Grain Accords Pose Problems For Elevators

WSJ **COMMODITIES**

12/26/95 By SUZANNE McGEE C1
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Gary Maxwell could see the smiles of relief dawn on the faces of the 35 remaining employees of the Great Plains Cooperative as they learned that the small Nebraska grain elevator operator would survive after losing $3 million on complex, off-exchange agricultural derivative contracts.

"The next day they went out and did their Christmas shopping now they're sure that they'll have jobs after all," says Mr. Maxwell, interim general manager of the Benedict, Neb.-based cooperative, whose directors last week voted 90% in favor of merging with another Nebraska elevator cooperative. "But we've still got a long way to go before we're out of the woods."

Great Plains is only one of a number of small grain elevators which will start the new year grappling with problems left over from 1995's extraordinarily volatile grain markets. Corn, wheat and soybean prices surged to their highest levels in years, propelled by poor crops, tight supplies and strong demand. And as they climbed, reports began to mount of cash-flow problems, losses and even bankruptcies among farmers and elevator operators who had been heavy users of new kinds of complex grain sale contracts.

At Great Plains, Mr. Maxwell says he is struggling to rewrite some of these contracts between the elevator and farmers. As is the case with all elevators, Great Plains depends on the timely delivery of grain from producers to cover its own hedging costs and make a profit. But so far, he says, many farmers haven't met delivery obligations. Instead, he says, they are rolling forward the contracts indefinitely, either because they are selling this year's crop elsewhere at higher prices or because crop problems left them with a smaller harvest. The contracts allow them to do this because they weren't properly drawn up by previous managers, who he believes didn't understand the ramifications of such rollovers.

"Basically, farmers have been using our contracts just like futures contracts and leaving us stuck with the margin calls," he says.

The contracts didn't contain any clauses requiring farmers to cover margin, or collateral, costs to the elevator of hedging their own exposure by selling exchange-traded grain futures contracts. That has left Great Plains in a financial bind.

In fact, Mr. Maxwell says, a routine audit uncovered contracts that had been

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signed with farmers as far away as Iowa and Wyoming, on which, he argues, they could have had no intention of delivering. "You can't realistically deliver grain even if you're 30-odd miles away," he says. In order for these types of forward sales to meet regulatory requirements, the commodity must ultimately be physically delivered.

"It's been an expensive risk-management education for everybody," he adds, grimly.

Even as Great Plains directors were voting on the merger that they hope will save their elevator, thousands of miles away in Washington, D.C., a wide range of industry participants were debating whether to remove a 70-year-old ban that bars farmers from using even more innovative derivatives. That prohibition on trade options, as the products are known, now applies only to agricultural commodities and prevents people dealing in off-exchange derivatives from signing any kind of contract that doesn't provide for physical delivery of the commodity in question.

The ban on trade options is a legacy of a past era "based on the stereotyped image of a poor farmer, wearing bib-coveralls chewing a piece of straw, unable to keep carpetbaggers at bay," argued Frank Beurskens, an agribusiness consultant based in Bloomington, Ill., in remarks prepared for delivery to the Commodity Futures Trading Commission roundtable. "Agricultural producers are demanding innovative risk-management tools.

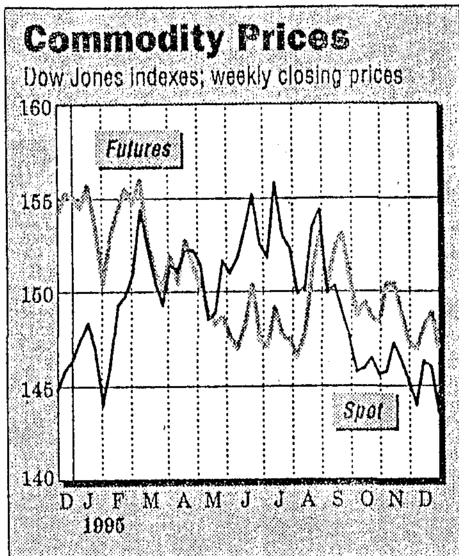
As the federal government backs away from the safety net of subsidies on which farmers have relied for decades, agribusiness representatives argue they need trade options, long legal for use by mining companies or gasoline refiners, to properly manage their own risks.

Already, blueprints for such new off-exchange products exist. One example: a forward sale contract between a seed company willing to guarantee certain price or revenue levels if farmers purchase all their seed, fertilizers and pesticides from them. These companies won't be willing to offer the contracts if they have to take delivery of the grain, farmers say.

Joseph Dial, a CFTC commissioner who hopes the ban will be gone by the time farmers make their final planting decisions in March, says a panoply of such contracts, now prohibited, could become available to farmers. Their use, he says, will teach farmers to be better businessmen, as well as farmers.

Moreover, advocates of the new risk-management tools say removing the ban will clear up the legal uncertainty that currently surrounds the use of contracts like those signed by Great Plains and other grain elevators. They also argue elevators will be forced to re-evaluate the adequacy of their own risk-management practices. This kind of scrutiny, they believe, might have averted some of the debacles that have already occurred.

But while Mr. Dial's growing clout at the CFTC is likely to lead to the removal of the ban this spring, problems like those experienced by Great Plains are almost certain to mean that use of the new contracts will still be somewhat constrained.



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	Close	Net Chg.	Yr. Ago
Dow Jones Futures	146.95	+ 0.10	154.20
Dow Jones Spot	143.59	+ 0.03	144.88
Reuter United Kingdom	2097.1	− 4.2	2225.3
K R-C R B Futures*	243.29	− 2.73	235.43

*Division of Knight-Ridder.

Even the staunchest supporters of allowing farmers unrestricted access to new derivative products concede that not all potential users are knowledgeable enough to use them properly. Mr. Dial himself acknowledges that many farmers remain "obsessed" with "getting in right at the top of the market and becoming a hero at the local Dairy Queen." As a result, he says, they don't focus on such issues as the risks associated with the credit of the broker or elevator with which they deal, or the importance of managing risks associated with the yield of the acres they plant as well as the price of the commodity.

"Nonperformance by farmer-customers can put a country elevator into bankruptcy," warns Jerry Osborne, chairman of the National Grain Trade Council, an industry group. "A country elevator who does not possess the expertise to manage complex financial instruments in times of unexpected market moves could be forced into bankruptcy, leaving farmer-customers as little more than creditors in a legal proceeding."

But as Rod Gangwish, a Nebraska corn and soybean farmer and chairman of the National Corn Growers Association, pointed out to the CFTC, that's happening already.

It's likely that the CFTC commissioners will spend more time debating what restrictions to impose on the use of trade options than they do on debating the removal of the decades-old ban. One option is requiring training or education, while others have argued for minimum capital requirements for those wishing to participate in such contracts. Others advocate regulatory oversight of the wording of the contracts, requiring that documentation spell out which party will be responsible for margin calls and for ensuring that that the derivative is properly hedged.

But even this won't go far enough to alleviate some concerns. Some commodities exchange representatives worry that any problems associated with trade options will leave veteran futures contracts with a black eye as well..