

Strategies

This section of the EPO guide provides some insight into the various EPO programs offered and how producers can use the programs to accomplish different goals. Expectations regarding CWB delivery calls and adjustment payments are based on previous crop years and may not necessarily be repeated in futures crop years.

Factors to consider when making an EPO commitment

The EPO program provides producers with two distinct benefits: 1) increased cash flow and 2) ability to lock in a floor price. There are different factors to consider, depending on the producer's objective.

Increased cash flow

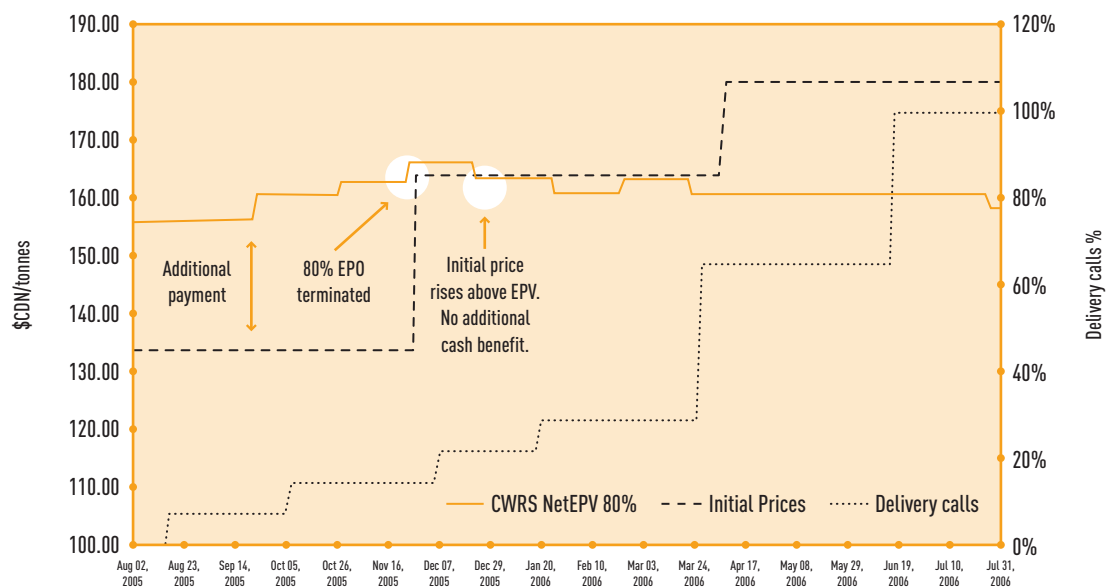
Delivery calls

Producers looking for a cash flow benefit should consider contracting only the amount of production that the CWB has called to date. If the tonnes committed to an EPO are greater than the amount called for delivery, producers will have to wait for the next delivery call before applying more deliveries towards the EPO. If the initial payment is increased above the EPV before the next delivery call is issued, the producer will have paid for the EPO discount without receiving any additional cash flow benefit.

It can generally be expected that initial payments will increase in November or December, bringing the initial payment of the reference grade within the range of 80 per cent of the current PRO value. If a producer contracted all of his or her Series A delivery contract to an 80 per cent EPO following harvest, only the first 25 per cent delivery call may generate an EPO additional payment. When the CWB calls the next 25 per cent in November or December, the initial payment may have already exceeded the 80 per cent EPV.

The graph below depicts the 2005-06 CWRS 80 per cent EPV, initial payment and delivery calls. It demonstrates how an increasing initial payment reduces the value of the EPO additional payment. By late December, the initial payment had climbed above the initial EPV. Producers with outstanding 80 per cent EPOs would receive no additional payment but would still be responsible for the discount.

2005-06 CWRS 80% Net EPV Initial and Delivery calls



EPV vs. initial payment

Before signing an EPO, producers should also consider:

1. What percentage of the PRO is already being issued in the form of the current initial payment?

If the initial payments are beginning to approach the current EPVs, producers should consider if it is worthwhile to lock in an EPO contract or consider locking in a higher EPV.

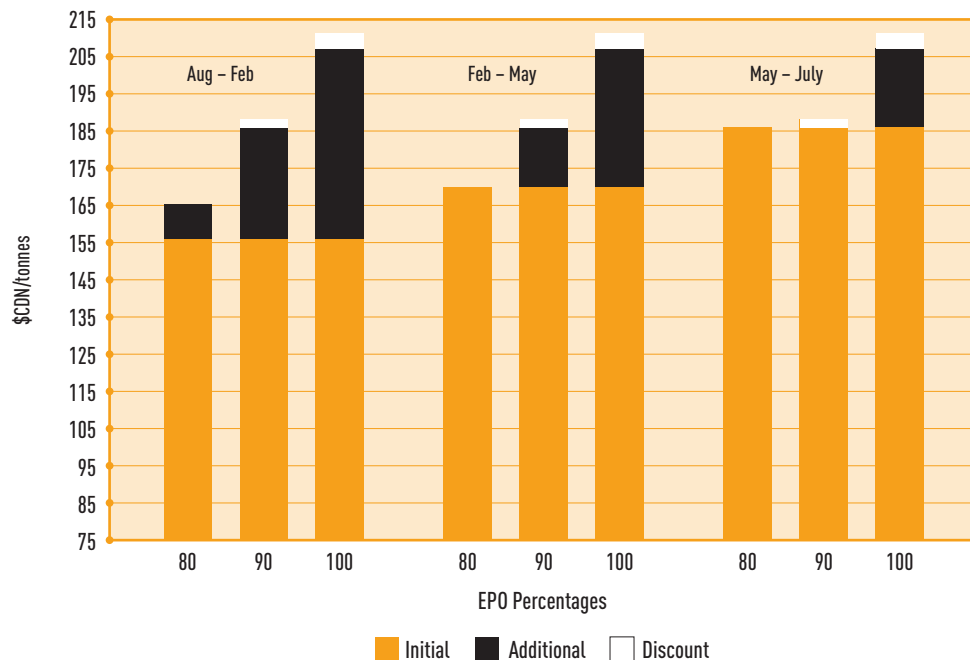
For example, if the current initial payment is \$149 per tonne and the current PRO is \$200 per tonne, producers are already receiving 75 per cent of the PRO from the initial payment. The 80 per cent EPO would only provide an additional payment of \$11 per tonne. It may be better to lock in a 90 per cent EPO that would provide an additional payment of \$31 per tonne, depending on the cash flow required and the current EPO discount cost for each EPV.

2. Is another adjustment payment about to be announced?

If another adjustment payment is about to be announced, the \$11 per tonne payment on the 80 per cent EPO will be eroded further and possibly eliminated. Producers should consider whether waiting for the adjustment payment would provide the required cash flow soon enough, rather than paying a discount for an earlier payment.

The following chart illustrates how the EPO additional payment will decrease in value for deliveries made later in the year as initial payments are increased.

No. 1 CWRS 13.5% – Initial vs. additional payment



The above shows three EPO contracts signed in August at different EPV levels, based on a PRO of \$207 per tonne.

- The 80 per cent EPO has an EPV of \$165.60 and a discount of \$1.50 per tonne.
- The 90 per cent EPO has an EPV of \$186.30 and a discount cost of \$4.50 per tonne.
- The 100 per cent EPO has an EPV of \$207 per tonne and a discount cost of \$12 per tonne.

Initial payments are raised twice during the crop year, reducing the EPO additional payment for deliveries made later in the year. The chart shows the impact of the increased initial payments on additional payments by EPV level:

EPO lock-in level	Period	EPV	Initial payment	Discount cost	Additional payment
80%	Aug-Feb	\$165.60	\$156.15	\$ 1.50	\$ 7.95
90%		\$186.30		\$ 4.50	\$25.65
100%		\$207.00		\$12.00	\$38.85
80%	Feb-May	\$165.60	\$171.05	\$ 1.50	\$ 0.00
90%		\$186.30		\$ 4.50	\$10.75
100%		\$207.00		\$12.00	\$23.95
80%	May-Jul	\$165.60	\$186.05	\$ 1.50	\$ 0.00
90%		\$186.30		\$ 4.50	\$ 0.00
100%		\$207.00		\$12.00	\$20.95

Note: These numbers are for illustration purposes only. The incremental payment for later deliveries has been omitted. Also, actual PROs, initial payments, adjustment payments and EPO discount values will vary from crop year to crop year.

From August to February, all three producers will receive an EPO additional payment.

Following the increase to the initial payments in February, deliveries against the 80 per cent EPO will not generate an additional payment because the initial payment is higher than the EPV. Producers are eligible for pool payments once the initial payment exceeds the EPV, but they are still responsible for the discount.

When the initial payments are increased again in May, only the 100 per cent EPO would generate an additional payment.

Floor price protection

Producers who want to set a floor price for their grain should consider only the 90 or 100 per cent EPV as the 80 per cent level likely will not provide a sufficient EPV for this purpose. If the objective is to lock in a price that will be higher than the final pool return, the 100 per cent EPV is the most likely to achieve this goal.

Producers should closely monitor the monthly PRO updates. When they feel a PRO is at a level that gives them an acceptable floor price, they should consider locking in the value.

In order to achieve the highest possible floor price, producers will attempt to lock in a combination of the highest possible PRO value along with the least expensive EPO discount to provide the highest possible net EPV.

Net EPV = EPV – discount

Once producers determine the PRO value to lock in, they may want to try to time sign-up to achieve the lowest possible discount.

Factors that influence the daily EPO discount

The daily discount cost for the 100 per cent EPV will be substantially more expensive than the lower EPV levels because the CWB is exposed to greater price risk. The cost of hedging this position is higher because the CWB must take a more aggressive market position to protect the price guarantee.

There are a number of factors other than the EPV that can affect the EPO discount. The impact on the discount of these factors increasing is discussed below. It should be noted that more than one of these factors could be influencing the discount at any one time.

PRO – if the PRO is increased, there is also increased risk and hedging cost to the CWB to guarantee the higher EPVs. The time value of money for earlier payment also increases. As a result, the EPO discount cost will be higher.

North American futures – A significant portion of the overall EPO discount (especially early in the crop year when only a fraction of the pool accounts are sold) is the cost to the CWB to purchase put options on various North American commodity exchanges. If futures markets increase in value (quoted in Canadian dollars per tonne), the EPO discount cost will likely decrease due to the lower cost to hedge in the futures markets.

Foreign exchange – Most hedging for the EPO program is conducted at U.S. exchanges in U.S. dollars. As the Canadian dollar strengthens in value relative to the U.S. dollar, the foreign exchange will result in a lower futures value when converted to Canadian funds. A lower futures price in Canadian dollars will cause the EPO discount to increase in cost.

Initial payments – When the initial payments are increased later in the year, producers receive a greater percentage of their total EPV at the elevator, reducing the additional payment issued by the CWB. Assuming PRO values are stable throughout the crop year, the risk and financing cost to the CWB decreases, resulting in a lower discount cost.

Percentage of pool sold – Assuming the PRO remains stable from month to month, the EPO discount typically decreases in cost later in the crop year because the risk to the CWB decreases as more of the pool is sold. However, volatile market conditions can make the PRO less predictable, which can cause the discount cost to increase.

Initial payment spreads

When producers deliver against an EPO, they receive the initial payment for the actual grade delivered. This effectively reduces or raises their contract price by the spread between the initial price of the reference grade and the initial price of the delivered grain on the date of settlement.

If producers have a range of grades and/or proteins available to deliver against an EPO, they should watch initial payment spreads to determine which will provide them with the best return. Changes to the PRO spreads during the crop year should also be watched to determine trends. If there is an adjustment payment recommendation, the PRO spreads reflected at the time of the recommendation are used to set the new initial payment rate. Knowing the trends in the PRO spreads will help producers decide which grade and/or protein to deliver and the best timing of settlement.

Example

On May 30, a producer commits 50 tonnes of CWRS to an EPO with an EPV of \$200 per tonne. The producer has 50 tonnes of No. 1 CWRS 14.0 per cent protein and 50 tonnes of No. 3 CWRS 13.8 per cent protein available for delivery and must decide which grade to apply to the EPO contract and which to apply to the pool.

In late October, the CWB recommends an increase to the initial payments. An adjustment payment is expected in the middle of November. Since deliveries against the EPO are subject to the initial price spreads on the date of delivery, the producer reviews the CWB PROs and initial prices to determine which grade to apply to the EPO. Remember, the adjusted initial prices will reflect the changes in the PRO spreads.

	Reference Grade No. 1 CWRS 13.5	No. 1 CWRS 14.0	Spread
Initial Price	\$135	\$140	\$ 5
July PRO	\$195	\$200	\$ 5
October PRO	\$205	\$220	\$15

The PRO spread between 1 CWRS 13.5 per cent protein and 1 CWRS 14.0 per cent protein has improved by \$10 per tonne (\$15 - \$5) from July to October.

	Reference Grade No. 1 CWRS 13.5	No. 3 CWRS 13.8	Spread
Initial Price	\$135	\$120	(\$15)
July PRO	\$195	\$180	(\$15)
October PRO	\$205	\$172	(\$33)

The PRO spread between No. 1 CWRS 13.5 per cent protein and No. 3 CWRS 13.8 per cent protein has deteriorated by \$18 per tonne (\$33 - \$15) from July to October.

Fundamentals suggest this trend will continue and that it will be reflected in the upcoming adjustment payments. The following table illustrates the consequences of delivering before and after the adjustment payment:

	No. 1 CWRS 14.0%	No. 3 CWRS 13.8%
EPV	\$200	\$200
- Initial price of reference grade	\$135	\$135
= Additional payment	\$ 65	\$ 65
+ Initial price of delivered grade	\$140	\$120
= Net EPV before adjustment payment	\$205	\$185
+ Change in PRO spread	\$ 10	(\$ 18)
= Estimated net EPO price after adjustment payment	\$215	\$167

Based on the change in PRO spreads, the producer's net EPO price would increase by \$10 per tonne for No. 1 CWRS 14.0 per cent protein following the adjustment payment and decline by \$18 per tonne for the No. 3 CWRS 13.8 per cent protein. Therefore, the producer would be better off to deliver the No. 3 CWRS 13.8 per cent protein against the EPO prior to the adjustment payment and leave the No. 1 CWRS 14.0 per cent protein in the pool.

Buyouts

When initial payments have surpassed the EPV, it may be more effective to buy out the EPO rather than to continue to apply deliveries.

As deliveries are applied to an EPO contract, producers are charged the EPO discount but are partially reimbursed for the time value of money portion in the form of an incremental payment.

Net EPO cost = EPO discount – incremental payment for the month of delivery

The incremental payment increases in value for each month, effectively reducing the producer's net cost for deliveries made later in the crop year.

However, if a producer buys out the tonnes remaining on the contract, the entire time value of money portion is credited.

Buyout cost = EPO discount – time value of money

The time value of money portion of the discount is typically equal to or very close to the maximum July incremental payment that was locked in when the contract was signed up. This means that applying deliveries made earlier than that will cost the producer more than buying out of the contract, without generating an additional payment.

Example

A producer locked in a 90 per cent EPO on August 15 for 200 tonnes, locking in an EPV of \$180 per tonne and a \$3 per tonne discount. The incremental payment rates for deliveries later in the crop year, which are also locked in at sign-up, are listed below.

Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.
\$0.00	\$0.15	\$0.35	\$0.50	\$0.60	\$0.70	\$0.75	\$0.85	\$0.90	\$0.95	\$1.00	\$1.05

In September, the producer delivers 100 tonnes. The initial payment is \$160.

$$\begin{aligned} \text{CWB additional payment} &= \text{EPV} - \text{reference grade initial} - \text{discount} + \text{incremental payment} \\ &= \$180 - \$160 - \$3 + \$0.15 \\ &= \$17.15 \end{aligned}$$

For the September delivery, the producer receives an additional payment of \$17.15 per tonne. The net cost to the producer is \$2.85 per tonne (discount – incremental payment).

In January, the producer plans to deliver the remaining 100 tonnes. However, the initial payment has been raised to \$185 per tonne. If the producer delivered against the contract, no additional payment would be generated but the producer would still be responsible for paying the net discount cost.

$$\begin{aligned} \text{Net cost to producer} &= \text{discount} - \text{incremental payment} \\ &= \$3 - \$0.70 \\ &= \$2.30 \text{ per tonne} \end{aligned}$$

If the producer chose instead to buy out the contract the entire time value of money portion of the discount, in this case the July incremental value, would be credited.

$$\begin{aligned} \text{Buyout cost to producer} &= \text{discount} - \text{time value of money} \\ &= \$3 - \$1.05 \\ &= \$1.95 \text{ per tonne plus } \$15 \text{ administration fee} \end{aligned}$$

In this situation the producer would save $\$2.30 - \$1.95 = \$0.35$ per tonne (less the \$15 administration fee) by buying out the contract instead of delivering against it.