

27th February 2015

**Wool Selling Systems Review,
Australian Wool Innovation
GPO Box 4177,
Sydney NSW 2001**

Dear Sir/Madam,

Reference: FEX submission to Wool Selling Systems Review dated 10th December 2014

Financial & Energy Exchange Limited, ABN 20 122 086 284 (FEX) is pleased to make this submission to the Wool Selling Systems Review ('WSSR') dated 10th December 2014. FEX is the registered owner of the Riemann Agriculture Services ('Riemann') business name that is used for our products and communications supporting the wool market.

Whilst Riemann intersects with the value chain throughout the process our submission is focused on the forward selling and risk management section of the paper (Phase General – Forward Selling and Risk management).

Please refer Annexure A for more information and background on Riemann. It should be noted that Riemann is independent of the underlying physical wool market, thereby offering total impartiality in the price formation process.

As a guide to the structure of our response, we will re-state the key sections to which we refer in the report, and will provide our response to each section specifically.

Only 8% of Australian wool is sold forward. This compares to other Australian agricultural commodities such as cotton at 70%, lamb and wheat at 60% and beef at 50%. The Panel is seeking input as to why wool has such a low percentage sold forward.

Riemann is unsure how the panel came to the 8% figure. This may have been the case between 1995 and 2009 where there were multiple financial products (such as the ASX Greasy Wool Futures), and volumes were on average 45m kilograms traded per annum. However, in recent years when Riemann was the only provider of a forward product, this volume averaged 2.7m kilograms trading from 2011 to 2014, which is less than 1% of the wool clip. Riemann's 2014 volume was a low 0.5m kilograms.

Riemann does not provide commentary as to why Wool is different from the other markets listed. Likewise, Riemann does not provide any specific reasons as to why there was a reduction in volume from 2008 to the present levels. However, from general observations it is probable that there were impacts due to the global financial crisis and the demise of MF Global in October 2011. The de-listing of the ASX24 Wool futures contracts in 2012/13 also may have had a further impact. These events highlight the importance of confidence

in and the stability of markets, and it may be that the combination of all these events are some of the key reasons for this significant reduction in forward trading volumes.

Although we can review the impact of the recent past, what we would like to do is focus on how we view the participation of Riemann now. First, it should be noted that our forward product offering is specifically designed for wool industry participants only. We have exporters on the buy side, and grower agents on the sell side. We do not currently support any other intermediary (e.g. traders, banks, financial brokers, etc.) participating in this product.

There are two observations on the current participation levels:-

1. **Asymmetric trading:-** The exporters (buy side) are much more active on the screens (price sensitive). They add/remove prices on screen on regular basis, based on the underlying physical market. However, the grower agents (sell side) are much less price sensitive. They tend to enter 'set and forget' prices which become unrealistic or stale over a period of time. Therefore, we can regard this scenario as creating price asymmetries, consistent price asymmetries or "widening price spreads" is known to reduce confidence and limits market growth. The primary cause appears to be the grower agent side not being as sensitive to (just not reacting to) changes in prices in the underlying physical market. Riemann can only speculate as to why this is occurring – it maybe an education issue to the grower on the effective use of price risk management models, it might be structural in terms of how price decision making is done and how it flows to the screen, or it might be lack of price information being disseminated broadly enough. Whatever the reason is, until the wool industry participants support a more symmetric view of wool forwards, then forward trading is likely to remain subdued.
2. **The lack of involvement with a broader base:-** Our current forward products are designed to support the needs of the primary participants in the underlying physical wool industry. These products and participation rights could be expanded to allow participation of non-primary wool participants. To do that, our product specifications would need to be adjusted and would become financial products. FEX can readily support this development as we have multiple market licenses granted by the Government approving the provision of financial markets. However, the core issue in #1 above will need industry discussion first – as any product (financial or otherwise) still requires the underlying support of the primary wool industry (and not just one side) that can use these products in their day-to-day price risk management programs. If this broad support is achievable, multiple products (each designed with feedback from the industry) can be developed. We believe that these proposed products will grow volume, enhance price quality and transparency, and (if cleared) reduce counterparty risk. The market for these products could also be structured as a neutral 'financial broker' market, allowing a more active role in developing price levels. Banks could also become involved (e.g. offering bank wool swaps), as it would give them more certainty in setting prices when offering potential funding opportunities based on independent forward valuations of inventories.

In summary, to encourage higher participation and growth in the forward products, a discussion is required that will effectively encourage wool industry support from both sides of the industry. Once this occurs, further development can be achieved (broader participation) and more innovative products could be offered.

FEX, through Riemann, has always made a commitment to the wool participants that their support of the wool forward product will form the basis of any ongoing product development. Though there was limited support in 2011-13, volumes in 2014 declined markedly. Therefore, based on recent history, it would be difficult to justify any capital expenditure to support the development of any new products at this time, without external industry support.

In addition, the participants of the wool forward market would be aware that the market is simply not large enough to support multiple product offerings (namely Riemann and iCap, before iCap closed their Ag desk). This fracturing of liquidity restricts commercial considerations needed to support the development of financial products such as a Wool futures and options contracts (which would normally be the next obvious development stage).

FEX remains committed to the wool industry, and would welcome any industry discussion as to how to enhance the existing Riemann Wool forward product, and/or develop new financial products suitable for the long term benefit of the industry.

**What forward selling mechanisms currently exist in the market place for wool producers?
What systems might be introduced and are worthy of further investigation?**

Riemann Wool Forwards have been available since 2011.

As mentioned above, FEX can develop a broad range of product offerings and market structures, from OTC platforms, futures and options contracts (via FEX Global), cleared and/or not cleared products. However, these products will only be developed based on direct feedback from the wool industry participants.

In other markets, automation and connectivity has made it easier for the development of derivatives products such as futures and options. Would such products create new hedging opportunities for woolgrowers and other market stakeholders?

As can be seen from the ASX Greasy Wool contract, the volume from 1996 to 2009 clearly supports the concept that futures and options can play a pivotal role in the industry. In 2007 and 2008, the annual volume averaged 22,000lots equating to 53m/Kgs of clean wool equivalent.

However, it is less clear as to the types of firms that did the trading, and for what reason. It is not clear what percentage of this historical volume was solely hedging by wool industry participants, and exactly how the underlying conditions of the wool market are different in 2015 from how they were in 2008. However, a highly liquid and relevant contract has been shown historically to be well supported, indicating broad acceptance by the wool industry in providing value in their hedging requirements.

For more information on the above, please do not hesitate to contact the undersigned on (02) 8024 5200 or by email to p.coyle@fex.com.au. Thank you for the opportunity to allow us to make a submission to WSSR.

Yours faithfully,

A handwritten signature in dark ink, appearing to read 'Peter T. Coyle', with a stylized, cursive script.

Peter T. Coyle
Head of Exchange Services

Annexure A

Agricultural Risk Management Products

Riemann Agricultural Services ("Riemann") facilitates forward price discovery for Australian Agricultural Commodities. Established in conjunction with leading agricultural and industry groups, Riemann will develop products across grains, livestock and wool sectors.

Riemann Wool Forwards and AUD Wheat Swaps are risk management products designed for the Australian Wool and Wheat Industries respectively.

Riemann allows growers and producers to manage their production and price risk. Riemann also allows investors to track and trade the performance of these market sectors.

Industry recognition

Riemann forward prices are being published on main industry reports, media channels and through consulting firms' publications such as: AWI, Profarmer, Landline, ICS and broker reports. All key wool exporters and the majority of wool brokers use Riemann as their main hedging/trading tool on behalf of their grower clients.

Product

The Riemann Wool Forward Contract is a forward contract for physical wool; deliverable to the wool broker's store. Includes fine and medium wool types (18.5 to 23MPG), and coarser types (28 and 30MPG). Maturity dates go forward up to two wool clips, with maturity dates set by key wool auction dates. Grower offers are listed on electronic trading platform via wool broker. Exporters have direct access to the platform. The Riemann Wool Forward Contract promotes real time price discovery and transparency in an efficient forward marketplace for the wool industry.

The start

The product has been available since June 2011. Market activity snapshot. Since its inception, more than 8,300,000 kg clean (approx. 67,000 bales) have been traded on Riemann. The 21MPG contract is the most active contract comprising close to 70% of all traded volumes. A combination of finer and coarser wool contracts make up to the other 30% of trades. Monthly traded volumes have a certain correlation with physical market activity and changes in wool prices.

