

GRAIN OUTLOOK

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WHEN WILL THE ETHANOL BUBBLE BURST?

There is no denying that the ethanol industry is growing a 'bubble' which could burst. On average, one new ethanol plant now comes online in the U.S. each week, further expanding industry ethanol production capacity. That will continue for at least the next eighteen months as plants now under construction are completed. Approximately 300 more ethanol plants have been announced. Since construction on those plants has not yet started, it can not be stated with certainty how many will actually be built.

Depending on size, each new ethanol plant will add up to about 40 million bushels to the annual demand for corn, which for ethanol production in total is expected to be 2.15 billion bushels this marketing year and as much as 3.9 billion bushels in the 2007/08 crop marketing year.

Here is a major cause of concern. By the end of 2007, the U.S. ethanol industry will have the capacity to produce approximately 9.5 billion gallons of ethanol per year. That will far exceed the Renewable Fuel Standards program 2012 mandate of 7.5 billion gallons of ethanol inclusion in gasoline. The excess ethanol will have to compete as a direct substitute for gasoline instead of as a mandated additive. The wholesale price of gasoline is currently in the \$1.60 to \$1.70 range. Because ethanol contains only two-thirds of the energy of gasoline, ethanol price would need to fall to about \$1.10 in order to compete. Ethanol price that low would bring on the industry collapse many fear. At some point, plants turning out red ink as well as ethanol would shutdown, causing corn price, and the prices of other agricultural commodities, to plummet.

If that were to occur, many would be hurt - farmers and others who have invested in ethanol plants, grain producers, the thousands of workers who have found employment in the ethanol and related industries, and the several hundred rural communities that have benefited from the positive economic development impacts of ethanol plants. These reasons alone would be enough for Congress to step in; to increase the mandated usage of ethanol.

However, the major underlying reason for producing renewable fuels and energy from non-petroleum sources such as wind, solar, geothermal, and nuclear is national security. Energy is the lifeblood of any modern developed economy. The United States, the world's largest economy, imports 60 percent of the oil it uses and if a significant portion of that imported oil were cut off, the U.S. economy would be pushed into a downturn. Even if other developed nations in the world continued to receive imported oil, it is likely they would also suffer recession.

Oil exporting nations have a strong self-interest in keeping the economies of their customer nations healthy. However, instability in some of the OPEC nations have many people concerned about the ability and willingness of those countries to continue to supply the U.S. Conversely, the OPEC nations working together could attempt to break the back of the renewable fuels effort by driving oil price down with increased oil production.

The member countries of OPEC supply about 30 percent of the oil used in the U.S. In his recent State of the Union address, President Bush called for us to end our dependency on that imported oil by ramping up biofuel production to supply 30 percent of the nation's vehicular fuel usage by 2030. He also proposed a national goal to produce 35 billion gallons of renewable and alternative fuels by 2017; about a five-fold increase in the 2010 mandate.

The conclusion may be drawn that Congress is not likely to allow the renewable fuels industry to collapse, whether threatened by overcapacity or a precipitous drop in oil price. The market agrees that the corn-based ethanol industry will remain viable, if it is true that the futures market takes into account all information that affects market price. On February 16th, closing corn contract prices were as follows: Dec 07 - \$4.1325; Dec 08 - \$3.8725; Dec 09 - \$3.705; and Dec 10 - \$3.60. Those prices can be interpreted to mean that the market expects more corn to be grown in the U.S. and around the world in the near future, hence the declining year-to-year price. But it is not anticipating a market collapse such as might accompany the closing of many ethanol plants.

At the present time, a relatively high corn price is still buying acres, although a lack of bullish news is causing the market to mark time. If good planting conditions prevail, look for corn price to fade because many ethanol plants and overseas buyers have contracted to cover needs until the new crop harvest. It is rumored that second-crop corn will be planted in Brazil following the soybean harvest just now getting underway. Nevertheless, low world coarse grain stocks may cause corn price to spike upward in the summer months as we near the end of the old crop marketing year.

Soybean price has strengthened considerably in recent weeks, but continues to follow the lead of corn in an attempt to limit a decrease in soybean acres. A large U.S. carryover supply and a potential record South American crop is dampening soybean price. There may be further weakness as the South American harvest progresses. On the other hand, if U.S. corn planting is unhindered by weather delays, soybean price could rise in anticipation of a smaller crop and short supply in the 2007/08 marketing year.

Wheat price appears to be diverging from corn, even though corn may pull acres away from wheat this spring. The downtrend in wheat price that began in October continues. Replenished moisture in the Great Plains and increased planting of winter wheat in the U.S., and in the Northern Hemisphere around the world, is pressuring wheat price.