

Grain Marketing and Price Risk Management Terminology

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Introduction

Understanding grain marketing terminology is essential for making sound price risk management decisions. Terms related to cash markets, basis, contracts, futures, options, hedging, and market trends explain how the market works and how transactions are structured. This publication is designed to be used with guidance from grain elevators, merchandisers, farm advisors, and Extension specialists to help producers fully grasp the terminology and how related decisions may affect farm profitability. Accurately interpreting and applying these terms can prevent misunderstandings, improve decision-making, and protect the farm business.

Basic Terminology

cash market – The market in which physical commodities are bought and sold.

cash price (spot price) – The price received for immediate delivery of a specific quantity and quality of a commodity. Example the price received for immediate delivery at your local elevator.

basis – The difference between the cash price for a commodity at a specific location and its associated futures price at a specified exchange (e.g., Chicago Mercantile Exchange). Basis is specific to the delivery / contract month, the most commonly quoted basis is the nearby basis (Basis = Cash Price – Futures Price).

- **basis risk** – Risk of change or variation in the basis over time.
- **even basis** – A condition that exists when the local cash price is equal to the futures price.
- **positive basis** (over-the-board) – A condition that exists when the local cash price is greater than the futures price.
- **negative basis** (under-the-board) – A condition that exists when the local cash price is less than the futures prices.
- **weakening basis** – Basis movement over time that occurs when the cash price is decreasing relative to the futures price.
- **strengthening basis** – Basis movement over time that occurs when the cash price is increasing relative to the futures price.

cash contracts – Contracts for the purchase of a crop, usually from producers.

- **basis contract** – The agreement establishes the basis but not the futures or cash price (note: cash price = futures price + basis). At a later date, the producer selects the day they wish to establish the future's price (before delivery or other time specified in the contract). At that time, the producer will receive that futures price plus the contracted basis.
- **delayed payment contract** – An agreement in which the price is established, and the crop is delivered, but payment is postponed until later. It is typically used to shift taxable income into the following year.
- **cash forward contract** – An agreement requiring the farmer to deliver a specific quantity and quality of a crop to the elevator or purchaser at a specified time and location for a previously agreed upon price.
- **hedge-to-arrive contract** – An agreement where a farmer chooses a future contract month and establishes the futures price for the crop they intend to sell. The basis is established later at the discretion of the producer. The producer's cash price will be the futures price plus the basis. Hedge-to-arrive contracts can often be rolled forward to another futures contract month. The elevator performs the hedging transaction. The farmer pays a fee to cover transaction costs.
- **minimum price contract** – An agreement in which a minimum sale price is established. The producer is guaranteed either the

minimum sale price or a greater price based on the prevailing market price. In exchange for the minimum price guarantee, the producer must pay a fee (similar in size to an option premium) to the elevator, or contract writer. For a minimum price contract, the producer is not an options market participant, it is the elevator.

- **min/max contract** - An agreement where a seller sets both a minimum and maximum price for grain. This allows the seller to guarantee a minimum price while still having the opportunity to benefit from a higher market price within the specified range. The ceiling lowers the fees through reduced premium costs. It's like having a floor price with some upside potential, but with a ceiling on how high the price can climb.
- **offer contracts** - A producer signs a contract with an elevator indicating their desire to sell a specific number of bushels of a crop any time the cash price reaches a designated price.
- **price-later (deferred or delayed price) contract** - An agreement in which a crop is delivered, and legal title passes to the elevator, but the price is established later at the discretion of the farmer. The price to the producer on any given day is the elevator cash price less a service charge. Both the basis and futures price are set at a later time.
- **production contract** - An agreement under which a farmer agrees to raise a crop in a manner established by the contractor, sell or deliver the crop to the contractor, and, in return, receive a payment from the contractor. The contract will usually set minimum quality requirements and establish a price or mechanism to determine price upon delivery. Many production contracts will specify acreage rather than quantity.

futures contract - A contract traded on a futures exchange (e.g., Chicago Mercantile Exchange) that calls for delivery of a standardized amount and quality of a commodity during a specific month. The contract price (per unit of commodity) is established through competitive trading at the organized exchange.

- **first notice day** - The first day on which notice intentions can be made or received to deliver actual commodities according to the futures contract. It usually precedes the beginning of the delivery period.
- **futures contract months** - The delivery months in which futures contracts are traded.
- **futures premium** (spread between contracts) - The amount that prices for one futures contract month exceed those of another futures contract month.
- **last trading day** - The last day of trading in a particular futures or options contract month. Unsettled contracts at the end of the last trading day must be fulfilled by delivery of the physical product or closed through cash settlement procedures if the contract does not permit delivery.
- **life of contract** - The time period during which a specific contract month has been trading.
- **maturity** - The period when a futures contract can be settled by delivery of the actual commodity or through cash settlement (if the contract does not take delivery).
- **nearby delivery month** - The futures contract month closest to maturity.
- **open contract** - Contracts that are outstanding and have not been offset. Futures transaction which has not been completed by an offsetting trade, or by delivery or receipt of the commodity.

futures trading - A market activity to buy or sell (or both) a commodity at an agreed upon price today, for delivery sometime in the future.

- **bid** - A willingness to buy a commodity at a specified price.
- **offer** - A willingness to sell a commodity at a specified price.
- **long** - Purchased futures contracts that have not been offset by sold contracts or delivery.
- **short** - Sold futures contracts that have not been offset by purchased contracts or delivery.
- **position** - Describes the position of a trader as a buyer (long position), a seller (short position), or a spread trader (long and short).
- **position limit** - The maximum futures market position speculators are legally permitted to own or control.
- **net position** - The difference between the long open contracts and the short open contracts of a commodity for a specific trader or type of trader.
- **liquidation** - Offsetting an existing position by selling (buying) a futures or option contract that was previously purchased (sold). Also called offset or covering.
- **opening transaction** - A trade that establishes a new position.
- **round turn** - A complete buy and sell transaction for futures or option contracts.

option - The right (but not the obligation) to buy or sell a particular futures contract at a specific price during the life of the option.

- **call option** - An option contract giving the buyer the right, but not the obligation, to buy a futures contract (underlying contract) at a specific price (premium) during a specific time period. The call option seller is obliged to sell futures to the call option buyer if the buyer exercises the option. The call option buyer pays a premium to the call option seller.
- **put option** - An option contract giving the buyer the right, but not the obligation, to sell a futures contract at a specific price

during a specific time period. The put option seller is obligated to buy futures from the put option buyer if the buyer exercises the option. The put option buyer pays a premium to the put option seller.

- **naked writing** – Writing a call or a put option in which the writer has no opposite cash or futures market position. This is also known as uncovered writing.
- **holder** – The option buyer who pays a premium in return for the right to exercise the option.
- **writer** – The option seller who receives the premium but is obligated to perform if the option is exercised.
- **strike price** – The price at which the buyer of a put or call option has the right to exercise the option. Each option has several strike prices to choose from. Each strike price has a different premium.
- **series** – All options of the same class which share a common strike price.
- **underlying futures contract** – The specific futures contract that may be bought or sold by exercising an option.
- **at-the-money** – An option with a strike price equal to the current price of the underlying futures contract.
- **in-the-money** – An option with intrinsic (exercise) value. A put option with a strike price above the current price of the underlying futures contract. A call option with a strike price below the current price of the underlying futures contract.
- **out-of-the-money** – An option which has no intrinsic (exercise) value. A put option with a strike price below the current price of the underlying contract. A call option with a strike price above the current price of the underlying futures contract.
- **option buyer** – The purchaser of either a call option or a put option; also known as the option holder. Option buyers receive the right, but not the obligation, to enter a futures market position. Option buyers pay a premium to the option seller.
- **option seller** – The seller of a call or put option; also known as the option writer or grantor. An option seller receives the premium and is subject to a potential market obligation if the option buyer chooses to exercise the option rights.
- **premium** – The price of a particular option contract determined by trading between buyers and sellers. The premium is the maximum amount of potential loss for an option buyer and the maximum amount of potential gain for an option seller.

hedging – The buying or selling of futures contracts as a temporary substitute for a later cash transaction to ensure against price change. Changes in the futures market are offset by changes in the cash market.

- **short hedge** – Selling futures contracts to protect against possible downward trending prices of commodities that will be sold in the future. Also known as a selling hedge.
- **long hedge** – Buying futures contracts to protect against possible upward trending prices of commodities that will be purchased in the future. Also known as a buying hedge.

margin – An amount of money deposited to guarantee the performance of a futures contract.

- **initial margin** – The amount of money that must be deposited at the time a futures position is entered. Also called original margin.
- **maintenance margin** – The minimum amount of money that must be maintained in a margin account on any day after the first trading day.
- **margin call** – A call from a brokerage firm to a customer to bring margin deposits up to the minimum after a loss has occurred in futures trading that results in a margin account failing below the maintenance margin.

market trend – The general direction of prices, either up or down.

- **bear market** – A market where a large supply and/ or small demand results in a price decrease. bearish – A market view that anticipates lower prices.
- **bull market** – A market where a small supply and/ or large demand results in a price increase. bullish – A market view that anticipates higher prices.
- **break** – A sudden sharp price decline.
- **bulge** – A sudden sharp price advance.
- **heavy** – A large number of sell orders hanging over the market without a corresponding number of buy orders.
- **rally** – A quick advance in prices.
- **recovery** – Advance in prices following a decline.
- **short covering rally** – A short-lived rise in prices caused by traders buying back previously established short positions.
- **soften** – Slowly declining market prices.
- **sell-off** – Downward price trend after an advance caused by traders selling previously established long positions.
- **technical rally (or decline)** – A price change led by technical market signals rather than supply and demand conditions.
- **seller's market** – A market where a crop is in short supply and sellers can obtain higher prices.

- **buyer's market** – A market where a crop is in surplus supply and buyers can obtain lower prices.

Interpreting the Futures Board - These terms are used in futures price reporting, which may be on the CME board, internet websites, local television networks, or in newspapers.

- **month**- The month and year of the contract.
- **open** - The first trade price of the day (session) for the contract.
- **high** - The highest trade, price for the contract during the trading day.
- **low** - The lowest trade, price for the contract during the trading day.
- **last or close** - The final trade price at the close of the most recent trading day session.
- **change** - The change in price between the most recent “last” or “close” and the previous day’s settlement price.
- **time** - Prices are delayed; the time indicates the clock time of the quote.
- **volume** - The total number of contracts traded during the trading day.
- **open interest** – Total number of futures or options (puts and calls) contracts traded that have not been closed out (offset) or liquidated.

Additional Terminology

arbitrage - The simultaneous purchase of commodities in one market and the sale of commodities in the same or different market. Arbitrage is profiting from a discrepancy in prices.

broker - One who executes futures trading orders for customers. The broker may be an employee in a local office of a brokerage firm or an employee of a crop merchandiser such as a cooperative, elevator, ethanol plant, or feed mill.

commission – Fees paid to the broker for execution of an order.

contract grades - Grades and standards specified in the rules of an exchange, which must be met to deliver against the futures contract. In many instances, grain meeting different grades and/or standards can be delivered at a premium or discount.

counterparty risk - The risk that the other party in a financial transaction will be unable or unwilling to fulfill their contractual obligations.

delivery - The transfer of the physical commodity in satisfaction of a futures contract.

exercise – The action taken by the holder (buyer) of a call if he wishes to purchase the underlying futures contract or by the holder (buyer) of a put if he wishes to sell the underlying futures contract.

expiration date – The last date on which the option may be exercised. Although options expire on a specified date during the calendar month prior to the contract month, an option on a November futures contract is referred to as a November option, since its exercise would lead to the creation of a November futures position.

expire – When option rights are no longer valid after the option’s expiration date.

extrinsic value (also known as time value) – The amount by which an option’s premium exceeds the option’s intrinsic value. If an option has zero intrinsic value, its premium is entirely time value.

fence - A risk management strategy that involves buying and selling options to create a defined range in which the price of grain can move, limiting both potential losses and gains.

force majeure - Refers to unforeseen events or circumstances that prevent a party from fulfilling contractual obligations, effectively excusing them from liability and the terms and conditions of the contract.

fundamentals (or fundamental analysis) - One of two major sets of factors in analyzing prices. Fundamentals are supply and demand factors that influence the prices of commodities.

futures price – The price of a futures contract determined by open competition between buyers and sellers on a futures exchange.

harvest contract - The futures contract with a maturity date closest to after harvest.

intrinsic value - The value of an option based on the immediate profit that would be realized if the option were exercised today, given the current market price of the underlying futures contract and the option’s strike price. For a put, the strike price minus the price of the underlying futures contract, if positive; otherwise zero. For a call, the price of the underlying futures contract minus the strike price, if positive; otherwise zero.

limit - The maximum price advance or decline allowed from the previous trading day's settlement price for a specific futures contract under exchange rules.

liquidation (closing transaction) – A purchase or sale that offsets an existing position. This may be done by selling a futures or option that was previously purchased or by buying back a futures or option that was previously sold.

nearby contract - The futures contract with maturity closest to the current date.

offset – Taking a futures or option position opposite to the initial or opening position of an identical futures or option contract; closes out or liquidates an initial futures or options position.

speculator – A market participant who buys and sells futures and/or options in hopes of making a profit and does not own or plan to own the underlying commodity– adding liquidity to the market.

spread - The difference in price between two futures contracts with different contract delivery months. A positive spread means that the distant month price (e.g. July) is higher than the nearby month (e.g. March). Spread can also be the difference in contract price between different commodities (e.g. corn and soybeans) or between exchanges and the same commodity.

technical analysis - Price forecasting that uses historical price and trading volume information in chart or graph formations.

transaction cost – Fees charged by brokers including exchange and clearing fees to buy or sell futures and options contracts.

volatility – The amount by which futures prices fluctuate or are expected to fluctuate in a given period of time.

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