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BASICS OF GRAIN MARKETING

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ABSTRACT

To sell grain at a profit, you need to establish what a good price is and determine if it is profitable. This is important because there are times when the market will not offer a profitable price. Identifying if a good price is available is the first step in deciding what marketing strategies you'll want to use.

INTRODUCTION

One of the most common misconceptions is that a good price is the highest price the market will offer. Producers that set their goal as the highest price often wait until they think the market has peaked and then sell their grain. Pursuing the highest price often creates a tendency to ignore risk management principles. This can be harmful to your farm, especially if markets are experiencing volatility. In a volatile market, prices can move up or down very quickly. If prices continue to drop, this can lead to settling for lower profits or no profit at all.

RESULTS AND DISCUSSION

The commodity futures market trades crops, livestock, oils, fuels, and metals on a global scale. It serves several economic functions for buyers and sellers of commodities. One of the primary functions is to transfer risk. Sellers can have risk in storing their crop or volatility causing price changes. Buyers have the risk of supply shortages and similar concerns about pricing changes. The market allows for price discovery and flexibility in determining a final price for a product. It can also aid in coordination of economic activities and market stabilization. For the purpose of this publication, we will focus on how the futures market influences selling your grain.

The most direct way to interact with the futures market is to take out a *future contract*. This is an obligation to buy or sell a fixed quantity of a commodity at some point in the future. The centralized marketplaces where buyers and sellers of these commodities meet is called the *futures exchange or market*. The price that is agreed to within the contract is called the *futures price*. Think of the futures price as the world price for each commodity in the market. It is set by the world supply and demand and can be quoted at various points in the future (March corn futures price, July corn futures price).

Your farm's grain isn't sold on the futures market, but at a local (domestic) price to a nearby cash market (grain elevators). The local price is called the **cash price**. This is the value agreed upon for immediate delivery of your grain or for accepting the current price for grain

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delivered earlier but not sold. There is no commitment to deliver a specific amount and it is an easy way to get cash quickly. The downside to a cash price is that timing of delivery can be inconvenient, especially at harvest. The cash price is also influenced by the futures price and basis on the date of sale. A common equation to calculate cash price is:

Cash Price = Futures Price + Basis

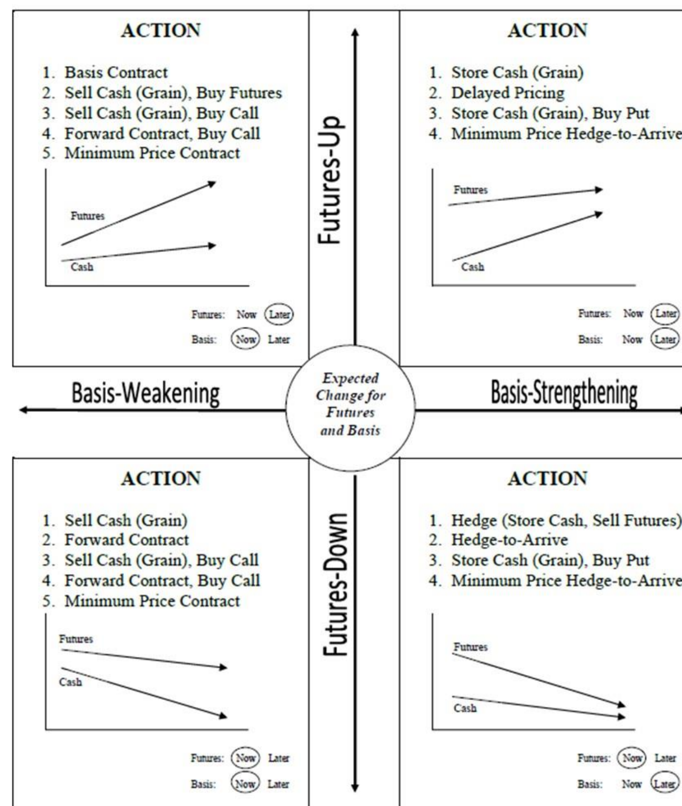
Basis is the difference between the current cash price and futures price with the nearest expiration date. For example, the basis on February 1 for a grain elevator in Webberville, Michigan, is the difference between the elevator's cash price and the price listed on a March futures contract (as of February 1). The difference between cash and futures prices is often a negative value and based on conditions at local grain elevators. These conditions can include transportation, storage and interest costs, and local supply and demand. Some examples of local supply and demand factors in Michigan include ethanol plant locations and geographic variations in yields.

A basis can be described as either strong or weak based on its relationship to futures and cash market prices. A *strong basis* is when the difference between cash and futures is very small or narrow. A narrow or strong basis is less negative or even positive. A *weak basis* is where the difference between cash and futures is very large or wide. A widening or weak basis is more negative. To better understand the relationship, the previously shown common equation for a cash price can be reformulated to focus on basis:

Basis = Futures Price – Cash Price

Basis can also be defined as strong or weak through comparison.

Pricing Decision Chart for Cash Product Sellers



Understanding what the pricing decision tools are is just one part of the marketing process. The second part is knowing what marketing conditions are expected and which tools can provide the most benefit. The key is to establish expectations on what basis and futures prices will do. Figure 1 illustrates four different market scenarios related to futures prices, basis, and cash prices. Each scenario outlines which pricing decision tools are best suited to help maximize the potential revenue for your grain sales.

Figure 1: Chart outlining the pricing decision tool options based on the expected market direction of basis and futures prices.

When basis is expected to weaken and the futures prices to go down, expect the cash price to trend downward as well. This trend indicates you want to lock in both the basis and the futures price now. You can take a number of actions, including using pricing decision tools.

Another action is to use a *forward contract*. The logistics involved to move grain can make it difficult to haul all of your production to the elevator at once. The use of a forward contract allows you to lock in a cash price at a time and location that is more advantageous to grain hauling. It also allows you to lock in the grain elevator's deferred cash price, locking in futures and basis. This is often used to establish a new crop selling price.

There is also the option of *selling grain and buying a futures contract*. Selling the grain allows you to exit the cash market and take the cash price received. By itself, this would lock in both the futures price and basis. However, by purchasing a futures contract, you re-enter the futures market with the opportunity to sell the contract for a higher price at a later date. The downside to this option is that prices may fall, and margin calls become required to maintain the contract.

If you are averse to holding onto a futures contract, you can use the *sell grain and buy a call option*. This provides you with the opportunity to buy a futures contract at a later date if prices continue upward as expected. If prices do not go up, the cost of holding the call option is the most money you would stand to lose. You also have the option to *forward contract and buy a call option* for the same reasoning. The main difference in this case is that you are locking in the cash price with a later delivery date. This may be a more advantageous option for operations with a lot of grain to move or limited ability to make immediate deliveries.

CONCLUSION

Pay attention to trends in the two components of market price— futures price and basis, and make a marketing plan that uses a few different marketing tools. These two simple rules can help you better manage your risk and improve your chances of locking in profitable prices. Once you have your pre-harvest and post-harvest marketing plans completed, don't hesitate to share them, and ask for input. The list of reviewers should include your management team, spouse, grain merchandiser, and even your lender. These individuals will help keep you accountable to your marketing goals and ensure they are reasonable. This is especially true as marketing plans can become more complex with a lot of grain or pricing decision tools being involved. Remember that the goal of your marketing plan is to keep you on track to achieve your pricing goals. Keep your plans reasonable, achievable, and simple.

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