

# CROP CONTRACTS



## Introduction

Cash market contracts can provide valuable alternatives to manage crop market risk. By entering into a cash contract, the crop producer gives a commitment to deliver product while the crop user gives a commitment to accept delivery of that product, either now or at some future date. A price will be attached to the transaction before, at, or after delivery. Differing cash contracts are offered by the various buyers. Producers should always read a contract carefully before signing one.

A factor that often causes problems in cash contracts is grade. A contract usually specifies a certain grade to be delivered, but not all contracts include a price schedule for delivered grades above or below the base grade of the contract. The producer should completely understand who will determine the final grade, and what implications a grade differential would have on product deliverability and price. For example, a lower grade than the base grade may be severely discounted by the buyer offering the contract, while another buyer may be paying significantly more for that same lower grade relative to the base grade price. The Canadian Grain Commission can provide a binding grade decision to producers who have a grading dispute with a licensed primary elevator.

Here is an overview of the most common types of cash contracts available.

## Production Contracts

A production contract is often used with the production of a specialty crop for a specific market. The production contract guarantees a delivery outlet to the producer and assures the buyer of supply. Typically, the production contract means that a producer agrees to deliver production from a certain number of acres. Depending on the contract, all or a limited amount of production from that acreage is deliverable. Typically, no minimum delivery is required in the case of a crop failure. The price may or may not be set at the time of signing. However, if no price is established at the time of contracting, the contract should direct how and when the price will be established. Also, the contract should indicate the delivery period for the product, and delivery delayed by the buyer past a certain date should result in storage payments due to the producer. Also, delays in

receiving payment from the buyer should result in stated interest charges being payable to the seller after a certain date.

## Deferred Delivery Contracts

A deferred delivery contract, sometimes called a DDC, is widely available and popular. A deferred delivery contract is an agreement that commits the producer to deliver a specified amount of product to a buyer by a certain date. The buyer agrees to pay a specified price, usually upon delivery or soon thereafter. The product grade to be delivered is specified. However, the contract should also state what happens if the delivered grade differs from that contracted.

The advantages of the DDCs are:

- they can be used as part of a marketing plan to capture higher prices that often are available prior to harvest
- they provide a delivery opportunity that may coincide with the need for cash flow
- they do not require margins as with futures accounts.

The limitations of DDCs are:

- the amount of product committed for delivery must either be delivered or a penalty may be assessed
- the producer may be committed to delivering to that buyer regardless of grade or prices available at alternative buyers at the time of delivery

## Target Pricing Contracts

A target pricing contract (also Grain Pricing Order or GPO) is an agreement between a seller and buyer to price a certain quantity of product at a certain price for a certain delivery period. A target pricing order may require renewal if unfilled after a certain period of time. An advantage of the target pricing order is that the producer can select prices from a marketing plan and know that, if the target price is reached, the order will be priced automatically by that buyer. Sometimes the buyer will select those producers with grain pricing orders at a particular price to contract with before that price becomes generally available. Once the target price is hit, the contract becomes a deferred delivery contract.

## Basis Contracts

A basis contract locks in only the basis on a certain quantity of product while leaving the futures component of price open until a later date. Basis is the difference between the price of a certain futures month and the cash price for a product. For those crops that have a futures market relating to them, the basis of an individual buyer is a reflection of how much that buyer wants the product compared to other buyers for that product on a given day. Location can be a major factor in basis, so a producer needs to know how the location of their crop as well as other factors affect basis for that crop. Some buyers will allow a producer to target a basis in advance, in effect a target basis contract.

The advantages of a basis contract are:

- it eliminates basis risk on that portion contracted
- it provides delivery opportunity for the contracted quantity at a certain time
- it enables the producer to separate the basis decision from the futures decision of pricing. A strong basis level often occurs at a different time than when futures prices are strong

The limitations of a basis contract are:

- it requires an understanding of basis and the factors that affect it
- it leaves the futures price open to risk until the producer decides to lock in that component
- it commits the producer to selling the contracted quantity to that buyer

Once the futures component is also locked in, the contract becomes the same as a deferred delivery contract. As with other contracts, the producer should know what happens in the case of a crop shortfall. Generally, buyers will be more forgiving of a shortfall if they are contacted soon after the seller recognizes the shortage. Sometimes, a neighbour can fill the balance of a contract to the satisfaction of all parties.

## Futures Only Contracts

A futures only contract (futures first contract) locks in, for those crops that have a futures market, only the futures component of price with a cash buyer. The basis is left open, to be locked in at a later date.

The advantages of a futures only contract are:

- it eliminates futures risk on that portion contracted
- it provides delivery opportunity for the contracted quantity during a certain time

- it enables the producer to separate the basis decision from the futures decision of pricing, usually without the concern of margin calls as with a direct futures trading account

The limitations of a futures only contract are:

- it requires an understanding of basis and the factors that affect it
- it leaves the basis risk open until the producer decides to lock in that component
- it commits the producer to selling the contracted quantity to that buyer

## Minimum Price Contracts

A minimum price contract enables a producer to lock in a minimum price while still being able to sell at a higher price if that higher pricing opportunity arises. The minimum price contract is similar to a deferred delivery contract in other respects. For those crops with a futures market, a minimum price contract resembles buying a “put” option except that the minimum price contract typically locks in both the basis and futures components. On a given day, the minimum price offered by a buyer through a minimum price contract is usually lower than that offered on a deferred delivery contract because of the cost of the built-in option.

## Deferred Pricing Contracts

A deferred pricing contract (DPC) enables a producer to deliver the product, accept a partial payment, and then follow the market for a higher price than available at the time of delivery. The popularity of these contracts dropped when the period within which the producer must notify the Canada Grains Commission of default by a licensed buyer was reduced to 30 days after delivery. Leaving grain unpriced for any significant time after delivery is not recommended.

## Summary

In summary, producers should carefully read and understand a contract before signing it. Consider all the possibilities of production and price. Do not hesitate to ask for clarification of any point. Remember that a contract should be valuable to both parties, so make your concerns known. A contract is still legal if written amendments are agreed to by both parties. If you have unresolved concerns about a contract being offered, you may wish to consult legal counsel or just decide not to enter into that contract.