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Sale by Contract: Yes, No?

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The use of cash contracts in marketing cash grain is fairly common among Nebraska producers. In recent years the same type of contract has been used in marketing livestock. In some instances, contracts are used to defer actual delivery for a short time until arrangements can be made for transporting the physical commodity to the buyer. In others, the contract sale is made weeks or months before production is completed. Some producers use contracts as a marketing tool year after year, but in most cases the contract becomes part of the marketing plan when the producer feels it is "appropriate."

Determination of when contracting is appropriate or not appropriate is the concern here. While it is impossible to establish criteria that will fit every producer's individual situation, a framework is suggested which will facilitate individual decision making. An awareness of the types of contracts, with their pros and cons, will help us to keep them in their proper perspective so that their performance can be properly evaluated.

Elements of a Contract

All contracts will contain five elements of a market exchange. These are: quantity, quality (or grade), delivery point, time of delivery, and price. While all five characteristics are in a contract, contracts may differ on some of the provisions, such as price and delivery date, depending on the type of contract.

Types of Contracts

A cash contract is one of the marketing tools a producer can use to forward price his production. A cash contract is a binding contract where the seller agrees to deliver a specified quantity and quality of grain to a specific location for a given price at a specified time.

There are basically three types of cash contracts used in Nebraska: (1) the fixed price agreement, (2) the deferred pricing agreement, (3) the pooled sales agreement.

Under a fixed price agreement, the producer agrees to provide a specified quantity and quality of grain for a specific price. There are two forms of the fixed price agreement. In one, the grain is paid for at the time of delivery. In the other, the payment may be delayed until some later date, such as after January 1.

The deferred pricing agreement is the same as the fixed price agreement except that the final price is not part of the contract. The final price is established at the seller's option during any business day before a date specified in the agreement. The deferred pricing agreement permits the producer to deliver his grain and transfer title to the elevator at harvest, but delays the actual pricing of the grain until a later date chosen by the producer within a range specified in the contract. If no decision has been made by the last date shown in the contract, the price received is that day's price.

The third type of cash contract is the pooled sales agreement. The pooled contract is used primarily by producer cooperatives. When the producer delivers his grain to the cooperative, he receives a cash advance. He receives additional payments as the grain is sold by the cooperative. The amount he receives is determined by the price the pool receives as the grain is sold. Under this form of pricing the producer receives an
average pool (yearly) price for his grain.

When signing any agreement that transfers title, the producer must consider the buyer’s liability position should an unforeseen catastrophe arise, such as bankruptcy, fire, etc.

Benefits and Concessions

Cash contracts offer four benefits to those who recognize them as a marketing tool: (1) they lengthen the time period within which the selling decision can be made, (2) they allow the producer to lock up a market outlet, (3) they make it possible for the producer to establish a fixed price and allow planning to proceed with this knowledge, (4) they eliminate the detrimental effect of a price decline before the commodity is physically delivered to market.

In order to receive these benefits, a number of concessions must be made. There are two which seem to be most important: (1) the deferred delivery commitment is binding and by law requires compliance; (2) once the commitment is made, the seller forgoes the opportunity to benefit from a rise in price above the established contract price.

A Framework for Decisions

Since benefits and concessions do exist, the question the producer faces is “should I sell now or later?” Once the contract is signed the sale is final. Before entering into a contract the producer should first determine his objectives. Generally, the first and foremost objective is price. However, other objectives that might be almost as important to the producer are (1) cover production costs and insure a profit, (2) obtain the highest price before prices decline, (3) insure that the grain has a home when it is harvested, (4) obtain a given rate of return on investment or (5) minimize losses.

The producer should be certain that a contract will fulfill the objective (or objectives) he deems most important. If it does not, he might look for other alternatives. An example might be a producer who is not only interested in price, but also does not have much on-farm storage. Many contracts contain a provision that allows the delivery date to be extended at the option of the buyer. In this case, the contract could place the producer in a bad position during harvest. Other things a producer should consider before entering into a contract are: (1) what are his production costs, (2) what price will he accept before reaching the point where his preference would be to gamble on the cash market, (3) what the market is offering at different locations, (4) obtain as much information as possible as to what future price expectations might be.

After considering available information, the producer must decide whether or not the contract price is acceptable to him.

If the price which can be locked in offers an acceptable return and market information suggests that prices in the future will not increase substantially, then selling grain by contract is probably a desirable commitment.

If the producer is not satisfied with the return or fulfillment of objectives, then a forward contract is not a desirable alternative. This decision is not an easy one, and it should be based on interpretation of as much information as it is possible to obtain.

The producer must remember that when he makes a decision based on the benefits and concessions previously mentioned, the benefits do not change from the time the contract is signed to the delivery time. The changes that may take place in the market will not affect the terms of the contract. Changes in the market, such as rising prices, only affect the magnitude of the concessions. It is because of this point that producers should base their forward selling decisions primarily on the benefits offered. If the producer keeps the benefits of a forward cash contract foremost in his mind, it will keep him from expecting more from the contract than what it was designed to do. Contracts do not guarantee the highest price during the year. A contract is just one of the marketing tools available to the producer.

Knowledge of the benefits and concessions is necessary if contracts are to be properly evaluated. If the producer makes decisions based on the benefits with a complete awareness of the concessions made, then a forward contract can be more rewarding and the results produced more acceptable.