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The Biodiesel Waiver Provision in the RFS

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As discussed in the two previous articles, EPA has issued a Notice of Data Availability (NODA) seeking data and comment on potential reductions to the biomass-based diesel mandates (see, *farmdoc daily*, October 5, 2017 and October 12, 2017). The third matter raised in the NODA, the specific waiver provision for biomass-based diesel (BBD), is discussed in this article.

BBD Waiver Authority

The threshold matter for any waiver to reduce mandated volumes must be balanced against the core Congressional intention when it passed the RFS. Congress in the statutory language, and the courts in their interpretation of it, have been clear that the RFS was intended to be a market forcing policy. Congress wanted it to create demand and increase the consumption of renewable fuels by the U.S. transportation sector, including BBD.

The RFS effectively provides four different waiver authorities. The first two are under the general authority discussed previously: (1) inadequate domestic supply; and (2) severe economic harm. These waivers establish a very high bar because through them Congress delegated authority to EPA to actually reduce the statutory mandates. Use of the general waiver directly contradicts the big picture intent of Congress to force technology and drive demand, as well as delegates to an agency the ability to effectively revise the statute. The other two waiver authorities are more specific, applying to: (3) cellulosic biofuel and (4) biomass-based diesel. The cellulosic waiver has been discussed briefly before and will not be covered in this article; it is broad authority to address the situation where the realities of cellulosic production fail to match the statutory goals for it.

The BBD waiver authority is different from the other three in its specificity and clearly limited applicability. EPA must determine that "there is a significant renewable feedstock disruption or other market circumstances that would make the price of biomass-based diesel fuel increase significantly" (42 U.S.C. §7545(o)(7)(E)). A waiver can only operate for up to 60-days and reduce by a quantity that does not exceed 15 percent of the applicable annual requirement, with the authority to extend for an additional 60 days and an additional 15 percent. This is waiver authority requiring specific triggering events that would allow relief that is temporary (60 days) and limited in scale (no more than 15 percent). The most

reasonable reading of the waiver is that it only applies to some temporary, emergency situation that causes a spike in prices.

The BBD waiver applies only in cases where there is a ***significant disruption*** in feedstock for BBD or other market circumstances that would cause a ***significant increase*** in BBD prices. Congress intended the RFS to be market forcing, and that would intuitively require higher prices to prod the market in the direction Congress sought. Therefore, use of the waiver would not be appropriate simply because prices are relatively higher or are trending upward. It would require a spike in prices that would indicate an extraordinary or anomalous situation.

Where the general provisions would be used to reduce the statutory mandates, the BBD provision is a standard waiver to reduce the requirements EPA has established for the annual requirements in accordance with the statute. It is retroactive to the rule, not preemptive. The waiver would be used in response to unforeseen circumstances that have caused problems, such as feedstock disruptions, that drive up prices unexpectedly after the requirements are in operation.

Finally, the BBD waiver is temporary and capped, further instructing that its use is retroactive and responsive. A waiver can be in place for only 60 days and a reduction cannot be more than a 15 percent reduction. This is a waiver as a temporary, emergency measure resulting from some aberration in the market that spikes prices. It is designed not to alter the program but to ease burdens by something unforeseen or extraordinary; used to provide temporary, limited relief until the emergency situation passes.

For example, EPA has proposed a 2.1 billion gallon requirement for 2018. The BBD waiver might permit a reduction up to 315 million gallons for 60 days during 2018 if something disrupts feedstocks and spikes prices. An example might be a weather event, such as a massive drought, that disrupts soybean production and requires temporary relief to find replacement feedstock. Another might be an event that temporarily disrupts transportation of biodiesel to the blenders, requiring a waiver until it is resolved and to avoid price spikes.

Triggering the BBD Waiver Authority

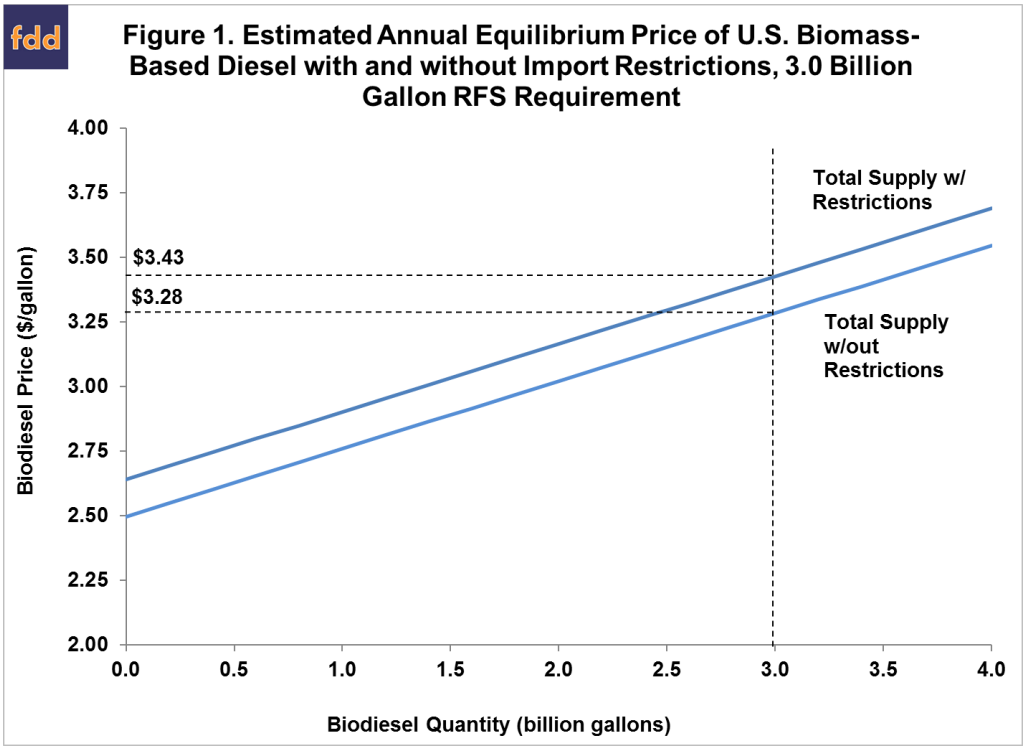
Based on several concerns, the NODA specifically asked for comments on the possibility of applying the BBD waiver authority for 2018. The first was the fact that the biodiesel tax credit expired at the end of 2016, and, thus far, has not been renewed by Congress. The EPA provided new data purporting to show that expiration of the tax credit impacted the “effective” price of BBD to blenders as well as the price of BBD blends to consumers. The way the new data in the NODA is presented leaves the impression that blenders largely, or possibly even entirely, absorbed the impact of the expiration of the $1 per gallon tax credit. In other words, when the credit expired at the end of 2016 the net price paid by blenders increased by $1 per gallon and this was absorbed in their blending margins. This, of course, ignores entirely the likelihood that blenders passed some or even most of this effective price increase on to consumers at the pump. Economic theory predicts that the higher cost is borne partly by refiners (obligated parties under the RFS), blenders, and consumers. The incidence on the various parties depends on the relevant elasticities of demand and supply. The evidence in Pouliot and Babcock (2016) indicates that consumers bear almost the entire cost of binding RFS mandates, so a reasonable expectation is that the price increase associated with expiration of the tax credit was largely passed through to motorists at the pump.

If the biodiesel price increase associated with expiration of the tax credit was passed on to consumers, the overall impact on the blended price of diesel would have been very modest. Assuming a BBD blend rate of 5 percent, a $1 per gallon increase in BBD translates into a 5 cent increase in the pump price of diesel, or an increase of around 2 percent based on recent pump prices. The small increase in blended diesel prices is simply a reflection of the low BBD blending percentages used in the U.S. at the present time. The key point is that even though the expiration of the tax credit led to an increase in the effective price of biodiesel to blenders and consumers, this had a very small impact on blended diesel prices. It is difficult to see how this constitutes the type emergency situation that would justify triggering the BBD waiver.

Another problem with triggering the BBD waiver based on expiration of the tax credit is a matter of timing. In particular, the triggering event must be related in time to the waiver decision and that the waiver is from requirements already in operation. While it is possible that elimination of the tax credit could lead to a

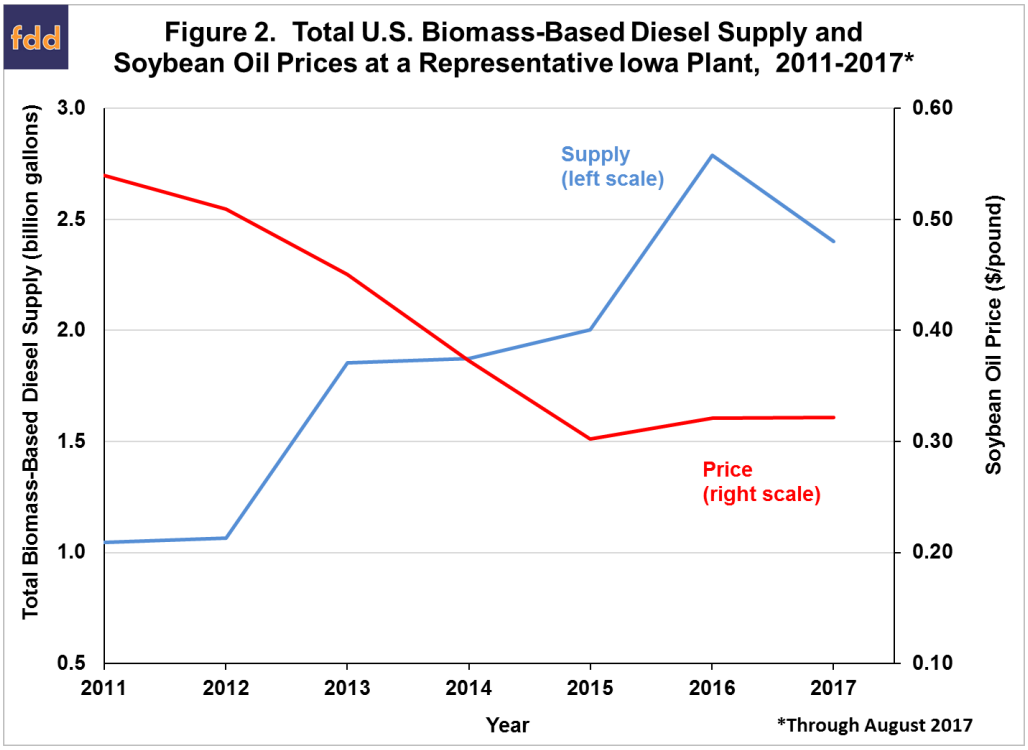
price spike that might justify the waiver, the problem for the industry is that the time for such a waiver would have been immediately after Congress allowed it to expire. It is difficult to see how the waiver could be used now, almost a year after the tax credit expired; any emergency, if it had existed at all, has surely passed.

A second concern in the NODA is the potential price increase associated with restricting BBD imports from Argentina and Indonesia due to an antidumping and countervailing duty petition filed by U.S. producers with the U.S. Department of Commerce (DOC) and the International Trade Commission in March 2017. The DOC made a preliminary ruling in August and imposed duties in the form of "cash deposits." The deposit rates range from 50.29% to 64.17% of the value of Argentinian biodiesel and from 41.06% to 68.28% for Indonesian biodiesel. If finalized this would likely be sufficient to eliminate all biodiesel imports from Argentina and Indonesia, which totaled about 546 million gallons in 2016, accounting for 48 percent of total BBD imports. The impact of this potential restriction on the price of biodiesel was analyzed in a recent *farmdoc daily* article (August 16, 2017). Figure 1 is reproduced from this earlier article and it shows projected equilibrium biodiesel prices with and without the elimination of BBD imports from Argentina and Indonesia. Imposing the import restrictions raises the biodiesel price by $0.15, from $3.28 to $3.43 per gallon, or 4.6 percent. There are two fundamental reasons why the biodiesel price impact is so modest. The first is the extreme price elasticity of the supply curve. With an estimated elasticity of four, only a one percent increase in price is required to increase biodiesel quantity by four percent. The second reason is that the shift in the total supply curve due to the import restrictions is modest in comparison to domestic supply. Once again, this evidence is not of the sort that would suggest triggering an emergency waiver provision.



While not emphasized in the NODA, another justification for applying the BBD waiver is feedstock disruptions. The impact of RFS mandates on BBD feedstock prices was the subject of two recent *farmdoc daily* articles (September 7, 2017; September 14, 2017). Figure 2 illustrates the findings in these two articles by plotting total U.S. BBD supply on an annual basis versus the annual average soybean oil price for 2011 through 2017 to date. Total BBD supply jumped from 1 billion gallons to around 2.5 billion gallons, a gain of about 150 percent, while soybean oil prices declined from around $0.50 to $0.30 per pound, a drop of almost 40 percent. The combination of good growing season weather around the world and China's soybean import boom explains this surprising state of affairs. Since soybean oil is a joint product that is produced in a fixed proportion when soybeans are crushed, China's soybean import boom necessarily also produced a huge quantity of soybean oil. In essence, China's soybean import boom, in combination with good weather, increased global soybean oil supplies enough to allow the U.S. boom in biodiesel production to take place without causing a corresponding boom in soybean oil prices. There is

no reason not to expect this situation to persist until the world experiences a series of poor growing seasons for soybeans.



Finally, industry commenters cited in the NODA raise the issue of the increasing level of imported BDD, relying on the preamble for EISA 2007 that states, in part, that the goal was to "move the United States toward greater energy independence and security" (see, EISA 2007 Preamble). They raise concerns about the speculative impacts of potential actions by exporters such as Argentina or Indonesia, which make this difficult to justify a BBD waiver. If actions of BBD exporters disrupted feedstock supplies or caused a temporary price spike, it is possible they could support use of the BBD waiver but it is difficult to conclude that the mandates can be waived preemptively based on speculation about what these other nations might do; the waiver reads as more of a reaction to events that shock the market and cause prices to spike.

A related issue is the industry concerns about whether increased use of imported BDD runs contrary to Congressional intent for energy independence and security. As discussed previously, the goals for the RFS as stated in the preamble for EISA must be understood in terms of the overall Congressional intent. Again, the method Congress elected to achieve the goal was to drive demand for renewable fuels. It is counterintuitive to justify a reduction in the mandate for renewable fuels, including BBD, because of an increase in imported BBD. If imports are taking up a larger portion of the domestic supply it is difficult to conclude that lowering the mandate would improve that situation and it is possible that domestic production would only be further squeezed out. This is especially true given the fact that the mandate is currently less than domestic production capacity. The goal in EISA counsels increasing the mandate to allow more room for domestic production rather than reducing the mandate. This weighs strongly against using it as a reason for a waiver.

Implications

The biomass-based diesel (BBD) waiver provides the EPA with the authority to waive the BBD RFS mandate for up to 60-days and to reduce the mandated quantity by an amount that does not exceed 15 percent of the applicable annual requirement, with the authority to extend for an additional 60 days and an additional 15 percent. The waiver is a temporary, emergency measure to provide relief once BBD requirements are in place, issued in response to an unforeseen triggering event that would cause prices to spike. The EPA recently asked for comments on applying the BBD waiver to the 2018 mandate. Our analysis suggests it will be difficult to justify such a waiver. For example, the EPA argues that the expiration of the biodiesel tax credit at the end of 2016 caused a substantial spike in "effective" biodiesel prices to blenders. The time for use of the waiver because of the tax credit expiring at the end of 2016

has already passed, and may not have been significant enough to justify waiver if it had been applied in a timely manner. Ultimately, any waiver decision has to take into account the facts that the RFS is designed to be a market forcing policy, BBD feedstocks are plentiful, production capacity is underused, and the increase of imports counsels expanding the requirements not reducing them.

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