

The Adequacy of Delivery Points On the ICE Number 2 Upland Cotton Contract*

Background

Recently, the Intercontinental Exchange (ICE) received a request from the American Cotton Producers (ACP) to establish new delivery points on the ICE Number 2 Upland Cotton Contract (Contract).

There should be no issue regarding cotton delivery points on the Contract. Unlike other agricultural futures contracts, the existing delivery points facilitate convergence in addition to providing storage space far in excess of the contract requirements. Simply put, in cotton there is both convergence and an overcapacity of storage space for delivery.

Within the cotton industry, another Texas delivery point is a political and not an economic issue. It is an argument lacking substance premised on a misunderstanding of the principle purposes of a futures market for providing price discovery and price protection through hedging.

Those advocating this position mistakenly believe that had there been a delivery point in Lubbock or Dallas, they would have been able to capture a chimera, the \$1.09 price, on March 3, 2008. What they fail to realize is that those with cotton in position on that fatal day – those long physical cotton and short futures - ended up either losing as much as 16 cents per pound in a matter of minutes or having to post well over \$1 billion in margin.

When the issue was initially raised in the aftermath of March 3rd, the National Cotton Council (NCC) appointed a Committee on Delivery Systems to review the issue. The NCC's economic staff and the Committee fully reviewed all of the relevant economic literature on the subject,¹ including the most significant study of cotton delivery points.²

The NCC summary of the economic studies reached the following general conclusions:

- The primary purpose of a delivery system is to ensure convergence between futures and spot prices during the delivery month, and is not designed as a means to obtain the contractual commodity.

* Prepared by the American Cotton Shippers Association.

¹ Pirrong, Haddoock, & Komendi, Grain Futures Contracts: An Economic Appraisal (1993); Irwin, Garcia, & Good, The Performance of CBOT Corn, Soybean, & Wheat Futures Contracts after Recent Changes in Speculative Limits (2007); Chance and Hemler, The Impact of Delivery Options on Futures Prices: A Survey (1993).

² Proposed Contract Market Rules, Chicago Board of Trade Medium Staple Cotton Futures Contract, Roger W. Gray, Food Research Institute, Stanford University, 1981.

- A good delivery system allows effective hedging by assuring a high correlation between cash and futures prices, contributes to market liquidity, generates a futures price that is broadly representative of prices in general, [and] is relatively invulnerable to manipulation by large traders.
- Delivery points should have sufficient storage space, access to multiple transportation modes, and a close connection with cash trading patterns. In addition, delivery points should be located closer to the final destination of commodity movement rather than the origin of movement.
- Delivery points and capacity should be sufficient to facilitate convergence but not so numerous as to increase the uncertainty and risks of taking delivery by consuming buyers.

No issue was taken by the Committee with regard to the Contract not comporting with these generally accepted delivery criteria. If any concerns were expressed, it was by those who consider themselves not sufficiently close to a delivery point, who desire the option of utilizing delivery as an alternative market strategy should the futures price diverge from the spot price – an opportunity that rarely occurs. The reason that neither producers nor merchants were able to take advantage of the price divergence in March 2008 was the lack of capital to finance their positions. It was not because of the availability of delivery points.

The final report of the NCC Committee on Delivery Systems concluded that it was “clear that no consensus emerged from the segment deliberations, particularly regarding key issues such as the location of delivery points.”

The merchants, mills, and warehousemen did not favor any change in the contract’s delivery points, while the producers, cooperative marketing associations, cooperative warehouses, and ginnermen (all producer organizations) favored additional delivery points close to their production areas.³ At the NCC Convention in February 2009, the producers brought the issue to a head recommending that New Orleans be dropped and Dallas added as a delivery point.

³ National Cotton Ginnermen responded that the New Orleans delivery point could be closed and replaced with a delivery point in Dallas. Cotton Growers Warehouse Association opposed consolidation but supported a possible relocation of delivery points, with Dallas as a possible alternative. CGWA also suggested a southeastern port location.

AMCOT suggested locations in Houston, Dallas, Memphis, Greenville, and Savannah. The ACP suggested that re-locating some of the delivery locations should be strongly considered rather than merely adding additional locations. Possible new sites that should be considered are Dallas, Lubbock, Corpus Christi, and Savannah.

Under NCC procedures the request was vetoed by the merchant segment.⁴ NCC procedures also permit any segment to take independent action, which the producers have done in this case.

The Issue

Over the life of the Contract,⁵ the issue of Western Delivery points in Phoenix, Bakersfield, and Fresno has been discussed and rejected by the cotton industry,⁶ since the cotton in these locations would be subject to the control of a few large merchants, one large producer, and a cooperative handling 50 percent of the Western region's cotton.

In the last five years, improved seed varieties have resulted in an ever increasing amount of West Texas cotton being tendered for delivery on the Contract. More importantly, the change in the crop pattern has resulted in West Texas now producing a substantial portion of the U.S. crop, giving rise to the request of West Texas producers to add Dallas and possibly Corpus Christi to the current Texas delivery points of Galveston and Houston.

The "financialization" of agricultural futures contracts through massive speculation, though now less an influence than in 2008, is also believed to be a contributing factor to the producers' belief that they could realize higher prices on the Contract than in the physical market. As we know, for part of 2008, the excessive speculative activity drove prices well above their spot market value.

The rise in prices leading into the March delivery period resulted in many producers mistakenly believing that they could have captured those prices if they had delivery points in their regional markets. The fact of the matter is that no one, including those with certificated stocks in the south west, mid-south, or southeast, was able to capitalize on that situation. Instead, as stated above, some were victimized by this market aberration, while others suffered by having to face unparalleled capital demands to meet margin calls impelled by a speculative run-up in the price of the options contract some 40% above the cash price.

Deliverable Supply & Storage Capacity

In the last five years, 2004 to 2009, the five Contract delivery points, Galveston (TX), Greenville (SC), Houston (TX), Memphis (TN), and New Orleans (LA) have averaged monthly storage totals ranging from as low as 60,000 bales in January 2005 to as high as 1.7 million bales in July 2008. As the data⁷ indicates, for the most part the combined Galveston and Houston totals are virtually similar with that certificated in

⁴ Under NCC procedures, any one of the seven segments can exercise a veto of a proposal. The warehouse and mill segments were also prepared to vote against the proposal.

⁵ The Number 2 Upland Cotton Contract began trading in March of 1967.

⁶ Id at footnote 2.

⁷ Attachment 1.

Greenville. More importantly, a significant portion of the Houston and Galveston stocks are of West Texas origin.⁸

Memphis far exceeds the combined totals of the other points given its centralized location, significant warehouse space, and transit capacity to either ship by truck to the domestic mill points or the east coast ports or to efficiently rail containers to the west coast ports.

The efficiency of Memphis as a delivery point is arguably the Contract's most valuable asset. This is evidenced by the large amount of West Texas cotton certified in Memphis – a minimum of 40 percent in 2006-07, which rose to 50 percent in 2008-09.⁹

Simply put, the delivery points are well dispersed and the economics are present for a cooperative, producer, merchant, or mill from any region of the country to make full use of the contract. The fact that the market participants who utilize the contract have no difficulty certificating West Texas cotton in three of the five delivery points demonstrates that the Contract is functioning as it should. Another Texas delivery point not only is unnecessary, but could have undesirable consequences.

Argument for Additional Delivery Points

The argument for seeking additional delivery points is not convincing and inconclusive at best.¹⁰ The advocates note only that the current points were established to reflect the line of transit to the points of domestic consumption and export.

While domestic consumption has been reduced by half in the last ten years due to foreign imports, the transit to export has not changed significantly in the last 35 years. The West Coast replaced the Gulf as the primary point of export in the 1970s, yet this has had no impact whatsoever on the cotton futures contract.

⁸ Data provided by private trade sources.

⁹ Data provided by private trade sources.

¹⁰ "The current delivery locations were originally correlated to a high percentage of domestic use and gulf export shipments. Cotton production in the southwestern region currently represents over 50% of the intended acreage for 2009. All indications are that this region will continue to be the dominant cotton production region of the U.S. It stands to reason that a delivery point should be located in a region where production and off take are concentrated.

"We contend that a Dallas location will provide more equitable access to warehouse capacity to a major cotton production area and represents a major transshipment point for the majority of cotton export in container vessels. While an argument can be made about the adequacy of cotton storage in the current delivery points, availability to such space is not equally accessible. Ownership of current capacity is closely controlled and expansion in some of the current sites is severely limited due to zoning and fire regulations. Because of no major infrastructure investment by cotton firms in the Dallas area, if this point is approved, all major interests would have equal opportunities to acquire or lease storage facilities."

The latest available data for 2008 of U.S. cotton exports by ports¹¹ lends no support to the point of transit argument. In the last few years, cotton has lost the competitive battle for land to corn and soybeans in the southeast and the mid south, permanent tree crops and urbanization have taken a significant amount of land out of production in the far west, while the acreage in the southwest has been less affected. Despite these changes, the contract operates efficiently within the current delivery structure providing accurate price discovery and convergence.

The other argument postured¹² is that “a Dallas location will provide equitable access to warehouse capacity to a major cotton production area” and that the “ownership of current capacity is closely controlled and expansion in some of the current sites is severely limited due to zoning and fire regulations” is apocryphal. The storage capacity in every delivery point has actually increased by a minimum of 35 percent.¹³ There is considerable space available in Memphis that has gone unused. In point of fact, the parties making this argument were reluctant to make the advanced commitments to lease the available space. As a result, some of the additional space that had been made available was shut down due to the lack of interest of third parties.

Argument Against Additional Delivery Points

It is often said that the perfect futures contract would be one on which no deliveries take place. As to multiple delivery points, early on, as the CFTC began to function in 1975, this issue was addressed by the Advisory Committee on the Economic Role of Futures Markets. The Committee Chairman, a member of the Commission, Dr. Gary L. Seevers, noted in his statement at the opening of the public hearings that:

“Producers, especially farmers, have long felt they should have more delivery points. To some extent this reflects their feeling that their basis would be more consistent, perhaps narrower, with a delivery point close at hand. To some extent it may be due to the mistaken feeling that a futures contract delivery point represents an additional cash market outlet. This probably should not be the case, since delivery on futures is seldom as efficient for the marketing chain as regular cash market delivery...”

¹¹ Attachment 2

¹² See paragraph 2, footnote 10.

¹³ Source: ICE Futures U.S.

COTTON CERT FACILITY STORAGE CAPACITY

	2005/06	2006/07	2007/08	2008/09
Memphis	1,130,040	1,195,540	1,530,540	2,030,540
Houston	65,000	85,000	85,000	120,000
Galveston	253,120	208,120	267,120	277,120
Greenville	200,240	189,480	198,510	406,510
NOLA	-	-		60,740
TOTAL	1,648,400	1,678,140	2,081,170	2,894,910

John R. Block, then testifying as a producer on behalf of the Illinois Farm Bureau, and who would later become Secretary of Agriculture, warned that:

“Too many delivery points could prove damaging to the existing futures market operations. If this happens, all producers, including those using the new delivery points, would suffer...”

Another witness at those hearings, Robert Alexander of the Pillsbury Company echoed Commissioner Seevers and the other witnesses, noting that:

“The prime purpose behind the futures delivery option is to maintain the relationship between the cash and futures. It should never become a substitute for a cash market. Delivery should be structured so it remains a relative inconvenience rather than the most convenient way of marketing cash (crops) ...”

The basic point or admonition expressed by all of the experts appearing before the Committee is the potential burden that a delivery point close by a delivering short, perhaps a large cotton cooperative, would place on the contract and eventually the shoulders of all producers.

The Advisory Committee Report concluded, “...that a commodity futures exchange is not a direct link in a physical distribution system for a commodity, but rather an auxiliary institution designed to enhance the working of the physical marketing system.” The report made the following recommendations pertaining to delivery point numbers and locations:

1. The contract must provide sufficient delivery capability to facilitate price convergence in the delivery month of the commodity’s cash and futures markets without distortion.

The ICE No. 2 Upland Cotton contract has more than sufficient delivery capability. The licensed warehouse capacity for certificating cotton is 2.9 million bales¹⁴ or 21% of the 2008-09 U.S. cotton crop, making it the agricultural contract with one of the largest delivery capabilities. More importantly, this substantial storage capacity, which has increased by 43% in the past four years, facilitates price convergence in the delivery month of both cotton’s cash and futures markets,¹⁵ and can be readily expanded for additional space.

¹⁴ See footnote 13 above.

¹⁵ The only known convergence problem occurred for a few weeks in the March 2008 contract as a result of excessive speculative trading.

2. Delivery points should not be added or changed unless that is necessary either to permit sufficient delivery capability or to significantly increase the net economic benefits of the contract.

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Currently, there is excess delivery capability. An additional delivery point could be an economic detriment to the contract.

3. The delivery point or points should be located at the markets for which prices are most important to those interests which use the contract or could be expected to use the contract. If delivery points are to be added or changed, it should be to significantly increase the net economic benefits of the contract. However, the possibility of continued use by those currently using the contract must also be considered.

Should a Dallas delivery point be added, it is likely to attract a large volume of West Texas cotton to the Contract. This would have the affect of depressing the overall price of cotton. Simply put, the best price would no longer be the spot price but the contract price. In essence, there would be one price – a lower price.

4. The exchanges and industry groups should constantly monitor the delivery points to assure their adequacy for effective hedging and price formation.

This process is ongoing by those actively using the market and periodically by the ICE Cotton Committee, which finds the delivery system adequate. In contrast to other agricultural contracts, the Cotton Contract works exceptionally well. It exceeds the adequacy standard.

In the present situation, where producers seek an additional Texas delivery point in Dallas, there is no economic justification for Dallas or another Texas location. Yes, Texas is producing more cotton, but that fact alone should not be the determinative factor. In contrast, while Iowa is one of the largest producers of corn and soybeans it has no delivery points. This proposal is plain and simple a misguided political effort to dictate delivery points.

What the proponents fail to realize is that a delivery point closer to the West Texas cotton fields, where in the current production dynamic upwards of 50-percent of the crop is produced, would likely dictate the futures prices for the entire cotton industry. The Dallas delivery point could put all U.S. cotton producers at a disadvantage. It would also limit and narrow the Contract's use as a widely accepted hedge for other world growths of cotton thereby reducing liquidity and ultimately the effectiveness of the Contract as a hedging market place.

Further, if the current cotton contract, which is working well, is deemed by the speculative community to be no more than a cash contract, they will go elsewhere with

their money. That would render the contract useless for producers to achieve valid price discovery or to hedge.

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Conclusion

In summary, the futures market was not designated to serve as a spot market, but as a market for price discovery and hedging. Hedging by producers is done solely to establish a price level for the cotton they have to sell in the spot market by locking in the more favorable futures price.

Professor Roger W. Gray put it best: “Futures markets best fulfill their major purposes of discovering a representative price level for a representative grade and quality of a commodity when they do not attract substantial deliveries.”

Summing up, consider these additional questions:

- o If you add an additional Texas delivery point in Dallas, a point more convenient to attract cotton from West Texas where upwards of 50-percent of the crop is currently produced, will the contract trade primarily as a Texas cotton contract?

Probably so, as the contract is likely to be overwhelmed with a large volume of West Texas cotton, thus making it a cash contract.

- o Would the addition of Dallas improve the performance of the ICE No 2 Upland Cotton Contract?

Probably not, given the uncertainty that would be created.

- o Will it benefit Texas producers?

Probably not, since the West Texas deliverable supplies would drive down both the futures and the spot price.

The addition of Dallas as a delivery point has no economic justification, nor would it benefit Texas producers. Were they to succeed, the likely result of their politicization of the contract would be lower prices across the Cotton Belt. For that reason alone, in order to protect their economic interest, their request should be dismissed.

In conclusion, the American Cotton Shippers Association, which represents a substantial majority of the commercial users of the Contract, strongly supports no change

in the Contract's delivery points as do most members of the ICE Cotton Committee, who represent a cross section of all industry segments.

Attachment 1

Monthly Averages

Cotton Historical Certified Stock Report Last Updated on 08-Jun-2009

Jun 2009 as of Jun 08, 2009

Date Posted	GALVESTON, TX	GREENVILLE, SC	HOUSTON, TX	MEMPHIS, TN	NEW ORLEANS, LA	Total
Jun-09	16,279	59,509	12,652	202,965	137	291,542
May-09	14,514	52,785	5,093	155,524	137	228,053
Apr-09	24,031	47,754	5,126	133,426	137	210,474
Mar-09	30,913	51,446	5,889	135,310	452	224,009
Feb-09	50,005	32,471	3,495	89,873	595	176,440
Jan-09	82,945	61,862	27,621	350,944	15,659	539,032
Dec-08	104,944	121,262	44,366	570,827	25,000	866,398
Nov-08	119,337	149,783	47,224	643,940	29,459	989,743
Oct-08	126,318	172,279	49,051	864,965	36,176	1,248,789
Sep-08	133,146	175,489	51,985	1,084,338	38,980	1,483,938
Aug-08	142,823	189,741	47,217	1,243,852	38,347	1,661,980
Jul-08	165,108	196,642	40,333	1,273,791	32,868	1,708,742
Jun-08	160,175	196,911	38,976	1,177,401	29,863	1,603,325
May-08	157,726	156,506	37,262	1,035,773	12,133	1,399,399
Apr-08	142,997	102,827	9,090	744,635	185	999,734
Mar-08	121,612	66,741	203	507,312	0	695,868
Feb-08	82,528	69,188	203	369,023	0	520,942
Jan-08	59,928	61,893	203	391,796	0	513,820
Dec-07	63,593	64,060	203	436,059	0	563,915
Nov-07	75,988	61,861	203	479,665	0	617,717
Oct-07	68,736	62,005	274	437,680	0	568,696
Sep-07	60,717	64,263	3,789	363,847	0	492,616
Aug-07	49,346	83,947	10,419	520,928	0	664,640
Jul-07	47,604	81,036	15,059	534,454	0	678,152
Jun-07	46,967	77,770	15,059	569,119	0	708,916
May-07	45,487	76,790	15,059	573,662	0	710,997
Apr-07	45,490	56,839	15,046	560,379	0	677,754
Mar-07	31,602	40,989	5,395	491,105	0	569,091
Feb-07	3,253	35,900	1,762	472,434	0	513,349
Jan-07	1,710	28,923	2,763	527,631	0	561,026
Dec-06	905	28,533	3,665	655,672	0	688,775
Nov-06	33,801	52,395	3,906	675,468	0	765,570
Oct-06	62,052	75,663	3,906	601,418	0	743,039

Sep-06	68,836	81,261	5,266	494,290	0	649,652
Aug-06	53,621	74,743	17,845	373,658	0	519,867
Jul-06	52,577	74,533	23,914	487,568	0	638,592
Jun-06	52,408	71,372	24,811	510,918	0	659,509
May-06	53,645	65,051	25,320	510,898	0	654,914
Apr-06	39,457	55,026	25,474	479,228	0	599,186
Mar-06	23,505	40,836	11,730	336,382	0	412,452
Feb-06	7,846	21,885	1,706	163,362	0	194,797
Jan-06	6,892	8,632	1,775	97,010	0	114,309
Dec-05	16,235	26,402	3,562	184,580	0	230,779
Nov-05	21,187	36,500	4,366	296,535	0	358,588
Oct-05	22,977	46,061	4,484	272,499	0	346,021
Sep-05	25,738	52,122	5,150	261,700	0	344,710
Aug-05	27,653	56,350	5,854	281,296	0	371,152
Jul-05	28,346	56,936	6,392	300,007	0	391,680
Jun-05	26,408	51,725	6,842	299,233	0	384,209
May-05	10,869	32,503	2,037	177,076	0	222,485
Apr-05	10,022	35,071	0	179,426	0	224,518
Mar-05	6,095	27,681	0	139,133	0	172,909
Feb-05	4,987	12,132	0	74,988	0	92,107
Jan-05	4,720	6,486	0	49,317	0	60,523
Dec-04	7,192	3,419	0	57,688	0	68,299
Nov-04	9,668	2,088	0	52,855	0	64,611
Oct-04	9,977	8,520	0	55,382	0	73,879
Sep-04	6,690	18,157	0	49,736	0	74,583
Aug-04	7,533	18,987	0	46,311	0	72,831
Jul-04	16,954	25,538	0	77,978	0	120,469
Jun-04	26,742	49,921	56	152,902	0	229,621

Attachment 2

East Coast Ports:

Savannah, Georgia	14.08%
Charleston, South Carolina	4.07%
Norfolk, Virginia	1.74%
Other	0.67%
	20.56%

West Coast Ports:

Los Angeles, California	42.18%
San Francisco, California	6.09%
Seattle, Washington	0.07%
Other	0.01%
	48.35%

Gulf Ports:

Houston-Galveston, Texas	12.22%
Laredo, Texas	11.86%
New Orleans, Louisiana	3.96%
Other	1.27%
	29.31%

Great Lakes Ports:

Detroit, Michigan	1.43%
Ogdensburg, New York	0.34%
Buffalo, New York	0.01%
Other	0.00%
	1.78%