RISK MANAGEMENT FOR AG PRODUCERS

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CHAPTER 10.2

TABLE OF CONTENTS

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Managing risk in agricultural operations is, by nature, an operation in conservative values and business practice. By using the different tools available the owner of the enterprise can smooth out returns of the business. Profit opportunities that wouldn't be available at the time of the commodities harvest or production end can be obtained. These more predictable revenues can be used to grow the business, stabilize cash flow, or reduce debt in a business that presents risk just by being exposed to nature.

Ag producers that are seeking to reduce their market risk in declining commodities markets have many tools that can help them. Forward contracting their production, revenue insurance policies, custom made over-the-counter products (OTC) and derivatives of these, and futures and option contracts. All of these have benefits and drawbacks. Each is unique in that all transfer the market risk to another party, that in turn takes it out of the hands of the ag producer.

Pros & Cons

Forward contracting and some OTC products take away the producer's right to sell his product to any buyers in the marketplace. They place the ownership and market risk into the hands of the buyer, removing the ag producer's ability to market the product. Doing this generally commits an amount of product that he or she may not be able to deliver because of an act of nature.

These products are also subject the ag producer to counterparty risk. This means that due to unforeseen circumstances, the seller may not be able to collect if the buyer is unable to pay or has been put out of business in the time it takes the commodity to mature.

Revenue insurance policies are generally government guaranteed. They may be marketed by an insurance company, which is backstopped by the government so counterparty risk isn't an issue. The problem is that they only give minimum prices, so any increase in the market won't be realized. There are some policies available that can capture increased market prices, but how does this happen? The government only guarantees a price floor. The increased price sought after is guaranteed, and the company transfers that risk to commodity futures exchanges by offsetting their risk in the futures markets. The insurance premium paid to these companies for the higher price is generally marked up, so the producer actually overpays a bit for getting the increased price.

Commodity Exchange	Futures Contracts
CME Group www.cmegroup.com	Live Cattle, Feeder Cattle, Lean Hogs, Corn, Soybeans, Wheat, Crude Oil, Natural Gas, Currencies, Interest Rates, Stock Indexes
ICE www.theice.com	Currencies, Cotton, Crude Oil

This leaves the ag producer with the futures and options markets that the futures exchanges provide for the commodities that are most produced in our country. The biggest and most important markets provide risk management opportunities for the commodities that are necessary to our country's food security. An ag producer can also use the exchanges' futures markets to hedge inputs, such as natural gas, or currencies markets for commodities with exposure to export markets.

Futures and options markets are transparent with prices posted minute by minute each day during the trading hours. The contracts are uniform with contract specifications that don't change without open discussion and agreement by interested parties. They are liquid. That is to say that an ag producer can use a broker to obtain the price that he or she sees on the screen they are looking at.

The futures exchanges guarantee performance of each counterparty by having collateral posted as margin in each account every day. In the event that one party becomes insolvent, then each party that has touched the transaction, from the broker through the brokerage company to the futures clearing merchant (FCM) and finally the futures exchange, will work together to make the other party whole.

Utilizing the futures market does not limit the producer to one buyer. By nature, the futures markets are independent of the cash markets. This gives the producer flexibility to market his or her product to as many buyers as they can find.

And finally, the futures markets are the benchmark used by the largest businesses in the industry. Any forward contract and most OTC products use the futures prices to derive value. This fact by itself creates value for an ag producer marketing his or her production to any of the big ag conglomerates.

Participating in the Futures Markets

For an ag producer to become involved with the futures markets, they need some basic things. They might seem trivial, but each piece is important to create the whole.

- Knowledge of the commodity contracts to be used
- Expectations of the producer
- Relationship with a broker
- A plan to execute with contingency

These things cannot be underestimated and are non-negotiable in order to successfully navigate year after year managing risk for an ag enterprise.

There are many different contracts available to hedge agricultural commodities: corn, wheat, soybeans, cotton, live cattle, feeder cattle, and hogs. Each contract has size and quality specifications. These generally coincide with industry standards used in the daily business of each different commodity. For example, live cattle are a 40,000 pound contract and that is the desired weight for a semi-load of cattle. The quality grade used is 55% Choice and 45% Select cattle with a yield grade of 2. These are important mostly in delivery situations but should be paid attention to in the introductory stages of learning about each contract. The price displayed of each contract is a price per unit, whether that be a pound or bushel, and can be used to determine the total value of the contract. In the live cattle example, a price of 1.29000 per pound or 129.000 per hundred weight gives the contract a total value of $51,600. This is calculated by taking 129.000 and multiplying it by 400 hundred weights, or 1.29000 multiplied by 40,000 lbs. As the price fluctuates on a daily basis, the value of the contract goes up or down.

The prices are determined by the marketplace, buyers and sellers that come together on each exchange to complete a transaction. Each price that is transacted is at least one contract exchanged at the agreed upon price by a buyer and seller. As the market moves around, thousands of contracts change hands on a daily basis. At the end of the day, a closing price is established, and that price determines the value of each participant's commodity account. If a person bought a contract and it closes above the price, then the account will have excess money in it. If the market closes below the price where the person bought it, then they will have a deficiency and have a *margin call* to meet. Margin calls are very common in the commodity trading world and only mean that the account owner has to send money in to cover the shortfall in the account.

Relevance to the Producer

Something that sets the commodity futures contracts apart from stock trading is that a person can sell a futures contract before he or she buys one. And they do not have to have possession of the commodity to do so. This is what enables the agricultural producer to utilize these financial instruments to hedge their production. By selling a futures contract and realizing a gain in a market that goes down, they are offsetting the loss in the production they have coming out of the field or pasture. In essence they are forward selling production they do not have yet, but will after the growing season. This enables the ag producer to have 365 days of marketing a product instead of only a few at the end of harvest.

These benefits of futures contracts, combined with a relationship with a trustworthy, experienced broker, will allow the ag producer to develop a solid risk management plan and a contingency plan of action. But, a producer should know what is expected of them. These responsibilities are not difficult but can be surprising to a first timer. Any good broker will try to communicate how these responsibilities should be handled. The producer should expect to know their cost of production, the expected harvest date, be able to meet margin calls in a timely manner, and keep abreast of news and prices in the market place. Needless to say, these are not skills that can be developed overnight, but they can be implemented and executed to the benefit of the producer.

The broker should question the producer to understand his or her expectations of the potential plan, learn about their operation, and should teach them and make recommendations based on the broker's experience. A trusting relationship will form a beneficial team for the producer to count on.

By utilizing the futures markets and becoming more experienced, an ag producer will reduce his or her risk to their business. This expanded time frame creates availability to capture higher prices outside of the traditional harvest marketing window. The effect of this ability to smooth out volatile market swings enables growth in equity or growth in the overall assets the enterprise owns, leading to more stable returns and food security for our nation as a whole.

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