

Mere Alcohol Doesn't Thrill Me At All

Did Cole Porter have denatured industrial ethanol in mind in 1934 when he penned "I Get A Kick Out Of You," to the best of my knowledge the only song in the English language to rhyme champagne with cocaine? Probably not, and chances are the songster would be amazed at how much of mankind's oldest bane - more than 1.3 billion gallons of John Barleycorn per year - is being consumed on the highway by cars, not people. What would he do today, rhyme gasoline with Benedictine?

Unwise In Any Steed

The blending of ethanol with gasoline ranks right up there with campaign finance reform as one of those bad public policy ideas that never makes sense and yet never goes away. If we took away the federal subsidies to grow corn, the federal subsidies to distill that corn into ethanol, and the federal subsidy in the form of the motor fuel tax rebate, we would not even think of putting this less-efficient fuel into an internal combustion engine.

But we are not going to take away those subsidies any more than we are going to take away the other welfare payments we shovel at farmers and agribusiness giants such as Archer-Daniels-Midland. Just watch how presidential wannabes fall all over themselves in the Iowa caucus in support of ethanol.

Ethanol use as a motor fuel is supported by one of those odd coalitions of strange bedfellows dotting our political landscape and mixing our metaphors. First, several centuries after David Ricardo outlined the principle of competitive advantage in international economics, there are those who would rather waste money on domestic energy boondoggles than buy a cheaper barrel of foreign oil.

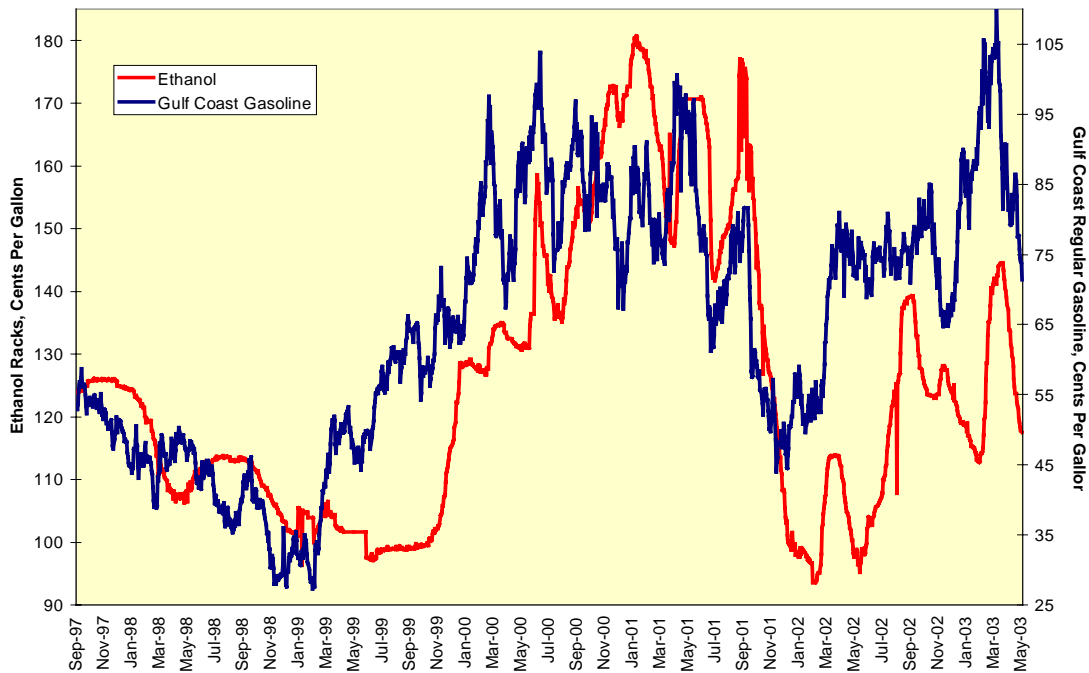
Memo to file: If you spend more energy on producing the fuel than the fuel contains, you lose. Brazil has been producing alcohol fuels from sugar for more than two decades in search of energy independence, and who wouldn't want to emulate the Brazilian economic miracle? But unlike other energy boondoggles such as oil shale, we actually get a useable fuel back for our money, so at least it isn't a complete loss.

Second, we have the environmental lobby, which has managed to convince itself that additives with high life-cycle environmental costs, such as ethanol and MTBE (methyl tertiary butyl ether, as long as you ask) lower air pollution by virtue of their embedded oxygen atoms (I'll skip the chemistry). Environmental costs include the uses of fertilizers and pesticides and the mining of ground water for irrigation for ethanol and groundwater pollution by MTBE.

Rack 'Em Up

But ethanol is a commodity, and like all commodities suffers from declining prices over time. Refiners such as Valero, Tosco, Coastal and Koch may sell branded ethanol at their terminals at what is called a rack price, but it is nearly impossible to add value to ethanol. Ethanol is supplanting MTBE as an additive in many markets due to the groundwater issue, and as ethanol producers such as Chippewa Valley Ethanol, which is doubling its capacity, ramp up, prices are plunging (to \$1.18 per gallon; think about that next time you buy a round).

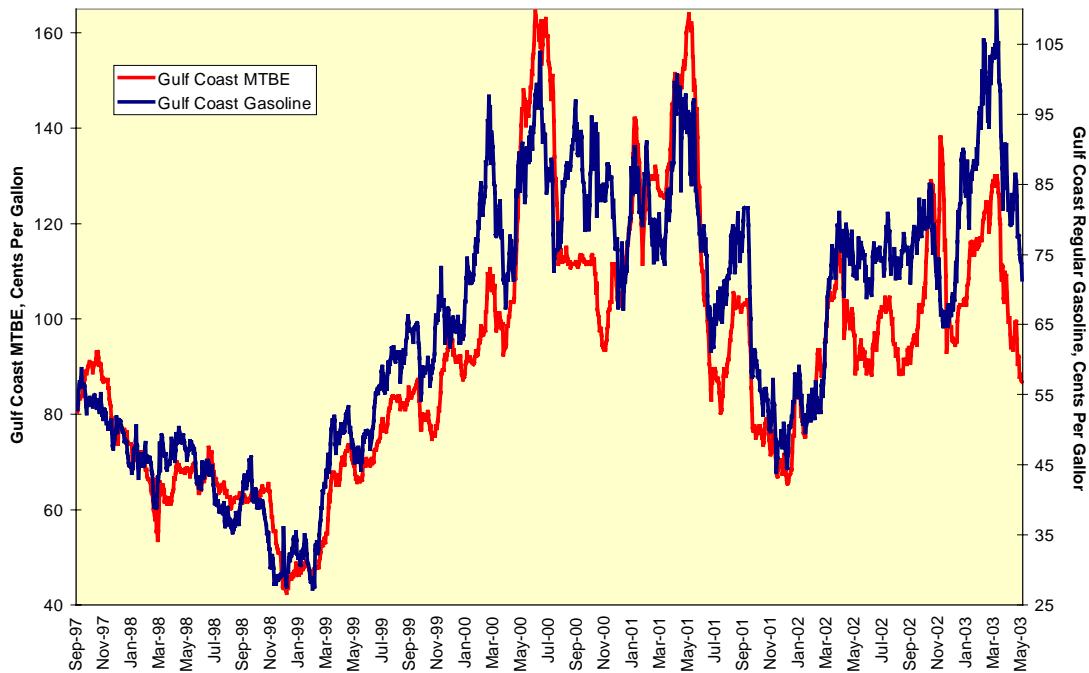
When Big Oil Meets Big Alcohol



The price of 87-octane conventional gasoline at the U.S. Gulf coast tends to lead the national average rack price of ethanol. The relationship has become tighter both in time and in absolute correlation since the groundwater pollution problems of MTBE became more apparent in early 2001. This relationship should be studied by government lawyers and others who still believe in "cost-plus" pricing, the notion that the cost of producing a good or service determines its price in the market. The opposite, the determination of production costs by the price in the final market (the central principle of Austrian economics, espoused by Ludwig von Mises and others) holds true here. As the price of gasoline rises and falls, so does the capacity of refiners to pay for ethanol and other additives.

By confirmation, the MTBE market tracks the price of gasoline closely as well. The degree of correlation starts to break down in early 2001 as its environmental problems became more apparent.

Ether Market Getting Sleepy



Trouble Brewing

In addition to Archer-Daniels-Midland, there are a number of smaller firms - and I do mean smaller - devoted to ethanol production. Take MBC Holding, which trades at \$0.001: This full-scale brewery produces Grain Belt, Pig's Eye, Brewers Cave and Yellow Belly malt beverages, some of which I am certain are cult classics. Keep your eye on the ethanol subsidies: They are presently developing an ethanol production facility through Gopher State Ethanol, LLC, not to be confused with either Badger State Ethanol, LLC, or Great Plains Ethanol, LLC.

We can move up the price curve and find Hybrid Fuels, which went out with a \$0.22 / .25 market on May 2, 2003. This development stage firm combines ethanol production with a beef finishing operation (cattle love dried malt, I'm told).

Other opportunities fall into the day-late-and-dollar-short category. Wyoming Ethanol and High Plains Corporation (no relationship with the aforementioned Great Plains Ethanol) have been acquired. Standard Energy, which manufactures ethanol from recycled garbage, and Intrepid Engineering Services, which combines ethanol production in Idaho with minerals in Montana for diversification purposes no doubt, trade at \$0.015 and \$0.008 per share, respectively. Chase them higher at your own risk.

There you have it. You can make money by producing alcoholic beverages for people, and you can make money by producing gasoline for cars. Combine the two, throw in a handful of nonsensical federal subsidies, and watch your stock move to the Pink Sheets.