Forward Pricing With Cash Contracts

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Increasing amounts of grain, oilseeds and specialty crops are being produced and sold under some form of cash contract or other forward pricing arrangement. Farmers have grown more interested in contracting because of wide price fluctuations, narrow operating margins, more specialization that tends to increase risk and a greater need for better financial planning. In short, they have found contracts to be a sound business practice that can help them reduce price risk and secure an advantageous price when the opportunity presents itself.

The grain farmer has a limited number of alternatives when it comes to pricing his grain. He can:

1. **Sell it for cash at harvest**
2. **Hold and speculate on a rise in the cash market**
3. **Use the government loan**
4. **Contract for delivery at a later date**
5. **Use the commodity futures market**
6. **Feed it to livestock**

The farmer who produces some of the specialty crops has even fewer pricing options.

If the farmer wants to price grain for later delivery there are only two choices - the futures market or the cash contract. Pricing grain via the cash contract is much more popular than the futures market. Although few farmers use the futures market to hedge (lock-in a price) their crop, their number is growing.

TYPES OF CASH CONTRACTS

There are three general types of cash contracts. The fixed price agreement, the delayed pricing agreement and the pooled sales agreement. The **fixed price agreement** is the most common contractual arrangement. In this type of contract, the seller agrees to deliver a specified quantity and quality of grain to the buyer at a specified time and place at a predetermined price. In the case of grains, the price is usually based on the relevant futures price. For example, suppose that in June, the Minneapolis September futures price was $3.50 per bushel. Also, assume the local elevator price is about 50 cents per bushel less than the September futures for August delivery to cover transportation and other costs. A price of $3.00 per bushel would be bid to the producer. The producer will receive $3.00 per bushel regardless of whether price goes up or down between June and August. If the producer accepts the $3.00 bid, the local elevator in turn, will most likely forward price the contracted grain to protect its position.

The **delayed pricing agreement** specifies quantity, quality, place of delivery and other obligations similar to the fixed price agreement except the exact price is not set. Instead, the price spread between the futures price and cash price is set. The exact price is then set at a later date. For example, the elevator manager may offer to buy the farmer's wheat in October at 30 cents under the March futures and let the farmer pick the date to establish the cash price. This type of contract permits the grower to deliver the grain to the elevator, transfer title to the elevator but delay pricing of the grain until some later date that the seller considers desirable but prior to the date specified in the agreement. Discounts for quality variations to be applied to the final settlement price should be spelled out in the agreement as in any other contract. This type of contract allows the producer to speculate on general price moves in the market. It also eliminates storage and shrinkage problems. The disadvantage of this contract is that the contract is not as secure as a warehouse receipt if the elevator should fail. This type of contract is not used by North Dakota farmers but it is used in the cornbelt.

Pooled sales agreement are the third type of cash contract that can be used. It has been used most often by cooperatives and by specialty crops marketing groups.

This type of contract can be quite simple. Each producer in the pool is usually given a partial payment when he delivers grain to the pool. During the year, as sales are made, each producer shares in the proceeds above the initial payment according to his contribution to the pool and according to the profits of the pool. Typically, sales are made throughout the year so the average sale price will not be near the high or the low for the year.

In any contract there must be advantages to each party or very little contracting will be done. There are also disadvantages for both parties that must be evaluated. The following are some advantages and disadvantages to be considered by both buyers and sellers.

ADVANTAGES OF CASH CONTRACTS

For the Seller:

- **The exact price can be negotiated in advance. If that price guarantees a profit, the producer doesn't have to worry about the final price and he can concentrate on production problems.**
- **A place for delivering the crop is assured. For some specialty crops this can be of paramount importance. It has been important for grains at times in recent years because of transportation problems that restricted grain movements.**
- **Quantities contracted for later delivery are more flexible than in the futures market. Futures contracts are in units of 1,000 and 5,000 bushels which may not fit the producer's production plans.**
- **Margins and commission fees are not required as with futures contracts.**

For the Buyer:

- **Assured of a share of the supply. He can make forward contracts with customers knowing he will have the supply.**
- **Allows better use of labor, equipment and other resources.**

DISADVANTAGES OF CASH CONTRACTS

For the Seller:

- **Must deliver at the contract price regardless of market price at delivery time.**
- **There may be occasions when cash contracts are not available when the seller wants to contract.**
- **Bankruptcy, strikes, and similar catastrophies could cause buyers to default or postpone acceptance of deliveries.**

For the Buyer:

- **Market price may be below contract price at delivery time.**
- **If sellers have trouble making delivery because of a late harvest or any other reasons, the buyer may have trouble meeting his commitments.**

WHAT SHOULD BE INCLUDED IN A CONTRACT?

The basic provisions of a contract are often summed up by the four W's.

WHO - Names and addresses of the parties involved.

WHAT - The quality and quantity of a specified commodity to be sold at a specified price. The quantity is usually specified in bushels or hundredweight. Sometimes the quantity is specified in acreage. Discounts for quality below specific standards should be indicated. Premiums for grain above the standard should also be included. Some provisions for slight deviations from the the quantity specified is usually included in the contract. A deviation of 5 percent or less is often allowed, meaning delivery of 950 bushels against a 1,000 bushel contract would constitute total delivery.

WHERE - The place of delivery should be indicated. If the buyer has more than one delivery point, the primary delivery point should be specified with appropriate price adjustments if the buyer elects to have the seller deliver at a secondary point.

WHEN - Date of delivery should be specified. The time of delivery should be spelled out in detail as "September1-September 31" and not left in vague terms such as "at harvest". The time of payment should also be specified. It will generally be at the time the grain is delivered but may be at a mutually agreed upon later date. Special clauses such as an Act of God clause may be included in a contract. An Act of God clause, for example, specifies the natural disasters that, if they occurred, would free the seller from the delivery obligations in the contract.

If there are any questions about the specific conditions of a contract, consult an attorney before signing.

SHOULD YOU CONTRACT?

A cash contract does not guarantee profits. In fact, it can limit profits under certain circumstances.

Both buyer and seller should consider the consequences before signing because a contract is legal and binding on both parties.

For the seller, the following points should be helpful:

- Determine your cost of production. If you don't know what it costs to produce a crop you can't determine if a contract price is profitable.

- Do not overcontract. The contract offers price protection and not crop insurance. If some disaster such as insects, disease, or bad weather destroys your crop, you are still obligated for the amount of the contract. Therefore, limit your contract to one-half to two-thirds of anticipated production. If the contract is for a designated acreage as might be the case in a pooled sales agreement, or if the contract has an Act of God clause in it, there is much less chance of overcontracting.

- Keep the buyer informed. If it appears that you overcontracted, inform the buyer. The buyer will work with you to minimize your and his losses. Don't wait until the delivery date to inform the buyer you can't deliver.

- Don't default on the contract. Defaulting damages your reputation and your credit rating and subjects you to prosecution in the courts. Even if you cannot deliver as planned, make other arrangements so a default is not necessary.

- Know the buyer. Contracting with someone whose reputation for sound business affairs is well established will give you much peace of mind. Don't hesitate to ask for references if you don't know the buyer.

For the buyer these points should be helpful:

- Know the seller. Don't contract with someone who doesn't have a good credit rating, or who lives outside your territory without checking him out.

- Limit contract size. Don't contract with a producer for all his expected production. The risk of his being unable to meet his commitment is too great for both the buyer and seller.

- Insure that the contract is fair. A contract is a service the buyer is offering the producer but it also offers the buyer some advantages in volume, time of delivery and quality of product delivered. Make certain that the contract provides equitable returns to each party.

- Spell out all obligations in writing. Don't leave anything important to later interpretation.

- Follow up on contracts. Check with the grower periodically on the condition of his crop. If the crop is less than satisfactory, discuss the problem with the producer and suggest ways that losses can be minimized.

- Be certain the grain under contract is free of all liens.

Both buyer and seller should read over the contract and clarify anything confusing, then both should sign the contract.

SUMMARY

A cash contract is one method for reducing risk associated with price changes of a crop during the growing season or while in storage. It is a sound marketing technique which is growing in popularity. There are three basic types: fixed price agreements, delayed pricing agreements and pooled sales agreements. Each can have many variations. Terms and conditions of the contract should be spelled out, understood and agreed upon by both parties to avoid misunderstandings and losses.

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