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Market Facts

An Impending Ethanol Cost Squeeze

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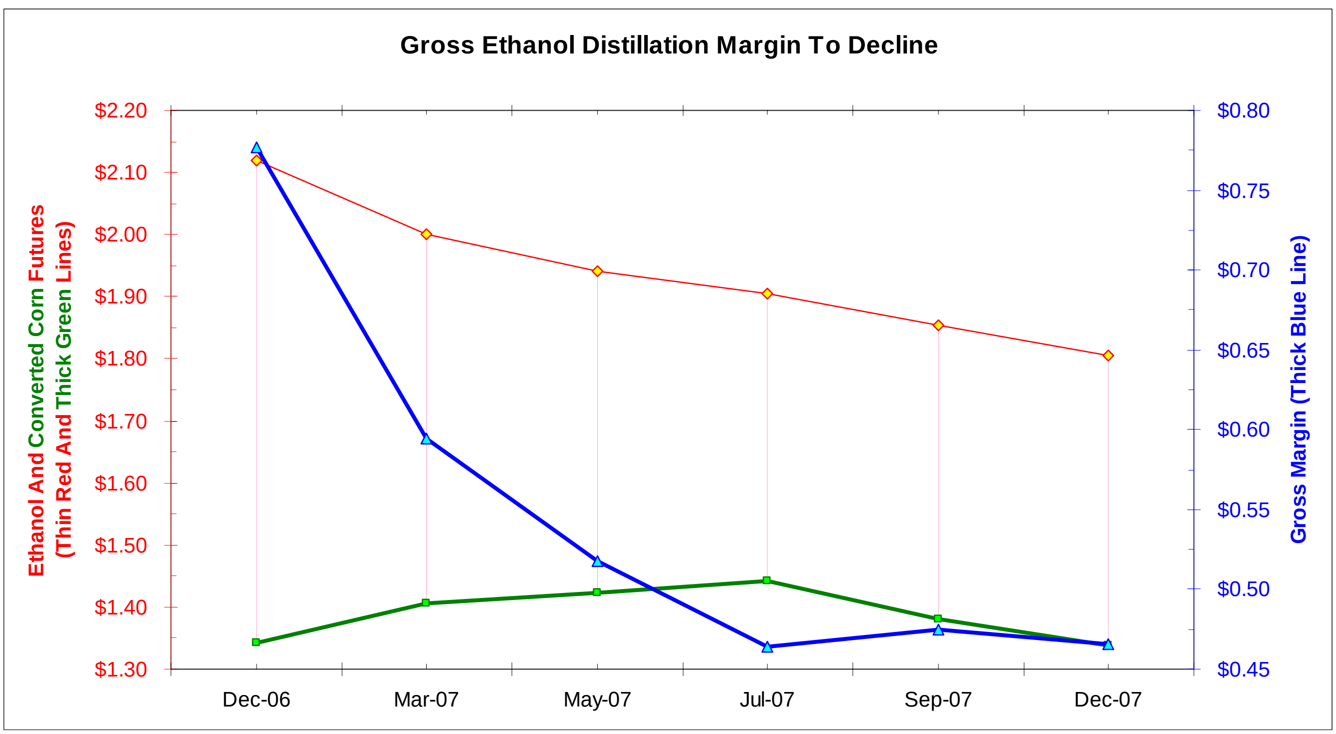
American energy policy is committed, for better or worse, to the expanded use of ethanol as a motor fuel blending agent. More important, the 54¢ per gallon tariff on imported ethanol, distilled primarily in Brazil from sugar, de facto makes U.S. ethanol distillation a corn conversion process.

Nothing below is intended as a summary of the biofuels industry; the intention here is to highlight how the diversion of corn from domestic and export human and livestock feedstock to yeast feedstock inevitably will affect the economics of all industries involved.

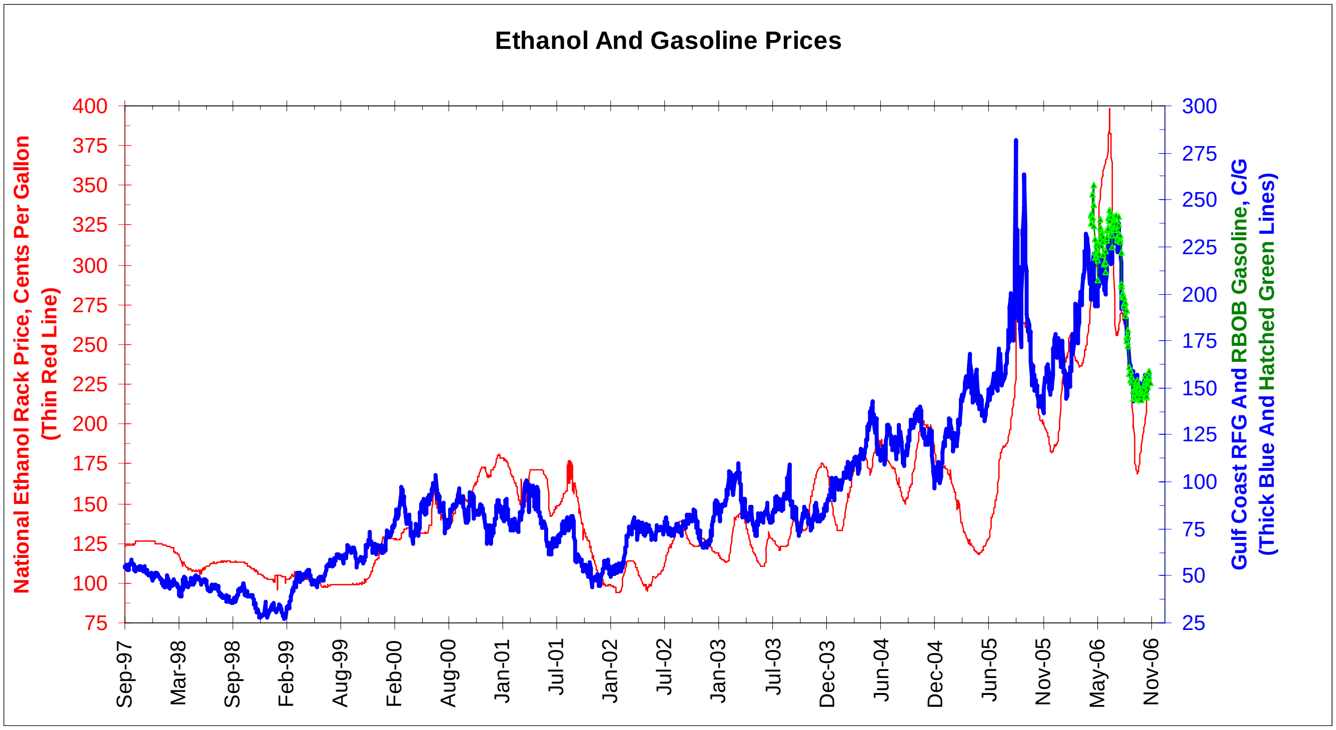
The distortions to come in agricultural economics will be the largest disruptions since the early 1970s. Global grain, oilseed, livestock and fuel markets will be affected, as will competitors for agricultural land. The increases in food prices will affect commonly quoted consumer price indices. Core inflation, we are happy to report, will remain unaffected. This inescapably will be a divisive public policy issue from which there will be no escape.

The industry affected first will be ethanol distillation itself. If we take the forward curves for ethanol and corn converted at a 2.55 bushel per gallon rate (thin red and thick green lines, respectively) and display the gross pre-processing margin, (thick blue line) we see a marked deterioration in margins through the end of the old crop year in July 2007. Higher demand for corn and increased ethanol production must affect margins in this manner; no amount of political subsidization can repeal the law of supply and demand.



This effect will be particularly acute should reformulated blendstock for oxygenate blending gasoline (RBOB, hatched green line, following page) prices continue to deteriorate; a statement, not a forecast. Over the past decade, national average ethanol rack prices (thin red line) have tracked reformulated gasoline (RFG, thick blue line) prices. That ethanol prices expand to capture the rent of higher gasoline prices should give pause to anyone operating under the illusion blending ethanol into gasoline can painlessly lower retail prices at the pump.

A deterioration of either gasoline or ethanol prices, or as is most likely the case both in tandem, coupled with higher corn prices will turn ethanol production uneconomic in the absence of further subsidization in addition to the 51¢ per gallon exemption from the federal motor fuels excise tax and the aforementioned tariff.



Conclusion

The entire corpus of international economics from the 18th Century forward has been based on the theory of competitive advantage. You do what you are good at doing and import cheaper goods and services as warranted.

Brazil and other sugar producers are better at feeding yeast than are American corn farmers. Producers of conventional hydrocarbons are better at fueling internal combustion engines than are American ethanol distillers. The impulse to declare energy independence in a dangerous world is understandable, but should be resisted if it is uneconomic in the absence of subsidization.

We have commented on several occasions, most recently in a September Commentary, at how minimal the damage to both the economy and financial markets has been from higher petroleum prices. These prices were pulled higher by stronger economic growth.

The distortions produced by an ill-considered move into ethanol will not be as pain-free. We have gone three decades without significant food price inflation. No one appeared to miss its presence. Why resume the experience now?

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