



**RENEWABLE IDENTIFICATION NUMBERS (RINS)
TRADING UNDER THE RENEWABLE FUELS
PROGRAM: CONTINUED UNINTENDED
CONSEQUENCES FOR SMALL FUEL RETAILERS
UPDATED REPORT**

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I. INTRODUCTION

Since my last report on the unintended consequences of the Renewable Fuel Standard (“RFS”) program for small fuel retailers, the Environmental Protection Agency (“EPA”) has proposed to deny requests to initiate a rulemaking to change the point of obligation under the RFS program.¹ As someone who studies and follows this issue closely, I believe the EPA’s Proposed Denial relied on and uncritically adopted views and statements proffered by large retailer coalitions—such as the National Association of Convenience Stores (“NACS”) and the Society of Independent Gasoline Marketers of America (“SIGMA”)—instead of independently assessing relevant information. The Petitioners provided myriad studies, data, and other useful resources to aid EPA’s evaluation. EPA’s cursory adoption of the large retailers’ views will encourage even more retail fuel market consolidation that will directly harm small fuel retailers across the United States. Rather than relying on spoon-fed claims and unfounded assertions of large retailer coalitions, EPA should conduct its evaluation of the merits of the Petitions independently in order to ensure a fair, unbiased, and accurate review.

To assist with this review and to advance public understanding about the negative effects on small retailers nationwide, this updated report assesses the latest evidence and further reinforces my previous conclusion that if the point of obligation is not changed, the current RFS system will continue to stifle competition in the transportation fuel market and drive additional small retailers out of business at the expense of efficient fuels

markets and local economies. Sections II, III(A), III(B)(1), and V below reiterate the findings of my August 2016 report, while providing updated information where appropriate. Sections III(B)(2), IV and VI offer new information based on case studies and additional data not contained in the August 2016 report.

II. BACKGROUND

More than a decade ago, in an effort to decrease imports, reduce greenhouse gas emissions, and enhance America's energy security, Congress passed the Energy Policy Act of 2005. Among other provisions, this legislation created a RFS mandating the blending of renewable fuels—such as ethanol—into gasoline and diesel. Each year, EPA sets a blending target known as the renewable volume obligation (“RVO”). For example, in 2010, EPA directed that 12.9 billion gallons of ethanol and other biofuels be blended into gasoline and diesel. By 2016, the amount had jumped to 18.1 billion gallons and the proposed RVO requirement for 2017 is 18.8 billion gallons. Since the law was passed, ethanol's share of the U.S. gasoline mix has increased from less than three percent to nearly 10 percent.

In addition, Congress directed the EPA to generate a system of tracking numbers that could be used to ensure that mandated blending requirements were being met by the “obligated parties.” Curiously, the “points of obligation” are refineries and gasoline-diesel importers, not the actual parties doing the blending.

¹ See U.S. Env'tl. Prot. Agency, PROPOSED DENIAL OF PETITIONS FOR RULEMAKING TO CHANGE THE RFS POINT OF OBLIGATION, at *9 (Nov. 10, 2016) [hereinafter PROPOSED DENIAL].

These 38-character tracking numbers, sometimes called “credits,” are known as RINs (renewable identification numbers). A RIN is assigned to each physical gallon of renewable fuel produced or imported and follows that gallon as it is transferred to a fuel blender. After blending, RINs are separated from the blended gallons of gasoline and diesel, and they are used by obligated parties as proof they have met their mandated volumes. Importantly, obligated parties may sell RINs to one another or to “non-obligated” parties. For example, if Refiner A has fulfilled its annual RFS requirement but continues to buy and blend renewable fuels, it can sell excess RINs to Refinery B or to an oil importer who has not purchased sufficient renewable fuels to meet its RFS requirement.

III. GAMING THE SYSTEM: SOME UNINTENDED CONSEQUENCES OF THE RENEWABLE FUELS STANDARD AND RINS TRADING

RINs trading has become a huge business. For example, in 2014 the EPA reported more than 50 billion RIN sales transactions, with 30 billion transacted by non-obligated parties.² In theory, allowing refineries and importers to buy or sell RINs makes economic sense. What’s more, market trading can help facilitate the realization of EPA’s annual RVO requirements. But because the entities actually blending renewable fuels into gasoline and diesel are not the “obligated parties,” many retailers find themselves at a competitive disadvantage.

² EPA data regarding RINs transactions is only available for years 2011, 2012, 2013, and 2014. Each year saw an increase in RIN sales transactions. *See* U.S. Evtl. Prot. Agency, Annual RIN Sales/Holdings Summary (last updated Feb. 16, 2017), <https://www.epa.gov/fuels-registration-reporting-and-compliance-help/annual-rin-salesholdings-summary>.

A. How the fuel market actually works

The retail fuel market in the U.S. is comprised of three types of companies: (1) convenience stores, who sell more than 80 percent of all fuels; (2) high volume hypermarkets like Walmart, Kroger, and Costco, who sell about 14 percent of all motor fuel; and (3) traditional service stations and marinas who account for about 6 percent of retail fuel sales.

About half of America's 123,807 fueling stations sell "branded" gasoline and diesel refined or imported by the 15 major oil companies. A branded retailer must purchase fuel from a branded supplier or distributor and can't shop around for lower-priced fuel that might increase its margins or be passed on to consumers through lower prices. What's more, in many cases a branded retailer may be required to abide by a minimum price while large unbranded retailers, even if they're buying fuel from the same distributor, don't have to abide by such price restrictions.

The other half of the nation's fueling stations are independents selling "unbranded" gasoline and diesel. Independents have the advantage of being able to seek lower priced fuel, often on the spot market, which in turn affords consumers lower prices. Large retailers sell both branded and unbranded fuel while most small retailers sell branded fuels only.

Finished gasoline and diesel containing varying amounts of renewable fuel are purchased by retail stations from petroleum marketers or wholesalers who do the actual blending. For branded retail stations, the blending specifications are controlled by the

brand owner, e.g. Shell, Exxon, etc. Unbranded retail stations typically don't have any specific blend specifications. However, as discussed above, the RFS obligated party is the refiner or the importer of petroleum, even though the blending occurs at the terminal/rack. Indeed, some large retailers do their own blending.

B. Gaming the system

Here is, where the market distortions come into play. Since the RVOs apply to refiners and importers, and not to other entities that control blending, "non-obligated parties" can game the system. For example, companies like Casey's, Couche-Tarde, Murphy's, Circle K, Sheetz, and other large retailers have been increasing their market share by taking ownership of fuels at the blending point and acquiring RINs they can sell at a profit, thereby generating additional revenues that allow them to undercut their competitors' retail prices. In practice, only these large retailers have the financial resources to participate in RINs trading; small retailers have neither the capital nor the market leverage to take positions in RINs trading.

Fuel blending entails costs in the millions of dollars, in particular the financial ability to purchase bulk quantities of gasoline and diesel blendstocks as well as ethanol and other biofuels. In addition, costs are entailed for terminal and pipeline services to move cargo to the blending location. Only large retailers can cover these expenses; but the profits from RIN trading can more than offset these costs.

The bias against small retailers has serious implications for their long-term survival because the current regulatory regime governing RINs trading allows large fuel

marketers and large retailers to gain revenues and a competitive advantage over small retailers. Reports indicate that large retailers are using the RIN profit stream for retail expansion and acquiring a larger share of a limited market. The acquisition of convenience store chains by cash-rich limited partnerships suggests the chains' market share will continue to grow. The effect of these convenience store chain acquisitions has been detrimental for small retailers. In fact, these retailers are losing both sales volume and stores to large retailers. In other words, small retailers aren't just less profitable than before; rather, they are going out of business due to their growing inability to compete with large retailers and a related loss of sales. As a result, the demise of small "mom-and-pop" fueling stations has accelerated, with more than 12,000 closing since 2007.

Furthermore, according to the 2017 NACS/Nielsen Convenience Industry Store Count, the number of convenience stores selling motor fuels (123,807) declined in 2016 by 0.6 percent (or 567 stores) with the single-store motor fuel segment dropping by 604 stores to roughly 70,000 stores. From 70,000 stores today, the number could dwindle to a mere 12,000 single-store operators within a decade, according to Joe Petrowski, former CEO of the Cumberland Gulf Group that owns and operates convenience stores and gas stations throughout New England, New York, the Mid-Atlantic states, and Florida. Based on Petrowski's extensive experience and my review of the available evidence, I suspect that his conclusion is indeed accurate.

With President Donald Trump freezing pending regulations for the next several months, which has stalled the implementation of a higher RVO for 2017, the price of

RINs has dropped markedly so far this year. Indeed, within a month's time from January 1st to February 1st, 2017, the price of a renewable fuel RIN (D6) dropped by roughly 50 percent from \$0.87 to \$0.44.³ Still, the bias against independent refiners and small retailers remains. The reduction in RIN prices that has resulted from the freeze supports the notion that speculators in the RIN market have caused some of the harm that contributes to fuel margin differences. Changing the point of obligation will provide permanent relief to keep spectators out of the RIN market and stabilize RIN prices while making fuel margins more equitable.

IV. RECENT EVIDENCE SUPPORTS THE NEED TO CHANGE THE POINT OF OBLIGATION

EPA's claims that a change in the point of obligation would not address challenges associated with problematic marketplace dynamics do not square with a recent study published by a renewable fuels expert or new statements and statistics from large retailers. Together, this evidence is emblematic of overall trends in the fuel industry that favor large retailers at the expense of small retailers. Casey's, Couche-Tard (the owner of Circle K, CST Brands, and other retail chains), and Murphy's, three large fuel retailers, provide informative case studies.

A. New Analysis Concerning Large Retailers' Fuel Margins

A recently completed and published analysis by a biodiesel expert, Ramon Benavides, describes how Love's Truck Stops and Pilot/Flying J Trucks Stops use RINs to secure fuel margins that are nearly twice the national convenience store average.

³ E-mail from EcoEngineers, RIN Index – 2/1/2017 (Feb. 1, 2017) (on file with author).

Specifically, Benavides found that for Pilot/Flying J, the per-store average margin nationwide was \$0.66 per gallon, and for Loves the nationwide store average margin was \$0.65 per gallon. Based on these figures drawn from his mathematically and academically robust estimated margin indicator model, he finds that these fuel margins equate to twice the profit than conventional wisdom might assume.

The scenario described in Benavides's analysis demonstrates the dramatic price competition that has allowed aggressive market consolidation in the fuel retail market. Truck stops are a segment of the fuel retail market that is experiencing the same level of unfair competition that all fuel retailers are experiencing under the RFS. Large truck stop chains, like Pilot/Flying J and Love's, are increasing market share while independents are dwindling year after year.

B. Casey's

During the second quarter of fiscal year 2017, Casey's sold \$17.8 million RINs for a total of \$15.9 million.⁴ These sales represented a roughly \$0.03-per-gallon improvement to the company's fuel margin. At that time, the average RIN price was approximately \$1.12. By comparison, during the third quarter of 2016, the average RIN price was \$0.61. A representative of Casey's stated during a recent earnings call that the company is "fortunate, I would say, to be able to benefit from [the point of obligation]

⁴ SEC Exhibit 99.1 "Casey's Builds Momentum for Future Expansion." See: <https://www.sec.gov/Archives/edgar/data/726958/000072695816000301/q22017pressrelease.htm>

and due to our market, where we operate and the way we distribute our fuel.”⁵ In all, the company’s RIN sales generated \$4.7 million for the company in Q2 2017 alone.⁶

In the first quarter of fiscal year 2017, Casey’s experienced increased fuel margins compared to Q1 2016 due to a decline in the wholesale cost of fuel and a favorable environment for renewable energy credits resulting in a fuel margin of \$0.195 per gallon for the quarter. During that time, Casey’s sold roughly 17.9 million RINs at an average price of \$0.82, which represented a benefit of a roughly \$0.027 per gallon benefit to the fuel margin.⁷

In the third quarter of 2016, the company’s fuel margins finished above the company’s goal due to elevated RIN values as well as a decline in wholesale fuel costs toward the end of the quarter.⁸

C. Couche-Tard

Couche-Tard’s Chief Financial Officer, Claude Tessier, acknowledged in a Q1 2017 earnings call that Couche-Tard benefits from “generally broader access to RINs in the U.S. than most of our competition. So as RINs increase in value we think that widens

⁵ Casey’s (CASY) CEO Terry Handley on Q2 2017 Results - Earnings Call Transcript. See: <http://seekingalpha.com/article/4029330-caseys-casy-ceo-terry-handley-q2-2017-results-earnings-call-transcript>

⁶ Form 10-Q for CASEYS GENERAL STORES IN. See: <https://biz.yahoo.com/e/160906/casy10-q.html>

⁷ SEC Exhibit 99.1 “Casey’s Posts Record First Quarter Earnings.” See: <https://www.sec.gov/Archives/edgar/data/726958/000072695816000270/q12017pressrelease.htm>

⁸ “Casey’s Posts 28% Increase on Year-To-Date Net Income.” See: <http://www.businesswire.com/news/home/20160307006417/en/Casey%E2%80%99s-Posts-28-Increase-Year-To-Date-Net-Income>

our competitive advantage and then finally we focus on the Categories. [W]e think we were widening what we believe is a key competitive and sustainable advantage in the fuel space” (emphasis added).⁹ The company’s Chief Executive Officer, Brian Hannasch, echoed Tessier’s comments with respect to Couche-Tard’s advantages over the competition:

I think in our situation with our scale, I think *we’re in a position that we’re able to capture a greater proportion of the value of the RINs across our footprint than most of our competitors*. So while it’s hard to quantify the exact impact, we think we’re advantaged vis-a-vis the industry when it comes to RINs, and that a higher RIN value is actually a positive for us vis-à-vis the industry, which is what I think is relevant (emphasis added).¹⁰

D. Murphy’s

In its Form 10-Q filed on November 3, 2016, with the Securities and Exchange Commission (“SEC”), Murphy’s directly acknowledges that it has benefited from “its ability to attain RINs and sell them at favorable prices in the market (page 28).”¹¹ In addition, on its Q3 earnings call, Murphy’s explained the specifics of its RIN-related profits, stating that: “RIN sales of \$48 million offset product supply and wholesale contribution of negative \$29 million, as higher RIN prices embedded in the refinery spot

⁹ Alimentation Couche-Tard's (ANCUF) CEO Brian Hannasch on Q1 2017 Results - Earnings Call Transcript. See: <http://seekingalpha.com/article/4003201-alimentation-couche-tards-ancuf-ceo-brian-hannasch-q1-2017-results-earnings-call-transcript>

¹⁰ Q4 2016 Alimentation Couche-Tard Inc Earnings Call. See: <http://finance.yahoo.com/news/edited-transcript-atd-b-earnings-231039709.html>

¹¹ 10-Q: MURPHY USA INC. TEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. See: <http://www.marketwatch.com/story/10-q-murphy-usa-inc-2016-11-03>

prices reduced our spot to wholesale rack margins, which stayed negative for much of the quarter (page 4).”¹²

While one might reasonably intuit that these RIN profit figures provide Murphy’s a competitive advantage vis-a-vis other market participants, that conclusion is confirmed through statements from a Murphy’s executive at the Raymond James 37th Annual Investors Conference. The most relevant excerpts follow:

- “We have access to the RINs through the blending. We have the credit. We have the scale and scope to hold the working capital and manage through the volatility *that smaller competitors don’t have* (page 5, emphasis added).”¹³
- “So what’s the *differentiated capability* that sets us apart? It’s our fuel supply chain. And the way we do that is 50% of the gallons we sell are sourced through proprietary barrels, meaning we buy them from the refiners in the refining centers, we ship them through the pipeline systems for which we have access through our historical shipper status. ... We blend it with ethanol. That captures the RIN. And that leaves us with a landed cost of supply when you add that supply advantage plus the RINs, *that’s going to be advantaged over our competitors* (page 4, emphasis added).”¹⁴

If Murphy itself admits it has a “differentiated capability” that its “smaller competitors” don’t have, how can EPA call into question the existence of a broader trend that is disadvantaging small fuel retailers nationwide?

¹² Q3 2016 Murphy USA Inc Earnings Call. See: <http://finance.yahoo.com/news/edited-transcript-musa-earnings-conference-205638433.html>

¹³ Transcript - Raymond James 37th Annual Investors Conference. Speaker: Andrew Clyde, President and Chief Executive Officer. See: <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NjEzNDA0fENoaWxkSUQ9MzI3MDcwfFR5cGU9MQ==&t=1>

¹⁴ *Ibid.*

Read together, the evidence from the latest report, and the statements of Casey's, Couche-Tarde, and Murphy's demonstrate the existence of strong, industry-wide gains among large retailers through obtaining renewable fuel – and RINs – at the blending point. These substantial RIN-oriented gains go well beyond what is necessary for these large retailers to turn a profit, and, if the point of obligation was shifted, these monies could be set aside for RFS compliance – rather than further padding large retailers' already robust pockets.

V. WHY COMPETITION MATTERS IN THE RETAIL FUEL MARKET

The trading of RINs purely for financial gain is a perversion of the original intent of the RFS program that was supposed to promote pass-through of the RIN value to retailers and consumers while encouraging higher renewable fuel blends. In practice, the RFS has promoted only modest increases in blend ratios while inducing a major shift in the retail market, with large retailers gaining market share at the expense of medium-sized and small businesses.

American households and businesses have long benefited from the lowest gasoline and diesel prices in the world, outside of some Organization of the Petroleum Exporting Countries (“OPEC”) countries. Relatively cheap and abundant motor fuel is not only a boon to American families, affording more disposable income for other necessities, but it has also helped maintain our global industrial advantages by restricting transportation costs. Historically, strong competition in the retail fuel market has been an

important factor providing price ceilings for consumers and businesses. But that competitive market is now at risk.

Industry-wide statistics highlight the vulnerability of small fuel retailers. For large retailers, average net profit margins increased to nearly 3 percent in 2014 compared with 1.6 percent in 2012. At the same time, net profit margins among small private gas stations were relatively flat. Furthermore, an analysis conducted in 2013 by Study Groups/Finance & Resource Management Consultants found that “high volume retailers suck a lot of volume out of the market, making the economics more challenging for traditional convenience store operators and the dealers they serve.” The same study cited a case in Northern New Jersey where two independent retailers reduced their prices by more than 10 cents a gallon when they saw cars lining up 10- and 15-deep at a nearby Costco location. One of the operators reasoned he would be out of business if he didn’t lower his price to compete with Costco. At the same time, of course, his profit margin dropped dramatically.

The owner of Plaza 95, a small operator in Martin County, Florida, complained last year that Racetrac and Speedway had launched a price war that was killing his business. “Plaza 95 is ten to 15 cents above the prices of bigger stations nearby. It’s continuously putting the small business man in a tougher position...I’m not putting that 15 cents in my pocket.” Furthermore, the weight of the available evidence suggests that this Plaza 95 owner is not alone in their assessment—that any profits yielded by large

retailers through the current RIN market is coming at the expense of small operators, who lack the financial capacity to compete with larger retailers in a “race to the bottom.”

On a global scale, if profit margins for small, independent retailers continue to narrow in order to “meet the competition,” even more of these businesses can be expected to fail in coming years. Fewer small retailers, in turn, will result in higher fuel prices for consumers along with a reduction in the services these businesses provide, such as auto repair and maintenance.

VI. CONCLUSION: HOW TO BALANCE THE PLAYING FIELD BY CHANGING THE POINT OF OBLIGATION

With higher RIN prices anticipated as mandated RVOs grow year after year, large retailers should increase the blending infrastructure for renewable fuels and promote higher blends by passing on the RIN value to consumers. But because large retailers are not obligated parties, they have no incentive to implement these initiatives. Put differently, higher RIN values won’t motivate large retailers to blend higher levels of renewable fuels because, in the current market, their RINs can be sold to generate substantial revenue.

On the other hand, if the RFS obligation were placed at the blending point, and large retailers become the obligated parties, to meet their newfound RFS obligations they would likely increase their marketing and distribution of higher renewable fuel blends. Importantly, such a change would eliminate some of the competitive disadvantage that small retailers currently face due to the RIN revenue generation capabilities of large retailers. Absent a shift in the point of obligation, small retailers will be increasingly

driven out of business, which will be harmful to market competition and local economies across the United States.