

Understanding and Charting Basis.

Workshop Four, December 17, 1999

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Concept 1. What is Best Price Theory?

a. The Best cash price = The highest Futures + the narrowest basis - any storage costs.

Concept 2. Basis is the difference between a cash market and a related futures market. $B = C - F$.

Concept 3. What are the components of basis?

a. Transportation costs (freight), storage costs (including interest and insurance), handling costs (the expenses of loading and unloading and cleaning), and sellers' profit margin.

Concept 4. How do I calculate basis for Spring Wheat? Winter What? Barley?

DNS or HRS local basis is **local cash** market quoted at the elevator **minus the nearby Minneapolis futures** contract.

HRW local basis is **local cash** market quoted at the local elevator **minus the nearby Kansas City Board of Trade futures** contract.

For barley, Barley futures are not trading currently on any US exchanges. Consequently I use nearby corn from the Chicago Board of Trade.

Concept 5. What location should I use when calculating basis for my crop?

Preferably your local elevator(s) or where you conduct your business. **If no records are available use PNW cash and subtract the published freight rate and grain handling margin to your delivery point.** This will be very close.

Concept 6. How does PNW Basis relate to Local Basis?

a. The difference between PNW Cash and Local Cash prices is the total of the freight and elevator margin. (Transportation and handling.)

Or: $\text{Cash}_{\text{PNW}} - \text{Cash}_{\text{Local}} = \text{Freight} + \text{Margin}.$

Since we know $\text{Cash} = \text{Futures} + \text{Basis}$

We can substitute into the formula and get:

$$(\text{Futures} + \text{B}_{\text{PNW}}) - (\text{Futures} + \text{B}_{\text{Local}}) = \text{Freight} + \text{Margin}$$

Or: $\text{Basis}_{\text{PNW}} - \text{Basis}_{\text{Local}} = \text{Freight} + \text{Margin}.$

Concept 7. Where can I get records to show me historical basis on different protein wheats?

This is where you are in luck! The Montana Market Manager web site has all of these. This is such an incredible service it well worth more than the annual subscription price just to have this data.

Concept 8. What does a change in basis tell me?

a. The most predictable feature of the basis is its *tendency to strengthen* --by the amount of reduced storage costs-- as the delivery month is approached. Thus if storage costs of 4 cents a month are included in the basis, the likelihood is that the basis will strengthen at the rate of 4 cents a month. This assumes the other components of basis remain unchanged. This tendency for the basis to become stronger as the delivery month approaches is known as *convergence*.

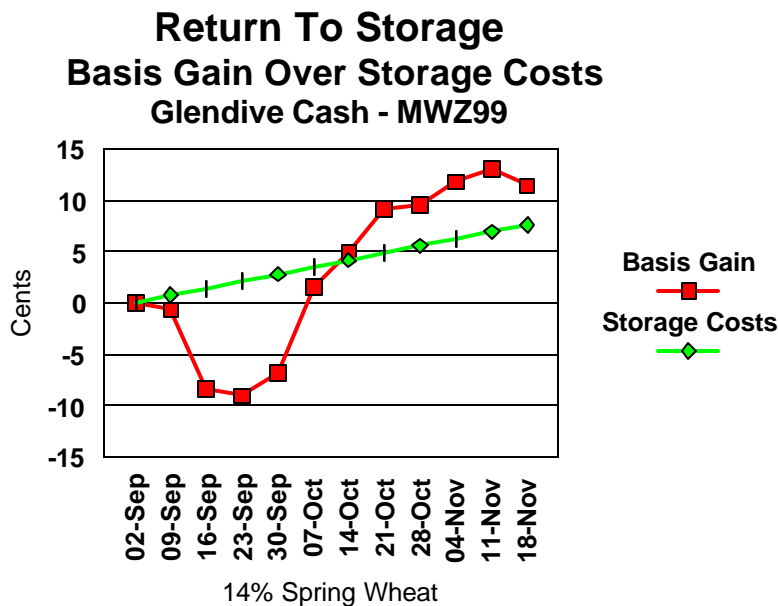
b. One description of basis is that it is a barometer of demand. When it narrows or gets more positive it is telling you time is passing and/or there is greater demand for the grain. If it widens or weakens it becomes less positive and is telling you that the elevator doesn't want the grain. Store it until you see an improvement in basis. You must still remember that there are two parts to price, the futures portion and the basis portion. If the futures are acceptable to you, lock it in with a HTA or FF contract or sell a futures contract. Refer to the dynamic analysis on the web site.

Concept 9. How good will basis get this year?

Again we have the historical data for the last four years posted on the Montana Market Manager web site. How good did PNW basis get last year? In the last three years? That will provide a target. If you look at 14% DNS it had an 85 over history to come back to and that is just what it did.

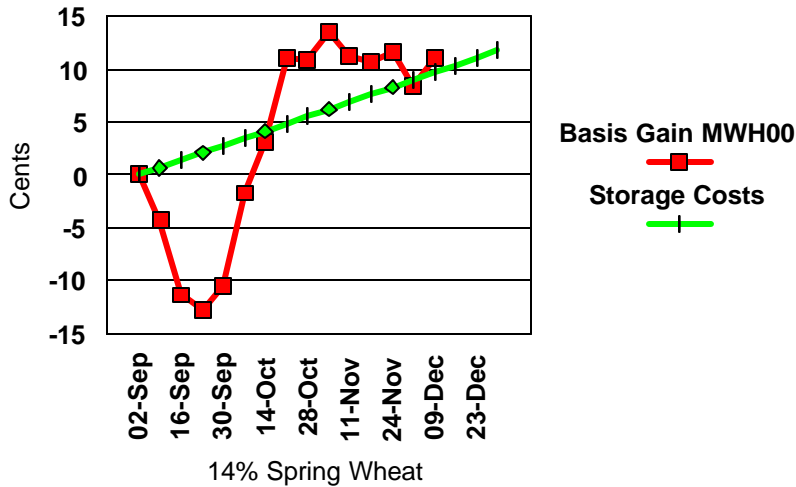
Concept 10. How can I see when local basis gain (appreciation) exceeds my storage costs?

Here we can construct a simple tool with our weekly local basis records and a sheet of graph paper. This goes on the refrigerator door or next to your telephone or wherever you will see it several times a day!



Return To Storage

Basis Gain Over Storage Costs Glendive Cash - MWH00



Concept 11. How can I lock in the basis and leave the futures open to rally?

a. There are

three ways to lock in basis:

1. Sell the wheat for cash on the cash or spot market. This locks in both the basis and futures portion of price. If you want to reown the wheat, purchase a futures contract in an outlying month or purchase a call option.
2. Sign a basis contract which leaves the futures part of price open and must be fixed later.
3. Create a synthetic basis contract by signing a forward contract and then buying a futures contract on an outlying contract month.

Concept 12. What happens to basis when the elevators roll to the next contract month?

a. The basis will be adjusted by the carry between the nearby and next contract month.

If you have a basis contract the elevator may charge you a fee for rolling as they have costs in buying back and rehedging the grain.

Concept 13. How much can I expect basis to appreciate after harvest on 14% HRS or 12 % HRW?

Again we refer back to the historical local basis appreciation. Looking at the years 1994 to 1999 it looks like Spring wheat normally appreciates 25 to 30 cents at my elevator and WW about 40 cents. The same information can be read from the PNW basis charts on the Montana Market Manager web site.

Concept 14. What impact does a Delayed Price contract have on local basis?

a. They have a negative impact. The elevator has the grain and does not have to procure it. DP contracts were introduced to producers when the elevators were willing to sell grain and the producers were not willing to sell but wanted to move it.

The 7 Habits of Highly Effective Marketers

Adapted from The 7 Habits of Highly Effective People
by Steven Covey

1. **Be Proactive.** Price a percentage (10-30%) of next year's crop in October, eleven months prior to harvest. Actively price percentages during the first 5 months of the calendar year prior to harvest. Use the tools that best fit the situation. Early -- use your own hedging account, later -- use Futures Fixed or Hedge to Arrive contracts at the elevator.

2. **Begin With The End In Mind.** Use cash flow planning. I use last years actuals, plus this years actuals to date and the balance of the calendar year projected plus the next year's projected budget. I graph the total of my outstanding loans to see if I am making progress in meeting my current and projected objectives.

3. **Put First Things First.** Marketing is the hardest and arguably the most important thing you are doing. If you aren't working on selling it maybe you shouldn't be producing it. Concentrate on quadrant II activities.

		The Time Management Matrix	
		Urgent	Not Urgent
Important	I		II
	ACTIVITIES:		ACTIVITIES:
	Crises		Prevention, PC activities
	Pressing Problems		Relationship building
	Deadline-driven projects		Recognizing new Opportunities
			Planning, recreation
Not Important	III		IV
	ACTIVITIES		ACTIVITIES
	Interruptions, some calls		Trivia , busy work
	Some mail, some reports		Some mail
	Some meetings		Some phone calls
	Proximate, pressing matters		Time wasters
	Popular activities		Pleasant activities

4. **Think**

Win/Win. Produce the highest quality product you can for the consumer -- give them the very best you can.

5. **Seek First to Understand, Then to be Understood.** Understand your elevator pricing, discounts for dockage, and protein premiums. What is it that our clients want and how can I get it to them in a timely manner?

6. **Synergize.** Work together with your banker, elevator manager and explain to them what strategies you have in mind and ask how you can best work together in order to mutually benefit.

Maturity Continuum

Dependency

Independency

Interdependency

You take care of me.
I blame you.
 Need **others to get effort**
what I want.
 I can't do anything to help myself

Get what you want with
Your own effort.
I can do it.

I will...
I prefer...
Self reliance

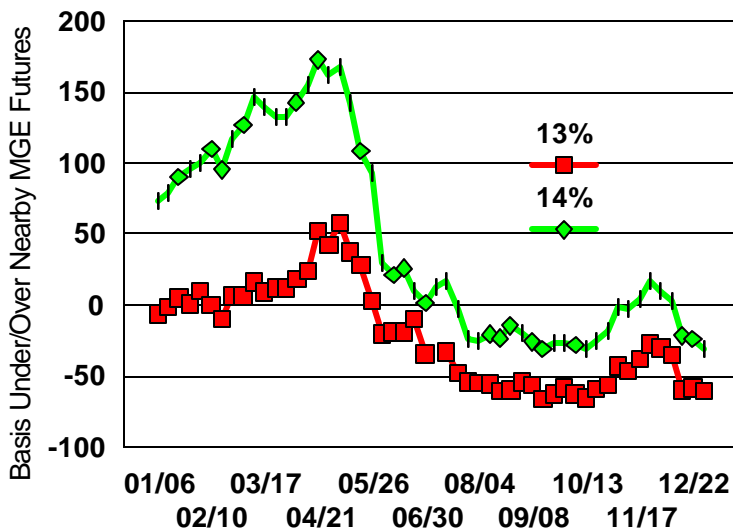
“WE”
Cooperation
 Requires **our own**

And effort of others
 To get what they want.
 Alliances, Marketing Clubs

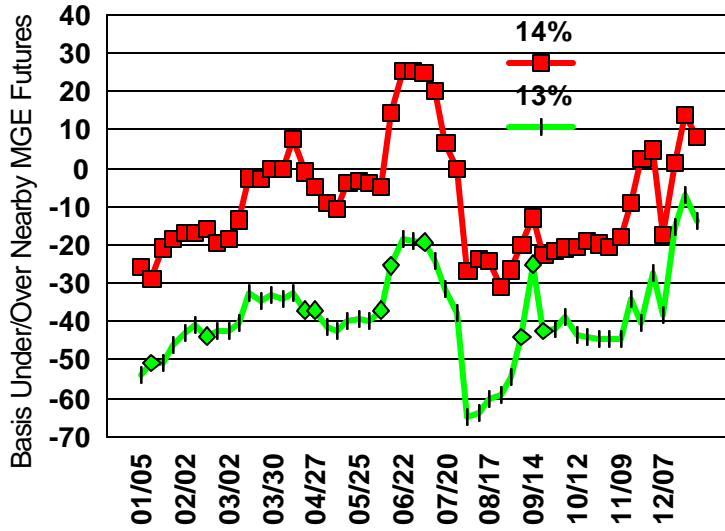
7. **Sharpen the Saw.** Join and attend a marketing club and contribute to its organization and function.

Appendix: Spring Wheat Basis - Glendive MT

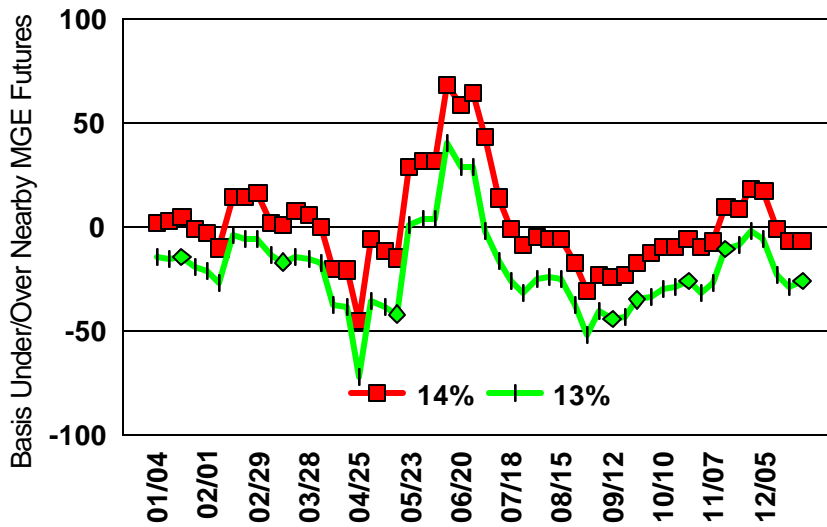
LOCAL SPRING WHEAT BASIS 1994 Glendive MT



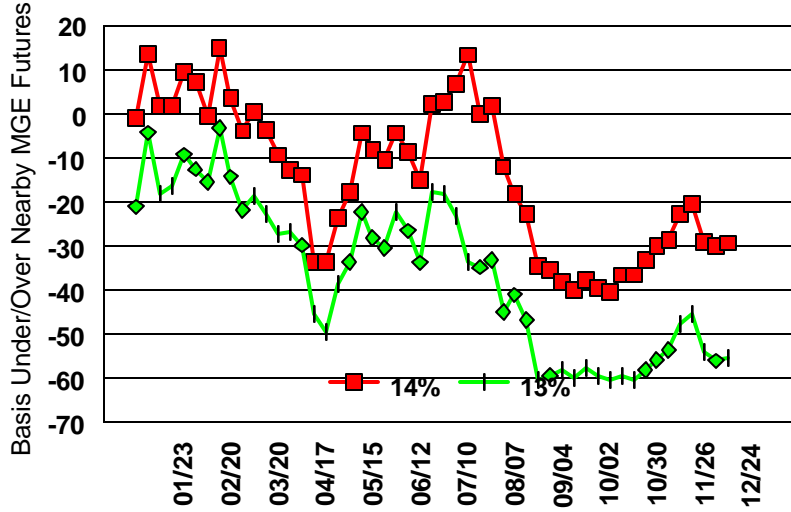
LOCAL SPRING WHEAT BASIS 1995 Glendive MT



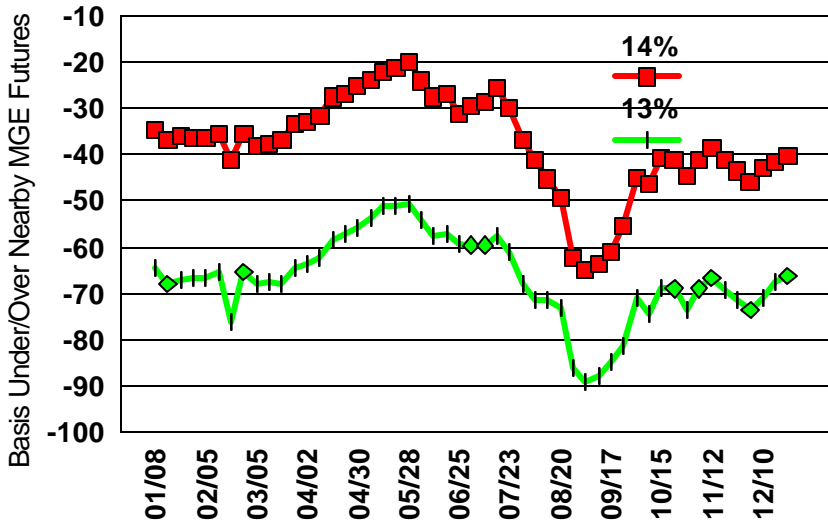
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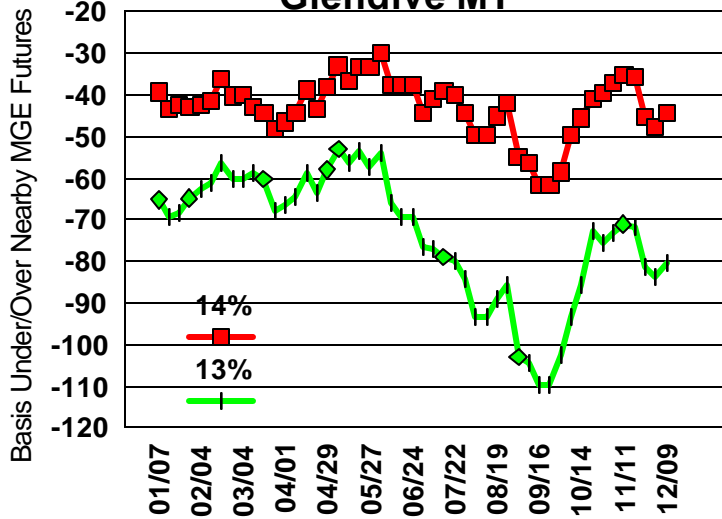
Local Spring Wheat Basis 1997 Glendive MT



Local Spring Wheat Basis 1998 Glendive MT

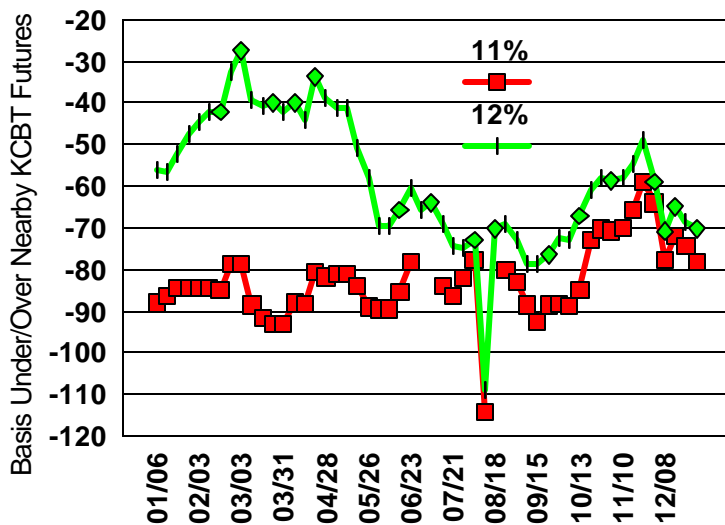


Local Spring Wheat Basis 1999 Glendive MT

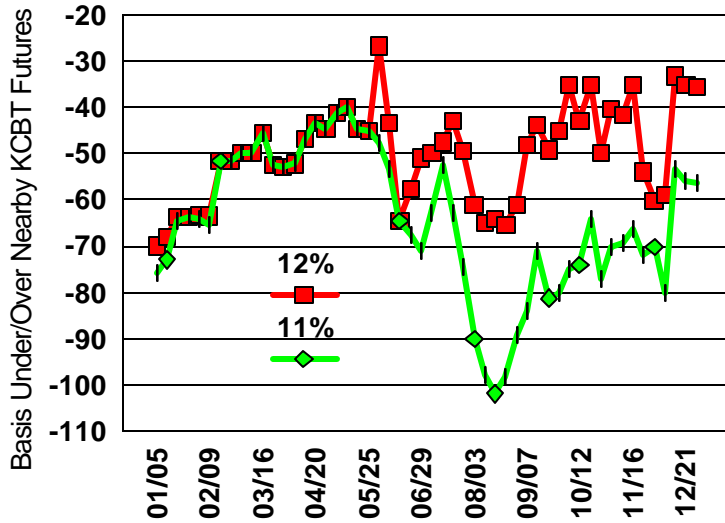


Appendix: Local Winter Wheat Basis

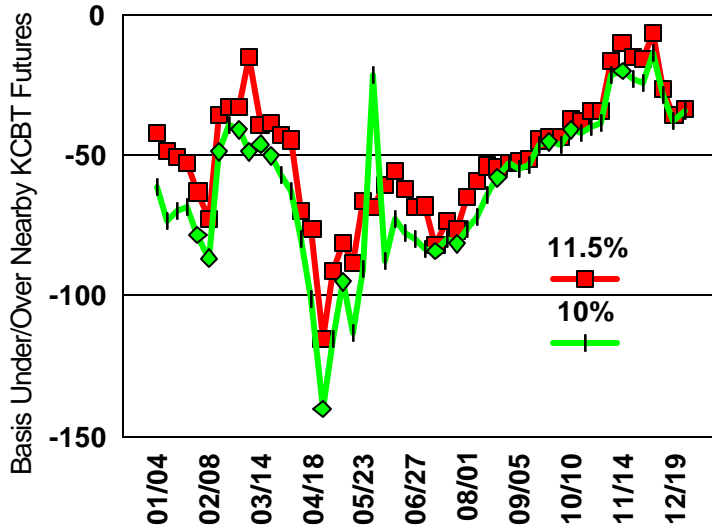
LOCAL WINTER WHEAT BASIS 1994 Glendive MT



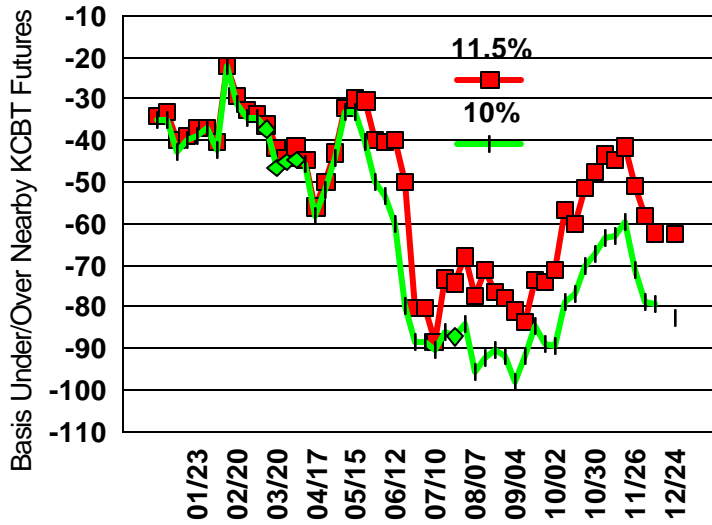
LOCAL WINTER WHEAT BASIS 1995 Glendive MT



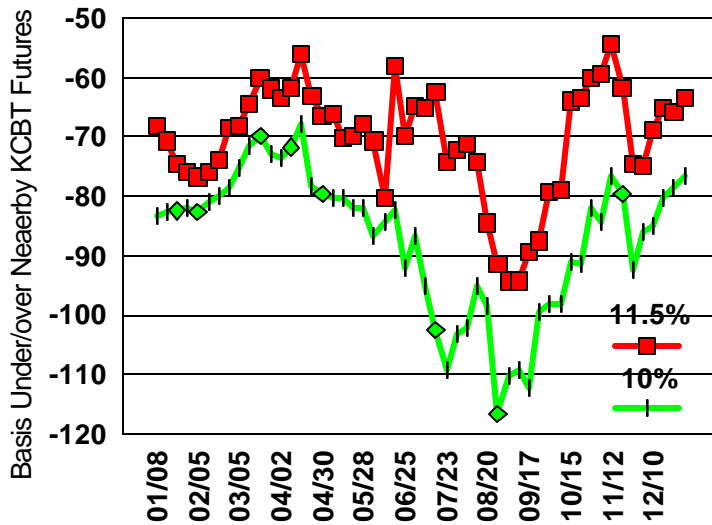
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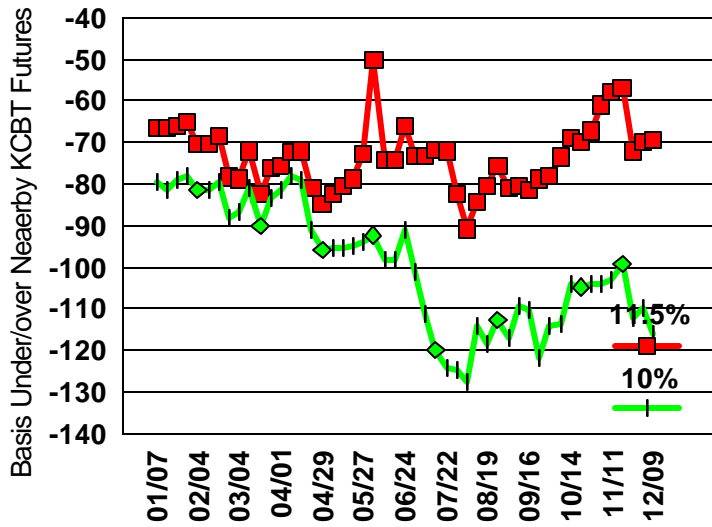
LOCAL WINTER WHEAT BASIS 1997 Glendive MT



Local Winter Wheat Basis 1998 Glendive MT



Local Winter Wheat Basis 1999 Glendive MT



Appendix: Basis Form

DATE	PNW BASIS										LOCAL BASIS															
	14% DNS AT PORTLAND					12% HRW AT PORTLAND					LOCAL BASIS DNS-GLENDIVE					LOCAL BASIS WINTER WHEAT-GLENDIVE										
THURSDAYS	14%	13%	Futures	MCE	MCE MARCH	14%	13%	Futures	11.5%	10%	11.5%	10%	CASH	CORN	BLV	14% cash	13%cash	MCE	14%	13%	FUTURES	11.5%	10%	11.5%	10%	
01/07			361.25			-361	-361				0	0	0	322	296	361.25	-39	-65	254	241	320.5	-67	-80			
01/14			361.25			-361	-361				0	0	0	318	292	361.25	-43	-69	248	233	314.5	-67	-82			
01/21			356.25			-356	-356				0	0	0	314	288	356.25	-42	-68	240	227	309	-66	-78			
01/28			360.75			-361	-361				0	0	0	318	296	360.75	-43	-65	244	231	309	-65	-78			
02/04			366.5			-357	-357				0	0	0	314	294	356.5	-43	-63	234	223	304.5	-71	-82			
02/11	426	402	350.25			76	52		353	338	297.5	56	41	0	309	289	350.25	-41	-61	227	216	297.5	-71	-82		
02/18	414	392	336.25			76	56		346	331	288.5	58	43	0	300	280	336.25	-36	-56	220	209	288.5	-69	-80		