Scranton Equity: Contract Guide

Most fundamental contracting principle: Futures + basis = cash price.

Futures: this is the global representation of the value of a commodity. Since all commodities are perishable, the futures market allows traders to mitigate risk by hedging a product for delivery at a specific time in the future; hence, the name.

Basis: this is the local representation of the value of a commodity. Contained within the basis is the freight cost to get the commodity to market, the cost to elevate and store the commodity, as well as a margin to operate that facility handling the commodity. Basis is highly localized and varies greatly between geographical regions. This is mostly due to cost and access to freight; be it truck, train, or boat.

Cash Price: The most common and standard contract which locks in the board price, as well as basis. The seller can specify the bushel amount as well as exactly when to deliver the bushels, up to two years in advance.

Pros:

- Very basic; cash price is set and locked in, allowing seller to budget
- No fees or additional costs
- Protected against negative market trends

Cons:

- Values cannot be changed; seller cannot capture beneficial market trends

Spot: Spot is a cash price contract which is sold at time of delivery. Most commonly, a spot sale will be priced at the closing futures price of the day the grain was delivered, using the current posted basis.

Pros:

- Seller is not obligated to a specific delivery time
- No fees

Cons:

- Once a spot sale is made, the grain is priced and cannot be marketed if the price goes up

Basis: A basis contract is a simple contract in which the seller locks in the basis, and not the futures. This contract can be used to contract grain, which is yet to be delivered, or grain which is unpriced and in storage at the elevator. The basic idea of the basis contract is that basis value and futures price are rarely at their best simultaneously in any given growing season. This gives the seller the freedom to lock in basis and futures independent of one another in order to maximize the value of the sale. An important thing to note is that the seller can lock in the futures price *after* the grain has been delivered.

Pros:

- The risk of the basis getting worse is mitigated
- If there is a rally on the board, the seller can take advantage of this
- No monthly storage costs: only a fee to roll forward each futures period if needed

Cons:

- Cannot take advantage if basis improves
- Downside risk to futures price

Futures Fixed: A futures fixed contract is like a basis contract, insomuch as instead of locking in the basis, the seller is only locking in the futures. This contract is for grain which is yet to be delivered to the elevator. The basis must be locked in prior to delivery, or on the day of delivery. Grain which is in the elevator cannot be applied to a futures fixed contract. This contract is commonly used to lock in futures values in advance, sometimes far in advance, during a high point on the board or a rally. Usually a small service fee associated with risk, depending on how far out the seller wants to lock in the board, will be applied to the contract.

Pros:

- Mitigates the risk of the futures going down
- Allows the seller to commit to delivering grain at a specific time in the future

Cons:

- Cannot take advantage of further market rallies
- Exposed to downside basis risk

Delayed Price (DP): The DP contract simply allows the seller to deliver grain without locking in the basis or futures; the grain is unpriced. This is by far the most flexible contract type, but it comes with a monthly fee and is highly seasonal.

Pros:

- Allows the seller to store grain in the elevator
- Freedom to lock in favorable basis and futures at a later time

Cons:

- Downside risk for both basis and futures
- Monthly fees are static and will not change once bushels are committed
- Elevators usually have a limit on how many bushels they can allow for DP; this is a risk-management decision