

WOOL SELLING SYSTEMS REVIEW

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BY

Dr JOHN WILLIAMS

Managing Director
Food and Fibre Supply Chain Institute
PO Box 603 Werribee, Victoria 3030
M. +61 428 260549
Email. comm.trade@bigpond.com
Web. www.institutefood.com

Background to author:

Dr. John Williams: Managing Director of the Food and Fibre Supply Chain Institute and Senior Researcher at the Australian Commodity Research Institute, an organization designed to provide independent objective analysis-research into commodity-based supply chains and enhance the knowledge of commodity markets. He is the author of *Agricultural Supply Chains and the Challenge of Price Risk*. Routledge UK. His 2012 book *Competition and Efficiency in International Food Supply Chains*, Routledge UK, was short-listed for the 2013 Commodity Business Award for 'Commodity Market Policy & Advisory Award'.

SUMMARY

EXISTING AUCTION METHOD

- The wool auction system encourages the passivity of sellers in the market
- There is no forward price discovery mechanism in the auction system
- The passivity and isolation of sellers encourages physical speculation
- Sellers have a disincentive to use hedging or pricing strategies
- Agents are generally warehousing agents and passive selling agents

The lack of a wool forward market through the dominance of the spot price auction system led to the formation of the Sydney Greasy Wool Futures Market in 1960. However, a forward futures market is entirely dependent on the existence of an underlying physical forward commercial trade market. There is no global precedent in commodities where a futures market has established a ‘virtual’ forward market without being based on an underlying physical forward commercial trade market. The failure of the forward greasy wool futures market during 1960-64 contributed to the establishment of the Reserve Price Scheme in 1965. This Scheme worked when wool prices rose in the 1970s, but failed completely when wool prices fell in the 1980s. The SFE & ASX wool futures market failed during 1960-2014 because of an inability of the futures market to establish a ‘virtual’ forward market when there was no active and coordinated physical forward commercial trade market because of the dominance of the auction system.

ALTERNATIVE COMMODITY EXCHANGE

- A physical commodity exchange would encourage selling agents to be more active
- Physical forward prices would be discovered in a physical commodity exchange
- A commodity exchange would not threaten the current market participants
- Sellers would become more motivated in the selling of wool
- Immediate market feedback could be made direct to the seller
- Better grower pricing and less speculation of wool would be encouraged
- Increased selling fees could be offset by less warehouse charges
- Less opportunity costs (cost of money in deferring sale) incurred by the seller
- Greater integration would be encouraged by involving the seller in the market process
- Buyers will benefit from interaction directly with sellers
- A commodity exchange would better support a futures exchange/market
- There would be minimum change in clearing house operations

Adelaide almost had a wool exchange centre in 1850 before the advent of railways dispersed wool through decentralized ports along the Australian coastline. A commodity exchange requires product concentration and a standardized monthly carry charge for stored wool, which are currently occurring through Australian Wool Handlers. The support and clearing house mechanisms for a wool commodity exchange already exist.

EXISTING WOOL SELLING METHOD

Auctions are characterised by two features. Firstly, only spot sales occur for immediate delivery. There are no forward sales permitted that would result in forward price discovery. Secondly, only buyers are allowed to participate in the auction method. Sellers of wool are very conspicuous by their absence, even as viewers, particularly when auctions are conducted thousands of kilometers from the location of many of the growers.

The question arises as to whether wool grower selling agents could become directly involved in the selling method.

Wool selling agents did not charge a warehousing fee until approximately 2000, preferring to receive a commission at sale time. This lack of warehouse cost encouraged growers to warehouse wool for long periods, particularly when prices did not achieve the desired price target levels. Subsequently, growers have paid a notional warehousing charge and many have justified the payment in the hope that price rises will offset the warehouse charge.

General industry consensus is that warehousing charges, opportunity costs, and price falls have usually exceeded physical speculative gains for most growers. The outcome has generally been physical speculative financial losses by growers, loss of cash flow, rising debt, and industry malaise, which has not been beneficial to industry stakeholders, including wool buyers.

Warehouse speculation has occurred despite market price direction. When prices fall, many growers warehouse their wool and physically speculate that they will be able to sell in the future at a higher price. When prices rise, many growers still warehouse their wool and physically speculate that they will be able to sell at an even higher price in the future. Therefore, regardless of price movement, many growers use warehousing to speculate on better prices for wool.

The question arises as to whether it is the passiveness of the wool selling system that induces a lack of motivation amongst growers to sell or to price wool, even when good pricing opportunities arise. Is the selling method isolating the grower from good marketing practice?

Most wool selling agents are passive, in that wool bales are only listed for auction upon instructions from the wool grower. Initially, wool agents function as warehousing agents for growers, undertaking the normal handling functions such as storage, classification, testing, display, and sampling. There is no discretionary action by these warehousing agents to sell the wool, until instructed by the grower. When this selling instruction occurs, the warehousing agent also becomes a selling agent.

When the selling instruction given by the grower is sale by auction, which is 95 per cent of the time, the selling agent then schedules the wool for auction on a certain wool-selling day. However, the selling agent then remains passive during the auction sale, with the

exception of listing or altering the reserve-selling price. Some feedback from the buyers in the auction room might be given back to the grower, but the selling agent is not an active participant in the auction process.

Few wool-selling agents are active in the market, in that they obtain implicit instructions from the grower to obtain a spot or forward sale directly with a buyer. Direct wool selling represents less than 5 per cent of total wool sales. Warehousing costs are minimized under this arrangement, but selling charges or selling commission is usually higher because the selling agent incurs more cost in contacting buyers direct. Feedback from potential buyers is usually given back to the grower immediately.

The question arises as to whether the lack of liquidity in the wool futures (forward) market might be due to the predominance of the auction system, which favours spot price discovery and totally excludes forward price discovery.

There is no other deregulated agricultural industry in Australia where this seller passivity dominates the selling method. Auctions occur in the livestock industry, but there are important distinctions. Livestock is perishable, meaning that animals cannot be stored beyond its turnoff weight, and must be sold immediately. The decentralization of livestock auctions creates a culture where sellers intermingle with buyers and obtain direct feedback. These characteristics contrast with wool that is warehoused for eventual sale by auction, which can be thousands of kilometers from the wool property. Market isolation is a major concern for sellers in the current wool selling method.

The wool auction system was initially adopted because buyers needed to inspect the wool before purchase at centralized locations, and the difficulty of sellers being present at the same time as buyers. It was convenient for the buyers to inspect the wool in the absence of sellers and then make a bid.

The disadvantages of the wool auction system are summarized as follows:

- Sellers are passive participants in auction (except for establishment of reserve price)
- There are no active selling agents at the auction
- No forward month price discovery
- No forward sales or pricing allowed (selling into spot market only)
- Agents for seller are only warehousing agents who assist in wool testing and display
- Warehousing agents have little incentive to link buyer feedback to the seller
- Large distance between seller and auction
- Inadequate feedback to seller on the auction when purchases are occurring
- Passive market involvement encourages speculative storage
- Passive market involvement discourages price risk management
- Passive market involvement leads to reactive decisions regarding reserve price

AN ALTERNATE PHYSICAL COMMODITY EXCHANGE

Commodity exchanges have existed at least for 4000 years, with regulations governing the rules of trade being written in the Middle East by 1850 BC. These exchanges involved both active participation by both the buyer or the seller, or their agents, with spot and forward transactions being conducted in separate designated areas, before the advent of trading pits in the 19th century. London, New York, and Chicago grew and developed because of the significance of their agricultural commodity exchanges and clearing houses.

The essence of a commodity exchange is that it is both a spot and forward price discovery mechanism resulting from transactions in separated forward month areas between both active buyers and active sellers, or their agents, and the price is publicly disclosed instantaneously. Market information is factored into a seller's offer price and a buyer's bid price before a transaction occurs. Selling agents are in close contact with their selling customers as to current market sentiment, thus encouraging maximum market feedback.

The question arises as to why the electronic exchange methods for privately selling wool have not been entirely successful to date (at various times, less than 1 per cent of wool has been sold through private electronic methods).

There are three choices for commodity exchanges regarding forward price discovery in the new electronic era of transacting. The most usual electronic method is to operate the spot and forward months concurrently on the same computer screen. Traders merely make bids and offers based on their preferred transaction month. The alternative is to allocate certain commodity exchange times for each transaction month. This may be more appropriate for wool as it is not a standardized commodity, with 10,000 different wool lines. **However, because physical inspection of the wool is required by the buyer before purchase, this results in a need for a physical commodity exchange rather than an electronic exchange.**

The advantages of a physical commodity exchange include the following:

- There would be forward price discovery by active market participants
- It does not threaten the current market participants
- The existing auction room can easily be converted into a commodity exchange
- Minimal clearing house change is required by the Australian Wool Exchange
- Warehousing agents can become more active as selling agents
- It would create more competition in the transaction process
- Sellers would be motivated to become more active in the selling of wool
- There would be more immediate market feedback direct to the seller
- Better grower pricing and less speculation of wool would be encouraged
- Increased selling fees could be offset by less warehouse charges
- Less opportunity costs (cost of money in deferring sale) would be incurred by sellers
- Buyers will benefit from interaction directly with sellers

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