



www.agmanager.info
abarnaby@agecon.ksu.edu
(785) 532.1515 (phone)
(785) 532.6925 (fax)

G.A. "Art" Barnaby Jr.

Copyright 2004. All rights reserved. Contact Art to be added to e-mail list

Disclaimer: This web page is designed to aid farmers with their marketing and risk management decisions. The risk of loss in trading futures, options, forward contracts, and hedge-to-arrive can be substantial and no warranty is given or implied by the author or any other party. Each farmer must consider whether such marketing strategies are appropriate for his or her situation. This web page does not represent the views of Kansas State University.

How Risky are Hedge to Arrive Contracts?¹

Art:

What are the risks associated with Hedge to Arrive contracts? Weren't these the instruments that got several farmers in trouble several years ago?

Thanks for your response.

Ag Banker

Dear Ag Banker,

The Hedge-to-Arrive (HTA) contracts based on harvest futures did not get growers in trouble. The issue was with the roll over HTAs. The elevator was selling July corn futures and then they were going to roll over to December futures. The contract spread between Jul-Dec did not narrow as forecasted by many marketing "experts" but widen. Because growers could not deliver corn in July they had to pay the cancellation penalty that was equal to the margin loss on the July futures contract.

The normal HTA procedure for new crop corn is for the elevator to sell December futures as they do for a forward contract. The only difference between an HTA and forward contract is the basis is open on the HTA but locked in on the forward contract. If the basis bid in the forward contract is weak the HTA will net a higher price if the basis improves.

¹Prepared by G. A. (Art) Barnaby, Jr., Professor, Department of Agricultural Economics, K-State Research and Extension, Kansas State University, Manhattan, KS 66506, April 6, 2004, Phone 785-532-1515, e-mail – abarnaby@agecon.ksu.edu.

Some elevators refer to these contracts as "open basis" contracts because of the "bad name" attached to HTA. Both the open basis contracts and the forward contract require delivery. If the grower can not make delivery under either the forward contract or open basis contract they will have to pay the cancellation penalty. In some cases some elevators have allowed growers to roll the contract forward and make delivery in the next crop year when growers can not make delivery due to crop failure. In most cases elevators are not under any obligation to allow growers with a failed crop to make delivery from the next crop.

Growers can reduce the financial risk caused by not being able to deliver due to a crop failure by purchasing Revenue Assurance with the Harvest Price Option (RA-HPO) or Crop Revenue Coverage (CRC). If the crop fails and market prices increase growers will receive a larger indemnity payment that will help cover the cancellation penalty and crop production expenses.

The results from an HTA and selling futures are about the same. The HTA requires delivery but the elevator is responsible for margin calls. Selling futures does not require delivery but growers must make the margin calls and they have the risk they could run out of credit and not be able to maintain the position. The non-delivery requirement for futures is only a small benefit because the assumption is that if prices increase requiring margin calls the producer will sell the cash crop for a higher price and cover the margin losses. If the crop fails those margin losses will approximately equal the cancellation penalty on a HTA or forward contract. An HTA based on December futures has similar risk as a forward contract or selling futures.

Some growers may be considering a roll over sale for 2005 corn (based on 5/5/04) one could sell July 05 corn for \$3.38. Then in July of 2005 they would buy back the July 05 corn futures and sell December 05 corn futures. The July 05 contract is currently selling for about \$3.38 while the December 05 corn futures is selling for about \$2.82 or a Jul-Dec spread of 56 cents for 2005. If the new crop old crop spread narrows by next July then the grower would gain using the roll over strategy rather than selling December 2005 corn futures. This could be done with an HTA but it is doubtful any elevator will offer the roll over HTA after all of the lawsuits. Therefore any grower who wanted to use this strategy will likely need to do it with futures and they should have had a large amount of experience with futures before they even consider this alternative.

The 95-96 old crop spread reached a dollar versus the current 56 cents. If the current 56 cent spread were to widen to \$1.00 growers would lose 44 cents and this is in addition to any margin losses caused by higher prices. Under the HTA any margin losses on the July futures shows up as a cancellation penalty for the grower. The worst outcome is to have the old crop-new crop spread widen and market prices increase combined with a crop failure. If one were going to put on this roll over hedge then it is probably a good idea to cover the crop with RA-HPO or CRC next March.

ART

Dear Art,

Can you give a similar analysis using a call option...sell forward contract (or cash) to establish minimum price, and use call option to capture a later price increase? It would be nice to see both sides of the coin.

Thanks

Marketing Advisor

Dear Advisor,

Covering grain sales with a call option will create a “synthetic put” and give about the same results as a put. For example if the grower sells futures and then buys at the money calls the results are nearly the same as puts. If I assume growers hold the synthetic put position until harvest then the results are the same because the time value in the call and the put are (nearly) zero.

However, if the call has any value it will likely occur in the summer when it still has time value while the put is held until harvest when the time value is zero. If the market increases during the summer and the grower sells the call, she will capture the intrinsic value and the remaining time value. Also the time value is likely to be higher in an increasing market during the summer because of greater market volatility and increase the value of the call sold back to the market.

The more common method is to sign a HTA or forward contract the bushels and then buy calls to cover the sale in case the price increases. Also for wheat one may find the call market is more liquid than the put market. This is not an issue for corn or soybeans.

The synthetic put is one of the least risky and easily understood methods for pricing grain before harvest. Growers with little marketing experience and their production guaranteed under CRC or RA-HPO will often select this method. I like this method just because it is simple. Because the synthetic put is simple is one reason for the wide use of this strategy. Also some elevators will take care of the option for the producer under a minimum price contract and generate similar results.

If a grower puts on a synthetic put then the next big question is when to sell the call back if prices increase this summer? In my risk adverse view of the world, if I can double my money and cover all commission cost; then take the money. If the market continues to increase then one will wish they had not followed my advice, but then markets also decline. One can always recover the sale with a new call with a higher strike. I have seen growers with calls that would have tripled their profit on the option but continue to hold the call. Often the market starts to decline as harvest approaches and growers lose the time value in the option too. The only reason growers would not cash in a profitable call is because they believe they can forecast the market.

ART