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Pricey Oil Could Squeeze Margins

By Dave Kurzawski

Buyers of soybean oil would be wise to heed this warning: You've got new competition — and those competitors are not making food, they're making fuel. With the price of gas at the pump approaching the mid-\$3-per-gallon mark in many areas of the country, scientists and entrepreneurs are working overtime to find a solution to our nation's budding energy crisis that doesn't include owning an oilfield in the Middle East.

Corn ethanol production has emerged as the current leader of the "new fuel" revolution in the United States. Yet just because advertising dollars have put corn ethanol on the map first, doesn't mean it's the only alternative. Those who are in the business of making the nation's dairy food supply should be aware of an alternative that's going to begin quietly making noise: biodiesel.

Biodiesel is derived from soybean oil, a by product of crushing soybeans into animal feed, and has been around for more than half a century. In 1913, Dr. Rudolf Diesel, creator of the diesel engine, stated: "The use of vegetable oils for engine fuels may seem insignificant today. But such oils may become, in course of time, as important as petroleum and the coal tar products of the present time." Better late than never, for Dr. Diesel's sake. For you, however, soybean oil prices over the course of the next few years will be volatile at best, significantly higher at worst.

It takes approximately 7.5 pounds of soyoil to produce one gallon of biodiesel. The United States is currently estimating 2006 soyoil production at 20 billion pounds, about 5 percent of which will go toward our burgeoning biodiesel usage. Of that, forecasts are calling for a 2006 supply of 150 million gallons. While 150 million gallons is double last year's production and seemingly enough to quench our current thirst, it's only one side of the equation.

U.S. soybean oil demand for biodiesel could reach roughly 1.0 billion pounds this year. That's approximately 133 million gallons and demand is expected to grow exponentially. Such growth could quickly overtake our current surplus supply situation. To meet the new demand, however, the National Biodiesel Board, a non-profit industry trade group, expects an additional 50 biodiesel plants to come on line within the next two years bringing the number of U.S. operating biodiesel plants to more than 100.

Nevertheless, as the U.S. dollar falls and energy and commodity prices rise due to increases in demand at home and abroad, input costs will tighten your bottom line. Prudent dairy food manufacturers will seek ways to lock up prices well into the future and, while there is more than one way to skin a cat, using soybean oil futures and options are as viable as any.

The soybean oil futures contract comprises 60,000 pounds of soybean oil and trades eight months a year, two years into the future. A 1-cent-per-pound price move in the soybean oil contract is equivalent to \$600 per contract. For example, a 5-cent move, from 25 cents to 30 cents, is a \$3,000 move for a 60,000-pound futures contract.

Recent soybean price rallies are not necessarily supported by current fundamentals. On July 11 of this year, soybean oil futures prices at the Chicago Board of Trade hit a two-year high of 27.60 cents per pound. The mid-summer jump in soybean oil prices, which was inspired more by a simultaneous rally to over \$75 in crude oil futures and speculative money flow than it was by a true soybean oil supply/demand imbalance, raises the \$64,000 question: what happens to price when there is rationing due to a legitimate supply/demand imbalance? Will prices spike to 30 cents per pound?

If your company's bottom line is sensitive to the price of soybean oil, examining its future price should be as much on your radar as the future price of butter.

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