STATEMENT OF
THE AMERICAN BAKERS ASSOCIATION

PREPARED FOR THE SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

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Excessive Speculation in the Wheat Markets

American Bakers Association

The Voice of the Baking Industry Since 1897

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The American Bakers Association (ABA) thanks the Senate Permanent Subcommittee on Investigations, and especially Chairman Carl Levin and Ranking Member Tom Coburn, for holding this critically important hearing on *Excessive Speculation in the Wheat Markets.* ABA greatly appreciates the opportunity to present its views to the Committee.

ABA is the national trade association that serves as the principal voice of the American wholesale baking industry. Its membership consists of more than 200 wholesale bakery and allied service firms. These companies include a variety of sizes, ranging from family-owned enterprises to Fortune 500 corporations. Together, these companies produce approximately 80 percent of the nation's baked goods. The baking industry generates over $70 billion in economic activity annually and employs close to half a million highly-skilled people.

Introduction

Since the inception of the grain exchange over 150 years ago, bakers and other wheat users have utilized this medium for purchase of necessary ingredients. Agricultural futures markets were created as a medium for producers to sell their commodities, including wheat, to users of the physical product. As stated on the Minneapolis Grain Exchange website, these markets were created to "address price risk management needs of buyers and sellers [and to] promote fair trade and to prevent trade abuses in wheat, oats and corn."[1] These markets enabled farmers to know what price they could receive for their grains in coming months and years and allowed manufacturers to plan for the future by using these same price points as a component for the food products they produce. This was, and still should be, the intent of these critical markets.

Unfortunately the true purpose of these markets has been skewed as new investment opportunities in agricultural commodities have arisen. With the influx of a category of "buy and

[1] Minneapolis Grain Exchange: About MGEX: <http://www.mgex.com/history.html>

hold" investors, commodity prices rose to record levels in 2008. Index funds increase market volatility when they enter the market using a "buy and hold" strategy in an exchange not originally created for investment purposes. Unlike the traditional speculator, who provides valuable liquidity to the markets and often acts as a link between agricultural producers and end users through buying and selling, index funds simply buy and buy more. They are buying agricultural commodities and using this investment as a new, marketable asset class. Grain is not an asset class but an ingredient in many basic foodstuffs, staples of the American diet.

The increased, unrestricted participation of these index funds artificially amplified the price of agricultural commodities, including wheat, in 2008, and this continues today. Physical users of the commodity compete with asset holding investment groups who operate with no limits to the amount of wheat they can purchase, unlike traditional market speculators. Due to the index funds' "buy and hold" strategy, volatility has greatly increased, adding undue financial risks to farmers and end users, including bakers.

Price discovery based on market fundamentals has diminished in importance in today's markets. Traditional hedging tools once allowed producers and end users to hedge their financial exposure, but now these same tools are difficult to manage and finance since index funds entered the wheat market. Historically speaking, a 10 cent price change in any wheat futures contract was considered extreme. But today, market fluctuations of 30 to 40 cents a day are all too common. As a recent example, in late May, wheat prices on the Chicago Board of Trade rose by over 30 cents in one day, just to have prices fall by almost 60 cents a few days later. This represented a 9.5 percent drop in prices in one day. On Monday, July 13th, 2009, prices again rose by 25 cents. As long as index funds hold up to 196 percent of this year's wheat contract[2]

[2] Commodity Futures Trading Commission, Commitment of Traders Report: <http://www.cftc.gov/dea/futures/deacbtlf.htm>

and operate without contract limits, volatility in the markets will continue to harm farmers, food producers, and American consumers.

In addition, examining data compiled from January 2005 to December 2007, the daily average trading ranges for the Chicago wheat contract increased 158 percent, with a similar trend in wheat contracts traded in Kansas City and Minneapolis. Over the last six months of 2007, ranges in the Chicago wheat contract increased to 226 percent.

Implied volatility has also increased at an alarming rate. From January 2005 to December 2007, the daily volatility of the wheat pit at the Chicago Board of Trade has increased 34 percent. A similar pattern exists when looking at the average wheat futures market volatility within the last six months of 2007, with variations of up to 39 percent.

This problem is not limited to Chicago wheat futures but also impacts other grain exchanges. As an entire commodity sector, volatility has been elevated due to the activity of index funds. The significance of the index fund position is increased due to the finite nature of the supply of physical wheat. Wheat is a one crop per year commodity. Once harvest is complete there will be no opportunity to increase the supply until the following year. In other words, wheat growers can’t plant more to satisfy market demand once the season has ended. Physical users of the commodity will acquire ownership equivalent to their usage levels and producers will sell their available supply up to the amount they have in their possession. With accumulation of long only positions by index funds, the availability of futures contracts diminishes as they effectively take contracts out of the available pool. The result is classic economic theory of supply and demand; the few remaining contracts are price rationed to reduce the demand for additional purchases of contracts.

Because of the inelastic demand for basic food products such as bread, end users are forced to continue purchasing contracts as the physical commodity is needed to produce food. As a result, the price of the commodity is higher than it would be if the index fund long position was not in existence, or if the fund operated under specified contract limits. In addition, resulting volatility renders the market much less effective as a hedging tool. When viable contracts representing major portions of the wheat harvest are technically taken off of the market by "buy and hold" investors, market volatility will always increase. This, in turn, eventually leads to higher food prices for American families.

Baking Industry Impact

As mentioned before, the baking industry generates over $70 billion in economic activity and employs almost half a million people. This economic activity came under heavy pressure in late 2007 and early 2008. As the Subcommittee is aware, wheat prices skyrocketed to record highs during this time, pushing many bakers to the limits of running a viable operation. In March and April 2008, wheat, cotton, soybean, and later corn prices, all skyrocketed to new record levels. Wheat on the Minneapolis Exchange rose to just over $24 a bushel, almost four times above the historic average, and three times above prices from the previous year. Wheat traded on the Chicago Board of Trade rose to above $13 a bushel, well above prices set the previous year. The daily move limit, or the limit to the amount any commodity can rise or fall during one trading day, was reformulated in January 2008 to account for Minneapolis Grain Exchange hitting the daily move limit on 16 of 21 business days and all three grain exchanges hitting the daily move limit for five consecutive days in February. The impact of these extreme price movements was that the exchanges closed down a few minutes after opening, meaning that farmers could not sell their commodities nor could bakers purchase needed ingredients for food production.

In response, members of the American Bakers Association participated in multiple events and held many meetings with Congress and Administration officials to discuss solutions to the crisis. In March 2008, ABA members filled the halls of Congress to petition their elected leaders for assistance in overcoming the looming food price crisis as part of the Band of Bakers March on Washington event. Follow up visits with many members of Congress occurred in additional meetings in June and September. ABA was also fully engaged with the Commodity Futures Trading Commission (CFTC) this past year, participating in the April and July meetings regarding volatility in the markets. In January 2009, ABA welcomed the opportunity to meet with staff members of the Subcommittee who were gathering critical information to create the recent report that spurred this hearing. Most recently, ABA submitted comments to the CFTC supporting the concept release proposing that new rules be offered to impose limits on index funds. ABA has been fully engaged in this issue as it is critically important to the basic operations of bakers across the country.

ABA was also invited to testify in Congressional hearings held by the Joint Economic Committee and the House Committee on Small Business in May 2008. Richard Reinwold, owner of a small family retail bakery in Long Island, New York, testified to the Joint Economic Committee that record high wheat prices were detrimental to his business:

> "In the last 12 months, we have seen explosive price increases on just about every commodity we use. This has created a perilous situation that threatens our ability to continue doing business in our community. For example, a one-hundred pound bag of bread flour that cost $17.00 in 2006 today costs $52.00. Semolina flour was $21.00 per one-hundred pound bag; today it is $72.50. Soy oil and eggs have also doubled in the last year.

> In a matter of weeks, our cost of goods sold soared to an all time high. Our bowl cost, or the cost of dough coming out of the mixing bowl, went from twenty-two cents per pound to fifty-one cents per pound for rye bread.
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> How does one respond to such increases? In the past, Reinwald's Bakery has tried to couple small price increases with a strategy that enabled us to 'sell' our way out of difficult times. The classic business response to rising material costs always has been to increase prices, cut labor, eliminate waste, seek economies of scale and pressure suppliers. We have been forced to do all of these things recently and until December of last year our strategy was working. Then in January the crisis came full circle – flour prices again reached new highs and wheat supplies plummeted to new record lows. Today I ask myself what strategy will we use to survive this year - what will we do now?"[3]

Frank Formica, owner of Formica Brothers Bakery in Atlantic City, New Jersey, shared a similar story in his testimony before the House Committee on Small Business:

> "Let me share a couple of examples of how the current conditions are impacting Formica's and our customers. Formica's uses over 50,000 pounds of flour a week. The price of baker's flour had been stable for well over 20 years at 14 cents a pound. Starting in September 2007 the price of flour jumped until it reached a peak of over 60 cents a pound in March. Today the price of flour has moderated a little. What does this mean to Formica's? A year ago we paid $7,000 a week ($364,000 a year) for flour …. Today that number is $20,000 per week ($1,040,000 a year) for the same amount of flour.
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> In addition to flour, all of our ingredients have substantially increased. On top of ingredients, the cost of distributing our products has soared - further threatening my business and the livelihood of the families of my employees. Formica's uses over 600 gallons of fuel a week to deliver product to our whole sale customers. Last year those costs averaged $1,200 a week, or $62,400 a year; today the cost is $2,000 a week, or $104,000 a year, for the same amount of fuel."[4]

In addition to these comments shared with Congress, Len Amoroso, owner of Amoroso Baking Company in Philadelphia, Pennsylvania, added his experience in comments given during a press conference held in conjunction with the ABA sponsored Band of Bakers March on Washington D.C. in March 2008:

> "A year ago my company was paying $14.66 per hundred pounds of flour. Two weeks ago I was quoted $57 for that same flour. That is nearly a 400% increase in my main ingredient. At that price, my flour cost would increase

[3] Richard Reinwold, Testimony Before the Joint Economic Committee, May 1, 2009
[4] Frank D. Formica, Testimony Before the House Committee on Small Business, May 15, 2009

> over $13,000,000 for the year. There is no way my company or any bakery in the country can absorb that kind of an increase without passing it on to their customers. The impact flour prices have on consumer pricing is dramatic. Producing with $57 flour, I would need to raise my prices over 32%. Even if flour were to stabilize at current prices which are around $40 per hundred pounds, we would need a 20% increase over last year's bread prices.
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> In addition to the price, we have had to deal with volatility in the markets that is unprecedented. For a two week period in February, wheat was increasing so fast that the markets were closed minutes after they opened. For decades the wheat markets could only increase by 10 cents per bushel in any day. Once that limit was reached the markets were effectively closed for trading until the next day. Because that limit was being reached within minutes of the market opening, the limits were increased to help stabilize the markets. Now we see days where the price per bushel has risen $1.35 in a day. Before it would take nearly 5 days for that to happen, which I never remember happening in my 40 years of experience.
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> With this type of volatility, the small baker in this country is going to find it increasingly difficult to manage his business and stay profitable. If he buys flour at the wrong time his cost can be substantially higher than his competitors. If he waits to buy, the market can run up on him to the point he can't afford to pay for the flour."

These experiences are similar throughout the entire wholesale and retail baking industry.

The impact of market volatility has driven away smaller, but extremely important market participants. Small businesses, including bakers, grain elevators and millers, who cannot qualify for large credit lines, may find it extremely difficult to participate in the current market. For example, in December 2007, the required wheat hedging margins at the Chicago Board of Trade increased 114 percent from the initial $700 per contract to $1500 per contract. During a nine day time span in October 2006, these required margins rose by $450, a 56 percent increase due to the upward volatility of the wheat market. These businesses may look for alternative hedging mechanisms since their ability to maintain liquidity is greatly reduced by an increasingly volatile market. Hedging in the futures markets may become an activity reserved for companies that carry extremely large amounts of liquidity and credit.

Convergence

The lack of convergence continues to be a major issue in the futures market. In an effectively operating commodity market, cash and futures prices will tend to come together during the delivery month. However, particularly in the Chicago wheat market, wheat futures prices are increasingly disconnected from wheat cash prices. As published in the recently-released report from the Permanent Subcommittee on Investigations, from 2000 to 2005, the average daily difference between the average cash and the futures price for soft red winter wheat traded on the Chicago exchange was approximately 25 cents. During the second half of 2008, this price differential jumped to between $1.50 to $2.00 per bushel higher than the average cash price, “an unprecedented price gap,” according to the report. Most recently, the July Chicago Wheat contract continued to lack convergence, with a 50 cent gap between cash and futures prices. While an improvement over a $2.00 per bushel gap, it is still double that of the historic average.

Commodity prices fluctuate for a number of reasons, including increasing/decreasing demand, adverse weather, supply problems (including crop disease), and other natural market factors. While these natural market factors played, and continue to play, a part in commodity markets volatility and the attendant lack of convergence, the impact of the index fund cannot be understated. ABA strongly believes that the lack of convergence exhibited in the market, and particularly the Chicago wheat market, is a symptom of the problem caused by the accumulation of long-only positions by index funds, rather than the problem itself.

ABA greatly appreciates the efforts of CME to address convergence issues with the wheat contract through increasing barge rates and adding delivery points. However, these actions are directed toward a symptom rather than the root problem.

Although traditional supply and demand economics were also at play in 2008, the market's inordinately volatile reaction to record low wheat supplies points to a deeper cause. Support for this view is evidenced by what occurred in the cotton contract during this same time. Like wheat today, cotton supply in 2008 was ample to meet the needs of the market. But prices, irresponsive to traditional market variables, followed a similar trend as wheat, also reaching record highs. While wheat prices have tempered, volatility, as previously discussed, and convergence, continue to disrupt the functionality of markets.

Policy Solutions

Congress and previous administrations understood the possibility of a speculator "cornering the market," which is why the government first instituted speculative contract limits. But the index fund has been categorized differently from that of a traditional speculator – they operate under the auspices of a bona-fide commercial hedger. Bona-fide commercial hedgers receive an exemption allowing them to operate without contract limits, and are only limited to the actual amount of grain they will use for food or feed production. Due to this discrepancy, the index fund currently operates in the market without encountering any natural or regulatory limit to the amount of contracts that can be purchased. ABA strongly believes that index funds must operate within the confines of a contract limit, similar to the limits that traditional speculators have efficiently operated under for many years. In order to address this critical market issue, ABA urges Congress and/or the Administration to:

- Restructure the definition of a commercial hedger to ensure that only those entities that use the physical product for production purposes continue to receive the unique benefits of the current definition.

- Restructure reporting classifications to accurately report contract holdings of commercial hedgers, index funds and all other contract holding entities.

- Place appropriate contract limits on the index fund, similar to those contract limits traditional speculators currently operate within.

These actions are critical to restoring the integrity of the Chicago Wheat contract, and all other wheat contracts, and will allow the market to return to manageable volatility. As such, ABA fully supports the Subcommittee's recommendation to phase out existing wheat waivers for index traders by creating a standard limit of 6,500 wheat contracts per trader.

In closing, ABA would again like to thank Chairman Levin and Ranking Member Coburn, as well as members of the Subcommittee, for the opportunity to provide the Association's views on this important subject. Volatility in the markets is a major concern to the baking industry. Today's volatility represents millions of dollars daily in undue financial risk to the industry. Our hope is that the Commodity Futures Trading Commission will react quickly to implement these limits on wheat contracts traded through the exchanges in order to reduce volatility and improve convergence. Only through these actions will the commodity markets return to responding to natural and fundamental supply and demand influences.