

Minimum Price Contracts

Description

This contract is intended to give the seller protection against price drops but leaves final pricing until a later date. The seller establishes a minimum price by paying the cost of an option plus a service fee. The buyer generally adjusts the basis level or futures level to reflect the cost of the option and fees.

Example: On April 1, a producer enters into a minimum price contract for a specified quantity of corn for November delivery. The minimum price is set at \$2.15 per bushel after deducting cash basis and fees. The final price will be set later as requested by the producer, but no later than the first day of the shipment period or expiration of the applicable option contract, whichever occurs first -- in this case, November 1. The final price will be the minimum price of this contract plus the value of a Chicago Board of Trade (CBOT) \$2.60 call option on the date of pricing.

Risk to Seller

Although a minimum price contract does not improve final cash price in every case, the strategy reduces risk by eliminating downside price risk. The seller bears the risk that any price increase may not be sufficient to offset up-front costs of the option and fees. 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

On the contract date, the buyer assumes futures risk that the final cash price locked in by the producer will exceed the original futures price.

Who Might Use This Contract?

A producer who wants to lock in the predictability of a set minimum price to help insure a certain income level or cash-flow, but who wants to retain the ability to benefit from price increases.

Upside Price Potential. The producer stands to gain from the increased value of the call in an up-trending market.

Downside Price Potential. Is not applicable; the producer is insulated from any downside price risk by locking in a minimum cash price on the contract date.

When Might This Contract Perform Well?

Generally, minimum price contracts will perform better from the producer's perspective in a rising market. While the minimum cash price is locked in on the contract date, the value of the call will be greater if the futures price has risen, resulting in greater gain for the producer.

When Might This Contract Perform Poorly?

By locking in a minimum price on the contract date, the producer has insulation against a declining market. However, if the futures price does decline following the contract date, the value of the call is zero and the producer will not gain from an increased value of the call.

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