Forward Contracting

Basic Facts

Hog prices in Ontario are affected by two major factors that can cause a downturn in the hog price. A decrease in the CME price (Chicago Mercantile Exchange) and/or a rise in the Canadian dollar value will push the Ontario 100% price lower.

For example, the 100% price in Ontario is calculated as follows:

100% Price = (**CME Price** – U.S. $0.56/cwt) *US dressing percentage of 0.74 * metric conversion of 2.2046 ***exchange rate** / Ontario dressing percentage of 0.80 / 1.1195 divisor

In order to protect against adverse price movements, producers may want to consider their options for hedging. There are many options available for producers to hedge:

Trading Directly on the Chicago Mercantile Exchange

Trading on the CME requires opening an account with a broker, depositing margin money and actively managing the margin account. Every hedge must be entered into and offset. Lean Hog and Canadian Dollar contracts are traded separately.

Advantages: Reduces price risk, as price can be locked in. Flexible so it can be offset at the producers' convenience.

Profit = Selling Price – Offset Price
= $170 - $168
= $2 Gain

Ontario Pork Forward Contracts

Forward contracts are available to all Marketing Members with a long-term commitment to Ontario Pork.

Key Benefits:

Effective Risk Management Tool

Forward contract prices are generated using the CME lean hog and Canadian dollar futures, allowing the producer to essentially have a short hedge on the lean hog and a long hedge on the Canadian dollar. This helps protect against a decline in the hog price and a gain in the Canadian dollar value.

Versatility

The delivery periods are four weeks in length, and the producer can decide when to ship hogs on the contract within those four weeks.

No margin fees

Since Ontario Pork is making the trades on the CME, the producer is not responsible for setting up or maintaining a margin account. Margin fees on the CME are the amount of equity needed to hold a futures contract.

Definitions

Cash Price: Price of hogs without signing forward contracts.
(Example: Pool Plus, regular contract, etc)
Forward Contract Price: Price of forward contract at time of signing.
Contract Closing Price: Price of forward contract at time of delivery.

BASIS

Basis is the difference between the cash and the futures market prices. Ontario Pork's program has a floating basis, whereby basis is calculated the day the producer ships hogs against the contract and applied to the contracted base price. The packer programs have basis included in their offered price. A producer trading directly on the CME will also be subject to basis risk.

Basis = Cash – Contract Close

Basis tends to follow a seasonal pattern. Basis is generally lowest during mid-April and highest during early August.

Factors that Influence Basis

Since hogs cannot be stored its basis is much different than a grain basis. Hog basis is generally influenced by: the relative strength of a producer's base price and the time between delivery and the expiry of the nearby futures contract.

FACT: *From January 15, 2011 to January 14, 2012 more than 128,000 hogs were shipped through Ontario Pork's Forward Contracts.*

The 10 year average basis values are included on the Forward Contract Price sheet, which is available daily through fax and e-mail for those who request it. The Forward Contract Price sheet can also be accessed on the OINK webpage (www.oink.ca). Average basis values for 3, 5, 10 and 15 year intervals are available on the OINK webpage and on request.

Ontario Pork Forward Contracting

Two Methods of Calculating Net Price

Assume:

Forward Contract Price = \$180
Contract Closing Price = \$177
Cash Price = \$175

Method 1

Net Price = Futures + Basis
= Futures + (Cash – Contract Close)
= \$180 + (\$175 - \$177)
= \$180 - \$2
= \$178

Method 2

Net Price = Cash + Futures Gain or Loss
= Cash + (Forward Contract Price – Contract Closing Price)
= \$175 + (\$180 - \$177)
= \$175 + \$3
= \$178

ONTARIO PORK TARGET PRICING

Through Ontario Pork producers can place a target price. If the target price is reached, a forward contract is generated and the producer is obligated to deliver the hogs during the pre-determined delivery period. If the target price is not reached, the agreement expires, with no cost. Since target pricing is an enhancement of the Forward Pricing program, basis will be applied to the producer's settlement price.

How the program works:

A producer can offer a set amount of hogs for a specific price and delivery period by calling 1-800-862-9001.

Benefits to the producer:

- Producers do not have to follow the futures markets on a daily basis.
- No additional cost to producer.
- Producers can cancel any time until an actual contract is created.

Forward Contracting *Basic Facts*

Decision Making

The following decision chart may help decide which hedging option is right for you, based on where you think CME lean hog futures prices and the Canadian dollar exchange rate are headed.

If you think:		Canadian Dollar		
		Will Lower	Will Remain Steady	Will Rise
CME Lean Hogs	Will Lower	Only Hogs on CME	OPFC	OPFC
	Will Remain Steady	Do not Hedge	Reduced OPFC	OPFC
	Will Rise	Do not Hedge	Do not Hedge	Only $ on CME

****OPFC – Ontario Pork Forward Contract*

Focus on Profit!!!

You can make business decisions by focusing on maximizing profit or minimizing loss without referring to the basis. It is possible to earn a profit or a loss on a forward contract. However, since nearby futures contracts and cash markets generally move in the same direction, you are likely to earn a profit on your forward contract when cash market prices are lower than you expect. You are likely to face a loss when cash prices are higher than expected. Either way, your revenue is stabilized.

The Math

Since,

1. $Profit = Net\ Price - Cash\ Price$ And...

2. $Net\ Price = Futures\ Price + Basis$ And...

3. $Basis = Cash\ Price - Contract\ Close$

Then,

$Profit = \boxed{Net\ Price} - Cash\ Price$

$Profit = Futures\ Price + \boxed{Basis} - Cash\ Price$

This means,

$Profit = Futures\ Price + Cash\ Price - Contract\ Close - Cash\ Price$

$Profit = Futures\ Price + \cancel{Cash\ Price} - Contract\ Close - \cancel{Cash\ Price}$

$Profit = Futures\ Price - Contract\ Close$

Contract Limitations

1. Forward Contract booking volumes are limited to a percentage of the producers' historic hog shipment volume. This helps to ensure that producers do not overbook for futures contracts and thereby reduces the instances of default for non-delivery.

Delivery Time	Volume Eligibility
Delivery within 4 periods	75 % of historical shipments
Delivery between 5 and 6 periods	50% of historical shipments
Delivery beyond 6 periods	25% of historical shipments

Futures Delivery Periods

Hog Delivery Period	Corresponding CME Lean Hog Futures Month	Corresponding CME Canadian Dollar Futures Month
January 16 to February 14	February	March
February 15 to March 15	April	March
March 16 to April 14	April	June
April 15 to May 15	May	June
May 16 to June 14	June	June
June 15 to July 15	July	September
July 16 to August 14	August	September
August 15 to September 15	October	September
September 16 to October 14	October	December
October 15 to November 15	December	December
November 16 to December 14	December	December
December 15 to January 15	February	March

Ontario Pork's Forward Contracting Prices are derived from the adjoining CME Contracting Months. The Daily Contract Closing price is derived from the current month's adjoining CME Contracting month.

Commonly Asked Questions

How do I make a Forward Price Contract?

In order to purchase a Forward Price Contract, a producer must first sign the Forward Pricing Contract Master Agreement. A producer can then call the Forward Price line at 1-800-862-9001 to purchase a contract for a specific delivery period. There is a $20.00 fee plus HST for each Forward Price Contract.

What condition do my hogs have to be in for delivery?

Hogs must be of normal standard and quality to be applied against a Forward Contract. The shipment must have a total average of at least 100 index. Hogs that are classified as condemned contaminated or ridglings do not apply to the contract.

Where do the hogs get processed?

Hogs will be shipped to the same plant that normally processes the producer's hogs. For example, if a producer has a standard contract with a particular plant, the hogs will be processed by that plant. The standard contract price would be used as the cash price in determining basis value. Similarly, if the producer ships Pool or Pool Plus hogs, the hogs would go to the plant normally used by the producer, and the Pool or Pool Plus price would be used as the cash price.

How do hogs get applied to my Forward Price Contract?

Producers must call the Marketing Division at least 24 hours prior to delivering hogs if they want the hogs applied to their Forward Contract. Once the initial 14 days of the delivery period has lapsed, all hogs delivered by the producer will be applied to their Forward Contract unless other arrangements are made.

What happens if I do not deliver the total amount of hogs on my contract?

If a producer does not fulfill a Forward Contract they will be required to pay any outstanding fees on their account, which would include the $20.00 contract fee, the regular service fee, and may also indicate a $7.00 fee per hog administration. Also, the producer would be responsible for all losses associated with the closing of the Forward Contract. If there would have been a gain, the producer forfeits gains on non-delivered hogs.