Pulp Nonfiction

Contributed by Christopher Hayes
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Critical Comment - Two years in Washington have started to make me feel jaded. I've come to expect that even nobly conceived laws will be manipulated and distorted for private ends. But once in a while I hear a story that gives me the queasy feeling that I'm nowhere near cynical enough. Such is the case with the tale of the paper industry and the alternative-fuel tax credit.

Thanks to an obscure tax provision, the United States government stands to pay out as much as $8 billion this year to the ten largest paper companies. And get this: even though the money comes from a transportation bill whose manifest intent was to reduce dependence on fossil fuel, paper mills are adding diesel fuel to a process that requires none in order to qualify for the tax credit. In other words, we are paying the industry--handsomely--to use more fossil fuel. "Which is," as a Goldman Sachs report archly noted, the "opposite of what lawmakers likely had in mind when the tax credit was established."

The massive tax subsidy has barely been reported in the press, but it's caused a stir in the paper industry, which is struggling to stay profitable in the teeth of the recession. "Everybody's talking about it," paper industry analyst Brian McClay told me. "In the US and elsewhere in the world--in Canada and Brazil and Chile and Europe." On March 24 International Paper (IP) announced it had received its first check from the IRS for a one-month period this past fall. The total? A whopping $71.6 million. "It's probably close to a billion a year of cash," McClay said. "If you look at the economics of this business, to make that kind of money today you'd have to be on another planet." IP's stock rose 12 per-cent on the news.

The origins of the credit are innocent enough. In 2005 Congress passed, and George W. Bush signed, the $244 billion transportation bill. It included a variety of tax credits for alternative fuels such as ethanol and biomass. But it also included a fifty-cent-a-gallon credit for the use of fuel mixtures that combined "alternative fuel" with a "taxable fuel" such as diesel or gasoline.

Enter the paper industry. Since the 1930s the overwhelming majority of paper mills have employed what's called the kraft process to produce paper. Here's how it works. Wood chips are cooked in a chemical solution to separate the cellulose fibers, which are used to make paper, from the other organic material in wood. The remaining liquid, a sludge containing lignin (the structural glue that binds plant cells together), is called black liquor. Because it's so rich in carbon, black liquor is a good fuel; the kraft process uses the black liquor to produce the heat and energy necessary to transform pulp into paper. It's a neat, efficient process that's cost-effective without any government subsidy.

"Seventy-three percent of the energy we use in our mill system we produce," says Ann Wrobleski, IP's vice president for global government relations. "We feel like we're the original green industry, if you will." (In developed nations, paper is the third-largest industrial greenhouse gas emitter, behind the steel and chemical industries.)

By adding diesel fuel to the black liquor, paper companies produce a mixture that qualifies for the mixed-fuel tax credit, allowing them to burn "black liquor into gold," as a JPMorgan report put it. It's unclear who first came up with the idea--Wrobleski told me it was "outside consultants"--but at some point last fall IP and Verso, another paper company, formerly a part of IP, began adding diesel to its black liquor and applied to the IRS for the credit. (Verso nabbed $29.7 million at just one of its mills in the final quarter of 2008 for its use of mixed fuel.)

Despite the obvious contrivance of the procedure, Wrobleski is unapologetic: "The credit is supposed to encourage the use of green fuel." Sure, I said, but isn't it a bit weird you're now adding diesel fuel to the process in order to take advantage of it? "It is what it is," she said.

Others are less charitable. "You use the toilet every day," said one hedge fund analyst who's been closely following the issue. "Imagine if you could start pouring a little gasoline into the bowl and get fifty cents a gallon every time you flushed."

No one in Congress seems to have anticipated this creative maneuver. This past fall the Joint Committee on Taxation computed the cost of extending the tax credit for three months and projected it would cost a manageable $61 million. It now appears that the extension (which was passed as part of the TARP) could cost as much as $2 billion before the credits expire at the end of this calendar year.

In fact, the money to be gained from exploiting the tax credit so dwarfs the money to be made in making paper--IP lost $452 million in the fourth quarter of 2008 alone--that the ultimate result of the credit will likely be to push paper prices down as mills churn at full capacity in order to grab as much money from the IRS as it can.

If there's a cloud hanging over the elation in the industry, it's the sneaking suspicion that once Congress gets wind of this racket, it will shut it down. "The one comment I do get from people [in the paper industry]," says McClay, "is whether it's going to be rescinded or redrawn before the end game."

Investment analysts echo this concern. "We think there is some question as to whether this tax incentive survives to yr-end," a Deutsche Bank analyst wrote recently. "Most industry leaders would like to keep a low profile on this issue. Unfortunately, we think it is a material enough issue that it will draw attention."

So far, though, to the surprise of McClay and others, there's been not a peep from Capitol Hill. Allen Hershkowitz, a senior scientist at the Natural Resources Defense Council and director of its paper industry reform project, told me the industry wields significant clout in Washington and has benefited from myriad federal subsidies throughout its history, but that "this is really a perverse exploitation at the expense of the environment."

I called up the Senate Finance Committee, and a staffer told me they were "aware of the issue, and are talking with the IRS about the technical details. The committee intended the credit to be primarily for transportation fuel and plans to closely review the situation."

Whether or not Congress gets around to turning off the spigot, the episode is a useful reminder of the persistently ingenious ways the private sector can exploit even well-intentioned legislation. Considering that the success of the Treasury's recently announced plan to rescue the financial sector depends, in part, on the private sector not gaming the rules, the black liquor story seems particularly germane.

About Christopher Hayes

Christopher Hayes is The Nation's Washington, DC Editor. His essays, articles and reviews have appeared in The New York Times Magazine, The Nation, The American Prospect, The New Republic, The Washington Monthly, The Guardian and The Chicago Reader. From 2005 to 2006, Hayes was a Schumann Center Writing Fellow at In These Times. He is currently a fellow at the New America Foundation. His wife works in the White House Counsel's office.

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