“New Generation Grain Contracts”

Econ 338c

April 19, 2007

Steven D. Johnson
Farm Management Field Specialist
Presentation Objectives

- Highlight 7 Megatrends in the Grain Industry
- Identify Producer Challenges and Opportunities with New Generation Grain Contracts (NGCs)
- Introduce NGCs, Describe and Provide Examples for each of 3 Primary Categories
- Review the Performance of Selected NGCs
- Draw Cautions, Conclusions and Further Observations about NGCs
The Seven Megatrends of the Commodity Grain Industry

• Larger-Scale Commodity Farms
• Producers Use of Crop Insurance Revenue Tools (CRC, RA w/HPO and GRIP w/HRO)
• Rapid Growth in the Bio-Fuels Industry
• Expansion of Grain Storage and Pre-Harvest Marketing Strategies
• “Originating more Bushels” by Grain Merchandisers
• Proliferation of Grain Production Contracts
• Advanced Risk Management Skills
Pre-Harvest Crop Marketing Plan

Crop Insurance Revenue Tools

New Generation Grain Contracts

Source: Johnson, ISUE Farm Mgt., 2007.
Producer Marketing Challenges

- Inability to “pull the trigger”
- Excessive emotion that leads to indecision
- Complexities from a variety of traditional marketing tools (futures and options)
- Lack of discipline in following a marketing plan.
NGC Characteristics

• Producer initiates the contract with grain originator

• Futures only contracts (HTAs non-roll)
  – Predetermined pricing rules
  – Non-discretionary (Cargill ProPricing)
  – Discretionary (Decision Contracts)

• Commitment of delivery
  – 5,000 bushel increments (corn)
  – Specified delivery period (weeks or month)
  – Basis typically remains open or must be accepted at time of delivery
NGC Categories

• Automated pricing (averaging)
  – Cargill *ProPricing* (A+)

• Managed hedging
  – Cargill *ProPricing* Market Pros

• Combination contracts
  – Decision Commodities (Rally)
  – FCStone *Accumulator*
Automated Pricing

• Advantages
  – Automates decisions (average price)
  – Overcomes pricing volatility
  – Optimizes producer time
  – Eliminates margin calls
  – Capitalizes on seasonal averages
  – Leaves the basis open.
A+ Contract

December Corn

A+ Contract Performance

A+ Consistency vs LH Sept/Oct Average

Updated on 7/12/2006
Managed Hedging

• Advantages
  – Locking in higher futures prices
  – Adding incentive for MarketPros performance
  – Leaving basis open
  – Taking the emotion out of the pricing decision.

• Risks
  – Dependent on the Market Pros’ performance
  – No guarantee of final price
  – Minimum contract size
  – Service fee
    • Approximately $0.05 per bushel
    • Paid at final settlement of the sale of the grain
Cargill Ag Horizon Contract Performance

Cargill Dec Corn

$3.20
$3.00
$2.80
$2.60
$2.40
$2.20
$2.00
$1.80

Dec 01  2.3850
Dec 02  2.6925
Dec 03  2.4450
Dec 04  2.8000
Dec 05  2.7500
Dec 06  2.4000
Dec-05  2.7550
Dec-06  2.7350
Dec-07  3.0100

Updated on 7/12/2006
Combination Contracts

• Advantages
  – Uses seasonal price trend
  – May provide higher selling prices than existing futures prices
  – May sell more bushels when futures are at higher prices
  – Leaves the basis open
  – Might allow for “rolling futures” should carry and basis warrant

• Risks
  – May be difficult for producers to understand pricing and bushels commitment
  – The issue of “doubling bushels” at high prices and “kick out” at low prices
  – The use of “over-the-counter” options used to offset futures prices
Decision Commodity – Harvest Corn Delivery

Rally Pricing Model Example

Commodity – Corn
Start Date – 01-01-06   End Date – 07-31-2006 (7 months)
Futures Month – Dec 2006 (CZ6)

Floor Price - $2.40   UpPoint – $0.00   Throttle -5

2001 2002 2003 2004 2005 2006

CZ - Floor: $2.40 - Throttle: 5 - UpPoint: $0.00  Decision Commodities LLC
Decision Commodity – June Corn Delivery

Rally Pricing Model Example

Commodity – Corn
Start Date – 01-01-05     End Date – 05-31-2006 (17 months)
Futures Month – JUL 2006 (CN6)
Floor Price - $2.50          UpPoint – $0.00            Throttle -

Rally
May/June

2001 2002 2003 2004 2005 2006

CN - Floor: $2.50 - Throttle: 5 - UpPoint: $0.00

Decision Commodities LLC
FCStone ACCUMULATOR ®

- Offered by country elevators through FCStone. Prices bushels weekly over a set period of time at a Selling Price above current CBOT.

**ACCUMULATOR DEC CORN SELLING PRICE**  $2.83

**CURRENT DEC CORN FUTURES**  $2.70

**KNOCK OUT PRICE DEC CORN**  $2.20
Example of 2006 Contract Offered
(December Corn Futures Chart)

Accumulator Selling Price $2.83/bu.

Knock Out Price $2.20/bu.

Source: www.futuressource.com
2006 Accumulator Contract

• Producer signs an Accumulator Contract with their local elevator. The following information is known:
  • Accumulator Selling Price: $2.83 (no basis determined)
  • Bushels Offered: 5,000
  • Bushels Potential: 10,000
  • Accumulation Period: 25 Weeks on Fridays, beginning April 7th through September 29th
  • Every Friday, 200 bu. are priced @ $2.83 futures as long as Dec CBOT futures have not closed/settled above this price or touched the $2.20 Kick Out price during any week of this Accumulation Period.
Benefits of NGCs from a Producer Perspective

• Benefits include*:
  – discipline in pricing grain
  – diversification of pricing
  – reduces emotion and time
  – eliminates margin calls

* Purdue University, Ag Economics Report, 2004
Cautions about NGCs

- Producer understanding the risks of production contracts
  - production, delivery and market price determination
  - reading the contract for details
- Small service fee
  - $0.02 to $0.05 per bushel
- Knowing number of bushels actually priced
- Timing basis decisions
- Placing too many bushels into any one NGC product and having it not perform
Further NGC Observations

- Rapid adoption by merchandisers with strong producer relationships (on-farm storage and access to trucks)
- Multiple pricing periods (beyond harvest)
- Longer pricing periods (up to 36 months)
- Varying contract originators and delivery locations (ethanol plants vs. elevator)
- Bundling input decisions with contracts
- Use of Crop Insurance with NGCs could lead to Acreage Contracts

Questions?

Steven D. Johnson
Farm & Ag Business Management
Field Specialist
(515) 261-4215
sdjohns@iastate.edu

www.extension.iastate.edu/polk/farmmanagement.htm