Soaring corn stirs up calls to curb ethanol demand

News analysis

Greatest potential for a reduction in corn demand comes from the ethanol industry, say **Gregory Meyer** and **Jack Farchy**

The world is running short of corn.

That is the message being delivered by the market, where prices yesterday pushed above $8 a bushel for the first time.

With no obvious abundance of international suppliers to make up for the drought-ravaged US corn crop and stocks close to record lows, traders and analysts believe demand must be pegged back.

A reduction in demand "will be necessary to prevent cupboards going bare", says Hussein Allidina, head of commodities research at Morgan Stanley.

"Demand rationing", as analysts call it, is already beginning to happen.

The US Department of Agriculture last week lowered its estimate of how much corn will be used to feed livestock by 650m bushels, or 12 per cent.

It also reduced its forecast for US exports by 300m bushels.

But the biggest potential for a reduction in corn demand comes from the ethanol industry, which is using about 5bn bushels of corn, or nearly 40 per cent of the US corn crop, a year to make fuel for cars and animal feed, a byproduct.

Already ethanol production, once seen as impervious to high prices, is waning as rocketing corn prices, weak gasoline demand and the expiry of subsidies hurt margins. US ethanol plants pumped out 33.7m gallons a day last week, the lowest volume since October 2009.

In late June Valero Energy temporarily closed two ethanol refineries in Indiana and Nebraska as local corn prices had shot too high to turn a profit. Each had the capacity to produce 120m gallons per year.

"We let the local markets know when we shut the plants down that we weren't going to be buying corn," said Valero. Eight other Valero plants remain open.

> 'Politicians are all in denial,' says an executive at a commodity trading house

The company said it hoped to reopen the plants once the new corn crop was gathered in the fertile Midwest states.

However, some demand is essentially guaranteed by the Renewable Fuel Standard, the congressional mandate that will require more than 13bn gallons of corn-based ethanol to be used in transport this year, regardless of the corn price.

"One of the peculiarities of the ethanol mandate is that regardless of how dire the corn crop may be, ethanol always eats first," says Scott Faber of the Environmental Working Group, which opposes ethanol subsidies.

Some traders and analysts believe that a decision by the US Environmental Protection Agency to waive the mandate could prevent a price spike as the US corn crop withers.

"Politicians are all in denial," says an executive at a commodity trading house.

"They have to address the US ethanol programme – that's the only way to tackle it. To take out big chunks of demand, you need to take out the US ethanol programme."

That appears unlikely in an election year. Ethanol is a political hot potato in the US, with grain producing states and some environmentalists lobbying for mandates.

The Renewable Fuels Association, an industry group, points out that petitioners seeking a waiver must show unequivocally that the ethanol mandate would "severely harm the economy or environment of a state, a region, or the US".

"The mandates are strong," says one senior trader.

"Just if they announce that there may be a change of legislation – I think that will put the market limit down."

The EPA said: "We can't speculate on waiver requests that we haven't received."

There are also technical issues that could prevent a large-scale reduction in ethanol use. Metropolitan areas with dirty air such as New York, Chicago and Los Angeles have to blend "oxygenates" into gasoline to improve car emissions.

Since an earlier oxygenate called MTBE disappeared, the industry has been using ethanol, says Tom Kloza of the Oil Price Information Service.

But ethanol output may fall back without waiving mandates.

Tom Vilsack, US agriculture secretary, said on Wednesday: "There's no need to go to the EPA at this point in time based on the quantity of ethanol that's currently in storage.

"There's no problem in that area at this point."

US ethanol stocks are at 821m gallons, potentially enough to cover shortfalls from closed plants.

Moreover, oil companies can meet ethanol mandates without using corn. In the event that they are unable to use actual ethanol, they can use credits called renewable identification numbers that they have banked in previous years.

Renewable identification numbers prices have shot up in recent weeks, perhaps reflecting demand from oil companies seeking to protect themselves in the event of an ethanol shortage. The US has been exporting large amounts of ethanol as US petrol demand has flagged.

Reduced ethanol demand may be enough, together with lower exports and a contraction in the meat industry, to balance the corn market. But while the USDA last week cut its estimates for corn and soyabean yields to 146 bushels and 40.5 bushels an acre respectively, traders are already anticipating a further fall to 130-135 bushels and 38-40 bushels an acre.

If the corn and soyabean belts go without rain for another two to three weeks, traders say, even those numbers could be too high, putting a more dramatic price increase on the cards.

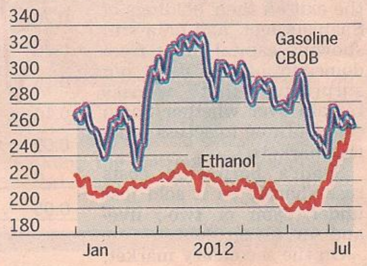
Running low

Where the US corn crop goes
2011-12 (%)

US ethanol production
'000 barrels per day

US corn crop converted to ethanol*
% of total crop

Ethanol and gasoline prices
Cents per gallon



Source: USDA; EIA; OPIS Photos: AP; Bloomberg; Getty; Dreamstime
* Ethanol plant byproducts include animal feed and corn oil ** forecasts