Ethanol producers should load up on corn: Gavin Maguire
By Gavin Maguire, Reuters News
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CHICAGO, April 29 (Reuters) - US ethanol producers should consider covering their corn supply needs for the medium to long term even though the corn market is faced with the potential for oversupply, ethanol prices hover near historically low levels and the ethanol industry itself is faced with deep uncertainty ahead of key legislative decisions.

The US Energy Information Administration confirmed today that US ethanol production hit a new record in February as the industry continues to ramp up output to comply with the Renewable Fuels Standard that mandates aggressive increases in alternative fuel production to be blended into the US gasoline stream. In order to meet the mandate, an estimated 12 billion gallons of ethanol will be required to be blended into the US gasoline stream in 2010, with that number rising to 15 billion gallons in 2015.

However, due to a combination of tight profit margins and expectations of an abundance of corn in 2010, many ethanol producers have been reluctant to lock in long-term corn-sourcing contracts and instead have opted to live hand-to-mouth with regard to their corn input needs.

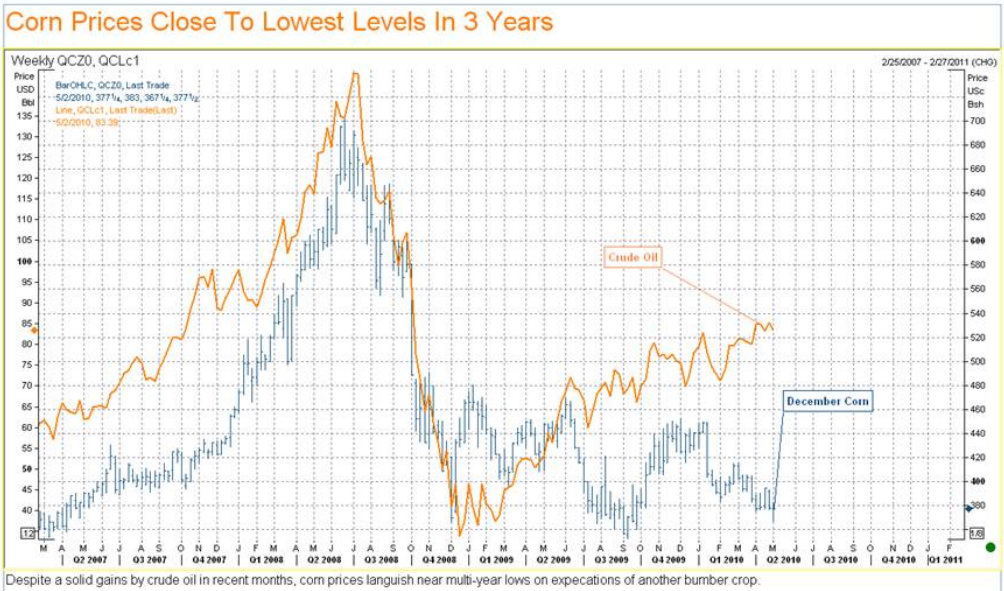
This low level of corn purchase commitments has enabled ethanol producers to weather the tight margin storm of late - as well as take incremental advantage of declining corn prices - but the time may have come for ethanol producers to be more aggressive about corn acquisitions ahead of a key few months for the industry.

CORN ALREADY LOOKING CHEAP

Taking a patient approach to corn purchasing has served ethanol producers well in recent months as new crop corn prices declined below $3.80 a bushel to roughly their lowest level in three years. Abundant supplies emanating from 2009's record US crop coupled with rampant plantings of the 2010 crop are behind this price softness, and could certainly justify additional price erosion in the months ahead should the planting season unfold under ideal weather conditions.

However, there is a strong likelihood that the corn market has already 'priced in' a friendly growing environment and so could rally on any bouts of crop-threatening weather. Should that occur, any end-users looking to purchase corn amid that environment would find themselves adding further fuel to any price strength and thereby reduce any corn cost savings that may be available currently.

In addition, while all commodities markets have endured a turbulent ride of late amid the uncertain macroeconomic environment, corn prices have underperformed other raw material staples such as crude oil due to the perception of ample upcoming supplies. This suggests that, once the corn market does encounter any weather scare, there may be an element of 'catching up' relative to other commodities that could spark a more aggressive upward acceleration in prices than perhaps may be warranted by the weather threat itself.



Despite a solid gains by crude oil in recent months, corn prices languish near multi-year lows on expecations of another bumber crop.

ETHANOL/RBOB SPREAD TOO WIDE

In line with the corn price and in reflection of the strong production levels seen, ethanol prices have declined toward multi-year lows of late and are currently trading at under $1.65 a gallon basis Chicago May futures.

However, nearby RBOB futures - the benchmark gasoline contract traded on NYMEX - are trading at above $2.30 and close to their highest level in six months thanks to recent draw-downs in US gasoline inventories.

As ethanol is blended with RBOB to make fuel products such as E-10, there traditionally is a tight correlation between the two markets in terms of price action. But ethanol prices have lagged RBOB lately to the degree that the spread between the two markets is currently at its widest since RBOB futures were introduced in 2006.

Traditionally very tight, the spread between ethanol and RBOB (reformulated gasoline blendstock for oxygen blending) has widened lately as ethanol prices slumped.

Should the recent trend in RBOB prices - and more importantly in gasoline inventories - continue, then ethanol prices can be expected to find support which should give ethanol producer profit margins a boost

just as we enter the crucial growing phase for the newly planted corn crop and the US 'driving season' begins when gasoline demand traditionally picks up further.

UNCERTAIN SUMMER AHEAD

While the uncertainty over the corn price is a major operational concern for ethanol producers, key industry-level issues also look set to be played out over the coming months that may complicate the decision making process further for all US ethanol producers.

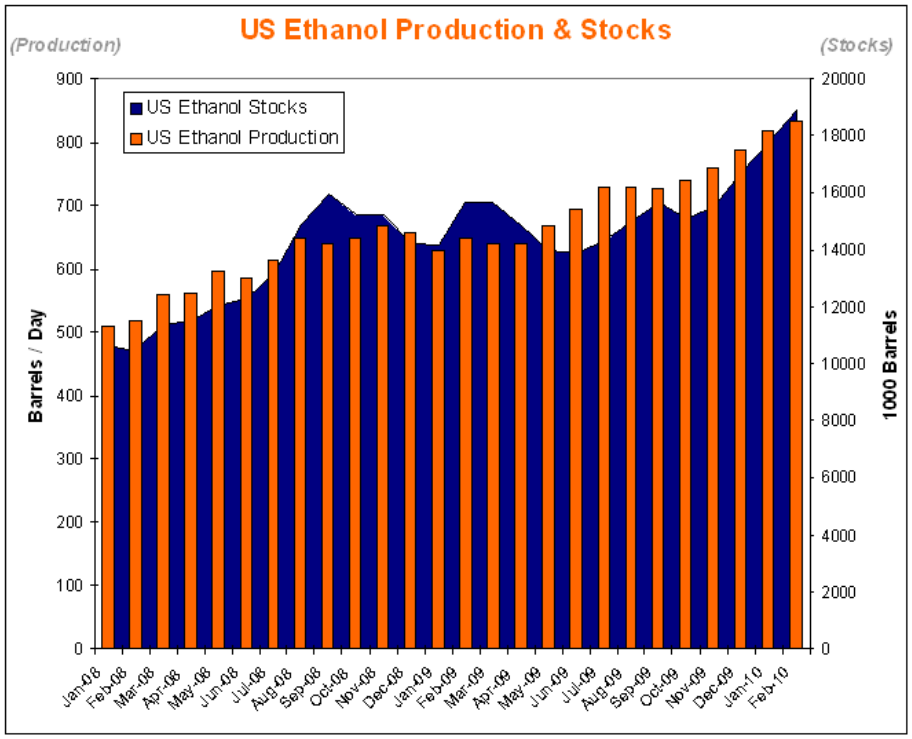
Of primary concern is the ongoing dispute in Congress over whether to extend the 45 cents per gallon tax credit that blenders receive for mixing the biofuel with gasoline. The current credit program is set to expire at the end of the year, but proposals for an extension were introduced last month that are set to be considered over the coming weeks. Opponents to extending the tax credit point out that the industry needs to stand on its own two feet if it is to play a genuine role in US energy independence. However, fears of widespread job losses and a derailment of the Renewable Fuels Plan if the credit is removed will likely outweigh those concerns, and probably ensure the credit be maintained for now.

A more vulnerable protective measure is the ethanol import tariff. Currently, the US places hefty tariffs on imported ethanol that have made it prohibitively expensive to bring in supplies from outside the US. This has certainly helped prop up US ethanol demand in recent years, but the argument to maintain that tariff has been weakened considerably after Brazil eliminated its tariff on US ethanol earlier this month and asked the US to reciprocate.

As the Obama administration appears to be actively promoting improved trade relations with Brazil following last year's resolution of a protracted dispute between the two countries over cotton, it is quite possible that legislators may not push to maintain the import restrictions quite as aggressively as they may fight for the domestic tax credit extensions - and thus may come up with a compromise measure that may loosen import restrictions.

PEERING OVER THE BLEND WALL

The final hurdle the industry needs to clear is the infamous 'blend wall' that is impacting the amount of ethanol that can be absorbed by the US gasoline stream. Because the US gasoline supply is mandated to have up to 10% ethanol, that limit is acting as a cap on overall ethanol demand and constraining the amount of ethanol that blenders can add to the fuel supply. This has led to a steady rise in ethanol inventories in recent months that can be seen in the below chart.



However, even here it is possible for significant changes to take effect over the coming months. The chief decision regarding how much ethanol is allowed into the nation's fuel stream lies with the Environment Protection Agency, which in late 2009 announced it would study the potential impact of a higher blend rate and make an announcement regarding any changes sometime in mid-2010.

Concerns about a higher ethanol content eroding pre-2001 engines is at the center of the EPA's focus, although opposition from other corn end users as well as environmentalists concerned with ethanol's carbon footprint are also being addressed. There is little indication so far as to which way the EPA is leaning, but it is clear that any lift in the blend wall would be a welcome development in the ethanol industry that would quickly help ease burdensome stock levels. On the other hand, any delay on changing the blend rate will likely lead to a further build in stocks that will continue to undermine prices and the industry itself.

In all, the ethanol industry may soon be impacted by important changes that could pave the way to faster absorption of the fuel into the US gasoline supply. Producers willing to place a wager that the legislative chips fall in their favor should stock up on cheap corn while they can.