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## Feed & Grain

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### Hedge to Arrive — Redux

Merchandisers' Corner



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Many elevator managers and merchandisers who were in the grain business in 1996 learned an important lesson: A strategy that works well in most situations can be a terrible strategy in some situations. But 2006 is a new year in a new decade; it's time to dust off the files, clear our heads, and revisit the strategy at the heart of the problems in 1996.

#### Refresher course

Hedge to Arrive is a contract strategy in which a futures reference price is fixed, but the basis remains open until the seller elects a date on which to set it. In a simple HTA example, a farmer might sell corn for delivery in the fall of 2006 on a day when December '06 futures are \$2.90. The farmer then has until delivery time to accept the elevator's published harvest basis to finalize the contract price. Also known as "Futures Only," this strategy has been used in the grain industry for over 25 years. In its simplest format, an HTA is easy to understand, easy to document, and not inherently more risky than most other pricing strategies.

[View charts in PDF format.](#)

#### The troubles began . . .

The troubles in 1995 started as thousands of farmers began to forward-sell hundreds of millions of bushels of grain on HTAs, as the corn market rallied above \$2.60 to levels not seen in two years. Selling corn above \$2.60 (futures) has been a "good" decision most years. But 1995/96 turned out much differently, as futures soared above \$4.00. And a number of farm advisers recommended selling 1996 crop corn using July 1996 futures as the initial "reference" price. The idea was then to later "roll" that price forward to December 1996 futures. (The elevator would buy back their July '96 futures hedge sale and sell Dec '96 futures.) The objective for the farmers was that the "inverse" between July '96 and Dec '96 futures would diminish, and hopefully even move from an inverse to a carry. This would allow the farmer to "capture" a better net futures price and improve the final cash price. For example, in Fig. 1, on April 15 if December futures were at \$4.00 instead of \$3.31, the elevator's published bid would have been \$3.50 (-50 Dec, or -92 July). In that situation if the seller finalized the basis, the cash price would be the HTA price (\$3.45 July '96 futures) plus the basis (-92 July), or \$2.53. That would be 13 cents better than if the farmer had just forward sold at \$2.40 back in December 1995, although far less than the elevator's published bid in April. But that's not what happened.

#### The aftermath

This "rolling" cross-crop-year HTA strategy went horribly wrong in 1996 because the July '96/Dec '96 corn inverse soared to over \$1/bushel, eventually peaking at \$1.60 inverse in May. (See the example in Fig. 1.) As the inverse rose, many farmers resisted setting the basis on their HTAs (for obvious reasons); others just waited and hoped the inverse would disappear. It was not a happy time and resulted in hundreds of arbitration and court cases that took years to resolve.

Multiyear and cross crop-year HTAs had seemed to many advisers (and farmers) to be a great way to boost their probable sale price. Unfortunately, not all farmers understood that spreads don't always move as expected, and that the farmer would have to bear the consequences. Lack of clear wording on many HTAs further increased the misunderstandings.

After 1996, many elevators stopped offering HTAs completely, or did them only with long-time customers, and only for current crop year delivery, allowing no rollovers.

#### Fast forward to 2006

Market volatility is rising again. "Big Money" from the investment sector has poured into commodities and fueled the rallies; December 2006 corn futures are over \$2.60, December 2007 is around \$2.90, and December 2008 is \$3.05! These represent historically "good" values as corn histograms (frequency of price occurrences) show. Understandably, producers have been forward selling 2006 crop corn and soybeans, with a growing percentage also selling 2007 crop, and even some 2008 crop.

But how wise is it for elevators to buy 2007 or 2008 crop corn on standard fixed-basis forward contracts? Fuel and energy prices have soared, freight costs are as uncertain as most traders can remember, and counter-party credit risk has to be considered on all long-term contracts. Deciding what basis a manager should quote for a contract that won't be delivered until 2008 is a challenge even for veteran managers. If the basis is wide enough to offset the elevator's potential risks, the producer may wonder if the elevator is cheating him.

#### **Hedge to Arrive contracts to the rescue?**

Hedge to Arrive contracts can be a win-win strategy this year — with some limitations. Allowing producers to forward-sell corn for '07 or '08 crop with only a Futures Reference Price locked in does two things:

1. Allows the farmer to delay setting the basis reduces the time period where the elevator is exposed to unknown fuel and freight costs.
2. Takes away the potential farmer argument that the elevator wants to short-change them on the basis with very wide quotes for one to two years out.

The fall of 2005 should remind everyone the potential cost of underestimating how cheap basis can get! But the elevator might end up quoting a higher basis later when the farmer is ready to set the basis. That seems to argue against HTAs from the elevator's perspective. But at least as delivery time nears, basis values tend to become better-defined and the elevator can decide whether to retain the basis ownership once the producer prices.

There is another dilemma for elevators: How much corn do you want to own one to three crop years in advance? HTA contracts don't eliminate margin calls or credit risk, for example. It is common for buyers to charge a service fee for Hedge to Arrive, Minimum Price contracts, and other hybrid strategies. Hybrids take more time to administer and to document properly in DPRs and monthly P&Ls. A service fee is justified (separate from the basis quote).

#### **Caution!**

The HTA crisis of 1996 did clarify several important issues for elevators that offer hybrid strategies.

- Have easily understood contracts that are clearly worded and have been reviewed by lawyers.
- Spell out all terms: pricing procedures and deadlines, that delivery is required, how the basis is determined, etc.
- Do not use language that says anything to the effect that the farmer is selling futures. The seller is only locking in a cash contract that will be based off a specific futures price.

HTAs are not inherently good or bad. This is a year to lay aside bad memories of the past and focus on the benefits the strategy can provide.

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