

Grain Contracts with Local Elevators

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Cash grain markets have changed significantly over the past ten years. A common method for a producer to market grain in years past was to harvest their crop, then deliver at the elevator and take the price offered. This document will discuss two methods to forward-price grain before delivering it at the local elevator.



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WORKING WITH THE LOCAL ELEVATOR

manager is the key to successfully marketing your grain. Producers should make sure that have built rapport with those involved in purchasing their grain. Like any relationship, this takes time and trust by both parties. Face-to-face meetings are not always necessary, but are important in establishing and maintaining a good relationship. Most elevator managers are happy to discuss your local marketing options with you.

Many grain producers find that they are most effective in marketing their grain when they have established a minimum price point. It is therefore important that producers have an exact knowledge of what their cost of production is. Marketing below cost of production will lead to difficult circumstances financially. Producers knowing their cost of production in order to make viable marketing decisions cannot be emphasized enough.

Producers must have at least a basic understanding of how the futures market affects the price they receive at their local elevator. One key concept is that of basis.

Basis: Elevators operate on the principle of basis. Basis is defined as the cash price minus the futures price. Basis can be calculated by subtracting the daily closing futures price of the nearby grain futures contract from the daily cash price of that same grain commodity. This is called the near term basis. Since cash grain prices in Montana are typically lower than futures prices, Montana basis is usually expressed as a negative number. Basis can also be calculated by subtracting a specific contract month's price from the local daily cash price. This process illustrates how basis changes over time.

Futures Price
+/- Basis
- Transaction Costs
<hr/>
= Local Cash Price

In essence, basis is an estimate of storage and handling costs, transportation costs, profit margins for sellers, and quality variations from those listed in the futures contract specifications. However, specific local supply and demand conditions can also impact basis. The costs listed are deducted from the futures price to arrive at a locally offered cash price.

Basis has seasonal patterns that can be used to develop strategies for selling or holding grain. If the producer knows the historic seasonal pattern for basis in his area, he or she will be able to estimate what basis might be at harvest or other times of the year. With historical basis information, local cash prices can be estimated. Understanding basis patterns is important in evaluating cash forward contracts, minimum price contracts, futures fixed contracts as well as evaluating cash prices offered at any given point in time during the year.

In referring to basis, two common terms are “a wide basis” and “a narrow basis”. A wide basis, or a widening basis is where the local basis is bigger than expected, or is getting bigger than it currently is. A narrow basis, or a narrowing basis is smaller than expected, or is getting small than it currently is.

Futures: One reason why most producers do not use futures is their complexity. However, grain growers must have at least a rudimentary understanding of futures in order to understand how their local elevator sets a price – either at harvest, or earlier in the year.

Futures are traded at various markets around the country, depending on the particular commodity. Elevators cover hedge nearly every bushel they purchase from producers by selling futures contract down

to every bushel if they can. That means, when you forward price with an elevator, they are going to the open market and selling those as futures on a trading exchange. By tracking futures, producers can determine what the market is doing and in what direction it is moving.

Cash Forward Contract versus Futures Fixed?

Both of these methods of marketing grain have pros and cons. Both involve delivery to a specific elevator. Both are direct methods of marketing grain with your local elevator. In both cases, producers do not have direct contact with any of the national grain trading exchanges. When they enter into either of these contracts, their local elevator sells one or more futures contracts to offset the obligation to pay for grain they just purchased from producers.

Cash Forward Contract: A cash forward contract is an agreement between the producer and the elevator in which they agree on price, delivery date, and quality considerations. Contracts can be more complex than that, but all contracts usually have these elements. This contract can be signed at any time. Delivery is made at a later set date. Most elevators will allow you to contract up to one year before you harvest. Cash Forward Contracts have historically been most effective in a market where the successive contract months have an increase in value (carry).

By agreeing to the terms, the producer is accepting the price offered in advance, along with the obligation to meet bushel quantities and quality standards. By using time to their advantage, producers have a large window in which to accept a price.

A cash forward contract sets the price the producer will receive, but the producer has no direct involvement or interaction with any commodity exchange contract. The elevator is using futures contracts or options to protect themselves against the risks of adverse price movements. If basis changes or futures price goes up, the producer will still receive the agreed upon price. This is a cash contract entered into at the producer's choosing.

Futures Fixed (Hedge-to-arrive): This term could refer to several different situations. The contract discussed here involves only two decisions by the producer – setting a futures price with the local elevator, and locking in a basis. A futures fixed contract

is identical to a cash forward contract, except that basis is not set initially. These contracts set a futures price with the local elevator, but not a basis. With time to the producer's advantage, he or she can wait until basis narrows before locking it into the contract. Once basis is set, this contract is essentially a cash forward contract. Producers should have a more fundamental understanding of how futures and options markets operate and must be willing to be continuously involved before they commit to this type of contract.

Typical seasonality of grain markets are such that March, April, and May have some of the narrowest basis margins in Montana. This will vary by location, so knowing local basis trends is vital for grain producers. Most often, basis widens as we get closer to harvest time. By setting a futures price at the producer's choosing, he or she has the opportunity to wait until basis narrows before locking it in. While this offers an opportunity that a cash forward contract does not, it also carries some risk. For instance, basis could widen, and the producer could receive a lower price than if they had agreed to a simple cash contract. This emphasizes the importance of knowing your local elevator basis trends.

Some of the advantages of using a cash forward contract or futures fixed contract versus a futures contract include:

- Producers can market any amount of grain. With futures contracts, they are required to sell in 5,000 bushel increments.
- Margin calls are not required because any futures contracts are entered into by the elevator, not the producer. Margin calls, in this case, are solely the responsibility of the elevator.
- Producers know exactly what their final price will be, once the basis is set.
- Many producers favor working with local elevators that they know and trust.

Some of the disadvantages of using a cash forward contract or futures fixed contracts versus a futures contract include:

- Producers must deliver the grain or be subject to potential penalties. If they have a loss, there could be some penalties involved in not delivering on a contract.
- Grain growers are locked into a specific elevator for the bushels of grain they contract.

How does a cash forward contract work?

Let's use the following example: Assume you are a winter wheat grower who wants to establish a cash price in early April for the wheat will be harvested in August. For this example, assume that your harvest will be completed on August 15. *The following scenarios are exactly the same as for a cash forward contract or a futures fixed, except for a changing basis value, which is demonstrated.*

Scenario 1: You decide to contact your local elevator and see what price they can offer you on April 1. The September winter wheat futures contract on the Kansas City Board of Trade is valued at \$5.50 per bushel on April 1. Remember that even if you are not selling a futures contract, your local elevator uses these to operate, so your contract is based on the futures market price. Historically, your local harvest time basis for wheat averages -50 (50 cents under the harvest time value of September wheat futures). Your elevator manager offers you \$5 per bushel for delivery August 15 using a cash contract.

Regardless of the value of September wheat futures on August 15, or the price they are offering at harvest time, you locked in a cash price of \$5 per bushel when you sold the contract on April 1. If you meet the contract specifications, this will be your final price.

Scenario 2: As in scenario 1, you decide to contact your local elevator for a price on April 1. The September winter wheat futures contract on the Kansas City Board of Trade is valued at \$5.50 per bushel on April 1. Historical harvest time basis is again expected to be -50. Your elevator manager offers you a futures fixed contract with a futures price of \$5.50 per bushel for delivery August 15. This type of contract allows the basis to vary until such time as the producer locks in the basis. When harvest arrives, the September wheat futures contract has dropped in value to \$5 per bushel. Cash prices have correspondingly dropped and the basis offered by your local elevator for wheat that day has narrowed to -40. With a locked in futures price of \$5.50, and a basis of -40, your final price is now \$5.10. Had you waited until harvest to market your grain, you would have received \$4.60. You were able to improve your final price received by a narrowing basis.

Your elevator sold a futures contract (or as many as they needed to cover your purchase) the day you sold them your grain on April 1. Even though cash prices moved lower over the season, the elevator used the futures market to protect themselves against a price decrease for the grain they purchased from you.

Scenario 3: On April 1, you contact your local elevator for a harvest price. They quote you \$5.50 a bushel based off of the September winter wheat futures contract. On August 15 the September wheat futures contract has increased in value to \$6 per bushel. Cash prices at harvest are now at \$5.50 a bushel. Unfortunately, you missed your window and you locked in basis at -60. Your final price is \$4.90 a bushel.

No matter what price does over the course of the year, your final price was decided when you entered into a cash forward contract or futures fixed. The only thing that could change that final price would be if you entered into a futures fixed contract and the basis fluctuated before you finalized the basis price. Thus, in all three cases you received \$5 per bushel, except where you had changes relative to basis.



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