Canola Long Hedging Example

Disclaimer
The example provided is purely for illustration and should not be construed in any way as a recommended trading strategy or current market conditions. The reader should verify current contract specifications and other relevant information before using these techniques and products.

Canola Brief Market Overview.

Unusually high prices for many of the world's top oilseeds and cooking oils have become the norm of late, but Canola/Rapeseed stands outright. Since 2020, canola prices have skyrocketed. The main reasons for these changes are insufficient supplies by Canadian manufacturers due to weather conditions and strong demand from the EU and China. In 2020, the historically significant price level of 700 was overcome, and the price growth continued.

Fig 1. Canola historically prices.

On the one hand, it may seem that this situation is good for the canola producer and negatively affects the consumer. However, this situation is difficult for both parties. Indeed, such price movement is going with the high price volatility and can negatively impact businesses.

Long Hedge Example:

A feedlot operator (manager) from Eastern Saskatchewan considerate in April to lock in a price for feeder cattle that will be needed in the future (point 1, fig.2). For April 29/2021 the Cash Price is 886.60 CAD/Tonne. The price can change dramatically in the fall, after the harvest. There may be a situation where the price could fall after a good harvest, however, prices for canola could be higher due to high demand and less than expected supply. The manager may assume a risk and not create a hedge or try to lock price his fall purchase.

The January (new crop) future (RSJ22) is 688.70 CAD/t for 29April. The lower future price enables the manager to buy canola cheaper in the fall. He estimates the typical basis for his location is CAD 20/t per ton under January future. So, the estimated purchase price in the fall will be at 668.60 CAD/Tonne (point 1, fig.2).

During hedging, the hedger deals with 3 new types of risks:

1. Basis risk. His estimation about discounted basis CAD 20/t under may be wrong, and in fall the basis can strengthen more. This case he can't reach estimation purchases price and will to pay higher price.

2. The manager fixes the price around his target price of CAD 668.70/t. However, the price level in the fall may be lower after the harvest. The manager, in any case, will not be able to buy cheaper than his fixed price.
3. As part of hedging, he must maintain sufficient margin. The margin is adjusted "mark to market", and this amount can be sufficient and taken into account when planning.

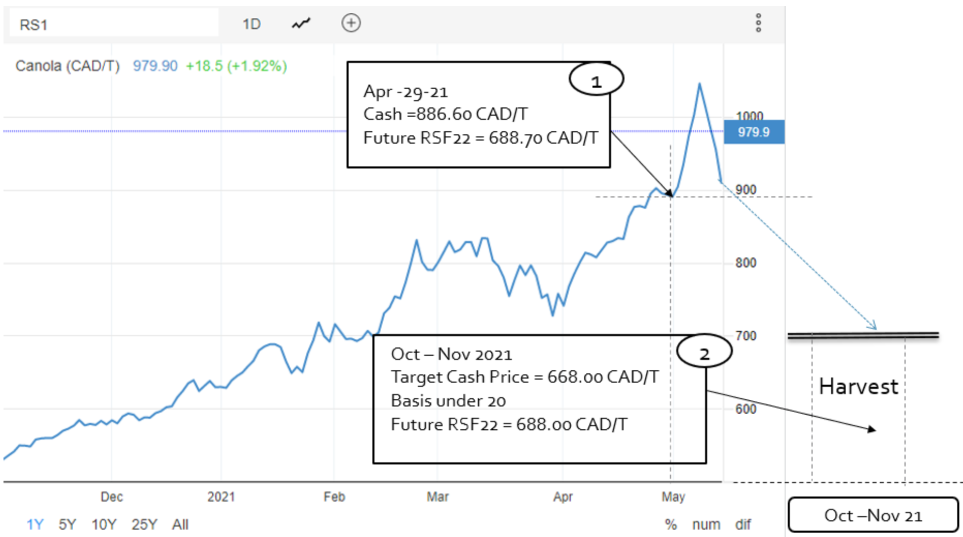

Fig 2. The Long Hedge Estimation

The manager wishes to buy 100 tonnes of canola seeds in the fall. To hedge, he instructs his commodity broker to buy 5 January canola futures contracts at 20 tonnes each. The actual fill price of the ICE RSF22 futures contract was CAD 688/t, so his estimated purchases price will be CAD 668/t (table 2).

The fall harvest was weak, demand for rapeseed continued to rise and prices reached new highs. At the end of October, the manager decided to withdraw the hedge.

On October 25, the he bought canola in the local market at CAD 948.50/t and closed (sold) January futures at CAD 946.00/t.

Date	Cash Market Price	Basis	Action	Future Price
At Spring	CAD 668.00 /t (target price)	CAD20/t under (expected fall basis)	Bay Future Contract (long hedge)	
April 29			Buy fill price	CAD 688.00 /t
October 25	CAD 945.50/t	CAD 0.5/t under	Sell (offset) fill price	CAD 946.00/t
				Future gain CAD258.00/t

Table 1. Long Hedge Canola Example.

Final canola bought price was:

CAD 945.50/to - CAD 258/t (future profit) = CAD 687.5/t; CAD 17.50/t over target price due to basis strengthening.

Please note that in the absence of hedging and full acceptance of market risk, the price for the feedlot operator in the fall will be CAD 945.50 per tonne and significant affect to his profit margin.

This example is good illustration why the developed hedging programs are nowadays an important part of the company's risk management framework.