

UNDERSTANDING CANOLA BASIS

A complete understanding of the basis and how it works is essential to effective canola marketing. Textbooks define the basis as the difference between the futures price and cash price. Basis reflects the cost of moving grain from the delivery point to its next use market.

Futures price – Cash price = Basis

Specifically, basis is the difference between the local cash price and the relevant futures price. Basis is negative (*under*) when the cash price is less than the futures, or positive (*over*) when the cash price is higher than the futures. The canola basis in the interior of western Canada generally trades under the futures.

Basis for canola is related to carrying costs. Carrying charges reflect the cost to carry grain forward from one futures delivery month to the next.

The canola basis varies between regions and delivery points within regions because of differences in transportation costs, local demand and competition between buyers. The major difference is usually freight cost (based on shipping to Vancouver). Freight in the Brandon, MB and Red Deer, AB regions can differ by \$20. Freight costs on the same day in December, 2003 were listed as: Brandon, MB \$43.43; Saskatoon, SK \$37.85; and Red Deer, AB \$27.40.

Basis as a market signal

Each delivery point has its own unique basis pattern that reflects its location and its supply and demand situation. Because of changes in local supply and demand, basis is used by buyers to encourage or discourage growers to sell canola.

A wider basis is meant to provide incentive to hold canola, while a narrower basis is intended to attract more deliveries or sales. If a particular elevator requires canola to fill an order, it will raise its cash bid price. One of the ways grain companies do this is by offering a rail incentive. For example, with a 50- or 100-car train to fill, an elevator may narrow the basis by \$4/tonne or \$6/tonne to reflect that demand.

Certain times of year, such as harvest when on-farm canola stocks are high, have historically featured a wide basis. In general, delivery points are flooded with canola at this time of year and companies will provide a disincentive to growers to deliver more canola by widening the basis.

Threat of delivery

Futures and cash prices tend to move in the same direction, but not always by the same amount. The mechanism that keeps the two linked is threat of delivery. In other words, a grower who has sold a futures contract could theoretically deliver canola to the futures market by carrying this short position into the delivery month. The buyer of the futures contract must accept ownership, pay for the canola immediately at the futures market price, and cover the storage and interest costs associated with owning the physical product.

If cash buyers bid prices too far below the futures price (basis becomes too wide), growers can sell futures and make delivery. This would cause cash and futures prices to converge because less canola would be available in the cash market, forcing buyers to raise their bids. At the same time, increased selling in the futures market would push futures prices lower.

Threat of delivery attracts hedgers and speculators to the futures market. Because most traders exit their futures market positions well ahead of the time when they may have to make or accept delivery, futures may seem to be a paper market, but the fact that delivery can occur establishes the link between futures and cash markets.

Follow the basis for improved profit

By following basis levels, canola growers can better choose when to market, where to market, and how to lock in prices. Shop around for the best pricing opportunities among local elevators and canola crushers. An awareness of local basis patterns will help evaluate selling opportunities. (See the graph for historic basis levels in eastern Saskatchewan and Manitoba.)

Basis is an important indicator of what kind of marketing tools to use when forward pricing canola. The first step in making this decision is to compare the current basis with the expected basis at the time of delivery in order to predict whether the basis will widen or narrow. A widening basis, while hedged, lowers the grower's net price for canola. A narrowing basis, while hedged, increases the grower's net price.

Basis is a signal of market forces at work and will change over time as the cash price and futures price converge. Because basis reflects the cost of marketing canola, it is not as volatile as futures and cash price movements.

Do not watch the basis in isolation. Refusing to sell because the basis seems \$5.00 too wide might make sense at one point in time, but if the futures price drops 10-15% before the basis narrows, it was not a good decision to wait. Therefore, watch both basis and price trends to decide when it is most profitable to sell canola. Hitting a target price that is over and above all costs of growing the crop and includes a return on investment is the most important goal of marketing.

Typical country elevator basis

December 2003 - Brandon, MB

(All costs expressed per tonne of canola.)

| | |
|-------------------------------|-----------------|
| Freight (to Vancouver) | \$43.87 |
| Freight on dockage | \$1.75 |
| Inspection and weighing | \$0.67 |
| Elevation | \$6.00 |
| Cleaning | \$6.00 |
| Storage | \$1.06 |
| Interest | \$1.70 |
| Total basis costs | \$61.05 |
| Destination value | \$15.00 |
| Rail incentive | <u>\$7.00</u> |
| Total basis incentives | \$22.00 |
| Total basis costs | \$61.05 |
| Total basis incentives | <u>-\$22.00</u> |
| Total basis | \$39.05 |

Canola Basis - Eastern region

