To drill or not to drill?

Drilling cereals in the hope grain prices will rise is no way to run a business in the 21st century, writes **Jeremy Cole**.

Over the past few years, when forward prices at drilling time have been lower than expected, I have advocated the use of an 'Option' as a hedging tool to lock into a net margin greater than that achievable at that time from drilling the crop.

There has been little take up of the new fangled idea as farmers usually drill crops in the expectation that the wheat price is bound to rise because nobody can survive at such low returns.

This is probably true, but the laws of supply and demand remain king and nothing should be taken for granted. Yet over recent weeks the situation has changed, and the attitude of some farmers seems to be changing too.

As I write, forward prices for November 09 are £105/t ex-farm. I am told that £130/t is needed to make a positive net margin, so drilling at current prices will produce a loss of £75-100/acre.

The gamble if the crop is drilled and not sold forward is that margins could fall further if prices fall further. Conversely, margins will increase if the market rises. But is this a way to run a business in the 21st century?

Would other long lead-time production industries do this? Of course they wouldn't. They would lock into some form of acceptable margin at the point of production – and often before that, at the time of planning or buying raw materials.

Some of my progressive clients have suggested that land destined for late or mauled-in second wheat crops, or redrilling in the spring of failed OSR crops, would leave them better off if the fields were left undrilled but covered by a hedging tool.

The theory is that you don't have to have a crop in the field to make money from market movements. The most expensive hedge possible at present, and there are many opportunities to reduce this headline number, is an 'at the money' Option.

A Call Option gives the buyer the right to sell at any higher price than today's prevailing futures prices and claim the difference. At present that premium (not a cost as the market hasn't moved yet and time has not elapsed) is approx £13/t.

This means that if the market stays the same or falls, the non-drilling farmer would have lost £13/t (£40-50/acre) depending on the yield expectation from the likely under-performing crop in question.

However, the savings made by not cultivating, drilling, fertilising, spraying, lower cashflow and storage requirements etc, would be considerably greater. You can put you own figures in.

A net benefit is made if the market rises, and especially if it rises beyond the cost of the premium. This 'insurance' must be put into context. The farmers doing this are taking the view that if the market moves significantly, over 10%, they want to be in the game.

They are not worried about a small rise as they would have loss significant sums by drilling the crop. They are applying a maximum cost to that acreage of land to help maintain or increase the overall net farm income for the year.

Just drilling for drillings sake, on this small percentage of their acreage, seems a pointless exercise to them, and I tend to agree. Do your own sums.

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