

February 3, 2017

FROM: Doug Parker, President, E&W Strategies 

SUBJECT: Update to: September 4, 2016 White Paper Addressing Fraud in the Renewable Fuels Market and Regulatory Approaches to Reducing this Risk in the Future¹

The findings and opinions within this supplementary report are based on my experience as a special agent and senior executive overseeing EPA's nationwide criminal investigation program, as well as additional review of relevant subject matter material. These insights have been developed over more than two decades in federal law enforcement and day-to-day execution of national environmental policy over that time frame.

Executive Summary

In concluding my earlier white paper on fraud in the renewable fuels market I stated: *"Requiring a more transparent market with more direct engagement and responsibility at the point of blending can limit fraud and lead to a significantly more effective program for the country. Absent such straightforward changes, one can expect a continuation of illegal conduct that will undermine the goals of the statutes and continue to reduce the benefits anticipated for the American public while also continuing to put taxpayers and consumers at greater risk."*

At this point, just five months later that prediction has been borne out. Not only have additional large scale civil and criminal fraud prosecutions in the RFS been announced, but the EPA's latest attempt at third party verification to prevent such fraud, the Quality Assurance Program (QAP), has been further called into question based on the agency's action last month proposing invalidation of tens of millions of RINs that were subjected to the QAP. Making straightforward structural changes in the RFS regulations by moving the point of obligation from refiners and importers to blenders will de-incentivize the fraud that has been a persistent and crippling burden to the legislative goals of the RFS.

The Opportunity to Fix the RFS

On November 10, 2016, the EPA issued a *"Proposed Denial of Petitions for Rulemaking to Change the RFS Point of Obligation."* This proposed denial opens the matter for public input prior to formally deciding on the petition. This presents an opportunity for the agency to reconsider the initial denial and craft a regulatory approach that would enhance the goals of the RFS and serve to dramatically de-incentivize fraud.

Within the fifty-page proposed denial, it states that changing the point of obligation: *"would also increase the burden associated with administering the RFS program, and would likely inhibit EPA's enforcement abilities while at the same time opening up new opportunities for additional types of fraudulent behavior in a*

¹ This supplementary report was prepared at the request of Valero Corporation to analyze the regulatory structure and related factors within the RFS that have significantly contributed to fraud within the renewable fuels sector.

*program that has already seen instances of fraud.”² This statement essentially predicts that fraud would **get worse** if the point of obligation was changed. As the former Director of EPA’s Criminal Investigation Division, responsible for crafting and overseeing the agency’s investigative response to fraud in the RFS, I can say this is simply not an accurate assessment. The most cost-effective approach to reducing fraud from a regulatory perspective remains changing the point of obligation to blenders so that **those that make the decisions on where to purchase and blend fuel** are appropriately incentivized to vet the legitimacy of fuel and producers.*

A Program Still Susceptible to Large Scale Fraud – Enforcement Cases in the Past Five Months

Unity Fuel – New Jersey – Criminal Conviction

On September 27, 2016, it was announced that Malek Jalal pleaded guilty to conspiracy and obstruction for his role in a criminal scheme to generate over \$6 million in illegal tax credits. According to the Department of Justice (DOJ), he conspired with others to “fraudulently claim tax credits and RIN credits multiple times on the same load of fuel.”

Chemoil – Civil Enforcement Settlement

On September 29, 2016, it was announced that Chemoil exported nearly 50 million gallons of biodiesel without retiring the more than 72 million RINs that were generated. As part of the civil settlement with DOJ, Chemoil was required to retire over \$71 million worth of RINs and pay a \$27 million fine.

Triton Energy – Indiana – Criminal Convictions

On October 12, 2016, Fred Witmer and Gary Jury of Indiana, who operated Triton Energy and Gen2 Renewable Diesel, pled guilty to fraud, conspiracy, and false statements related to a scheme to illegally generate over \$60 million in tax credits.

NGL Crude/Western Dubuque – Iowa – Civil Enforcement Action

On October 4, 2016, DOJ announced the filing of a civil complaint against NGL Crude and Western Dubuque alleging that NGL sold finished bio diesel to Western Dubuque as feed stock. This led to a second set of RINs being produced, and the complaint seeks the retirement of 36 million RINs while Western Dubuque paid a civil penalty of \$6 million. The EPA estimates that the double counting of the RINs resulted in an estimated additional 151,319 metric tons of carbon dioxide being generated.

Gen X/SRC – Florida - Sentencings

On November 8, 2016, Thomas Davanzo and Robert Fedeyna were sentenced to 121 months and 135 months in prison, respectively for “their participation in a multi-state fraud scheme to defraud biofuel buyers and U.S. taxpayers.” They generated some 60 million RINS associated with fuel that was never produced.

William Letona – New Jersey – Criminal Conviction

² November 10, 2016 - EPA Proposed Denial of Petitions for Rulemaking to Change the RFS Point of Obligation

On November 30, 2016, William Letona pleaded guilty to conspiracy as a result of destroying documents that were subject to a grand jury subpoena in a RIN fraud investigation. Letona was trying to conceal that he had claimed fraudulent IRS tax credits associated with the RFS.

Supporters of the status quo have made the claim that the trend in RFS fraud is in fact lower today. In the five months since my original report, the federal government has announced two significant civil enforcement actions involving RIN fraud where over 100 million RINs are or will be retired and proposed civil penalties of \$33 million. Additionally, four separate individuals pled guilty to RFS crimes (in three separate matters) with \$66 million in illicit gain associated with the cases. Lastly, two individuals were sentenced to a total of 25 years in prison related to an ongoing RFS fraud case. One federal enforcement action per month averaging some \$20 million per incident does not strike me as a “slow-down” in RFS fraud.

Response to Critics of Moving the Point of Obligation

Those who are seeking to maintain the status quo within the RFS have presented a series of criticisms that essentially claim that changing the point of obligation would have no impact on fraud within the RFS. These critiques have not been proffered by experienced criminal investigators or veteran prosecutors but rather by representatives of the companies that are financially benefiting from the current point of obligation while fraud persists in the market. There are simply no criminal investigators or prosecutors with experience in RIN fraud who have stepped forward to support the regulatory status quo within the RFS or who have substantively disagreed with my conclusions.

Among the criticisms leveled against my earlier report was that changing the point of obligation to blenders would lead to an explosion in the number of obligated parties and cause even greater compliance challenges. That is simply false. Moving the point of obligation would result in roughly the same number of obligated parties as are currently designated.

Another criticism by those in favor of the status quo is that moving the obligation to blenders would “exacerbate” compliance issues as blenders have “no prior RFS compliance experience.” This claim demonstrates a lack of understanding of both the current program and the causes of fraud in the RFS or similar markets. Under the current structure of the RFS, refiners and importers are *multiple* steps removed from the decision point on where renewable fuel is purchased in order to blend it. Therefore, they have no realistic ability to vet these producers. Blenders on the other hand often have direct engagement with renewable fuel producers and are uniquely positioned to assess the quality and integrity of their suppliers. There is no one *better* positioned to serve as the party of obligation than those directly making decisions on who to purchase renewable from that is later used in the blending process.

Conducting due diligence should be nothing “new” for blenders. As part of sound business and compliance practices they currently have to ensure that what they blend meets appropriate specifications. Similar quality assurance procedures that are currently employed by blenders can be applied to renewable fuel producers. Claiming they have “no experience” with due diligence would suggest that they currently pay little attention to what they blend – a dubious proposition.

Finally, the supporters of the status quo have offered no meaningful approach to how fraud can be reduced within the RFS. Preserving a system that benefits their financial interests will continue to put the taxpayer at risk (see: Triton Energy case costing the federal treasury some \$60 million) and hurt small, often rural producers as they are unfairly tainted by ongoing fraud in the RFS market.

Reducing the Incentive for Fraud by Reducing Prices

A key element in any fraud scheme – from healthcare fraud to illegal conduct in the RFS – is the presence of large financial opportunities that can be illegally exploited due to structural or regulatory weaknesses within a market segment. In the case of the RFS, the soaring prices of RINs in recent years have made for an opportune target for fraudsters. If RIN prices are reduced there will simply be less of a target for criminals to point to in their illicit schemes. Moving the point of obligation to blenders can significantly reduce the price of RINs as the blenders would then be utilizing RINs they already generate to meet their own obligation rather than primarily selling on the market. In basic terms, if one wants to prevent mosquitos from spreading disease, the first step is removing the stagnant water that they are drawn to. The same basic principle applies to the massive price growth and attraction to it by fraudsters in the RFS. The lower the prices, the lower the incentive for fraudsters to attack the market. There is no more practical way to impact RIN prices – and the resulting opportunity for illicit gain – than by moving the point of obligation. If the prices are reduced through this commonsense approach, there will be far less opportunity and incentive for criminal enterprises to focus on the RFS as the opportunity for illicit profit will be significantly reduced.

The Outlook Moving Forward

In my earlier report, I emphasized that improved transparency and ongoing enforcement are also critical to bringing rationality to the RFS and reducing fraud. Maintaining the status quo will do nothing to improve transparency. Additionally, across the board hiring freezes and anticipated deep budget cuts at the EPA and DOJ will undoubtedly reduce these agencies' ability to effectively police the RIN market fraud. That means that one leg of the RIN integrity stool, transparency, will remain unchanged and wobbly. The second support for that stool is enforcement – which will experience increasing resource limitations and may get increasingly unsteady.

That leaves changing the point of obligation as the final leg of the RIN integrity stool that can be addressed in order to reduce fraud and bring far greater stability to this market. As I said in my September 2016 white paper, **“Expecting a different level of compliance in the RFS without altering the structure and incentives within the program is an exercise in wishful thinking.”** That statement remains as accurate today as it was in September. EPA now has a chance to meaningfully improve the integrity and effectiveness of the RFS by moving the point of obligation from refiners and importers to blenders.