Contracts & Managing Risk

Crop Opportunity &
Scott Research Update

March 6, 2014
North Battleford

Effective Risk Management

- **Anticipating possible difficulties AND planning**

to reduce their consequences,

NOT just reacting to unfavorable events

Risk Management Decision

- **attitude towards risk**
- **financial position**
  - **-exposure to change in income**
- **probability of loss or profit**
  - **-your average yield vs. risk area average**
  - **-variations from your average yield**
  - **-price expectations**
  - **-price setting alternatives & opportunities**

Management Strategies to Reduce Risk

- **Diversification**
- **Flexibility**
- **Insurance**
- **Marketing Alternatives (price & delivery)**

Marketing Process

- Know costs of Production & Breakevens
- Follow Market Situation and Outlook
- Set Target Prices
- Know & Assess Delivery & Pricing Alternatives
- Act on your Plan
- Review and adjust plan
- Learn from your experiences

Considerations of your Marketing Plan

- **Costs of production (breakeven price levels)**
- **Crop & herbicide rotation factors**

- **Cash flow: amounts and timing**
- **Seasonality of price and basis**

Considerations of your Marketing Plan

- **Your risk-taking ability**
  - **- Financial**
  - **- Personality**

- **Storage Considerations**
  - **- Volume**
  - **- Conditioning required**

- **Tax Considerations**

Contract

- To take advantage of favorable prices
  (to manage price risk)

- To manage our cash flow needs

- Is now normal business practice

Contract Types

- **Production Contract**
- **DDC (Deferred Delivery Contract)**
- **Basis Contract**
- **Futures First Contract**
- **Target Price Contract (Grain Pricing Order)**
- **Deferred Pricing Contract**
- **Minimum Price Contract**
- **Price Pooling Contract**
- **Futures & Options account**

Production Contract

Agreement to deliver some or all production from a specified # acres

- Price & volume may not be fixed
- Grade specifications ???
- Quantity limit (e.g. bu/ac)
- Delivery date – who decides??

Production Contract

Advantages

- Guaranteed delivery
- Crop failure release usual
- Pricing can remain open

Limitations

- Basis or price left open
- Delivery commitment to the buyer

Deferred Delivery Contract (DDC)

•Agreement to deliver specific quantity by/on certain date

•Buyer pays specified price on delivery date for specific grade

•Grade discounts/premiums??

•Production shortfall may have to be made up by paying difference, if current delivery price is greater than DDC price

Deferred Delivery Contract (DDC)

Advantages

- **Removes price risk**
- **Provides delivery opportunity (or farm pick-up)**
- **Widely available**

- **Limitations**
- **Commitment to quantity**
- **Commitment to buyer**
- **Price locked in**

Basis contract

- Specific quantity at fixed basis
- Final price = Futures Price – BASIS
- Grade adjustments ?

What is "The Basis"?

- Cash Price - Futures Price = Basis
- Basis includes:
  - Freight
  - Elevation, Handling & Administration
  - Cleaning
  - Storage
  - Interest
  - Exchange rate
  - Company profit

Basis: what is it?

Basis = Cash Price MINUS Futures Price

Example:

March 4 1 Canada Canola June price $ 408.68/tonne {9.27/bu.}

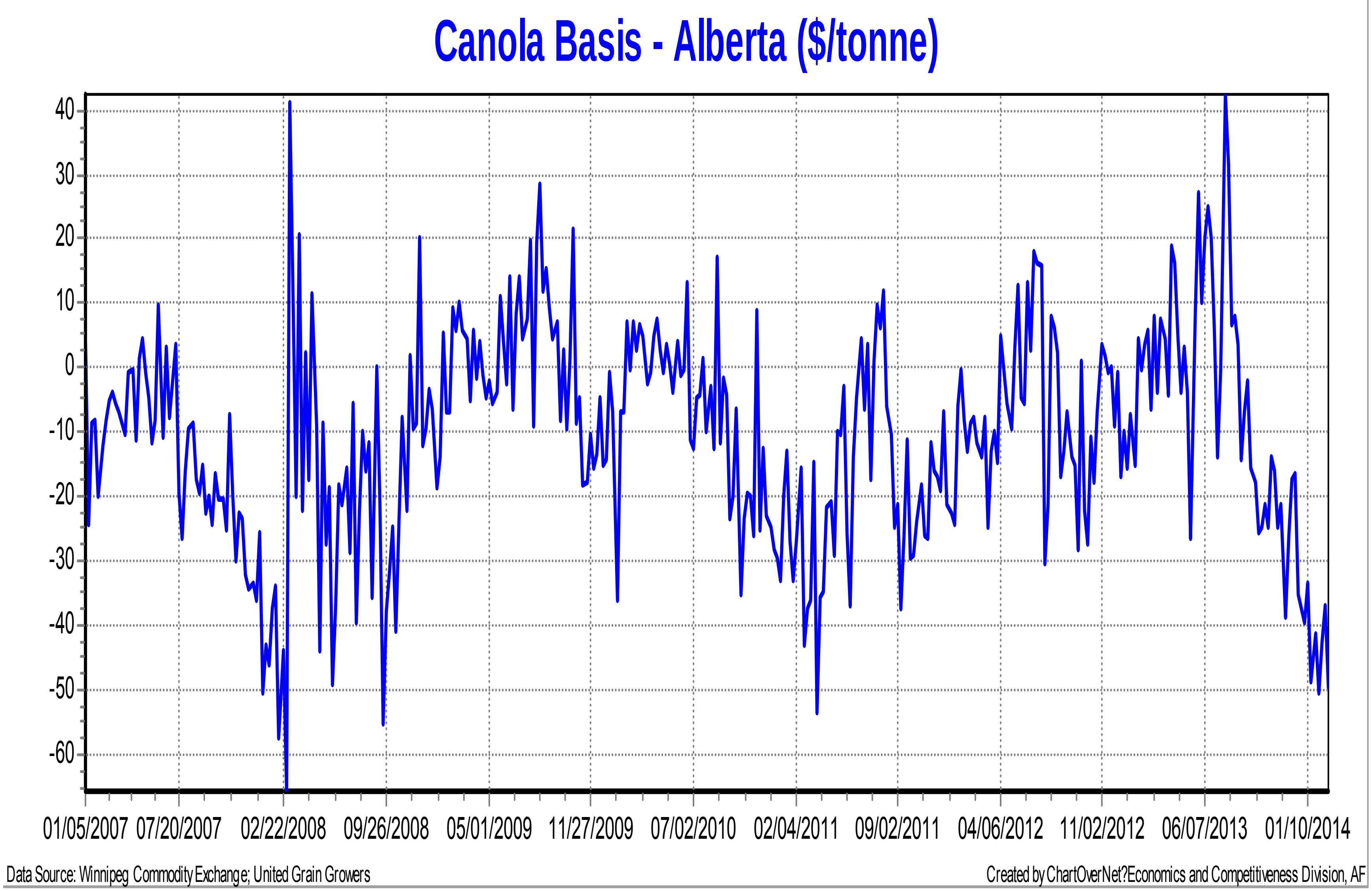
MINUS

March 4 ICE July Canola futures $ 458.60/tonne {10.40/bu.}

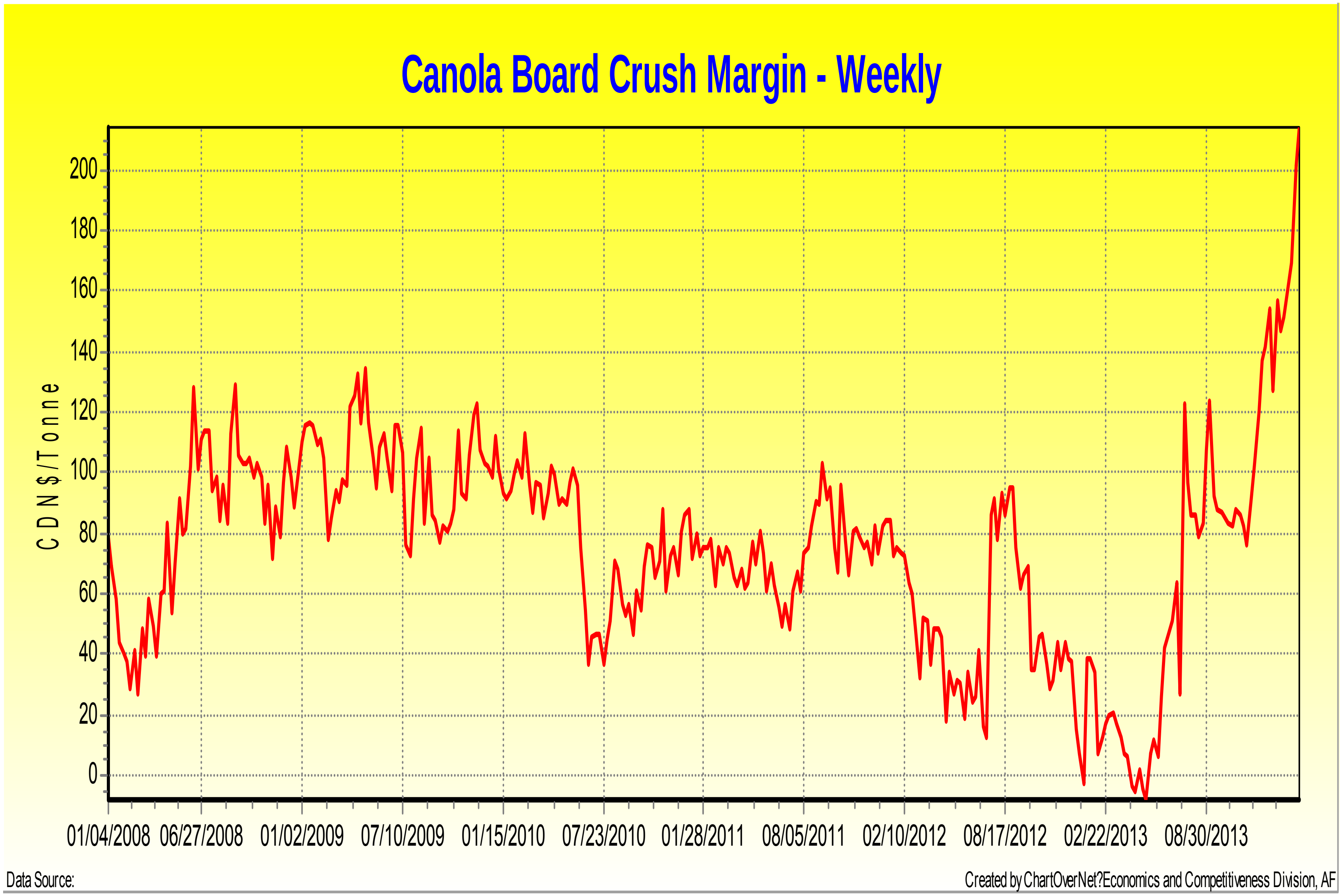
= $389.80 MINUS 427.80 = ($ 49.92/tonne) (1.13/bu.)

= basis level for that buyer at that location

Compares to (51), (57), (74) basis for June delivery vs. July futures for other area buyers



Canola Basis - Alberta ($/tonne)
40
30
20
10
0
-10
-20
-30
-40
-50
-60
01/05/2007
07/20/2007
02/22/2008
09/26/2008
05/01/2009
11/27/2009
07/02/2010
02/04/2011
09/02/2011
04/06/2012
11/02/2012
06/07/2013
01/10/2014
Data Source: Winnipeg Commodity Exchange; United Grain Growers
Created by ChartOverNet?Economics and Competitiveness Division, AF



Canola Board Crush Margin - Weekly
CDN$/Tonne
200
180
160
140
120
100
80
60
40
20
0
01/04/2008
06/27/2008
01/02/2009
07/10/2009
01/15/2010
07/23/2010
01/28/2011
08/05/2011
02/10/2012
08/17/2012
02/22/2013
08/30/2013
Data Source:
Created by ChartOverNet?Economics and Competitiveness Division, AF

Basis contract

Advantages

- Removes basis risk
- Provides delivery outlet
- Could use with futures for “perfect hedge”

Limitations

- Need to understand basis
- Price risk remains
- Delivery commitment

Advantages of following Basis Levels

Basis:

- reflects local supply and demand
- provides market information
- change can give commercial demand indication
- can move independently from futures
- can be locked in separately from futures

Futures First (open basis) contract

- **Locks in futures for a specific quantity & quality**
- **Basis is left open to lock later**
- **Would use when futures strong but basis weak**

Advantages

- **lock futures without your own account; no margins**

Limitations

- **Basis risk remains**
- **Delivery commitment to buyer**
- **May have a cost**

Question to buyer:
Will I be offered the same basis opportunity as someone signing for “new” delivery?

Target Pricing Contract (GPO)

•Pick desired price for specified quantity & grade

•Can be used pre-delivery or after delivery for allowable pricing extension period

Target Pricing Contract (GPO)

Advantages

- Take advantage of carry/spread in market
- Trigger points correspond to marketing plan
- Pricing and delivery established when targets hit

Limitations

- If prices go up after price set, will miss those
- May require periodic renewal

Deferred Pricing Contract

Producer delivers, accepts partial payment, completes pricing later

Advantages

- **Product gone and graded**
- **May reduce on-farm storage needs**
- **Can follow price rise**

Limitations

- **Price and/or basis risk remain**
- **May not be eligible for basis specials**

Minimum Price Contract

- Similar to buying a “PUT option”
  but basis usually locked

Advantages

- Locks a floor price on specific quantity & quality
- Can still take advantage of price rise
- Delivery commitment

Limitations

- Premium cost
- Commitment to deliver to specific buyer

Price Pooling contract

- Locks a price for a certain quantity at regular intervals
- Result is a blended or average price over the period
- Available through most buyers including CWB

Futures and Options

- **Use own hedge account for futures &/or options trades**

Advantages:

- **Flexibility (can exit position at your discretion)**
- **Can shop the market for best basis**
- **May get a better price by separating components**

Disadvantages:

- **No physical delivery commitment to a buyer**
- **Need to understand the futures or options market**
- **Margin required for futures trade**

Grain Contracts

Some things to consider …

Production Factors

- Does the contract require you to:
  - Invest in equipment or facilities?
  - Increase your production costs?
  - Purchase crop insurance?
- If specialty variety, is the projected yield less than the conventional variety?
- Are there agronomic obligations?

Payment Issues

- Payment Terms
  - How & when will payment be made?
  - Base Grade? Premiums? Discounts?
  - Storage payments?
- Crop condition?
  - Moisture, test weight, dockage?

Delivery Factors

- Where and when is the crop to be delivered?
- Specific amount of grain to deliver?
    - Transferability to another supplier?
    - Are there penalties for shortfall?
    - Do you receive storage compensation for delivery delayed by the buyer?

Delivery Issues

Contract Clause

“Delay by Company. If the company is delayed in taking delivery of any or all of the Crop due to circumstances beyond its control, the Company may extend the time for delivery by the Producer. Such cause will include, without limitation, defaults of third party buyers of the Crop, fire, flood, strike, lock out or labor dispute, fuel or labor shortage, weather conditions, natural disaster, acts of God, war or terrorism, machinery breakdown, lawful acts of public authorities, shortage of supply or unavailability of railcars or storage space, or delays or defaults caused by common carriers.”

Delivery Issues

Advance Payments Program

- **provides cash advance on agricultural products during a specified period**
- **federal government guarantees repayment of cash advances**
- **cash advance rate not > 50% of average market price estimates**
- **maximum cash advance $400,000/producer**
- **federal gov’t pays the interest on first $100,000 advance per period**
- **have up to end of the production period to repay their advance**
- **Grains, Oilseeds, Pulse Crops, Winter Wheat, Wheat, Durum and Barley**

Delivery Issues

“Escape” or “Act of God” clause:

If the seller is unable to deliver the quantity contracted due to production circumstances beyond the producer’s control, the buyer will excuse the contract quantity shortfall.

Example:

Contract by legal description(s) of land

Maximum of 10 bu./acre

Cost of $10/tonne via weaker basis on quantity under the clause

Buyer has first right of refusal on contracted amount

Legal Factors

- Can the contract be amended?
- Under what conditions can it be terminated?
- How are disputes resolved?

Contracts Project

Canadian Canola Growers Association

- Review of available contracts
- Goals:
- Less bias
- Standardized clauses

Contracts

Read and understand contract before signing

University of Manitoba study shows ….

only 17 % of Manitoba farmers read their entire contract

Reminder …

- Read and understand the contract before signing

- Consider the “what if’s?”

- If you don’t understand the contract, seek advice

Grain Marketing Resources

- Grain Marketing Manual → ARD
  - agric.gov.ab.ca
  - open market wheat & barley site
- CWB, Other Grain Companies
- Brokers
- Marketing courses
- Subscription Services

Grain Contracting Resources

Saskatchewan Agriculture & Food

- Introduction to Grain Contracting – Grain Pricing and Contracting Alternatives

Alberta Agriculture & Rural Development

- Marketing my Grain – Contracting
- Contracting and Marketing Wheat and Barley
- Management Considerations in Agricultural Contracting
- Contract Checklist for Grains, Oil Seeds, Pulses
- Utube.com “What About Contracts”

Questions ?

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