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***Ethanol Producers Dealing With Growing Pains as Production Outstrips Demand

U.S. ethanol producers are dealing with growing pains.

Following a two-year race in the industry to increase production, U.S. ethanol supplies have shot sharply higher, forcing prices lower and leaving some producers flirting with break-even margins.

"At these levels, is it a serious concern that we're cranking out product with no place to go?" one Midwest ethanol plant manager said. "At this point, yeah, of course it is."

U.S. ethanol production rates averaged more than 991,000 b/d last year, up from960,000 b/d in 2015, according to U.S. Energy Information Administration (EIA) data. That number was up from 925,000 b/d in 2014 and 855,000 b/d in 2013.

Through the first three months of 2017, U.S. ethanol production rates jumped to an average of 1.043 million b/d, including the most recent reporting week's rate of 1.019 million b/d.

The growth in production is attributed to a combination of factors, but the largest has been a move to improve plant efficiencies through "debottlenecking."

"It's been kind of a quiet evolution, but it's turned out to be quite significant," Renewable Fuels Association (RFA) Senior Vice President Geoff Cooper said. "We basically have the same fleet of plants that we had three or four years ago, but they've dramatically increased their capacity. They've increased productivity and efficiency, and the takeaway for us is, if the demand is there and the margins are there, these plants will find a way to produce more efficiently."

Cooper said the technology behind the production has come a long way, including enzymes he called "amazing." For years, the accepted average yield for ethanol production was 2.8 gal/bushel, but Cooper said the number is now approaching 2.9 gal/bushel on average and he wouldn't be surprised if it reaches 3.0 gal/bushel.

"I do think we have quite a bit of room to grow in terms of yield, but also room to grow in debottlenecking and physical expansion as well. The mindset has changed some that we don't necessarily need to build a bunch of new plants. We have a very flexible fleet of facilities."

As a result of the jump in production, ethanol stocks have moved sharply higher. Inventory hit a record high of 23.705 million bbl in the week ended March 31. And although the first quarter is generally a time for the industry to build stocks ahead of the high-demand summer driving season, the build-up this year is well ahead of the pace of prior years.

From the start of 2017 to the end of the first quarter, ethanol supplies swelled 5.27 million bbl, or 26.9%. By comparison, stocks grew just 1.11 million bbl, or 5.3%, in 2016 and 1.64 million bbl, or 8.7%, in 2015.

Midwest stocks have consistently reached levels never seen before, prompting Kinder Morgan for a few weeks earlier this year to redirect truck deliveries from its key Argo supply terminal. Argo levels were approaching capacity, and ethanol prices in the spot market took a huge hit. When ethanol prices fall, margins also suffer.

Through the first three months of 2017, ethanol margins at a representative Iowa ethanol plant have averaged just 13.9cts/gal, according to Iowa State University's Center for Agricultural and Rural Development (CARD).

By the same model, margins averaged 25.4cts/gal in 2016, improving from a down year in 2015 when they averaged 15.4cts/gal. But in 2014 -- the year that sparked the big race to growth -- margins averaged 66.6cts/gal, up from 40.7cts/gal in 2013.

"Everybody jumped on the bandwagon after that, thinking it could be repeated," one ethanol marketer said. "But that year was just a perfect storm for margins that I honestly don't think we'll ever see again."

Ethanol producers are banking on another year of massive growth in exports to save them. U.S. ethanol exports in 2016 topped 1 billion gal for the first time in five years, reaching the second-highest level on record, U.S. Census data show. Total exports last year came in at 1.05 billion gal, up nearly 28% from the 2015 and 2014 totals of about 836 million gal.

So far in 2017, exports are on pace to surpass that total, thanks to surging demand from Brazil and in February rose to highest monthly level since December 2011, reaching 139.4 million gal.

Most sources expect ethanol exports to again top 1 billion gal in 2017, while the more optimistic sources in the industry are hoping could approach or exceed 1.4 billion gal. That would be a major boost for producers, especially considering the fact that U.S. gasoline demand has fallen short of expectations.

In 2016, the average weekly refiner and blender net input of ethanol into the gasoline pool reached 905,000 b/d, up from 877,000 b/d in 2015. So far in 2017, input demand has fallen to 870,000 b/d. Ethanol blending, however, is typically low in the first quarter.

EPA in November issued final 2017 Renewable Volume Obligations under the Renewable Fuel Standard that finally matched the 15 billion-gal cap mandated by Congress and if the current 2017 average of 1.04 million b/d is maintained for the remainder of the year, the industry output would come in at roughly 16 billion gal, meaning 1 billion gal may have to find a home elsewhere. But in showcasing the industry's ability to readily produce above the statutory cap, Cooper said producers helped persuade EPA to move to the cap.

"It goes a long way in showing how EPA put the RFS on track," Cooper said. "Not only are we meeting the cap -- we are exceeding it. It went a long way in supporting our argument in saying if the supply is available, the RFS has to find a way to get it into the marketplace."

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