Commodity Challenge

Section II: Basic Pricing Tools

Chapter 11: Forward Contracts and Other Pricing Alternatives

Learning objectives

- Learn about other grain pricing alternatives
- Understand the pros and cons of different pricing tools

Key terms

Forward contract: A cash market transaction in which a seller agrees to deliver a cash commodity to a buyer at some point in the future.

Hedge-to-arrive contract: A contract where the futures price is set, but the basis level is set later (typically before delivery). A producer might use this contract when futures prices are good but the basis is not.

Basis contract: A contract where basis is set, but futures prices are set later. A producer might use this contract when basis is good but futures prices are not.

Delayed price contract: A contract where the producer delivers grain to the buyer with discretion to set the price later, up until the final delayed pricing date (usually giving up title to the grain).

Pricing Alternatives

Selling futures contracts is just one way to price grain, and it is far from simple. We started there because futures markets play a central role in establishing prices and in risk management. There are other, simpler pricing alternatives available to producers. Not all of these alternatives are available to players in Commodity Challenge.

Cash grain sale

A simple cash sale after harvest eliminates storage costs and involves no fees. If the price works for you, it’s a straightforward choice. The downside is that once grain is sold, you cannot benefit from higher prices, if the market trends gigher.

Storing unpriced grain

Storing grain provides opportunity if prices rise, but risk if prices fall. Storage costs must be considered.

Forward Contract

A forward contract is a cash market transaction in which a seller agrees to deliver grain at a specific time in the future. Elevators routinely offer these contracts.

Advantages:

- Final price is known
- Flexible contract size
- No margin deposits or margin calls

Disadvantages:

- Institutional risk (buyer bankruptcy)
- Potentially poor basis in the forward price

Example: If December corn futures are $5.00/bu. and your elevator bids $4.60/bu., the basis is 40 cents under. Whether this is a good basis depends on your understanding of basis in your local market.

Hedge-to-Arrive (HTA) Contract

An HTA contract sets the futures price now and the basis later. Sometimes this is called a Basis-not-Established contract (BNE). Mathematically, the HTA contract is just like selling futures, but the brokerage fee is replaced by an elevator fee.

`futures price (when sold) + expected basis - HTA fees = expected price`

Commodity Challenge does **not** offer HTA contracts.

Basis Contract

A basis contract locks in basis now and futures later. It is not a strong risk management tool because basis is typically a smaller component of price.

Commodity Challenge does **not** offer basis contracts.

Delayed Price Contract

The producer delivers grain but does not set the price. The elevator takes ownership and may offer free storage.

Warning: If the buyer has financial trouble, the producer becomes an unsecured creditor. DP contracts are risky and should be used only when futures and basis are extremely weak.

Commodity Challenge does **not** offer delayed price contracts.

Exercise #11

Match the function with the correct pricing tool.

Function	Pricing Tool
1. Locks in the difference between the cash and futures price	Cash grain sale
2. Contract that sets the futures price but leaves basis open	Storing unpriced grain
3. Established price and basis for immediate delivery	Basis contract
4. Locks in cash price for later delivery	Delayed price contract
5. Cash grain is held without price protection	Hedge-to-arrive contract
6. Futures and basis is set later; elevator owns grain	Forward contract

