

### What are Futures?

Futures are standardised, legal contracts that refer to the delivery of a specified quantity and quality of a commodity, such as feed wheat or skimmed milk powder. They are for a particular date, with the price agreed in advance. Unlike Forward contracts, few Futures contracts actually make it through to expiry and therefore physical delivery, as they are traded against each other by investors and end (are closed) before they reach maturity (delivery date).

The value of the Futures contract is negotiated at a futures exchange, which acts as an intermediary between the buyer and seller; and is based on the market's view of the value of the physical item (e.g. tonnes skimmed milk powder) at the point of delivery.

Futures contracts can be used by those involved in the supply chain (such as farmers and processors) who are looking to reduce their risk and exposure to market price volatility; a process referred to as 'hedging'. Hedging allows both buyers and sellers to lock in a price for the product, giving them price certainty for the future.

Speculators also trade on the Futures markets for profit. In comparison to hedgers (those in the supply chain), speculators seek to take advantage of the price risk that hedgers try to avoid. Speculators make a profit by advantageously trading Futures contracts (buying low and selling high or selling high and buying low). Although this activity is often portrayed negatively, speculative trading is essential in adding cash, referred to as 'liquidity', to the market. Liquidity is necessary in enabling hedgers to buy or sell contracts. Without speculative trading, hedgers would have to rely exclusively on each other to make opposite transactions.

It is important to note that there is no assurance that market liquidity will necessarily exist in a Futures market at all times. Some Futures contracts and specific delivery months tend to have more trading activity and hence higher liquidity than others. This can have important implications to the actual application of the Futures markets as a risk management tool.

### How do Futures link to physical prices?

The Futures market price represents the world price for the product and can be used as a benchmark to determine the product's value at a 'local' level.

The 'basis' describes the difference between a specific Futures contract at any given point in time and the local spot price. In essence, the basis can be thought of as 'localising' the Futures price.

The basis reflects local market conditions and can be influenced by a number of factors, such as:

- Transportation cost
- Local supply and demand conditions: quality, availability, requirements, weather conditions
- Storage costs
- Handling costs
- Exchange rates

As these factors vary, the basis also varies. A shortage in one region will result in the local spot price increasing relative to the Futures price. This movement is referred to as a 'strengthening basis'. The opposite would be a falling demand or excess supply of a commodity, which can result in a fall in the local spot price relative to the futures price; a movement referred to as a 'weakening basis'.

## How are contractual obligations enforced?

In order to trade Futures, buyers and sellers are required to post 'margin deposits' with the futures exchange or clearing house (intermediary between buyer and seller). These represent a financial guarantee that buyers and sellers will honour the contract. Margin deposits typically range between 5% and 15% of a contract's face value and are set by the Futures exchange where the contracts are traded. The size of the margin deposit depends, in part, on the likelihood of a price change. A higher margin is required in a more volatile market, indicating a higher degree of risk.

Margin deposits are automatically amended as the market moves. If there are insufficient funds deposited to cover this, the trader's accounts will be suspended until they have made payments to cover it. This can reduce the appeal to producers of using futures markets directly as cash flow problems may occur in the short term if the market moves against you.

## What are *futures-based forward contracts*?

A simple instrument available to deal with price risk is a Forward contract, where farmers and buyers of agricultural produce agree in advance on the terms of delivery regarding quantity and price. Prices are frequently in line with Futures prices but can also be fixed. With this type of contract, the farmer foregoes the opportunity of achieving a lower price for input purchases (or a higher price for their output) on the open market but is able to lock-in a price for future delivery.

Forward contracts can have an important impact in the planning of the business, allowing you to plan ahead of requirements and improve management of cash flow, having already secured the price for your input costs and/or outputs.

### Forward contracts vs. Futures contracts

Fundamentally, Forward and Futures contracts have the same function in fixing the price of a commodity for delivery at a future date. Both contracts also serve the same purpose of providing price certainty and reducing risk. However, there are some key differences.

Futures contracts are exchange-traded and therefore, standardised contracts. Forward contracts, on the other hand, are private agreements between two parties. The private nature of Forward contracts means that there is a chance that a party may default on its side of the agreement. In contrast, Futures contracts have clearing houses that guarantee the transactions, removing this 'counter-party' risk.

In practice, as speculative investment is a significant element of Futures trading, few Futures contracts make it to expiry (delivery), as most are closed prior to maturity. Forward contracts, on the other hand, tend to be used only by hedgers (those in the supply chain) looking to reduce price volatility and delivery of the commodity will usually take place.

To explore how Futures are used in the Dairy Sector please read our [DairyLeader](#) article on [Reducing your risk](#).