A NEW RISK MANAGEMENT TOOL: COTTONSEED FUTURES

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Abstract

The Minneapolis Grain Exchange (MGE) has been conducting due diligence to establish a futures market for cottonseed. Meetings with all interested parties have been conducted, and all segments of the cottonseed industry have had direct input into the development of a contract for cottonseed. If approved by the Commodity Futures Trading Commission (CFTC), whole upland cottonseed will begin trading on the MGE within the next six months. The trading unit will be 120 tons, traded the months of January, March, May, August, and November. Minimum price fluctuations and daily price limits will be $0.10 per ton and $10.00 per ton respectively. Memphis, Tennessee is the par delivery location. Valdosta, Georgia, Lubbock, Texas, and Fresno, California are all delivery locations, with each location priced at either a premium or discount to Memphis. Par delivery grade will be basis grade 90 or better; however, there are provisions for the delivery of below par quality seed. Delivery will be based on shipping certificates with the short side of the contract initiating the delivery.

Introduction

Cottonseed price volatility and the absence of any reliable cross hedge mechanism have imposed tremendous price risk on growers, ginners, crushers, merchants, feed mills, and dairy producers. There are numerous recent cases of hardship in the cottonseed industry that have resulted from the inability to adequately protect oneself from fluctuations in cottonseed prices that are the natural result of constantly changing supply/demand fundamentals.

Figures 1 and 2 demonstrate the extreme volatility of the cottonseed market that can move independently of either the feed ingredient market or the fats and oils market.

The likelihood that a futures market for cottonseed will be established at the Minneapolis Grain Exchange is exciting because this will finally provide a reliable hedging mechanism for everyone having financial exposure due to cottonseed price volatility.

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Discussion

The following outline is a summary of the most recent (Draft #5 dated 12-7-99) specification for the cottonseed futures contract.

I. Exchange
Minneapolis Grain Exchange, Minneapolis, Minnesota

II. Par Commodity
Fuzzy, Whole, Upland Cottonseed. Pima, and mechanically or chemically processed cottonseed not deliverable on contract.

III. Months Traded
January, March, May, August, November

IV. Trading Hours
9:45 a.m. to 1:30 p.m. (Central Time)

V. Trading Unit
120 tons

VI. Minimum Price Fluctuation
Ten (10) U.S. cents per ton.

VII. Daily Price Limits
Ten (10) U.S. dollars per ton.

VIII. Par Delivery Location(s)
Memphis, Tennessee at par. Valdosta, Georgia at a $23.00 per ton discount. Lubbock, Texas at a $0.50 per ton premium. Fresno, California at a $27.00 per ton premium.

IX. Par Delivery Grade(s)
Cottonseed with a basis grade of 90 or better as defined in Chapter II of the National Cottonseed Product's Association *Trading Rules* at par. Cottonseed below 90 basis grade deliverable at a 1.0 percent of settlement price discount per whole basis point down to a minimum of 85 basis grade.

Buyer and seller may mutually agree to modify or change the par delivery grade on the contract.

X. Delivery/Settlement Procedures
Minneapolis Grain Exchange shipping certificates obtained through Exchange designated regular Issuers. Each regular Issuer shall have a maximum outstanding balance of certificates based upon either physical or financial capacity to guarantee delivery. Each certificate has a maximum duration of one year from initial issuance.

Short initiates delivery by notifying clearing house of intent to deliver. Long is issued shipping certificates that call for on-track rail delivery, cost and freight to the Short's (Issuer's) chosen delivery location (i.e., Memphis, Valdosta, Lubbock, or Fresno), which also determines location premium/discount. Issuer

notifies Long of shipping origin by 12:00 noon Central Time. Long has until 4:00 p.m. Central Time on the same day to forward billing instructions to the Short.

Upon cancellation of the shipping certificate by the Long, the Long notifies Issuer of 15 calendar day notification period followed by 15 calendar day delivery window. (This accounts for the 30-day free period.) The Issuer performs delivery by placing loaded boxcars on track and deducting the official published railroad tariff and switching charges to the chosen delivery market from the contract price. The Issuer also must supply the required export documents for deliveries originating outside of the United States. The Long then forwards billing instruction to the Issuer, and a bill of lading is drawn for the account of the Long. The Long can bill the cars to any destination of their choosing. First official grades and first certified weights to prevail with costs paid by the Issuer.

Long is responsible for paying Issuer a 2.75 cent per ton per day carrying charge for each calendar day that certificate is held until cancellation or certificate is redelivered.

Issuer is guaranteed payment within 30 calendar days of certificate issuance regardless of when certificate is actually cancelled. Exchange clearinghouse will only guarantee deliveries occurring within the first 30 calendar days after certificate issuance.

Buyer and seller may mutually agree to alternate delivery arrangements (i.e., barge, truck, etc.) outside the rules of this contract.

XI. Allowances (Premiums and Discounts)
As mentioned in Sections VIII and IX above.

XII. Speculative Position Limits
1,000 contracts net long or short in all months, 600 contracts in any month as of the day preceding first notice day.

XIII. Options Specifications

- A. Strike Price Increment: $5.00 per ton for first five above and below at-the-money. $10.00 per ton for next five above and below at-the-money.
- B. Minimum Premium Fluctuation: five cents per ton.
- C. Hours of Trading: 9:50 a.m. to 1:35 p.m. (Central Time)

Cottonseed Futures Delivery

Delivery on the Minneapolis Grain Exchange (MGE) cottonseed futures contract will be accomplished using shipping certificates rather than the traditional warehouse receipt. This form of delivery varies significantly from warehouse receipt delivery; therefore, the following discussion attempts to explain each of the two systems.

Warehouse Receipts Versus Shipping Certificates

Warehouse receipts (or pen receipts in the case of livestock) are the traditional method of delivery on most commodity futures contracts. A warehouse receipt is a document guaranteeing the existence and availability of a given quantity of the commodity which is held in store at a "regular" warehouse (or a "regular" stockyard in the case of livestock). Surrendering a receipt from the Seller to the Buyer effectively transfers title of the physical commodity. It is then up to the buyer to loadout and transport the commodity to their facility, if they desire to use it, or they can redeliver (in the case of storable commodities) on a future delivery month.

A *shipping certificate* represents a claim on the Issuer's ability to provide loadout and conveyance of the par commodity to a designated destination. Firms are designated as "regular" based upon either their physical ability to perform delivery based upon the loadout and storage capacities of their facilities (i.e., regular as an "elevator"), or their historical amount of merchandisings and their financial resources (i.e., regular as a "merchandiser"). When the holder of a shipping certificate cancels that certificate with the clearing house, they initiate the start of a delivery process that usually lasts anywhere from 15 to 30 days. The Issuer performs delivery by loading out a mode of transportation (rail, barge, or truck) with freight and switching charges prepaid to one of the designated delivery destinations. The bill of lading is drawn up for the account of the buyer, who may then bill the cottonseed to their preferred destination, thus absorbing any freight differentials between their ultimate destination and the designated contract delivery destination.

Advantages of the Shipping Certificate Delivery

The shipping certificate delivery instrument is ideally suited for commodities that are produced in widely distributed geographic regions and are highly dependent upon the transportation system for conveyance to processing and consumption centers. Most food and feed grains fit into this category, as does cottonseed. Another requirement for a shipping certificate delivery instrument is the existence of publicly quoted and widely disseminated transportation tariffs and/or rates. The western railroads (i.e., Burlington Northern/Santa Fe and Union Pacific/Southern Pacific) provide up-to-date tariff quotations on their respective Internet web sites.

Unlike the warehouse receipt, there are no "deliverable stocks" on a shipping certificate delivery. Essentially, the entire existing supply of the par commodity is potentially "deliverable" on the contract. Therefore, it is nearly impossible for any large commercial participant to buy up

"deliverable stocks" and force a pricing "squeeze" on the marketplace, as Feruzzi S.P.A. tried on the soybean futures in the late 1980's. The lack of pricing squeezes assures that the contract price will converge to the underlying spot price with almost certainty at contract maturity. The considerable threat of delivery arbitrage results in a futures price that correlates at higher levels with the underlying spot price. This enhances the commercial value of the contract as a hedging vehicle.

Shipping certificate delivery also has the advantage of opening up the delivery process to more market participants. Companies with storage facilities located outside the contract delivery regions can apply and become regular issuers of shipping certificates. Merchandisers who don't own handling facilities can also become regular issuers of shipping certificates based upon their merchandising history and financial position.

End users, such as mills and processors, also have the advantage under the shipping certificate delivery of billing the cottonseed directly to their processing facilities without the burden of ordering railcars or paying loadout charges.

Market participants, such as locals and pure investors, who are forced into a delivery position due to low market liquidity - a problem endemic to new futures contracts - have the added flexibility under a shipping certificate in how they handle their cash position. In addition to redelivery, the long market participant can work out a cash sale to a mill and then have the cars billed directly to the mill. For the short market participant, there are a great number of regular issuers that they can work with to acquire and deliver the par product.

Disadvantages of Shipping Certificates

The main disadvantage of the shipping certificate is the lack of physical backing. The cottonseed stocks don't necessarily have to exist in order to issue a shipping certificate. Therefore, the use of shipping certificates as financial collateral is not widely accepted.

Another disadvantage stemming from the lack of physical backing is the added risk of delivery default on a shipping certificate. However, this risk can be averted if the long cancels the shipping certificate immediately at issuance, and allow the Clearing House to verify performance prior to release of funds.

The Cottonseed Delivery Process Step-by-Step

The MGE cottonseed futures contract will have the following important dates related to contract maturity and delivery:

The following steps illustrate a delivery using rail as the mode of conveyance:

1. The Short, or seller of the futures contract, may initiate a delivery. The clearing member of the Short wishing to make delivery will go to the Official Registrar at the Exchange Clearing House and register a Shipping Certificate(s) at any time prior to initiating the delivery process.
2. The Short's clearing member will issue and deliver a Notice of Intention to Deliver Form to the Clearing House. Notices can be submitted before 3:30 p.m. Central Time, from one business day prior to First Notice Day through one business day prior to Last Notice Day.
3. The Clearing House will assign the Notice to the oldest long in the market as of the close of business on the day that the Clearing House receives the Notice. The Long will receive the Notice the following morning.
4. The Long's clearing member will present the Notice, with full payment to the Clearing House, by 11:00 a.m. Central Time on the business day following their receipt of the Notice. At this time, the Long will receive the registered Shipping Certificate(s) from the Short's clearing member.
5. The Clearing House will hold the Long's payment in a special interest bearing account for a 30-day free period. The first day after receipt of payment at the Clearing House is the "first date that the Shipping Certificate is outstanding."
6. At this time, the Long has possession of the Shipping Certificate and has three options: a) **take delivery** of the cottonseed, b) **hold** the shipping certificate and cancel when the cottonseed is desired at a later date, or c) **redeliver** back into the futures market. Note that a Shipping Certificate is only valid for a period of up to one year after its issuance, at which time it must be returned by the Long to the original Issuer for reissuance. The Long will be subject to an additional penalty charge for each day overdue.
    1. **Take delivery.** The Long calls for delivery of the cottonseed by canceling the outstanding Shipping Certificate at the Clearing House on the date payment is made to the Clearing House. Within one business day of cancellation, the Long surrenders the canceled certificate to the Issuer. Accompanying the canceled certificate, the Long gives the Issuer at least 15 days written notice of declaration of the 15 day shipping

period. This accounts for the 30-day free period.

The actual delivery takes place when the Short places loaded railcar(s) on track with railroads tariff and switching charges prepaid to the designated delivery location railroad switching district.

The car numbers and point of origin must be tendered from the Short to the Long by 12:00 noon Central Time any day during the 15 day shipping period. The Long has until 4:00 p.m. Central Time, on the same day, to forward billing instructions to the Short.

The Long may bill the railcars to a destination of their choosing. The Short shall draw up the bill of lading to the Long's chosen destination for the account of the Long. Therefore, the Long takes title to the cottonseed at the origin but is compensated for the rail freight from the origin to the chosen delivery destination (Memphis, Valdosta, Lubbock, or Fresno) switching district. In many cases, the Long's net shipping cost will be the outbound portion of the railroad tariff from chosen contract delivery destination to their ultimate destination.

When the Short provides the Clearing House with proof of shipment (bill of lading, proof that tariff has been paid, receipts showing car numbers, etc), the Clearing House will release full payment to the Short's clearing member, and will remit the interest accrued minus a servicing fee to the Long.

2. **Hold the Shipping Certificate until a later date.** The Long holding the Shipping Certificate may cancel the certificate at any time up until it is one year outstanding, at which time it must be returned to the original Issuer.

   Regardless of when the Long cancels the outstanding Shipping Certificate, the Short will receive full payment (principle) from the Clearing House and the Long will receive interest accrued minus a servicing fee no later than the first business day following the 30th calendar day after date payment was received by the Clearing House. Also, the Long will pay a premium charge of 2-3/4 cents per ton per day to the Short (Table 1) for each day the certificate is outstanding (i.e., from the first business day after certificate issuance to the calendar day fifteen days prior to the start of the fifteen day shipping period.

3. **Redeliver the Shipping Certificate.** The Long may redeliver the Shipping Certificate by establishing a short position in a later futures delivery month and initiating a delivery. The original Long has then turned over the outstanding Shipping Certificate over to a new Long. The new Long is required to treat the Shipping Certificate in the same manner as any delivery, following the applicable rules.

   The Shipping Certificate shall be kept in the special Clearing House account for the 30-day period. Only the person who is Long and cancels the Shipping Certificate is entitled to the "free period." The Long who redelivers is obligated to pay the premium charges of 2-3/4 cents per ton per day from the date the certificate is first outstanding until the date that it is redelivered to the new Long.

   Hypothetically, the Shipping Certificate can be passed from party to party up until it is one year outstanding, but the original Short will receive all premium charges, will receive payment for the cottonseed no later than 30 calendar days after Shipping Certificate has become outstanding, and will be responsible for making the ultimate physical delivery to the par delivery market.

Summary

The establishment of a futures contract for cottonseed at the Minneapolis Grain Exchange will finally provide the cottonseed industry with a reliable mechanism for the management of price risk. Several diverse and seemingly unrelated industry sectors will be able to hedge future transactions by taking advantage of the cottonseed contract, thereby managing and hopefully minimizing the uncertainty caused by the extreme volatility of the cottonseed spot market.

Table 1. The following table shows the allocation of delivery costs between the Long and the Short:

Cost	Long Pays	Short Pays
Loadout		x
First Official Inspection		x
First Certified Weights		x
Rail Freight to Delivery Location*		x
Freight Differential Between Delivery Location and Billing Destination	x	
Premium Charges (2-3/4 cent per ton per each day Shipping Certificate is Outstanding)	x	

*Or a buyer and seller may mutually agree to alternate delivery arrangements (i.e., truck, barge, etc.) outside the rules of this contract.

Table 2. Definitions

First Notice Day	One business day prior to the first business day of a delivery month. This is the first day for which current holders of short positions may notify the Clearing House of their intention to deliver on the contract.
Last Notice Day	One business day prior to last business day of a delivery month. This is the last day for which current holders of short positions may notify the Clearing House of their intention to deliver on the contract.
Last Trading Day	The seventh business day preceding the last business day of a delivery month. Trading ceases following the close on this day.

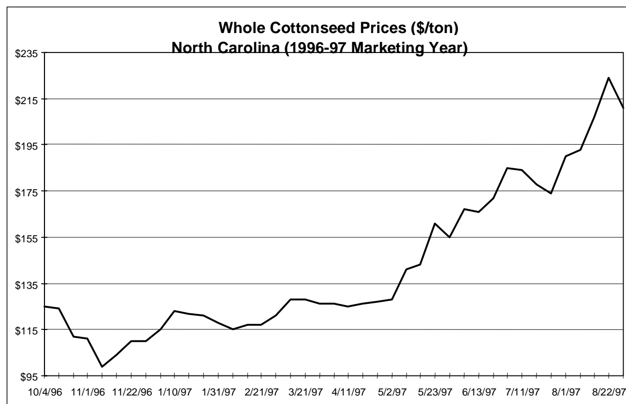

Figure 1

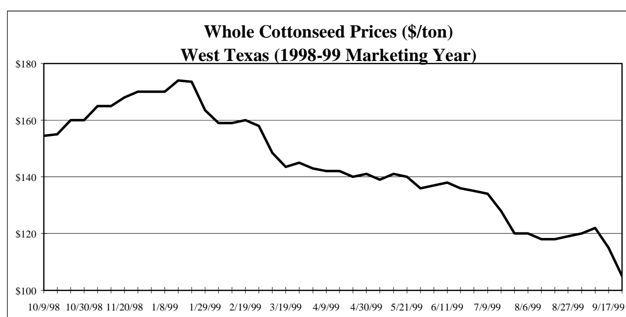

Figure 2