Basic Hedge-To-Arrive Contracts

Description
This type of contract is the basis of a contract; it permits the seller to set the futures level on the contract date, but the basis level is determined by the seller at a later date. The contract transfers the futures risk and opportunity from the seller to the buyer on the contract date.

Example: On July 1, a producer agrees to sell a specified quantity for November delivery. The futures price is set at $2.50 per bushel per the December contract on the Chicago Board of Trade (CBOT). The basis level remains open, to be set by the producer at some future date (usually no later than the date of delivery).

Risk to Seller
The seller's futures risk ends on the date and at the price of the contract, but the seller retains the basis risk. The seller also is subject to production risk; that is, the producer is responsible for delivering the contracted amount on the delivery date.
Risk to Buyer
The buyer accepts the futures risk at $2.50 per bushel on the contract date.
Who Might Use This Contract?
A producer who believes that basis (cash price minus futures price) will narrow as the referenced contract month approaches. This producer should be prepared to assume the financial risk that the basis could widen or invert (cash price above futures price).

Upside Price Potential. The futures price is established in the contract, so any gain to the producer will be on basis. As cash prices and futures prices tend to converge near contract expiration, basis levels may narrow and some price benefit might be gained, depending on when the producer establishes the basis level.

Downside Price Potential. Again, since the futures price is established in the contract, any gain or loss to the producer will be on basis. If the basis does not narrow as contract expiration nears, or if the basis inverts (cash price above futures price), the producer stands to be liable for such losses.

When Might This Contract Perform Well?
Traditionally, cash and futures prices converge as the contract expiration date nears. If that relationship holds true, the producer stands to gain from the narrowed basis level.

When Might This Contract Perform Poorly?
In unusual market conditions, such as occurred in the summer of 1996 due to low corn stocks and strong demand, the basis (cash price minus futures price) may not perform as expected. If the basis widens beyond basis levels on the contract date, producers will find that their expected sales price will be diminished by that difference. If extraordinary circumstances result in an invert (cash prices above futures prices), the producer could find their sales price considerably reduced from expectations when they entered into the contract.

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