



Who's Driving This Bus?

Record crops, record demand, and record barge freight are reshaping grain merchandising. And record speculative and investment capital is reshaping grain futures and spread trading.

Grain merchandisers and managers will do well to learn the lessons from the past year. Corn and soybean basis collapsed in the fall of 2005 but it wasn't solely because of Hurricane Katrina. Broader forces are at work: Record crops, record demand, and record barge freight are reshaping grain merchandising. And record speculative and investment capital is reshaping grain futures and spread trading. This isn't bad — it's just different and traders and managers who don't recognize and understand these changes will suffer. Savvy basis trading isn't enough anymore.

Freight rates

Barge freight climbed to over 800% of benchmark values in the fall of 2005 as the industry grappled with a fleet scattered and cut by Hurricane Katrina. Many barges were recovered but some are gone for good. Many more are old and worth more as scrap than as part of the fleet, and the cost of building a barge has jumped from \$245,000 a few years ago to almost \$500,000. Barge lines sent some of the U.S. fleet to South America when U.S. rates were low and revenues fell a few years ago. Demand for northbound freight soared in 2005 and remains strong,

further slowing turn times which effectively reduces the available

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southbound fleet and forces rates higher. Crude oil at \$60+ also raises the variable cost of operation. The only way to increase the fleet

is to get rates high — and keep them there.

Merchandisers have to recognize how much barge freight impacts interior basis everywhere. Spot barge freight in October used to trade at 250% to 300% of benchmark rate for Northern Illinois locations. In 2004 it peaked at 425%, and in 2005 traded from 500% to 850% in October with a few trades closer to 1000%. The impact on total cost is dramatic:

100%	250%	300%	500%	850%
14.2¢	35.5¢	42.6¢	71¢	\$1.207

Barge freight in cost/bushel, LaSalle IL to New Orleans, for corn.

Barge freight was double the “typical” 35 to 40 cent cost and varied 50 cents/bushel during October last year. But the basis at the Gulf for corn barges stayed between +42 and +64 Dec, a 22-cent range. During November-December 2005, Illinois River freight weakened only slightly, mostly trading 350% to 500%, and stayed 400%+ until late February. And it still has not fallen below 360% for nearby loadings.

Inland river terminals lower their basis as freight cost rises. Interior country elevators that sell to the river face the same freight volatility and risk, just indirectly. Volatile barge freight also affects what other country elevators will pay and impacts their offering levels to other markets such as ethanol plants and feedlots. Everyone is affected.

High barge freight and huge crops increase the demand for rail freight, which also gets bid up in

the secondary market and directly affects elevators’ margins. Rail freight is also vulnerable to unpredictable fuel surcharges.

Space a serious concern

According to the most recent U.S.D.A. statistics, U.S. off-farm grain storage capacity totals 8.53 billion bushels, up just 130 million bushels since 1994! And U.S.D.A. lists on-farm capacity at 11.355 billion bushels, up only 160 million bushels from 1994. Total available space is up less than 300 million bushels, but production has increased by 2.8 billion bushels over that time for just corn, soybeans and wheat.

Total U.S. storage capacity is approximately 20 billion bushels*, with a sizable amount of that in the Western Plains states and not readily accessible for corn and soybeans. (*This space also has to warehouse sorghum and all other U.S. crops.)

In 2005, U.S. corn, soybean and wheat production plus September 1 beginning stocks totaled 18.5 billion bushels, and big yields in 2006 could push this fall’s volume to 19.5 billion bushels — potentially forcing the grain industry to accommodate an additional 1 billion bushels this fall. Even at just 145 bushels/acre on corn and 42 bushels/acre on soybeans, crops plus beginning stocks could still total as much they did last fall.

Last year the U.S.D.A. approved approximately 800 million bushels of emergency plus temporary storage for 2005 crop but even that

wasn’t enough. Farmers and some elevators are building new bins in 2006, but the cost of construction will limit the expansion; the space deficit will pose real logistical dilemmas for many elevators. Underestimating the total demand for space in an elevator’s area could force a manager to sell and ship more grain just when freight costs are likely to be highest.

Outside money arrives

Index and speculative funds are pouring money into commodity futures. Industry sources estimate that index funds alone control \$75 billion with a percentage of

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that invested in ag commodities. Experts say that could easily reach several hundred billion dollars in 2 to 4 years. Conservative pension funds are even diversifying and including commodities now, and the pool of that available capital is largely untapped.

Index-fund investment in commodities is longer-term and mostly price-inelastic. Most of their posi-

tions are in nearby futures months where liquidity is highest. The upshot is that ag futures may soar even when fundamentals look

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bearish as money flows into the market. And those positions all have to roll before a front (futures) month goes into delivery. This will create consistent, high-volume spread trading that more than not has the potential to promote wide carrying charges.

There are a number of traps elevators may fall into in this new world.

- Freight-cost risk is now bigger than destination basis risk for many shippers.
- Locking in freight availability before harvest, but failing to lock in freight costs.
- Staying long new-crop basis preharvest from farmer purchases even though the elevator can't hold all the grain.
- Underestimating the total local demand for space and filling with low-rate storage or high-basis ownership.
- Underestimating the potential for futures to climb in the

face of huge crops, which can trigger atypical farm selling, raising financing and basis risk. Higher futures don't always represent strong nearby demand.

- Forgetting that the CBOT delivery system effectively caps the basis but does not set a floor.

Reassess what your core business is. Is yours a firm with plenty of space and money? Then position your business to be ready when others are full, to buy when basis is cheap and carries are wide — and not rush to fill early. Your firm can use wide futures carries and be selective in basis sales.

But if your firm has limited space and must ship continuously, your core business is logistics. Futures carries and forward basis opportunities won't be as important as managing transportation: lining up freight early, locking in freight costs when possible and when not possible, setting handling margins to allow for big increases in costs. Building a new-crop to-arrive position is fine but rising freight costs could wipe out your margin.

Summer 2006 barge freight is bid around 350% for the Illinois River, and October is quoted at 475% to 500%. Even so, there is probably not much downside potential for October 2006 and there is a real risk rates could soar again as the trade struggles to move big crops.

Interior basis will almost surely stay more volatile than the ranges managers are used to trading. Merchandisers should hide their

historical basis charts on a back shelf. Betting and planning on those levels will be a mistake. New demand from ethanol may help but can't guarantee high basis. It's time to think outside the box.

Setting basis wide now for fall 2006 to protect your business against logistics and freight risk may not make you popular with farmers, but that's better than being bankrupt. ■



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