Feeder Associations of Alberta Ltd.

Forward Contracting of Cattle

Alberta Agriculture Market Specialists

Introduction

The structure of the Canadian cattle industry has seen many changes recently which have lead to increased concentrations at both the packer and feedlot levels of the industry. In this new environment of fewer packers and larger feedlots, more and more buyers are securing their cattle supplies well in advance to avoid risks associated with volatile price fluctuations. Due to the higher price risks involved, narrowing margins and often the need for additional financing, many sellers have welcomed the opportunity to minimize price risk by forward contracting cattle.

Forward contracting is a way for cattle sellers and buyers to price their livestock ahead of an expected sale date. When used properly, forward contracting can reduce price risk. Although there are different types of contracts available to sellers, most forward contracts involve slaughter cattle. However, feeder cattle and calf contracting are becoming more common. As with any legal contract there are predetermined specifications and obligations for all parties involved.

Forward contracting offers a marketing alternative which may suit a producer's situation and can therefore be evaluated along with other marketing choices. The information in this module will help farmers make an informed decision on whether forward contracting is a suitable marketing method for them. Companies which offer forward contracts for feeder and slaughter cattle are listed below.

What is a Forward Contract?

A forward contract is a legal, binding commitment that prices a respecified product at a certain time, to be delivered to a specified place. Whether it is a packer or a feedlot, the buyer of the contract is looking to reduce price risk at market time by 'locking in' a price well ahead of the expected sale day. If a seller requires financing, lenders will often look favourably at risk management tools being used. Before forward contracting, it is imperative that sellers determine their breakeven price and decide what an acceptable rate of return is (see **Breakeven Analysis for Feeder Cattle**). Although forward contracting cannot guarantee a specific profit because of the specification requirements in the contract and possible increased input costs, it can reduce the adverse impact from sudden and unexpected changes in the market price.

Definitions

The following terms are used in reference to forward contracting. They are defined below in that context.

Futures market - the commodity market in Chicago for slaughter and feeder cattle that is most often used to establish a local Alberta price when forward contracting.

Cash (or Spot) market - current price for a specific commodity in a specific market.

Basis - the price difference between the cash market and the futures market at a specific time. This number represents such things as current local supply and demand conditions, freight between markets and marketing fees.

Contract specifications - description of the cattle to be delivered under the terms of the contract agreement. Cattle not meeting these specifications may be subject to discounts which may or may not be preestablished in the agreement.

Delivery - the agreed upon time frame to deliver the cattle.

FOB (Freight On Board) - FOB point of origin means the cattle are sold at the farm/ range/feedlot, etc. and the buyer pays the freight. FOB delivery point means the cattle are delivered to a pre-specified point (feedlot, plant, etc.) and the seller pays the freight. Most forward contracts are based on delivered basis, meaning the seller pays the freight.

Load lots - most forward contracts are based on a load lot or 40,000 lb live weight. This is approximately one cattle liner full of cattle; 40 or more animals. Numbers will vary depending on the weight of cattle. Also, for feeder cattle contracts, the load lot must be made of uniform cattle.

Types of Forward Contracts

There are two main types of forward contracts. One is a basis contract and the other is a flat (or cash) price contract.

Basis contract

The forward contract price most often offered by a buyer consists of the following three factors:

- the futures price;
- the corresponding exchange rate for converting to Canadian dollars;
- the basis.

These factors change constantly and therefore the forward contract price fluctuates accordingly. Some buyers will offer a basis price and leave it to the seller to decide what futures price and exchange rate to use.

Basis is seasonal and will change depending on the months in question (see **Basis Levels in Cattle Markets**).

Each buyer may offer different levels of basis depending on their own specific requirements at that time. If a 'normal' basis for April was $5 per cwt under the April futures contract but a plant desperately requires supply, it may offer $4 under to attract additional sellers. Conversely, if a plant feels it has sufficient supply in April it may widen its basis to $6 under the April contract.

When forward contracting, shopping for the best basis is just as important as selling to the highest bidder when trading on the cash market. Monitoring basis fluctuations is important when forward contracting on a basis contract (see **Basis Levels in Cattle Markets**).

A basis contract is not fully complete until all components are decided and agreed upon, which includes the futures price, exchange rate and basis. If a basis value is accepted but the seller wishes to wait to price the futures market, then the final price remains unknown. Some buyers will only offer all three components at the same time. This means there is no waiting to price the other components later. With a basis contract the buyer is usually offsetting his position in the cash market for a position on the futures market.

Table 1. Calculating a basis contract.

Example 1: (using a $7 Canadian basis)	
Slaughter (live) cattle in April:	(price X exchange) - basis
	= ($75 US X 1.40) - $7.00
	= $98.00 delivered to buyer.
Example 2: (using a $5 US basis)	
Slaughter (live) cattle in April:	(price less basis) X exchange
	= ($75 US - $5) X 1.40
	= $98.00 delivered to buyer.
Example 3: (using a $1 US basis)	
Feeder cattle in August:	(price X exchange) - basis
	= ($71 US X 1.40) - $1
	= $98.40 delivered to buyer.

Flat (or cash) price contract

Sometimes matters are simplified by offering a flat price for a forward contract. Usually this means the buyer has already calculated the end price using the futures, exchange and basis. This net price is what is offered to the seller. It appears less complicated to the seller and can be quickly compared to the current cash market.

In calculating a flat price contract the buyer may or may not use the calculation used above for calculating a basis contract. For example, the buyer may be using the same figures in Example 1 but simply offer $97.50 per cwt. Or a buyer may have predetermined that to attract sellers he may have to offer a certain price. For example, if a feedlot needs cattle for August but $90 per cwt (feeder futures equivalent) does not seem to be attracting any cattle he may have to offer $95 per cwt. The price being offered is not directly related to the futures market - it is a reflection of what local supply and demand conditions are indicating. While it is useful to understand how the buyer established the price he is offering, it is not essential.

Flat price contracts may avoid using the futures market to base prices on. Sometimes another base is used such as a local price average, a four-or-five week rolling average, or any other acceptable 'base' price. This type of contract is more prevalent in forward contracting of feeder cattle and calves because in many areas and/or times of the year, the feeder cattle futures market may not be indicative of the expected local feeder market.

Cash contract may also be based on an independent or non futures price. A buyer may decide to use some variation (straight average, rolling average, etc.) of a well-known market price. For example, a backgrounder looking to buy fall calves may offer a four-week rolling average of the Canfax or Agriculture Canada average feeder price for a specific weight category. The rolling average tends to 'flatten out' any weekly fluctuations that may occur.

Forward Contract Specifications and Terms

All types of forward contracts contain specifications and terms that vary for slaughter and feeder cattle. This section summarizes the specifications and terms that can be found in slaughter and feeder cattle contracts.

Slaughter cattle

A slaughter cattle contract may contain specifications and terms referring to: grade, weight, yield, sex, conformation type, delivery date, delivery points, weighing conditions (shrinkage, stand, tag), and freight expenses. The discounts for cattle not meeting contract specifications and their affect on the settlement price may or may not be pre specified in the contract. If they are not specified, then the discounts at the packing plant on the day the cattle are slaughtered will prevail.

Contract specifications vary from plant to plant and between Canadian and United States plants. The grade, weight, and yield requirements (as well as off grades) can significantly differ between the two countries because of different grading systems. For example, Packer 1 may require minimum specifications on slaughter steers of 65% yield grade 1, 30% yield grade 2, 5% yield grade 3, 600-750 lb carcass and 59.5% hot yield. While Packer 2 may call for 50% yield grade 1, 40% yield grade 2, 10% yield grade 3, 600-800 lb. carcass and 60% hot yield. Meanwhile an US packer may have specifications of 70% Choice, 25% Select, 5% other grades, 600-900 lb. carcass and 63.5% US hot yield. It is important to clearly understand what is required of the seller to meet all the contract specifications.

Feeder cattle

Contract specifications and conditions vary greatly for feeder cattle because there is no standard grading system and it is more difficult to describe feeder cattle. A buyer will look at type, sex, conformation, frame size, degree of flesh, weight, feeding/grazing program, etc., before offering a contract price. As with slaughter cattle, delivery date and point, weighing conditions and freight expenses are also predetermined. Weight specifications will depend on access to an approved scale, shrink and length of stand. All these factors should be included in weighing conditions of the contract. Buyers may often wish to view the cattle before offering a price.

Some type of flexibility should be allowed in the contract specifications to accommodate special circumstances. These are referred to as default conditions. For example, severe drought conditions which make it necessary for cattle to be moved off pasture earlier than expected could also make it very difficult for a seller to adhere to the contract specifications. In these unusual situations it is in the best interest of both the buyer and the seller to remain flexible. It is important to remember, however, that all forward contracts are legally binding agreements and not adhering to the requirements may result in legal action by either party.

Decide When to Forward Contract

Buyers

There are several reasons why buyers (packers or feedlots) may want to forward contract. These reasons include:

- securing their supply in advance;
- establishing a price in advance (limits upside price risk);
- can be selective on the cash market if other supplies are contracted;
- distribute delivery more evenly;
- able to specify type and weight of cattle.

By contrast, there are also reasons why buyers would not want to forward contract. These reasons include:

- can affect ability to manoeuvre on the cash market when supplies are mostly contracted;
- reduces opportunity to buy cheaper cattle should the chance arise.

Sellers

The seller of the cattle (a cow/calf producer, backgrounder or feedlot operator) will also have various reasons to forward contract. These reasons include:

- securing a buyer in advance;
- establishing a price in advance (limits downside price risk);
- may help in financing requirements;
- less initial capital required and no margin calls compared to hedging (also no brokerage fees);
- take advantage of strong prices or good basis at any time (whether marketing or not);
- forces seller to keep marketings current.

As with buyers, there are also times when forward contracting might not be the most suitable alternative for a seller. These reasons include:

- eliminates option of selling to other buyers;
- limits potential price increases;
- offered price does not meet profit requirements;
- cattle which fail to meet contract specifications could be subject to large discounts;
- seller who forward contracts an US price still faces exchange rate risk if it is not locked in;
- production risk, if contract cannot be fulfilled;
- wide basis.

There are obviously several advantages and limitations for buyers or sellers when contemplating forward contracting. It is important for all participants to fully understand what is required of them, to know current market conditions (and basis) and breakevens. Unlike hedging, a broker is not required, and a producer can do the contract work at no extra cost.

Examples of Forward Contracting

Example 1 - slaughter cattle

Conditions: It is February 15. A feedlot owner is finishing steers that will be ready for market in April. The breakeven on these steers is $90.00/cwt Packer A is offering a basis of $5.00 US under April. The April futures market is at $74.00 US. The exchange rate is $0.71. Freight to Packer A is $1.50/cwt Therefore, the calculation to determine the final price is:

$74.00 US less $5.00 US (basis) = $69.00 US

$69.00 US ÷ 0.71 = $97.18 Cdn.

$97.18 - $1.50 (freight) = $95.68/cwt F.O.B. feedlot

The feedlot owner in this example assumes that the cattle will need $1.50/cwt for grading costs (cattle that do not meet contract specifications).

$95.68 - $1.50 (grading) = $94.18/cwt actual

$94.18 - $90.00 (breakeven) = $4.18/cwt profit

The feedlot manager decides that a $4.18/cwt profit is reasonable and books one load for an April contract.

Results: The steers are shipped the second week of April. The cattle are all in the ideal weight range (no weight discounts) but grade with more finish than anticipated and the final grade discounts work back to $2.00 per cwt rather than to $1.50 per cwt first estimated by the feedlot owner.

$95.68 - $2.00 = $93.68/cwt actual

$93.68 - $90.00 (breakeven) = $3.68/cwt profit

Example 2 - backgrounder cattle

Conditions: It is early May. A producer has 125 grass steers that weight 550 lb. He wants to forward contract them for September and expects to put 300 lb. gain on them between May and September. The breakeven on these steers is $104.00 per cwt at 850 lb. Feedlot Z is offering a forward contract for September of $105.00 per cwt and a 0.05 sliding scale based on

850 lb. (see **Electronic Marketing of Cattle** for a complete discussion on sliding scale pricing). This means that for every pound over or under 850 lb. the price is adjusted up or down by $0.05 per cwt He contracts the cattle with the feedlot.

Results: The cattle are moved early in September. A two percent shrinkage from the weight measured on the feedlot's scale had originally been agreed upon as well as the producer paying the freight. The net weights and prices after shrinkage end up as follows:

75 head X 850 lb. X $105.00/cwt = $ 66,937.50
10 head X 870 lb. X $104.00/cwt = $ 9,048.00
10 head X 900 lb. X $102.50/cwt = $ 9,225.00
10 head X 830 lb. X $106.00/cwt = $ 8,798.00
20 head X 800 lb. X $107.50/cwt = $ 17,200.00
125 head total $111,208.50
Average weight: 846 lb.
Average price: $105.16/cwt
$105.16 - $2.00 (freight) = $103.16/cwt net
$103.16 - $104.00 (breakeven) = $-0.84/cwt loss

Example 3 - calves

Conditions: It is July 10. A cow/calf operator has 200 calves (100 steers and 100 heifers) that will be weaned in mid October. Rather than ship the calves and take the going price for that day he decides to look into forward contracting. After checking around, he finds a reputable local order buyer who forward contacts calves (his customers are both finish feeders and backgrounders). He bases his contract on a four-week rolling average of the Canfax average feeder prices in central Alberta. The prices from the two weeks before the calves are shipped and the two weeks after are averaged to get the price on the appropriate weight category. At that time the cow/calf manager accepts the contract he also agreed on weighing conditions, price conditions (sliding scale) and freight.

Results: The calves were shipped October 20 and the steer average weight was 550 lb. while the heifers were an average of 450 lb. The following averages were reported by Canfax:

	500-600 lb steer	400-500 lb. heifers
Week 40	$115.97 per cwt	$114.94 per cwt
Week 41	$111.88 per cwt,	$117.00 per cwt
Week 42	$113.10 per cwt	$114.78 per cwt
Week 43	$115.90 per cwt	$116.28 per cwt
4-week rolling average	$114.21 per cwt	$115.75 per cwt

The following companies routinely offer forward contracts on slaughter and/or feeder cattle. However, other larger feedlots will offer forward contracts when the need arises. Therefore, when selling feeder cattle, contact all local feedlots as well.

Slaughter and Feeder Contracts

✓ Lakeside Packers and Feeders
Brooks, Alberta
Contact: Lonnie Wigemyr, (403) 362-3326

✓ Nilsson Brothers
Clyde, Alberta
Contact: Keith Stickney, (780) 348-5893

Feeder Contracts

✓ Western Feedlots
Strathmore and High River, Alberta
Contact: Dave Moss, (403) 601-8651

Slaughter Contracts

✓ Cargill Foods
High River, Alberta
Contact: Bruce Hepburn or Sherri Marthaller, (403) 652-8406

✓ XL Beef
Calgary, Alberta
Contact: Rod Couglin, (403) 215-7685

✓ Iowa Beef Processors
Pasco, Washington
Contact: Harvey Dann or Jackie Dann,(800)665-2494

✓ Packerland
Hospers, Iowa - HOLSTEINS ONLY
Contact: Harvey Dann or Sherri Dann,(800)665-2494

✓ Cantriex (E.A. Miller Beef)
Hyrum, Utah
Contact: Tony Saretsky, (403) 783-5528

Other businesses in Western Canada offering contracts

✓ Alert Agri Distributors (Alberta), Inc.
Box 17, Group 242, RR2, Winnipeg MB R3C 2E6
Contact: Harvey Dann, Jackie Dann, (800)665-2494 or (204)941-3914

Cattle Contracted: slaughter steers and heifers and slaughter Holsteins, all for US plants.

Contracts: basis and flat price contracts

Contract Currency: US dollars

Representing; Iowa Beef Processors, Dakota City and Pasco

Exchange Lock: yes, lock US$ exchange rate

Comments: US slaughter contracts can lock in Choice-Select spread

✓ Cantriex Livestock International, Inc.
RR4, Ponoka AB T4J 1R4
Contact: Tony Saretsky (403)783-4477

Cattle Contracted: slaughter steers and heifers

Contracts: basis and flat price contracts, but prefer flat price contracts

Representing: E.A. Miller, Hyrum Utah

Contract Currency: US dollars Exchange Lock: yes, lock US$ exchange rate.

Comments: Primrose Livestock, Picture Butte and Kasko Livestock, Lethbridge are agents for Cantriex.

✓ Cargill Foods
Box 3850, High River AB T1V 1P4
Contact: Bruce Hepburn, Sherri Marthaller (403)652-8410

Cattle Contracted: slaughter heifers and steers for the High River plant

Contracts: basis and flat price contracts

Currency: Canadian dollars

Comments: contracts are paid out in Canadian dollars but basis is quoted in US dollars.

✓ Grasslands Cattle Company
Box 1790, Yorkton SK S3N 3R2
Contact: Myron Tartaniuk (306)783-3737

Cattle Contracted: feeder steers and heifers

Contracts: basis and flat price contracts

Representing: Lakeside Feeders, Brooks

Contract Currency: Canadian dollars

- ✓ Greiner and Sons Livestock
  Box 333, White City SK S0G 5B0
  Contact: Terry Greiner, Scott Greiner (306)352-1636

  Cattle Contracted: feeder and slaughter steers and heifers

  Contracts: basis and flat price contracts

  Representing: Monfort, Inc., Greeley and Grand Island for slaughter cattle, Canadian feedlots for feeders

  Contract Currency: US dollars for slaughter, Canadian dollars for feeders

  Exchange Lock: yes, lock US$ exchange rate for slaughter cattle

- ✓ Heartland Livestock Marketing Services
  Box 37, Regina SK S4P 2Z5
  Contact: Jamie Christie (306)757-5350

  Cattle Contracted: slaughter steers and heifers primarily for US plants, feeder steers and heifers for Canadian or US feedlots

  Contracts: basis and flat price contracts

  Contract Currency: feeders in US or Canadian dollars, slaughter in US dollars

  Exchange Lock: yes, lock US$ exchange rate.

- ✓ JGL Livestock
  Box 40, Moose Jaw SK S6H 4N7
  Contact: Bill Jamison (306)692-4911

  Cattle Contracted: feeder and slaughter steers and heifers

  Contracts: basis and flat price contracts

  Contract Currency: U.S.or Canadian dollars for slaughter and feeder cattle

  Exchange Lock: yes, lock US$ exchange rate.

  Comments: US slaughter contracts quote basis in US dollars

- ✓ Lakeside Feeders
  Box 800, Brooks AB T1R 1B7
  Contact: Lonnie Wigmeyer (403)362-3326

  Cattle Contracted: slaughter and feeder steers and heifers

  Contracts: basis and flat price contracts

  Representing: IBP-Lakeside

  Contract Currency: Canadian Dollars

  Comments: IBP-Lakeside doesn't do any contracting for US IBP plants.

✓ McCarthy Cattle, Inc.
3501 57 St. Camrose AB T4V 4N2
Contact: Pat McCarthy (780)672-2990 or (cellular) (780)679-8999

Cattle Contracted: slaughter and feeder steers and heifers, also slaughter Holsteins. McCarthy also offers basis contracts for calves delivered in September.

Contracts: basis and flat price contracts

Contract Currency: dollars for US contracts, Canadian dollars for Canadian buyers.

Exchange Lock: yes, lock US$ exchange rate.

✓ Nilsson Bros., Inc
Box 119, Clyde AB T0G 0P0
Contact: Keith Stickney (780)348-5893 or (780)348-5898

Cattle Contracted: feeder and slaughter steers and heifers

Contracts: primarily flat price contracts but some basis contracts

Representing: XL Foods, Calgary; Alsask Beef, Edmonton and Monfort, Inc., Greeley, Colorado

Contract Currency: feeder cattle and XL and Alsask slaughter cattle in Canadian dollars, Monfort, Inc. in US dollars

Exchange Lock: yes, lock US$ exchange rage

✓ Porter and Maclean Cattle Company
3381 Gershaw Dr. SW, Medicine Hat AB
Contact: Rick Porter, James MacLean (800)794-5305 or (403)528-2991

Cattle Contracted: slaughter and feeder steers and heifers plus backgrounding contracts

Contracts: basis and flat price contracts, but prefer flat price contracts

Contract Currency: feeders in Canadian dollars, slaughter in US or Canadian dollars

Exchange Lock: yes, lock US$ exchange rate.

✓ Three J Livestock
Box 239, Coaldale AB T1M 1M3
Contact: Ron Chizmazia (403)345-3853 or (cellular) (403)380-9588

Cattle Contracted: slaughter steers and heifers

Contracts: basis and flat price contracts

Representing: Washington Beef Inc., Toppenish, Washington

Contract Currency: US dollars

Exchange Lock: yes, lock US$ exchange rate.

- ✓ Weiller and Williams, Ltd.
  5301 127 Ave, Box 1240, Edmonton AB T5J 2M7
  Contact: Jennifer Wood (780)476-1346

  Cattle Contracted: feeder steers and heifers

  Contracts: basis and flat price contracts

  Representing: Lakeside Feeders

  Contract Currency: Canadian dollars

- ✓ Western Feedlots, Ltd.
  Box 5279, High River AB T1V 1M4
  Contact: Dave Moss (403)652-3933 or (403)601-8653

  Cattle Contracted: feeder steers and heifers

  Contracts: basis and flat price contracts

  Representing: Western Feedlots

  Contract Currency: basis contracts in US dollars, flat price contracts in Canadian dollars.

  Exchange Lock: yes, lock US$ exchange rate.

  Comments: Western will also arrange basis or flat price contracts for slaughter cattle being custom fed in their lot.

Summary

As the desire to minimize risk in the cattle industry increases, forward contracting is becoming an acceptable marketing alternative. There are two main types of contracts offered and both may contain many different specifications and terms. When entering a forward contract, producers must understand all the specifications required for the cattle and how the price will be adjusted if the specifications are not met. It is important to understand that this is a legal contract and all terms should be clearly identified.

Most types of cattle can be forward contracted provided they are supplied in load lots of uniform type. There are several different companies in Alberta and US Northwest that offer contracts for both slaughter and feeder cattle. These companies will go through their specific contracts, step by step, thereby ensuring all parties understand their responsibilities.