specifically, EPA predicated its regulations on 1) faulty assumptions about the administrative burden of a point of obligation, and 2) faulty assumptions about the functionality of the RIN market. Critically, EPA also committed to revisiting the point of obligation if it became clear that the RIN market is not functioning as intended.¹⁶

It is clear that the RIN market is not working as intended, particularly in light of EPA's decision to breach the E10 blend wall and complications with RIN acquisition arising from the ethanol RIN requirement placed on diesel production. The U.S. hit the E10 blend wall in 2013, when RINs increased from \$0.02 to \$1.48 per gallon. Although RIN prices have retreated from their record highs, they are still trading at \$1.00 or more per credit in the aftermath of EPA's proposed 2017 RFS volumes. RINs have evolved from their intended purpose of facilitating a program where the use of biofuels would be uneven among regions to a commodity that has become a profit center for large fuel retailers with dominant positions in certain geographic markets. This has dramatically increased the costs of implementation for certain obligated parties and disadvantaged consumers.

As a result of this dysfunction, and in light of its commitment to take action in the event of a broken RIN market, EPA has both the authority and the imperative to change the point of obligation. Thus, pursuant to 5 U.S.C. § 553(e), AFPM hereby petitions EPA to move the point of obligation further downstream of its current location. Specifically, AFPM petitions EPA to propose and take final action to change the definition of "obligated party" under the RFS program, 40 C.F.R. 80.1406 to

An obligated party is the entity that holds title to the gasoline or diesel fuel, immediately prior to the sale from the Bulk transfer/terminal system (as defined by IRS regulations) to a wholesaler, retailer or ultimate consumer and is required to report any federal excise tax liability on IRS Form 720 – Quarterly Federal Excise Tax Return. An obligated party also includes the entity that is the enterer (as defined by IRS Regulations in 40 CFR §48.4081-1) of the gasoline or diesel fuel into the U.S. outside of the bulk transfer/terminal system and is required to report any federal excise tax liability on its Form 720.

For purposes of this petition, AFPM will use the term "Rack Seller" to identify the parties that hold title to the petroleum fuel at the point of blending and are currently responsible for excise taxes. The Rack Seller is distinct from "below the rack" blenders that would remain unobligated under AFPM's proposed definition. This proposed definition will reduce the

¹⁶ 75 Fed. Reg. at 14,722; 80 Fed. Reg. at 77,431.



number of obligated parties, make the RFS more sensitive to market realities, and more equitably distribute the compliance burden among those parties in the best position to determine feasible compliance scenarios. And, for these reasons, it would reduce the systemic and compliance costs of the RFS program, which ultimately would benefit consumers.

I. EPA's Original Justification for the Current "Obligated Party" Definition is Obsolete; EPA Indicated it Would Revisit Definition of Obligated Party if Certain Circumstances, Now Present, Manifested

A. EPACT 2005 (RFS1)

Congress provided EPA with some discretion to implement the details of the RFS program, including how to measure compliance. In particular, Congress directed that the RFS "contain compliance provisions applicable to refineries, blenders, distributors, and importers, as appropriate, to ensure that the requirements of this paragraph are met. . . ."¹⁷ In promulgating regulations implementing EPACT, EPA placed the obligation on refiners and importers largely out of administrative convenience for the Agency. EPA estimated that approximately 1,200 entities blended ethanol into gasoline downstream from the refinery, and considered that including these entities as obligated parties would increase the "complexity of the RFS program beyond that which is necessary to carry out the renewable fuels mandate under the Act."¹⁸ As discussed further below, based on EPA's own analysis, this assumption no longer remains valid.

In addition to settling on the point of obligation, EPA also created the RIN system in RFS1 as the mechanism for obligated parties to demonstrate compliance. In the RFS1 rulemaking, EPA identified several advantages to having a RIN-based system, including verification of renewable fuel production, real-time RIN trading to provide compliance certainty, ensuring the ability of renewable fuel to be produced, distributed, and blended "*where economic to do so*" (emphasis added), and reduction in double-counting of renewable fuel claimed for compliance.¹⁹ EPA described the RIN-based trading program as "an essential component of the RFS program, ensuring that every obligated party can comply with the standard while providing the flexibility for each obligated party to use renewable fuel in the most economical ways possible."²⁰ The RIN-based system was therefore a recognition that some refiners would have access to terminal blending facilities and others would not. The system was also intended to ensure that obligated parties could meet their RVOs without wholesale changes to the fuel distribution infrastructure or methods by which fuel and fuel additives were transferred.

B. EISA 2007 (RFS2 Proposed Rule)

EPA's implementation of EISA did not change the RIN-based system or alter the requirement that RFS apply "to refineries, blenders, and importers, as appropriate."²¹ In the RFS2 rulemaking, EPA maintained its assumption about the number of entities that would be

¹⁷ Energy Policy Act of 2005, Pub. L. No. 109-58 §1501 (o)(2)(A)(iii)(I).

¹⁸ RFS1 Final Rule, *supra* note 4 at 23923.

¹⁹ *Id.* at 23908.

²⁰ *Id.*

²¹ 42 U.S.C. §7545(o)(3)(B)(ii)(I).



potentially obligated, but recognized in the proposed rule that changes in the fuel market driven by RFS2 reduced the rationale for retaining the point of obligation at the refinery level. As a result, EPA considered changing the definition of obligated party “to more evenly align a party’s access to RINs with that party’s obligations under the RFS.”²²

In discussing the potential change, EPA noted that by placing the point of obligation closer “to the points in the distribution system where RINs are made available, the overall market prices for RINs may be lowered and consequently the cost of the program to consumers may be reduced.”²³ (emphasis added). EPA also recognized that:

if obligated parties seeking RINs cannot acquire a sufficient number, they can only carry a deficit into the following year, after which they would be in noncompliance if they could not acquire sufficient RINs. The result might be a much higher price for RINs (and fuel) in the marketplace than would be expected under a more liquid market. Given the change in circumstances brought about through EISA, it may be appropriate to consider a change in the way obligated parties are defined to more evenly align a party’s access to RINs with that party’s obligation under the RFS2 program.²⁴

AFPM (formerly the National Petrochemical & Refiners Association (“NPRA”)) has long supported placing the point of obligation with the position holder at the terminal rack. AFPM submitted comments to EPA during the RFS2 rulemaking stating that “[t]he current form of the regulation does not: maximize benefits and minimize costs, treat all regulated parties equally, or minimize costs to the consumer. It is not workable and is causing unintended consequences.”²⁵ This implementation problem stems from the fact that parties who have control of gasoline and diesel at the rack may not have an obligation under the RFS and therefore have no direct incentive to blend renewable fuel into gasoline. Therefore, AFPM observed that:

[i]t is the party that has title to the gasoline and diesel at the truck rack that controls how much renewable fuel, if any, is blended (absent state clear gasoline laws). The current and proposed form of the regulations relies on an indirect incentive for the regulations to be workable since the parties that control what if any renewable fuel is added to gasoline and diesel at the truck rack are not necessarily RFS obligated parties.²⁶

During the RFS2 rulemaking, AFPM also warned that the “uneven playing field between obligated parties and renewable fuel blenders” place refiners at a disadvantage to marketers that hold title to fuel at terminals, particularly in areas where un-obligated Rack Sellers have significant market share. AFPM further commented that, “[i]n addition to creating market

²² Regulation of Fuels and Fuel Additives: Changes to Renewable Fuel Standard Program 74 Fed. Reg. 24904, 24963 (proposed May 26, 2009) [hereinafter “RFS2 Proposed Rule”].

²³ *Id.* at 24963-64.

²⁴ *Id.*

²⁵ American Fuel & Petrochemical Manufacturers (formerly NPRA) comments to RFS2 Proposed Rule at 13, (Sept. 25, 2009) [hereinafter “NPRA Comments”].

²⁶ *Id.*



distortion and an un-level playing field, this same situation could result in the obligated parties hitting the blend wall earlier than projected (i.e., marketers that have no RFS obligation and choose not to blend effectively put higher percentage RFS obligation on refiners at an earlier time).²⁷ Although this situation was somewhat mitigated when the effective nationwide ethanol obligation hit ten percent, it will arise (and indeed already exists) when obligations imply an ethanol blend percentage greater than ten percent.

Finally, AFPM argued that:

[t]he structure of the current RFS1 regulations makes the regulations less achievable when the RFS2 volumes require renewable fuel to be blended into essentially all of the U.S. gasoline pool. Because the parties that have control of the gasoline and diesel at the rack may not have a RFS obligation, there is no direct incentive for them to blend renewable fuel into the gasoline or diesel. The current regulatory structure is relying on the market prices of renewable fuels, gasoline, diesel and RINs to provide an incentive for the blending of mandatory volumes of renewable fuels. This indirect incentive is not as strong as a direct RFS obligation and, depending on market prices, may not be any incentive at all.²⁸

C. RFS2 Final Rule

Despite AFPM's warnings and EPA's own analysis seemingly echoing many of the same issues, EPA nevertheless maintained the RFS 1 definition of an obligated party in the final RFS2 rulemaking. And in promulgating RFS2 regulations, EPA reiterated its initial RFS1 rationale:

[the existing RIN system] met our goals of being straightforward, maximizing flexibility, ensuring that volumes are verifiable, and *maintaining the existing system of fuel distribution and blending*. RINs represent the basic framework for ensuring that the statutorily required volumes of renewable fuel are used as transportation fuel in the U.S. Since the RIN-based system generally has been successful in meeting the statutory goals, we are maintaining much of its structure under RFS2.²⁹

In doing so, however, EPA recognized that changes in the RFS and in the fuel market generally would change the dynamics of the RIN market. In particular, EPA observed that even prior to final implementation, the RFS2 volumes were already “resulting in changes to the demand for RINs and operation of the RIN market.”³⁰ For example, EPA noted that “obligated parties who have excess RINs are increasingly opting to retain rather than sell them to ensure they have a sufficient number for next year’s compliance.”³¹ Of particular importance, EPA

²⁷ *Id.* at 14.

²⁸ *Id.*

²⁹ Regulation of Fuels and Fuel Additives: Changes to Renewable Fuel Standard Program 75 Fed. Reg. 14670, 14684 (March 26, 2010) [hereinafter “RFS2 Final Rule”].

³⁰ RFS2 Proposed Rule, *supra* note 7 at 24963.

³¹ *Id.*



forecasted that the gasoline market would be virtually saturated with ethanol by 2013,³² and that refiners with marketing assets and those without would result in “*significant disparities between obligated parties in terms of opportunities to acquire RINs.*”³³

The disparity created between obligated and non-obligated blenders is in direct contravention of EPA’s stated goal of maintaining the existing fuel distribution system through use of the RIN system. Moreover, the disparity that EPA recognized in 2007 and 2010 is even more acute today as the overall burden borne by obligated parties has increased year-over-year. While the percentage requirement for renewable fuel was 4.02 percent in 2007 and 8.25 percent in 2010, the 2016 RFS imposes a 10.10 percent requirement.

In the final RFS2 rule, EPA also recognized that “the rationale in RFS1 for placing the obligation on just the upstream refiners and importers is no longer valid.”³⁴ Despite the recognition, EPA maintained the previous point of obligation based on its belief that “the market will continue to provide opportunities for parties who are in need of RINs to acquire them from parties who have excess.”³⁵ Notably, however, EPA stated that it would “continue to evaluate the functionality of the RIN market. Should we determine that the RIN market is not operating as intended, driving up prices for obligated parties and fuel prices for consumers, we will consider revisiting this provision in future regulatory efforts.”³⁶

Setting the point of obligation at the refinery level during the early years of the program has always been problematic for the reasons described above. But since the level of the RFS in the early years of implementation was below the E10 blend wall, the effect of this decision was muted. RIN prices stayed relatively low and the more gradual “ramp up” of applicable volumes in RFS1 and the first years of RFS2 allowed time for the distribution and retail infrastructure to accommodate E10. However, circumstances have materially changed. It is now clear from the current dysfunction in the RIN market in the wake of the onset of the blend wall, and from EPA’s use of its general waiver authority in the 2014-16 and 2017 rulemakings, that the condition precedent EPA identified in the final RFS2 rulemaking, that “the RIN market is not operating as intended,” has been triggered. Therefore, EPA has both the opportunity and the obligation *now* to address this situation through a regulatory change to change the point of obligation. Changing the point of obligation will enable EPA to minimize the economic impacts of the RFS in the future and mitigate disruptions for industry and consumers.

II. The Onset of the Blend Wall and Resulting RIN Market Reaction Makes Clear that the RFS is Dysfunctional and Warrants Change

A. The E10 Blend Wall

The onset of the E10 blend wall in 2013 amplified the dysfunction of the RIN market and the need to change the point of obligation. During the initial years of the program, RIN prices

³² *Id.*

³³ *Id.* (Emphasis added).

³⁴ RFS2 Final Rule, *supra* note 6 at 14722.

³⁵ *Id.*

³⁶ *Id.*



generally traded at \$0.04 per RIN or less. Beginning in 2013 when the E10 blend wall became a real concern, however, D6 RIN prices began to spike, reaching as high as \$1.48 per RIN. In the three years since the initial run up in RIN prices, D6 RINS have not dropped below \$0.29, fluctuating largely in response to anticipated and announced EPA actions.

In a 2011 Small Refinery Exemption Study, the Department of Energy (“DOE”) identified the arrival of the blend wall as a triggering event that would increase the cost of compliance industry wide, but especially for refineries that rely on purchased RINs for compliance.³⁷ Of course, every refiner is, or will be, affected by the E10 blend wall, particularly as the mandates continue to grow. However, refiners are situated differently, and will experience the impacts of the RFS differently depending on product slates, access to terminals and other marketing assets, and regional competition. For instance, ethanol-blended finished gasoline is not permitted in a common carrier pipeline. As a result, many merchant refiners sell petroleum fuels in bulk, which are purchased by downstream Rack Sellers prior to mixing of traditional petroleum fuel and biofuel at a terminal or truck rack. These refiners are uniquely exposed to the RIN market and had compliance costs over a billion dollars last year alone.³⁸

B. RIN Market Dynamics

There is some contention that the RIN costs are included within fuel wholesale prices, diminishing the impact RIN prices may have on refiners. For instance, during its 2014-16 RFS rulemaking, EPA used data from New York Harbor to demonstrate that the wholesale price of gasoline reflects the cost of the RIN, and that RINs are bought and sold in a “closed loop.”³⁹ There are several problems with this analysis. First, New York Harbor is among the most competitive markets in the country, and not necessarily reflective of other regional markets. For instance, refiners in the U.S. mid-continent produce different base gasoline in order to meet state air regulations and to conform to pipeline specifications. These regional differences result in a disparate ability among refiners to capture the cost of RINs in their wholesale markets. Much RIN-related activity occurs at local fuel racks, where RIN prices and associated gasoline sales do not necessarily reflect New York Harbor activity. Furthermore, individual obligated parties short on RINs do not typically buy RINs and sell gasoline at the same time. In other words, extrapolating a conclusion about national RIN impacts on companies and consumers from a large, but localized, transparent, and unique market such as New York Harbor is inappropriate. The RINs obligation results in timing and local differences that expose obligated parties like merchant refineries to a large regulatory risk.

The analysis also fails to consider the market impacts that result from competition that occurs at the blending rack. Refiners compete for market share by trying to beat each other in

³⁷ U.S. DEP’T OF ENERGY, OFFICE OF POL’Y AND INT’L AFFAIRS, SMALL REFINERY EXEMPTION STUDY: AN INVESTIGATION INTO DISPROPORTIONATE ECONOMIC HARDSHIP 18 (March 2011) (stating “[w]hile current RIN prices for ethanol are moderate (adding less than 2 cent per gallon of renewable fuel, there are numerous circumstances when RIN prices could rise, increasing the cost of compliance and perhaps increasing the cost of compliance more for refineries that rely on RINs for compliance compared to those that do not.”).

³⁸ Data compiled from publicly available financial reports.

³⁹ Dallas Burkholder, U.S. EPA, Office of Transportation and Air Quality, An Assessment of the Impact of RIN Prices on the Retail Price of E85 (Nov. 2015) [hereinafter “Burkholder Memo”].



the market on a price basis. The entity offering the best price to the buyers are the ones who can sell more of their products than their competitors. As a result, some refiners may not be able to pass along the full cost of their RIN compliance to a non-obligated Rack Seller, because their competitors may be able to absorb a higher proportion of the RIN cost in order to offer a more competitive price as a result of their market positions. In other words, a refiner that is short RINs (i.e. has to buy most of its RINs for compliance from other parties) due to lack of its own blending capabilities may not be able to pass along significant portions of its RIN costs, because a competitor that is long RINs (i.e. has more than needed for compliance) can use the value of its excess RINs to try and offer buyers a discount. The ability of Rack Sellers with localized market dominance to use RINs to capture additional market share is a fundamental shift in the fuel market, which is directly contrary to EPA's stated goal of avoiding wholesale changes to the manner in which fuel is distributed.

In addition to whether there is pass-through, there is also a significant temporal issue regarding when the costs are actually passed through. For instance, Knittel et al. found that the price pass occurs later, and that in some time periods, there may be higher or lower pass-through.⁴⁰ Knittel further noted that "even with full pass-through, however, an obligated party could face RIN price risk because of timing differences between when the RIN obligation is incurred and when RINs are acquired."⁴¹

The impact on consumers largely depends on the ultimate blender. For instance, RIN prices can be passed along to consumers in the form of a rack discount. This scenario is embraced by advocates for the use of sustained high RIN prices as a mechanism to drive greater penetration of E85.⁴² Of course, as AFPM has repeatedly observed, this dynamic is also constrained by consumer demands and infrastructure constraints at the retail level. For these reasons, as discussed by EPA in the proposed 2017 rulemaking,⁴³ as well as by Professors Christopher Knittel, Ben Meiselman, and James Stock, the RIN value is not reflected in the market for E85. The professors specifically state, "[t]here appears to be incomplete pass-through of RIN subsidies to E85 prices, and there has been slow national growth of E85 sales in 2013 and 2014 despite high RIN prices."⁴⁴ As a result, they believe that the point of obligation should be moved:

RINs are separated at blending but the obligated parties are refiners and importers, not blenders. This creates two frictions. First, because blenders either are retailers or sell to retailers, blenders are better situated to pass the RIN subsidy for high-renewable content fuels along to the consumer than are the current obligated parties, who are further upstream. This raises the possibility that

⁴⁰ Christopher Knittel, et. al, THE PASS-THROUGH OF RIN PRICES TO WHOLESALE AND RETAIL FUELS UNDER THE RENEWABLE FUEL STANDARD (June 2015) [hereinafter "Knittel Report"].

⁴¹ Knittel Report at 20.

⁴² Burkholder Memo at 13.

⁴³ Renewable Fuel Standard Program: Standards for 2017 and Biomass-Based Diesel Volume for 2018; Proposed Rule, 81 Fed. Reg. 34778, 34790 (proposed May 31, 2016).

⁴⁴ Christopher Knittel, Ben Meiselman and James Stock, Columbia University SIPA Center on Global Energy Pol'y, THE RENEWABLE FUEL STANDARD: A PATH FORWARD at 21 (Apr. 2015).



shifting the obligation to the blenders could improve RIN pass-through in E85 and other higher blends. Second, some obligated parties, such as merchant refiners, are currently left with net RIN deficits that need to be filled on the market by purchasing RINs from net RIN generators. As discussed previously, movements in RIN prices appear to be passed through to RBOB prices, suggesting obligated parties with net RIN deficits can pass through their RIN costs *on average* [emphasis added]. Still, the current system leaves those obligated parties with net exposure to RIN price fluctuations, and their ability to recover RIN costs might be incomplete because of lags and variability in RIN prices. The purpose of the RIN system is to ensure compliance with the RFS, not to add price risk to the balance sheets of obligated parties that happen to have a generation/obligation mismatch.⁴⁵

If anything, given the thin market for E85, marketers and retailers appear to be capturing a higher price for a low volume of E85 sales, content to take a higher margin on low throughput rather than a lower margin on higher throughput. As the Burkholder memo discusses, this is to be expected in an undeveloped market like E85.⁴⁶

While AFPM agrees with the professors that RIN values are not fully passed through to consumers, we also believe that they fail to fully acknowledge the extent to which non-obligated Rack Sellers can retain some or all of the RIN value. For instance, some publicly-traded, non-obligated companies are reporting significant revenue from RIN sales.⁴⁷ For example, in 2015, Murphy USA reported that RINs added \$117.5 million to its bottom line, representing 85 percent of 2015 net income from continuing operations for Murphy USA.⁴⁸ In 2016, Murphy USA announced that it sold 54 million RINs in the first quarter for an average price of \$0.72/RIN, contributing \$0.039 to its fuel margin.⁴⁹ This is indicative that the full value of the RIN is not being passed through to the consumer and, rather, being retained by the marketer as profit. Likewise, Casey's General Store sold 12.7 million RINs for \$9.1 million in the fourth quarter.⁵⁰

⁴⁵ *Id.*

⁴⁶ Burkholder Memo; see also Paul Bernstein, et al., NERA Economic Consulting, EFFECTS OF MOVING THE COMPLIANCE OBLIGATION UNDER RFS2 TO SUPPLIERS OF FINISHED PRODUCTS at 18 (July 2015) [hereinafter "NERA Report"] (stating that blenders investing in higher blends "would be contrary to the blenders' financial interest, as the more renewable fuel the blender purchases and blends, the more RINs will be created and those excess RINs will decrease the value of RINs").

⁴⁷ See, e.g. Tristan R. Brown, *Murphy USA Blows Past Its Q1 Earnings Estimates on Strong Gasoline Demand*, SEEKINGALPHA (May 17, 2016) <http://seekingalpha.com/article/3975452-murphy-usa-blows-past-q1-earnings-estimates-strong-gasoline-demand>; CASEY'S GENERAL STORE FISCAL YEAR 2016 (June 6, 2016), <http://www.caseys.com/sites/default/files/4thQtrfy2016.pdf>.

⁴⁸ Press Release, Murphy USA Reports Fourth Quarter 2015 Results (Feb. 3, 2016), <http://finance.yahoo.com/news/murphy-usa-reports-fourth-quarter-220201317.html>.

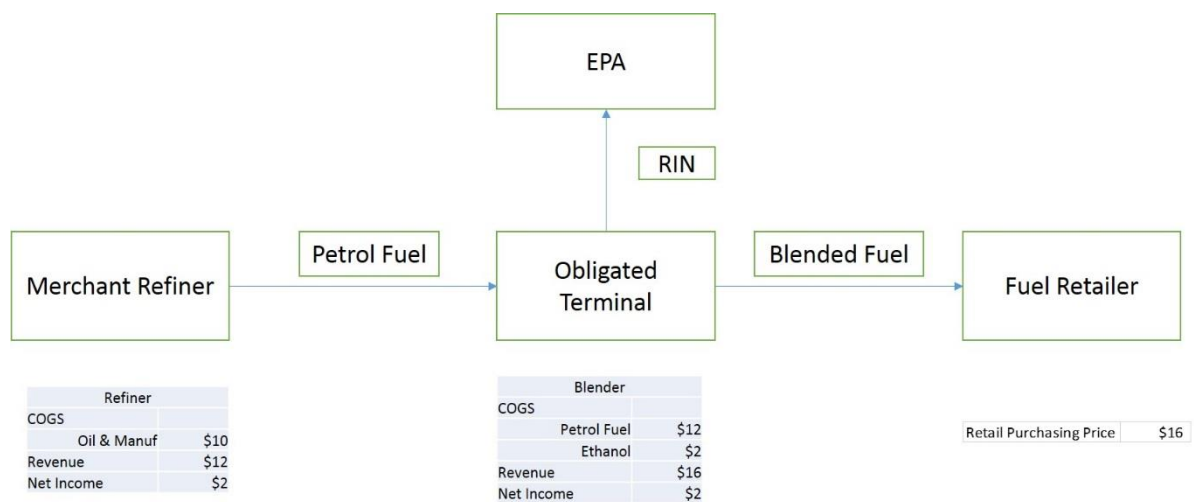
⁴⁹ Tristan R. Brown, *Murphy USA Blows Past Its Q1 Earnings Estimates on Strong Gasoline Demand*, SEEKINGALPHA (May 17, 2016) <http://seekingalpha.com/article/3975452-murphy-usa-blows-past-q1-earnings-estimates-strong-gasoline-demand>.

⁵⁰ CASEY'S GENERAL STORE FISCAL YEAR 2016 (June 6, 2016), <http://www.caseys.com/sites/default/files/4thQtrfy2016.pdf>.



Building on this point, maintaining a high RIN price allows Rack Sellers to maximize profit and acts as a disincentive to maximize ethanol blending. Artificially forcing RIN scarcity through the RIN program structure, and consequently elevating RIN prices beyond those that would be experienced in a more equitable structure, may serve the best interests of these non-obligated Rack Sellers, but it comes at the expense of refiners and ultimately consumers. The following theoretical examples highlight this phenomenon.

In Figure 1, the point of obligation is moved to the hypothetical Rack Seller rather than the refiner. The merchant refiner produces fuel for \$10 (“cost of goods sold” or “COGS”) and sells it to the Rack Seller for \$12, a hypothetical \$2 profit. The Rack Seller incurs the cost for purchasing the fuel and the cost for buying ethanol (hypothetically \$2 dollars here) and then sells the fuel for \$16 to retailers. In this situation, the refiners and terminals are able to profit, and thus stay in business, and Rack Sellers do not bear RIN costs, since they are separated from the acquired ethanol at the time of blending and simply turned over to EPA for compliance. In this instance the rack seller does not need to purchase the RINs from another party, because it detaches and retains RINs when it blends ethanol into the fuel supply. The Rack Seller is incentivized to maximize blending, to the extent consumer demand and other market constraints on the utilization of renewable fuel will allow it, to avoid incurring RIN costs. RIN scarcity will still occur when consumers demand for ethanol has reached its limit and other market and infrastructure constraints prevent the use of ethanol or other renewable fuel by consumers. For instance, if EPA continues to mandate unachievable biomass-based diesel, advanced, and cellulosic volumes, pressure on RIN markets will continue to grow. However, the changed point of obligation would not encourage market participants to benefit through RIN scarcity.



Note: In this situation, the terminal is obligated to turn RINs into EPA for compliance and, thus, is incentivized to maximize blending to minimize the potential for incurring RIN costs.

Figure 1



Figure 2 is more reflective of the current situation where Rack Sellers are not obligated parties. In this scenario, under the current point of obligation, the non-obligated Rack Seller is able to sell the RIN for additional profit. In contrast, the refiner faces a situation where it *loses* money due to the point of obligation, threatening its business model and ultimately consumer fuel supplies. As the figure shows, this scenario also highlights how a terminal can *increase* overall profit via RIN sales. The fact that a higher RIN price leads to higher profit clearly exemplifies that the current point of obligation does not produce the most efficient economic outcome.

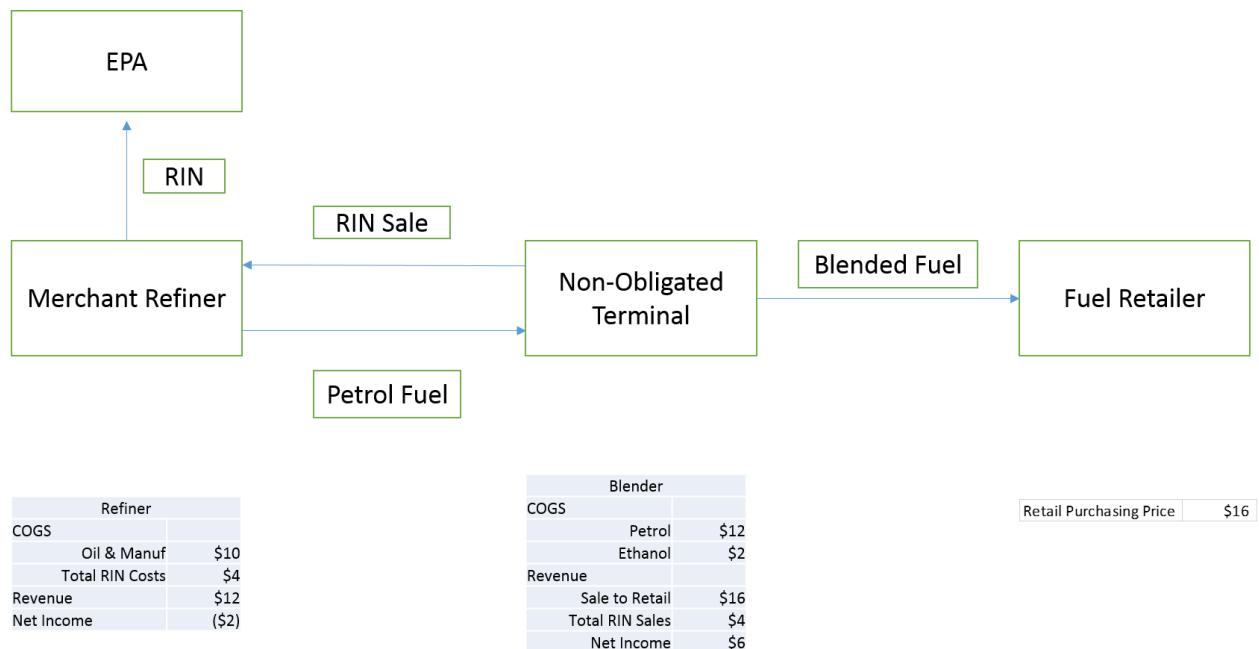


Figure 2

One could argue that the refiner in Figure 2 should simply increase the price it charges non-obligated Rack Seller to account for the RIN cost. In practice, several factors limit the ability of merchant refiners to fully pass through RIN costs, such as competition from other refiners with lower overall cost structure and consumer demand (which could serve to limit prices that can be charged).

Additionally, one could argue that the situation displayed in Figure 2 would at some point lead to some non-obligated Rack Seller introducing more biofuels into the fuel supply to garner more RINs and, thus, more profit. However, non-obligated Rack Sellers under the current point of obligation are given the market power and incentive to keep RIN costs high. Companies also make decisions based, in part, on their expectation of competitor reactions. As a result, non-obligated Rack Sellers will recognize the potential for lost profit in a higher RIN supply scenario. The CEO of a Murphy USA, a significant Rack Seller, demonstrated this approach in a recent investor call:



If you add the combination of the gross margin from product supply and wholesale and the RINs and divide over the total retail gallons sold, you actually see a fairly consistent incremental \$0.025 per gallon over the past two years. So as we discuss guidance later in the call, please keep this interplay in mind.

....

The benefit, though, is the RINs that you get from shipping your own barrel and, when there are constraints in the system, the additional uplift you have not only in the spot-to-rack prices, but the fact that if rack prices rise across the board because of the constraints, there are more high-priced barrels out there and your low-price position benefits you significantly. So there's a lot of upside associated with that.

We've never tried to define how much of the spot-to-rack margin gets depressed because RIN prices are over \$0.30 or \$0.40 or \$0.50 or \$0.60, but we know that the behavior by the refiner marketers whose next best alternative is to dial back refinery runs, which they are not going to do when crack spreads are high, or look to export, especially if the export markets are constrained. They are going to put those barrels out there.

So the question is, what do you believe about the market outlook for the next 12 and 24 months for this part of the business? And if you believe that RINs maintains some level over \$0.50, you can get to a number that's been pretty consistent over the last two years of about \$0.025 per gallon when measured using our total retail volume.⁵¹

Murphy USA reported significant RIN revenue in its earnings reports, and its statements about RIN contribution to net income suggests a scenario similar to that described in Figure 2 is occurring. In fact, on June 29, 2016, Goldman Sachs released a research report upgrading stock recommendations for several large, exempted blenders while underscoring the exposure of some merchant refiners to the RIN market.⁵² Such evidence indicates that non-obligated Rack Sellers are using RINs to maximize profit, which is contrary to the intent of the RIN system to serve as simply a flexible compliance mechanism.

This dynamic is exacerbated by the fact that only about 60 percent of U.S. refiners and importers also blend gasoline, and an even smaller percentage are able to blend their full obligation.⁵³ Moreover, the U.S. gasoline market has become increasingly de-integrated as refiners increasingly sell unblended gasoline to third party Rack Sellers, who, along with retailers, make decisions about the ultimate price differential among various blended fuels. This dynamic allows entities closer to the consumer to understand and meet the needs of their market.

⁵¹ Transcript of Murphy USA First Quarter Earnings Call, Andrew Clyde, President, Murphy USA, Thompson Reuters (Feb. 4, 2016).

⁵² Adam Samuelson, et al., Tighter RIN Markets into 2017 Create Biofuel/Refiner Dislocations, Goldman Sachs, Inc. (June 29, 2016).

⁵³ NERA Report, *supra* note 45 at 7.



For instance, a Gulf Coast refiner selling unblended gasoline into the Colonial Pipeline does not necessarily understand consumer demand and how it might differ at various points along the East Coast. At least 50 percent of gasoline produced by obligated parties moves through unaffiliated Rack Sellers.⁵⁴ In other words, the refiner has virtually no ability to influence how much of the RIN is passed through to the consumer as a rack discount as opposed to being retained by the Rack Seller. A closer alignment of incentives and risks associated with obligation and compliance will reduce these systemic costs, benefiting the overall fuel market and consumers.

C. The Diesel Deficit Contributes to RIN Market Dysfunction

Although a great deal of public debate is centered on the ethanol blend wall, the dysfunction in the RIN market is exacerbated by the disparate treatment of diesel and gasoline under RFS regulations. More specifically, EPA imposes percentage standards on refiners based on the total volume of transportation fuel they produce for sale in the United States. Therefore, for every gallon of gasoline or diesel a refiner produces for domestic consumption, they incur a RIN obligation in each of the statutory categories. Under this regulatory system, a company that produces diesel must produce or acquire biomass-based diesel RINs in addition to ethanol RINs, despite the fact that ethanol cannot be used in diesel and biodiesel cannot be used in gasoline.

In 2015, the U.S. produced approximately 1.9 billion gallons of biomass-based diesel and renewable diesel, enough to comprise approximately 3.1 percent of the 55.5 billion gallons of petroleum diesel demand. After accounting for the 1.5 RIN multiplier, biomass-based diesel RINs therefore accounted for only 4.7 percent of U.S. diesel consumption. However, in 2015 each gallon of diesel produced was required to meet the 9.52 percent RFS percentage standard. As a result, every gallon of diesel a company produces incurs a RIN deficit that needs to be accounted for elsewhere in the company's obligation. Prior to the onset of the blend wall, additional conventional ethanol was used to meet the resulting gap. Due to the onset of the E10 blend wall, this is no longer feasible.

Moving the point of obligation to the Rack Seller will provide greater parity between refiners with different product slates by alleviating this RIN deficit for refiners who produce diesel. Eliminating this disparity will ultimately allow refiners to produce fuel for market demand rather than making artificial decisions based on the ability to acquire sufficient RINs to cover their obligation.

⁵⁴ *Id.* at 19.



III. Changing the Point of Obligation Will Reduce the Systemic Cost of the RFS to Obligated Parties and Consumers, and Will not Result in a Significant Administration Burden to EPA or Newly Obligated Parties

A. Moving the Point of Obligation Will Reduce Systemic Cost by Making the RFS Program More Sensitive to Market Realities

As currently structured, 40 percent or more of the compliance obligation is on refining companies with minimal ability to influence investment decisions and wholesale pricing at the point of blending. These refiners are captive to the RIN market and must bid for RINs against other refiners and even financial speculators.⁵⁵ If the point of obligation were moved to the Rack Seller, the obligation would fall on those are in the best position to ascertain consumer demand as well as weigh the benefits of various compliance options. As a result, the volatility of RIN pricing will diminish, reducing both the business risk and associated systemic cost. AFPM takes note that EPA already acknowledged this fact in the RFS2 rulemaking, discussed *supra* Part I, and it has recently been argued by former National Economic Council advisor Ron Minsk.⁵⁶

B. Moving the Point of Obligation will not Increase Administrative Burden

In addition to reducing the systemic cost of complying with the RFS program, moving the point of obligation to the Rack Seller will not increase the administrative burden on EPA. The numbers of obligated parties are likely to decrease, are easily ascertainable, and are comprised of entities that already have extensive experience in complying with IRS registration requirements.

As an initial matter, the number of obligated parties under AFPM's proposed definition (provided below) is likely to decrease compared to the status quo. Based on an analysis conducted by IHS, less than 200 entities would be subject to the RFS under AFPM's proposed definition, compared to approximately 220 today.⁵⁷ Many refiners will remain obligated parties, but as a result of the more equitable calculation of obligation, will only be responsible for the fuel they blend.⁵⁸ This analysis shows that EPA's assumption that 1,200 or more terminals would become obligated parties is based on a different point of obligation and is therefore erroneous under this petition.

AFPM's proposed definition has the added virtue of placing the point of obligation on a clearly identifiable segment of the fuels industry, because Rack Sellers already register with the IRS for excise tax purposes. These companies have experience in the administrative procedures

⁵⁵ Gretchen Morganson and Robert Gebeloff, *Wall St. Exploits Ethanol Credits, and Prices Spike*, NY TIMES (Sept. 14, 2013), http://www.nytimes.com/2013/09/15/business/wall-st-exploits-ethanol-credits-and-prices-spike.html?_r=0.

⁵⁶ *Oversight of the Renewable Fuel Standard, Hearing before the Sen. Comm. On Env't and Public Works*, 114th Cong. 10 (Feb. 24, 2016)(written statement of Ronald E. Minsk)[hereinafter "Minsk Testimony"].

⁵⁷ RFS Obligated and Non-Obligated Party Lists, IHS GLOBAL, INC. (Apr. 2016).

⁵⁸ In fact, at least 60 percent of refiners, representing 80 percent of fuel sold by Rack Sellers, will likely remain obligated under AFPM's proposed definition.



to register and comply for tax purposes. In fact, according to EPA's EMTS data, currently obligated parties separate over 80 percent of RINs.⁵⁹ Therefore, the regulatory obligation will continue to fall largely on AFPM's members. However, it would also ensure that the other 20 percent of RIN separators have a more equitable stake in the functioning of the RIN market.

IV. EPA has the Legal Imperative to Change the Point of Obligation to Address Identified Problems in Implementing the RFS and Changed Circumstances Since the RFS1 and RFS2 Rulemakings

Congress directed EPA to set the point of obligation on "refineries, blenders, and importers, as appropriate."⁶⁰ Although EPA has discretion to interpret "as appropriate" in implementing the RFS, it must do so in a way that is consistent with the purpose of the statute.⁶¹ In addition, in determining what is appropriate, EPA may not "entirely fail to consider an important aspect of the program."⁶² During RFS1 implementation, EPA provided at least a modicum of support for its decision to exempt certain Rack Sellers. In the 2010 RFS2 rulemaking, however, EPA abandoned its rationale for placing the obligation solely on refiners and importers. Despite the clear change in EPA's analysis, EPA maintained the previous point of obligation premised on the assumption that a sufficient number of RINs would be available for compliance, and on notion that exempting certain Rack Sellers would reduce the administrative burden for EPA. As demonstrated, neither assumption currently holds true, and as a result it is no longer "appropriate" for EPA to maintain the current definition.

As outlined above, AFPM believes that the time has come for the RFS to be repealed, as the underlying purposes of the act are no longer valid or are not being achieved by the program. Until that happens, however, EPA has more than sufficient evidence and reason to act at this time. Escalating RIN prices due to the advent of the E10 blend wall and concurrent waivers of applicable volumes show that the RFS is not working, much less working with the efficiency originally expected. EPA has the opportunity through rulemaking to set the RFS on a different course and to mitigate, if not eliminate, several issues concerning implementation of the program.

Accordingly, AFPM respectfully requests EPA to take prompt action to propose and finalize a change to the definition of obligated party under the RFS. Moving the point of obligation closer to the point of compliance would better reflect market realities and would reduce the systemic cost of the RFS by more closely aligning regulatory obligations with blending decisions and consumer demand.

Recommended regulatory text:

An obligated party is the entity that holds title to the gasoline or diesel fuel, immediately prior to the sale from the Bulk transfer/terminal system (as defined

⁵⁹ Minsk Testimony at 17.

⁶⁰ 42 U.S.C. §7545(o)(3)(B)(ii)(I).

⁶¹ See, e.g., *Chem. Mfrs. Ass'n v. EPA*, 217 F.3d 861, 866-67 (D.C. Cir. 2000).

⁶² *Michigan v. EPA*, 135 S.Ct. 2699, 2707 (2015).



by IRS regulations) to a wholesaler, retailer or ultimate consumer and is required to report any federal excise tax liability on IRS Form 720 – Quarterly Federal Excise Tax Return. An obligated party also includes the entity that is the enterer (as defined by IRS Regulations in 40 CFR §48.4081-1) of the gasoline or diesel fuel into the U.S. outside of the bulk transfer/terminal system and is required to report any federal excise tax liability on its Form 720.

AFPM appreciates the opportunity to submit this petition for rulemaking and requests that EPA take prompt action to proceed to rulemaking in this matter.

Sincerely,

Chet Thompson
President