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SEVEN | The commodity conundrum

by Amy Westervelt - 1.4.08

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In the past, when crude-oil prices went up, the price of most raw materials went up as well, because it simply cost more to transport them. Today, erratic weather patterns that include flooding and drought, along with population increases, a rising global middle class, a weak U.S. dollar and growing demand for biofuels have been added to the equation, driving the cost of feedstocks—and food staples—up even further with no end in sight.

Corn has been the commodity most in the spotlight due in part to large U.S. subsidies for ethanol in 2006 and 2007 that helped drive the cost of corn higher, which in turn sent prices for dairy products and meat sky high, as farmers passed the higher cost of feed grain on to consumers.

Meanwhile, analysts say the U.S. market for ethanol is saturated, and many of the large-scale refineries that planned to take advantage of federal subsidies will be cut before they even open. Public support has waned for ethanol as the food-versus-fuel debate becomes increasingly prominent in the media, and ethanol stocks, such as Pacific Ethanol (Nasdaq: PEIX), have plummeted.

Following the opening of its 40 million-gallon-per-year plant in Boardman, Ore., Pacific Ethanol announced Nov. 16, 2007 that Cascade Investment, which is owned by Microsoft (Nasdaq: MSFT) founder Bill Gates, may sell its 21 percent share of the company. The announced resignations of several key board members preceded the news. The company's stock fell 63 percent over the course of the year, prompting the Bloomberg News Service in November 2007 to call ethanol "the worst investment of the year."

With investor confidence and public support low, the price of ethanol hit a 28-month low by the end of 2007, resulting in the cancellation of six proposed ethanol plants, Eitan Bernstein, an analyst at Friedman Billings Ramsey & Co. in Arlington, Va. recently told Bloomberg News.

Despite the closed plants, Bernstein says several new mills are still under construction and annual U.S. output may reach 11.3 billion gallons by the end of 2008, while annual demand could decrease by about 3 billion gallons due to recently passed restrictions on the time of year ethanol can be used in Georgia and Florida.

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Herb London, president of conservative think tank the Hudson Institute maintains that, just as commodity prices have risen throughout history, they're destined to fall again. Darin Newsom, a senior commodities analyst with DTN in Omaha, contends while prices may eventually come down, they will remain high throughout 2008.

Though various elements are contributing to high costs, Newsom points to the weak dollar as the primary culprit, and says its continued weakness will likely keep prices high. "We'll have to reach a point where inflation causes recession and we change policies, interest rates rise to support the dollar, which increases the value of the dollar and makes commodities less attractive," he says.

Though ethanol and its connection to high corn prices has caught themostmedia attention, increased demand for biodiesel has also begun to send the price of soybeans soaring.

Newsom predicts crude oil could get as high as $105 to $110 a barrel in 2008, with soybeans reaching $12.50 to $16.50, and corn hitting $6 to $6.50 (it's currently at $3.75 to $4). In late 2007, the cost of soybeans rose high enough to begin affecting the biodiesel market in much the same way rising corn costs first began affecting the ethanol industry, with companies such as Indiana's North Prairie Productions halting construction on proposed biodiesel plants, citing rising commodity costs as the primary reason.

Benefuel, a Chicago-based biodiesel refining and distribution company, says its solid, acid catalyst technology could help insulate the biodiesel industry from such detrimental feedstock price fluctuations, by allowing virtually any vegetable oil and some animal fats directly into biodiesel without pre-processing, according to the company. Benefuel's construction of a 10 million-gallon-a-year biodiesel plant in Seymour, Ind., is set to begin in 2008.

Although analysts and investors agree 2008 and possibly 2009 could be rocky years for commodities, biofuels and the economy in general, Newsom says given the natural cycle of the economy, the dollar is likely to rebound after a recession, driving commodity prices down. In the meantime, government will continue to subsidize both conventional farmers and biofuel producers.