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Brazil's Biofuel Markets Have Tanked. What Happens Now?

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Introduction

As 2020 began, prospects were promising for Brazilian biofuels. The previous year had seen ethanol sales reach a new record level, and prices looked good. Meanwhile, at the beginning of March, the mandatory blend of biodiesel in diesel was set to rise from 11% to 12%. Yet in the space of a few weeks, everything changed. As Brazil acts to minimize the spread of coronavirus, a sharp decline in fuel use has crushed ethanol and biodiesel sales. What does the road ahead look like for players in these markets?

A Slump at the Pump

World oil and gasoline prices were already weakening in February as the market contemplated reduced demand stemming from the coronavirus crisis. However, they truly plunged in early March following the shock announcements that Russia had abandoned its oil supply agreement with OPEC and that Saudi Arabia would open up its taps, flooding the market.

This, by itself, was bad news for Brazil's ethanol sector. Approximately two-thirds of ethanol consumption is via direct sales at the pump of pure ethanol for use in flex-fuel cars, which account for almost 80% of the car fleet. In this part of the market, ethanol is competing at the pump with gasoline. Its pricing is, therefore, influenced by local gasoline prices, which in turn depend on international prices and the BRL/USD exchange rate. So, with these developments, the outlook for ethanol prices declined, which rapidly became bad news for the world's sugar market too. Diminishing prospects for ethanol indicated that Brazilian millers would favor sugar over ethanol production in 2020. World sugar prices took a dive.

The worst was yet to come. By the beginning of April, measures taken by Brazilian authorities and businesses to boost social distancing had resulted in enormous declines in fuel use. By early April, traffic in major Brazilian cities had declined between 50% and 80%.

This hit the cane ethanol business particularly hard. The milling season in Centre/South Brazil (where over 90% of ethanol is produced) begins in April. Thus, demand disappeared overnight just as production was ramping up. Prices in early April were 40% down on the previous month and are now at their lowest levels since mid-2017, indicating very little margin for all but the most efficient operators. At these prices, the small but rapidly expanding corn ethanol sector in Brazil is also under pressure.

For biodiesel, demand has been negatively impacted by the reduction of road transportation, which declined 20% in March versus the previous month and is expected to register a 40% contraction in April. While freight demand from the food and agribusiness sectors has been stable, a dramatic decline in construction and industrial transport activity, along with diminished bus services, has seen a steep decline in consumption of diesel and biodiesel.

The Road Ahead

We believe that pressure on ethanol prices will be sustained as long as fuel use remains limited by the partial lockdown measures in place. So any recovery in world market oil prices is, on its own, unlikely to bring much relief to ethanol producers.

This is because the current mismatch between ethanol supply and demand is such that the discount of ethanol pump prices to gasoline prices will continue to be substantial, dwarfing any positive pull from a higher oil price. Higher oil and gasoline prices could only contribute meaningful new support for the market with the return of fuel demand to more normal levels.

What are players doing to minimize the financial impact of these developments? And is there any prospect of the government stepping in to provide some temporary support?

In the short term, cane millers have a couple of options. First, as long as they have ample liquidity, they can opt to simply store the ethanol they produce, hoping that the worst of the crisis passes before they run out of tank capacity. Some companies have sufficient capacity to last until August without making a sale. A second, and complementary, strategy will be to maximize the proportion of cane that is milled to produce sugar, which continues to offer better margins than ethanol.

Meanwhile, some corn ethanol players have opted to reduce ethanol output and take advantage of currently high local corn prices, selling stocks of corn originally purchased months ago.

Regarding government measures to alleviate the stress, there are three main options under discussion, more than one of which could eventually be deployed.

1. A temporary suspension of the federal PIS/Cofins tax paid by mills on ethanol production
2. An increase in the federal CIDE tax on gasoline to enhance ethanol's competitiveness at the pump
3. An ethanol stock financing program

We believe that the suspension of the PIS/Cofins tax is an effective measure, as it represents a direct cost reduction for mills. We believe that an increase in the CIDE tax would risk being ineffective because it is an indirect measure and may not materially impact sales prices or volumes. Meanwhile, a stock financing program is a good idea, but it could be complex and time-consuming to set up and execute. More news on government support measures for ethanol should emerge during the rest of April 2020.

Owing to uncertainty around diesel demand in the coming months, Brazil's National Agency of Petroleum, Natural Gas, and Biofuels (ANP) – which organizes auctions to ensure the mandatory mixture of 12% biodiesel in diesel is met – announced that buyers (fuel distributors) will be obliged to withdraw 80% of the settled volume instead of the standard 95% in the forthcoming auction in April, concerning deliveries for May and June.

The possibility of lower biodiesel demand has implications for local soybean consumption, as soy oil represents 70% of the feedstock used to produce biodiesel. Thus, while high local prices for soybeans mean that farmers are very willing to sell, soybean crushers have been slowing down or suspending new purchases of soybeans.

Imprint

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