

Contracting in the Cash Market

Most cash contracts only exist because the risk associated with offering a cash contract can be laid off to a speculator in the futures market. If you understand the relationship between the cash contract and the futures price, you are in a position to evaluate the quality of any cash offering.

A cash forward contract is an agreement between a buyer and a seller for delivery of a specific amount of grain at a predetermined price at some futures date.

Advantages

- ✓ Eliminates price and basis risk
- ✓ Easily understood
- ✓ Flexible in terms of quantity sold
- ✓ Seller maintains title to grain until payment is received

Disadvantages

- ✓ Increases production risk
- ✓ Cannot benefit from strengthening basis
- ✓ Cannot benefit from improved prices
- ✓ Usually involves a substantial penalty for failure to deliver

A fixed futures contract is just like a forward cash contract, except that the basis is not established

Advantages

- ✓ Eliminates price risk
- ✓ A strengthening basis improves final cash price
- ✓ No margin calls
- ✓ Can be used to price out more than one crop year

Disadvantages

- ✓ Increases production risk
- ✓ Contains basis risk
- ✓ Usually not flexible in terms of amount contracted

A basis contract is similar to a forward cash contract, except only the basis is established. This might be attractive if you expect the futures price to increase, but are concerned the basis could weaken. Often done at harvest for grain to be stored.

Advantages

- ✓ Eliminates basis risk
- ✓ Often receive a payment before final price is set
- ✓ Profit from storage opportunities without storage facilities

Disadvantages

- ✓ Increases production risk before harvest.
- ✓ Contains price risk
- ✓ Elevator takes title to grain at delivery
- ✓ If prices deteriorate, could owe the elevator more than the initial payment

A delayed price contract allows you to deliver at harvest, but not establish the price until later in the year.

Advantages

- ✓ Can deliver at harvest and still benefit from profitable storage opportunities
- ✓ Lengthens the grain marketing year
- ✓ No need for storage facilities
- ✓ Usually receive an up front payment at delivery

Disadvantages

- ✓ Contains both price and basis risk
- ✓ Elevator takes title to grain before payment is received
- ✓ Results in an un-secured loan to the elevator
- ✓ If prices deteriorate you may owe the elevator some of the initial payment

Risk Ranking of Marketing Alternatives

Less Risky

- Forward Cash Contract
- Hedge on the Futures Market
- Fixed Futures Contract

More Risky

- Delayed Price Contracts
- Basis Contracts
- Routine Storage