FARMING'S PRONTIBR

Marketing Tools

Marketing Tools and Contract Production

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Marketing Tools/Contract Production
Risk Management Implications

Pacific Northwest and Alaska Risk
Management Education Regional Conference
Spokane, WA - March 24, 1998

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SPOT (CASH) MARKETING ALTERNATIVES

1. Cash Sale at Harvest

- "harvest" crop or livestock output and deliver to market (pricing occurs when delivery is complete)

a. Advantages
   - easy to implement
   - price risk limited to growing period
   - price risk and production risk separated in decision - making

bm Disadvantages
   - limited flexibility
     - e.g. tax planning, cash flow
   - price often at seasonal low
   - selling decisions made during busy time

SPOT (CASH) MARKETING ALTERNATIVES (continued)

2. Cash Sale Sometime After Harvest

   - harvest crop, place in storage for later sale, and price using a decision rule

   a. Advantages
      - added pricing opportunities
      - more time to "assess" market
      - may earn revenue for storage activity

   b. Disadvantages
      - incur additional costs
      - added exposure to price risk
      - easy to "re- think" decision

FORWARD PRICING DEFINED

Forward pricing is defined as any technique which permits the buyer or seller to establish a commodity's price (or a price determining procedure) prior to or after the point in time when the actual physical exchange takes place.

FORWARD PRICING ARRANGEMENTS

1. Traditional cash market contracts:
   a. production contracts
      - includes a variety of contractual arrangements
   b. cash forward contracts
      - typically focuses on price + 2Q's
      - flat price or basis
   c. deferred price contracts
      - deliver and price later

2. Hybrid cash market contracts:
   a. hedge to arrive (HTA)
      - price from designated futures
      - complexity comes from flexibility provisions
   b. min/max price contracts
      - price from options on futures
      - variations increase complexity

3. Hedging using futures

4. Using options on futures

What is Optimum Opportunity to Forward Price?

1. Production Considerations
   a. pre- harvest (storable or non-storable)
      - commodity may not be available to meet commitment
        e.g., reduced yields

2. Price Considerations
   a. more opportunities to evaluate prices
      - still must determine "good" price and establish

3. Risk-Bearing Considerations
   a. can establish varying levels of risk
      - must assess risk-bearing capacity

4. Timing Considerations
   a. longer time period to evaluate prices
      - still must "pull trigger"

FORWARD PRICING ALTERNATIVES

1. Cash Forward Contracts
   - enter into a contractual arrangement with existing commodity buyer for future delivery at agreed upon price (or basis) with time, quantity, and quality specified

   a. Advantages
      - involves the "local" market
      - may be only alternative
      - eliminates price (or basis) risk
      - easy to understand

   bm Disadvantages
      - typically a firm price commitment and some quantity commitment
      - may have shorter time frame than other forward pricing alternatives
      - non-performance risk may exist
      - contractual terms can vary making comparisons more difficult

FORWARD PRICING ALTERNATIVES (Cont.)

2. Deferred Pricing Contract
   - deliver commodity to cash market and agree on a pricing formula that can be used to price by an established date in the future

   a. Advantages
      - flexibility to deliver now and eliminate storage costs
      - potential to capture future price increases
      - may allow deferral of income to a future time period

   b. Disadvantages
      - risk of price change not eliminated
      - typically some "up front" cost

FORWARD PRICING ALTERNATIVES (Cont.)

3. Hedging Using Futures Contracts
   - using a futures market position to offset an existing cash position in such a way that price risk is replaced with basis risk

   a. Advantages
      - flexibility to eliminate position if necessary
      - can reduce price risk associated with the cash market
      - pricing opportunities continuously and consistently reported (about 1 to 2 years ahead)

   b. Disadvantages
      - _must_ understand futures markets and basis concepts
      - necessary to maintain futures account and deal with margin calls
      - cost of protection is giving up chance for price increase
      - subject to basis risk
      - limited to commodities with futures

FORWARD PRICING ALTERNATIVES (Cont.)

4. Buying a put to provide price insurance
   - a put represents the right (but not obligation) to sell a specified futures position at a designated price. The buyer may use the right when it is advantageous, but may choose not to exercise the right. The cost of this right is the premium.

   a. Advantages
      - can obtain price protection without completely giving up price increase
      - cost is known in advance and no margin calls

   b. Disadvantages
      - must understand futures and options
      - desired protection may be unavailable and/or too expensive
      - subject to basis risk
      - limited to commodities with options

MARKETING ALTERNATIVES
(Summary)

1. Several marketing tools available and **likely** to see more in the future
2. Understanding tools is an important step in using effectively
3. Alternative marketing procedures have definite risk management implications
   - tools can be used or abused as for risk management purposes