

Cash Marketing Tools

By: David Bau, Regional Extension Educator, Ag Business Management

Erlin J Weness, Professor Emeritus

8/2006

A good farm-marketing program is built with the use of marketing tools. Tools can range from a simple cash sale to complicated futures or options strategies. In most cases, cash marketing tools appear simple from the producer's viewpoint: however, the elevator is using the future's market to guarantee funds to meet their obligations to you. The availability of the future's market makes cash tools possible. Without the future's market most cash contracts would not exist.

Why Forward Price Your Grain?

Forward pricing of your grain has several advantages. First, it allows you to capture price opportunities which occur all year long, especially opportunities which occur during the growing season. Prices fluctuate dramatically during an average year. In one SW Minnesota site, the annual cash prices offered farmers has fluctuated an average of more than \$.92 per bu. on corn and \$2.14 per bu./ year on soybeans in the past 10 years. Forward pricing allows the capturing of some of the higher prices offered in the spring and summer months .

Fixing a price in advance of harvest reduces the price risk associated with taking what is offered at harvest or placing the crop in storage. Forward contracting also eliminates storage costs. Finally, forward contracting guarantees a market for your grain.

How much can you safely forward contract?

If too much crop is forward priced in a year of poor production, delivery commitments may be hard to meet. Most forward pricing contracts call for the absolute delivery of a specified amount of crop on a given day for a given price. If you cannot deliver as you promised, you will be expected to buy crop at the going price and deliver it at the contracted price.

Example:

Sam Smith contracted to deliver 20,000 bu. of corn for December delivery at \$2.20 /bu. He had a hailstorm on August 10th that reduced his harvested crop to 12,000 bu. of corn. Mr. Smith will deliver his 12,000 bu. and receive the promised \$2.20 per bu. On the shortage of 8,000 bu., he will have to purchase corn on the open market for delivery. If the cash price on delivery date or before is \$2.50, he will have to buy 8,000 bu. at \$2.50 and immediately sell at \$2.20 losing about \$2,400.00. (8,000 bu x \$.30 = \$2,400.) He not only lost a portion of his crop but had another loss when delivering on his contract.

Most people feel comfortable forward pricing 10-20% of anticipated production. Others feel comfortable in going up to 50% of anticipated production. If a producer carries crop and or hail insurance which guarantees a gross income per acre if a crop disaster occurs a farmer should be more comfortable pricing the crop during the growing season. With a revenue based crop insurance a producer can guarantee 50 to 85 percent of their (APH) actual production history and may be comfortable pre harvest marketing up to their insured level with a forward contract.

Cash Grain Marketing Alternatives

Cash Sale - You deliver your grain to an elevator and are paid the current cash price being paid at that time for that grain (less any discounts for poor quality).

Cash Forward Contract - You contract to deliver a specified amount and quality of grain to the elevator on a later specific date. On that date, you are paid a price which is agreed upon today. The price you are bid today for the future date of delivery is determined by the elevator. They deduct an amount (basis) off an upcoming futures contract to determine a bid price. If you contract more than you actually produce, elevators can force you to meet the contract. If a hailstorm wipes you out, you may have to purchase \$6.00 cash beans to deliver on a \$5.50 contract. Some elevators offer contract clauses which can limit your losses on these contracts. Be sure to read the contract.

Price Later Contract - (Sometimes called Delayed Price Contracts or No Price Established Contracts.) You deliver your grain to an elevator and transfer title to the elevator or buyer. The buyer gives you a specified amount of time to price the grain. When you chose to price it, you are paid the price the elevator is paying that day. Some elevators will pay up to 80% of the projected sale price on the date of delivery with the balance to be paid upon final pricing.

Delayed Payment Contract - You deliver your grain and price it, similar to a cash sale. You then contract with the elevator or buyer to delay the check (payment) until a later date. This is usually done by cash basis taxpayers to defer taxable income to a later year.

Farmers using the price later contract or the delayed payments contract have financial risk regarding performance by the buyer. Most elevators sell the grain

and ship it out once they own it or hold title to it. If they are later unable to pay you for it, it may be your loss.

Basis Contract - You contract to sell and deliver your grain to an elevator at a set basis. The basis is the difference between the cash and futures price on a given day. If you sign a basis contract to deliver corn in June at a basis of \$.30 under the Chicago futures price, you will gain if futures prices rise and lose if futures prices fall. If the futures price is \$6.00 on the day you deliver, you will be paid \$5.70 for your delivered cash crop. **You'd use a basis contract if you expected futures prices to rise and basis to widen.** Some elevators will pay you a portion of your money when you deliver the grain and finish payment when you finally price your basis contract.

Hedge to Arrive - You contract with your elevator to deliver grain at a designated future's price. If prices rise, you don't share in it and if prices drop you are protected. You will get the futures price less the basis for the day you do your pricing. For example: You could sign a hedge to arrive (HTA) contract with your elevator for \$6.40 July soybeans. In July you will be paid \$6.40 less the basis (difference between July futures price and local cash price) on the day of delivery. If the basis is \$.40, you get \$6.00; if it is \$.20, you get \$6.20. If the basis improves (is less) you capture the basis improvement. **You would use a "hedge to arrive" contract if you expect prices to go down and basis to narrow or improve.** Some elevators allow you to set the basis after you enter the contract but before you deliver the grain. Doing so puts you into the same position as a cash forward contract. Other elevators do not allow it and the basis is set only on the day of delivery. Caution: rolling HTA contracts puts you in a speculative position. If prices go up, and/or contract spreads move adversely, your risk of loss is great.

Minimum Price Contracts - You contract to deliver a certain quality and quantity of grain. You are usually given a time period to price the grain. The contract specifies the minimum price you will receive for the grain (before quality discounts). The minimum price is determined from the futures market, less a basis amount and a cost for the elevator to purchase a put option on your grain. The minimum price will be less than the elevators forward contract price of the same month due to the options premium cost. With this contract you lock in a guaranteed minimum price while you wait for price improvements later in the season. **These contracts are used when you would like to take advantage of the current price, but chances are good for even stronger prices ahead.**

Caution: When using any forward pricing technique, use caution. Once title is passed to the buyer, the farmer has

financial risk if a check has not been issued. A contract is not as secure as a warehouse receipt. If you hold a warehouse receipt, you still hold title to the grain. If the elevator files bankruptcy, a warehouse receipt will receive a higher priority for payment than other contracts.

Every grain elevator and grain buyer has a different contract. Any contract where a price is not locked in involves risk of markets moving against you. Understand what you are getting into before signing on the dotted line. Know exactly how much risk you are assuming and what is expected and permitted under the contract.

Any type of cash contract is a legal obligation. They should be compared and sometimes combined with other hedging, storage or options strategies when formulating a good marketing plan.

Other Tools: There are many other types of marketing tools that are offered by the different elevators with many different names. Many of these tools are derived from the tools already described or some combination of these tools. When using these tools make sure you understand all the terms for the tool or tools you decide to use to market your grain.

Remember to lay out your marketing plan first and then utilize these tools when they fit into your plan.

The University of Minnesota is an equal opportunity educator and employer.