

CROP MARKETING ALTERNATIVES

I. The Cash Market

A. Definition: A price agreement for the immediate delivery of a commodity.

B. Advantages

1. Cash quickly available
2. Price is known at time of sale
3. No commitment to deliver a given amount
4. Easy to understand
5. Deal with people you know

C. Disadvantages

1. Timing may be inopportune, especially at harvest
2. May not be able to take advantage of special pricing opportunities before harvest
3. Selling price is not established when commitment is made to produce a crop
4. Similarly, storing for later cash sale entails considerable risk

II. Forward Contracts

A. Definition: Price agreements for future delivery of a commodity.

B. Advantages

1. Easier to understand than futures contracts
2. No margin money necessary
3. Quantity not standardized
4. Price specified at sale
5. Deal with people you know

C. Disadvantages

1. Difficult to get out from cash contract if oversold, i.e., crop failure
2. May offer lower net return than futures contract
3. May have to buy on market to fulfill forward contract
4. One party may default

III. Delayed Pricing or Price Later Agreements

A. Definition: Agreements that grain delivered to elevators will be priced at a time selected by the seller. The elevator takes title to the product, may sell it, and charges the producer for "service" and storage.

B. Advantages

1. Easy to understand
2. Price determined by producer on date after commodity is delivered to elevator
3. No margin money required
4. Quantity not standardized
5. Provides off-farm storage at harvest

C. Disadvantages

1. Grower loses title of commodity on delivery
2. Service and storage costs may be higher than other alternatives
3. Cannot use contract as loan collateral
4. Claim against elevator is same as any other creditor
5. No downward price protection

IV. Hedging with Futures

A. Definition: Hedging is establishing an opposite position in the futures market as being held in the cash market, concurrently. In that way, the hedger is isolated from major changes in the level of price since the cash and futures markets tend to move together. An individual committed to the production of a commodity or holding the commodity would have sold futures to be hedged. An individual committed to the production of a commodity would have purchased futures related to inputs that must be purchased later in the cash market.

B. Advantages

1. Reduces risk by locking in a price (profit)
2. Flexibility
 - a. Offset--futures position can be liquidated quickly without additional costs
 - b. Deliver--while rare, this option is always available
3. Returns can be estimated in advance and used to evaluate other prices
4. Extends period of marketing (at least another year)

C. Disadvantages

1. Requires margin
2. Difficult to understand terminology
3. Requires knowledgeable and willing lender
4. Requires competent broker
5. Basis risk
6. Quantity traded is standardized
7. Psychology of marketplace, i.e., requires discipline

V. Basis Contracts

A. Definition: Contract to price a product at a fixed discount (or premium) to a given futures contract. Timing of the pricing is determined by the producer as with Delayed Pricing.

B. Types

1. Delivery to elevator at specified times in the future, either later in the same crop year or at harvest or later in the new crop year
2. Immediate delivery to the elevator which takes title to the product and pays the producer some proportion (like 80 percent) of the current cash value of the product

C. Advantages

1. Allows producer to take advantage of a favorable basis when the level of price may not be attractive
2. Easier to understand than futures contracts
3. Deal with people you know
4. For "Type 2" basis contracts, cash is available for a portion of the current value of the contract

D. Disadvantages

1. Producer is exchanging a speculative position in the cash market for one in the futures market
2. Difficult to forecast futures prices
3. Not available in some locations
4. For "Type 2" basis contracts, elevator retains a portion of the value of the contract for which no interest is paid; an alternative is to sell the entire amount for cash and buy the equivalent in futures contracts
5. For "Type 2" basis contracts, producers may be liable for margin calls

VI. Exchange Position in Cash Market for Same Position in Futures (Sometimes called a "repurchase hedge")

A. Definition: For a seller, buying an equivalent amount of futures at the time the cash product is sold. For a buyer, selling an equivalent amount of futures at the time the cash product is purchased.

B. Advantages

1. Allows producer to take advantage of a favorable basis when the level of price may not be attractive
2. Provides flexibility in timing sales and purchases related to such considerations as availability of storage space, transferring income from one tax year to the next, need for cash, etc.; unfavorable prices can be avoided when the cash transaction must be made

C. Disadvantages

1. Same as for hedging with futures except that the risk is in the level of price rather than in basis
2. Difficult to forecast futures prices
3. Higher margin requirements than for hedging
4. Lenders may be unwilling to finance margins
5. Profits or losses are treated by IRS as capital gains or losses and not normal income or business expenses as is the case with gains or losses from hedgers (an advantage for profits)

VII. Agricultural Commodity Options

A. Definition: An option is a contract that gives buyers the right, but not the obligation, to buy or sell a particular commodity at a specific price for a specified period of time.

B. Advantages

1. Producers can establish a minimum selling price, yet retain the opportunity to benefit from higher cash prices
2. Producers know the hedge cost; the option premium is known when the option is purchased
3. Option buyers do not make margin deposits if the option is never exercised
4. Producers are not required to take a position on the futures market since offsetting an option position is usually the best alternative
5. There are several strike prices and associated premiums available for most futures contract months which offers flexibility in establishing a price floor for producers
6. The option buyer has the right, but not the obligation, to initiate or not initiate any action

C. Disadvantages

1. If a buyer seeks to acquire a desired net selling price, option premiums may be relatively expensive
2. An option writer's losses can be virtually unlimited during the life of an option
3. Options are tied to underlying futures contracts and basic hedge risks, such as basis changes, still are embodied in the hedge

VIII. Government Programs

A. Definition: A number of instruments are involved including non-recourse loans, target prices, and the farmer-held grain reserves.

B. Advantages

1. Most programs help to reduce price risks