

Forward Contracts - A Risky Business for Graingrowers

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The current seasonal and market conditions for grains are causing a problem for those growers who, in the middle of this year, when crop conditions were excellent and prices attractive, committed part of their expected production to forward prices. Since then prices have continued to rise on the back of global demand and supply and in many areas rains have failed and yields are expected to be less than a few months ago. This has left those who have forward sold with the prospect of having to 'washout' their contracts at some cost.^[2] This is not the first time that this has happened. In 2002 similar events occurred. It is therefore timely to review the issues surrounding the practice of forward contracting for forward pricing, either through deliverable contracts or through derivatives such as swaps.

The term *hedging* is used, often without understanding, when discussing this subject. An important point to make is that if a farmer is a producer only (and not also a miller) then hedging in the same manner as everyone else up the distribution chain is simply not possible. A perfect, or water-tight hedge, is where a purchaser or user locks in the price of a product having also achieved a guaranteed sale price, thereby assuring a profit. A farmer can lock in a forward price but does not know with any certainty what the yield or quality will be at harvest and is therefore involved in only one side of the hedge. Because of this the process of forward selling (i.e. hedging) to reduce risk of the price falling may have an outcome very different to that intended simply because it is not what many believe it to be. It can in fact increase risk in as much that it may require the farmer to buy back or cancel out contracts if the crop falls short of expectations. The situation in 2007 is similar to the 2002 season when low yields resulted in some forward sellers being unable to fill their commitments and having to wash out contracts at higher prices with money they didn't have.

It recalls research carried out by the author in 2004 that investigated farmers' attitudes and practices to price risk management^[3]. This study showed that farmers used a range of alternatives depending on perceptions at the time. Not all farmers forward contract (also referred to as forward selling and forward pricing), thus flying in the face of conventional wisdom offered by others who seek a revenue stream from offering the service. But why should this be? Pannell^[4] describes how he observes farmers as risk takers who see the loss of opportunity of a higher price as a loss. Given the constant uncertainties surrounding most forms of agricultural production this is not surprising. Against this climate of uncertainty that they operate in, many farmers are in fact good risk managers just to survive. They may well remain skeptical about forward contracting, and related derivative market instruments, as they are risk takers by dint of being in the business of primary production.

It has been argued that farmers should concentrate on production and leave the management of pricing to others^[5]. Grain pools go some way to meeting the farmer's need in this respect. While some individuals are able to take advantage of pricing services and possess a dealer instinct and a high tolerance of risk, others may need to seriously consider whether their production risk is a greater threat to their livelihood than price risk. There is a wide difference between personal attitudes to risk, not just between individuals, but also gender. My survey showed how partners often had quite different attitudes to risk management and individual willingness to tolerate risk varied. For example, production risks in the Mallee are greater than in more assured rainfall areas.

Add to this ‘climate change’ or ‘climate shift’ that may further influence production risk in all areas and the future may not be the same as the past.

Speculators execute a high percentage of derivative trades of all types⁶¹. Farmers have but one shot in their lockers. Traders by definition can continue to trade out of adverse situations. Those who have read the theories of derivative trading and then put them into practice may have discovered the vast difference between the two; somewhat akin to playing with a flight simulator on the computer and then expecting to fly an aircraft when sitting in the cockpit. Farmers are like punters at a race meeting, betting on the outcome of the season in terms of yield and price. Banks that offer swaps, for example, take the farmer’s bet and pass it for a consideration to another party that has a use for the product, who might in turn lay off the risk through a hedge.

Undoubtedly there are some farmers who are successful at forward selling and have built up a deal of experience. However, they appear to be in a minority and may possess a level of business acumen denied others, enabling them to profit where most are unable. In the survey conducted with 52 South Australian grain growers regarding their choice of pricing, the growers were not able to state what the benefits were. They were however well aware of the costs incurred including, in their minds, the opportunity of higher grain prices foregone.

In summary, the practice of forward contracting is producing some nasty surprises once again. The question that continues to go unanswered is: How much better off over time are the forward sellers compared with other alternatives? Or, in fact, is any choice any better than others over time? If farmers are keen to secure forward prices then there are ways in which this can be achieved without betting the farm. These include the use of options and futures where price movement can be insured against and can be implemented in such a way that the maximum cost can be fixed should things go awry.

To ‘cherry-pick’ the success stories of the big wins experienced by some grain growers, without discussing the disasters, does little for the integrity of promoters. Farmers are not mugs. Like most of us, they do not like being moved out of their comfort zones with risk management instruments, which can in some circumstances, increase the risk of an already risky business.

Despite the increased resourcing of risk management training for farmers in the past decade, there remains a need to improve the quality of the training for grain growers with respect to the real risks of each alternative to the spot market. Better training may also be required for those in the business of promoting derivative instruments to primary producers. In the survey referred to above, 56 percent of respondents who had attended marketing workshops were only partially satisfied with the training. The principal complaint being that the presenters assumed too great a prior knowledge of the participants and too much information was provided, given the complexities of the subject.

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^[2] *The Land*, NSW, September 20 2007

Stock Journal, SA, October 4 2007

^[3] Wynter, Hugh, 2004, *Price Risk management Strategies for South Australian Wheat Growers*, Report submitted for Degree of Master of Applied Science by Research, University of Adelaide

^[4] Pannell, David, 2007, *Why don't Farmers use Futures Markets more?* - Pannell Discussions – <http://cyllene.uwa.edu.au/~dpannell/pd/pd0107.htm>

^[5] Kingwell, R. 2000, Price Risk Management for Australian Broad acre Farmers; some observations. *Australian Agricultural Business Review* – Vol8 – 2000

^[6] Geisst, Charles R. 2002, *Wheels of Fortune, The History of Speculation from Scandal to Respectability*. John Wiley & Sons Inc. New York