Planning for 2008: Costs and Risks Rising with Grain Prices

by Bruce Erickson

Nearly all of the financial benchmarks have shifted upwards for Midwest crop producers. Prices for corn, soybeans, and wheat are high, as is the cost of seed, fertilizer, and land. While high grain prices have certainly drawn a lot of attention, it is the margin between grain prices and costs that is the more important factor, and a less straight-forward measure.

“Those increases in grain prices are somewhat misleading,” said Mike Holden, a west central Iowa farmer and cattleman. “Direct payments, countercyclical payments, and LDPs in past years resulted in per acre gross incomes that were perhaps 20% lower than what you might have with today’s grain prices. With the upward spikes we’ve seen in fuel, fertilizer, and seed, times aren’t as flush as many would want you to believe.”

Input prices and land charges are expected to move even higher for next year and with virtually no government safety net, the 2008 crop will expose producers to ever higher levels of risk. Based on Purdue’s 2008 Agricultural Outlook, here is a look at some of the fundamental factors affecting production next year:

Record Corn Crop, Record Usage The market needed more corn in 2007, and producers responded by producing 13.3 billion bushels (September estimate). Record usage due to the huge growth in ethanol production is expected, growing to 12.8 billion bushels, with ethanol consuming 27% of that. World stocks will remain very tight, near the record lows of the mid-70s. Strong economic growth outside the U.S. and the low value of the dollar mean foreign export demand will remain strong and compete with livestock and processors for those tight supplies.

The ethanol industry is expected to experience some growing pains this fall and into 2008. Ethanol producer margins are expected to narrow and reach breakeven or even losses. This will likely slow some plant construction plans, and may result in fewer bushels going into ethanol. At current ethanol prices breakeven corn prices are currently about $3.00 to $3.50 per bushel—prices above that may result in some plants running at less than capacity.

Soybeans Shift from Surplus to Short Fewer soybean acres and average yields will result in this fall’s harvest being about 18% below last year’s. Yet, domestic crush is expected to remain high as the use of soy meal remains strong, the capacity for biodiesel continues to grow, and there is continued strong export demand. The result will be that the world market will rely on U.S. supplies this fall, and then the size of the South American crop will help determine prices into the winter and spring. Basis levels are depressed this fall, so soybeans may provide higher returns to storage and probably have higher upside price potential for those who store and speculate. Expect more soybean acres in 2008.

Record Wheat Prices: Wheat/Double Crop Soybeans Attractive Option This year’s below-normal wheat yields in the U.S. and poor yields in parts of Australia, Europe, and Canada have tightened wheat supplies so much that wheat is no longer a partial feed grain, but priced only as human food consumption. Other countries are aggressively buying up U.S. inventories this fall. Worldwide acreage next year is expected to increase, bringing prices back down. Still, next year’s prices are forecast to be strong at around $5.50. At this price the budgets for winter wheat/double crop soybeans beat single crop corn or soybeans in traditional double-crop areas such as southern Illinois, southern Indiana, and southern Ohio.
**Input Prices Up—Way Up**  The cost of producing corn and soybeans has risen every year since 2002, but the biggest bump is likely for next year’s crop—Purdue’s cost and returns forecast for 2008 currently indicates that the variable costs of growing rotation corn after soybeans will increase approximately $37/acre (16%) relative to 2007. For soybeans it is a $19 (16%) increase, and for wheat, $25 (21%). These figures are all for average yield situations. Comparing back to 2002, that’s an increase of $129/acre for corn and $42/acre more for soybeans. Clearly the grower’s financial risk exposure increases as the dollars invested in an acre of crops increases.

**Land Prices and Rents Moving Ever Higher**  Cash rents are expected to move strongly higher in the year ahead. Budget projections indicate increases of at least 10% could occur. This would follow 2007’s 9% increase in cash rents and 17% increase in land values as measured by the June Purdue survey.

This new environment has created uncertainty about how to divide the net return, or the margin that remains after paying for crop production inputs, the investment in machinery and facilities, and labor to produce the crop. One part of this margin is the return to land—the other a return for the risks of growing the crop. In a cash rent situation, the landlord receives the return to land and the tenant receives the risk-taking return.

**Margin Sensitivity**  The following example demonstrates how sensitive returns can be with fluctuating grain prices. Assuming average productivity soils on a 3000 acre corn/soybean rotation farm, $3.25 corn with production costs (including labor and machinery) at $358/acre, $7.80 soybeans with production costs at $221 per acre, Purdue budgets show the return to land and risk in a corn/soybean rotation is about $175/acre. If corn and soybean prices drop just 10% below the above levels but production costs remain the same, the land/risk margin decreases nearly 40% to about $110/acre. This is before considering possible fluctuations in input costs or eventual yields.

**Safety Net Dragging Bottom**  The relatively low current commodity program safety net provides little protection with these higher costs and rents. Developing plans to manage the margin risk is important this year—unexpected grain price declines could turn anticipated positive returns into losses more quickly than in the past. Margin management considers both input costs and output values, crop insurance, and diversity in management strategies, among other factors.

At Holden Farms, Mike received lease termination notices from a few of his landowners, a common occurrence across the Corn Belt this year. “While I don’t necessarily enjoy getting these types of notices, this is all part of the process,” said Holden. In Iowa, unless otherwise specified, leases renew with the same terms unless the tenant is delivered notice before September 1. “It is important to keep open communication--my goal with all of my rented or shared ground is to foster a long-term relationship that is positive for both the landlord and me.”

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