5-1-1979

Forward Pricing Corn

J. William Uhrig
David C. Lyons
Mark Miller
Gary Van Hoozer
Forward Pricing Corn

J. William Uhrig, Donald Hilger, David C. Lyons, Mark Miller and Gary Van Hoozer
Department of Agricultural Economics

Choosing the best time to sell your corn is a difficult task. In a typical year, prices to producers vary widely from month to month, depending upon such things as weather conditions, new crop outlook, rumors of export opportunities and other factors which affect the supply and demand for corn and other feed grains.

You can be sure of one thing though -- the basis (difference between cash and futures prices) is nearly always widest at harvest time. This usually results in depressed prices at harvest time. So, if you're looking for maximum returns for your crop, you can rarely get them by selling straight from the combine.

What Forward Pricing Is

The alternative is to learn how to forward price, or to "pre-sell" your crop before you are ready to deliver it. This gives you control over the marketing process. You can think of forward pricing as a temporary substitute for a cash sale. It's a way to manage risk, or lessen the possibility that you will have to sell your crop for a price that is unsatisfactory to you.

Forward pricing, then, is a broad term that covers any technique that you might use to tie down a future price for a corn crop that is still unplanted, still growing or in storage. Used skillfully, forward pricing is a highly flexible money management tool that can give you control over the marketing of your crop and increase your profits.

You can forward price by either cash contracting or hedging in the futures market. Cash contracting usually means contracting corn with your local elevator. Advantages to the producer include: (1) having a price established before delivery of the crop, (2) having the exact price known before sale, and (3) having a definite delivery point specified. On the other hand, the producer who cash contracts ahead of delivery gives up some flexibility in marketing his crop. He loses control of his options since he must deliver his crop exactly as specified in the contract and for the specified price. He also usually does not receive the highest price for his crop. Since the elevator operator who contracts with the producer provides a service and assumes some degree of market risk, he usually offers the producer a price under the futures price for corn delivered at the same time.

Hedging in the futures market also allows the producer to establish a price for his corn before delivery. He can't establish an exact price, as he can with a cash contract, but he can establish a price within a very narrow range. This way, he can evaluate the profit potential of a corn crop before it is ready to sell and lock in a profit that he will accept.

The futures market also offers the corn producer maximum market flexibility. Since he can offset his contract at any time, he doesn't actually have to deliver his corn as specified in his contract. He simply buys an offsetting futures contract on the day he sells his corn in his local market and applies the profit or loss he receives on the futures transaction to the price he receives locally. Most producers who hedge in the futures market do offset their contracts and actually sell their corn on their local cash market.

Futures trading has its disadvantages, too. It requires a high degree of knowledge...
about how the market operates. Most contracts also involve large amounts of grain -- 5,000 bushels per contract. Futures trading also requires that you guarantee your transaction with margin money.

If prices start to rise, the margin requirements could represent a substantial sum of money. Unless one is financially independent, it is essential that you discuss margin requirements with your banker and obtain a line of credit for meeting margin calls.

Common Advantages

Both cash contracting and hedging in the futures market offer corn producers the advantages of being able to lock in a price for crops yet unplanted, still growing, or in storage. Having a price locked in makes it much easier for producers to make production and storage decisions and to get needed credit.

Both methods reduce marketing risk, so lenders will usually advance credit more readily and in larger amounts against growing crops or stored grains that are hedged or cash contracted. Many lenders today are requiring that their borrowers forward price a portion of their crop.

Should You Forward Price?

Whether you should forward price your corn depends upon two things:

1. How much risk do you want to assume? If you are financially independent, you can take risks and survive; if prices go against you, you may prefer to take your chances with the cash market. You simply produce or store unpriced. If you are set up to store your corn and watch the market, you have some added security -- but you are still holding your corn for an unknown price.

Many farmers prefer to avert risk. They are either unable because of financial commitments or unwilling because of temperament to assume the risks of adverse price changes. So, they hedge their crop by locking in a desired profit with cash or futures contracts to avoid price risks.

Young farmers just starting out especially need marketing security in order to make payments on debts, have sufficient income for family expenses and capital for expanding their business.

Some producers use cash contracts or futures contracts to cover only their direct costs of production or storage. They speculate on the remainder of their crop.

2. Your pricing objective. If you are after the top price during the year and you want maximum flexibility to store your grain and second guess the market, then you probably don't want to forward price your crop. But, if you want to lock in an acceptable profit, have peace of mind, be sure to meet all of your financial obligations and obtain credit easier, then you probably should consider forward contracting a part of your corn crop.

Establishing Your Marketing Objective

The success of any particular case of forward pricing depends entirely upon the objective of the producer involved. There are three basic objectives of forward pricing:

1. To get a higher price than the ultimate cash market. If your objective is to get the highest price by using the futures market, your chances of success are not too great. To be successful, the producer with this objective must be able to accurately forecast the cash market price that will prevail at the time of sale. In other words, he must be able to outguess the market. If you are trying to get the highest price, you may hedge, but you're thinking like a speculator,

2. To lock in an acceptable price and avoid large price declines. If this is your objective, your odds for success are excellent. You figure your production costs, add your desired return to management and profit and then lock in your price when it is offered to you through a cash contract or the futures market. There may be times when you
may not be able to lock in a profitable price, but may wish to do so anyway in order to avoid a larger loss.

3. To base management decisions on known prices. With this as an objective, you can use the futures market or cash contract prices to help you decide whether to plant corn, soybeans or some other crop in any particular year. You can also use it when deciding to sell corn at harvest or store for later sale. You won't be too concerned about whether you get the highest price using forward pricing. You will make your money from smart management decisions rather than from trying to outguess the market.

The most frequently-made mistakes by a grower who forward prices is failure to define his objective before he begins or trying to change his objective somewhere along the line.

Three Steps to Successful Hedging

Regardless of whether you choose to forward price by cash contracting or hedging in the futures market, you should follow three basic steps:

1. Determine a price objective or asking price: Once you determine your objectives, the first step in forward pricing is to estimate your production costs. Without an estimate of production costs, there’s no way to know whether you are selling at a profit or a loss. The best way to determine production costs is to work through a production budget, including both variable and fixed expenses. Variable expenses include such things as land rent, taxes, seed, fertilizer, tractor operating costs, hired labor, etc. One way to think of variable expenses is that they are those expenses you could avoid if you decide not to produce a crop.

If you use the futures market to forward price your crop, then you must also include the interest cost on the margin money requirement.

Fixed expenses, on the other hand, are expenses which will be incurred regardless of whether you plant a crop. For example, a tractor depreciates -- used or not.

After you have estimated production costs, you should add some return to management. One way is to figure what you could earn if you were working for someone else either as a farm manager or in off-farm employment. You should be able to make at least as much money managing your own farm as you could make working for someone else. Once you have decided how much "salary" you would like to make, you can allocate that amount of money among all of your farm enterprises. This way, you can determine how much should come from your corn crop.

Then, you should add some profit. What kind of profit should you make above the return to your management? This will depend upon your opportunities, competition from producers in other areas, your desire to grow corn, etc. A rule of thumb might be 10 percent above your costs and return to management.

Now you can arrive at a total "asking price" for your corn and decide whether to accept prices offered to you through cash contracts or the futures market.

You would usually not want to hedge if your local market price did not cover your variable costs, since you in effect would be locking in a loss. However, there might be situations where you may wish to lock in a loss if you feel that you could be avoiding an even bigger loss.

2. Localize the futures price: If you are forward pricing by hedging in the futures market, you must "localize" the futures price to determine the net price you will actually receive. Futures prices quoted for corn are prices for corn delivered to Chicago in a given month. You must adjust those prices according to your own location, anticipated time of delivery, product quality and cost of hedging. This is called "adjusting for the basis." To complete a successful hedge, you must know how to accurately fig-
ure your "basis" - or the likely difference between the futures price and the actual cash price on your local market at the time your hedge is completed.

An understanding of your basis and its annual pattern is an essential part of a successful hedge.

3. Make the hedging decision: Once you have figured your target or asking price and determined your local market price, your only decision left in order to forward price is to decide whether to accept a price being offered to you. Again, this decision should be based on your own costs of production, your own desired return to management and profit, your overall marketing objective and careful study of the market.

Summary

Forward pricing by either using cash contracts or hedging in the futures market allows you to "pre-sell" your crop before it is planted, while it is growing or while it is in storage. You can think of forward pricing as a temporary substitute for a cash sale. Whether you should forward price depends upon how much risk you want to assume and your pricing objective. The three possible objectives of forward pricing are (1) to get a higher price than the cash market will offer you, (2) to lock in an acceptable price and avoid price declines, and (3) to base management decisions on known prices.

The three steps to successful forward pricing are (1) determine a target or asking price, (2) localize the futures price if you are hedging in the futures market, and (3) make the hedging decision.