

December 18, 2009

## Planning and Financing 2010 Price Risk management

Although price ranges were less than in 2008, volatile market price action continued throughout 2009. New crop corn futures prices (December 2009 contract) varied more than \$1.60 per bushel during the year. November 2009 soybean futures prices moved more than \$3.00 per bushel. Depending upon the crop and yields, these price ranges can add up to \$250 or more per acre in revenue. Weather, US production/use, World supply/demand, energy prices, the value of the dollar, the economy, large speculators and investment fund positions all contributed to the uncertainty and volatility that occurred in the markets. This resulted in considerable price risk for farmers.

At this time, it does not appear that 2010 will be much different than 2009. Record 2009 US corn yields and the second largest total production did nothing to change corn carryover. The USDA's estimate of 2009-10 corn ending stocks of 1.675 billion bushels is nearly identical to 2008-09's ending stocks of 1.674 billion bushels. Although record soybean production is expected to allow soybean carryover to increase, the current USDA estimated ending stocks of 255 million bushels is less than one-month's use. So large crops are likely to be needed again in 2010, but preparations for next year are off to a slow start. The wet conditions and late harvest limited the amount of fall tillage and fertilizer applications. Harvest for some of his past year's crop may even be delayed until spring. Other fields have ruts and compacted soils from the muddy harvest conditions. This makes spring weather critical for preparing fields and planting the 2010 crops. South American production and export competition may result in downside risk for market prices in the New Year. Many other factors that affected prices last year also continue to contribute to market risk. Other supply/demand factors, volatile energy prices, changing dollar value, the economy and fund buying or liquidation appear influence prices almost daily. It seems like nothing has really changed. A variety of factors could impact prices positively or negatively, resulting in considerable market volatility and risk in the coming months.

**Market risk management is critical to the farm business.** Everyone understands that efficient production is necessary. Increasing production involves planning and financing along with adopting and implementing new production technology. The same is true for risk management and marketing. But, while producers continue to rapidly adopt new seed technology and precision farming practices, acquiring new marketing skills and the use of more sophisticated marketing tools continues to lag. One market analyst recently reported that a lender had informed him that only about twenty-five percent of their producer clients used any form of forward pricing! Other assessments and surveys of farmer marketing practices offer similar results.

The unwillingness or inability to use forward pricing in volatile markets is similar to farming today without new seed genetics and other new production technology. During the past two years, those who used some form of forward pricing had the opportunity to capture prices well above harvest time prices. In 2008, pre-harvest sales offered significant returns as prices collapsed from new record highs. In spite of a harvest time counter seasonal rally in 2009, new crop corn futures prices in April and

June were higher than the harvest price. July soybean prices also exceeded 2009 late harvest time price highs. Failure to capture pricing opportunities is giving up revenue, just like the failure to adopt new production technology may give up the chance to increase revenue.

The ability to use cash contracts, futures hedges and options on futures is necessary to be able to forward price. The appeal of cash contracts for forward pricing has been that they are usually readily available, generally low risk, simple and are low or no cost to use. However, the past two years have illustrated they have shortcomings as well. They are not always available in volatile markets. They have counter-party risk of buyer defaults. Most have become detailed and complicated. Some cash contracts have fees to cover buyer risks and administrative cost. They have always had production risk associated with delivery requirements. While cash contracts have and will continue to be an effective marketing tool, they are not the best choice for every market situation.

The ability and willingness of farmers to use futures and options provides additional tools to manage price risk, especially when cash contracts do not meet marketing objectives or are not available. Using the futures markets may require learning new skills as futures (and options) are more complex and the processes to use them may seem more complicated than making cash sales. It is not unlike adopting new production technology as there are “learning curves” and mistakes can sometimes be costly. But the skills needed to use futures and options can be mastered, just as production technology skills can be mastered. A variety of private and public resources can provide training and assistance in learning how to use futures hedges and options to manage price risk. However, some producers may be more comfortable hiring marketing skills or services. Just as some farmers hire crop consultants to assist with production and crop protection decisions, hiring a market consultant can help with marketing. Whichever route is taken, learning marketing skills or hiring expertise, the ability to use futures and options along with cash contracts greatly enhances the ability to manage price risk in volatile markets.

***Price risk management requires cash—maybe a lot of cash.*** The amount of cash or financing depends what marketing tools are used. Historically, cash contracts have required little or no upfront cash. But more and more cash contracts have fees associated with them. Futures contracts require margins and broker fees. Options have premium costs and fees. Just as production costs must be planned and financed, marketing cash needs must be planned and financed. It is essential that the lender understands expected risk management strategies and is willing to finance them. Lenders will finance futures hedges and option strategies, but most insist that the borrower understand the strategy and that it be a true hedge. They are not likely to knowingly finance speculation and usually insist that speculative activities do not occur. If using a market advisor, they may need to be included in discussions with the lender. It is important to discuss credit limits and how cash needs will be handled. It may also be desirable to have a line of credit designated for risk management and separate from the production line of credit.

Futures hedges are relatively low cost strategies that may have high cash flow requirements. The net cost of using futures is essentially limited to the broker fees and interest on margin funds. Basis can impact the net price and basis changes may result in lower or higher net cash prices. While some

may consider basis losses a cost, it generally does not impact initial financing needs. Cash flow needs for meeting futures account requirements can be large, maybe huge. In a true hedge, margin losses are eventually mostly offset by gains in the cash market. It is important that enough financing is in place to cover margin needs. What happens during large price moves should be discussed. Credit limits should also be considered before entering futures positions. *A forced liquidation of a position because financing is inadequate will result in losses that equal the margin requirements already deposited!* However, if financing is in place, futures hedges offer a readily available and flexible marketing alternative to lock-in prices with no counter-party risks or delivery requirements.

Purchasing put options can avoid some of the very large cash flow risks. However, the option premiums, broker fees and interest on these all represent cash costs. Unlike futures margins, these are not offset by gains/losses in the cash market and are effectively non-recoverable costs that may require financing. At-the-money put option premiums can be expensive, sometimes more than fifty-cents per bushel for corn and more than one-dollar per bushel for soybeans. Some price spreading strategies that buy and sell options reduce net premium costs, but it is important to understand the risks associated with them. Some short option positions (selling an option) require margins and they may add to financing needs. Both the producer and lender should understand the strategy and be prepared for the possibilities of margin needs.

The New Year appears to promise more market volatility and price risk. Having and being able to use a variety of marketing tools is just as important as using the latest production technology. This requires cash flow planning and financing to accomplish.