

Agribusiness: Understanding Grain Marketing Alternatives

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This Note discusses grain marketing alternatives, including forward contracts and deferred delivery contracts and more traditional approaches for the sale of grain such as cash sale contracts. This Note also discusses the issues parties should consider to ensure that their forward contracts comply with the Commodities Exchange Act, CFTC regulations and applicable state laws.

Various forms of grain purchase contracts can provide viable marketing alternatives for sellers and buyers of grain to manage prices and protect against market changes. But parties to these arrangements and their counsel should weigh the risks of each type of contract against its merits. Additionally, buyers should ensure that they understand the inner workings of each contractual arrangement as well as the licensing, bonding and regulatory obligations that govern these arrangements.

This Note describes some of the more commonly used grain marketing contracts. However, due to the complexity of futures markets and the wide variety of contracts that are used, this Note does not exhaustively cover the different economic strategies buyers and sellers employ when negotiating and entering into these contracts. Rather, it is intended to provide a framework of the basic contracting principles of these agreements and the main risks associated with their use.

GRAIN MARKETING ALTERNATIVES

WHAT IS GRAIN MARKETING?

Grain marketing is a systemic approach producers take to achieve price objectives for their grain. It takes into account the producers' yields, costs of production and market prices. It also uses a combination of futures contracts, spot and forward contracts, commodities programs and insurance (to name a few) to offset risk. One common form of grain marketing is for producers to sell their grain to buyers using one or more grain purchase contracts. These contracts are often variations of simple cash sales with terms that may

be similar to other asset purchase contracts (see *Traditional Types of Grain Contracts*). But these sales may not garner the best price for the seller. To help manage price fluctuations and ensure they meet their price objectives, many producers and elevators execute more complex grain marketing contracts (see *More Complex Grain Contracts*).

TYPES OF GRAIN CONTRACTS

The grain marketing contracts used by producers and elevators are a type of off-exchange (over the counter transaction) in which one party (the seller) sells a physical commodity to another party (the buyer) for either a fixed price or a price to be determined sometime in the future. There are several types of contracts that can achieve this objective, including:

- Spot sales (see *Spot Sales*).
- Cash sales with deferred delivery (see *Cash Sale with Deferred Delivery*).
- Cash sales with deferred payment (see *Cash Sale with Deferred Payment*).
- No price established contracts (see *No Price Established Contracts*).
- Basis contracts (see *Basis Contracts*).
- Minimum price contracts (see *Minimum Price Contracts*).
- Hedge to arrive contracts (see *Hedge to Arrive (HTA) Contracts*).
- Some new generation contracts (see *New Generation Contracts (NGCs)*).

Regardless of the grain marketing contract used, the parties must establish the basis for the grain to determine the price at which it will be sold.

BASIS

Basis is the difference between the cash market price and the futures price of a grain (as established by the applicable board of trade, usually the Chicago Board of Trade (CBOT)). The cash market price (also referred to as the spot price) is either:

- The price set by the local elevator that is purchasing the grain.
- The average price for the grain set in a particular regional market.



The basis is a good indicator of a particular area's pricing and can be used to compare prices in other markets. It reflects local market conditions and may be influenced by:

- Transportation costs.
- Storage and interest costs.
- Local supply and demand.

By keeping track of the historical basis in a particular market, the parties can more effectively plan how to market their grain using a grain purchase contract that best suits their needs and meets their marketing objectives. Adding the expected basis to a futures month price, enables the parties to calculate a future cash price for their grain. Since transportation costs can greatly reduce the profitability of a grain sale, sellers should use a cash price as close to the source of the grain as possible when calculating basis.

Basis can be "under" or "over" the futures price.

UNDER BASIS

Basis is referred to as being "under" if the futures price for the grain is higher than the cash price. The cash price is the price the buyer pays to the seller for the commodity being sold under the grain purchase contract. If the cash price for the grain declines relative to the futures price, the basis becomes a smaller positive number (and possibly negative). This is known as a weakening basis.

Generally, sellers hope that the cash price increases in comparison to the futures price (strengthening) while buyers hope that the cash price declines (weakening) in comparison to the futures price.

By way of example, if in July 2014, a farmer wants to sell corn to a local elevator and at the time, the cash price for corn is \$4.00 per bushel (bu.) and the applicable futures month price is \$4.50 per bu., then the basis is "under" at \$-0.50 per bu. By contrast, if in September 2014 the cash price of corn is \$3.35 per bu. and the applicable futures month price is \$4.25 per bu., the basis is still under at \$-0.90. But it is a weakening basis because the cash price is declining relative to the futures price. The cash price decreased by \$0.65 while the futures price fell by only \$0.25. The weaker the basis, the worse it is for the seller and the better it is for the buyer because it reflects a lower price the buyer is paying for the grain. In this example, the seller would have been better off selling its corn in July when the cash price was higher.

The fact that a basis is "under" does not necessarily mean the basis is weakening in and of itself, and vice versa. The cash price of the commodity could move from \$4.00 to \$4.50 while the futures price remains steady at \$4.55. This would be an example of a basis that is both "under" and strengthening. So the buyer and seller need to be aware of not only the cash and futures price, but also their relation to one another over time.

OVER BASIS

Basis is referred to as being "over" if the cash price for the grain is higher than the futures price. Basis becomes a higher positive number (or less negative) if the cash price improves in comparison to the futures price. When the cash price gains strength against the futures price, this is known as a strengthening basis. The more positive the basis, the better it is for the seller and the worse it is for the buyer because it reflects a higher price the buyer is paying for the grain.

By way of example, if the same farmer as in the above example wants to sell a new crop of corn in September 2015 and the cash price is \$4.00 per bu. and the futures price is \$3.50 per bu., the "over" basis is \$0.50. If in December the cash price of corn is \$4.05 per bu. and the futures price is \$3.45 per bu., the basis would not only be "over" at \$0.60 but would also be considered strengthening since the futures price decreased by \$0.05 and the cash price increased by \$0.05. The seller should sell in December when it can receive a higher price.

GRAIN CONTRACTS EXCLUDED FROM REGULATION

Cash and forward contracts are exempt from regulation by the Commodity Futures Trading Commission (CFTC). A forward contract is a type of grain marketing arrangement in which a buyer agrees to buy, and a seller agrees to sell, a given quantity of an underlying asset or good on a specified future date at a price agreed to at the time the contract is signed. Buyers and sellers use these contracts to manage their risks and fluctuations in market price. For more information on forward contracts, see *Practice Note, Derivatives: Commercial Uses* (<http://us.practicallaw.com/6-386-9004>).

Generally, forward contracts are exempt from the requirements of the Commodity Exchange Act (7 U.S.C. § 1) if the following conditions are satisfied:

- There is a specified quantity of goods.
- There is a specified quality of goods.
- The contract is between industry participants, such as farmers and grain merchants.
- The price can be agreed on in advance, or the price will be determined at the time of delivery.
- The contract terms are negotiated, rather than standardized.
- Delivery is set at a specified future date at a specified place.
- The totality of the facts and circumstances indicate that the agreement is a forward contract and not a futures contract.

(See *Nagel v. ADM Investor Servs., Inc.*, 217 F.3d 436 (7th Cir. 2000) and 7 U.S.C. § 1a(27) (2013)).

The CFTC has allowed this exemption primarily because forward contracts have proven to be a viable way for buyers and sellers to secure attractive prices for their grains (see *Nagel*, 217 F.3d 436). This exemption is significant because it allows producers and elevators to freely contract for grain through transactions that offer the hedge-like benefits of derivatives, swaps and options, but without the same level of regulation.

When a buyer and seller enter into a forward contract, they are watching how the basis on a particular commodity plays out over time. In most forward contracts, the buyer wants to see the basis weaken and the cash price decline, while the seller wants to see basis strengthen and cash price rise. For example, if the parties entered into an agreement under which they agree that at a future date the seller will sell a certain quantity of corn to the buyer for \$4.00 per bu., then, if at that future date, the price per bu. is \$5.00, the buyer is better off. It is paying \$1 dollar less per bu. than it would if it had purchased the corn in a spot sale at a later date (see *Spot Sales*). If, by contrast, the price on the agreed future date fell to \$3.50 at the later date, then the seller is better off as it is receiving \$.50 more per bu. than it would if it had waited for the sale. For more information on the effect of basis on commodity prices, see *Basis*.

IMPORTANCE OF PHYSICAL DELIVERY

Cash and forward contracts may be settled by cash or physical delivery (see *Practice Note, Derivatives: Overview (US): Forwards and Futures: Physical Settlement or Cash Settlement* (<http://us.practicallaw.com/3-387-5073>)). However, a commodity must be physically settled for the transaction to be exempt from regulation under Title VII of the Dodd-Frank Act, the CEA or the Securities Exchange Act (see *Legal Update, Regulators Define Key Dodd-Frank Terms "Swap" and "Security-based Swap" Triggering Title VII Compliance: Transactions that are Not Swaps or Security-based Swaps* (<http://us.practicallaw.com/2-520-3275>) and *Practice Note, Summary of the Dodd-Frank Act: Swaps and Derivatives: Derivatives Excluded from Title VII Regulations* (<http://us.practicallaw.com/3-502-8950>)).

Relevant case law has also held that the contemplation of the physical delivery of the grain "is the hallmark of any unregulated [] forward contract." (See *Grain Land Coop v. Kar Kim Farms, Inc.*, 199 F.3d 983, 990 (8th Cir. 1999)). In determining whether a contract contemplates physical delivery, courts have considered the following factors:

- Whether the parties to the contract are in the business of producing or obtaining grain.
- Whether the parties are capable of delivering or receiving grain in the quantities provided for in the agreement.
- Whether there is a definite date of delivery.
- Whether the contract explicitly requires actual delivery, as opposed to allowing delivery obligations to be rolled indefinitely into the future. While deferred delivery is permitted, this deferral cannot be indefinite.
- Whether payment takes place only on delivery.
- Whether the contract's terms are negotiated, as opposed to standardized.
- The course of dealing between the parties.
- The totality of the circumstances surrounding the contract's execution, "assessing the transaction 'as a whole with a critical eye toward its underlying purpose.'"

(See *Lachmund v. ADM Investor Serv's, Inc.*, 191 F.3d 777, 778 (7th Cir. 1999)).

The terms of the contract are often the starting point for the CFTC and federal courts in determining whether the contract is exempt from regulation. Some contract terms are more likely to support the physical delivery requirement. These terms include:

- A definite date of delivery or deadline by which delivery must take place.
- A condition dictating what happens if the grain is delivered in an improper grade or is unmerchantable.
- Specific times for shipment.
- Allowing the buyer to route the grain to alternate destinations if it is unable to receive the grain at the time of delivery.
- Allowing the seller an option to fulfill the contract with grain from its own production or a different source.
- Requiring the grain to conform to applicable food standards.
- Requiring pricing to be made on or before delivery.

(See *Lachmund*, 191 F.3d at 778.)

While federal courts have traditionally held a more lenient view on the delivery requirement, the CFTC has been known to reclassify some transactions as illegal off-exchanges under the CEA (sometimes levying fines against the buyer) when delivery becomes too attenuated (see *In re Competitive Strategies, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,635* (CFTC Nov. 25, 2003)).

FORWARD CONTRACTS VERSUS FUTURES CONTRACTS AND SWAPS

To ensure that grain marketing contracts do not become subject to CFTC regulation, counsel for the buyer and seller should be mindful of how grain forward contracts relate to two closely related (but different) instruments:

- Futures contracts.
- Swaps.

A transaction is most likely to be defined as a forward contract if the following conditions are met:

- The contract and performance are between a buyer and seller.
- The buyer and seller are market participants who regularly make or take physical delivery of the grain in the ordinary course of their business.
- The contract provides for a set specific delivery date.

Futures Contracts

A futures contract is a contract for the purchase or sale of a commodity for future delivery (7 U.S.C. § 1a(27)). While this may sound similar to the definition of a forward contract, as "future delivery" is defined, the term does not apply to forward contracts because it excludes any "sale of any cash commodity for deferred shipment or delivery" (7 U.S.C. § 1a(27)). In addition, a futures contract is:

- A financial instrument that is usually traded on a regulated exchange (most notably, the CBOT) and a key component of which is the assumption or shifting risk.
- Between individuals who are not actual producers of the commodity being sold or merchants.
- Less likely to be backed by physical assets and more speculative in nature.
- Subject to the regulation of the CFTC.

By contrast, forward contracts are:

- Usually between market participants.
- Backed by the physical delivery of the actual asset they contemplate (see *Importance of Physical Delivery*).
- Exempt from CFTC regulation.

In addition, futures contracts are typically much more speculative.

Swaps

A swap is another regulated financial arrangement that farmers and elevators can use to manage their risk (7 U.S.C. § 1a(47)(B)). Notably, several changes to the definition of a swap under the Dodd-Frank Act caused some uncertainty with regard to the forward contract/swap relationship. The CFTC has taken steps to help clarify this relationship.

A forward contract is not a swap so long as:

- The commodity is a non-financial commodity.
- The transaction is a sale for deferred shipment or delivery.
- The parties intend to physically settle the sale and individually negotiated.

For more information on swaps, see *Practice Notes, Summary of the Dodd-Frank Act: Swaps and Derivatives* (<http://us.practicallaw.com/3-502-8950>) and *Road Map to Dodd-Frank Swaps and Derivatives Regulation* (<http://us.practicallaw.com/7-557-8945>) and *Legal Updates, CFTC Clarifies Dodd-Frank Exemption for EVO Forward Contracts* (<http://us.practicallaw.com/1-614-1625>) and *Certain Forward Contracts with Embedded Volumetric Optionality (EVO) to Be Excluded from Dodd-Frank Swaps Rules* (<http://us.practicallaw.com/5-589-7585>).

DISTINGUISHING BETWEEN REGULATED OPTIONS AND OPTIONS IMBEDDED IN GRAIN CONTRACTS

Many grain contracts include provisions that give the parties the option to defer payment or delivery of the grain (for example, some of the more complex grain contracts such as managed hedging contracts and automated pricing contracts (see *More Complex Grain Contracts*). The inclusion of these options does not necessarily subject these agreements to the regulation of the CFTC. Like other exempt grain contracts, an important point of consideration when implementing grain contracts that use options is ensuring that the agreement obligates the seller to actually sell and deliver the goods, rather than providing the seller an option to walk away. For example, a seller may pay a cancellation fee in exchange for the right to terminate the contract in the event of grain shortages. This helps differentiate the arrangement from exchange-traded options, which are instruments that confer "upon the holder the right, but not the obligation to buy (or sell) a specific amount of a commodity within a certain period of time at a given price." So long as the contract is carefully constructed and performed, the CFTC has held that options imbedded in forward contracts (like those in a minimum price contract (see *Minimum Price Contracts*)) may be exempt from regulation. (See *In re Cargill, Inc. [transfer binder 2000-2002] Comm. Fut. L. Rep. (CCH) ¶ 28,425 (CFTC Nov. 22, 2000).*)

RISKS OF FORWARD CONTRACTS

One of the main risks of a forward contract is counterparty risk (see *Industry-Specific Risks Created by Grain Contracts for Sellers*). The buyer bears the risk that at the time the grain is supposed to be delivered, the seller will not have the grain. Similarly, the seller bears the risk that the buyer will refuse or be unable to pay the purchase price. In addition, both parties bear the risk that the other may become subject to a bankruptcy proceeding. However, if certain conditions are met, the Bankruptcy Code contains safe harbor provisions that give non-debtor parties certain rights (including the ability to terminate the contract) under specific types of financial contracts (including forward contracts) entered into with counterparties that become debtors in bankruptcy. For more information on these rights, see *Practice Note, Bankruptcy Code Avoidance Action Safe Harbors* (<http://us.practicallaw.com/7-538-9025>) and *Guide to Bankruptcy Code Safe Harbors for Financial Contracts: Checklist* (<http://us.practicallaw.com/2-535-6287>).

OTHER NOTABLE CONCERNS WHEN USING GRAIN CONTRACTS

There are many practical issues that the buyer and seller should consider before entering into a contract for the sale of grain. These considerations include:

- Establishing, in compliance with certain state statutory requirements, minimum purchasing quantities to ensure the process is worthwhile for the parties.
- Specifying cancellation fees that may be payable for crop failures since the likelihood of crop failure increases over time.
- Whether the buyer is required under applicable state law to post a bond to secure the performance of its obligations under the forward contract and the length of time for which it must do so.
- Whether there are any state law provisions that must be included in the purchase contracts as well as statutory timelines that must be observed for making payments to the seller after delivery (see, for example, *Mo. Rev. Stat. § 276.461*).
- Whether the buyer is required to have a grain dealer's license under applicable state regulations before buying grain. Classes of grain dealers, and their corresponding rights under their respective licenses, vary from state to state. The buyer should ensure that its license allows it to enter into deferred pricing or deferred payment arrangements and any other sales on credit. Licensing rules should be carefully reviewed under the applicable state statutes and regulations.
- Any state warehousing laws and obligations that may apply if the buyer takes delivery of grain before pricing is established (see, for example, *Mo. Rev. Stat. § 411.255* and *UCC Article 7*). This can require additional licensing and obligations on the part of the buyer. The parties can avoid this risk by ensuring pricing occurs before delivery or that they occur on the same date.
- Whether there are any collateral issues that apply. Because forward contracts contemplate a sale between a farmer and an elevator (or between successive grain mills) for grains that have yet to be processed, the buyer may have certain rights as to the grain against other creditors of the seller. For example, the Federal Food Security Act of 1985 was enacted to protect purchasers of farm products from becoming sureties for the farmer's debts to lenders that hold a security interest in the purchased farm products (*7 U.S.C. § 1631*). On the other hand, some state laws provide strong statutory liens for landowners, giving them a first priority security interest in crops that are grown on their land under a lease. A contract for the purchase of grain will need to address the applicable federal and state laws covering both to ensure that the buyer has good title to the goods at the time of sale. For example, see *Tex. Prop. Code §§54.001-54.007* and *87.705-755*; *Ga. Code Ann. §§ 44-14-341 to 44-14-348*, *S.C. Code Ann. §§ 29-13-30 and 29-13-60 to 29-13-130* and *735 ILCS 5/9-316*.
- Identifying the party who bears the risk of loss. Risk of loss and ownership can become unclear unless the agreement clearly states when title passes and whether the grain is priced FOB (free on board) buyer's location. For more information on risk of loss and other issues related to the sale of goods, see *Practice Note, Delivery of Goods* (<http://us.practicallaw.com/6-521-8246>) and *Standard Clauses, General Contract Clauses: Title to Goods* (<http://us.practicallaw.com/3-531-0246>).

- Specifying the party responsible for handling the shipment of the goods.
- Specifying any adjustments to the purchase price. The buyer wants to ensure that the contract expressly states that the price may be adjusted to take into account the buyer's:
 - discount schedule;
 - premiums or service fees;
 - CBOT fees for offsetting trades;
 - transportation costs; and
 - storage, labor, utilities and other adjustments.

Sometimes the basis will take some of these items into consideration, but the buyer should be sure that it covers its costs expressly in the contract, if possible (see *Basis*).

- Whether applicable state laws require the buyer to give the seller purchase confirmations to which the buyer may attach standard terms and conditions. When drafting these terms and conditions, the buyer should be aware of the trade association rules that are prevalent in the agriculture industry, most notably, the National Grain and Feed Association for North American transactions and the Grain and Feed Trade Association for international transactions. These associations often have rules that reflect industry standards and have favorable arbitration services that are specifically tailored to the grain industry.
- The seller's familiarity with forward contracts. The buyer's business relationship with a seller may be damaged if the seller is not familiar with forward contracts (as may be the case with many local producers) and the seller loses money based on market fluctuations. The buyer should note who its seller is and whether it should enter into complex grain purchase contracts with them.
- Traditional contracting principles under the UCC.

INDUSTRY-SPECIFIC RISKS CREATED BY GRAIN CONTRACTS FOR SELLERS

Sellers may also be subject to certain risks that are inherent in different types of grain marketing contracts. This Note discusses these risks in the context of several different types of agreements (see *Traditional Types of Grain Contracts* and *More Complex Grain Contracts*). However, sellers should have a basic understanding of each type of risk:

- **Price-level risk.** This is the risk that futures prices will change in adverse directions from the current price level.
- **Production risk.** This is the risk that the seller will not be able to fill the contracted quantity of grain due to shortages or weather. Production risk is inherent in any contract that requires the seller to deliver at a later point in time.
- **Basis risk.** This is the risk that basis will weaken over time. Basis risk is usually much smaller than price-level risk as it has a stronger historical track record than futures prices, which can vary greatly.
- **Counterparty risk.** This is the risk that the buyer will be unable to pay for the grain. This risk is increased anytime grain is sold on credit such as when a no price established contract is used.
- **Spread risk.** This is the risk that the price differentials between nearby and distant futures prices will move in a direction that reduces the price.

- **Control risk.** This is the risk that the seller will not be able to adequately manage the contract's decision-making processes to handle market swings. This risk is increased by the complexity level of a particular grain contract.

TRADITIONAL TYPES OF GRAIN CONTRACTS

While more complex contracts may be used by the buyer and seller, many buyers and sellers use simpler arrangements such as:

- Spot sales (see *Spot Sales*).
- Cash sales with deferred delivery (see *Cash Sale with Deferred Delivery*).
- Cash sales with deferred payment (see *Cash Sale with Deferred Payment*).
- No price established contracts (see *No Price Established Contracts*).

SPOT SALES

Spot sales (also known as cash sales) are the simplest form of grain sales. In this arrangement, the seller sells a certain quantity of grain to the buyer for the current market price. Payment and delivery usually occur simultaneously. The risks to the seller in a spot sale are relatively low. However, market price risk may arise depending on how the buyer applies the cash price. If the buyer sets the cash price on the first shipment date to the whole quantity of grain, market risks are relatively low. The seller knows the price it will receive for each subsequent shipment. If, by contrast, the buyer's policy is to price each shipment as it is delivered (which is common), the seller could be subject to market price fluctuations during the time it takes to tender full delivery of the grain. In such an event, the seller should be aware of the time between shipments and how the price will be applied to each one.

CASH SALE WITH DEFERRED DELIVERY

A buyer and seller may also enter into a grain purchase contract that includes a deferred delivery arrangement in which the key provisions of the sale are finalized, but the actual delivery of the grain does not take place until a later time. This is known as a cash sale with deferred delivery (or a forward cash contract). The reasons for entering into a deferred delivery contract vary, but one common reason is to secure an immediate fixed price for grain that may be produced and delivered later.

Typically, a cash sale with deferred delivery contract sets out:

- The specific delivery date.
- The quantity of grain the buyer must deliver.
- The price the buyer must pay for the grain.
- The shipment terms of the goods to the buyer's location.

Because all the pertinent payment and delivery terms are finalized simultaneously, future market price risks are mostly non-existent. But the seller does not get to participate in market rallies if they occur between the date of contracting and delivery.

The seller also bears production risks since it is obligated to deliver a certain quantity of grain at a future date. If the seller's harvest yields a smaller amount than expected because of weather or other conditions, the seller may have to acquire grain from another source

to meet its contractual obligations to the buyer. These environmental risks are the primary trade-off for the predictable pricing offered by a cash sale with deferred delivery.

CASH SALE WITH DEFERRED PAYMENT

This contract specifies the price, delivery date, quantity and shipment terms at the time of the agreement is signed, but the buyer is given the option of deferring payment for the grain into a new tax year. This type of contract exposes the buyer to warehouseman licensing laws if it receives the grain before title is transferred to it. This arrangement also poses a credit risk to the seller since there is a chance the buyer could go out of business or fail to pay for the delivered grain.

NO PRICE ESTABLISHED CONTRACTS

No price established contracts (also known more generically as price later or delayed price contracts) allow a seller to deliver its grain (and transfer title) to the buyer without setting a sales price. The buyer takes delivery of the grain and charges the seller a fee for allowing the price deferral. The seller may use this type of arrangement to capture higher future prices and at the same time secure storage for its grain. However, as the name suggests, no price established contracts carry a heavy credit risk for the seller and also exposes the seller to many issues, including:

- Market price risk.
- Basis risk.
- Counterparty risk.
- Spread risk.

Some parties (and their counsel) do not like using these contracts because they are too speculative and have the potential to damage commercial relationships. However, it does offer some benefits. In the case of the buyer, in addition to the fee it receives, it is able to avoid paying the seller for a while. Also, both parties hope the price changes in a way that benefits them at a later point in time.

MORE COMPLEX GRAIN CONTRACTS

Certain grain contracts provide greater "hedge-like" qualities that sellers and buyers can take advantage of. As payment terms and delivery obligations become more complex, both parties will have greater obligations to manage basis, along with futures and cash pricing. The main types of complex grain contracts are:

- Hedge to arrive contracts (see *Hedge to Arrive (HTA) Contracts*).
- Minimum price contracts (see *Minimum Price Contracts*).
- Minimum/maximum price contracts (see *Minimum/Maximum Price Contracts*).
- Basis contracts (see *Basis Contracts*).
- New generation contracts (see *New Generation Contracts (NGCs)*).

HEDGE TO ARRIVE (HTA) CONTRACTS

An HTA is a contract between a buyer and a seller for the sale of a fixed quantity of grain for delivery at an agreed time in the future. There are two types of HTAs:

- Non-rolling HTAs.
- Rolling HTAs.

Non-rolling HTAs

In a non-rolling HTA the price of the commodity is tied to a futures contract price that usually expires in the month of delivery. The futures price is set at the time of contracting, but the basis floats until the seller decides to fix it. If the seller does not fix the price before the deadline specified in the contract, the price is automatically set by the terms of the non-rolling HTA.

These agreements offer the seller the benefit of avoiding market downswings, but the seller does not get to participate in market rallies because, although the basis is subject to change up to the point of expiration, the futures month reference price is set and does not change. While this type of contract may limit the seller's ability to benefit if prices rise, it also limits their exposure if prices decrease.

Pricing is calculated as follows:

- The seller sets a certain futures contract month as its price.
- In exchange, the seller pays buyer a service fee (usually per bu.).
- The seller has up to the contract expiration date to set its basis, based on the reference futures month price (see *Basis*).
- The buyer pays the seller the contracted for futures price, plus or less the seller's basis for the goods minus the buyer's service fee and any other additional fees the buyer may charge.

Alternatively, the buyer establishes a corresponding futures hedge position on a commodity exchange to hedge against price fluctuations between signing and delivery. Since the futures price is already set, the buyer takes a "long" position in the contract with the seller. This means that if the price for the commodity rises, the buyer gets the grain for a cheaper price than it would normally. However, if the price falls, the buyer is stuck taking the grain at a price higher than the market rate.

To hedge against this risk, buyers also take a "short" position on a futures contract for the same quantity of grain, guaranteeing to sell the grain for the contract price. This way, if the price of the grain falls between the time of signing of the contract and delivery, the buyer will lose out on the contract with the seller, but will make up the loss in its futures contract where the buyer gets to sell the grain at the fixed price. In a non-rolling HTA, the primary risk to the seller is basis risk (the risk that the basis will weaken) incurred after the time the contract is executed and before the seller's basis is locked in on the delivery date.

Rolling HTAs

Non-rolling HTAs are relatively simple. Rolling HTAs are more complicated. Under these agreements, the seller (usually after paying a fee and adjustment in the price) can defer delivery beyond the original date specified in the original HTA. The buyer will then close out its current corresponding futures contract by buying a new futures contract that is scheduled to expire on the new delivery date. When the delivery date for that contract comes, the seller is offered the option of again rolling the hedge. This can be repeated several times, but it can cause the contract to come under the scrutiny of the CFTC because delivery is being continually deferred (see *Importance of Physical Delivery*).

Rolling HTAs from year to year increases the contracts':

- Price level risk.
- Basis risk.
- Control risk.
- Spread risk.

There are several kinds of rolling HTAs:

- **Intra-year rolling HTAs.** These HTAs change the delivery date to another time within the same crop year.
- **Inter-year single-crop rolling HTAs.** These HTAs change the delivery date from one crop year to another but still cover the same crop.
- **Multi-year inter-crop rolling HTAs.** These HTAs change the delivery date from one crop year to another and also expand to cover subsequent crops.

The seller engages in higher levels of speculation when the HTA is rolled over more years and for different crops. In addition, losses the buyer incurs from selling futures to cover its positions can quickly become the obligations of the seller.

MINIMUM PRICE CONTRACTS

A minimum price contract is a grain sale contract that allows the seller to lock in a minimum price for the grain while allowing the seller to take advantage of higher prices that may occur later. The minimum price is determined by the seller agreeing to a "strike price," for which the buyer charges an option premium and trade costs, adding or subtracting basis. Both the option premium and trade costs will be priced per bu. Under this arrangement, the seller can benefit from higher prices that occur after the date of contracting, but must be careful to watch to see if the futures price rises high enough to account for the additional costs the seller is paying to the buyer.

On or before the option expiration date, the seller can deliver its grain to the buyer, locking in the purchase price. The purchase price will be based on a futures price for the date of delivery and will be adjusted to account for:

- Basis.
- The premium.
- The buyer's adjustments for additional fees it may incur for purchasing offsetting positions in a futures contract.

Because the seller is protected against market downswings, the price will be the greater of the cash price at the delivery or the minimum price. The downside of a minimum price contract is that the premium (which is usually higher than the service fees charged for other forward contracts) must be first accounted for the seller to earn a profit.

Basically, the price on the delivery date is:

- The minimum price (usually determined by reducing the strike price by the premium and trading cost).
- Plus any gains on the pricing date (the difference between the strike price and futures price, if any, for the futures month price).
- Plus basis.
- Minus the buyer's additional fees.

Minimum price contracts have relatively low risk compared to some of the other forward contracts. But they still expose the seller to:

- Production risk.
- Control risk.
- Some market volatility risk.

In addition, buyers should consider that if the minimum price contract becomes too complex, it could deter potential sellers from participating. It should also be noted that although these contracts include an option, they are not subject to CFTC regulation (see *Distinguishing Between Regulated Options and Options Imbedded in Grain Contracts*).

MINIMUM/MAXIMUM PRICE CONTRACTS

A variation on the minimum price contract is the minimum/maximum price contract. In this type of contract, the seller pays the buyer a service fee to establish a guaranteed price range by using put and call options. The seller uses the call option to offset its trading costs and premium fees under the contract and, in exchange, sets up an "option fence" that establishes the maximum and minimum price for which its grain will be traded. Depending on the buyer, the parties may vary when and how basis is established under the agreement. The minimum/maximum contract protects the seller from price declines, but it also limits its upside potential during market rallies.

Similar to minimum price contracts, these contracts are not subject to CFTC regulation even though they include options (see *Distinguishing Between Regulated Options and Options Imbedded in Grain Contracts*).

BASIS CONTRACTS

Basis contracts allow the seller to lock in the basis of its choice at the time of contracting. The seller is betting that the basis it locks in early will be more favorable than the grain's basis will be at a later point in time. The seller has up to the contract expiration date to choose a delivery date, at which time the seller's "buy" basis will be applied to the futures price of the grain. In exchange for this right to lock in basis early, the buyer receives a service fee, which is usually priced per bu.

Under these agreements, the purchase price is equal to:

- The futures month price on the date of sale (usually the delivery date).
- Plus the seller's "buy" basis.
- Minus the buyer's service fees.
- Minus the buyer's additional fees.

Basis contracts are typically used by sellers that are familiar with basis and are especially useful when a particular local basis has repeatedly beat the grain's national average price. The seller may also prefer a basis contract when it foresees a strong likelihood of the grain price increasing by the time of delivery and the basis weakening.

One major benefit of basis contracts is that they allow the seller to participate in market rallies should the price of grain increase before delivery. Basis contracts are often more attractive to a seller post-harvest, as basis is usually stronger at this point in time than it is at the time of harvest.

Basis contracts eliminate future basis risk, but they expose the seller to market price fluctuations. Additionally, if the basis strengthens (for instance, when basis moves from an under to over basis after the time of contracting), the seller will not be able to benefit in the strengthened cash price for its grain and will be forced to apply its "buy" basis to the weaker futures price. The buyer will usually cooperate with the seller by helping them select the right date to deliver and sell their grain, but if the seller isn't familiar with basis or lacks market sophistication, basis contracts can be risky as they do come with some control risk.

NEW GENERATION CONTRACTS (NGCS)

These are contracts that are designed to address some of the drawbacks and limitations of the traditional and more advanced grain contracts, namely the level of control risk that is present with many of those contracts. The three main types of NGCs are:

- Automated pricing contracts.
- Managed hedging contracts.
- Combination contracts.

Automated Pricing Contracts

Automated pricing contracts are not necessarily new contracts, but are a pricing mechanism that can be combined with other grain purchase contracts. Under these contracts, the seller can lock in an average price for equal amounts of grain in set time periods. The price the buyer pays for the grain under an automated price contract may be based on the average market price for that grain over an agreed pricing period. The benefits of this arrangement include consistent prices (including during volatile periods) and a pricing mechanism that relieves the pressure of price management from the seller.

The seller can also benefit from automated pricing contracts by establishing its price for time periods when the average price is seasonally high. The seller pays a fee to the buyer in exchange for this average pricing model (usually per bu.) and may still be subject to market price fluctuations and other price risks. Additionally, the seller should inform itself about the formulas the buyer is implementing in establishing the pricing average and whether the buyer is attuned to local prices.

Managed Hedging Contracts

Managed hedging contracts are similar to automated pricing contracts, except that the price for the applicable period is determined by recommendations from certain market analysts. The seller will pay a fee to the buyer (usually per bu.) for this managed hedging contract, and these fees are usually higher than what are paid under an automated pricing contract. Because costs are higher under this form of contract, the seller will have to closely monitor its price in relation to the fees it pays to the buyer to establish when the contract will be profitable.

Combination Contracts

Combination contracts are a blend of both the managed hedging contracts and the automated pricing contracts. Pricing is conducted similarly to the automated methods used by the automated pricing contract, but the producer may also be able to share in the gains earned by the pricing analyst used by the managed hedge contract. These contracts may vary depending on the local grain merchandiser.

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