ONTARIO PORK

Risk Management Fact Sheet

In 2006, Ontario Pork hosted Risk Management courses across Ontario, which highlighted many important concepts for developing a risk management plan for Ontario hog farmers.

Hog prices in Ontario are affected by two major factors that can cause a downturn in the hog price. Specifically, 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

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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**
  Money must first be deposited in a margin account with a broker, and then producer can buy/sell futures contracts to establish a fixed price.

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

- **Packer Forward Contracts**
  Fixed price contracts are offered by Maple Leaf and Quality Meat Packers, to producers that already have standard contract agreements with the plants.

Calculating a profit on a Packer Forward contract, assuming a contract price of $132 and a cash price of $130:
Profit = Fixed Price - Cash Market Price
= $132 - $130
= $2 Gain

- **Ontario Pork Forward Contracts**
  Forward contracts are available to all Ontario pork producers, regardless of individual marketing arrangements.

Key Benefits:
Effective risk management tool Forward contract prices are generated using the CME lean hog and Canadian dollar futures, so the producer is essentially enacting 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.

Potential to plan for future payments Producers are locking in a base price through the Forward Contract program. Ontario Pork also lists the average basis range with the pricing list, so producers can estimate what their final basis level will be.

Ontario Pork Forward Contracts

Two Ways to Calculate a Net Price

Assume: Forward Contract Price = $135
Contract Closing Price = $132
Cash Price = $130

A. Net Price = Futures + Basis
= Futures + (Cash – Contract Close)
= $135 + ($130 - $132)
= $135 - $2
= $133

B. Net Price = Cash + Futures Gain or Loss
= Cash + (Forward Contract Price – Contract Closing Price)
= $130 + ($135 - $132)
= $130 + $3
= $133

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
Basis in livestock is different from basis in grains in that grain basis can be affected by product quality and exchange rate, which is not the case in hogs. Hog basis is influenced by the relative **strength of a producer's base price** and the **time** between delivery and expiry of the nearby futures contract, as this influences the premium or discount futures prices have to the cash market.

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

If you think:

CME Lean Hog Futures	Canadian Dollar	Potential Action
Will Strengthen	Will Remain Steady	Do not Hedge
Will Weaken	Will Remain Steady or Lower	Hedge hogs, not dollar, on CME

If you think:

CME Lean Hog Futures	Basis	Potential Action
Will Weaken	Will Follow Trends	Hedge with Ontario Pork
Will Weaken	Will be Weaker than Normal	Hedge with Packer

Important definitions:

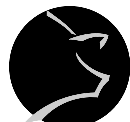
Basis – the difference between the cash and futures market

Fundamental Chart Analysis – using supply and demand information to estimate upcoming price trends

Long – buying of futures, bought with the intent to sell back at a higher price

Short – selling of futures, sold with the intention to buy back at a lower price

Technical Chart Analysis – method to estimate short term price trend using historical data


ONTARIO PORK

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