Hog Contracting

A number of marketing firms and packing plants are offering forward contracts that make it possible for livestock producers to forward price through a contract rather than by hedging in the futures market.

It is important that the producer understand the conditions of the contract before signing the contract. Also, the various contracts are sufficiently different so that a producer should be able to select the contract that has the most desirable features. All the features should be considered before a contract is selected.

The forward sale contract is a contract between a buyer (normally a meat packer or a marketing agent) and a seller (normally a producer) where the producer agrees to sell, at a future date, a specified number of hogs to a buyer for a certain price. The buyer will normally have taken an opposite position in the futures market to offset any price fluctuations that may occur between the signing of the contract and the delivery date. To cover margin and commission, the contract price offered by the packer may be lower than futures price adjusted for a typical basis.

Size of contract

The contracts offered range from 5,000 to 40,000 pounds carcass or 5,000 to 50,000 pounds live, with the most common being 20,000 pounds carcass or 25,000 live weight. Therefore the contracts range in size from about 20 head to 220 head. Producers who market a small number of hogs every week will prefer the smaller contracts. Also, the producer who varies the proportion of production that is forward-priced may want to consider the smaller contracts.

Discount from futures price

The size of the discount used to adjust the futures price to a contract price varies from $0 per cwt. to $7 per cwt. Firms offering forward contracts offset their risk by taking a position in the futures market. In order for them to do this they must localize the futures price. The size of the discount from the futures (basis) will vary depending on the contract month and the contract specifications.

For example, one firm may use a small discount that shares the basis risk with the producer. If the actual differential is larger, the firm absorbs half of the difference and the producer half of the difference. The opposite is true if the differential is narrower.

Contract specifications can also affect the size of the discount. Another factor affecting the discount is time—how far ahead the contract is being made. Usually the more distant contracts will have the higher discount from the futures. The more distant contracts require more margin risk; hence, the higher discounts. Historic hog basis levels, files **B2-40** and **B2-41**, can be used to analyze futures price discounts.

Weight and grade

Forward deliverable contracts will specify standards for deliverable hogs with regard to yield, weight range, and leanness. Typically, the packer's carcass merit buy program will apply.

Delivery point

It is important that producers know where their hogs are to be delivered. Some contracts call for delivery to a buying station; others require plant deliveries. The distance that hogs must be hauled not only affects the transportation costs, but also the shrink loss if sold on live weight basis.

Delivery period

It is important that the producer clearly understand the delivery time requirements and other delivery conditions before signing a contract. Usually contracts specify a time during which delivery may be

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made. Some contracts allow the producer to decide the day of delivery—but specify that the contracting firm must be notified first. Other contracts stipulate that the contracting firm determines the delivery day during the time established.

A few of the contracts do not require delivery of the entire contract at one time. Instead, deliveries can be made in smaller lots during the delivery period. However, most contracts require that the entire delivery be made at one time.

Delivery shortfall

A producer not delivering sufficient hogs to fill the contract will have to pay a penalty for the pounds not delivered if prices rise after the contract is made. However, if prices decline after the contract is made, the producer may receive some payment for the shortfall. The size of the penalty or the additional payment is dependent on the specific contract and the price changes that occur.

Delivery excess

Delivering more hogs than the contract requires means the producer will be paid current cash market prices for any excess pounds. The excess delivery will not earn the contract price but will receive current cash market prices.

Canceling the contract

Contracting firms are very reluctant to allow cancellation of the contract, and it can be costly to the producer. If cancellation is allowed, the producer has to pay any losses the contracting firm incurred in the futures market.

Basis

Be sure you understand what carcass merit standard is used to establish the basis offered. The CME Lean Hog Futures are based on 51 to 52 percent lean carcasses. Does the contract use this standard or the packer's existing carcass merit buying program? The lean standard used will have an impact on the lean premium you receive.

The cattle feeder, hog producer, cow-calf producer, or hog feeder who is considering forward pricing has two methods available. The producer may either sign a forward contract with a buyer or marketing agency or hedge on the futures market. The producer has to select the technique that best fits the livestock operation and personal preference.

Forward contracting vs. hedging

Advantages of forward contracting

- Specific contract price
- No margin deposit
- Negotiate with local firm
- Local delivery
- Potential premium for exceeding specifications
- Greater variation in contract sizes
- No knowledge of futures trading required

Disadvantages of forward contracting

- Difficult to cancel contract
- Each firm has different contract
- Discount from futures price may be too large
- Contracts are not always available
- Most contracts reduce cash market flexibility
- Delivery required
- Delivery period can be restrictive

Advantages of hedging

- Easy to cancel
- Higher returns if basis narrows
- Withdraw market gains early
- Two methods of meeting contract (delivery or offset)
- Contracts standardized
- Contracts constantly available
- Maintains cash market flexibility

Disadvantages of hedging

- Requires knowledge of futures trading
- Knowledge of basis patterns necessary
- Lower returns if basis widens
- Margin deposit required
- Added funds for margin deposit may be required
- Only two contract sizes
- May encourage speculating in futures