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Grain Producer Marketing Alternatives

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Marketing is a tough job. To market a crop, a producer must first produce and harvest it. American farmers are among the most efficient producers in the world. But, to make a profit, grain must be marketed, not just sold.

Very few producers sell at the highest possible price. More profit is lost waiting for the highest price than is made if a marketing strategy is followed. It is essential to have a target price. And, much time and effort is required to have a good marketing program. Production, knowledge, time, and effort are essential for good yields. But, knowledge, timing, and effort do not guarantee a good yield. The odds are just increased. It is the same with marketing.

Grain marketing is a systematic approach toward achieving a reasonable return from a producer's capital and labor. Marketing requires detailed planning, which includes estimating costs, cash flow needs, and the market price outlook. Simply, marketing involves knowing the alternatives, what the alternatives offer, and how the alternatives meet the needs of the farm.

This Fact Sheet describes some of the marketing alternatives available in most areas of the state. Every producer uses at least one of the following alternatives. The result of not having a marketing plan is being forced by cash needs to sell on the cash market.

Alternatives

Nearly all wheat is sold on the cash market. Other marketing tools may he used to "lock in" a price; but, in the end, the wheat is sold for cash. There are exceptions. For example, wheat can be delivered against a futures contract and then the futures contract is converted to cash.

Timing of the sale is a major factor with any marketing alternative. There are numerous methods to "lock in" a price. The key is to recognize what price should be locked in. Setting target prices is presented in OSU Fact Sheet Number 475, "Setting Target Prices to Manage Risk."

Sell at Harvest for Cash

Selling at harvest has been the most popular method to sell grain. But, because of pricing inflexibility and seasonally low harvest prices, producers are using this method less. Even though selling at harvest is less popular now, sometimes the harvest price will be the highest net price when compared to the net price received for stored grain after storage and interest costs are subtracted.

The advantages of selling at harvest are:

1. Easy and well understood,
2. Requires no storage,
3. Doesn't tie up money after harvest,
4. Limits speculation to growing season, and
5. Price is known immediately.

The disadvantages are:

1. No pricing flexibility,
2. Harvest prices usually lower than at other times of the year,
3. Basis usually weak at harvest, and
4. May confront harvest congestion at local elevator.

Hold Grain in On-Farm Storage and Sell Later

Producers with on farm storage have the option of storing the grain for later delivery and sales. Producers that do not have existing on-farm storage and are thinking about building on-farm storage should read OSU Fact Sheet Number 157, "On-Farm Versus Commercial Wheat Storage cost."

Besides price, the major consideration overlooked by many producers is interest cost. With $3.50 per-bushel wheat and interest rates at 10 to 15 percent, interest cost will run three and one-half to four cents per bushel per month.

Some advantages of on-farm storage and deferred cash sales are:

1. Adds pricing flexibility since pricing can be done at various times after harvest,
2. Adds greater flexibility and control over where to deliver grain, and
3. Utilizes on-farm storage facilities.

The disadvantages are:

1. Still speculating on the cash market after harvest,
2. Potential losses due to deterioration in grain quality,
3. May restrict timeliness in meeting marketing opportunities, (sometimes premium prices are offered for grain that can be delivered within a short time period), and
4. Storage and interest may cost more than the price increase.

Store Grain in Commercial Elevator and Sell Later

Oklahoma producers without no-farm storage normally can store grain in commercial grain elevators. Only during record harvests is storage space not available.

Some advantages of storing in commercial space and selling later are:

1. Adds pricing flexibility since the grain can be sold any time after harvest,
2. Requires no physical management; there is no risk of quality deterioration,
3. Marketing activity can be conducted by simply delivering warehouse receipt,
4. May get loan with warehouse receipt as collateral, and
5. Call benefit from seasonally increasing prices.

The disadvantages are:

1. Still speculating on cash market,
2. Storage and interest costs may be more than the price increase,
3. Ties up money after harvest, thus there is a loss due to potential interest earnings or savings,
4. Lacks flexibility and control over where to sell, and
5. Must pay commercial storage rates.

Cash Forward Contracts

There has been an increase in the use of cash forward contracts by farmers. For future grain sales, forward contracts offer the opportunity to lock in a price. Forward contracts are agreements to deliver a fixed amount of grain (or turnover ownership of grain in commercial storage) at a specified price to a certain location.

Forward contracts can be for grain in production or for grain in storage. For example, you have 2,496 bushels of wheat in commercial storage and wheat prices are expected to decline, for tax reasons you don't want to sell until after the first of the year, and the elevator is offering an acceptable forward contract price for January delivery. A forward contract would be signed specifying a sale of 2,496 bushels of wheat meeting the description of the wheat on the warehouse receipt for a specified price to become effective on a given day in January.

Some advantages of forward contracts are:

1. Most widely used and best understood of forward pricing marketing alternatives,
2. Sales are final thus market fluctuations, especially priced declines, will not affect the price,
3. Easy and legally binding if contracts are signed by both parties,
4. No margin money for initial deposit or meeting margin calls is required,
5. Can sell any amount–do not have to sell 1,000- or 5,000-bushel increments, and
6. Eliminates both basis and price risk.

Some disadvantages are:

1. Must deliver the specified amount of grain–if the grain is not yet produced, growers run the risk of not producing enough to cover the contract,
2. Inflexible–once you have signed the contract, it usually cannot be changed without a penalty fee, and
3. Cannot benefit from basis gain–you may have locked in a basis wider than usual and any basis appreciation profits will go to the elevator, not you.

Delayed Pricing

With delayed pricing, producers deliver grain to the elevator and sign a contract agreeing to price the grain before a specified date. The elevator takes ownership of the grain. Often the elevator will pay a percentage of the current price when the contract is signed. If the producer does not price the grain before the specified date, the default price is the price posted at closing on the contract maturity date.

Some advantages of delayed pricing are:

1. Can deliver grain at harvest but don't have to accept harvest prices –have the option to price your commodity later when you anticipate higher prices,
2. Lengthens your grain marketing year thereby allowing you to capture price improvements, and
3. Storage cost may stop when the contract is signed.

Some disadvantages are:

1. Producers are speculating the cash price will increase after harvest, thus there is no protection against price declines,
2. Still have interest costs,
3. Elevator takes title to the grain when the delayed pricing agreement is signed, and
4. Producers have essentially given the elevator an unsecured loan and become a common creditor. If the elevator should go bankrupt, holders of unsecured loans may be among the last to receive payment.

An example of a delayed pricing contract is: A producer has delivered 4,444 bushels of Number 1 hard red winter wheat to the local elevator on June 20. The current price is $3.20 and is expected to increase. The elevator offers to stop all storage costs if the producer agrees to sign a delayed pricing contract and price the grain before December 1. The producer signs the contract. Any day between June 20 and December 1 the producer can accept the posted price on that day. If a price is not accepted, the posted price on December 1 is paid to the producer.

Basis Contract

Basis contracts are essentially the same as delayed pricing contracts except the price is not determined by the elevator's posted price. The price will be determined by the contracted basis and the specified Kansas City (Chicago if specified in the contract) Wheat futures contract price on the day the producer chooses. Basis contracts work well when the basis is abnormally high. To effectively use basis contracts, it is critical to have historical basis information.

Some advantages of a basis contract are:

1. Allows you to bypass possible weak harvest-time basis and corresponding low prices,

2. May be able to receive up to 80 percent of the value of the contract on the day of delivery thus eliminating partial interest loss,
3. Eliminates basis risk, and
4. Stops storage costs.

Some disadvantages are:
1. Still have price risk,
2. Still have interest costs,
3. Cannot realize any price gains due to basis gains,
4. Basis contracts may not be universally available,
5. If the elevator advances you 80 percent of the value and the market turns against you before you price your grain, the elevator can recall a portion of the 80 percent advance.
6. Elevator takes title to the grain when the agreement is signed, and
7. Producer becomes unsecured creditor.

Cash Versus Futures Markets

The above marketing methods are considered to be cash marketing. With cash marketing, producers deal directly with the grain industry and are essentially letting the elevator make contracts on the futures markets for them.

Normally, an elevator will not take cash price risk. Elevators either sell the grain (called back to back cash selling) or cover (hedge) the cash position in the futures markets. With deferred pricing, delayed pricing, and basis contracts, elevators protect themselves against price changes with futures contracts.

There is some risk to elevators for offering the above cash contracts. Thus, the producer pays a cost, normally an increased margin, to cover this risk. A producer can hedge the grain and take the basis risk rather than paying the elevator to hedge the grain for them. But, then the producer becomes responsible for the margin account and margin calls.

Hedging in the Futures Markets

Hedging, like cash forward contracts, are used to reduce price risk. But, unlike forward contracts, price risk is traded for basis risk. For six-month predictions, price risk is normally about 12 percent. Thus, if the expected price is $3.50, then two out of three times the wheat price will be between $3.92 and $3.08. And one time out of six the price will be below $3.08.

The basis risk for wheat varies depending on the month. But, basis risk normally is about four percent or about 13 cents with $3.50 wheat. Thus, if a hedge is placed at $3.50, two out of three times the price will range between $3.37 and $3.63. A hedge reduces risk. But, the potential gain from cash price increases is also reduced.

Some advantages of hedging are:
1. Increases marketing flexibility–can sell futures contracts then buy them back if market situations change,
2. Lengthens your marketing year–a producer has up to 20 months to market the crop,
3. Can capture basis gains and reduce price-level risk, and
4. Basis is more predictable than cash prices.

Some disadvantages are:
1. Have to sell in 1,000- or 5,000-bushel increments,
2. Accept basis risk, and
3. Requires a margin account and the margin account must be maintained at a specified level. If the futures market moves against the producers, relatively large amounts could be required to maintain the hedged position.

Note: the majority of the margin money will be recovered when the hedge is complete. Losses on the futures may be offset by gains in the cash market. Conversely, if the futures move in the anticipated direction, the producer could receive credits to the margin account thus gaining from interest from gains in the futures market.

Option Contracts

Normally grain producers will only be involved with “put” options. A put option allows a producer to buy the right to sell a futures contract at a specified price. In other words, if a producer buys a put, the producer has the right but not the obligation to hedge the grain at a specified price. Put options can be a method to hedge the grain without the requirement to deliver the grain and without the margin account requirement.

In most cases, producers will complete the option contract by selling back the put. Thus, to use options as a marketing alternative, the producer would purchase a put. If prices are less than the effective put option price, the producer would sell the put at the same time the grain is sold in the cash market. Also see OSU Fact Sheet F-549, Marketing Puzzle: Futures Option Contracts.

Some advantages of option contracts are:
1. Limits downside price risk–the premium paid for the option is the maximum loss,
2. Lets producers take advantage of cash price gains,
3. Increases marketing flexibility–can buy option contracts then sell them back if market situations change,
4. Does not require a margin account until the option is exercised (normally options will not be exercised but will be sold back to take advantage of the option value),
5. Lengthens your marketing year–a producer has up to 18 months to market the crop, and
6. Can capture basis gains.

Same disadvantages of options are:
1. Option premiums for acceptable prices may be prohibitive,
2. Options are bought and sold in 5,000-bushel increments,
3. Requires knowledge of basis patterns, and
4. Producers still have basis risk.

Making the Marketing Decision

Marketing decisions may be improved by following a set procedure. First, the target price should be calculated. The target price may be based on production costs and cash flow needs. Second, the marketing alternatives available in the area must be determined. Third, the price each alternative is offering must be calculated. And, forth, the risk involved with each alternative relative to the producer’s risk-bearing ability should be considered.

Marketing the crop before harvest (or planting) poses more problems than after the grain is in the bin. How is something sold before it's produced? Simple, by any method that does not require delivery until the grain is produced. But, it may not be that simple. How much grain will be produced? It's impossible to know. Just as it's impossible to know exactly what the price will be.

One method is to review the flexibility of each marketing alternative and the risk associated with each. Delayed pricing and basis contracts are normally only available after the grain is in the bin. Thus, preharvest alternatives include forward contracts, hedge on the futures, and options.

Forward contracts are the most inflexible. Futures contracts and option contracts both specify amounts. But, positions with futures and option contracts can be reversed easier than a forward contract.

The question, how much grain should be priced before harvest, is difficult to answer. First, the producer must have a good knowledge of expected yield, the yield variability, and how much the loss will be if too much grain is contracted and whether the potential loss is worth the gain.

If the expected yield is contracted, 50 percent of the time there will be more grain produced than contracted and 50 percent of the time not enough grain will be produced to meet the contract. One strategy is to contract less than the expected amount, and as yields become more certain (if the price is still acceptable), contract additional grain.

Summary

Producers should select a marketing strategy they can live with. If margin calls cause a bit of anxiety, don't use the futures markets. But, alternatives offered by elevators allow producers to receive the benefits of the futures markets without having to deal directly with futures contracts. Because most supple and demand conditions are reflected in the futures market, producers should have some knowledge about price discovery in futures contracts.

The marketing plan may include a combination of the above alternatives. Producers should become knowledgeable about a marketing alternative before using it. The first time a marketing alternative is used, the producer may use only a small part of available grain. Thus, the costs of mistakes are minimized. Conversely, the gains from the right decision are small.

There is no method to guarantee the highest price. However, using a full set of marketing tools and a well-developed marketing plan will increase the odds that the prices received will meet the cash flow needs.

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