KC Wheat Futures Shift Gears

By Diana Klemme

2010 has been rough on hard red wheat farmers, merchants and the Kansas City Board of Trade. Farmers watched KC wheat drift lower from late 2009 until harvest. Exporters struggled to sell hard red wheat before harvest against cheaper overseas offers. But adverse weather slashed Canada's wheat crop by 17% and the FSU crop by almost 30% and wheat futures climbed as the scope of the problems widened.

Then a 1+-billion-bushel U.S. hard red wheat harvest arrived. Terminals were ready, the early boats were in port, and the combines rolled. Elevators were overrun with wheat, but a lot of the new wheat couldn't meet export protein specs. Terminals dropped the basis for this wheat, with some markets falling 50+¢ in a matter of days. Country elevators continued to buy, hedge, and hold wheat, then more wheat. Basis continued its slide even as some exporters struggled to find quality wheat for their export commitments.

In Kansas City, wheat futures were climbing and many elevator managers struggled to meet margin calls on their short hedges. Some firms weakened their bid basis further to increase their handling margin on the higher-priced wheat. More speculative money bought wheat futures, drawn by the news of global crop woes and by bullish technical signals. Managed money's net longs in KC wheat climbed 50,000 contracts from late June to early August (futures and options combined) and KC wheat futures moved from $4.90 to $7.25 in five weeks!

But elevator wheat bids trailed further as futures rose, with basis at some interior locations at -150 or lower. The prospect of a record corn crop coming in the Plains states only added to the space woes. Elevators were concerned; they owned large quantities of hedged hard wheat from higher basis values, with cash prices *diverging* from futures and no way to sell the wheat profitably. Farmers also began to complain loudly about cash prices not following futures, again attracting the attention of the Commodity Futures Trading Commission in Washington.

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An omen for KCBT

The principle of convergence is central for effective hedging: Cash prices and futures should come relatively close together in the delivery market during the delivery period for futures. Hard red wheat basis convergence hasn't been very good in recent years, and when basis nose-dived *away* from KC futures in 2010 to record lows, regulators responded quickly and decisively. The CBOT/CME had already gone through their turn in the regulatory barrel after soft red wheat basis had fallen to historically cheap levels as far back as 2006 with minimal recovery. This had raised the ire of farmers, elevators and Congress, yet SRW basis remained depressed from 2007 through 2009. After two years of analysis and implementing small steps that might aid convergence, the CBOT passed their Variable Storage Rate program in November 2009 which took effect July 2010. The CBOT's path to convergence took this route:

- CBT capped ownership of Delivery Shipping Certificates by noncommercial entities to 600 contracts, 3 million bushels (effect February 2009).
- Added delivery locations in northern Ohio and along the Ohio River for CBT wheat (effect July 2009).
- Added a seasonal storage rate from July 15 through December 15 (effect July 2009).
- Lower vomitoxin standard took effect September 2009.
- VSR (Variable storage rate program) replaced the Seasonal Storage Rate (effect July 2010).
- Vomitoxin standard will decline again, to 2 ppm effective September 2011.

CBOT's VSR concept is simple in theory but complex for traders and hedgers to execute. Traders must now anticipate what a storage rate might be months or even years in the future when setting spreads. VSR sets a time frame during which the front-month CBT wheat spread is

Diana Klemme is a longtime contributor to *Feed & Grain*. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at diana@grainservice.com.

monitored against a "Full Carry" formula. If the spread stays above 80% of FC during the allotted time, the delivery market daily storage rate will be increased by $.001/bushel on a designated date. If the average spread is below 50% of FC at the end of the analysis period, the delivery market storage rate will decline $.001/bushel, but with a floor at $.00165/bushel/day (5¢/month). Note: only one change of $.001/bushel/day can occur on any delivery cycle, for a maximum change of $.03/bushel/month. There is no limit, however, on high the rate can eventually go. As of December 2010, CBOT's wheat storage rate is at 14¢ *per month*!

KCBT's response

The KCBT Board of Directors and the exchange's wheat committee monitored the CBOT's changes and observed soft red wheat contract performance, but pressure on KC for dramatic change wasn't heavy. Hard red wheat cash and futures were tracking *reasonably* well and basis values were high enough that farmers were satisfied. But 2010 threw a wrench in those gears.

The Kansas City Board of Trade's wheat committee studied the situation and debated first whether any change was necessary; amending terms of a futures contract is a major step, after all. (Some "issues" are seasonal or a function of an unusual crop and resolve themselves in time.) But the pressure from hedgers and from regulators increased as cash and futures remained far apart into the fall of 2010. KCBT's wheat committee and board continued their review, and submitted a final proposal for membership vote to approve contract changes, which passed on November 30, 2010. Under CFTC regulations, approval will be automatic unless the CFTC finds material problems with KC's amendments.

New rules of the road

These are the major amendments to the KCBT hard red winter wheat contract, effective with the September 2011 futures contract month, pending CFTC approval:

1. The base storage rate on deliveries rises from 4½ ¢/bushel/month ($.00148/bushel/day) to 6¢/bushel/month ($.00197/bushel/day), during the calendar months of December through June;
2. During the months of July through November, there will be an additional Harvest Storage Premium added at 3¢/bushel/month ($.00099/bushel/day).

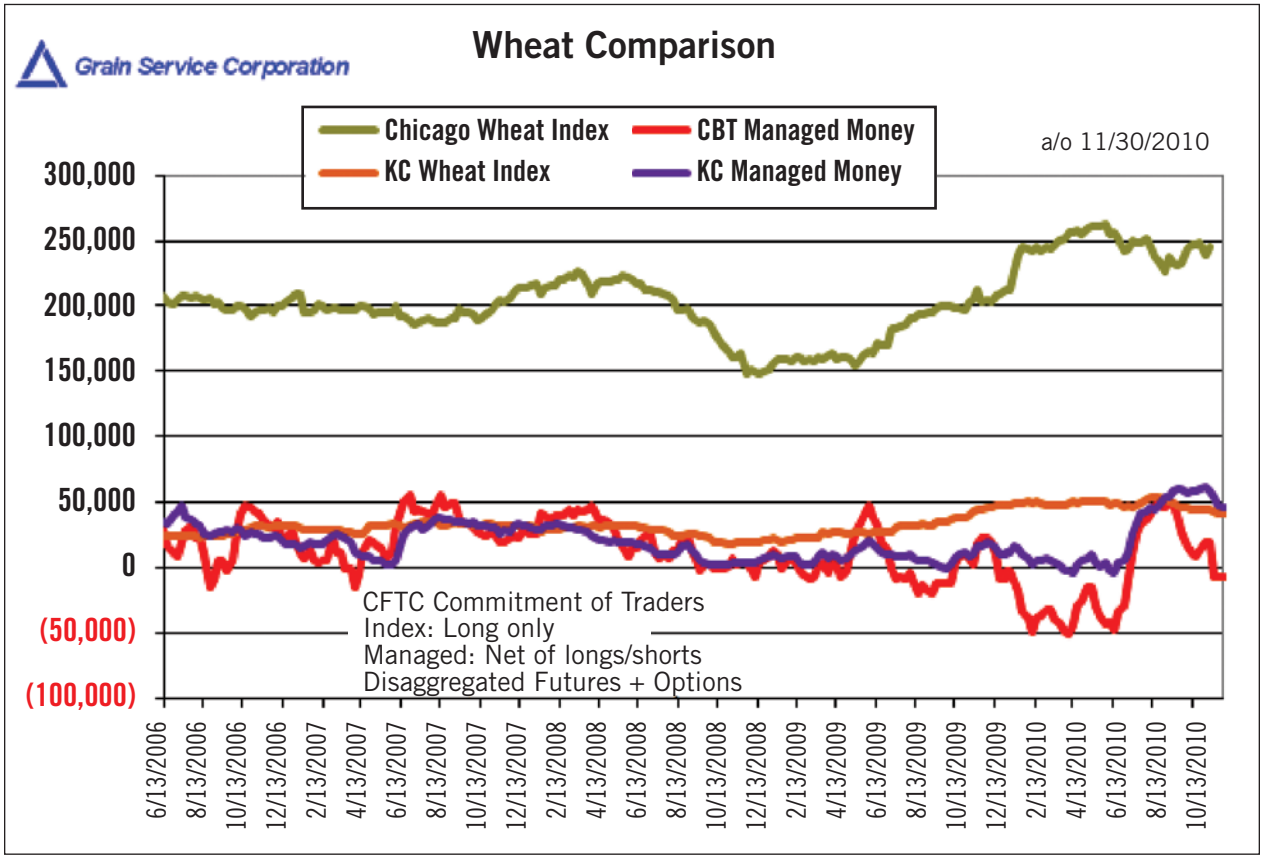
This raises the effective storage rate during these months to 9¢/bushel/month ($.00296/bushel/day);

3. The Harvest Storage Premium shall become effective on September 1, 2011;
4. Effective with the September 2011 futures contract, deliverable grades of HRW shall contain a minimum 11% protein level. Protein levels of less than 11%, but equal to or greater than 10.5% are deliverable at 10¢ discount to contract price. Protein levels below 10.5% are not deliverable. (There is no protein requirement on KC delivery wheat under existing rules.)
5. Holders of outstanding warehouse receipts following the expiration of the July 2011 contract month will have five business days (August 24-30, 2011) to present such warehouse receipts to the issuing warehouse for upgrading to reflect a deliverable protein level. The issuing elevator may charge the holder 12¢/bushel to upgrade receipts with a designation of 11% minimum protein, or 2¢/bushel to upgrade receipts with a designation of 10.5% minimum protein. Warehouse receipts not upgraded shall not be deliverable against futures contracts from September 2011 forward;
6. Effective September 1, 2011, the vomitoxin restriction shall be reduced from 4 ppm to 2 ppm.

Raising a delivery storage rate increases the cost of holding delivery instruments (warehouse receipts or shipping certificates), and widens Full Carry (FC) by that same amount. Reducing the maximum vomitoxin raises the quality of the wheat for a buyer, and all else equal may add to the value of the wheat. Adding a minimum 11% protein requirement also raises the potential value of wheat futures to a buyer. KC's "seasonal storage rate" has the benefit that it's a known, fixed premium, which reduces spread risk for traders.

Raising Full Carry can help isolate surplus inventory from the market. ("*Why sell the basis today, the spread is paying me far more than my costs…*") This in turn can raise the nearby basis — one step toward convergence. Raising Full Carry also makes it somewhat less attractive for speculators to buy and hold front-month wheat futures as they might have to "roll" those longs forward in a wide carry. Some believe front-month spec longs artificially keep wheat futures above "real" cash values and discourage convergence.

It's too early to say for certain whether the changes are good for either Chicago or KC's wheat contract, and whether convergence will improve. The KC amendments take effect September 2011, and VSR is still new to Chicago.



Changes that affect KC wheat affect country elevators

One issue for the KC contract is that Kansas wheat doesn't always grade 11% protein. That poses the risk that the available wheat would not make delivery grade. The result could be a cash value for wheat *far* below futures at times, which could cause basis *divergence* rather than convergence.

On the positive side, the KC wheat contract amendments will allow wider futures carries to develop when basis is weak and wheat is plentiful. But wider potential carries also mean greater uncertainty as to what constitutes a "good" carry relative to a country elevator's holding cost. Some of the risk that's currently reflected in volatile basis can transfer to *spread* volatility after the changes takes effect in 2011. Learning how to calculate the new Full Carry rates will be important!

> Full (futures) carry = (daily storage rate + daily interest cost) x days in the delivery cycle
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> Simplified example, assuming $7 wheat, .3% (3-mo Libor) and a 60-day delivery cycle:
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> $.00296 (storage) + $.000447 (2% over Libor times $7) x 60 days = 20.4¢ Full Carry

The new KC program effectively widens Full Carry for Sept11/Dec11 KC wheat to 30+¢ (27¢ storage plus interest). Actual storage and FC are based on the exact number of days for the three-month cycle. Adding the 11% protein requirement doesn't affect the Sept11/Dec11 spread, but it does put a one-time premium of 12¢/bushel on Sept11 receipts over July 11 receipts, which has the effect of widening the July11/Sept 11 Full Carry by 12¢.

Managers and traders have a learning curve to negotiate and have to reframe their spread and basis expectations. Higher delivery storage rates don't guarantee higher basis; they only offer a transparent alternative: Wider futures carries for holding the wheat until somebody wants it. Adding the changes to the risks associated with high futures volatility, extra caution is in order when buying and merchandising 2011 crop wheat, and wider margins are well-justified. ▮