August 2018 Newsletter

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From the General Manager

Summertime is coming to an end, and harvest time is fast approaching. While we have seen some hail damage and there are some small areas that have suffered from drought, the 2018 corn and sorghum crop looks good at this time. ProExporter's lastest report shows Kansas having a record corn crop of 739M bushels of corn, compared to 699M bushels last year. However, the same report has Kansas sorghum production decreasing from 268M bushels last year to 201M bushels this year. From a national perspective, the most recent USDA report pegged the 2018 corn crop at 14.6 billion bushels and a yield of 178.4 bu/acre, which would shatter the old record of 176.7 bu/acre set last year.

Even with the good crop last year and what looks like another good crop coming, our industry continues to struggle with depressed margins. Margins started falling about this time last year, and they have yet to gain any traction. Over-supply of ethanol and political pressure seems to be at the forefront of our issue.

Ethanol production continues to remain strong. As an industry, we set new production levels last December, and production levels are once again creeping back upward. Just last week, the industry recorded the 2nd highest production level in history (around 16.9B gallon/year equivalent). There is a new plant coming online in Q3 2018, 2 additional plants currently under construction, the announcement of yet another plant to be built in Indiana, and various capacity expansions at facilities across the country. It looks to me like these production levels are the new normal, and we should expect to see continued increases. Domestic demand for gasoline, and hence ethanol, has remained strong, outpacing 2017 demand by around 1.5%. Further, ethanol exports are booming. In 2017, we set export records at 1.379B gallons. Through May of 2018, we have already exported 0.784B gallons. Strong domestic demand and strong ethanol exports are definitely helping to balance the high production levels, but it hasn't been quite enough. The over-supply continues to keep values depressed. Today, wholesale ethanol values are around $0.50/gallon cheaper than wholesale gasoline. This is spread is historically wide, and it has recently been as high as $0.75/gallon. Unfortunately, I don't see much changing in the future, and I expect margins are going to remain tight throughout 2018 and through at least Q1 of next year.

Our industry has also faced tremendous political pressure over the last several months.

Senator Cruz (R-TX) and Senator Toomey (R-PA) have been at the forefront of opposition against ethanol and the RFS. We have been very fortunate to find strong congressional support throughout the Midwest, including our own Rep. Marshall, Sen. Moran, and Sen. Roberts.

At the heart of the political argument is the future of the RFS and the ability to sell E15 as a regular fuel year-around. Today, E15 can only be sold as a regular fuel from September 15 until June 1st. During the remaining time, E15 has to be sold as flex-fuel only. This is due to an arcane rule going all the way back to the Clean Air Act. A simple administrative change by the EPA could open up year-around sales, but political opposition by the gasoline industry continues to block the change. This argument has risen all the way to President Trump, who we hope will soon recognize that year-around E15 is vitally important for the today's struggling ag producers, and that by granting this change he could offer ag producers some relief to help offset pressure from the current trade tariff situation.

Adding further insult to injury, the previous EPA Administrator Scott Pruitt was secretly providing RFS waivers to oil refineries. Today, oil refineries hold the obligation to meet the blending requirements as laid out in the renewable fuels association. A provision does exist that allows the EPA Administrator to grant a waiver to a small refinery who can demonstrate severe economic harm. Unfortunately, Administrator Pruitt had a very liberal view of severe economic harm, and he granted waivers to various refineries totaling more than 2.5 billion gallons. That is 2.5 billion gallons of the 15 billion gallons of conventional biofuels that are required under the RFS. Administrator Pruitt came to the heartland in June, trying to win back support in Kansas, Nebraska, and South Dakota. Unfortunately for him, he did not find the support he was looking for, and he resigned his position soon thereafter. But, the damage from the waivers was already done.

Finally, the Trump administration recently announced plans to re-examine the federal fuel-efficiency requirements knows as CAFE standards (i.e. mile-per-gallon targets for cars and trucks). Congress first required the National Highway Traffic Safety Administration to develop CAFE standards in 1975 after gasoline shortages during the Arab oil embargo. The EPA began regulating greenhouse gas emissions from vehicles in 2007. Today, the agencies work together to produce the standards.

The standard for passenger cars stayed at 27.5 mgp from 1990 until 2007. In 2009, the government set a fuel economy standard of 34.1 mpg for cars and light trucks by 2016. In 2012, it set a new target of 54.5 mpg by 2025.

I believe that the announcement to re-examine the requirements is positive for our industry. In 2016, the Obama administration reviewed the program, but they only reviewed engine technology and they failed to include fuel, specifically octane, in the review. Ethanol is the cheapest and most abundant octane source on the planet, and octane allows for higher compression engines that can obtain higher fuel efficiencies. In my view, it is incomplete to determine fuel-efficiency standards without doing a comprehensive study of both engine technology and available fuels. Hopefully this new decision by the Trump administration will help illuminate

ethanol's contribution to increasing fuel efficiencies for all consumers.

The quarterly financial statements are included on the following pages. As I have mentioned earlier, it has been a tough year with tight margins. In fact, margins started to tightened last summer, and they have not shown any improvement since.

Net sales for the fiscal quarter are up by 2.7%, driven predominantly by distiller oil sales. Oil sales are up 60% as we have processed more corn and less sorghum than we did during the same quarter last year, and extraction of oil is easier from corn than sorghum. Ethanol sales volumes are up for the quarter, but ethanol revenues are down by 1.6%. The big driver for poor margins are higher grain costs, which are up 26% for the quarter, despite only increasing bushels used by 3.7%. Ethanol conversion yields are up slightly coming in at 2.94 gallon per bushel compared to 2.92 bu/gal for the same quarter last fiscal year. Net income for the quarter are down 74.5%.

For the first nine months of the fiscal year, ethanol sales are only up by 0.5% while grain usage is down by 0.9% which provides an ethanol conversion yield increase of 1.1% from the first three quarters of last year. Net sales are down by 5.8%, and grain costs are up 15.2%. EBITDA values are off by 69.5%, and net income is down by 75.1%

Members equity increased by 4.5% during the first three quarters of the fiscal year, and long-term debt was cut nearly in half.

The bottom line is that margins are tight, and I expect them to stay tight. We have to remember that we are in a commodity-based business, and commodity businesses run in cycles. My perception is that this cycle is going to continue until at least we reach the start of driving season in Q2 of 2019. While ethanol exports have been really strong, we are simply producing too much ethanol and drowning domestic prices.

Even with my low optimism on the markets, there are still some positives. Our conversion yields continue to slowly increase, and the plant continues to operate well. This summer we discovered a significant issue with one of our molecular sieve reactors, and we will be commissioning a new set of reactors during our fall outage in September. The project is on schedule and remains within budget, and the project will also alleviate one of our rate limiting pinch points.