Alternatives for Forward Contracting Grain

Columbia Grain

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Forward Contracting Defined

- Used a broad definition, Forward Contract is:
  - Locking in one or more components that determine the final price received.
    - Futures, Basis, etc.
  - You may not be able to lock in some components until the actual sale
    - Protein premiums & discounts
    - Discounts for other grain quality factors
      - Dirty, plump, etc.

FUTURES + BASIS - FREIGHT & MARGIN

+/- Other Adjustments = CASH

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Estimating Local Cash Price

Futures Price for specific commodity

- **- Transportation**
  – All costs Farm to Market
- **- Local storage, handling, profit**

= Basis

- **- Discounts**
  – Class = HRW Ord. versus 12%
  – Quality = dirt, chaff, other, etc.
- **+ Premiums**
  – Class & Quality

= Expected Local Cash Price for specific commodity

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Contracting Options

- **Cash Contracts**
- **Forward Contracts**
- **Futures Fixed Contracts**
- **Basis Fixed Contracts**
  - **Local**
  - **Destination**
- **Delayed Price Contracts**
- **Minimum Price Contracts**
- **Others??**

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Types of Contracts

Unraveling the Mystery

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Fixed Price Contract:

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- Most common contract used by Montana elevators.
- The producer calls a local elevator and is quoted a cash price for a particular commodity for a nearby delivery period
- Locks in both the futures price and the basis, effectively transferring all price risk to the buyer.
- Shipment is usually “buyer’s call” (whenever the elevator can take the grain) during the contract delivery period and full payment is made upon delivery.

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Cash Fixed Price Contracts

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- Most common contract used by Montana elevators.
- Elevator offers a cash price for a particular commodity for a nearby delivery period
- Locks in both the futures price and the basis
  - Effectively transfers all price risk to the buyer.
- Shipment is usually "buyer's call" during the contract delivery period
- Full payment is made upon delivery

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Cash Contracts:

ADVANTAGES	DISADVANTAGES
Easy, no complications.	Price locked in, can't participate in a market rally.
Cash price, quantity, and delivery are known.	Payment not received until grain is delivered.
Risk of price decrease is eliminated.	Possible penalty for cancellation.
No service or storage charges.	
All proceeds available on delivery.	
Income can be deferred.	

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Cash Forward Contracts

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- A forward contract is a cash contract that allows a producer to sell grain for future delivery.
- Although both futures and basis are set, premium and discount scales may or may not be able to be set until delivery.
- Example: Selling new crop grain many months before harvest if market conditions lead you to believe that prices will be lower at that time.

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Forward Contracts:

Advantages	Disadvantages
Easy, no complications.	Price locked in, can't participate in a market rally.
Locks in price, no downside risk.	No payment until delivery.
Can take advantage of a carry market.	May not be able to lock in premium or discount scales.
No service charge.	Risk involved if production doesn't meet expectations.
Can defer income.	

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Futures Fixed Contracts (HTA)

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- Allows the producer to lock in a futures price with the elevator
  - Basis is set at a later time.
- The elevator will establish a hedge in the futures on your behalf in exchange for delivery of the cash commodity at a set time.
- This contract is useful if futures prices are relatively high and market conditions lead you to believe that they will weaken and/or you think that there is room for improvement in basis levels.

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Futures Fixed Contracts HTA, con'd.

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- This contract will be complete when the producer sets the basis, which will determine the cash price.
- Basis must be set prior to delivery and while the contracted futures month is still being used by traders to calculate cash price.
  - Usually the 15th day of the month preceding contract expiration

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Futures Fixed Contracts:

Advantages	Disadvantages
Limits downside futures price risk.	Can't participate in futures rally.
Can take advantage of basis improvement.	Downside basis risk.
No margin requirements to the farmer, since the elevator is carrying the position.	Must monitor basis levels closely to lock them in when high.
May be allowed to buy back the contract if you are unable to deliver.	Locked in to the elevator and required to deliver (unless allowed to buy back the contract).
May be allowed to roll the contract to a later month in the same crop year.	If grain is delivered prior to pricing basis, there may be service charges.
	This type of contract can only be executed during trading hours (8:30 a.m. to 12:15 p.m. MST)

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Basis Fixed Contracts

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- In this type of contract, the producer locks in a favorable basis with the elevator
  - Leaves the futures price to be set later.
- Basis contracts are used successfully when the basis is at historically strong levels and market conditions lead you to believe that there is room for improvement in futures prices.
- It is important to ask your elevator manager for basis levels for more than the nearby futures month and to determine if storage costs warrant fixing the basis farther out.
- Delivery date and quantity will be negotiated with the elevator.

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Basis Fixed Contracts, con'd.

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- Discounts and premiums are usually set at the time the basis is established, unless the sale is for new crop delivery.
- A basis contract allows the producer to collect a 70-75% advance on their final estimated payment upon delivery of the grain.
- If the deadline comes when you must lock in the futures price, but you want to leave the option open and allow for further possible futures price increase, you may roll the basis contract into a deferred futures month.
- If the deferred futures market has a carry built into it (the deferred price is higher than the nearby price) your basis contract will be reduced by the amount of that carry.
- If the deferred futures market is in an inverse (the deferred price is lower than the nearby month), the amount of the inverse will be added to your basis contract.

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Basis Fixed Contracts:

Advantages	Disadvantages
Eliminates downside basis risk.	Risk of futures price decrease. (If futures prices drop below the level used to calculate your advance, you may have to pay back a portion of the advance.)
Can take advantage of potential futures price increase.	Required to deliver grain as stated in contract.
Can collect an advance on delivered grain without locking in the final cash price.	Must track the futures and market trends to lock in a favorable futures price.
No storage costs.	Full payment is not made until the futures price is locked in.
By "rolling the basis" contract can remain unpriced for extended period of time.	

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NPE/Delayed/Deferred Price Contracts

NO PRICE ESTABLISHED

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- For this type of contract, the seller delivers and transfers ownership of his grain to an elevator without setting a sales price.
- No futures or basis are established until the contract is priced.
- You will want to discuss with your elevator manager if a service charge will be applied to this contract and if there is a time period that the grain must remain un-priced or a time limit on fixing a final price.
- It is also important to clarify if discounts and protein scales will be locked in at delivery or time of pricing.

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NPE/Delayed/Deferred Price Contracts

Advantages	Disadvantages
Can ship grain immediately.	Unlimited downside price risk.
Can take advantage of futures and/or basis improvement.	Title of grain is transferred to the elevator.
Allows you to defer income.	No payment is made until contract is priced.
It may be possible to change an NPE contract to a basis fix contract, thus stopping service charges and allowing you to receive an advance.	May have to lock in discounts and protein scales.
	Service charges may apply.

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Minimum Price Contracts

(Option Contract):

FUTURES + BASIS - (FREIGHT & MARGIN) = CASH

- Minimum price contracts are commonly used among producers as they are very simple to execute and have the least risk involved.
- The seller locks in his cash price, buys a call option to replace the amount of the sale, and delivers his grain.
- This strategy can be executed through your elevator or through a broker.
- The seller establishes the minimum price by subtracting the cost of the option from the cash sale price.
- He can choose to sell his option at any time before expiration, as long as it has value.

Minimum Price Contracts, cont.

- Any premium that he collects from his option is then added to the original minimum price to arrive at the final selling price.
- Although a minimum price contract does not improve the final cash price in every case (option may expire worthless), the strategy reduces risk by eliminating the downside exposure.
- The advantage to a minimum price contract is that once the seller locks in his cash price, he is no longer exposed to adverse market movement.
- If the futures market moves higher after the cash sale, he can still participate in that move through the call option.

Minimum Price Contracts, cont.

- The increase in the value of the call will be added to his net selling price once he sells the call.
- The disadvantage of a minimum price contract is that the seller can no longer take advantage of an increase in the basis since he has locked in the cash price, and the call only reacts to futures price movements.
- Also, time decay will erode the call's value as it approaches its expiration date, which will partially offset increases in value due to rallies in the futures.

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Minimum Price Contracts:

Advantages	Disadvantages
No downside price risk.	Can't take advantage of basis appreciation.
If futures rally, you receive increase in option value.	Cost of option can be expensive depending on length of expiration date and strike price used.
Full payment (at established minimum price) is received when grain is delivered.	The value of an option does not move 1 for 1 with the futures market.
	If futures fail to strengthen, contract will expire and the minimum price will be the final price.
	This contract can only be executed during trading hours (from 8:30 am to 12:15 pm MST).

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Conclusions

- Marketing in a volatile environment is even more important than “normal” times
- Keep informed daily on local and global market conditions
- Knowing your cost of production may help you implement your marketing plan

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