

Everything You Need to Know About A Minimum Price Contract

A Minimum Price Contract is just what it sounds like: a tool that allows farmers to lock in a minimum price for their canola while staying open to profit from further upside in the futures market.

Some people might think the idea of locking in a minimum price sounds too good to be true! Others may think the wider basis makes it sound like a rip-off. Depending on market conditions, both perspectives could be correct. Just like all canola contracting mechanisms, there are good and bad times to use Minimum Price Contracts in marketing.

Most grain companies offer a version of the Minimum Price Contract. Alternatively, growers can exactly replicate the risk management profile of a Minimum Price Contract for themselves by buying put or call options through a broker.

Regardless of the mechanics or the buyer, the cost of establishing a minimum price guarantee will be the price of the option. In taking out a Minimum Price Contract, a farmer has to accept a lower net price for his or her canola than it could be sold at into the cash market. This is the tradeoff for maintaining the ability to profit from further upside in the futures.

How It Works

Setting up a Minimum Price Contract involves combining a cash sale (for either spot or deferred delivery) with the purchase of an option. Either call or put options can be used; which way works better will depend on the timing of the cash sale.

A Minimum Price Contract using calls is the more common way to construct this type of trade. Selling into the cash market locks in the price and the long position in the market is maintained by owning a call option.

The value of the call will rise in value if the futures market moves higher. In this way, holding the option leaves the grower open to profit from further upside. If the futures market moves lower, the farmer is guaranteed not to receive any less than the cash market price the canola was sold at.

Example – MPC Using Calls

Suppose the futures are at \$400 and the basis is \$40 under, putting the cash price of canola at \$360 per tonne. November \$400-strike call options are trading at just under \$25 per tonne.

By fixing the cash price and replacing the position with a call, instead of locking \$360 with no protection, this strategy fixes the price at $\$360 - 25 = \335 per tonne, as a minimum. If the futures rally from the current level of \$400 per tonne, the grower will capture additional profits via the calls.

A Minimum Price Contract can also be constructed using puts, but the risk management profile is different than when a cash sale is combined with a call. Using a put option to lock in a minimum price is similar to a traditional hedge: the price is 'locked in' on paper, but the grain is not sold into the cash market until later, leaving the grower open to basis risk.

If the market moves lower, losses in the value of the cash commodity will be offset by profits in the put option position. If the market rallies, the grain may be sold at the higher price, but the puts will expire worthless.

Example – MPC Using Puts

Assume November \$390-strike put options are trading at around \$18 per tonne while the underlying futures are just above \$400. Setting a 'minimum price' simply requires the grower to buy the puts.

The cash price locked in would be around $\$400 - \$40 - \$18 = \342 per tonne, but note the farmer remains open to basis risk in this example. If the basis widens out before the canola is sold, the cash price will be less. By the same token if the basis narrows, the cash price will end up higher.

Establishing a Minimum Price Contract using puts only takes care of the futures price downside risk, whereas both the futures and the basis risk are managed when calls are used.

Puts or Calls?

If the basis is wide and expected to narrow, while the futures are giving off topping signals, puts should be used to establish a Minimum Price Contract. If an attractive basis comes available and cash flow and/or storage space are needed in the short-term, selling the cash and buying call options would be the best strategy.

Holding puts fixes a minimum price, but not a specific delivery or payment window. The canola will still need to be marketed later on, even though the price is protected.

Capturing profits from a call option position will require ongoing monitoring of the canola market. The more important job of selling the crop for an attractive price has been taken care of, but profiting from the option side of the strategy will still require a bit of work.

Advantages and Disadvantages

1. The main advantage of a Minimum Price Contract is that it allows farmers to be disciplined in selling at their target price, and maintain the ability to capture more profits in the future.

In all of these examples, the flat price locked in works out to more than \$7.50/bu, which is well above most farms' breakeven price. Even though a higher cash price of \$360 per tonne or \$8.16/bu could be locked in, there would be no upside protection associated with it.

When canola bids are attractive, above break-even and target price levels, farmers need to be diligent about capturing those margins. But it's hard to sell when the market outlook is still bullish. The Minimum Price Contract is the perfect tool to use in such a situation, because the ability to profit from further upside is not lost once the cash price is fixed.

2. The second major advantage of setting up a Minimum Price Contract is the limited cost. It's like taking out insurance against the risk of falling prices: there is a cost, but it is known up-front and as such can be measured against the perceived risk to the farm's overall profitability.

So, even though a Minimum Price Contract basis ends up wider than the cash basis, the risk in this strategy is fixed and limited to the option premium. In hedging this way, a grower isn't opened up to the risk of sudden futures market losses and margin calls, which is a major advantage over hedging via futures.

3. Minimum Price Contracts can also be used to manage production risk. If the crop falls short of the tonnage contracted, and the market rallies, there will be profits in the calls to offset the cost of buying out the cash contract. Note this advantage only applies to a Minimum Price Contract set up with calls, not with puts.

Sometimes, profitable prices can be locked in before the planting season for delivery in fall but heavily forward contracting (under a Deferred Delivery Contract, for example) intended canola production before it's in the bin can be very risky.

Forward contracting for fall delivery works to lock in profits, but could create a major liability if yields come in below expectations and prices rally. Unless a contract has an Act of God clause – which is rare in canola – companies normally require growers to buy out obligations they are unable to meet, at the going market price.

The Minimum Price Contract can be used to manage the risk of production falling short and the market rallying. Because it leaves the seller long the market even after the cash price for the canola has been fixed, profits will be available to offset the cost of buying out the contract at a higher price if the crop isn't there and the market rises.

Summary

It's hard to go wrong with a Minimum Price Contract. In the event production meets or exceeds expectations, and the market rallies, the canola will end up being sold for more than expected. If the market drops, the crop will still have been sold at a profitable price

level and if production falls short, some buyers will allow the cash contracts to be bought back at a lower price.

The only real disadvantage of this strategy is the lower cash price that is locked in. The worst-case scenario under this strategy would be for the market to drop and production to come in above-expectations. That would leave the grower with additional canola to sell at a lower price, and holding worthless calls.

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