

George Flaskerud
NDSU Extension Economist
February 8, 1999

<http://www.ag.ndsu.nodak.edu/aginfo/cropmkt/cropmkt.htm>

CONTRACTS



CONTRACT ELEMENTS

- Obligation to buy or sell
- Place
- Price
- Quantity
- Quality
- Delivery date
- Written

CONTRACTING IMPLICATIONS TO ELEVATORS

■ ADVANTAGES

- ▶ Volume
- ▶ Transportation efficiency
- ▶ Grain stock management
- ▶ Elevator profits

■ DISADVANTAGES

- ▶ Quality loss if grain stored
- ▶ Possibility of producer default

CASH FORWARD CONTRACT IMPLICATIONS TO PRODUCER

- Cash price is fixed
- Most frequently used marketing tool for locking in a price prior to harvest
- Possibility of drought and higher prices as well as the uncertainty of yields is a disadvantage of the CFC

CROP MARKETING STRATEGIES

<u>EXPECTED CHANGE</u>		
FUTURES	BASIS	ALTERNATIVES
INCREASE	STRENGTHEN	STORAGE DELAYED PRICE CON.
INCREASE	WEAKEN	BASIS CONTRACT MINIMUM PRICE CON.
DECREASE	STRENGTHEN	HEDGED-TO-ARRIVE CON.
DECREASE	WEAKEN	CASH SALES CASH FORWARD CON.

MINIMUM PRICE CONTRACT

- Cash contract based on the option market, which allows the seller to insure against lower prices and to take advantage of higher prices.

CROP MARKETING STRATEGIES

<u>EXPECTED CHANGE</u>		
FUTURES	BASIS	ALTERNATIVES
INCREASE	STRENGTHEN	STORAGE DELAYED PRICE CON.
INCREASE	WEAKEN	BASIS CONTRACT MINIMUM PRICE CON.
DECREASE	STRENGTHEN	HEDGED-TO-ARRIVE CON.
DECREASE	WEAKEN	CASH SALES CASH FORWARD CON.

MINIMUM PRICE CONTRACT FEATURES

- Elevator may use
 - ▶ Futures and calls
 - ▶ Puts
- Basis fixed at the time of the contract
- Option can be sold anytime before expiration
- Timing of delivery is specified
- Minimum quantity may be required
- How premiums and discounts will be handled are specified

MINIMUM PRICE CONTRACT EXAMPLE

Date_____

Delivery _____(Date)

Minimum price

_____Cash/CFC

_____Buy_____ Call (Mth & strike price)

_____Fees

_____Amount (Minimum price)

Final price established by _____ (Date)

Date_____

If futures = _____

_____Minimum price

_____Call value

_____Net selling price

Date_____

If futures = _____

_____Minimum price

_____Call value

_____Net selling price

MINIMUM PRICE CONTRACT ADVANTAGES TO PRODUCERS

- Price risk limited to premium
- Reduced price volatility
- Unlimited upside potential
- Another marketing alternative
- Delivery and pricing decisions separated
- Benefit from elevator efficiency
- Provides cash flow since minimum price is paid when grain is delivered
- Eliminates storage cost

MINIMUM PRICE CONTRACT DISADVANTAGES TO PRODUCERS

- Delivery obligation
- Cost of option (premium, fees, interest) which may be lost
- Risk of stronger basis
- Rely on integrity of elevator

BASIS FIXED CONTRACT

- Producer can lock in the basis
- The futures price is established at a later time
- Cash flow can be generated through an advance of the contract value after delivery of the grain

CROP MARKETING STRATEGIES

<u>EXPECTED CHANGE</u>		
FUTURES	BASIS	ALTERNATIVES
INCREASE	STRENGTHEN	STORAGE DELAYED PRICE CON.
INCREASE	WEAKEN	BASIS CONTRACT MINIMUM PRICE CON.
DECREASE	STRENGTHEN	HEDGED-TO-ARRIVE CON.
DECREASE	WEAKEN	CASH SALES CASH FORWARD CON.

BASIS FIXED CONTRACT FEATURES

- Basis is fixed at the time of the contract
Futures price is fixed at a time chosen by the seller
- Final date for pricing is specified
- Timing of delivery is specified
- How premiums and discounts will be handled are specified

BASIS FIXED CONTRACT EXAMPLE

Date _____

Delivery _____(Date)

Advance _____percent after delivery

Basis _____

Futures contract month _____

Price established by _____(Date)

Date_____

_____Futures price

_____Basis

_____Net selling price

Date_____

_____Futures price

_____Basis

_____Net selling price

BASIS FIXED CONTRACT ADVANTAGES TO PRODUCERS

- Can lock in favorable basis level
- Can receive a cash advance of the contract value after delivery
- Indirect method of replacing cash grain sales with futures
- No margin requirements
- Price flexibility
- Another marketing alternative
- Delivery and pricing decisions separated
- Benefit from elevator efficiency
- Eliminates storage cost between delivery and pricing of futures

BASIS FIXED CONTRACT DISADVANTAGES TO PRODUCERS

- Delivery obligation
- Risk of declining futures price
- Potential loss of some interest income
- Risk of stronger basis
- Rely on integrity of elevator

HEDGED-TO-ARRIVE CONTRACT (BASIS OPEN CONTRACT) (FUTURES FIXED CONTRACT)

- Producer can lock in the futures price
- The basis is established at a later time

CROP MARKETING STRATEGIES

<u>EXPECTED CHANGE</u>		
FUTURES	BASIS	ALTERNATIVES
INCREASE	STRENGTHEN	STORAGE DELAYED PRICE CON.
INCREASE	WEAKEN	BASIS CONTRACT MINIMUM PRICE CON.
DECREASE	STRENGTHEN	HEDGED-TO-ARRIVE CON.
DECREASE	WEAKEN	CASH SALES CASH FORWARD CON.

HTA CONTRACT FEATURES

- Futures is fixed at the time of the contract
- Basis is fixed at a time chosen by the seller
- Final date for fixing the basis is specified
- Timing of delivery is specified
- How premiums and discounts will be handled are specified

HTA CONTRACT EXAMPLE

Date _____

Delivery _____(Date)

Futures

Month _____

Price _____

Basis established by _____ (Date)

Service charge _____

Date____Fut.@_____

_____Fut. price in con.

_____Basis

_____Service charge

_____Net selling price

Date____Fut.@_____

_____Fut. price in con.

_____Basis

_____Service charge

_____Net selling price

HTA CONTRACT ADVANTAGES TO PRODUCERS

- Can lock in favorable futures price
- Provides opportunity for basis improvement
- Indirect method of using futures market
- No margin requirements
- Price flexibility
- Another marketing alternative
- Delivery and pricing decisions separated
- Benefit from elevator efficiency
- Reduced price volatility

HTA CONTRACT DISADVANTAGES TO PRODUCERS

- Delivery obligation
- Risk of weaker basis
- Cannot benefit from higher futures prices
- Service charges if any
- Rely on integrity of elevator

DELAYED PRICE CONTRACT (NO PRICE ESTABLISHED CONTRACT) (PRICE LATER CONTRACT) (DP CONTRACT)

- Producer delivers grain but prices it at a later date at the buyer's nearby cash bid

CROP MARKETING STRATEGIES

<u>EXPECTED CHANGE</u>		
FUTURES	BASIS	ALTERNATIVES
INCREASE	STRENGTHEN	STORAGE DELAYED PRICE CON.
INCREASE	WEAKEN	BASIS CONTRACT MINIMUM PRICE CON.
DECREASE	STRENGTHEN	HEDGED-TO-ARRIVE CON.
DECREASE	WEAKEN	CASH SALES CASH FORWARD CON.

DELAYED PRICE CONTRACT FEATURES

- Title of grain is transferred to the buyer when the grain is delivered
- Timing of delivery is specified
- Producer prices the grain at a later time
- Producer receives board price posted in the elevator
- Final date for pricing is generally specified
- Service charge is specified
- How premiums and discounts will be handled are specified
- Payment when grain is priced

DELAYED PRICE CONTRACT EXAMPLE

Date_____

Delivery_____ (Date)

Final date for pricing _____

Service charge _____

Date_____

_____ Cash price

_____ Service charge

_____ Net selling price

Date_____

_____ Cash price

_____ Service charge

_____ Net selling price

DELAYED PRICE CONTRACT ADVANTAGES TO PRODUCER

- Provides opportunity for cash price improvement
- A substitute for on-farm storage
- Risk of quality loss is transferred to the elevator
- Delivery and pricing decisions separated
- Another marketing alternative
- Benefit from elevator efficiency

DELAYED PRICE CONTRACT DISADVANTAGES TO PRODUCERS

- Risk of declining price
- Title transferred upon delivery
- Service charges
- Earns no interest income
- Not covered by warehouse bond