WEEKLY OUTLOOK
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BASIS CONTRACTS

THE CURRENT LOW LEVEL OF CORN AND SOYBEAN PRICES suggests that many producers are reluctant to sell large quantities of their 1982 crops. Retaining ownership of most of the expected production creates two problems. First, because of the large supply of grain, storage space will not be adequate to hold all the grain that some farmers want to own. Second, storing most of the 1982 crops could put pressure on the cash flow situation for some farmers.

Several alternatives are available to producers facing one or both of these problems. If storage is available but cash flow is a problem, eligible producers can use the CCC loan program. All producers are eligible for the soybean loan program, but only those who participated in the Reduced Acreage Program are eligible for the corn loan program.

Producers who want to own more grain than they can store may have as many as three options: Grain could be sold at harvest and replaced with futures; grain could be delivered on a price-later contract; or grain could be delivered on a basis contract. In all three cases, the title of the grain is transferred to the buyer, but the seller retains the right to price the grain later. Basis contracts have become a popular option for many producers.

Under a basis contract, the buyer and seller agree that the price paid to the seller will be the price of a specified futures on the day of the seller's choosing, minus the basis that exists at the time of the contract. That is, the basis is fixed and pricing is based on a specified futures contract. The popularity of such contracts has increased when buyers have offered a partial payment to the producer at the time of delivery. Typically, the payment might consist of 80 percent of the cash price at the time of delivery. The balance, if any, is paid at the time of pricing.

Producers sometimes view basis contracts as a costless way to retain ownership of grain. However, the producer who delivers on a basis contract will not benefit from a narrowing of the basis during the storage season. In addition, interest costs would be incurred on the 20 percent of the cash price that is not received at delivery.

An Example. On September 2, the cash price of new crop corn in central Illinois was approximately $1.96 per bushel. July 1983 futures closed at about $2.63. The July basis, then, was 67 cents ($2.63 minus $1.96). A basis contract entered into on September 2 might call for corn to be delivered at harvest, with pricing to take place anytime before June 30, 1983. The price paid would be the July futures price on the day of pricing minus $0.67. An advance payment of $1.57 per bushel might be made to the producer. What is the cost of this contract to the producer? The cost is the magnitude of basis improvement after September 2 plus interest on 39 cents ($1.96 minus $1.57). If, as last year, the July basis narrows to 40 cents by the first of January, the basis cost would be 27 cents, and interest cost would be about 1.5 cents. By June 1, 1983, the basis could be as narrow as 15 cents if last year's pattern is repeated. The basis cost then would total 52 cents, and interest would be 4 cents per bushel.

Ownership of grain under any conditions is expensive. With a basis contract, the cost is less obvious. The important thing to remember is that the seller has forfeited any gain from basis improvement. And the producer gains only if futures prices go up.

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