Business point

Locking up input costs

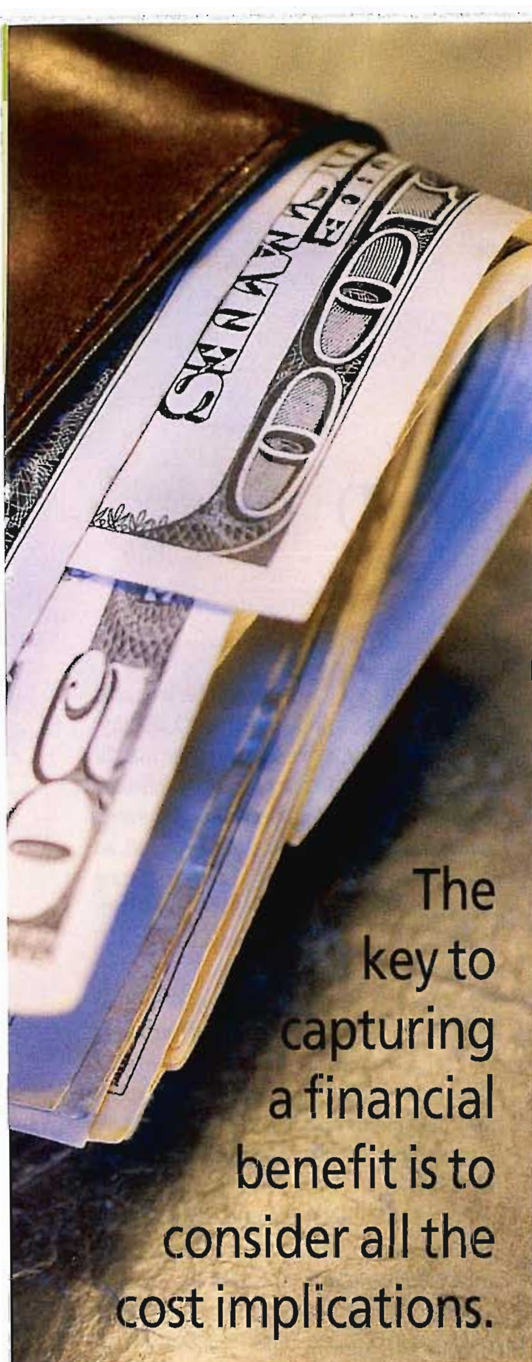
Many of you have recently had the opportunity to price and pay for some of your 2009 crop inputs. Your fertilizer dealer or supply co-op likely made you aware that nitrogen and dry fertilizer prices were heading up this year. They probably suggested locking in prices and quantities as sound money-saving business decision.

Because fertilizer prices generally have moved up since the spring, this advice appears to have been correct. However, let's take a more complete look at what you committed to when you made these input purchases.

This year's situation

It is not unusual for a producer to purchase (and apply) the upcoming year's inputs in the preceding year. Typically, there's an active market in the fall not only for fertilizer but also for seed, pesticides, fuel and cash-rent agreements, enabling a grower to negotiate favorable prices.

For those who apply product in the fall, the work occurs after the growing season to take better advantage of available labor and machinery. As long as a grower uses an accrual basis income statement, this practice



presents no financial concerns. It doesn't distort accrual net farm income with the prepaid expenses listed as an end-of-year prepaid expense in the preceding year and as a beginning-of-year prepaid expense in the following year.

Locking in fertilizer prices

In the spring of 2008, producers had an opportunity to price 2009 fertilizer inputs before planting the 2008 crop. The premise was that prices were increasing and availability might be less than robust in the fall. By committing to a price and quantity, a grower could remove the price uncertainty and also be assured the desired product would be available when needed in the fall.

Assuming a producer uses an operating note to finance these advance-purchased inputs, this producer is initiating borrowing on the 2009 operating note before the 2008 crop is planted, and certainly before the producer's 2008 operating note is retired, assuming the operation sells the 2008 crop in 2009 and doesn't pay off the 2008 operating note until early 2009.

Interest adds up sooner

The new wrinkle: By purchasing 2009 inputs in the spring of 2008, the producer has begun borrowing on his 2009 operating note six months earlier than usual. This likely means the producer will pay more interest on what's likely going to be a larger note due to increased input prices. This can result in an increased commitment to pay interest in addition to the higher input costs.

One of the positive things about locking in prices and quantities is it removes uncertainty of price and availability. This ensures a known quantity for a known price: It makes for a more certain — even if increased — cost of production.

One of the outcomes of this strategy can be that after the grower locks in price and quantity, prices rise or availability decreases. If this occurs, the producer has saved money and reduced price and availability risks.

The other possible outcome — where buyer's remorse sets in — is when the price decreases and supplies become more available after the buyer has made an early commitment. The grower's cost of production ends up higher than it could have been if he or she had waited.

Other risks arise

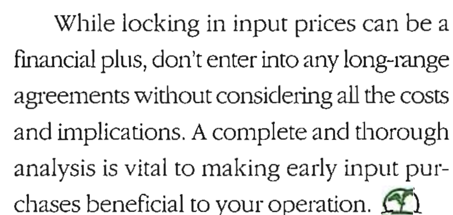
Risk reduction has two sides. Consider this: Committing early to price and quantity for inputs creates the need to market the crop earlier to cover those already-committed input costs. To reduce this risk, growers can market the 2009 crop at a level that covers the inputs priced.

Ideally, higher commodity prices will offset any increase in input costs stemming from early commitment, providing some level of risk reduction. Once an operation knows its input costs, it can market the crop more aggressively to cover them.

How secure are you?

Are you a secured creditor? Probably not. If you've priced and paid for inputs but not taken delivery of those inputs, you may be an unsecured creditor. This introduces additional risk to your operation.

Even if you enter into a contractual agreement to price and secure inputs, pay attention to the details of the contract. Know the terms and conditions in the unlikely event you or the supplier can't honor the contract.



While locking in input prices can be a financial plus, don't enter into any long-range agreements without considering all the costs and implications. A complete and thorough analysis is vital to making early input purchases beneficial to your operation.

__Editor's note:__ Kent Vickre and Dwight Raab write a tax and finance column for each issue of Pioneer GrowingPoint® *magazine. Vickre is state coordinator of the Iowa Farm Business Association. Raab is state coordinator of Illinois Farm Business Farm Management. They address issues that influence agribusiness success.*