

Lessons about competition between leading oils



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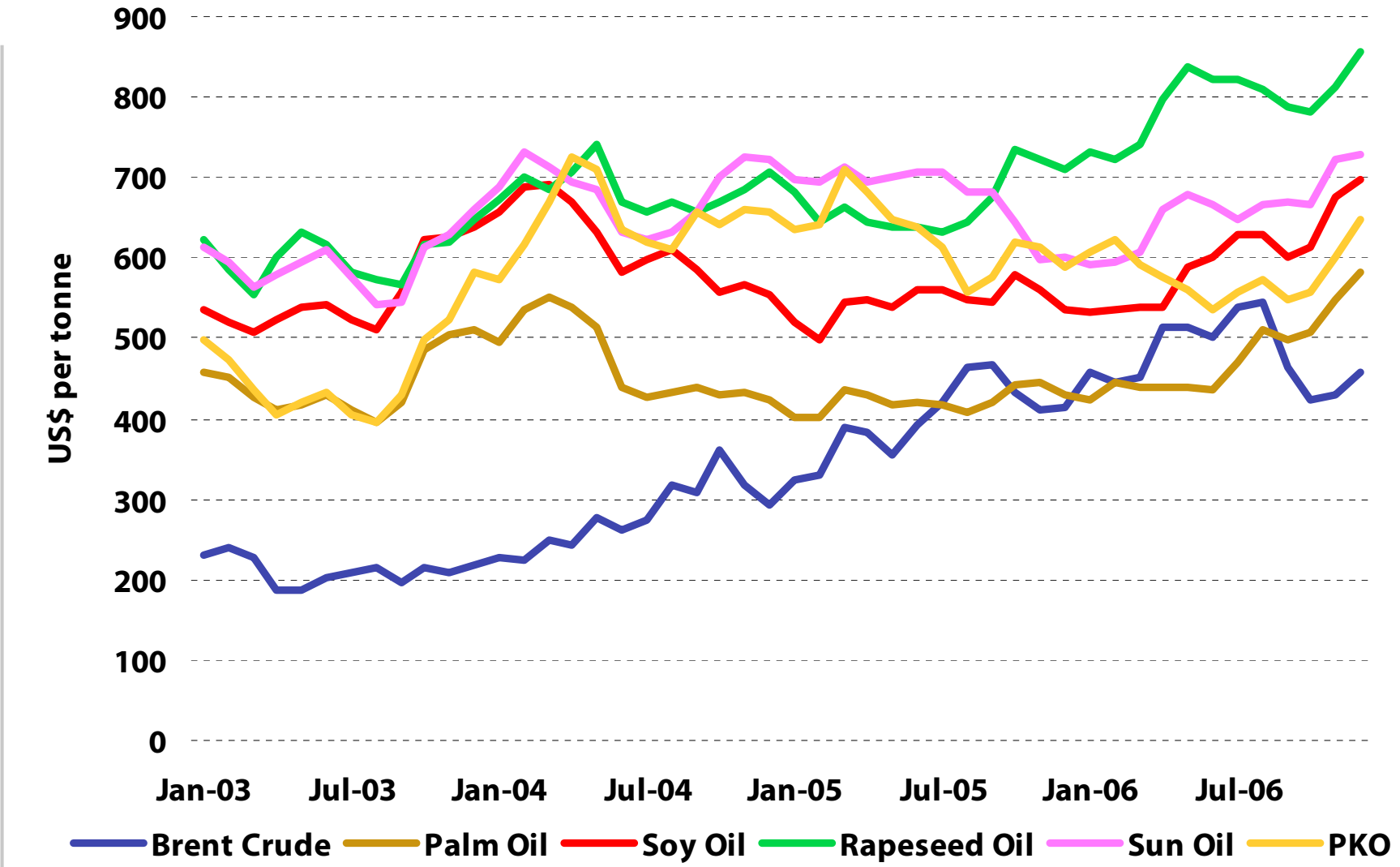


Setting the scene

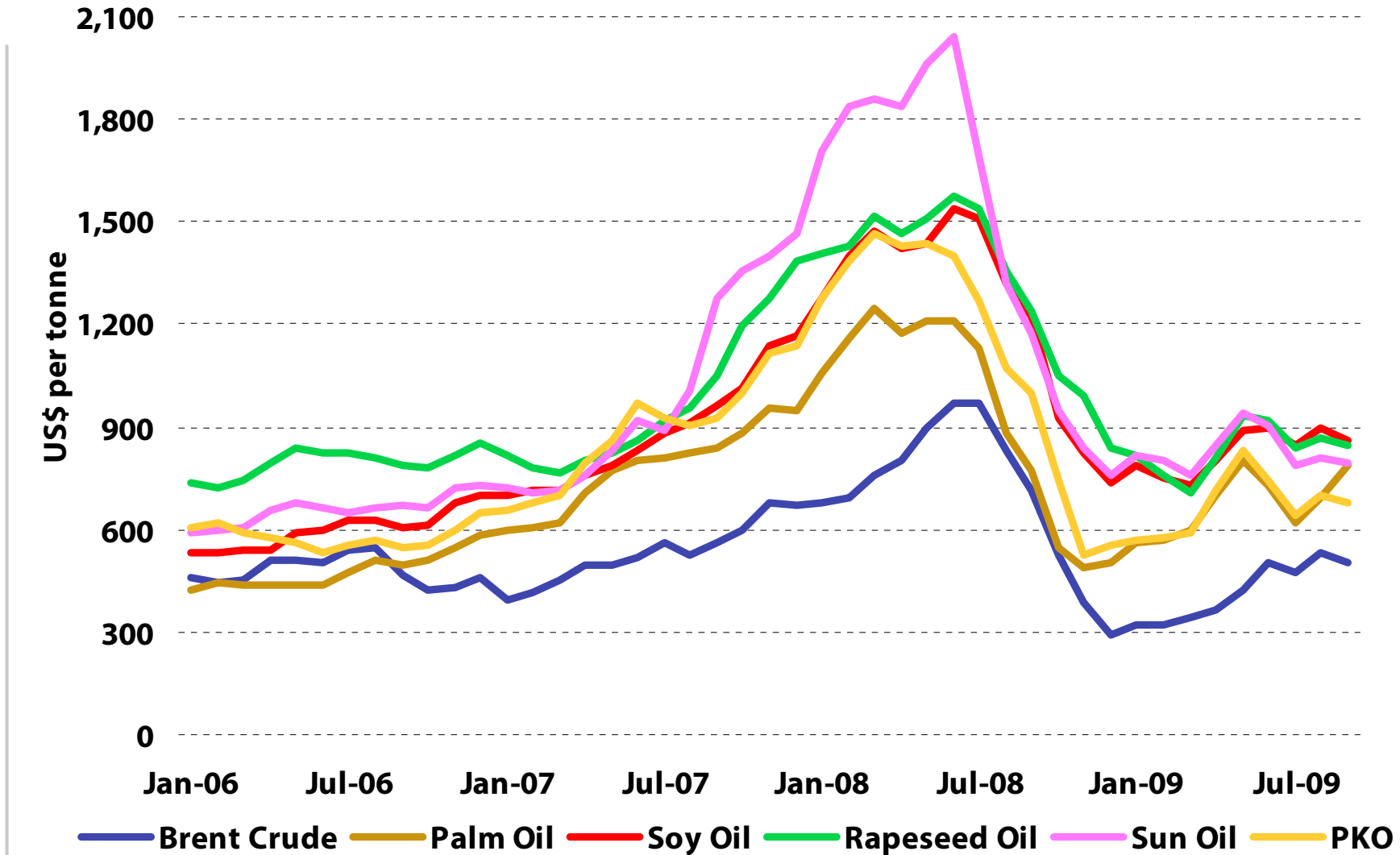
- If we had been meeting here barely two years ago, this presentation would probably have been very different.
- The reason is that vegetable oil prices as a whole, and most agricultural commodity prices in general, have become linked to energy markets by biofuel demand.
- I will illustrate how this link arises, and consider whether it will continue to apply into the future, and in particular what factors could end the link.
- The link with energy prices is not the only interesting price relationship that has become apparent in recent months; price relativities between oils and fats have been responding to the new realities.

The links between vegetable and mineral oil prices created by biofuel policies

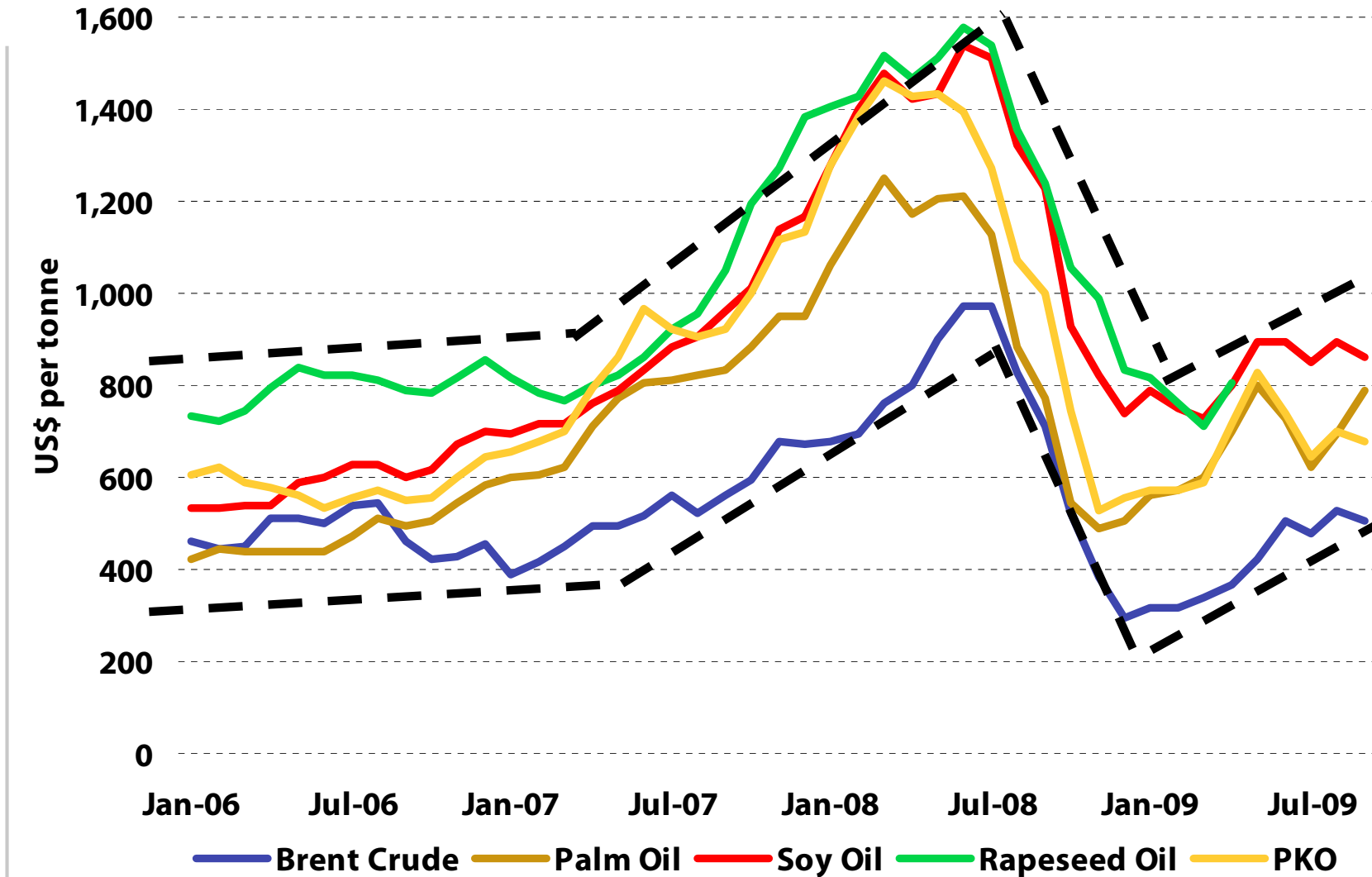
In early 2007, we were still in the “old” world, in which you didn’t see crude oil mentioned in the same breath as vegetable oil prices



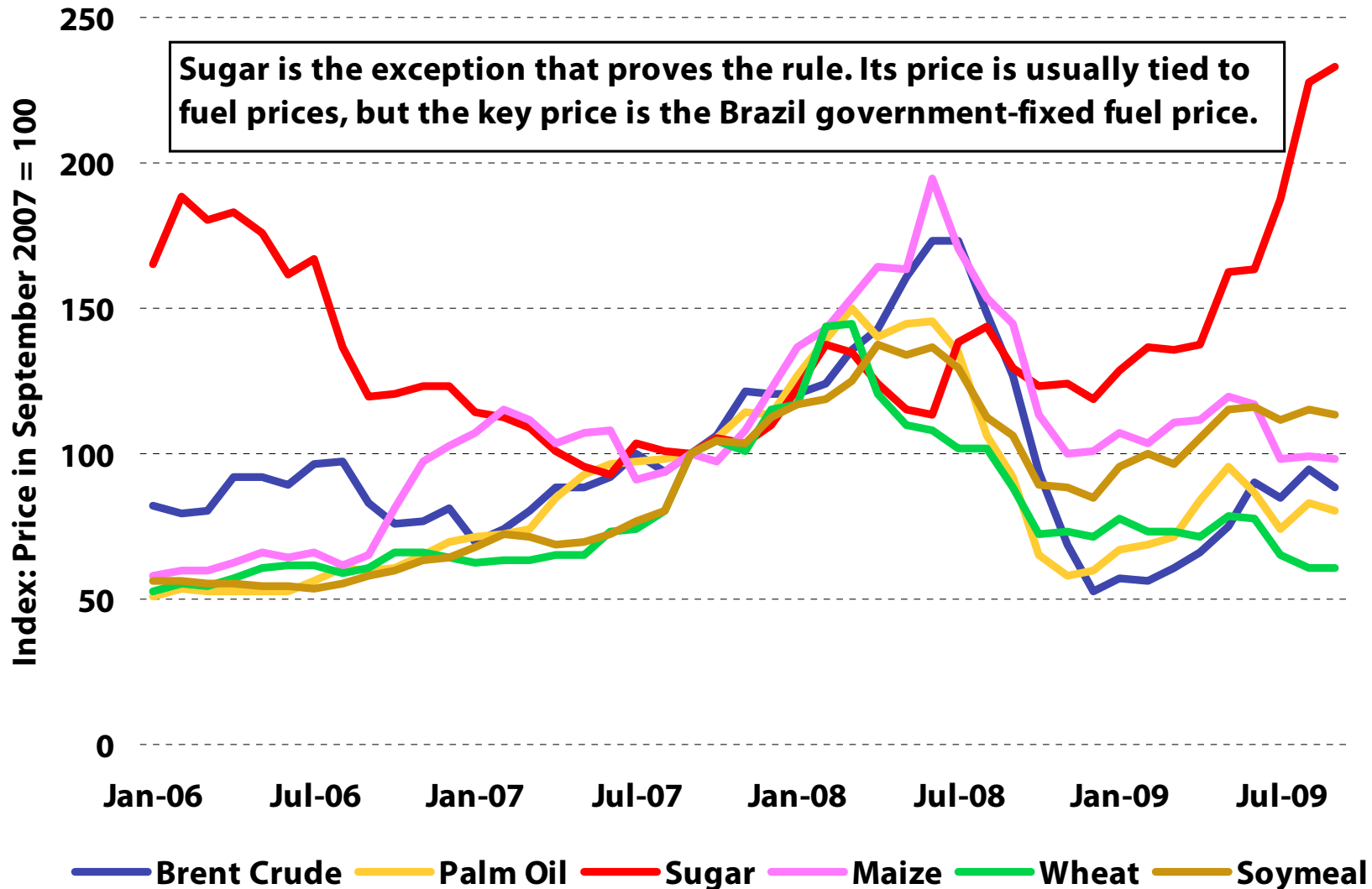
Since then, it has all changed; vegetable and crude oil prices have been linked for the past three years.



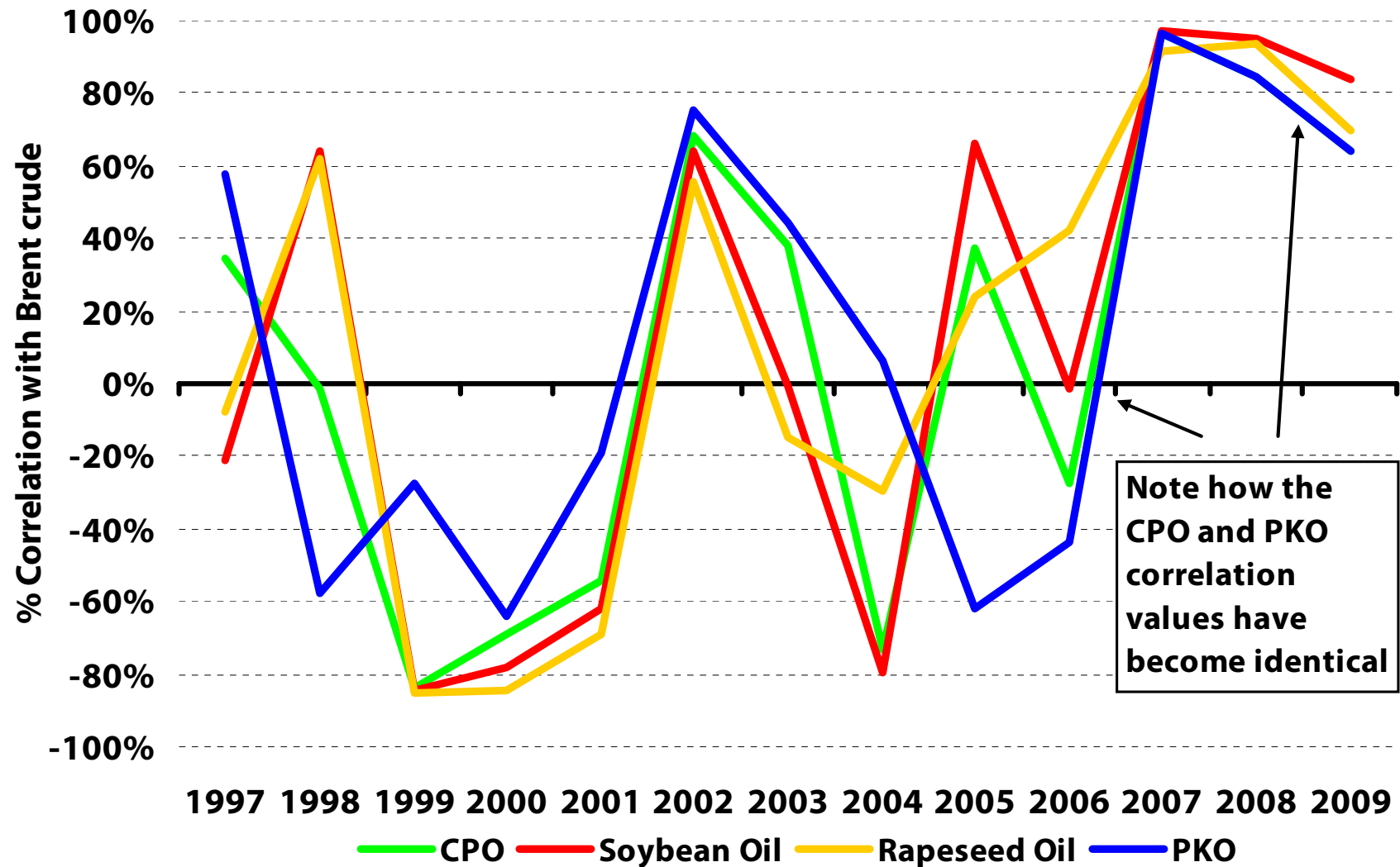
A price band is at work. Here I have added lines to illustrate how the new price bands work.



If you look at the world prices of most agricultural products, apart from sugar, you can see the close links to crude oil prices.



The new link may be seen in these annual correlation coefficients (100% is a perfect fit; 0% is none at all; -100% is a mirror image)

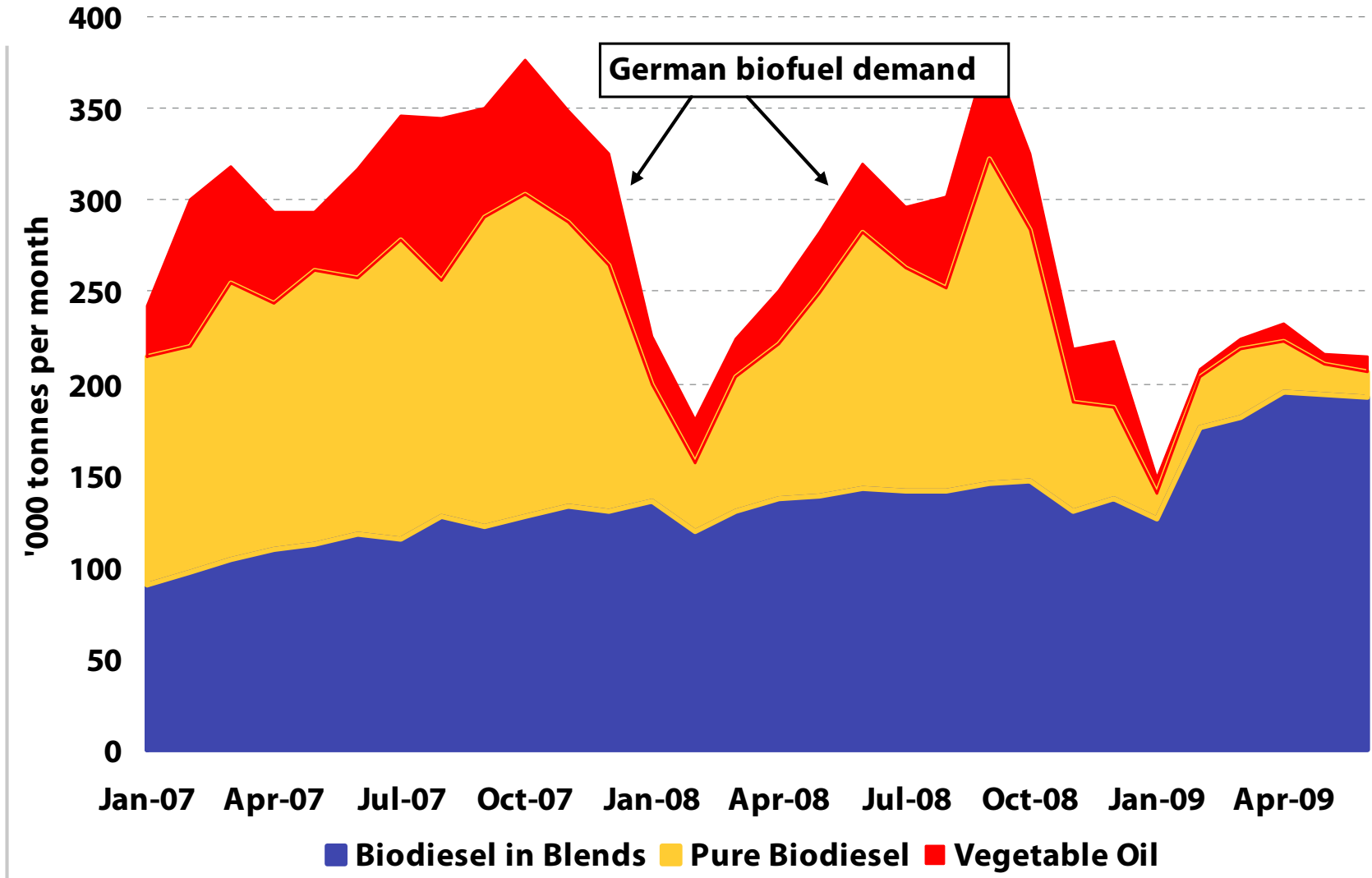


The brave new world has arrived, with petroleum an essential factor

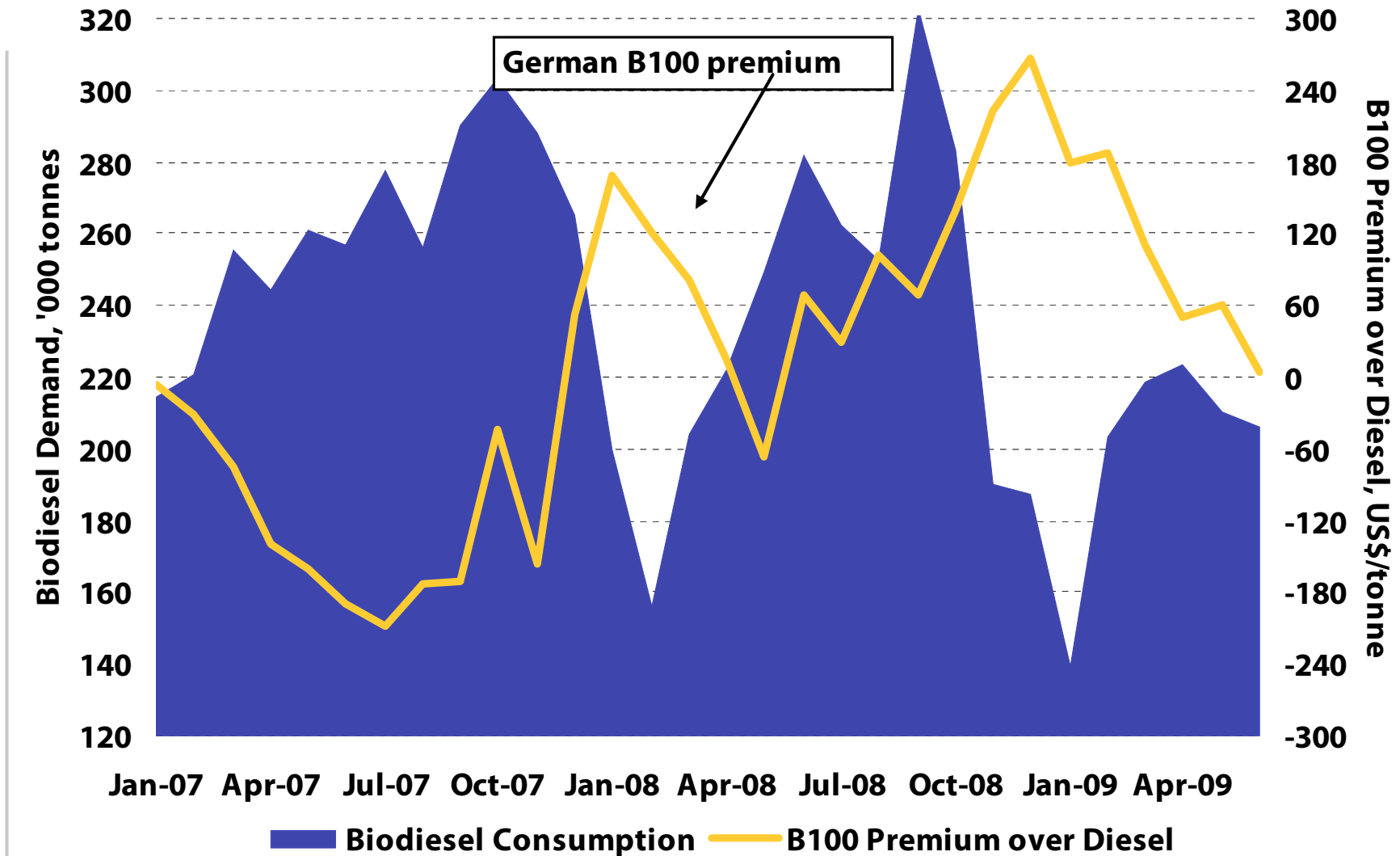
- The empirical evidence is surely very persuasive.
- It is not surprising that the correlations were particularly high during the major price swings of 2008.
- This is because fluctuations in differentials between oil prices were dwarfed by the swings in the crude price.
- Now that price volatility is less, price movements within the price band assume greater relative importance, and hence the correlations with petroleum prices are smaller in 2009. However, the price band persists.
- Note that all oils share in the new link, even if they are not used in biofuels, since they substitute for other oils when gaps are left in the market for oils in food uses.

The ways in which the biofuel market has created the new price linkage

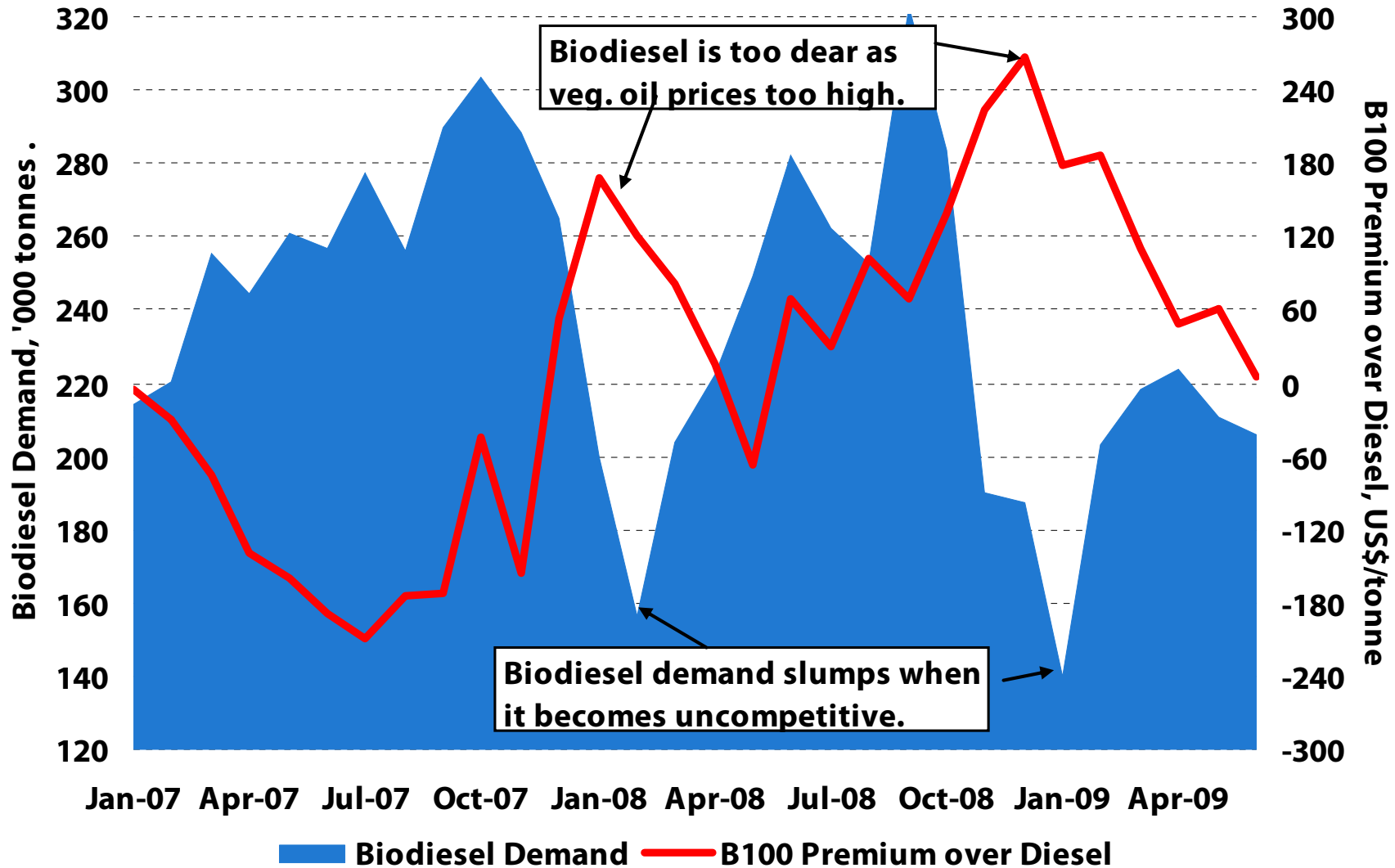
Biodiesel demand can, and does, vary sharply from month to month. This diagram relates to Germany, the largest EU market for biodiesel.



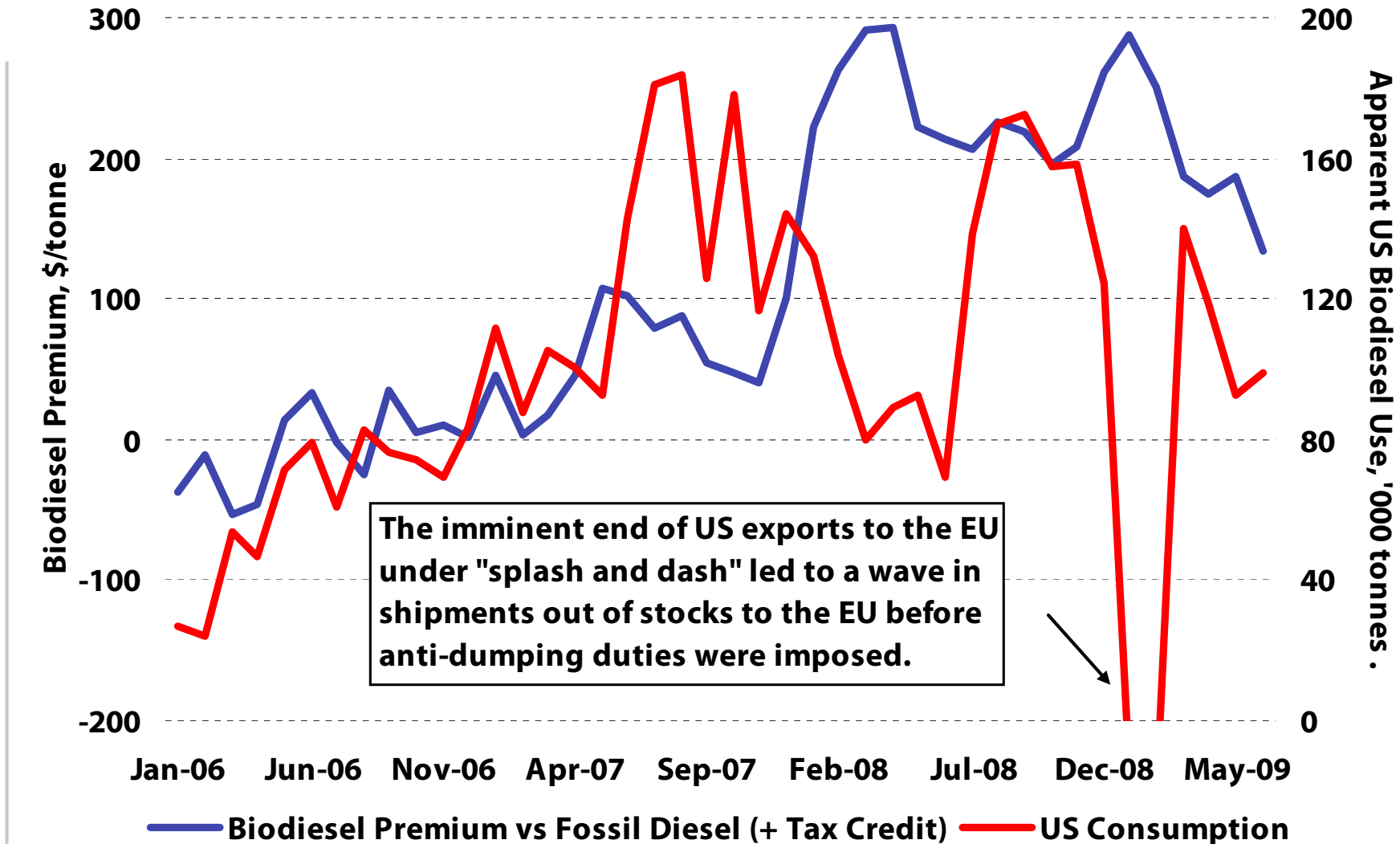
We can see the rapid feedback from a high premium for biodiesel over fossil diesel fuel to the level of biodiesel demand.



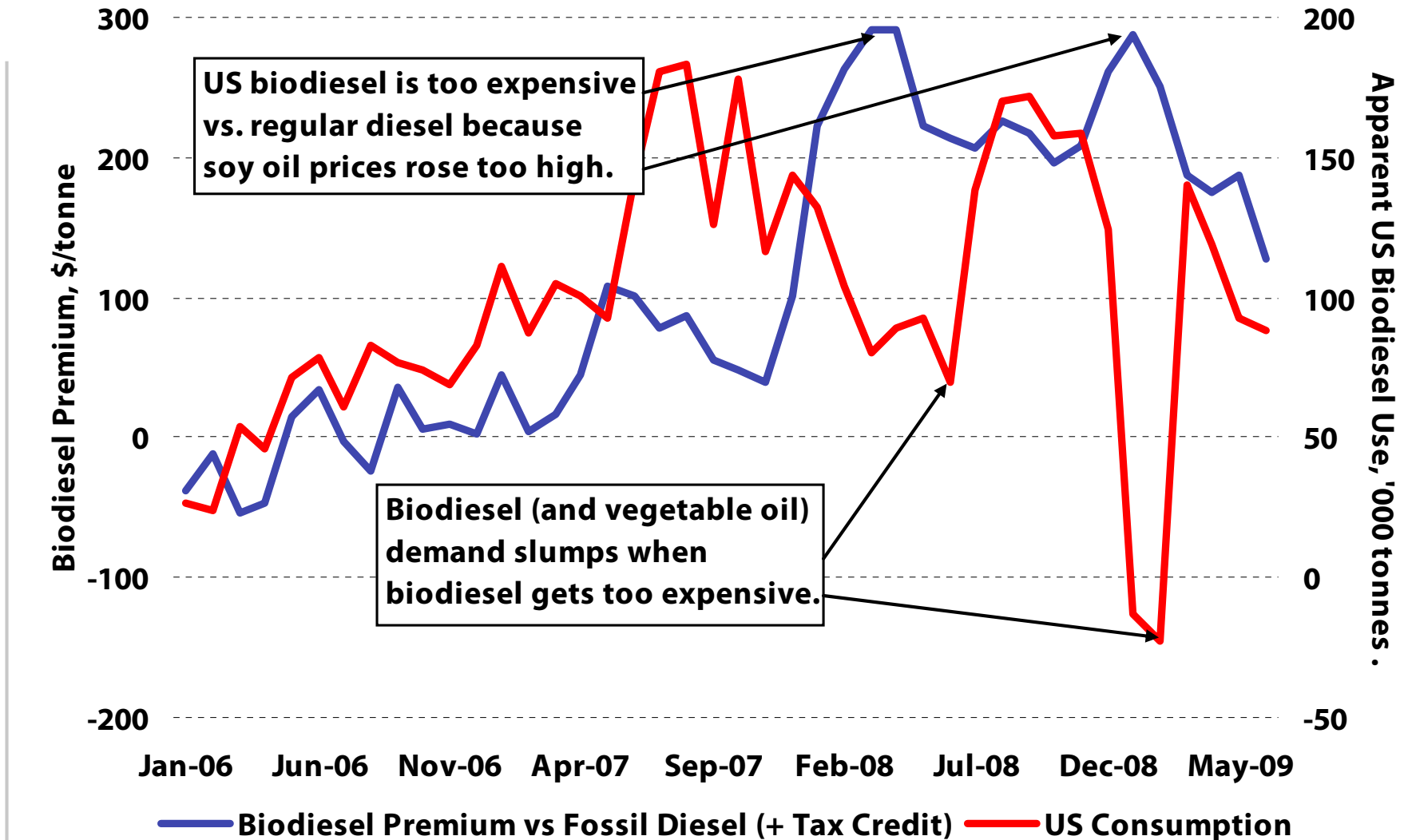
This identifies the key times when end-use demand responded massively to price signals



In the US, another large biodiesel user, we can again see the feedback from the price of biodiesel to consumer demand



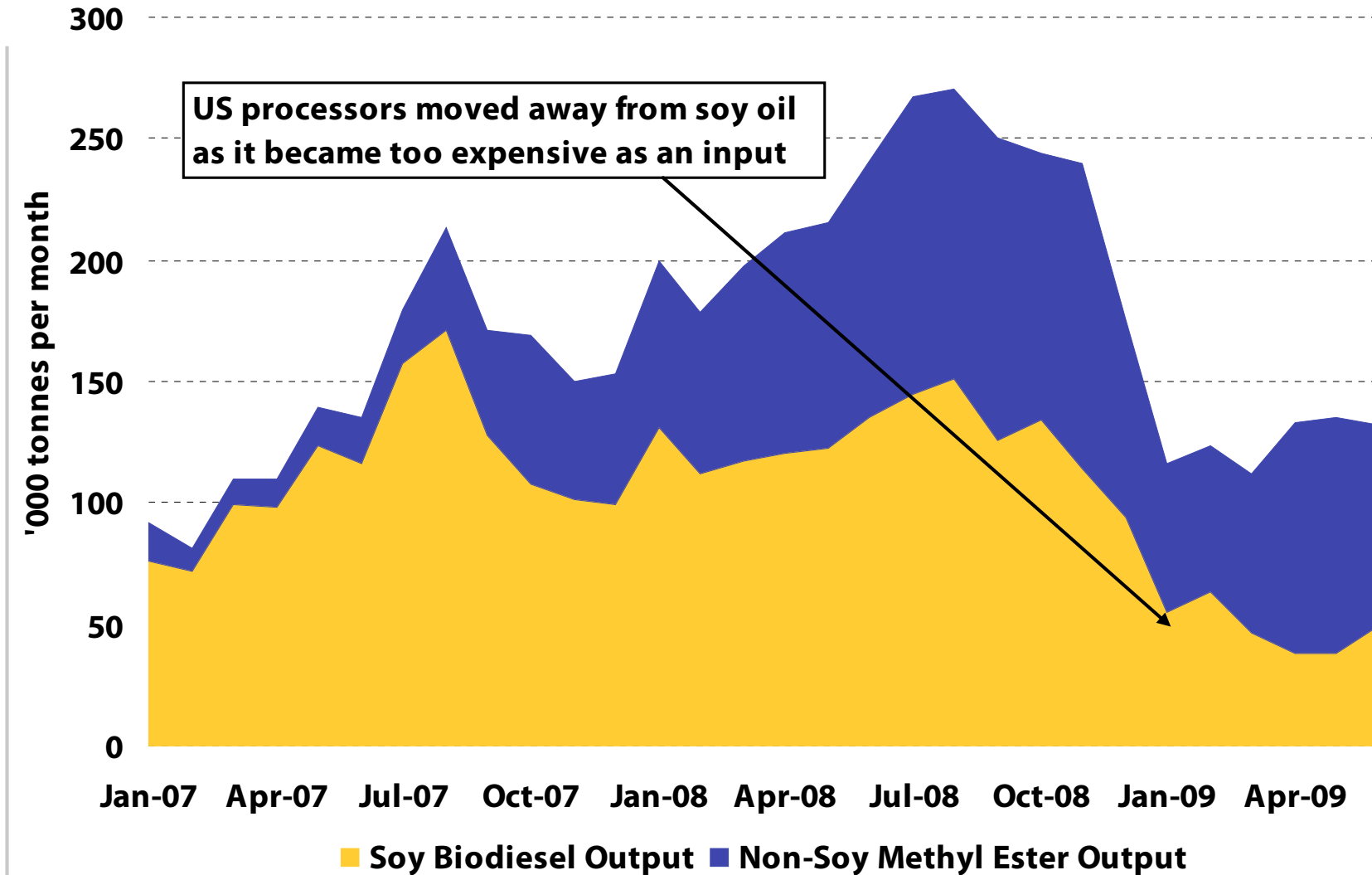
When vegetable oil prices rise too high, biodiesel (and therefore vegetable oil) use is reduced very quickly.



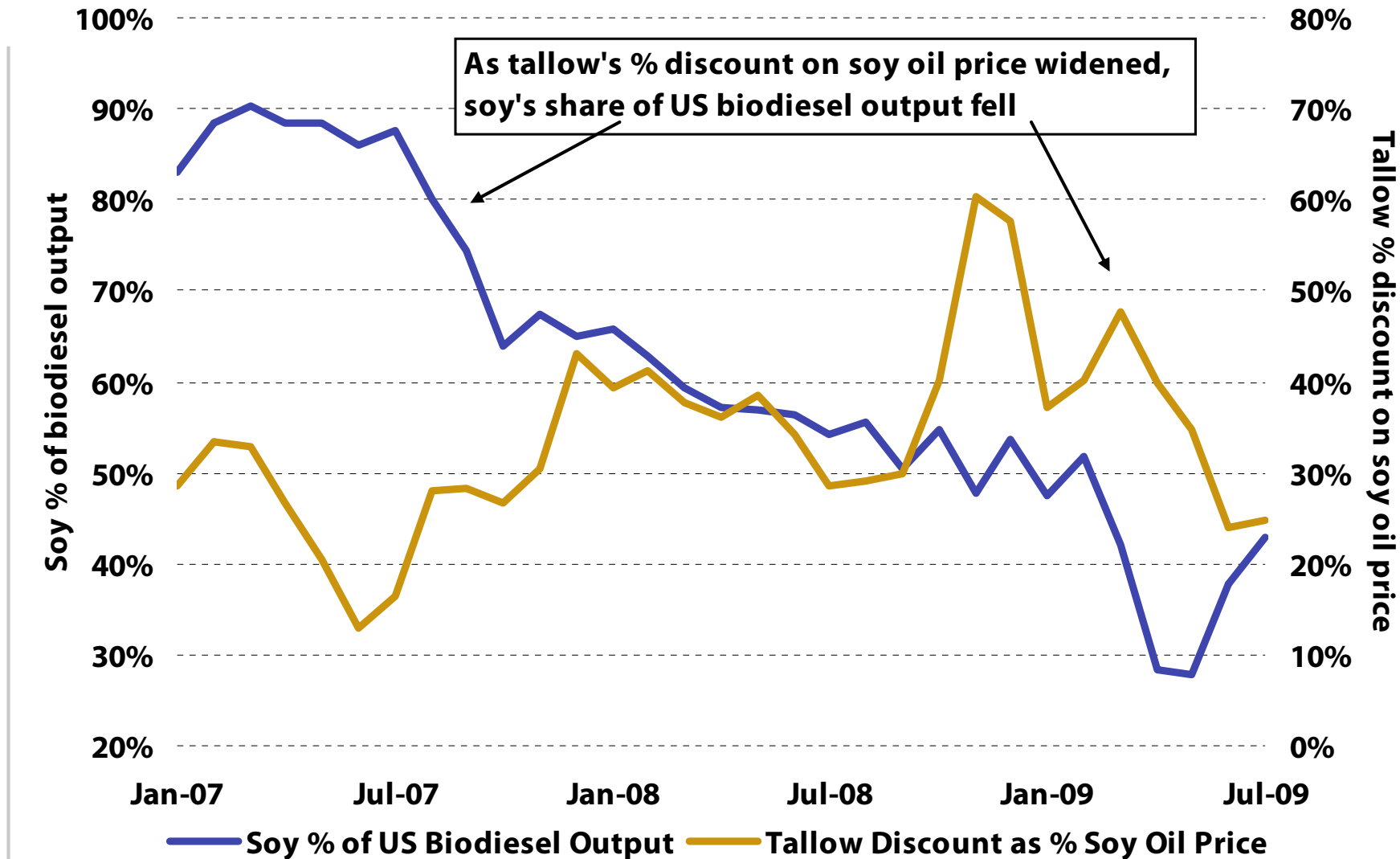
As long as biodiesel use is not all mandated and price-sensitive demand exists, biodiesel demand creates a crude-vegetable oil link

- In both Germany and the US, there is no doubt that the policy framework has created a mechanism for a rapid feedback from vegetable oil prices (and the profitability of biodiesel manufacture) to non-food demand for these oils.
- The feedback has been very fast, and the swings that have occurred in demand are quite large.
- Together, the swings in monthly demand in the US and Germany can reach 250-300,000 tonnes (i.e., over 3 million tonnes per annum), which is large in relation to the much more stable growth in world food demand.

The US also demonstrates one other factor: biodiesel manufacturers have found it fairly easy to switch to cheaper oils and fats



We see the sensitivity of the biodiesel choice of feedstock to price differentials; when tallow has a big discount, soy oil's share falls.

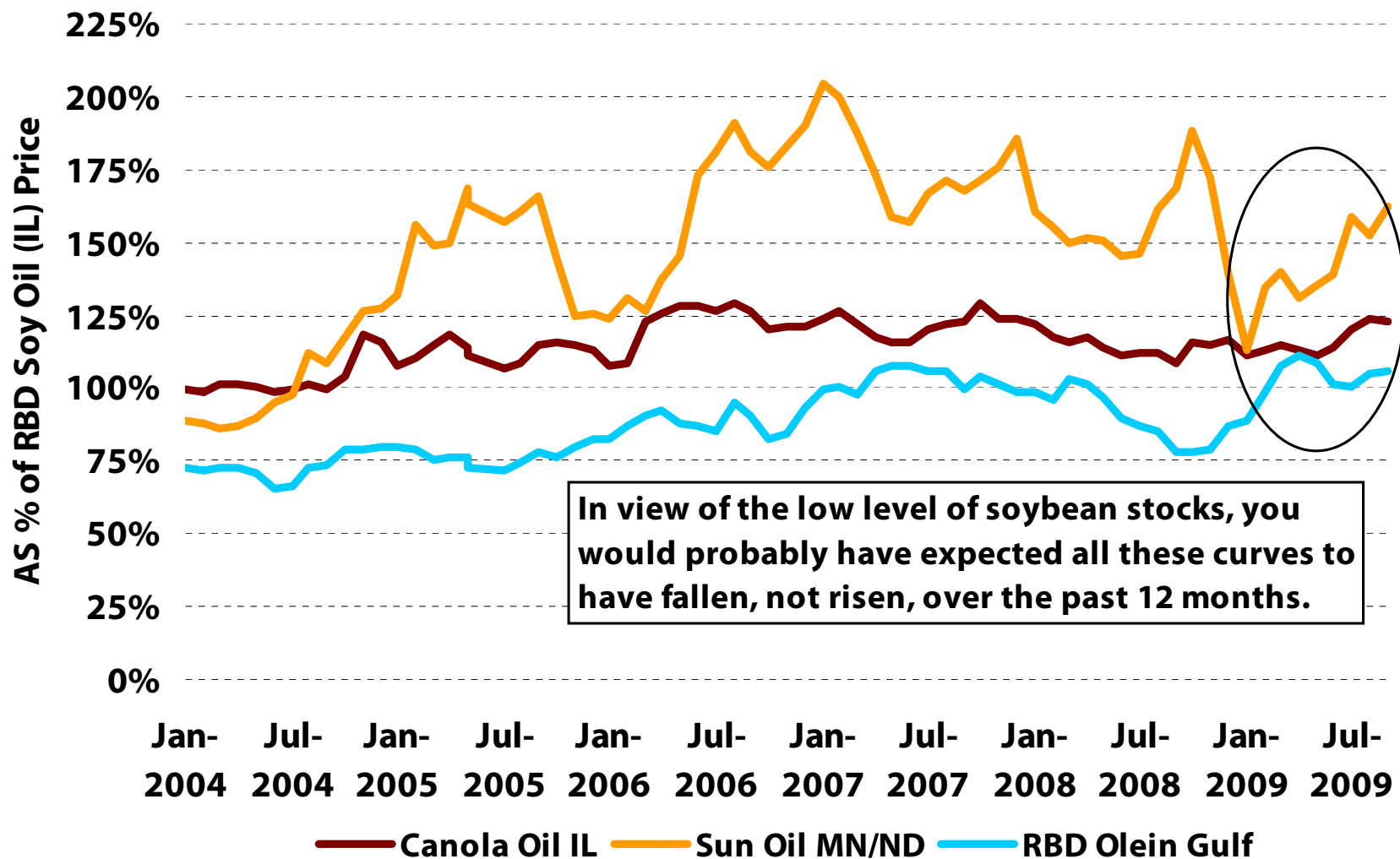


The biodiesel industry seems to be learning more about the substitutability of different oils in biodiesel manufacture

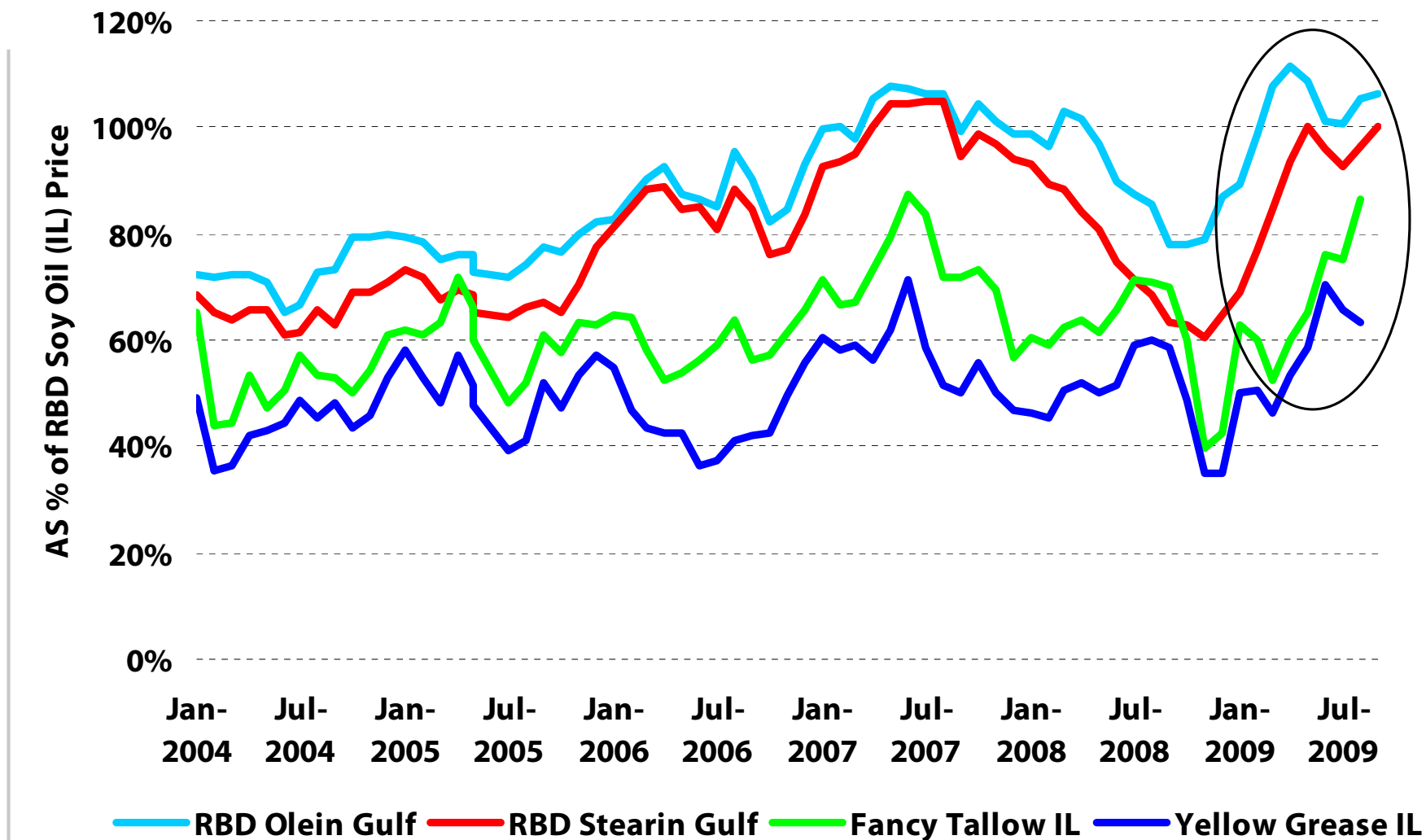
- The US experience demonstrates that biodiesel demand is not synonymous with soybean oil use (likewise, EU processors do not confine themselves to rapeseed oil, despite the German government's efforts).
- Substitution - in biodiesel, food, feed and oleochemical applications - plays a major role in ensuring that the prices of different oils and fats are linked to one another.
- For this reason, non-tariff barriers, like those proposed against palm in biodiesel use, act mainly as an irritant, since palm oil substitutes for other oils in food, etc.
- In the same context, it is ironic that biodiesel use has helped the EU to by-pass the efforts to keep out GM oils.

What is happening to the price relativities between oils, given the tight soy market?

One of the big surprises is that US relativities of RBD canola, sun and olein vs. soy oil show few signs of the tightness in the bean market.



If we focus on palm fractions and the main fats, once again, we see few signs of soybean market tightness right now.

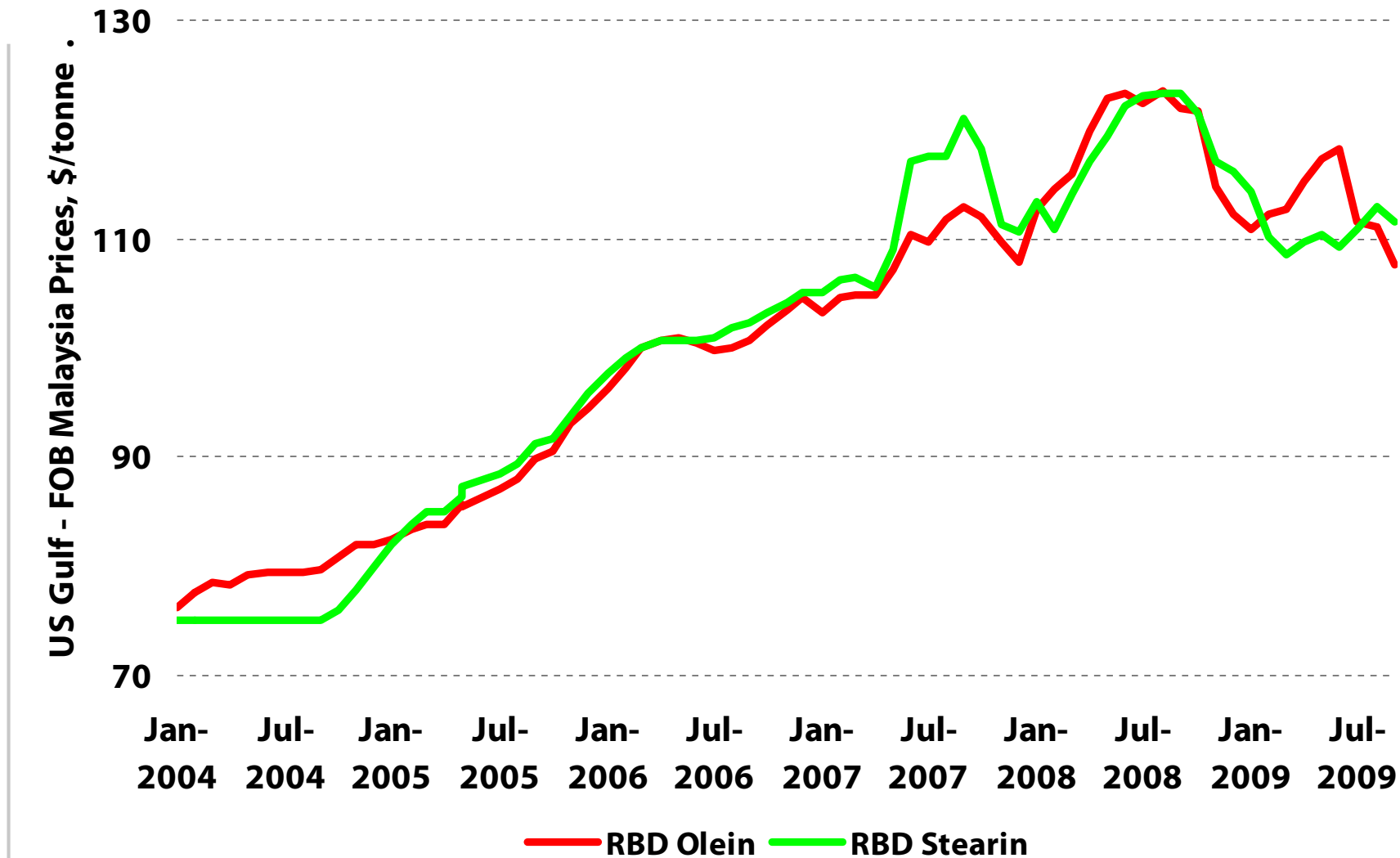


The failure of the soy oil price to respond to the tightness of world bean stocks in the past 12 months needs some explanation

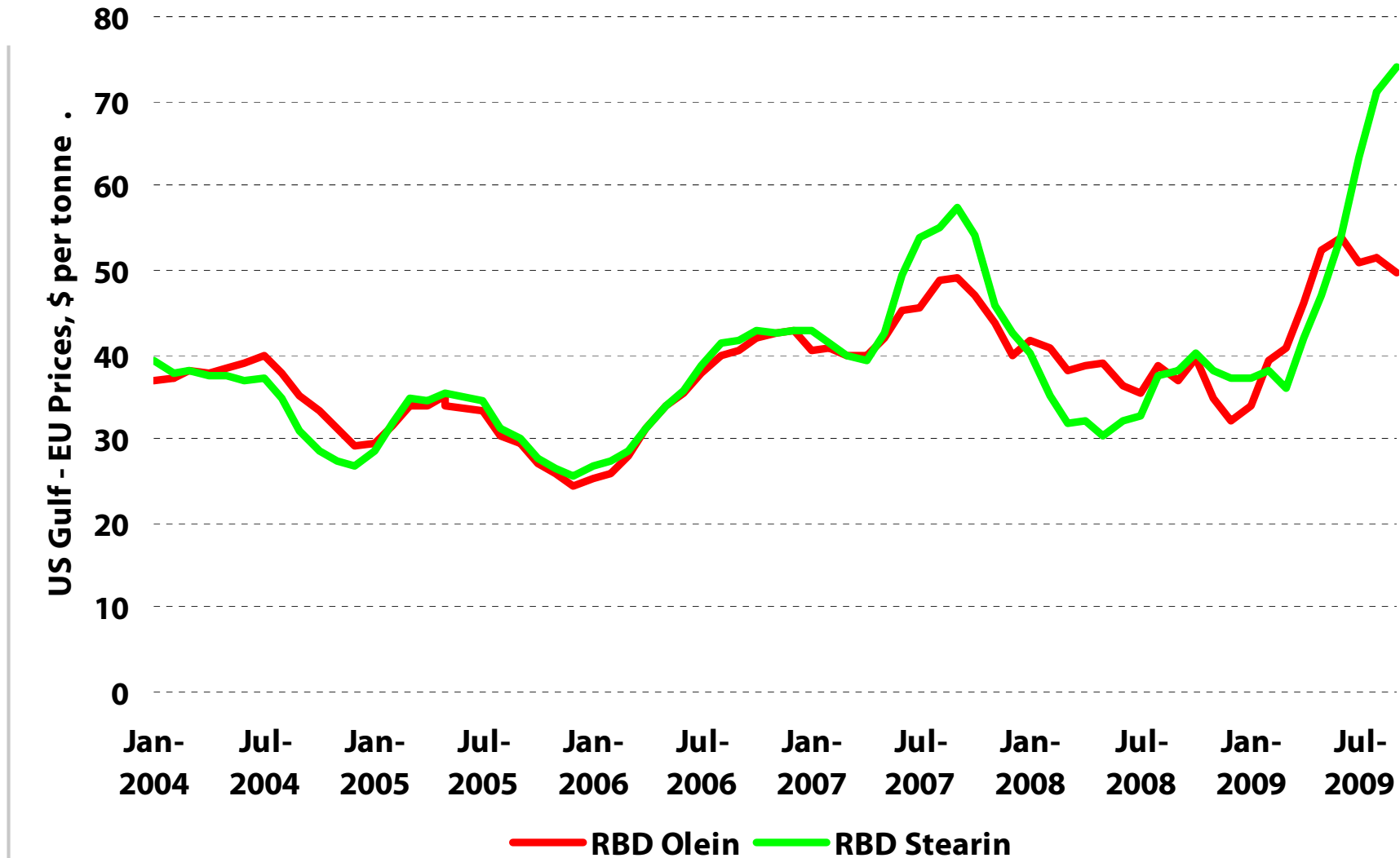
- Among the reasons that help to explain this conundrum are the following:
- The trans-fat issue has favoured some other oils over soy oil; that may be a factor for palm fractions.
- The sensitivity of biodiesel manufacturers to the prices of their feedstocks may have lifted animal fat prices.
- The reason that is the most intriguing is the possibility that the vegetable oil market does not give too much attention to the stocks of individual oilseeds. This confirms the view that the key oil that drives world vegetable oil markets is palm oil, the only oil that has to be produced as an oil, and cannot be stored as a seed.

What is happening to price differentials between the US, SE Asia and the EU?

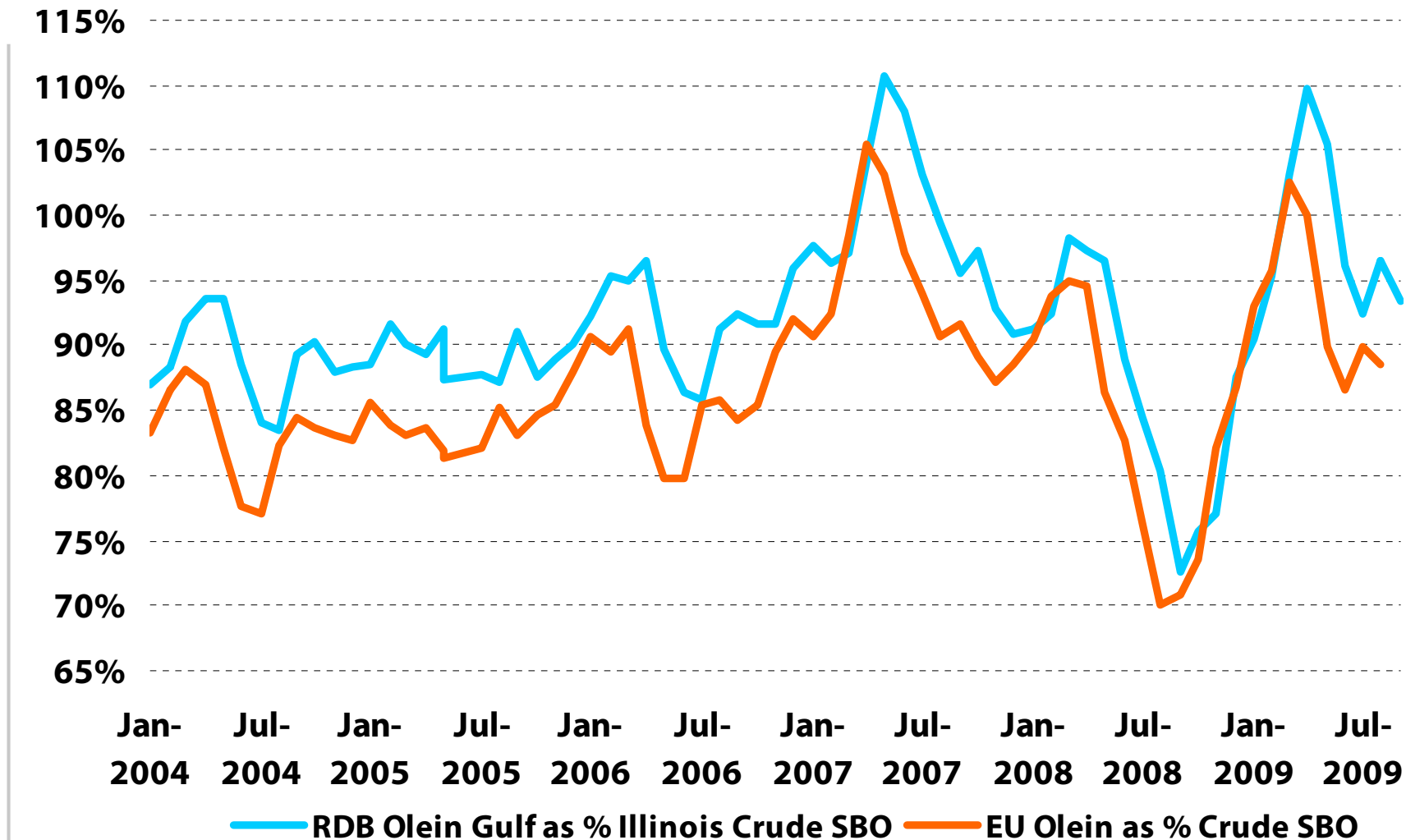
Another puzzle: the US Gulf premium over SE Asian export prices stubbornly remains high, although freight rates have fallen back.



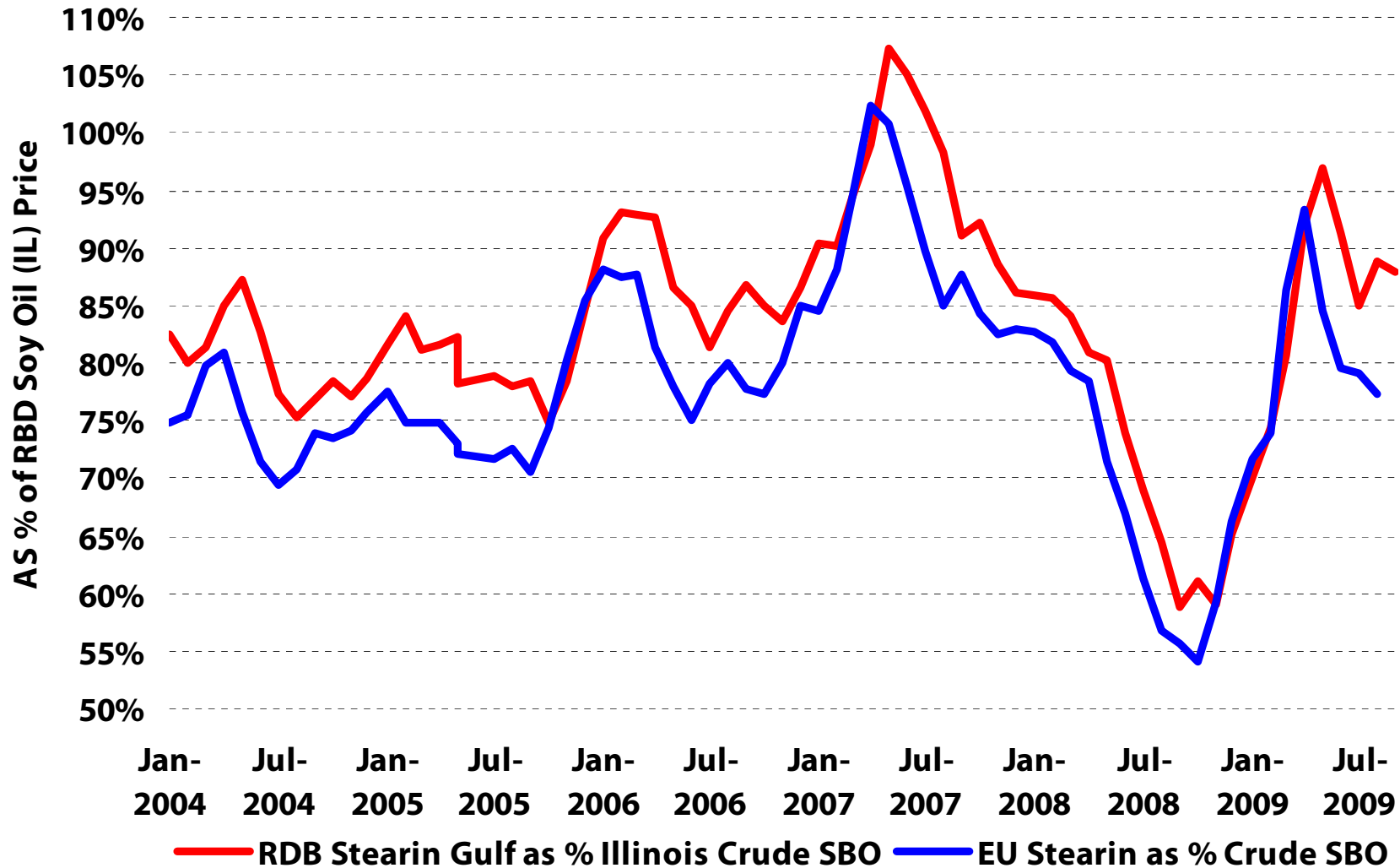
Another way of looking at the same puzzle: landed prices of US imports of palm products remain well above those in the EU



RBD olein is less competitive vs. soy oil in the US than the EU. Higher sea freight costs and the supply of local soy output are the causes.



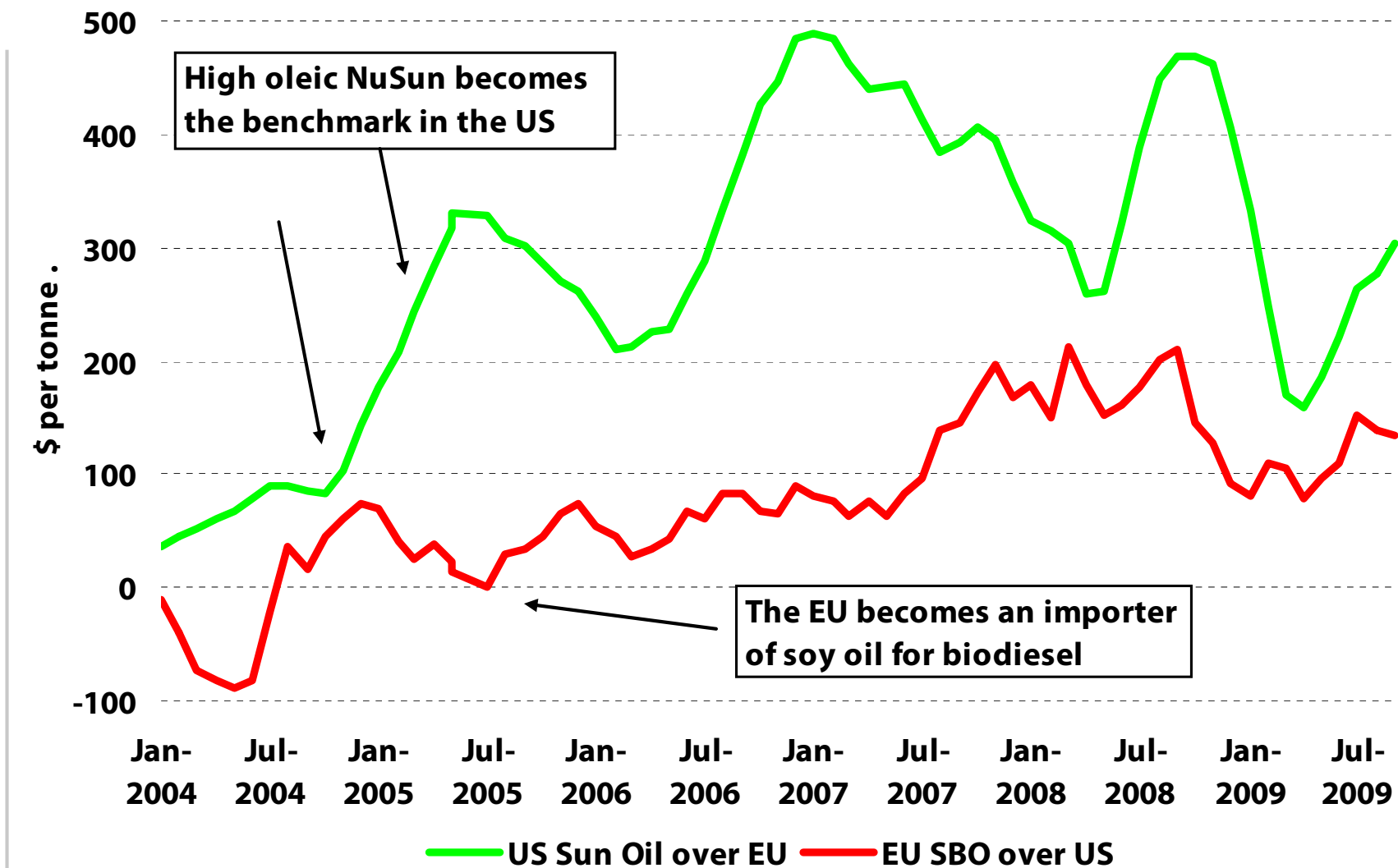
The picture for US and EU stearin vs. crude soy oil prices is virtually identical



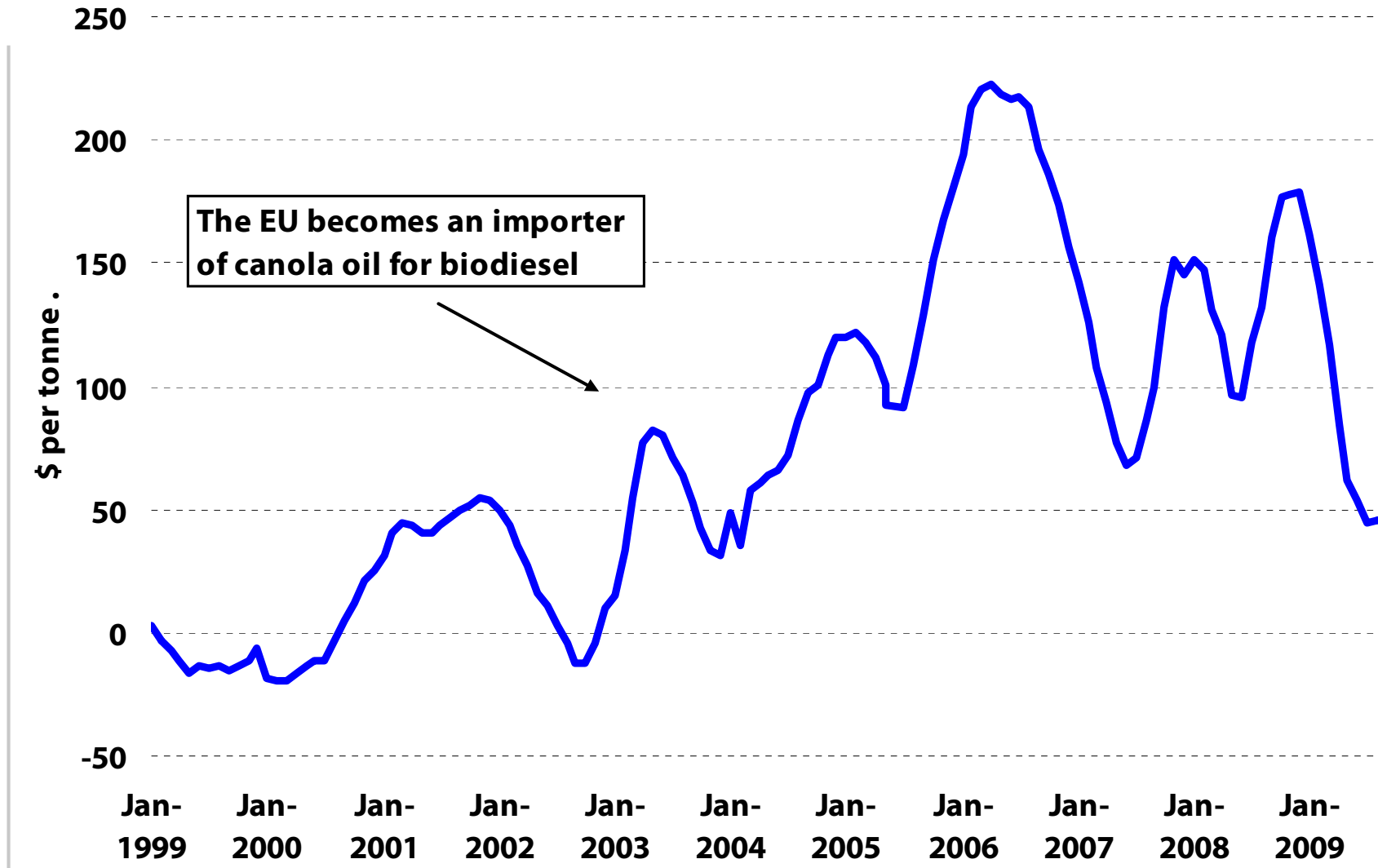
The US is importing a bigger volume of palm products, and yet landed prices of imported products remain well above EU levels

- It would always be somewhat difficult for palm to compete with soy oil in the heart of the world's soybean industry, since soy oil is priced at export parity, while palm oil is sold at import parity (including sea freight).
- Yet, this does not explain why RBD palm products should consistently sell at \$40-\$50 per tonne above the prices of the same products landed in the EU.
- Small import volumes are a partial explanation of higher freight rates from SE Asia, but the US is growing as an importer, and even so, the differentials refuse to budge.

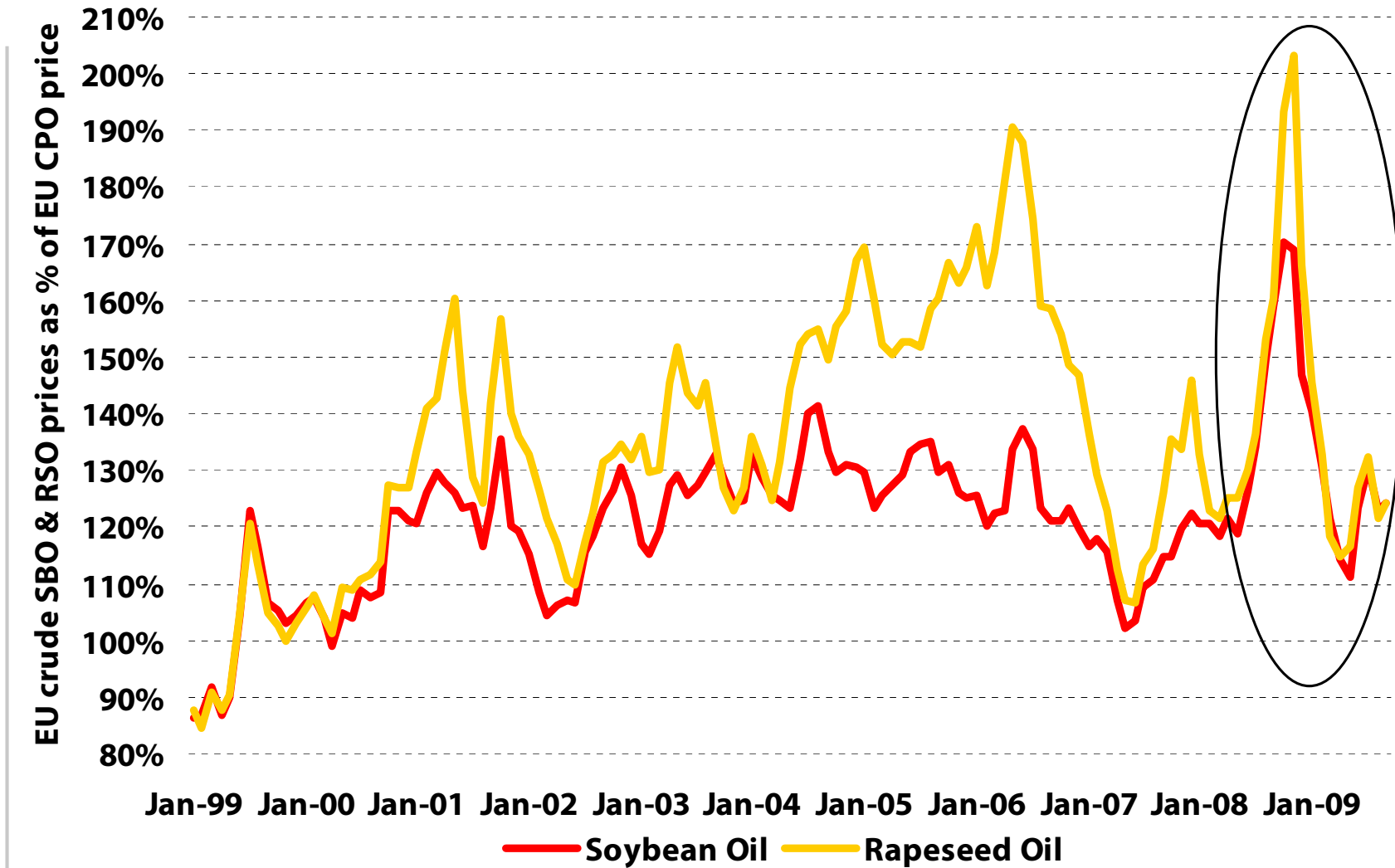
EU-US price relativities for sun and soy oil have changed, in the case of sun because of NuSun; for soy it was caused by EU imports for biofuel.



The premium for EU canola/rapeseed oil over the Canadian price was lifted by imports for biodiesel (previously the EU was an exporter)



One effect of the EU biodiesel policy has been to pull prices of the world's two main biodiesel feedstocks closely into line with one another.



The price relativities between oils and fats have changed in the past few years

- This quick review of prices has, I hope, persuaded you of the central role played by fuel prices in the oils and fats sector, thanks to biodiesel demand.
- Within the sector, we can see that the willingness of biodiesel producers to substitute cheaper feedstocks for soy oil, and simply to stop producing when output becomes unprofitable, helps to pull prices closer.
- This explains why biofuels are now acting as a major influence on vegetable oil demand and prices, by providing a rapid feedback when prices get too much out of line with one another.

Puzzles remain, but a picture is starting to emerge of a new world order in oils markets

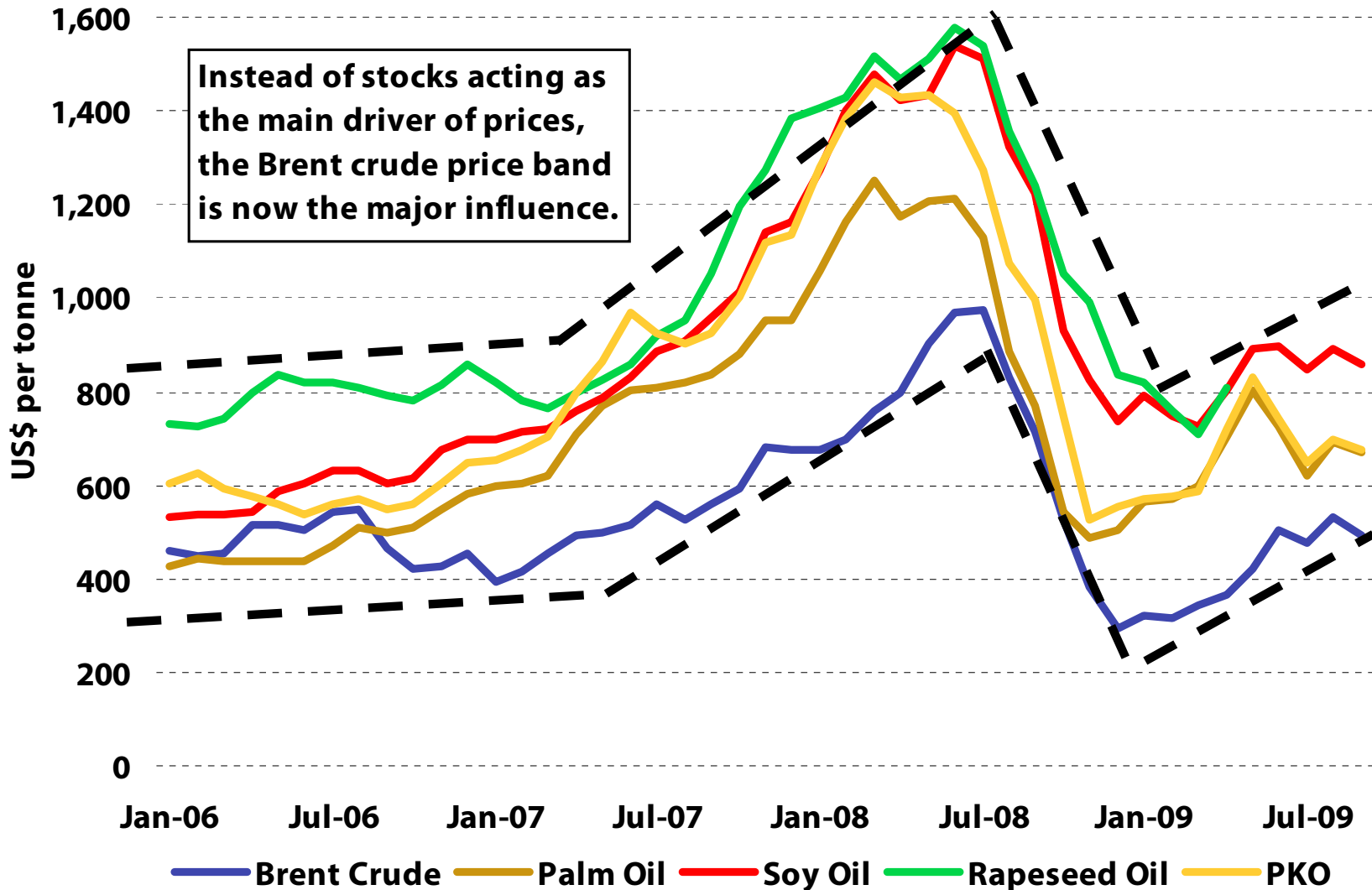
- Within the spectrum of prices, not everything has behaved quite the way one might have expected.
- For example, if one did no more than look at the relativities between soy oil and other oil prices, one would never guess that soybean supplies are tight.
- Another puzzle is that US palm product prices remain stubbornly \$40-50 above those in the EU.
- In the background, the EU is playing a more central role. Thanks to its biodiesel policy (which does not block GM oils), soy and canola oils are now being imported into the EU, and prices are reflecting this.

What could upset this new world order?

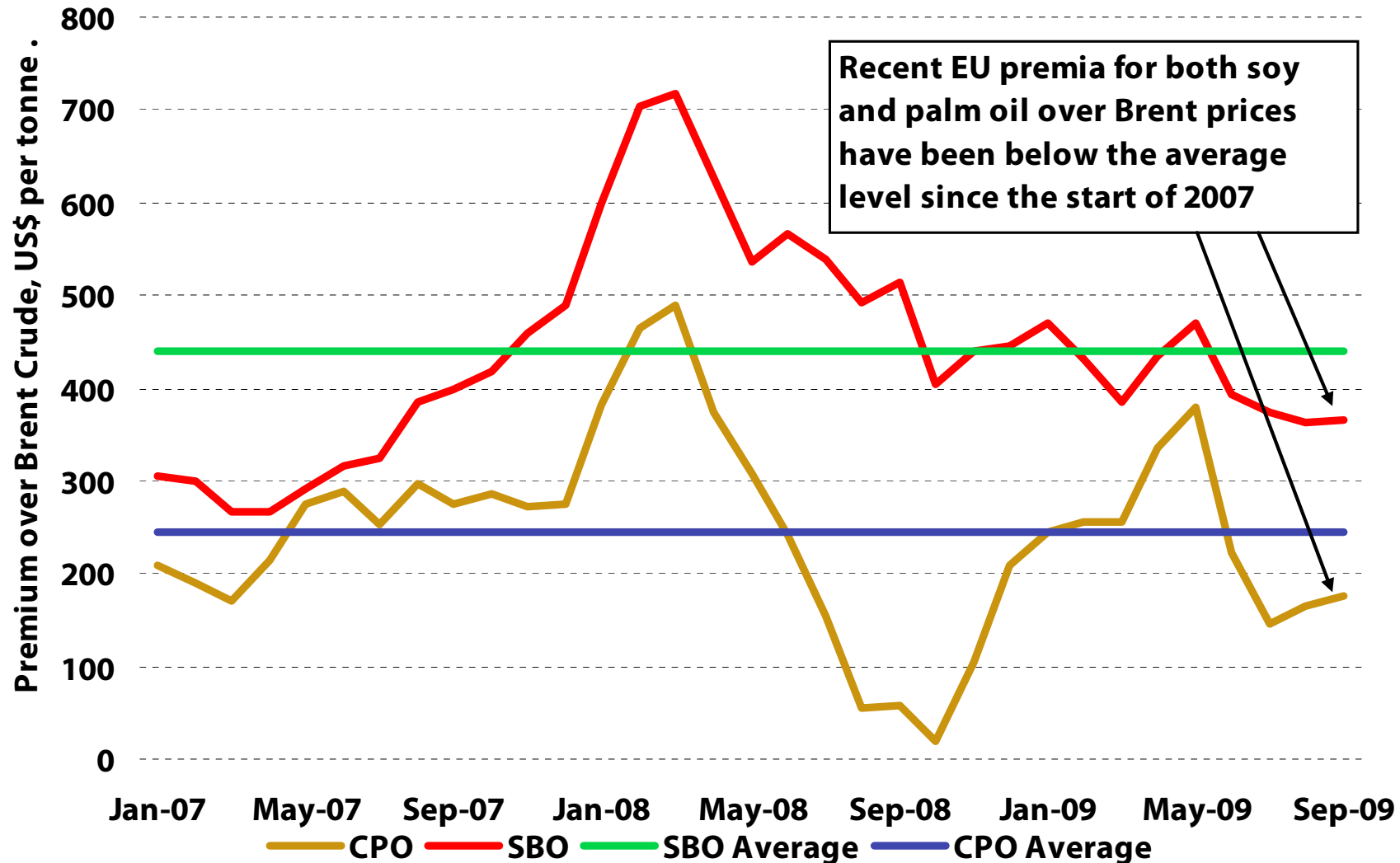
- The policy change that would do most to disrupt the new-found link between mineral and vegetable oil prices would be if countries round the world opted for strict mandates on biofuel use, rather than policies that retain a price incentive.
- Some countries are doing this, but I believe (hope?) that many governments still feel it is not good policy to allow food prices to be driven up excessively high just to meet an arbitrary biodiesel mandate.
- As long as there continue to be several governments willing to let markets work, there will remain a feedback from crude oil prices to vegetable oil prices.

What are the implications of the new world order for short term oil price movements?

First, we need to agree that a price band has been established, linking vegetable and mineral oil prices. Here's the evidence again.



This means we should focus on differentials between vegetable and mineral oil prices. The current EU situation is illustrated here.



Thank You



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