Ag commodity prices:

Livestock producers are experiencing tectonic shifts due to higher feed costs. Put simply, many are paying more to feed and house animals than the animals are worth when ready for harvest.

By **JACOB D. BYLUND** and **MICHAEL R. STEWART***

RECENT months have seen dramatic fluctuations in agricultural commodity markets.

These market fluctuations have been the focus of much attention within the industry, in the media and in government. However, the impacts of higher commodity prices on certain segments of the agricultural sector and the legal issues that flow from such market conditions, including the allocation of risk, have gone largely unnoticed.

Had prices remained at the high levels reached in June and July or gone even higher, an industry-wide crisis may have resulted.

While market prices did ebb more recently (creating additional issues for certain industry participants), prices remain at historically high levels, and the future remains uncertain.

This article considers how high agricultural commodity prices have adversely affected industry participants and assesses which market participants bear the risks of the higher prices.

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Impact on producers

Given these record-breaking commodity prices, Americans might reasonably assume that farmers are prospering. In fact, many are. Others, though — both crop farmers and livestock producers — are facing financial peril.

To understand why, it's necessary to understand how many farmers market their crops.

Like most businesspeople, they plan ahead. Thus, in the summer of 2007, when grain farmers saw futures prices for the 2007 crop, including the July 2008 futures contracts for corn and soybeans, trading at what were then considered high prices ($4/bu. for corn and $9/bu. for soybeans), many chose to "forward contract" their 2007 crop to grain buyers — to sell the crop before it was harvested, for a fixed price and for delivery at a specified time in the future.

Under a standard forward contract, a grain farmer agrees to deliver a certain number of bushels months or even years later. In return, he is guaranteed a price tied to the applicable futures reference price, minus the basis (the difference between the futures price and the local cash price).

Assume, for example, that in September 2007, Mr. Maize, a grain farmer, saw July 2008 corn futures trading at $4/bu.

He called his local grain elevator (buyer) and, with a basis of 25 cents (to account for local market variation), contracted to sell 50,000 bu. of corn at $3.75/bu. for delivery in July 2008.

When delivery time arrived, though, corn prices had risen, and Maize had to deliver a crop worth more than $7/bu. while accepting payment of $3.75/bu. — a lost profit opportunity of $3.25/bu.

For some farmers, however, more than a missed opportunity is at stake. Since 2007, costs have increased considerably, including rent (which has risen on pace with record land prices), diesel fuel and fertilizer. For the most part, those higher costs did not affect the 2007 crop, though, so Maize may have enjoyed a profit, even at $3.75/bu.

Vary the hypothetical, however, and the outcome changes dramatically.

Assume that in September 2007, instead of selling 50,000 bu. for July 2008 delivery, Maize sold 50,000 bu. of his 2008 crop for November 2008 delivery, also at $3.75/bu., but in 2008, Maize has to pay higher rent; he may even have lost some production acres because of rent increases. Meanwhile, the spring was very wet, and Maize only planted about 90% of his remaining acres to corn. He lost another 10% to flooding. Fertilizer and fuel costs were also dramatically higher.

In November 2008, the spot market is trading at $6, and Maize delivers his entire crop — just 40,000 bu. — to Buyer, who invoices Maize $2.25/bu. on the undelivered 10,000 bu. Maize may have lost a considerable sum on the bushels sold and remains indebted to Buyer.

Livestock producers, who are but one step removed from this process, are experiencing similar tectonic shifts due to higher feed costs. Put simply, many producers are paying more to feed and house animals than the animals are worth when ready for harvest.

Impact on buyers

Grain buyers, including grain dealers, feed companies and processors, may also be negatively affected by higher grain prices, albeit in a complicated fashion.

Such buyers hedge against the risk of fluctuating prices by entering into futures contracts in association with forward contracts to purchase grain from producers.

Look again at Mr. Maize, who agreed in September 2007 to sell 50,000 bu. of corn via a forward contract to Buyer for $3.75/bu., with delivery by July 2008.

Grain dealers don't make money by speculating; they don't want to risk losses due to fluctuations in market prices.

In order to hedge against price risk, when he agreed to buy Maize's corn, Buyer also sold 10 corn futures contracts (standardized at 5,000 bu. each) at the $4/bu. futures reference price.

In July 2008, the cash market was $7/bu., and the July futures contract was trading at $7.15. Thus, Buyer made a profit of $3.25/bu. on the contract with Maize (bought for $3.75 but worth $7.00 at delivery).

However, he also needed to close out his hedge position in the futures market, so he bought 10 futures contracts at $7.15/bu., a loss of $3.15/bu. that offset most of his gains on the cash market. Buyer did make 10 cents/bu. through the narrowing basis. He then sent Maize's corn, along with corn from other producers, to a processor, where he

A crisis averted?

made a few more cents per bushel.

That's how grain transactions are generally *supposed* to work. The seller delivers all the grain called for by the cash forward contract. The futures market, in turn, accurately reflects the cash market, making the buyer's hedge efficient.

Futures/cash convergence

Recently, however, the price of commodities like corn in the cash market and in the futures market at or near expiration of the futures contract have not been as close as in the past.

This failure of the two prices to converge is difficult to explain, even for economists.

Some commentators — and some within the grain industry — think the cause is excessive speculation, but while the failure to converge has been widely reported, its effects have been less well understood.

In some instances, the difference between the cash price and futures market at the expiration of the futures contract has been as high as 55 cents/bu. for corn and 80 cents for soybeans.

A wide gap puts buyers in a difficult position.

Assume, for example, that instead of buying 10 futures contracts (50,000 bu.) at $7.15/bu. (a total of 50,000 bu.), the Buyer in the previous hypothetical had to pay $7.75 because the markets did not converge.

In that scenario, Buyer profits $3.25/bu. on the cash contract with Maize but also loses $3.75 on the hedge position for a net loss of 50 cents/bu. Buyer has lost a considerable sum because of his hedge position.

Producer default

Another risk grain buyers currently face is producer default. There is a degree of risk in all contracts that the other party may default. However, record commodity prices combined with production problems in certain areas have driven counter-party risk for buyers to an unprecedented level.

As 2007 crops were first being delivered to buyers in the fall of 2007, it became clear that grain prices were moving higher.

For a significant number of producers, those rising prices proved to be too great a temptation, and many elected to breach their agreements with buyers and default on 2007 crop contracts.

The increase in producer defaults is reflected in the significant number of new arbitration filings with the National Grain & Feed Assn., which maintains an arbitration system for its member companies and their contracting parties (roughly 70% of the industry).

The 2008 crop may present even greater issues — with the volume of producer defaults likely reaching new highs — for several reasons.

First, many farmers forward sold their 2008 crop in 2007 at prices that did not take into account significantly higher 2008 costs. As a lost profit opportunity turns to a loss, the risk of default increases. Extremely poor spring weather exacerbated the problem. Many producers simply may not have enough grain to deliver against their forward contract commitments.

Margin calls

While the hypothetical buyer's hedge transaction described is basically accurate, it fails to account for another significant impact of price volatility: the margin call.

In the previous example, Buyer bought back the futures contracts when grain was delivered, inferring that the money was spent then. In reality, Buyer would have to pay in increments, as the futures market moved higher, in the form of margin calls, which commodity exchanges use to ensure that parties have funds to cover losses.

As the market moves against a party's position, he must deposit money to offset losses.

In the hypothetical, as the futures price moved from $4/bu. to $7.25, Buyer would have to deposit roughly $3.25/bu. If, as is typical, this money was borrowed, Buyer would have to pay interest. Thus, unlike a typical year, where the price might move a few dozen cents and Buyer might incur minor interest charges, he is now paying a significant amount of interest.

Meanwhile, credit has tightened, and some buyers have found it difficult to meet their margin requirements.

In recent weeks, market prices have moved considerably lower but remain at historic highs that continue to be a cause for concern, as outlined in this article. However, it is important to keep in mind that extensive market volatility can create significant disruptions for industry participants whether the market moves up or down.

Indeed, the recent downward movement in markets caused some futures market participants to incur extensive margin calls. Thus, while the rapid increase in agricultural commodity prices over the past year has raised issues and concerns, a rapid retreat to pre-2007 crop price levels would likely create an entirely new set of issues.

Real risk holders

Within the agribusiness community, there is a broad expectation that 2008 and 2009 may see an increased number of defaults on contracts and liquidations among livestock producers.

Determining who will bear the financial losses, however, may be the task of lawyers, arbitrators, judges and juries for several years to come. When fully accounted for, all parties in the production chain — and their lenders — will likely have shouldered some of the burden.

In comparison to the farm crisis of the 1980s, however, many "farmers" today are not individuals. Instead, many have formed limited liability companies (LLC) in order to protect personal assets, including farmland.

Thus, while many individual farmers may retain full liability for breaches of commodity contracts, others may simply wind down the contracting LLC.

Historically, the cliché of business with a handshake has been the norm in agriculture. Asking for information about the other party to a contract was seen as impolite.

As the use of LLCs became widespread, though, old habits did not change. Many industry participants failed to recognize the impact of limited liability entities.

Of course, someone has to carry financial losses. If the seller is an LLC without sufficient assets to cover its obligations, then the next party in the chain — the buyer — may find itself on the hook.

In 2008 and 2009, many grain buyers may find themselves writing off significant amounts of producer liability.

For some, the costs could not come at a worse time as many are already strapped by margin calls, higher interest costs, increased fuel costs and other factors.

For some buyers, the future may be dictated by market conditions beyond their control.

To a significant extent, however, buyers may suffer due to their failure to adequately assess and guard against counter-party risk.

If a grain buyer fails, the losses will move to the next level: the buyer's lender. To a significant extent, lenders, too, are at the mercy of market conditions, such as debtors' higher operating costs. They cannot go back in time and force buyers to be more diligent in contracting with LLCs. Lenders cannot undo the fact that many farmers oversold their 2008 crops.

Many grain and livestock producers may go out of business due to market volatility.

Many buyers of grain — including dealers, feed companies and processors — may also suffer.

The ultimate outcome is predictable: fewer market participants. Given the capital barriers to market entry, they may be lost forever.