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The Coming Biodiesel Mass Extinction Event

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- There has been absolutely no catalyst this year to make the year-end passage of tax extenders a reasonably certain thing. We have reduced our odds of an extenders bill passing from 60-40 over the summer to about 50-50 now.
- Tax extenders are a handful of expiring tax provisions that Congress renews either annually or every two years. Most extenders of interest to investors in public companies were either eliminated or made permanent in the PATH Act of 2015 and the TCJA of 2017. The big two that remain are the biodiesel tax credit (BTC) and the Section 45G track maintenance credit for short line railroads.
- *Republicans and Democrats, the House and Senate, have been far apart on extenders all year long. Republicans have favored a slim list of classic extenders including the biodiesel tax credit (BTC). Democrats have bigger, bolder ambitions for new tax credits that aren't extenders at all. These would include investment tax credits for offshore wind and energy storage. Push may come to shove when a looming wave of plant closures threatens to close a sizeable number of BTC-dependent biorefineries in the electorally sensitive farm states.*

There comes a time when not even Congress can ignore its own deadlines. Two years past the drop-dead date is about the limit. That's where the plausible pretense that Congress accidentally missed a deadline is no longer tenable.

The $1 per gallon biodiesel tax credit (BTC) is one of 26 items that are approaching the biennial mark. As of December 31, the vintage 2017 tax extenders will have been dead for two full calendar years, and there will be no obvious next opportunity for Congress to restore them.

The lame duck session after an election is a typical time to do extenders, but the next lame duck session is more than one year out, and let's face it, the political environment in December 2019 will be unpredictable.

Worse, the tax credits will have been expired for nearly three years by then, and they might as well be considered new tax credits at that point. In the past, Congress has not renewed extenders that have expired for more than years. The upshot is that the BTC and other extenders need to pass this year, or they are not passing at all.

Congress has less than one week, and three working days left before the current Continuing Resolution (CR) expires on November 21. There is no way an extenders bill will be ready by then. Everything is going to ride on the next funding bill, be it another CR or a full-year omnibus, which will likely be due on December 20.

Current Odds on Extenders

We're currently about 50-50 on extenders. There are positive signs, but there is still a fair degree skepticism on the Hill whether extenders will be possible at all, and even whether a full-year funding bill is possible as well. In general, an omnibus is the preferred vehicle for extenders, since there is little question it will get the 60 votes needed in the Senate to pass an extenders bill without pay-fors.

A full-year CR might just do it, but is dicey. In theory, a CR shouldn't carry policy changes, and the chance that an extenders package could catch a ride on it would depend on how strong Congress feels about the extenders. We don't get the sense that strong feeling is universal.

Most people in the conventional corporate tax community, which is a club that we would love to join if they would let us in, have no interest in extenders. There is basically nothing corporate in the mix except for short-track rail. Yet oddly, House Democrats oppose a straight extenders bill because it is supposedly all corporate, which simply isn't true, but like so many other things is a popular mass delusion on Capitol Hill.

Republicans and Democrats

The impasse for many months now is that the Senators Charles Grassley (R-Iowa) and Ron Wyden (D-Ore.), the Chairman and Ranking Member, respectively, of the Senate Finance Committee have introduced and expressed their preference for a bipartisan extenders bill which is a straight, two-year extension of all the 2017 items. This would extend the biodiesel tax credit retroactively from 2018 through the end of 2019. It would bring to current the many small and family-owned biorefineries who rely on the tax credit for their economic viability and position them well for another extension, as is customary, in a year or two, provided that there is no break in the chain and this particular package does go through.

However, House Democrats to date have insisted that extenders, ostensibly because they benefit big corporations, should not go through without a "win" for the progressive side, which they define as an extension of low-income tax credits such as the expanded Earned Income Tax Credit (EITC) and Child Tax Credit (CTC), which scores at $131 billion over 10 years, according to the JTC. Ideally, House Democrats would like certain renewable energy tax credits added as well, even though these arguably represent new and don't count as extenders in the classical sense.

If there is going to be any new policy added, Senate Democrats want renewable energy tax credits added as well, particularly for energy storage and offshore wind. Senate Democrats will take as much as they can get, up to and including a lifting of the caps and de facto massive expansion of the Electric Vehicle Tax Credit (EVTC)

Republicans in the House and Senate aren't particularly interested in any of these. They balk, somewhat hypocritically, at the cost, but more importantly don't like the idea of turning straight extenders, an exercise that involves nothing but changing the expiration dates on current policy, into an opportunity for new policy.

But if Democrats want non-extender new policy items, Republicans have a wish list of their own. This starts with technical corrections to the Tax Cuts and Jobs Act (TCJA), which Democrats oppose because they feel no responsibility for errors in the Trump tax reform bill that passed with no Democratic votes. Republicans would also like to extend CFC lookthrough, which is an extender that does benefit large corporations, though it is an extender in a different class than the 2017.

The Four Corners Far Apart

The four corners of the compass are House and Senate, Republicans and Democrats. They have been nowhere near meeting in the center. Until recently, it didn't look likely that there would be a full-year omnibus either. Conventional wisdom was looking at a three-month CR to March at best. Now, perhaps, the omnibus is not as laughable as it seemed as recently as the end of October. But it is not shooting fish in a barrel.

The coming biodiesel mass extinction event may focus legislators on finding a center they can meet in. The vast majority of biodiesel in the United States is produced by thinly-capitalized co-ops or smallish, family-owned or closely-held companies that don't have the efficiencies, economies, and balance sheets of a publicly-traded integrated refiner. According to statistics published in Biodiesel magazine, the average plant has a capacity of only 20 million gallons per year, while the median capacity is less than 10 million gallons per year.

Already, according to the National Biodiesel Board, 200 million gallons per year of capacity representing the equivalent of 20 median-sized plants (out of a total universe of 122 plants) is idle because of policy uncertainty. Also, ten plants have closed this year, and total production is down 8%, according toNBB. (Total industry capacity is 2.6 billion gallons per year, according to EIA, but this total reflects the size of a few very large players.)

On Tuesday, according to a report from OPIS, NBB said in a press call that "dozens of plants" -- that is, a sizeable percentage of all plants in the industry -- could be forced to close if Congress does not extend the tax credit. NBB also released a study by ABF Economics showing that in early 2019, falling oil prices had reduced the cost of conventional diesel to below the production cost of biodiesel.

Hard Winter Coming

The combined cost of a gallon of conventional diesel plus the D4 RIN was $2.65, while biodiesel production cost was $2.86. This makes biodiesel unable to compete for volume in the open market. Add this to the widely held view that biodiesel is not profitable to make without the tax credit even in the largest and most efficient plants, and one sees a true industry crisis impacting the smaller, standalone plants most seriously. It gets even worse when one considers the cold-weather properties of biodiesel. Because of viscosity, no one produces much biodiesel during the coldest months of winter, which are coming up. Reduced production as needed to fulfill the RFS mandate means not only less profitability but less cashflow for firms with weak to non-existent balance sheets.

The biodiesel industry faces a brutal winter quarter, which makes the disconnect between tax policy and trade policy all the more striking. As we write, President Trump is pulling out all the stops to negotiate a trade agreement with China that will feature primarily a commitment by China to buy more US farm exports, to the tune of $40 to $50 billion per year, or about double what the US farm exports to China were before Trump began his trade war. Trump has even told reporters that he would like to sign the trade deal in Iowa, where as a younger man, Chinese President Xi Jinping spent two weeks living with a farm family in 1985. But signing the deal in Iowa may be too generous a gift for Trump from Xi, unless Trump is willing to withdraw more tariffs than seems likely. Other locations are reportedly being discussed.

Extenders After All?

We have found it hard to believe in our heart of hearts that an extenders bill really could get done this year, given the division between the four points of the compass we described above. For most of the year, we have had 60-40 odds that Congress will complete an extenders bill, but this has mostly to do with the established pattern passing an extenders bill at least once every two years that Congress has maintained for decades. There doesn't seem to be strong sentiments on the Hill for passing extenders simply to maintain old traditions, and many of the most compelling extenders were made permanent in the PATH Act of 2015 and the TCJA of last year. In recent weeks, we have reduced odds from 60-40 to 50-50 that extenders could pass because of bipartisan discord, the distraction of impeachment, and the apparent impasse between the House and Senate on appropriations. We have been looking for a catalyst that could make possible an extenders-plus bill, consisting of extenders, a few renewable energy items, technical corrections, and CFC look-through. The biodiesel crunch, which gives Republicans an incentive to play, may be it.

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The following analysts hereby certify (1) that their views about any and all of the subject companies and securities discussed in this report are accurately expressed and (2) that no part of their compensation was, is, or will be directly or indirectly related to the views expressed in this report: James Lucier.