



Ag Concepts Unlimited Pty Ltd

ACN 109 746 278
ABN 81 109 746 278

AFSL 316516

23rd February 2015

200 Skipton Street
Ballarat Vic. 3350
Postal:
PO Box 498W
Ballarat West Vic. 3350
e-mail: info@agconcepts.com.au
Ph: 1300 987 742
Fax: 03-53337762

Australian Wool Innovation “Wool Selling System Review” (WSSR) submission.

Ag Concepts Unlimited P/L (ACU), market analysts and risk management advisors, and as a founding broker of Riemann Wool Forward Contract (Riemann), make the following submission to the WSSR, focusing on the identified areas of the WSSR relevant to ACU & Riemann Wool Forwards. Broadly these are:

1. **Risk management** - Assess the adequacy of different risk management strategies available to greasy wool sellers and buyers.
2. **Improve risk management adoption** - Identify any alternative strategies (private & industry) that would enable the cost effective management of price risk by wool sellers and buyers.
3. **Increase competition** - Identify any strategy that could be implemented by either private parties or industry bodies to increase competitive pressure in the selling and buying of wool through time and/or at different locations.
4. **New sale initiatives** - Identify any market reforms to the sale of greasy wool that would lead to a cost reduction in associated transfer costs.
5. **General** – Other issues and ideas relevant to this WSSR and based on ACU/Riemann expertise.

Background to Ag Concepts & Riemann.

Ag Concepts Unlimited P/L is an independent, specialist Agricultural advisory service with its focus firmly on the financial enhancement of primary production and price risk management.

The company was established by Robert Herrmann in Adelaide in 1996, following 11 years as District Wool Manager (Hamilton) and in Head Office (Adelaide) with Elders Ltd.

With a strong background in agriculture, ACU's commitment was to deliver a high quality proactive risk analysis and management service to clients. The formation of ACU was in response to the changing landscape of the wool industry post Reserve Price Scheme and has since expanded into the areas of livestock and grain price risk management.

The service includes in-depth analysis regarding futures and spot markets in wool, livestock and grain. ACU also composes forward selling/buying strategies for its clients and identifies suitable times to implement these strategies by using Futures Exchange traded contracts as well as Bank Commodity Risk Management products and various other forward contracts.

ACU's qualities and initiatives result in continued demand for their independent and valued opinion in the Agricultural Sector.

Riemann Wool Forward Contracts provide a transparent forward contract for wool producers via their wool broker to trade Wool Forward Contracts. The contracts are deliverable to the brokers' store with settlement managed by the wool broker. Riemann Wool Forward Contracts began trading in 2011 in response to industry requests to fill a void previously filled by Macquarie Wool Futures and CBA Wool Swaps.

Ag Concepts submission to the Wool Selling System Review

Submission.

This submission will focus only on the areas of the WSSR where ACU& Riemann have direct involvement in the wool industry, have extensive experience or where ACU & Riemann believe they can add value in future wool sale models.

1. Risk Management.

At the present time only Riemann Wool Forward contracts are available to wool producers wishing to manage price risk. Key features of Riemann Wool Forward contracts are:

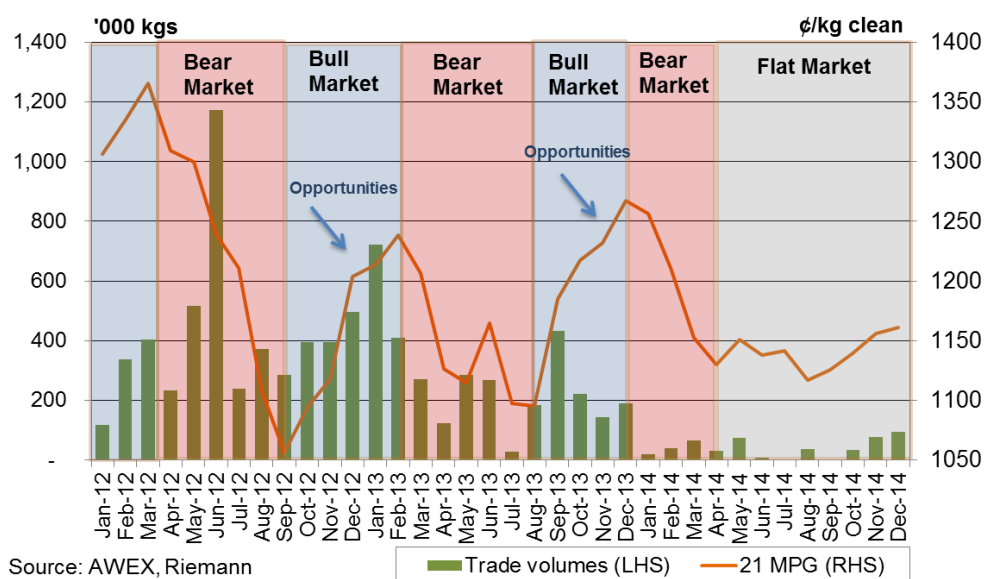
- Counter parties are Wool Brokers (representing the wool producer) & Wool Exporters
- An easy to access price risk management product for wool producers and wool exporters.
- Transparency of price with Bids & Offers displayed.
- Wool grower only required to deal with their nominated wool broker.
- Delivery is to the broker's wool store.
- Not margined / not cleared
- Bilateral credit risk agreed prior to trading
- Trading anonymity to the point of matching bid & offer (based on the credit matrix)
- Counterparties disclosed to wool broker & buyer only after matching
- Less global in nature than futures contracts (ie difficult to get global firms involved).
- Domestic and early stage wool industry participants only.
- No speculators / no retail participation.

Riemann Trading history.

To date wool producers have placed sell orders on Riemann via their nominated wool broker. The orders placed have generally been at the high end of recent wool market traded levels; this has resulted in “lumpy” trade volumes with the market stagnating when auction wool prices retreat while trade is vibrant when the market rallies.

Figure 1 shows the volumes traded in the Riemann forward market since Jan 2012 alongside the 21MPG price (¢/kg clean). A bull, or increasing, market offers growers a good opportunity to secure prices, in graduating steps as the market moves higher, in advance. The objective is to lock-in prices for wool delivered in the future to protect against future market falls, thereby hedging their wool price.

Figure 1. Wool prices and traded volumes



Source: AWEX, Riemann

In early 2012, the rise in price was accompanied by an increase, albeit slightly delayed, in forward contracts traded on Riemann. This was repeated again in late 2012, although this

Ag Concepts submission to the Wool Selling System Review

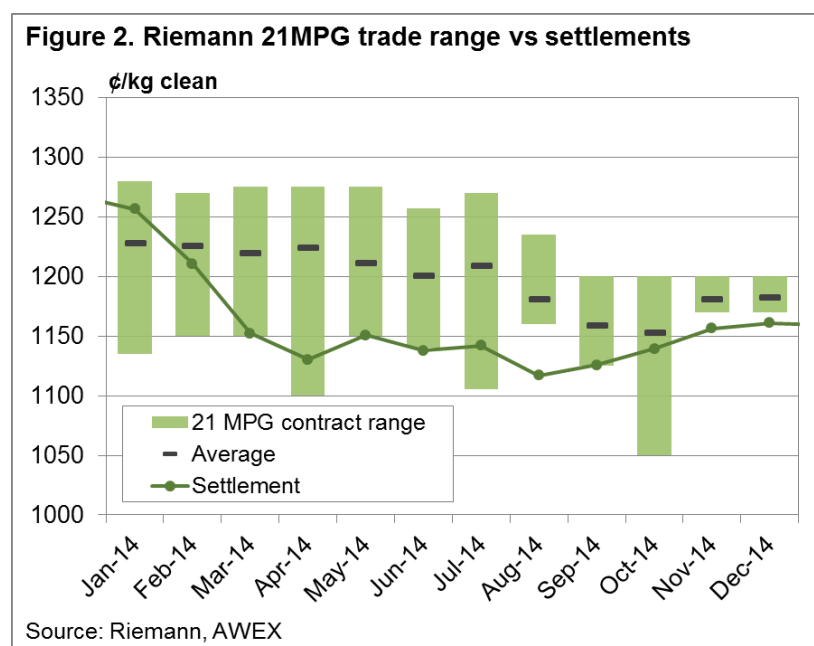
time growers were able to respond more quickly to the increasing price (possibly through greater awareness and understanding of the Riemann market).

In contrast, in late 2013, when price increased significantly, growers failed to take advantage of the higher prices to minimise their forward price risk. The subsequent downturn in the wool market exposed the opportunity that was presented and largely missed in the wool forward market by wool producers. Had growers traded forward when the market was increasing, they could have locked away prices around 1200 to 1250¢/kg clean for all months to December 2014.

Less than 1% of the Australian clip is currently forward priced with Riemann contracts holding the vast majority of forward sales.

Despite the relatively benign trading conditions for 2014, growers hedging for delivery in 2014 received on average a benefit compared to not forward selling.

Figure 2 shows the price range, and average price, for 21MPG contracts, as well as the settlement price for each maturity. At the top of the range, contracts were traded at around 1270-80¢/kg clean with settlements between January and July, before easing to 1200¢/kg clean in spring/summer. At the lower end of the scale, prices varied largely between 1100 and 1150¢/kg clean for most months. Taking the average traded price as a benchmark to represent an 'average hedge outcome', in 11 out of 12 months sellers received an extra 15-94¢/kg clean, or roughly 2-8%, above the physical market rate. For producers selling at the top of the range, proceeds were lifted by up to 100¢, or 13%. On the other side of the ledger, trades executed at the bottom of the range settled up to 9.5% below physical rates. A full analysis is available at <http://www.mecardo.com.au/commodities/wool/analysis/riemann-wool-forwards-in-2014.aspx>



2. Improve risk management adoption

Wool producers have used Riemann largely as an offer board attempting to capture rallies. While in essence there is nothing wrong with this strategy; the market at any time should include a percentage of wool producers (and wool exporters) who are seeking to manage risk and to lock in prices.

A consequence has been that the producer has generally acted as a trader as opposed to a price hedger. As a trader, they have looked to pick the highs of the market while the strategy of managing price risk using *Cost of Production* and *Return on Equity* as the basis for setting price targets has not been prevalent.

Ag Concepts submission to the Wool Selling System Review

A need exists for wool producers and their advisors (wool brokers) to learn the principles of managing commodity price risk, and to become proficient in applying those principles to their wool business.

Improvement in advisory services by wool brokers in the area of Price Risk Management advice would enhance the understanding by wool producers of the opportunities in the wool forward market. It would also build a valuable skill set in the wool advisory services of wool brokers.

There is a history of “Price Risk Management” workshop delivery in the wool industry; however recent lack of activity in the forward markets suggests that the industry is not conversant with applying risk management principles to a hedge strategy.

The following is proposed:

Price Risk Management Workshops be made available by AWI, presented and facilitated by experienced industry participants and Cert 4 Workplace Training accredited workplace trainers.

- I. Initial training delivered in a series of three (3) one-hour webinars. This will foster a supported learning environment.
 - Webinars to be supported by workshop notes – delivered electronically but with option to print.
 - Webinars and supporting notes both branded as an AWI resource.
 - All webinar participants to be surveyed on value and knowledge following attendance.
 - Webinars to be recorded and posted on AWI website.
 - Promoted through wool brokers as well as directly to wool producers via wool grower groups
- II. Additional interactive training workshops provided.
 - One day workshops focusing on risk management strategy.
 - Presented regionally via “wool grower groups”.
- III. Funding.
 - AWI to support the design and preparation of workshop program and notes.
 - Full “cost recovery” via training funding (Federal & State)
 - Management via approved Registered Training Organisations (RTO’s).

The following topics are proposed:

1. How to identify risk and its effect on the wool producing business.
 - a. Do I need a risk management program?
 - b. What is hedging?
 - c. What are the possible scenarios
 - i. If I hedge?
 - ii. If I don’t hedge?
2. Calculating your cost of production – a simple way to get a handle on your COP (use AWI COP Calculator)
3. Forward contracts
 - a. How do they work?
 - b. What are your obligations?
 - c. How are they settled?
 - d. What if my wool varies from what I expected/contracted?
4. Strategy and setting targets to manage risk and take advantage of opportunities
 - a. How do I know when and how much to forward sell?
 - b. How to set a price target?
5. Following the market
 - a. What information is available?
 - b. What information do I need?

Ag Concepts submission to the Wool Selling System Review

- c. How do I access and interpret it?
6. Putting it all together
 - a. Developing an action plan
 - b. Monitoring your trade
 - c. Execution
 - i. What are the basics of putting a trade in place?
 - ii. What type of market orders can be used?
 - iii. What is the role of my wool broker?

Industry benefits.

- I. Better management of price volatility by wool producers.
- II. Enhance planning for growers.
- III. Improve wool industry “business management” (encourage higher level executive involvement)
- IV. Provide larger volume of forward cover to exporters. (assist with forward commitment)

3 & 4. Increase competition & New sale initiatives

Currently participation in the wool purchase process is largely limited to buyers who are able to operate at the wool auction, engage an Australian wool buyer or exporter, or purchase privately either directly from the producer or a local merchant.

A commodity market with a reduced supply and potential price volatility (such as current wool market environment) can be attractive to a range of traders; however access to the market needs to be simple, transparent and secure.

The implementation of a Wool futures contract with appropriate margining and novation would provide access to potential buyers, processors, speculators & traders regardless of their current or previous wool industry connections.

It is acknowledged that wool futures contracts have at best had a chequered career, however a failure to update the SFE Greasy Wool Futures Contract, and a reliance on wool producers to support contracts were the main causes of failure. Properly constructed, industry accepted and commodity relevant futures contracts provide an important role in modern commodities today; wool should be able to also benefit.

Wool Futures Contract

The (proposed) contract should have the following features:

- Traded on a registered Futures Exchange
- 19.5 MPG reflecting the median of the Merino clip
- Margining, clearing and novation conducted through a registered Clearing House
- Total trading anonymity
- Attractive to a wider (global?) audience
- The option to make or take physical delivery
- Physical Delivery via Talman system
- Attractive to speculators and retail participants.

Importantly any contract should be targeted at providing a secure and transparent market that provides market access to producers, exporters, traders and speculators.

History shows that producers have proved unreliable in supporting commodity futures contracts, so the aim in providing essential liquidity to any proposed futures contract should be to engage other industry participants, banks and speculators.

A liquid futures market will then provide the platform for wool industry service providers to offer transparent, fair and user friendly forward contracts to wool producers.

Industry benefits.

- I. Provide alternative supply accumulation systems (deliverable contracts)
- II. Increase market participation (speculators, traders)

Ag Concepts submission to the Wool Selling System Review

- III. Provide a regulated market for existing buyers and sellers to trade.
- IV. Cross-hedging opportunities (Riemann Wool Forwards & this contract)

General

Forward Indicators.

Australian Commercial Banks operating in the rural sector would benefit from a forward wool price indicator on a daily basis to assess their risk exposure, help promote bank lending based on forward sales and provide advice to customers.

Better price risk management structures including forward indicators would facilitate advantages over other competing enterprises for finance and capital where price risk is not able to be managed eg. Prime Lambs vs Wool Production.

Wool Broker Services

The following comments are provided based on the experience as a wool broker over 11 years and the subsequent provider of services to the wool industry in the subsequent 18 years while observing the wool broker service model.

It should be noted that the primary purpose of the wool broker is to get a bale of wool into his/her company's wool store; and if that is not the primary purpose then his/her shareholders and management would be disappointed.

The accepted method of achieving this is to provide value add services to the wool grower, to whatever level it takes to encourage the wool producer to support his/her company.

Wool broker charges as disclosed on the wool growers account sales have not kept pace with either inflation or rising operating costs.

At the same time services to the wool grower are now at an all-time high, as brokers compete for a diminished wool clip.

For example, the number of wool broker representatives in Hamilton (formerly "The Wool Capital of the World") is not dissimilar from the early 1990's when national sheep numbers were almost 190 million. Added to the wool brokers resident in Hamilton is a number who regularly travel from the wool store to canvass for wool clips or provide grower services.

It is common practice for a wool producer to receive multiple visits from a variety of wool brokers during the year & around shearing time either to canvass for business, provide advice or because "I was just driving past so thought I would drop in!". When over-laid with livestock and merchandise rep's the wool producer has a busy driveway!

This system (cost) is unsustainable and offers little added value to the overall wool harvesting, clip preparation or selling that could not be provided using modern communication methods.

Rationalisation of wool brokers operating in regional areas, both in terms of the costs structure and personnel in much the same way as the wool export companies have in recent times, will reduce the cost to the wool industry and directly to wool producers.

In fact, in a survey of wool producers in Tasmania and Victoria ¹a common theme was that the wool grower considered there were too many visits, they often came when they were busy, were un-announced and the wool producers were concerned about the cost of this service.

Compounding this is the fact that more of the wool clip (X Bred wool) is considered a by-product of the sheep meat enterprise requiring less servicing of the wool clip, not more.

The problem is that this increased service model (over-servicing) is now entrenched as a method to win new business.

¹ Private survey commissioned by wool broker's and conducted by ACU, December 2008 & September 2011

Ag Concepts submission to the Wool Selling System Review

It is worth considering that up until the 1980's the specialist wool advice was provided from the wool store, with generally one visit to the farm per year during the wool recess. The development of the internet, mobile phones etc. has resulted in many other industries providing remote services and advice in a more cost effective model. The wool broker's service has not progressed in line with technology advances to reduce costs.

The service of providing market intelligence relating to special clip preparation is often used as an excuse for multiple visits on farm. While this is dubious at best, the lack of training and/or annual refresher courses by wool rep's means that the wool grower can receive conflicting advice. Often this doubtful advice is used as a reason to change from the existing broker with the grower selecting the advice that best suits him. The advice of what to "brand" or describe lines of wool is a classic example. It is not rational to argue that branding PCS as BKN will add value to the wool when surely the measured traits are the deciding factor of value; however this is a regular offering. Much of this advice is delivered in an attempt to enhance the reputation of the wool broker in the eyes of the wool producer; to either retain or secure the clip.

A wide variety of services are provided including clip preparation, sheep classing, ram selection, wool store visits etc. The total service package is offered in varying degrees to growers, usually dependant on the grower's requests or offered by the broker based on the perceived need of the grower. This result in different services to each grower; however a "one size fits all" approach is generally applied to broker charges. In essence, growers not using the full extent of broker services are subsidising those that do. Transparent charging for services offered would allow producers to evaluate the value of the service and choose what is appropriate for them.

Either greater value needs to be extracted from this service model; or it needs to be dramatically scaled back with the classer provided with regular market information so as to class the clip in the knowledge of any recent market requirements.

This is a difficult change to initiate, and may prove to be impossible, however without change either the cost of selling (both transparent costs and non-transparent costs) must continue to rise; or wool broker businesses will fail.

In order to maintain this increase in services and operate profitably Wool Brokers, while not raising costs to the producer, have progressively increased their revenue from:

1. Retention of wool sample. When sale by sample commenced the major portion of the wool sample was credited to the wool grower. Today there is no credit for the sample to be rebated back to the grower (at least for the wool producers and brokers I am aware of) with the sample value used to off-set selling costs.
2. Increased Post Sale Charges. When first introduced, this charge covered direct costs & services provided to the buyer including lunch, offices and freight delivery to dump. These services are now much diminished however the charges have almost annually been raised. This has resulted in not only an annual increasing of buyer service charges, but also a wide range of charge levels (\$25 to \$40 per bale). This indicates that the charge is not a direct result of the cost of the service. Brokers charging at the lower end of the scale must question whether or not to fall into line and raise their BSC to the upper levels and increase their profit.

Wool brokers would argue that the total revenue generated per bale to them is fair; and it may well be, however the post-sale charges are not transparent to the wool grower who is the ultimate contributor (buyers must allow for these charges when buying and selling wool.)

So to solutions. This area is long overdue for review, however given that wool brokers operate under commercial pressure to maintain or gain business, and that the current practices are well entrenched, it will be difficult to implement major change.

The enhancement by the wool industry of communication, on-going training and regular market updates to wool classers would seem a logical advancement and possible solution. There is good information as to the classer's registration and recent work history to allow for an improved communication and training program to be implemented.

Ag Concepts submission to the Wool Selling System Review

The classer should have access to a clip report of previous wool clips prior to commencement of shearing. This report would identify any issues with previous preparation, new initiatives as a result of market requirements, and any suggested improvements.

Having this information prior to commencement of shearing will provide the best outcome providing wool classers are supported with evidence based market information.

AWEX currently manages wool classer accreditation, however its major focus is on regulating classers to maintain Code of Practice; a valuable addition would be to provide "Market Information" services. This could include initiatives such as visits to wool sales and wool stores by wool classers to hear "what the market requires this year", followed by on-going communication to develop the classer's skills to prepare clips.

Too often, the wool classer today who relies on the wool broker for the latest advice on clip preparation complains of getting a different story from each broker and at each shed. They also struggle with determining any market trends they should be aware, this has resulted in a difficult relationship between rep's and classers.

Recommendation.

A program is provided by AWI or AWEX where wool classers can engage with on-going training each year, focused on COP, market information and the latest market requirements. This would provide a coordinated message into wool sheds and assist the classer to provide greater value to the clip.

Additional broker services

Increasingly farmer isolation and the challenge to survive have seen the issue of farmer mental health come to the fore.

The agent or wool broker is often the only trusted & regular contact to these farmers and there are examples of these reps dealing with difficult and complex matters with their clients.

A training program provided to the reps who are interested, could become a valuable resource in the area of early detection of problem situations; where when identified the rep would have knowledge of how to report and engage appropriate support services.

Robert Herrmann
Managing Director,
Mecardo & Ag Concepts Unlimited P/L
Robert@agconcepts.com.au
0417 564 898