Basis – marketing's often overlooked opportunity

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Here is a riddle…Two farmers price corn at the same elevator (just outside Memphis) at exactly the same time (Aug 30, 2012). Neither received preferential treatment yet one farmer gets 75¢ more per bushel. How could that happen? The answer…One kept up with the "basis" and took advantage of an opportunity, the other did not.

At a time when profit margins are uncertain and a few cents per bushels can make a difference, many farmers are overlooking an important strategy. With a little understanding of how the game works and some preparation, a producer is often able to significantly add to his or her sale price. It begins by asking the right questions when you talk with your buyers. "What are you paying for beans today?" will only tell you part of what you need to know. If you want to take advantage of every opportunity you will also ask, "What is your basis?" and you will ask that question over and over throughout the year.

While most producers understand that "basis" is the difference between the price the buyer is willing to pay and the current futures market, many still focus solely on the "cash price". Even those who understand what basis is will often not put themselves in position to take advantage of their opportunities. "Working the basis" requires a little preparation and a little work but can pay big dividends.

First a little background information. Despite what a producer may think at times, the "basis" is not a number the buyer arbitrarily comes up with out of thin air. It generally reflects transportation and handling costs the buyer expects, a minimum profit for the buyer and very importantly, local supply and demand considerations. It's that last component that often determines whether it is a good time for a producer to lock in the current basis or wait for a better opportunity.

Look at it from the buyer's perspective. Basis is the primary tool a buyer has to influence a farmer's decision. When the local supply and demand situation is tight and the buyer needs production now, they will "narrow" or "tighten" the basis in order to encourage producers to sell. Chances are other buyers in their area also need production and they often end up battling for business. In this sellers market, a producer will often find attractive basis opportunities. When supplies are ample and the buyers see no need to encourage producers to sell just then, they will widen their basis. That is generally not the best time for a producer to set the basis.

A farmer has three basic choices when it comes to negotiating a contract with a buyer. He or she can lock in both the futures and the basis at the same time (straight booking), lock in just the basis (basis contract) or lock in the current futures price only (hedge to arrive). That flexibility means a producer can deal with basis risk and futures risk separately on their own terms.

Let's go back to our riddle and take basis data from a Memphis elevator. On Aug 30, 2012 let's say corn futures are trading at $8.10 at the time both farmers price their corn. The basis at the time was -80 which means the buyer was paying $7.30. Several months earlier for various reasons the basis at this same elevator was -5. One of our two farmers made it a habit to call this elevator once a week and check on the basis. He had been doing this for years and had some historical data. He knew for example, the pre-harvest basis at this particular elevator tended to range between 0 and -30. When he saw the basis firm to -5 he knew this was an opportunity so he called and negotiated a "basis contract" set at -5. Let's go forward to the sale day. Our basis watching producer informs the buyer he is ready to price his basis contract. His final contracted price is set at $8.05 ($8.10 - $.05). His neighbor who sold at the same time only gets $7.30 ($8.10 - $.80).

The preceding is admittedly an extreme example but is does show the benefit of "basis watching". Opportunities to lock in a favorable futures price and a favorable basis rarely show up at the same time. Very often basis will actually widen (get worse) when futures prices go up because buyers do not have to use basis to encourage sales, the futures market does it for them. Producers who only focus on the cash price will often sell when basis is not in their favor.

What should a producer do? Our suggestion is to do what we do for clients, call a key elevator once a week in your area and ask for basis quotes. Once you get several years of data, you are able to identify seasonal tendencies and typical ranges which can prove very helpful when you make your basis decisions. Whether you do it yourself or get someone else to do it for you, but by all means keep up with your basis.
