8 *Pricing and Price Risk Management*

In addition to consolidating price information, the cotton futures market provides a means for all sectors of the cotton trade to manage or hedge their exposure to the risk of unexpected price fluctuations. Dramatic fluctuations of cotton prices may be attributable to a number of factors, ranging from weather changes in cotton producing regions to government policies. Cotton producers, ginners, merchants, and textile mills employ the cotton futures market to achieve price protection, reduce their effective purchasing costs or increase their ultimate selling price. By hedging the price of cotton they must buy and sell, they can avoid the potentially devastating effects of unexpected price fluctuations. This is possible because other market participants, professional traders and speculative investors are willing to assume the risk in return for the opportunity to profit should the market move in their favor. The following terms and definitions are used in the *cotton price risk management.*

An option is *In-the-Money* when an option's strike price is the same as the current trading price of the underlying futures contract.

Basis is the difference between the specific futures contract price and the cash price for cotton at a local delivery point. Normally, the futures price should be equal to the present cash price plus the cost of storage, insurance and interest charges necessary to carry the commodity to the delivery month of the contract. In addition, basis pricing also reflects the location (port of delivery) and the quality differential of the commodity.

Basis Risk is the risk associated with a widening or narrowing of the basis between the time a hedge is established and the time it is liquidated.

Buyer is a market participant who takes a long futures position or buys an option. An option buyer is also called a taker, holder or owner.

Call Option is a contract that gives the buyer/taker the right to buy the underlying futures contract at a stipulated price (strike price) at any time up to the expiration of an option, or to establish a long position in cotton futures. The buyer pays a premium to the seller/grantor for this contract. A call option is bought with the expectation of a rise in prices.