EPA Proposes Replacing RIN Confusion with Audit Nightmare

by Jean-Cyril (JC) Walker and Adrienne M. Timmel

In response to concerns and Congressional pressure over widespread fraud in the renewable fuels market, the U.S. Environmental Protection Agency (“EPA”) is proposing to establish an innocent purchaser defense, for those companies that purchase Renewable Identification Numbers (“RINs”) audited by an EPA-registered, third-party auditor. At the heart of the program is a complicated and invasive auditing scheme, whereby an independent third-party would verify the validity of RINs generated by a renewable fuel producer through quarterly in-plant audits and records review and monitoring.

In short, EPA’s proposal hinges on the disclosure of information previously held confidential by renewable fuel producers, raising serious concerns for producers that seek to protect such information from other market players. In addition, EPA’s proposal fails to address the flaw in its Renewable Fuels Standard (“RFS”) Program, which initially led to the RIN fraud, namely the Agency’s failure to adequately oversee its own program.

RFS and RIN Background

The RFS program requires producers and importers of gasoline and diesel fuel (“obligated parties”) to blend a certain amount of renewable fuel into the conventional fuel they produce or import each year. This amount, referred to as a renewable volume obligation (“RVO”), depends on the renewable fuel mandates set by Congress for the specific year, and the amount of non-renewable fuel that the obligated party introduces into U.S. commerce that year. Obligated parties demonstrate compliance with their RVOs through the use of RINs. RINs are alphanumeric codes that identify the renewable fuel producer, facility, batch, feedstock, production process and type, among other descriptors. They remain with the renewable fuel throughout its distribution until it has been blended into transportation fuel, heating oil, or jet fuel, at which time the blender separates the RINs from the renewable fuel and either uses them to demonstrate compliance with its RVO, or sells them to another entity seeking to meet its RVO. Accordingly, obligated parties can purchase RINs without actually purchasing the renewable fuel associated with those RINs. This introduces some risk of fraud and is the basis for the extensive recordkeeping and reporting obligations tied to RIN transactions.

Although charged by Congress to establish a RIN trading program under the Clean Air Act, EPA has taken the position that it has no obligation to verify the validity of RINs or warn of threats to the RIN market. The current regulations reflect the Agency’s “buyer beware” policy, which has resulted in the assessment of millions of dollars in civil penalties against refiners that innocently purchased fraudulently generated RINs to satisfy

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2 40 C.F.R. § 80.1427.
3 40 C.F.R. § 80.1425.
4 See 42 U.S.C. § 7545(o)(5).
5 See 40 C.F.R. § 80.1431(b)(2).
their RVOs. Adding insult to injury, EPA also required the refiners that purchased the fraudulent RINs to buy approximately $200 million in replacement RINs. These RIN fraud cases and related enforcement actions introduced significant uncertainty in the renewable fuels market and made it more difficult for smaller renewable fuel producers to sell their RINs. As a result, both industry and Congress pressed EPA to establish a RIN verification mechanism.

The Proposed Quality Assurance Program

On January 31, 2013, EPA Administrator Lisa Jackson signed a Notice of Proposed Rulemaking (“NPRM”) to establish a voluntary RIN Quality Assurance Program and make other amendments to the RFS regulations. According to the NPRM, the Agency intends for these changes to facilitate the sale of RINs by smaller renewable fuel producers and promote greater liquidity in the RIN market.

The Agency’s proposal envisions three types of RINs with commensurate differences in due diligence efforts as well as RIN prices for: “A-RINs,” “B-RINs” and unvalidated RINs. Companies that purchase A-RINs or B-RINs will be able to avail themselves of an affirmative defense against civil liability for the use or sale of any verified RINs that are later discovered to be invalid. Obligated parties can forego the affirmative defense and purchase unverified RINs, likely at a discount, but given the concerns over RIN fraud, there may be little interest in such products.

Under the proposal, independent third-party auditors would become subject to the registration, recordkeeping and reporting requirements of the RFS Program. As part of their registration process, auditors would submit draft Quality Assurance Plans (“QAPs”) describing the processes they

intend to use for verifying A-RINs or B-RINs. The NPRM sets forth the minimum elements of an A-RIN QAP (“Option A”) and a B-RIN QAP (“Option B”). QAPs for A-RINs and B-RINs share many of the same elements. Both place the initial responsibility for replacing any invalid RINs on the renewable fuel producer that generated such RINs. They also require the auditors to monitor, on a quarterly basis, feedstock, production processes, RIN generation and RIN separation records. Examples of these records include feedstock receipts, certificates of analysis, co-product reports, RIN activity reports, RIN transaction reports, RIN generation reports and product transfer documents (“PTDs”). Under both types of QAPs, auditors must also contact the producer’s feedstock suppliers and renewable fuel customen to verify the producer’s feedstock purchases and biofuel sales. Finally, QAPs for both A-RINs and B-RINs must include quarterly inspections of the renewable fuel plant to verify that the owner is actually producing, storing and blending biofuels at registered levels, is operating in accordance with its EPA registration and is generating valid RINs in accordance with the regulations.

Options A and B diverge, however, in the extent of due diligence to be conducted as well as in the level of protection offered.

**Option A QAPs: The Gold Standard**

Under Option A, the auditor must collect and evaluate certain data from the renewable fuel plant on an ongoing or batch-level basis. In addition, the auditor bears the responsibility of replacing any A-RINs discovered to be invalid should the renewable fuel producer fail to do so in a timely manner. As a condition of registration, each auditor must have in place a “RIN replacement mechanism,” such as an insurance policy, a financial instrument, a RIN escrow account, or a RIN bank, demonstrating that it can meet the “RIN replacement cap” at all times. The RIN replacement cap is a temporary limit on the amount of RINs an auditor must replace. Until January 1, 2016, the cap equals two percent of each
type of A-RIN (i.e., biodiesel RIN, cellulosic biofuel RIN, etc.) verified by the auditor within the last five years. Since RIN replacement will be carried out by the RIN generator or auditor, purchasers of invalid A-RINs can still use these RINs to meet their RVOs.

Option B QAPs: The Silver Standard

Option B requires quarterly, rather than ongoing or batch-level, monitoring of a renewable fuel producer’s records, and generally requires monitoring of fewer data elements than Option A. Accordingly, EPA expects that B-RINs likely will be less expensive than A-RINs. The trade-off for purchasers of B-RINs is that they bear the responsibility of replacing any invalid B-RINs should the renewable fuel producer fail to do so in a timely manner. In addition, RIN purchasers cannot use invalid B-RINs to satisfy their RVOs, but must retire these RINs in the EPA Moderated Transaction System (“EMTS”). Obligated parties do not, however, have to adopt a RIN replacement mechanism, as EPA assumes these companies have the capital to replace the RINs as required under the current “buyer beware” system. Option A also exempts obligated parties from replacing invalid B-RINs that account for up to two percent of the parties’ RVOs for the relevant types of renewable fuel. This exemption would expire on January 1, 2015.

Asserting an Affirmative Defense

Under the affirmative defense proposed by EPA, a purchaser of A-RINs or B-RINs that are ultimately held to be invalid would not be liable for civil penalties in the event of an EPA enforcement action, provided the purchaser meets the following conditions:

- It notifies EPA within the next business day of discovering the invalid RINs;
- It establishes that the RINs were verified by an independent third party auditor in accordance with an EPA-approved QAP;
- It demonstrates that it did not know or have reason to know that the RINs were invalidly generated;
- It shows that it did not cause the RIN invalidity;
- It demonstrates that it did not have a financial interest in the RIN-generating company;
- For Option B only, it adjusts its EMTS records, reports and compliance calculations by the number of invalid RINs, if any, used to meet its RVO; and
- It submits a written report to EPA within 30 days of discovering the invalid RINs, which describes how it meets each element of the affirmative defense.

Critically, this affirmative defense only applies to RINs that were improperly generated by the renewable fuel producer. Properly generated RINs can also become invalid when a purchaser improperly separates them from the renewable fuel they represent. The Agency proposed separate amendments to address RINs that become invalid after separation.

Proposed Interim RIN Verification Measures

Aware that significant uncertainty and anxiety continues to exist in the RIN market, EPA proposed conditions under which auditors may verify RINs while the proposed rule is pending. Specifically, auditors may verify RINs generated in 2013, before conducting an inspection of the renewable fuel plant and any necessary ongoing monitoring, if:

- EPA has reviewed the auditor’s registration application and proposed QAP(s) and preliminarily determined that these documents satisfy the proposed requirements;
- The auditor conducts the plant inspection and initiates any necessary ongoing monitoring by the effective date of the final
rule in accordance with the QAP(s) actually approved by EPA; and

- Each batch of renewable fuel for which RINs were generated meets the QAP verification requirements.

To give this early verification process teeth in the absence of a final rule, EPA’s Office of Enforcement and Compliance Assurance (“OECA”) separately issued on January 31, 2013, a “Second Interim Enforcement Response Policy [for] Violations Arising from the Use of Invalid 2012 and 2013 Renewable Identification Numbers.” The enforcement policy states, with respect to 2013 RINs, that:

EPA generally does not intend to initiate enforcement actions during the 2013 calendar year against parties who transfer or use invalid 2013 RINs verified prior to publication of the QAP final rule [in accordance with the NPRM].

EPA will apply its March 14, 2012, “Interim Enforcement Response Policy” for 2012 RINs, which it initially limited to invalid biodiesel RINs generated in 2010 and 2011.

Other Amendments to the RFS Program

Finally, EPA proposed several amendments to the current RFS regulations. Arguably, the most controversial of these relates to what many producers consider confidential business information. Under the NPRM, the Agency would publish the following RFS registration and reporting information on a facility-by-facility basis, in monthly, quarterly and annual reports:

- Company and facility name;
- Fuel products;
- Total permitted capacity;
- Production volume;
- Volume of denaturant;
- Production process type;
- D-Codes and number of RINs generated for each D-Code;
- Feedstocks and whether these were claimed to have met the definition of renewable biomass;
- Co-products; and
- Applicable equivalence values.

As discussed further below, public disclosure of the above information may hurt, rather than help, the renewable fuels market.

Implications

Congress intended for renewable fuel credits to form the cornerstone of the RFS Program. RIN validity is critical not only for day-to-day transactions used to satisfy refiners’ RVOs, but also to EPA’s assessment of the availability of biofuel in estimating future production requirements. EPA’s proposed plan for promoting RIN validity in the wake of massive RIN fraud, however, raises significant confidentiality concerns and could change the nature of the supply chain.

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9 See id. at 2.


11 Other proposed amendments include: (1) an alternative method for reporting RIN trades in EMTS; (2) reclassifying RINs that were improperly separated as valid RINs, so obligated parties can use these RINs for compliance purposes; (3) requiring additional information on RIN PTDs; and (4) prohibiting the generation of RINs for renewable fuels other than ethanol, biodiesel, or renewable diesel, such as butanol, unless the producer can demonstrate that it used or ensured the use of the fuel as a blendstock or additive for transportation or other specified fuels. |
invasive catalog of information normally provided solely to EPA under a claim of confidential business information. The Agency also proposed to regularly publish certain registration and reporting information typically claimed as confidential, which could adversely affect a producer’s competitive position. Moreover, the proposal entirely fails to address how audit reports will be treated in an enforcement context. These issues, coupled with the added financial costs of generating RINs, may result in biofuel producers exiting the market contrary to both the intent of Congress in enacting the RFS Program and EPA in proposing this rule.

More importantly, questions remain as to whether EPA’s proposal will in fact provide the certainty and security sought by the RIN market. The Agency’s “buyer beware” position has always seemed rather curious in light of the onerous registration requirements it imposed on renewable fuel producers, including: (1) a description of the renewable fuels to be produced, the feedstocks for each fuel type, and the production processes and capacity for each fuel type; (2) any other records requested by EPA; and (3) “an independent third-party engineering review and written report and verification” of the ability of the company to produce valid RINs.12

A renewable fuel producer also must submit an updated engineering report every three years and before it makes any changes to its fuel production process. In addition, the regulations require both renewable fuel producers and obligated parties to submit annual “attest engagement reports” prepared by an independent Certified Public Accountant (“CPA”) or Certified Internal Auditor (“CIA”).13 Like a financial audit, the CPA or CIA must review a party’s underlying records, including production data, feedstock contracts and purchase invoices, and determine whether they agree with the transactions and other information reported to EPA. These data requirements were intended to allow the Agency to conduct a relatively technical and detailed review of a company’s renewable fuel production process. According to EPA:

> [W]e are requiring producers . . . to provide us with information on their feedstocks, facilities, and products, in order to implement and enforce the program and have confidence that producers and importers are properly categorizing their fuel and generating RINs.14

The ability for a few parties to generate and sell over 140 million fraudulent RINs through the Agency’s EMTS demonstrates that EPA’s review of the information provided by RIN producers “amounts to little more than a rubber stamp approval,” which “has enabled biodiesel producers to game the system,” as one trade association testified to Congress in an RFS oversight hearing.15 Nothing in the current proposal suggests that the Agency now has the resources or the will to perform any greater investigation or due diligence inquiry into the financial status and other bona fides of third-party auditors than it had for renewable fuel producers.

Interested renewable fuel producers and other RFS stakeholders will have an opportunity to voice their concerns to EPA during a public hearing to be held in Washington, D.C., on March 19, 2013. The Agency will accept public comments on the proposal until April 18, 2013.

Please contact Jean-Cyril (JC) Walker (walker@khlaw.com, (202) 434-4181) or Adrienne M. Timmel (timmel@khlaw.com, (202) 434-4164), if you have questions or concerns about this proposal or any other questions about the RFS Program.

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12 40 C.F.R. § 80.1450(b).
13 See 40 C.F.R. § 1464.