

21 January 2014 | Sector update

Oil & Gas and Plantation sectors

2014 Renewable Fuels Standard 2 proposal

Maintain POSITIVE

WTI Crude: USD93.75pb

CPO: RM2,560MT

- The U.S. Environmental Protection Agency proposed to reduce the annual volume of renewable fuel.
- We believe that this will not impact the prices of global crude oil as overall impact remains minimal.
- Local plantation companies are not expected to be negatively impacted by this rule-making either.
- Maintain Positive on both Oil & Gas and Plantation sectors.

U.S. Energy Independence and Security Act of 2007. On 19 Dec. 2007, ex-U.S. President, George W. Bush signed into law the Energy Independence and Security Act of 2007 with the goal of reducing gasoline consumption in the U.S. by 20% in 10 years. The main spirit of the Act was to promote greater energy independence and to increase the production of clean renewable fuels, among others. Action plans sought in this bill was to cut subsidies in the petroleum industries and to promote industries involving clean renewable energies.

2014 Renewable Fuels Standard 2 (RFS2). However, on 15 Nov. 2013, the U.S. Environmental Protection Agency (EPA) released a proposed rule-making (creating detailed or setting boundaries on regulations) that sets the minimum annual volume of renewable fuel (including ethanol and biodiesel) to be contained in transportation fuel sold in the U.S. The EPA has proposed to reduce the amount of ethanol required in the U.S. gasoline supply as mandated by the Energy Independence and Security Act of 2007. The EPA noted concerns over complications with increasing the blend of ethanol above 10%. This limit, known as the "blend wall," refers to the practical difficulty in incorporating increasing amounts of ethanol into the transportation fuel supply at volumes exceeding those achieved by the sale of nearly all gasoline as E10. The demand for gasoline in the U.S. has not been growing as previously estimated. This new standard has been opened for a two-month public comment period (until 28 January 2014).

Impact on renewable fuel industry. From Table 1, should the EPA proposal be passed, we could potentially see target total renewable fuel fall below the prior year's for the first time since 2007. This rule-making will most likely impact corn methanol (under '*renewable fuel*'), slashing 2014 required volumes by -5.7%yoy should the EPA proposal go through, as opposed to a previously projected increase of +4.3%yoy. In addition, the '*other advanced biofuel*' volume quota is expected to be slashed by close to -40%yoy. This reduction will primarily impact sugarcane-ethanol imports from Brazil. Biodiesel quota on the other hand, is not expected to be impacted by this rule-making. In terms of total renewable energy consumption in the U.S., biodiesel consumption only constitutes >2% of total renewable energy consumption, or 0.17 quadrillion Btu.

U.S. biodiesel production still strong. As of 10M13 (latest available information), cumulative U.S. biodiesel production was 1,076 million gallons. Total production has by far, surpassed 2012 and 2011's full years' total production of 991 million gallons and 967 million gallons respectively.

Table 1: Renewable Fuels Standard 2 Volumes for Different Biofuels

billion gallons (thousand barrels per day)

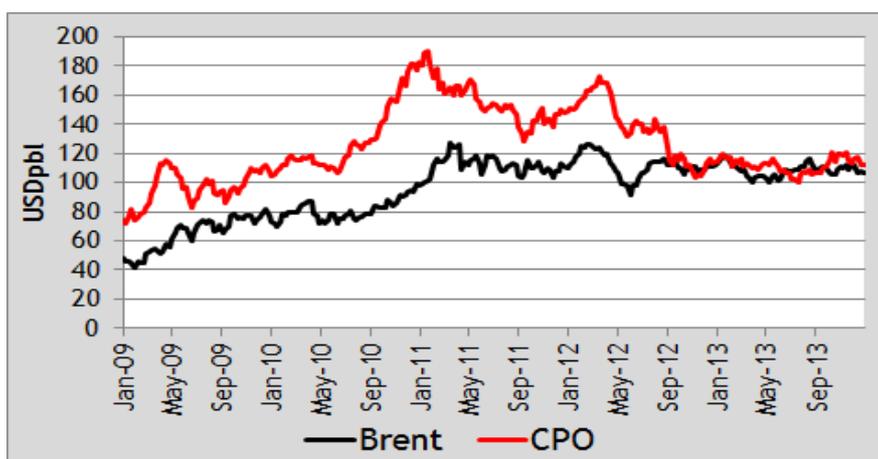
Year	2013	2014 (current EPA proposal)	2014 (as proposed in 2010 RFS2)
Renewable fuel (net)	13.8 (900)	13.01 (849)	14.4 (939)
Advanced biofuel	2.75 (179)	2.2 (144)	3.75 (245)
<i>of which biodiesel</i>	1.28 (84)	1.28 (84)	1.0 (65)*
<i>of which cellulosic biofuel</i>	0.006 (0.4)	0.017 (1.1)	1.75 (114)
<i>other advanced biofuel</i>	1.46 (94.6)	0.90 (59)	1.0 (65)
Total renewable fuel	16.55 (1,080)	15.21 (992)	18.15 (1,183)

*this was a minimum requirement

Source: U.S. Environmental Protection Agency (EPA), U.S. International Energy Agency (IEA), MIDFR

Impact on Malaysian biodiesel exports to U.S. Apart from soybean and corn oils, palm oil also has been used widely as a feedstock inputs to biodiesel production. In terms of productivity yield, palm oil yields about 5,000-6,000 litres of biofuel per hectare. This is much higher compared to corn (1,500-4,000 litres per ha.) and soybean (<1,500 litres per ha.). As the second largest global palm oil producer, Malaysia exported approximately 161,192 tonnes of biodiesel in 2013 compared to 28,983 tonnes of biodiesel in 2012. The surge in biodiesel exports was mainly due to the narrowing premium of CPO price over crude oil price (see Figure 1). Based on MPOB statistics 2012, biodiesel export to the U.S. is very minimal. Most of these exports were to European countries and Asian region, accounting for 75% and 23% of total biodiesel exports respectively. Therefore, we believe that the proposed rule-making by EPA would not have a significant impact to Malaysian export of biodiesel.

Figure 1: Brent crude vs. crude palm oil prices



Narrowing premium of CPO price over crude oil price

Source: Bloomberg, MIDFR

Expected impact on crude oil prices. Although the growth in the supply of renewable fuel is expected to decelerate in 2014, we also do not expect significant impact on crude oil demand. This is because, biodiesel production in the U.S. is expected to average 84kbpd in 2014 and 2015; which is only around 0.6% of total U.S. liquid fuel supply. Moreover, oil demand/consumption in the Americas and Europe is still expected to be subdued with downside bias in 2014.

News has insignificant impact, but we reiterate our POSITIVE stance on the plantation sector. Since there is no significant impact on Malaysia biodiesel exports to the U.S. arising from the proposed rule-making, CPO prices is unlikely to be affected by this. From a general perspective, continuous export of palm oil to the U.S is expected to be sustained. In 2013, about 6.0% of the total palm oil was exported to the U.S. We continue to expect CPO price to recover and to be supported by other fundamentals such as (i) lower production and; (ii) stronger demand from other importing countries. We reiterate our **POSITIVE** stance on plantation sector as we expect improving CPO prices to improve the margins of local plantation companies. Our 2014 average CPO price target remains at RM2,700MT.

News is technically POSITIVE on oil & gas sector. Technically, the reduction of biofuel has an inverse correlation to, and a positive impact on the demand for conventional gasoline. Fundamentals remain intact and we maintain our 2014 average WTI forecast at USD94pb. Maintain **POSITIVE** on local oil and gas sector. 

DAILY PRICE CHART

Crude palm oil price (KO1)



Brent crude oil price (CO1)



Source: Bloomberg, MIDFR

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STOCK RECOMMENDATIONS

BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.

SECTOR RECOMMENDATIONS

POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.