

Grain Pricing Orders, or, Target Price Contracts

Grain markets are volatile, making it a tough and often stressful job for farmers to monitor bids. What's more, the basis and the futures can both move from one day to the next, sometimes in the same direction and sometimes not.

In forecasting prices, it's best to treat cash and futures as separate markets. But this makes it more complicated to form an opinion about when the market will reach a good flat price to sell at. Yet most growers know at what price they make a profit, and wish simply to pull the trigger at that level. This is a practical and focused approach to marketing.

Most canola buyers allow farmers to register their target prices with them, and will automatically buy the canola if and when the market reaches that level. Under this type of pricing contract, which most companies refer to as a Grain Pricing Order (GPO), the canola is immediately sold when the target price comes available. A GPO can be placed for spot or deferred delivery.

In general, Grain Pricing Orders can only be taken out for a specified target flat price. A target basis level can't be registered to automatically sign up a Basis Contract without fixing the futures, nor will most companies administer Grain Pricing Orders for target minimum price levels. Simply put, when the combination of the futures and the basis result in the flat price hitting the growers' target, his or her grain is sold.

Example: Farmer Brown has been holding onto the last 10% of his 2003 canola crop in hopes of the market rallying to \$10/bu. He put the remaining canola under a \$10/bu Grain Pricing Order with the nearest local elevator. One day, during a particularly volatile futures trading session, the market rallied to the point local cash bids hit \$10.10/bu for about an hour. By the end of the day prices had dipped back down to \$9.95/bu but because he had a GPO, the grower's canola was automatically sold and priced at his target price level of \$10.

Advantages

The main advantage of a Grain Pricing Order is that it removes much of the burden of monitoring market prices. Growers can establish the level at which they wish to sell, and forget about having to call around every day to see if any buyers have hit their target.

Grain Pricing Orders also widen out the window of opportunity for pricing the futures portion of a cash grain contract. Some companies only price cash grain contracts outside futures market trading hours (9:30AM-1:30PM), which limits sellers to the closing or settlement price. But if, during the session, the relevant contract month trades up to a level that brings the flat price up to a growers' target, a Grain Pricing Order would trigger the sale while the market is open.

Perhaps most importantly, Grain Pricing Orders force discipline in marketing. When a market is rising can be the toughest time to pull the trigger on sales. If it gets done automatically, the risk of being too greedy and missing a profitable selling opportunity is very well-managed.

Disadvantages

Grain Pricing Orders have a couple of minor disadvantages that should also be considered. First, because the canola is sold automatically under this mechanism growers lose the ability to re-assess market conditions when the market hits their target price. If new fundamentally bullish news has come into play, the optimal strategy might be to hold off rather than to sell immediately.

Growers also commit to selling their canola to one particular company at a fixed price level. On the day the market reaches that level, it is possible that competing buyers are showing a better basis than the company holding the GPO. So, under this contracting mechanism the seller loses the ability to shop around for the best basis on the day a sale is made.

It may be possible to get around the disadvantages of automatic contracting by asking the buyer simply to phone and alert the grower to recent market developments that have brought prices up to his or her target level. This way, the seller has the opportunity to re-assess market conditions and shop around the basis to other bidders before pulling the trigger. However, it should also be kept in mind that without the sale being triggered automatically the advantage of forcing discipline is lost.

Prepared by Brenda Tjaden Lepp, Mercantile Consulting, 947 3032.