

## THE HOUSE EDGE

## *Wall St. Exploits Ethanol Credits, and Prices Spike*

By **Gretchen Morgenson** and **Robert Gebeloff**

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It was supposed to help clean the air, reduce dependence on foreign oil and bolster agriculture. But a little known market in ethanol credits has also become a hot new game on Wall Street.

The federal government created the market in special credits tied to ethanol eight years ago when it required refiners to mix ethanol into gasoline or buy credits from companies that do so. The idea was to push refiners to use the cleaner, renewable fuel, or force them to buy the credits.

A few worried that Wall Street would set out to exploit this young market, fears the government dismissed. But many people believe that is what happened this year when the price of the ethanol credits skyrocketed 20-fold in just six months, according to an analysis of regulatory documents and interviews with more than 40 people involved in the market, including industry executives, brokers, traders and analysts.

Traders for big banks and other financial institutions, these people say, amassed millions of the credits just as refiners were looking to buy more of them to meet an expanding federal requirement. Industry executives familiar with JPMorgan Chase's activities, for example, told The Times that the bank offered to sell them hundreds of millions of the credits earlier this summer. When asked how the bank had amassed such a stake, the executives said they were told by the bank that it had stockpiled the credits.

A spokesman for JPMorgan, when asked about the exchange with the executives, disputed the account, saying the bank does not trade ethanol credits for a profit in the way it trades other securities, but is registered to deal in credits through its energy business. From time to time, the spokesman, Brian J. Marchiony, said in a statement that the bank also purchased credits "on behalf of clients who need to fulfill their E.P.A.-mandated obligations," though it had not done so in the past year.

But other market participants, including Thomas D. O'Malley, chairman of PBF Energy in Parsippany, N.J., identified JPMorgan Chase and other financial institutions as being active sellers of the credits this year. He said the institutions had helped transform an environmental program into a profit machine, contributing to the market frenzy this year. "These things were designed to monitor the inclusion of ethanol in the gasoline pool," Mr. O'Malley said. "They weren't designed to become a speculative item. For the life of me I can't see the justification for it."

While banks are by no means the largest player in ethanol credits, Wall Street's activity in this market reflects a larger effort by financial institutions to exert their influence over loosely regulated markets for basic commodities, from aluminum to oil. The opacity of the ethanol credit market makes it difficult to determine the extent to which large financial actors have profited.

The banks say they have far less influence in the market than others are suggesting, and are doing nothing wrong. But the activities, while legal, could have consequences for consumers. In the end, energy analysts say, the outcome will be felt at the gas pump — as the higher cost of the ethanol credits gets tacked onto the price of a gallon of gasoline. (The credits, which cost 7 cents each in January, peaked at \$1.43 in July, and now are trading for 60 cents.)

The Valero Energy Corporation, a refiner that owns thousands of gas stations, says the squeeze in ethanol credits might cost it \$800 million. PBF Energy, also a refiner, puts its bill at about \$200 million. A review by The Times of a federal registry of nearly 1,500 businesses and individuals in the renewable fuel market found big Wall Street banks as well as a handful of people with troubled legal histories among the participants. Several high-profile cases of fraud have emerged.

Scott Mixon, the acting chief economist of the Commodity Futures Trading Commission, said in an interview Friday that the issue of banks' involvement in this market was something the agency was tracking and might look into more deeply because of the ethanol component. The commission regulates the commodities futures market, including trading in ethanol and gasoline.

Though the ethanol credits are traded by many major investment houses, they were created not on Wall Street but in Washington, on Capitol Hill and at the Environmental Protection Agency. At its inception, the so-called Renewable Fuel Standard was promoted as a means to reduce the nation's reliance on foreign oil, fight global warming and provide a boost to farmers. The rules call for a set amount of ethanol, most of which is made from corn, and other renewable fuels to be blended with fossil fuels each year, with quotas assigned to individual refiners and importers.

Every time they mix ethanol into gas, or import fuel already blended with ethanol, energy companies get a credit from the government, and that credit can be sold to other companies that don't blend ethanol to help them meet federal requirements. If refiners fall short of their obligation, they can face fines of \$32,500 a day. To monitor compliance, each gallon of ethanol is assigned a 38-digit Renewable Identification Number, or RIN. Six billion of them were generated in the first six months of this year.



*The credits "weren't designed to become a speculative item. For the life of me I can't see the justification for it."* **THOMAS D. O'MALLEY**, the chairman of PBF Energy in Parsippany, N.J. Chester Higgins Jr./The New York Times

The E.P.A. makes sure participants comply with the fuel standard. But rules that apply to almost every other market — on transparency, disclosure and position limits, for example — are not imposed on the trade of RINs, making Wall Street's role harder to gauge.

If Wall Street traders take a 5 percent stake in a public company's stock, for instance, they are required by law to flag that they have acquired a sizable stake in a filing with the Securities and Exchange Commission. There is no such obligation for traders buying RINs.

Like JPMorgan, other big banks downplay their involvement, contending that they are in the market primarily because their firms, through subsidiaries and other arrangements, have ownership interests in gasoline and other energy production and therefore are required to participate in the federal renewable fuels program.

Until 1999, regulations barred banks from owning nonfinancial companies like commodities operations. This was meant to keep banks from self-dealing or pursuing monopolistic practices in their financial operations that could benefit their nonfinancial affiliates. Separating these operations, regulators believed, would also protect a bank's

core lending and deposit-taking businesses from risky trading by nonfinancial units. Those restrictions fell by the wayside with the passage of the Gramm-Leach-Bliley Act, which struck down Depression-era banking laws. Now, however, the Federal Reserve is reviewing commodities ownership by banks.

In the case of JPMorgan, the industry executives familiar with its activities in the RINs market said they were told by a top banker in its commodities operation about the stockpiling. The executives said the banker maintained that one of JPMorgan's traders had urged the bank to buy up every available credit. The executives spoke on the condition of anonymity for fear of harming business relationships.

Through a spokesman, the banker denied that the conversation took place. Mr. Marchiony, the JPMorgan spokesman, characterized the report as a misunderstanding. He denied the bank had stockpiled the credits. He added that the bank mainly dealt in RINs as a byproduct of its joint venture with a refiner in Philadelphia. "The fact of the matter is, we simply don't trade RINs, nor do we carry an inventory other than a marginal amount for compliance purposes," the statement said.

Morgan Stanley also generates RINs through TransMontaigne, a subsidiary with 21 blending facilities, and it trades the credits via the Morgan Stanley Capital Group. According to regulatory filings, TransMontaigne's biggest customer for its energy products is the commodities unit of the Morgan Stanley Capital Group, a trading operation that runs out of the former Texaco headquarters in Purchase, N.Y.

Mark Lake, a spokesman for Morgan Stanley, said that the firm had not benefited from the increase in RIN prices in 2013. "The firm's obligation to purchase RINs as part of our importing and blending of gasoline exceeded the RINs we have received from our wholesale business," he said.

Mr. Lake declined to discuss Morgan Stanley's holdings of RINs or to say whether the bank's traders used market information received from TransMontaigne.

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Trading on information gleaned from a subsidiary like TransMontaigne would be illegal in the stock market, but there are no rules against it in commodities. (Morgan Stanley also holds a stake in Heidmar Holdings, of Norwalk, Conn., which owns a fleet of oil tankers.)

Saule T. Omarova, an associate professor of law at the University of North Carolina at Chapel Hill, said Morgan Stanley's overlapping activities illustrate how large financial institutions have become deeply entwined in every aspect of the commodities markets.

"In the trading chain between the oil well and the gas station," Ms. Omarova said, "Morgan Stanley is clearly accumulating as many stakes along the way as possible because that is what gives them the most flexibility of control."

### Seizing an Opportunity

The market in ethanol credits is exactly the kind Wall Street loves: opaque, lightly regulated and potentially very lucrative.

*"The last thing we wanted in implementing this program is to get price increases for the customer."* **MARGO OGE**, former director of the Environmental Protection Agency's office of transportation and air quality. Daniel Rosenbaum for The New York Times

Officials at the E.P.A., which oversees the market, say they have seen no evidence of improper trading, like hoarding, in the market. But they do not police the RIN market as a financial regulator would.

"If there were any evidence now or in the future that that was happening, we have the ability to amend the regulation to constrain that," said Christopher Grundler, director of E.P.A.'s office of transportation and air quality, which oversees the renewable fuels program.

It is difficult for outside groups, or even other regulators and law enforcement agencies, to keep tabs on the market, because the E.P.A. declines to disclose who actively trades the credits, or how much they trade, citing the confidentiality of refiners and other participants.

Trading is a private affair, usually conducted by phone, and just about anyone can participate. In creating the market, the E.P.A. says it did not limit the market for RINs to refiners and other energy companies because it wanted to encourage a free market.

Price movements on other commodities futures are limited by the exchanges on which they trade as a check on speculation. But the biofuel credits are not traded on an exchange: their prices are unbridled. And, unlike in the broader financial industry, no formal qualification or license is required before a broker can start trading.

"There is a RINs trading desk at any major brokerage now," said Paul Niznik, bio-fuels manager for Hart Energy, based in Houston. "There are people who are not refiners that are buying and selling RINs like a commodity. They treat it like something to be traded, to be day-traded."

The RINs story began in 2005, when the Bush administration joined Democrats in Congress to pass an energy bill mandating renewable fuel standards. That law was broadened in 2007 to establish requirements for the amount of biofuel to be blended into gasoline annually through 2022. This year, refiners and importers are required to blend 13.8 billion gallons of ethanol, up from 13.2 billion last year. For 2014, the figure is 14.4 billion.

But the estimates Congress used about how much gas Americans would keep buying were wrong. When the biofuel credits were created, gasoline consumption was projected to grow 6 percent by 2013. But thanks in large part to the recession and more fuel-efficient cars, consumption has actually fallen.

As a result, refiners this year began hitting what is known as "the blend wall," meaning that the amount of ethanol the government is requiring them to use is close to the maximum amount that can be blended into gasoline without creating problems for gas stations and motorists.

Distributing gasoline with greater levels of ethanol is more costly and corrodes gas station pumps and tanks. Raising the ethanol level in gasoline, therefore, would require gas stations across America to install new systems. Therefore, refiners have turned to RINs to meet their government obligations rather than blend more ethanol into gasoline.

Some say financial players saw it coming, and jumped into the market.

“When you see something change as rapidly as this, somebody’s hoarding them, somebody’s buying them, somebody’s making big bucks,” said Senator Thomas A. Coburn, Republican of Oklahoma, a big oil state. After his staff examined the run-up in prices this summer, he said he was concerned that “big moneyed interests” were gaming the credits.

For now, companies like Valero say that they are eating the cost of high RIN prices, which are still eight times more expensive than they were in January. But industry analysts, executives and even researchers at the investment banks predict the cost of the RINs’ surge will be passed along to consumers by increasing the price of gasoline, if not later this year then next year.

Mr. O’Malley, the chairman of PBF Energy, likens the outcome to a hidden tax on the public. Unlike other taxes, which go to the government, this one goes to the speculators.

At a Zarco 66 gas station in Lawrence, Kan., various fuels. Cathryn Farley/Reuters

### **Double-Dipping on Credits**

Every day, RINs are born in places like Fort Lauderdale, Fla., Chesapeake, Va., and Bainbridge, Ga. Across a network of 45 fuel terminals in the Southeast, and along the Mississippi and Ohio rivers, Morgan Stanley’s TransMontaigne stores, blends and distributes gasoline and other fuels.

Even though it is based in Denver, TransMontaigne sits at the center of a powerful Wall Street energy operation. It delivers 200,000 barrels of refined petroleum products each day, just under 2.5 percent of the total market, and plays a role in the RINs market in addition to any trading its parent, Morgan Stanley, might do. Morgan Stanley bought TransMontaigne in 2006.

For banks, trading RINs for clients can be lucrative. A big reason is that the credits are far more difficult to buy and sell because they are not traded on exchanges like stocks. As a result, the difference between the price at which one party is willing to sell and another is willing to buy is unusually wide. Those fat spreads mean big money for anyone serving as a middleman.

At a hearing in late July at the Commodity Futures Trading Commission, Mr. Mixon, the commission's acting chief economist, estimated that RIN spreads were 4 percent of a transaction's value. That is far more than the average stock commission.

In addition to Morgan Stanley and JPMorgan Chase, other big banks, like Citigroup and Barclays, are also registered with the E.P.A. to trade the credits.

Edward Westlake, an analyst at Credit Suisse, said many big financial firms have gone beyond RINs trading and pushed into blending fuel to create them as well. "Building a tank and blending doesn't cost a lot of money," Mr. Westlake said, "and there are folks on Wall Street who own tanks who are benefiting from the RINs."

Bank research departments are also trying to pique investor interest in this market. Goldman Sachs and Bank of America Merrill Lynch recently published bullish reports on the market. In July, Morgan Stanley published a report predicting that RIN prices would keep rising — and eventually cause gas prices to spike later this year.

Officials at the E.P.A. do not see excessive influence by financial speculators. They suggest the price spikes in RINs this year reflect the expectation of a shortage of the credits because rising renewable fuel mandates are occurring as consumer demand for gasoline is falling. "The market is expecting this future scarcity as the statutory mandates continue to increase," Mr. Grundler said.

Others say that prices are up mostly because the oil industry has refused to invest in renewable energy. For example, Jeremy Martin, a clean energy expert for the Union of Concerned Scientists, said many of the complaints about the credits come from industry players who want to see the renewable fuels program killed.

"It was meant to change behavior, and it was understood that if it was to be binding, RIN prices would not be close to zero," Mr. Martin said.

In fact even before RINs took off, they had become a contentious issue within the energy industry. Ethanol producers like the renewable fuel standards because they essentially guarantee a market for their product. But refiners — particularly those without operations to blend the fuel — regard the standards as an onerous and unnecessary business cost.

### **The Impact at the Pump**

Margo T. Oge, who oversaw the creation of the ethanol credit program at the E.P.A., says that the rising price of RINs — no matter the cause — is good news and an indication that the program's goals are being met.

As the credits get more expensive, she says, oil and gas companies have a financial incentive to add more ethanol to fuel rather than buy credits. That, in turn, reduces oil imports and emissions — which was the point of creating the system in the first place.

A Valero station in California. Justin Sullivan/Getty Images

Ms. Oge, who retired from the E.P.A. last year and is now a visiting scholar at the International Council on Clean Transportation, a research group in Washington, said RINs were never supposed to affect the price of gasoline at the pump. If that is the result of the price run-up this year, as many energy analysts predict, it would be an unwelcome outcome, she said.

“The last thing we wanted in implementing this program is to get price increases for the consumer,” she said.

Even beyond the likely rise in gasoline prices, critics of the RINs market say it is deeply flawed, and they do not share Ms. Oge’s optimistic takeaway of this year’s market frenzy.

First, by allowing anyone to trade, including those with no real interest in energy, the E.P.A. encouraged speculation, the critics say. Second, the market operates largely in the dark, leaving it vulnerable to manipulation. Third, and perhaps most significant, the federal requirement for ethanol in gasoline means oil companies are captive buyers — meaning they are required to buy the credits when they do not or cannot blend their own fuel — a fact that savvy traders use to their advantage.

“The problem the E.P.A. had is they opened up the market on the trading side, but restricted it on the obligated side to refiners and importers,” said Lawrence J. Goldstein, the former president of the Petroleum Industry Research Foundation, a nonprofit bipartisan group.

Analysts and others say the market is vulnerable to questionable practices like short squeezes, where prices are pushed up by holders of the credits to benefit their positions.

“Anybody who’s participating in these markets has the opportunity to throw their weight around,” said David J. Hackett, president of Stillwater Associates, a transportation energy consulting firm. “Whether it’s a hedge fund or a refiner or ethanol producer, they would tend to drive the market in directions that are beneficial for whatever their goals.”

An examination by The Times of participants registered with the E.P.A. found several people with troubled pasts, including one who was accused of helping run a Ponzi scheme, and another who pleaded guilty to illegal storage of hazardous waste.

The RINs market has come off the boil recently, but at 60 cents apiece the credits still cost far more than they did at the beginning of the year. While the E.P.A. says the market is sound, W. David Montgomery, an economist at Nera Economic Consulting, a unit of Marsh & McLennan, said the agency should install an overseer.



The E.P.A. disagrees, but said it was considering providing more data on who trades and holds RINs and had instituted a voluntary certification system for participants.

“We are exploring things like increasing the regularity of updating the transactional data system and providing more information about production volumes,” Mr. Grundler, the E.P.A. official, said. “All are aimed at increasing confidence in this market and increasing compliance, which is our major concern.”

But Tom Kloza, an analyst at the Oil Price Information Service, a leading source of petroleum pricing, said the potential for abuse will not disappear on its own.

“You could conceivably have a company in the middle holding millions of RINs,” Mr. Kloza said. “Any entity could have a 1, 2 or 5 percent market share in RINs and is waiting to sell them at some explosive gain. I wonder, who’s got the score card?”