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Market Facts

Ethanol, Corn And Food Price Inflation

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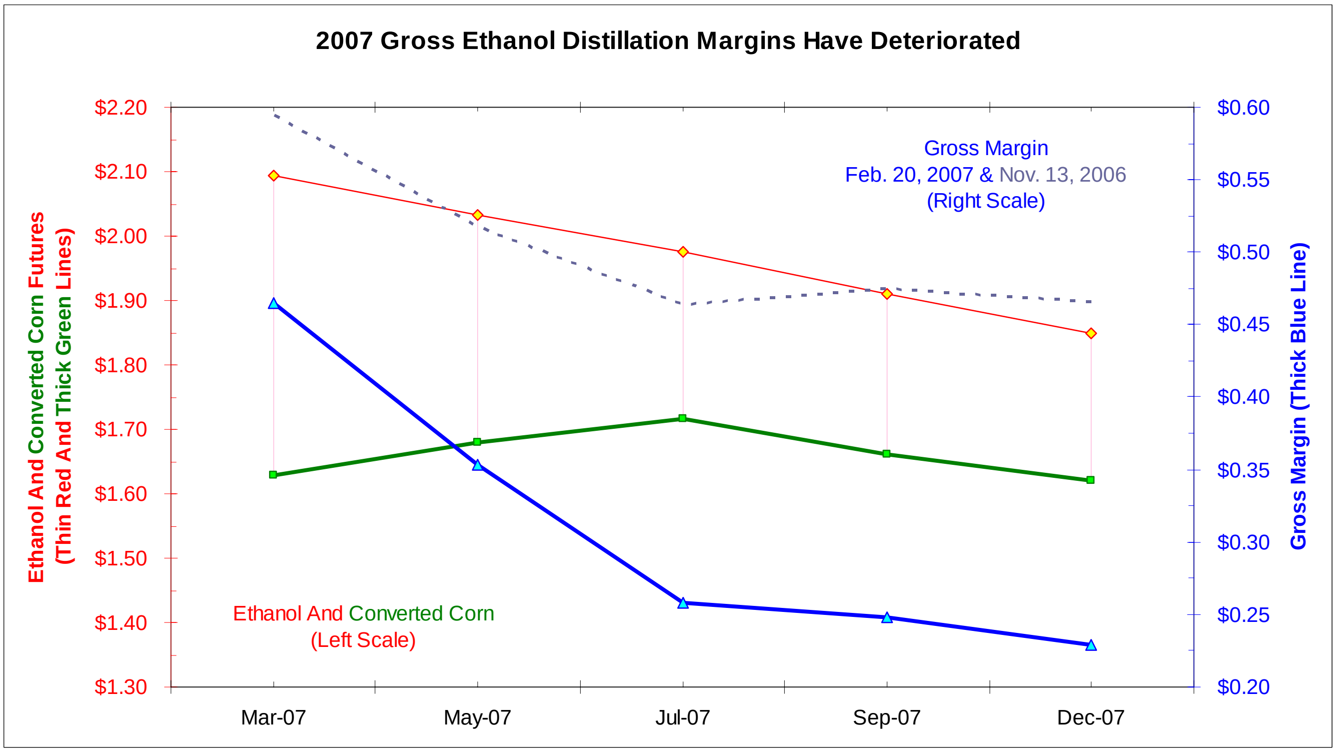
Now that we are a month past the State of The Union address wherein President Bush made increased ethanol production a national priority, it would be useful to update two recent *Market Facts* on ethanol, corn and food price inflation.

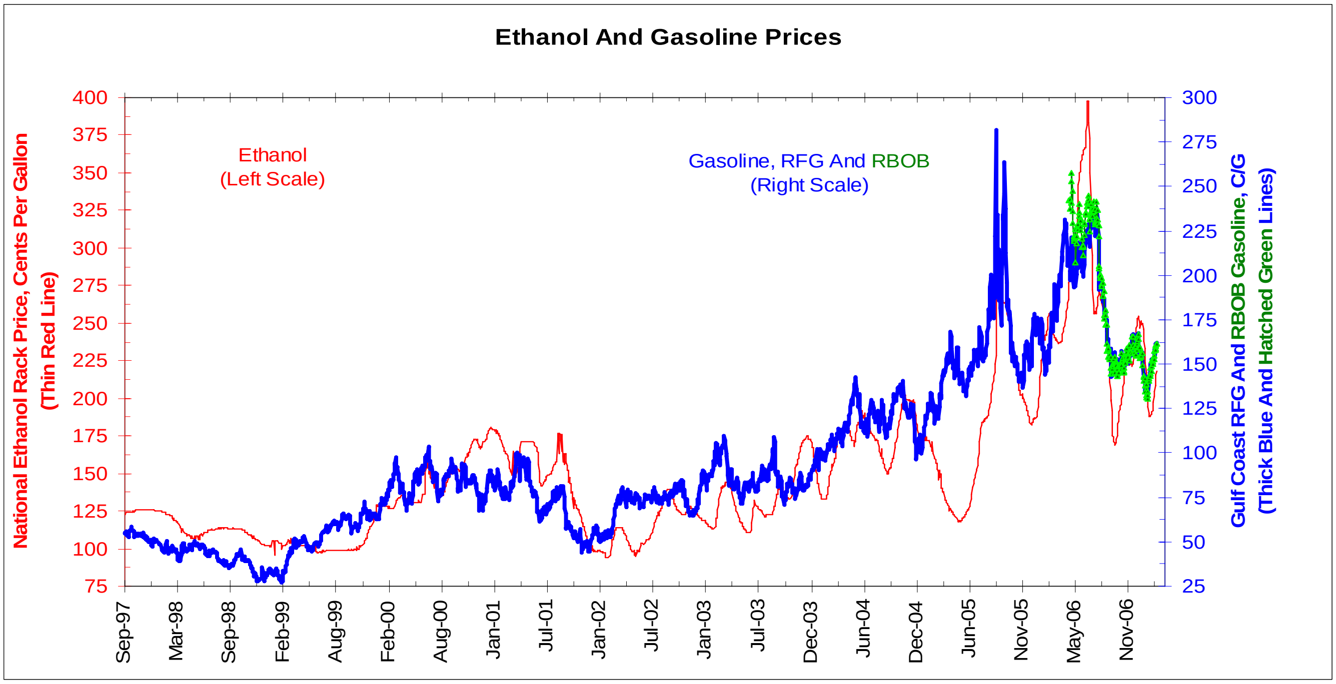
The first, from November 2006, underscored the deteriorating margins for corn-based ethanol distillation. The second, from January 2007, looked at relative food price inflation as a function of the July/December corn futures inversion.

Distillation economics have deteriorated badly, as predicted in November. If we convert corn at 2.55 bushels per gallon of ethanol (green line) and subtract it from ethanol prices (red line), the gross board margin (thick blue line) has declined significantly since November (dashed line).



Relief for distillers could come in one of three ways. The first would be for ethanol prices to move higher even as new plants come on-stream. While this would run counter to the law of supply and demand, it could happen in the short-term if gasoline prices moved higher first. Even though U.S. ethanol (thin red line, following page) is used as a gasoline extender, not as a gasoline substitute, it has tracked both standard 87-octane reformulated gasoline at the U.S. Gulf Coast (RFG, thick blue line) and the newer reformulated blendstock for oxygenate blending (RBOB, hatched green line) closely.

This would be a perverse solution: America's attempt at "energy independence," a misnomer if ever there was, would be rescued by higher prices for imported petroleum.



Corn Prices

A second solution would be for corn prices to fall under the weight of increased production both in the U.S. and in the Southern Hemisphere. Brazilian soybean farmers have the capacity to second-crop corn on soybean acreage, and already U.S. soybean farmers are diverting soybean acreage into corn.

This raises an interesting set of consequences and vulnerabilities. Lower corn prices can be achieved through either higher soybean prices or by demand destruction for ethanol. At present, plans are on the books for as many as 300 more ethanol plants.

On average, a new plant adds 40 million bushels of corn demand. The U.S. corn crop diverted to ethanol could be 2.15 billion bushels this year and 3.9 billion bushels over the 2007-2008 crop year. The latter number will be a claim of 35-40% of corn production, depending on yield and acreage.

If all of these plants are built, which is not at all a given, the U.S. ethanol industry could produce 9.5 billion gallons of ethanol by the end of 2007. For comparison, the Renewable Fuels Standards program targets 7.5 billion gallons as a gasoline extender by 2012.

Excess production would have to compete directly with gasoline, and as ethanol is only about 70% as efficient as gasoline, an RBOB price of $1.60/gallon should translate to an ethanol price of $1.10-$1.15 per gallon at the margin. Current ethanol rack prices are about $2.15 per gallon.

In the absence of political subsidization, ethanol plants would have to be canceled in the planning state or closed in operation. That would send corn prices plummeting, once again in the absence of political subsidization.

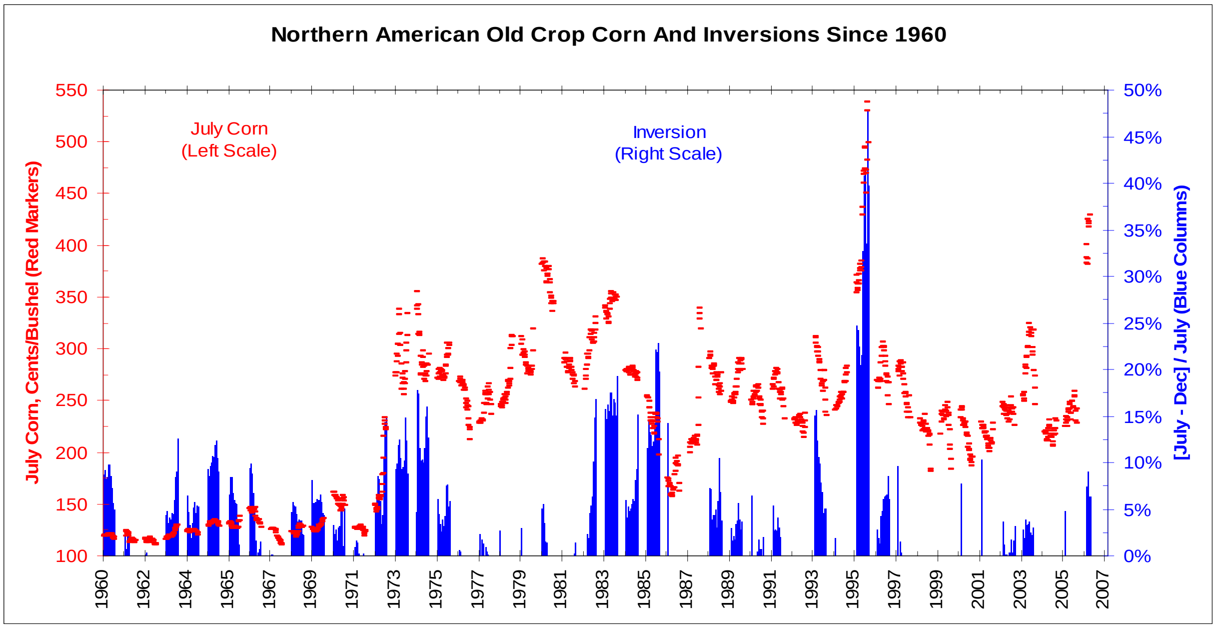
The prospect of lower corn prices for 2007 U.S. December, or new-crop, corn is keeping July (red markers, following page), or old-crop, corn at an inversion premium (blue columns) to December. That inversion premium has climbed from 4.6% in January to 6.3% today, and this premium could climb much further as July nears expiration.

We observed in January:

> *Previous inversions broke after July, but previous inversions never had to contend with a third major use of corn, ethanol production.* ***It is different this time, and we are not afraid to say so.***

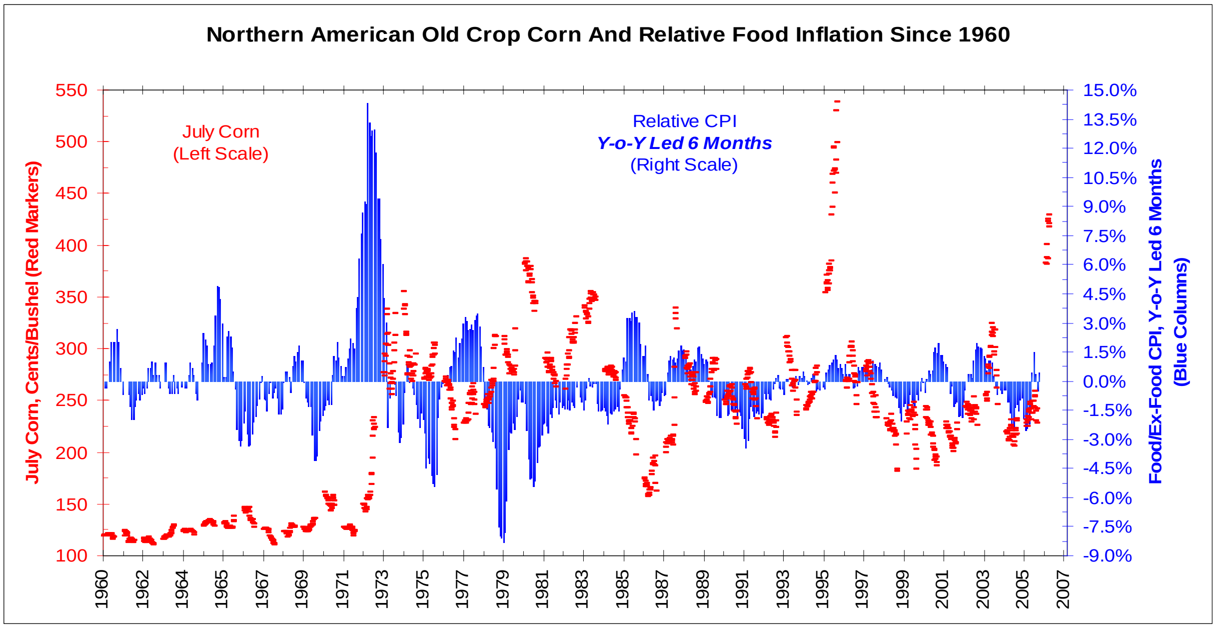
The implications are astounding. The U.S. government has embarked on a course of guaranteeing via subsidy both higher prices for corn and production of ethanol well in excess of immediate demand as a gasoline extender. Acres will be diverted from other crops and corn will be diverted from food uses to satisfy this unnaturally high demand for corn.

And let's call the obvious end-game well in advance: None of this will contribute a whit to energy independence or, to its companion in peoples' minds, national security. Restated, you can produce all the ethanol you want and you will still have to take your shoes off at the airport. **This lose-lose-lose (let's dub it Lose^3) proposition is the third source of relief for ethanol distillers.**



Food Price Inflation

We noted in January how previous surges in July corn (red markers) did not cause food price inflation to increase relative to inflation ex-food (blue columns) after a six-month lag. This is still true through the end of the January according to the latest CPI data.



Conclusion

Subsidies such as the 51¢ per gallon motor fuel excise tax holiday for ethanol and the 54¢ per gallon tariff on imports of Brazilian sugar-derived ethanol have distorted agricultural economics already. Further market distortions are going to be addressed with further subsidies for farmers and distillers and by the political allocation of corn between the food and energy markets if supplies become stressed.

To-date, the macroeconomic and financial market damage has been contained. This will not always be the case. The price controls and mandatory allocations of the 1970s helped create a decade of malaise. Why revisit that unhappy era?

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