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An Ear for the Market

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CONGRESS is considering several bills to extend the 51-cent-per-gallon tax credit for ethanol producers beyond its 2010 expiration date. But let's hope that our elected representatives don't make their decision in the grips of an ethanol haze. The state of the ethanol industry changed so substantially since the last extension, one year ago, that a fundamental and clearheaded redesign is in order.

Sky-high oil prices and a national ethanol mandate have undermined the rationale for incentives. With oil at \$60 a barrel, ethanol can compete with gasoline without federal subsidies. For much of 2005, oil prices approached or surpassed the \$60 level. In recent months, they've hovered near \$70.

Last year, Congress ordered a near doubling of ethanol sales by 2012. Industry has responded so rapidly that the nation may have enough capacity to meet the Congressional goal by 2008. Indeed, Congress is already debating measures to increase mandated levels to 10 billion gallons in 2010 and 30 billion in 2020.

If the current 51-cent-per-gallon tax credit remains in place, these mandates would cost the Treasury Department \$5 billion in 2010 and more than \$15 billion in 2020. In the face of high oil prices, such subsidy levels are likely to prove politically untenable when there's no need for tax credits to make ethanol competitive.

Moreover, the rapidly changing structure of the ethanol industry argues for an entirely different kind of incentive. In 2003, some 50 percent of all ethanol refineries and perhaps 80 percent of all proposed plants were controlled by farmers, with an average annual output of about 40 million gallons each. But now, around 80 percent of new ethanol production is coming from plants controlled by absentee owners that produce 100 million to 125 million gallons.

As farmer and ethanol refinery have become delinked, so have biofuels policy and agricultural policy. True, the increased demand for ethanol has benefited farmers, but only modestly, raising the price of a bushel of corn by 10 cents to 15 cents. But when the farmer is also an owner in the refinery, he or she receives annual dividends averaging about 50 cents a bushel and

more than \$1 a bushel in very profitable years. Farmer-owners can also use an ethanol plant as a hedge against a drop in the price of their raw material. If the price of corn falls, so does the production cost of ethanol; all other things being equal, refinery profits and therefore dividends will rise.

How might Washington redesign the federal incentive to reflect the realities of an increasingly competitive absentee-owned, large-scale ethanol industry?

First, tie incentive levels to an index comprised of the price of a bushel of corn and the wholesale price of a gallon of gasoline. (A similar index can be developed for biodiesel or cellulose-derived ethanol.)

Such an incentive would honor the nation's commitment to both farmers and taxpayers. The farmer-producer would be protected if the price of oil plunged or the price of corn (or soybeans or cellulose) jumped. The taxpayer would be protected from having to underwrite handsome subsidies when the biofuels industry no longer needs them.

Second, transform part of the federal incentive from a gas tax exemption for those who market the ethanol into a direct payment to those who produce it. Minnesota did this in the 1980's, turning an incentive for consumption into one for production.

The new federal producer payment should encourage locally owned ethanol plants while not being a continual drain on federal resources. A payment of 15 cents per gallon for the first 20 million gallons produced each year might be offered to an absentee-owned plant with payment increasing to 25 cents a gallon if the majority of a plant's owners were farmers or local residents. No plant should be able to receive payments for more than 10 years.

Drastically changed times call for a drastically changed federal biofuels incentive, one that minimizes the long-term costs to America's taxpayers while maximizing the long-term benefits to our rural communities and farmers.

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