CANOLA HEDGING BASICS

Introduction

Farm product prices change because of actual or perceived changes in supply and demand for that product. Tight supplies relative to demand usually lead to high prices. Attractive pricing opportunities often arise before crops are physically available to sell. Forward pricing at those relatively high prices can be done directly with a buyer by using a deferred delivery contract or, for those commodities with a futures market, by hedging.

What is a Hedge?

For commodities with a futures market there are two markets whose prices tend to move together: the cash (or physical) market and the commodity futures market. The difference between the prices in each market is called basis. The commodity futures market is a market where the obligations to either deliver or accept delivery by some future date for the specified price is bought and sold. The price of the contract represents a forward price of the commodity at a certain delivery point in the future. Hedging is the act of taking opposite positions in the cash and futures markets to reduce the risk of price changes in either market.

For example, a farmer who seeds a canola crop must buy the seed, fuel, fertilizer, herbicide and all the other inputs. In essence, the farmer buys the canola crop by buying the inputs. If, at some time during the growing season, the farmer hedges the canola crop by selling futures contracts, he has sold that crop for a price at some point in the future. This creates the hedge which is really holding opposite positions in the cash market (bought production) and the futures market (sold futures). With the sell hedge in place, a drop in the canola futures price will make the growing canola crop worth less, but the sell or "short" canola futures position will be worth more. The money lost in one market will be offset by a profit in the other market.

Example Hedge

In the spring, after considering costs of production, expected yields, market outlook and cash flow needs, suppose that a producer decides to target a local canola cash price of $380/tonne for late October delivery. He decides to use a futures hedge to lock in that target, if the opportunity arises. He estimates that the basis (difference between the cash price and futures price) in November for his location will be $20/tonne under the November futures price. Therefore, to reach the $380/tonne cash price target with a basis of $20 “under”, he needs November canola futures to reach at least $400/tonne. He places an order with his commodity futures broker to sell 5 contracts (100 tonnes) of canola futures at $400/tonne.

On May 20, the November canola futures price rises to $400/tonne, and his sell futures hedge order is completed at his target price. Now, while the canola is growing in the field, he has 100 tonnes of that crop priced with his sell futures position. Thus, on that 100 tonnes of canola with the sell futures position, he has reduced his risk to that of basis. The basis is not locked in until he signs a contract to deliver to a buyer of physical canola.

On October 21, the producer decides to deliver his 100 tonnes of canola to a physical canola buyer for $340/tonne, the highest cash price he found by shopping the market. This highest cash price implies that it is also the best basis available. With the November futures price that day at $360/tonne, the basis with that canola buyer is $20/tonne under the November futures. Of course, the producer also considers trucking costs and experience with that buyer into his decision.

Having sold the physical canola, the producer must offset his canola futures hedge. He does that by contacting his commodity futures broker and buying back 5 November canola futures contracts. The buyback (offset) of his November futures sell position is done at $360/tonne. Here is how his canola hedge worked out.

Example

Date	Cash Market Price	Basis	Futures Action	Futures Price
At Spring Planning	$380/t (Target Cash Price)	$20/t (expected late Oct basis)	Sell Order (Hedge)	Target Futures at $400/t or better
May 20			Sell (Actual)	$400.00
October 21	$340 (Actual Cash Price Received)	$20/t (Actual)	Buy (Actual)	$360
October 21	Cash price below target by $40/t.			Futures gain of $40/t.

Total Canola Price = Cash Price Received + Futures Gain
$380/tonne = $340/tonne + $40/tonne

The 100 tonnes of canola was delivered in late October as planned. Sale proceeds were $340/tonne from the cash sale plus $40/tonne profit from the hedge (short futures contract). In this example, the total price was $380/tonne, the target price set in the spring. This is called a "perfect" hedge because the final return matched the producer's original target price. The small commission cost of futures hedging has been excluded from this example. In the case of a crop reduction during the growing season, all or part of the futures hedge could have been easily reversed. Had the canola futures price risen from the entry point to the exit date, the cash canola price would risen by a similar amount. The net result of that hedge would have been the same…. $380/tonne, with the rise in the cash price offsetting a loss in the futures trade. Remember that, once the hedge is in place, the only item that can change the end result is a change in basis from the original estimate.

Summary

Hedging with the futures market enables a producer to lock in the major component of price before delivery. While the basis remains open, the delivery commitment is also open. This gives the producer flexibility in what buyer to deliver to and when to deliver.

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