

## The Trouble with Flat Priced Pools



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## Table of Contents

Flat Priced Pools .....	3
Flat Priced Pools with a Single Desk.....	3
Pool Return Outlooks .....	3
Initial Payments .....	4
Flat Priced Pools in an Open Market .....	5
Price Signals .....	6
Basis Pools Can Work.....	6
References .....	9

# The Trouble with Flat Priced Pools

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## Flat Priced Pools

The CWB pooling system is often criticized that it can't react to changes in market prices. This is because the CWB's pools have a flat price attached to it. There are actually two prices; the Initial Payment and the Pool Return Outlook. Both can change over the course of the crop year, but they are meant to reflect the weighted average of all sales made in the pool.

In each crop year, the CWB offers five different pools to farmers; non-durum wheat (which includes spring wheat, winter wheat and other minor classes of wheat), durum wheat, designated barley (used primarily for the production of barley malt), and two feed barley pools. Each of these pools provides a flat price to farmers. The term "flat price" refers to the fact that the price is an "all-in" price, representing the whole price provided to farmers. Being a pooled price, it also represents the weighted average of all sales made by the CWB throughout the pool period, taking into account all market situations through the pool period – low market prices, high market prices, and everything in-between.

This characteristic of the CWB's pools is also the reason that CWB single desk supporters suggest a voluntary CWB will not work. It all comes down to the fact that the pool prices provided to farmers are flat prices that don't change in step with the market.

## Flat Priced Pools with a Single Desk

### Pool Return Outlooks

Prior to the start of a crop year the CWB begins its monthly release of its Pool Return Outlook (PRO), the CWB's best estimate of the final return in the pool account for the upcoming year. PROs are usually issued on the fourth Thursday of every month. The first PRO is released in February, before seeding has even taken place, and continues each month until March of the following calendar year. After that, PROs for wheat, durum and malting barley are issued every other month until September (March, May, July and September). The feed barley PRO continues on a monthly basis.

The CWB defines the PRO as "the weighted average of (priced grain + forecasted prices on unpriced grain)"<sup>1</sup>. As such the PRO is a projection of how much money the CWB expects to return to farmers who delivery the specified grain to the CWB.

According to the CWB, "The PRO is designed to give farmers market signals and to provide an indication of cash flow expectations. It gives farmers an idea of what pooled payments to expect. It provides a sense of the movements in spreads between the various classes and grades of grain. It can also be used to help decide when to take advantage of off-board markets or use Producer Payment Options to manage individual price risk."

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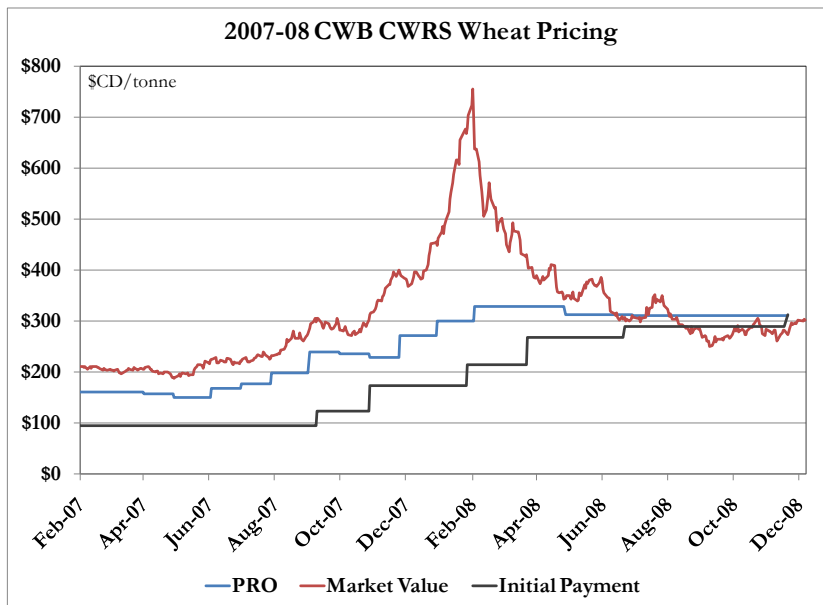
<sup>1</sup> <http://www.cwb.ca/public/en/farmers/outlooks/what/>

## Initial Payments

The CWB starts each crop year pool price with an Initial Payment, usually released around August 1<sup>st</sup>, the first day of the crop year. This is the amount the CWB guarantees farmers for their grain delivered into a specific pool and is the amount paid on delivery.

According to the CWB, “The initial payment represents only a portion of the total expected value of the grain. When market circumstances warrant, farmers may also receive adjustment, interim and final payments. Adjustment payments occur during the course of a crop year when increases are made to initial payments. Only farmers who delivered prior to the initial payment increase would receive an adjustment payment. An interim payment is paid after the end of a crop year and is like an advance on the final payment. Final payments represent the remaining portion of money still owing to farmers after all crop year marketing costs have been deducted.”<sup>2</sup>

Both Initial Payments and PROs lag the actual market price activity, particularly notable in years of high volatility. A good example of this is 2007-08, when wheat prices were very strong through the first half of the crop year and much weaker later in the crop year. The chart below graphically shows the market price activity (using the DTN spring wheat average street prices) and the CWB Initial Payments (with Adjustments) and CWB PRO.

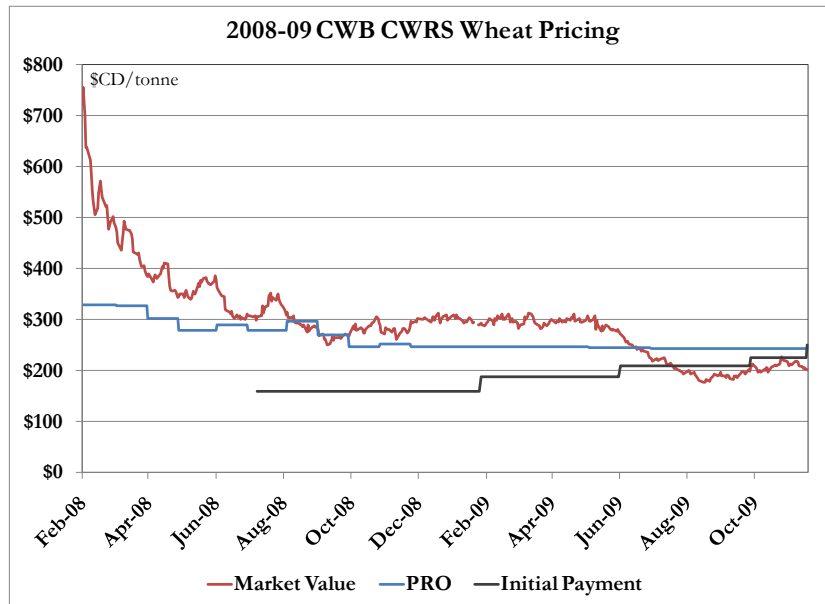


This chart shows clearly how the CWB’s pool prices (Initial Payment and PRO) do not track or reflect market price changes over time. This is considered by many to be the main impediment of CWB pricing to be relevant price signals.

The following chart shows similar data for the 2008-09 crop year – a year a declining prices. Here too it can be seen that CWB price signals (Initial and PRO) do not track the actual market. Interestingly, here the CWB anticipated the drop in prices as demonstrated by the low PRO in the initial months. Also, it is noted that, even though the PRO tends to be set conservatively (low), the PRO exceeded the market value for brief

<sup>2</sup> <http://www.cwb.ca/public/en/farmers/payments/>

periods, particularly toward the end of the pricing period as most sales in the pool would have been made yet the spot market prices continued to slide lower.



## Flat Priced Pools in an Open Market

As mentioned above, CWB single desk supporters suggest a pooling with a voluntary CWB (open market) will not work. Their position is based on the assertion that farmers will respond to market signals and given the choice that an open market would provide, they will opt in and out of the pool when the prices indicate. For example, it is suggested that farmers will opt into the pool when the PRO is above the market price (and the market appears to be heading even lower); additionally, the theory is that farmers will opt out of the pool when the market price is higher than the PRO (and Initial Payments).

In other words, when the market is moving higher farmers will opt out of the CWB pool since it would likely show a lower return (PRO). Conversely, in a down-trending market, there is the possibility that the PRO would be higher than the spot market.

Applying this theory to the two crop years in the charts above, the theory suggests that in 07-08 farmers would have opted out of the pool as the open market price was higher than the PRO and the Initial Payment and moving higher. This argument could be extended to suggest that in a year like 07-08, a voluntary CWB pool would not attract any wheat at all due to an uncompetitive price. If that were the case, the CWB would not be able to offer a meaningful PRO either, particularly early in the crop year.

In a year of declining prices such as 08-09, CWB supporters argue that the pool would be more attractive than the open market. However, the chart above suggests otherwise; even with declining prices, the Initial Payment is set so low as to ensure the market price doesn't go below it, thereby negating it as being an attractive price signal, even in a declining market. Also, the PRO was set low as well. It could be argued that the CWB could err in its forecasts and provide a PRO that is too high and unsustainable. In that event, the PRO would eventually come down through the year; since the PRO is not a price guarantee, this would not

represent a financial risk to the CWB, although it would come under considerable criticism is the PRO were to drop substantially.

It all comes down to the fact that the pool prices provided to farmers are flat prices that don't change in step with the market. When CWB single desk supporters suggest that farmers will only stay in a pool when the price is higher than the open market price, they are assuming that the structure of a voluntary market would allow farmers to freely opt for one marketing option or the other. Although beyond the scope of this report, it can be assumed that contractual obligations can be set up to mitigate the type of migration that single desk supporters fear.

## Price Signals

Pool prices are flat prices and cannot adjust with the underlying market, particularly in volatile time (when you need price signals most). Unfortunately, this means that pools with this price structure are minimally effective as price signals and fall short of the CWB's stated purpose of the PRO. The CWB suggests the PRO is:

“...designed to give farmers market signals and to provide an indication of cash flow expectations. It gives farmers an idea of what pooled payments to expect. It provides a sense of the movements in spreads between the various classes and grades of grain. It can also be used to help decide when to take advantage of off-board markets or use Producer Payment Options to manage individual price risk.”

In this regard, since the pool return (PRO) is partly based on flat price sales already made, it become more of a function of what the CWB has sold and not a reflection of the market. To the extent that the PRO could be wrong (particularly early in the crop year, when price signals are needed most), the PRO as market signals can fail farmers substantially.

## Basis Pools Can Work

For the most part, the price of grain is made up of futures and basis. For example, for every sale of spring wheat made by the CWB, the futures at the time of sale can be easily determined and by subtracting this futures price from the sale price, the basis can be determined as well. (Often sales are made as a basis, to be priced using the appropriate futures contract at the time.)

Since the futures prices are truly market prices, any premium the CWB is able to get in the course of making wheat sales is not reflected in the futures – it is only reflected in the basis. The CWB can't get a better futures price for farmers – just a better basis. In other words, the benefit of the CWB marketing effort is reflected in the basis only, not the futures.

By guaranteeing a flat price to farmers through the Initial Payment and making sales on a flat price basis for the pool, the CWB is accepting much larger risk on behalf of farmers than necessary. Because of this large market risk, the CWB is forced to set the Initial Payment very low (something like 60% of the expected pool return) and the PRO tends to be conservative as well. Setting the Initial Payment low enough to manage this risk means farmers get less on delivery, reducing their cash flow from CWB sales.

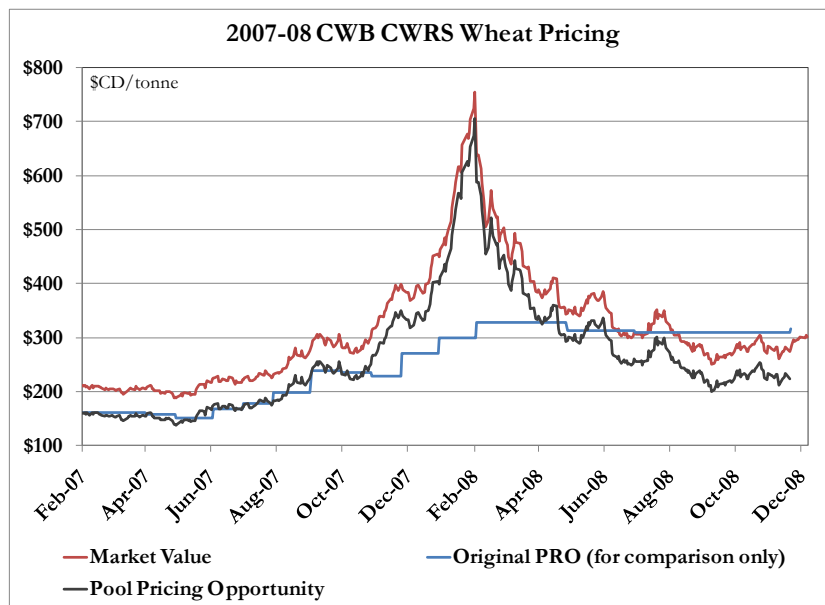
One option that would make pooling in a voluntary market (open market) work well is the concept of the basis pool. In this type of pool, all farm contracts with the CWB would begin as a basis contract. The basis

would be guaranteed by the CWB but nothing else. There would be no guaranteed Initial Payment. the price provided by the CWB would be a basis only.

Guaranteeing only the basis would mean less risk to the CWB. A typical basis (on CWB sales) to the appropriate futures market could be identified and the potential range of that basis calculated. The CWB could advise as early as seeding time what the basis would be for all classes and grades of wheat and barley. Because the CWB would be guaranteeing only a basis, the risk to the CWB would be greatly reduced.

Just like the current Initial Payment, the Initial Basis would be guaranteed, meaning it would never go down. And there would be final payments (based solely on the difference in the basis sold compared to the initial basis).

Farmers would sign up deferred delivery basis contracts with the CWB at the beginning of the year – just like they do with grain companies on canola. And just like the non-CWB market, the contract would be priced at a time of the producer's choosing (not at the CWB's discretion).



This chart shows the price impact for farmers with the Initial Basis concept if it was made available during the 07-08 crop year. This assumes a simple basis of \$50 under futures (at the farm gate). The black line shows how the price opportunity to farmers would change as the market changes. Although there would be no need for it with an Initial Basis, the PRO for this year is also shown for comparison only; it should be noted how much better the price opportunity to farmer is with the Initial Basis.

With an Initial Basis farmers would price to the market according to their own thoughts and needs; the CWB would simply transmit those pricing orders and hedge accordingly (just as a grain company does with canola).

Beyond offering a competitive and meaningful price in an open market (and one that changes as the underlying market prices change), there are other benefits:

- It could be very effective in a voluntary market.
- Farmers could get paid on delivery a higher proportion of the final sale value, helping with cash flow.

- The CWB would have much less risk making it easier for the CWB to manage its risk (therefore it would cost less).
- There would be no need for complicated PPOs.
- The CWB could offer shorter pooling periods.
- Farmers could opt into the pool at any time with no additional risk to the CWB.
- The CWB could offer pricing off the different futures contracts which would allow for better price signals for deliveries. For example, if there was a price advantage to deliver in the spring instead of the fall, the price would provide that incentive.
- Farmers that want just a flat price initial (as they have now) could get that from the CWB too.
- Better price discovery and transparency; better price signals.

## References

CWB PROs: 2007-08 and 2008-09

<http://www.cwb.ca/public/en/farmers/outlooks/what/>

CWB Payments: 2007-08 and 2008-09

<http://www.cwb.ca/public/en/farmers/payments/>

Market Values: DTN street prices

[http://www.mgex.com/history/historical\\_new.cfm](http://www.mgex.com/history/historical_new.cfm)