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Delivering on a Hog Futures Contract

Producer Marketing Management—Fact Sheet #7

By J. Marvin Skadberg, extension economist, Iowa State University.
Reviewers: Glenn Grimes, extension economist, University of Missouri, and Gene Murra, extension economist, South Dakota State University.

Although most hedgers do not actually make delivery on a hog futures contract, it is the potential for delivery that makes hedging an effective market risk reduction technique. Normally, to fulfill the futures obligation, a producer buys an offsetting futures contract rather than making delivery.

Actual delivery on a futures contract should take place only when the basis during contract maturity is greater than anticipated—and greater than the delivery costs.

According to theory, the price difference (basis) between the futures and the cash markets should be the same or less than the delivery costs; hence no deliveries. But, as is often the case, reality may differ from theory, and thus there are times when the basis is greater than the delivery costs.

Delivery may be feasible in some market areas and not in others because cash prices differ by regions. The futures price represents a specific type of hogs at specific markets whereas cash prices vary by the supply/demand conditions in each local area. Therefore, it is possible that hedgers in some areas may make deliveries because of an adverse basis relationship, while in other areas the basis may be sufficiently small so that delivery is not a good alternative.

Delivery most likely will be made by producers who are located near a futures delivery point, but any producer whose hogs will meet the contract specifications can make delivery.

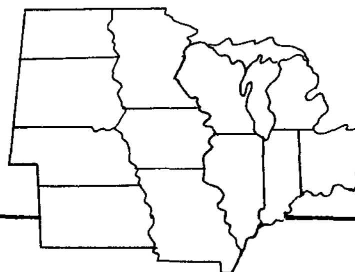
An alternative to delivery of the producer's own hogs would be for the producer to purchase hogs at the market where the delivery is to be made and to make delivery of those hogs. The producer should check with a livestock commission firm or market representative of the market before making this decision.

When to Deliver

As stated previously, delivery should be made only when the current basis is greater than the delivery costs. The basis is determined by subtracting the local cash market price from the appropriate futures contract price. If, for example, the delivery costs were $2 per cwt. and the basis was $3 per cwt., the basis would be greater than delivery costs and delivery should be seriously considered. Delivery in this case would net the producer an additional $1 per cwt. ($3 − $2 = $1). If the basis was only $1 per cwt. and the delivery costs were $2 per cwt., delivery should not be made. Instead, the producer should gain $1 per cwt. by selling the hogs on the local market and buying back a futures contract.

When the difference between the basis and the delivery costs is less than 50 cents per cwt., it is generally advisable to buy a contract rather than delivering. The reason is because the delivery costs can only be estimated before actual deliv-

NCR Extension Publication No. 217 | March 1986
Sponsored by the Extension services of Indiana, Iowa, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin, in cooperation with ES-USDA.



ery. It is possible the delivery costs could be larger than estimated because of quality or weight discounts.

Size of Delivery Unit

Delivery on the Chicago Mercantile Exchange must be 30,000 pounds of barrows and gilts, which, depending on the weight of the hogs, would require from 131 to 150 hogs. The delivery unit on the MidAmerica exchange must be 15,000 pounds of barrows and gilts (approximately 66 to 75 hogs). The delivery unit cannot exceed the weight specified by more than 5 percent.

Delivery Period

Hogs can be delivered from the first of the contract month to the last business day of the month. Deliveries are not allowed on Fridays, holidays, or days preceding a holiday. Deliveries are optional for the short hedger from the first of the month until the close of the contract (approximately the 20th of the contract month). Delivery is mandatory after trading has been closed for any contract that has not been offset.

Delivery Costs

Before making delivery, a hedger should estimate the delivery costs. The delivery costs include the marketing fee, transportation costs, shrink costs, quality and weight discounts, and delivery point discounts. It is important to check the current specifications on all contracts since the contract specifications are revised periodically.

Marketing Fee

Hogs delivered on a futures contract normally are assigned to a livestock commission firm at the delivery point market. It is this firm's responsibility to weigh, sort, and pen the hogs, in preparation for grading, and to collect the money due on the hogs. The firm charges a fee for this service.

The delivery point public market charges a fee for feeding, weighing, watering, and use of the pens.

The USDA Market News Service charges a fee for grading the livestock.

The commission firm pays all fees due on the hogs, collects the money due, and remits the remainder to the deliverer.

These three factors make up the marketing fee, which should not exceed $1 per cwt.

Transportation Costs

A producer estimating transportation costs for delivery should estimate only the added cost of transportation to the delivery point. To do this, the producer should subtract the cost of hauling to the local market from the cost of hauling to the delivery point, and use the difference for the transportation cost.

If, for example, it costs a producer 50 cents per cwt. to haul hogs to the local market and 75 cents per cwt. to haul them to the delivery point, only the 25 cents per cwt. additional cost should be used for delivery decision purposes.

Shrink Costs

Shrink loss for delivery is estimated in a manner similar to that used in estimating transportation costs—only the added shrink loss is considered. Assume that a producer's shrink loss to the local market is 3 percent, while the shrink loss to the more distant delivery point is 4 percent. By subtracting the local shrink loss from the delivery shrink loss, the producer obtains an added shrink loss of 1 percent (4 percent − 3 percent = 1 percent).

The 1 percent shrink loss is multiplied by the price level per cwt. to estimate the shrink cost of delivery. If the price level was $40 per cwt. and it was multiplied by a 1 percent added shrink loss, the producer's shrink cost of delivery would be 40 cents per cwt. ($40 × .01 = 40 cents).

Quality and Weight Discount Estimation

A producer planning on delivering should determine if all the hogs delivered will meet the par contract specifications. If some of the hogs are likely to be discounted, these discounts should be estimated before the delivery decision is made. The futures contract specifies the appropriate discounts for both weight and quality.

Delivery Points and Discounts

The delivery points for the futures contracts are at public markets at the following cities. Delivery point discounts are listed.

Peoria, Illinois	no discount (par)
Sioux City, Iowa	25 cents per cwt.
Omaha, Nebraska	25 cents per cwt.
St. Paul, Minnesota	25 cents per cwt. (proposed change to 75 cents per cwt.)
East St. Louis, Illinois	25 cents per cwt.
Kansas City, Missouri	50 cents per cwt.
St. Joseph, Missouri	50 cents per cwt.
Sioux Falls, South Dakota (to be added)	50 cents per cwt.

Hogs delivered to delivery points other than the par delivery point are discounted from 25 to 75 cents per cwt. depending on the specific delivery point.

Since the designated delivery points and discounts may change, a producer considering delivery should obtain the current information from a broker.

Delivery Cost Worksheet Example

Futures price (appropriate contract)		$48.00 per cwt.
Delivery costs		
Marketing fee	$1.00 per cwt.	
Transportation (added)	.25 per cwt.	
Shrink (added)	.40 per cwt.	
Quality discount	.05 per cwt.	
Weight discount	.20 per cwt.	
Delivery point discount	.25 per cwt.	
Total delivery costs	$2.15 per cwt.	– $2.15 per cwt.
Net futures price (futures price minus total delivery costs)		$45.85 per cwt.

Rules to Remember

Rule 1. If the net futures price is the same as or lower than the current cash price for hogs, the hedger should buy back futures and sell hogs on the cash market.

Rule 2. If the net futures price is higher than the current cash price for hogs, the hedger should either deliver the hogs on contract or delay lifting the hedge.

Delivery Procedure

A producer intending to deliver on a futures contract must notify the broker of the number of contracts, the delivery point, and the delivery date. The broker is required to notify the clearing house in writing (Notice of Intent to Deliver) no later than 1 p.m. one business day prior to the actual delivery date.

On the delivery date, the hogs must be delivered to the delivery point in sufficient time to be weighed, penned, and graded with an official USDA Agricultural Products Certificate.

The producer delivering will usually assign the hogs to a livestock commission firm at the delivery point. The responsibility of the livestock commission firm is to weigh the hogs, assign them to a pen, sort the hogs if necessary, and notify the grader about the delivery unit. Once the hogs have been accepted, the commission firm will collect the money due, subtract the marketing charges, and pay the producer for the hogs. In case substitutions have to be made in the delivery unit, the commission firm will handle these transactions.

It would be advisable for the producer intending to make delivery to notify the livestock commission firm at the delivery point about the intention to make delivery. By doing this, the producer can receive some assistance in selecting the appropriate hogs and be ensured that delivery is made in sufficient time to meet all the requirements.

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Grading and Weight Estimation

The USDA Market News Service personnel have been designated by the exchanges as official graders. The grader's responsibility is to grade the hogs and estimate weights of individual hogs that fall out of the par weight range. Live weight of the total shipment is obtained by weighing the hogs, but individual hog weights are obtained by the grader's estimating their weights. These estimated weights become the official weights and are used in computing discounts for individual hogs.

Hog grades are also established by viewing the live hog. The USDA grading standards for live hogs are used by the grader to establish the grades of the hogs delivered.

Hog Delivery Worksheet

Use this to calculate your delivery costs.

Futures price (current price, appropriate contract)		______ per cwt.
Delivery Costs		
Marketing fee	______ per cwt.	
Transportation (added)	______ per cwt.	
Shrink (added)	______ per cwt.	
Quality discount	______ per cwt.	
Weight discount	______ per cwt.	
Delivery point discount	______ per cwt.	
Total delivery costs	______ per cwt. –	______ per cwt.
Net futures price (futures price minus total delivery costs)		______ per cwt.

Rules to Remember

Rule 1. If the net futures price is the same as or lower than the current cash price for hogs, the hedger should buy back futures and sell hogs on the cash market.

Rule 2. If the net futures price is higher than the current cash price for hogs, the hedger should either deliver the hogs on contract or delay lifting the hedge.

This fact sheet is a product of the North Central Ad Hoc Producer Marketing Committee including the following members at the time of preparation: Dean Baldwin (Ohio), Gerald Campbell (Wisconsin), Ken Egertson (Minnesota), John Ferris (Michigan), Darrel Good (Illinois), Glenn Grimes (Missouri), Hugh McDonald (North Dakota), Gene Murra (South Dakota), Mike Sands (Kansas), Marvin Skadberg (Iowa), Bill Uhrig (Indiana), Al Wellman (Nebraska), and Ken Bolen (Nebraska), Administrative Liaison. Partial funding support provided by the Farm Foundation.

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Issued in furtherance of Cooperative Extension work, Acts of Congress of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture and Cooperative Extension Services of Illinois, Indiana, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin. Robert L. Crom, Director, Cooperative Extension Service, Iowa State University, Ames, Iowa 50011.