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STREET SMART

Democrats Manage To Out-Ethanol Bush

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A DOW JONES NEWSWIRES COLUMN

NEW YORK -- Among many other things for which he'll be remembered, George W. Bush will likely go down in history as the only president to use the words "cellulosic ethanol" in a State of the Union address.

Despite the administration's conspicuous support for the biofuels industry, investors in stocks in the sector seem to believe that the sweeping Democratic victory in midterm elections Tuesday points to even greener pastures ahead.

Ethanol related stocks -- which had been battered down by as much as 80% from their peaks earlier this year -- surged across the board Wednesday. The move surprised some observers who questioned not only the logic that Democratic control of Congress might bring much improvement in ethanol producers' fortunes but also why that thinking hadn't been factored into prices before Tuesday's heavily predicted shift.

"These are all across the board, significant jumps," said Rob Wilder, chief executive officer of WilderShares LLC, the company behind the first exchange traded fund to track alternative energy. "Markets are really far from efficient."

A Question Of Volume

The trigger, according to Kevin Book, an analyst at investment bank Friedman Billings Ramsey who analyzes government policy, was the news Democrats may have won a surprise victory in the Senate as well as the expected victory in the House.

Ethanol capacity has grown so much more rapidly than the federal mandate requiring its use in motor fuels that both parties have been preparing bills to expand the existing Renewable Fuels Standard from

the current target of 7.5 billion gallons by 2012. About 4 billion gallons of biofuels were produced in 2005 and billions of gallons of new capacity will be added to that this year and next, leaving supply well ahead of target.

The current Democratic version of the bill to revamp the RFS would boost the volume that must be used by 6 billion gallons. The Republicans are backing an increase of only slightly over half that amount -- hence the excitement over a Democratic victory and the change in sentiment overnight. A Democratic win in the Senate would smooth the way for the bill, and this hadn't been foreseen.

"The news couldn't be much better than this," Book said. "They weren't predicting a bicameral Democratic victory."

Impressive Gains

The gains racked up by the biofuels sector were impressive and stood out from other sectors like defense, health care and tobacco that investors had focused upon prior to the election as possible winners or losers.

Ethanol producer VeraSun Energy Corp. (VSE), at Tuesday's close down 39% from its high earlier this year, closed up 9.0% Wednesday. Pacific Ethanol Inc. (PEIX), down nearly 64% from its 2006 peak, surged by 8.0%. Xethanol Corp. (XNL), down a whopping 82% from its peak, rose 3.8%. Archer Daniels Midland (ADM), down 28% from its 2006 peak, rose 6.6% despite ethanol being only one of the agribusiness giant's many profit centers.

Wilder said that he was surprised by the size of the gains and saw the election as an excuse for investors to re-enter a sector that has been pounded.

"These stocks had gotten overbought, and then they probably got oversold," he said. "Buyers were looking for a trigger to get back in."

Wilder noted that Nancy Pelosi, likely the incoming speaker of the House, is a known supporter of cellulosic ethanol, a technology that has yet to be commercialized and would convert nonfood plants like switchgrass into fuel. But he said that, come the 2008 presidential

election, Democrats and Republicans would pander equally to voters in corn growing states.

"In two years, you'll have both parties on bended knee in Iowa," he said.

Petroleum Substitutes

It's clear though from the market's narrow focus on biofuels that the surge didn't reflect a belief that a Democratic victory would be good for alternative energy overall. Ryan Katofsky, a consultant specializing in biofuels at Navigant Consulting, noted that stocks associated with solar energy or fuel cells posted more modest gains or even losses.

An additional explanation for the outperformance of biofuel-related stocks and not other alternative energy sectors like wind, solar and hydrogen is offered by Lisa Frantzis, who heads Navigant Consulting's alternative energy practice. She said that the public's preoccupation with Iraq and oil may have translated into a focus on companies that purport to provide an alternative for imported oil. Wind and solar power don't displace petroleum.

"The key technology that addresses that is renewable fuels," she said.

Indeed, the victory also helped other companies seeking substitutes to petroleum as a transportation fuel including coal-to-liquids company Rentech (RTK) and fuel-cell maker Ballard Power Systems (BLDP), both up about 9% at the close.

Another key political decision regarding ethanol will be an extension, already widely expected to be approved, of the 51 cent a gallon excise tax rebate for biofuels before it expires in 2010. But Katofsky said the Democratic victory made it no more likely.

"The imperative is there to continue the credit," he said.

(Spencer Jakab, a columnist who provides insightful and unique takes on the stock market, previously wrote about the energy market. Prior to being a financial journalist, he was an emerging markets equity analyst.)

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