Short Situation

What to Consider if Production Comes Up Short on a Deferred Delivery Contract

Adverse weather conditions and corresponding crop losses can place farmers in a difficult contract position. As part of an ongoing initiative to help farmers get the best value for their crop, the Canadian Canola Growers Association investigated possible options for farmers who find themselves in a "short situation" with their deferred delivery contracts.

<u>Cancel the contract and pay the buyout/replacement cost to the grain company</u>

When you signed the contract, the company sold either the futures or the cash commodity. If you come up short, so will the company. The grain company must either replace the grain it expected to get from you or unwind its futures position. In years where the market has risen since the contract was signed, the cost can be substantial.

If the contract is cancelled or its obligations are not met, in most cases, the cost is charged back to the farmer. The liquidated damages incorporated in the contract terms and conditions are designed to cover this cost.

If you are short, there are a few things to consider:

- Speak to the grain company as soon as you are aware of a potential shortfall. There are likely other farmers facing a similar situation. So being the first to come in and discuss your options means there's a better chance of negotiating a workable solution.
- Some contracts include language making it the farmer's responsibility to inform the company of possible difficulties in fulfilling contract obligations.
- Often there are liquidated damages associated with cancelling a contract. You may be able to negotiate a reduction or a waiving of this fee, especially if adverse weather is the reason for the shortfall.
- Consider buying grain from a neighbour to deliver against your contract and avoid the cancellation costs.
- Contract buyout costs may be eligible expenses under AgriStability. If you anticipate making an AgriStability claim this crop year, check with your accountant on the eligibility of these costs.
- Familiarize yourself with the cancellation and liquidated damage clauses in the contract to ensure the cost is calculated by the company in accordance with contract terms.
- When giving instructions to cancel a contract, provide clear instructions to the grain company to avoid any misunderstanding or confusion around what should be done.

<u>Roll delivery to the next crop year when you expect to have more production available</u>

This may be more of a feasible alternative if your delivery period is later in the crop year. It avoids immediate cash payments to close out the original contract, but it may result in a price discount in the future. Be prepared for the basis to be much wider on a new crop contract due to carrying charges and other market forces, and be aware of the price risk associated with staying in the market.

Buy a call option

If the market price has gone up, a call option can help offset the cost of cancelling a contract by giving you the right to buy the underlying futures at a certain strike price potentially below the current market price. One expert calls options a “phenomenal way to manage price risk” because you know the costs up front. With options, you pay a premium to purchase them, but their costs and risks are very limited beyond that. You do need an account with a broker to purchase options.

If you didn’t buy a call option in the spring, it isn’t necessarily too late. Anytime you have priced volume and are uncomfortable with your crop production potential as well as a significant portion of the national crop, you may be able to benefit from purchasing a call option. Since the futures market needs to go up for you to benefit from a call option, localized events such as hail probably wouldn’t affect the market enough. On the other hand, a wide-spread early frost or rained out harvest could affect the market in this way.

Considerations for Future Years

There are a few things you can do to help reduce this risk in your grain-marketing plan.

1. Review the contract cancellation and liquidated damage clauses from the various companies to determine which is best for you.

2. Understand your obligations and risks in any contract you sign.

3. Educate yourself on the alternatives that help mitigate the risk of being short on contracted volume. One alternative is to purchase a call option when signing forward priced contracts. Another alternative is utilizing a type of contract that provides extra protection against changes in futures prices between the time of contracting and delivery. In the event of crop failure, the value of these contracts can be used to offset contract cancellation costs. Speak to your grain company(s) about how this type of contract might fit in your grain marketing plan.

In any crop year, taking the time to thoroughly understand the risks in your grain marketing plan and the alternatives available to mitigate them is a good investment in the future of your farm operation.

For more information on grain contracts, view CCGA’s Practical Guide to Grain Contracts handbook here.

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