Contracts & Managing Risk

Crop Opportunity & Scott Research Update

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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

Compared to (51), (57), (74) basis for June delivery vs. July futures for other area buyers
Canola Board Crush Margin - Weekly

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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