

Submission to

AWI Wool Selling System Review

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by

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My submission to the Australian Wool Selling Systems Review (WSSR) is based on two decades of analysis of the wool market in Australia. The two decades have been a journey of change as the industry has moved from the disaster of the collapse of the Reserve Price Scheme through massive stockpiles of wool to fine wool booms and the long draw down of sheep flocks around the world.

During this period various alternatives to auction sales have been trialled in Australia, usually meaning some involvement in processing by farmers generally with delayed payments, and increased financial risk in some cases. The pipedream of farmers moving down stream to capture a greater share of profits from the sale of their commodities usually underplays the risk involved and the expertise required.

One of the big issues of wool farmers moving downstream is that they cannot accurately foretell what specifications their wool will be. Fibre diameter, staple strength and mid-break vary with some subjective faults such as colour and cotts coming and going. This issue, which varies from region to region, has certainly discouraged the development of some supply chain linkages.

Forward markets have come and gone during the past two decades (apologies for those contracts I may have overlooked in the following potted history). The SFE switched from a 22 micron contract to 21 micron in the mid-1990s, which has subsequently been shut down by the ASX due to low liquidity. The SFE also developed 19 and 23 micron contracts which have failed. Macquarie Bank set up cash settled contracts in the mid-1990s, with this trading desk closing in 2004 as it did not meet Macquarie's internal financial targets. The NAB subsequently tried to develop cash settled wool contracts, which have also closed. In recent years the Riemann platform has developed a range of cash settled wool contracts (and is still operating) while ICAP deliverable China type contracts were also developed and subsequently closed. Concurrent to this range of forward cash settled contracts wool trading firms have offered forward physical prices during the past two decades. Note also that the beef and grain markets have tried to develop futures markets in Australia during this period with little success.

From the limited view in Wagga it appears that the supply chain has also changed during the past 20 years. In the mid-1990s the likes of Chargeurs would have an order book of up to 12 months forward to refer to. The development of "just in time" processes does not seem to favour long term views and contractual issues are now a big issue when prices fall significantly. More informed commentators can expand on this topic but it suggests the supply chain background has become less favourable to the development and maintenance of forward markets.

The litany of failure of agricultural forward markets in Australia during the past two decades indicates a poor definition of risk where price risk is conflated as business risk for farmers. For the likes of irrigated cotton farmers this may be appropriate but for extensive farmers producing wool it is not the case. AWI project EC740¹ looked at this issue (amongst others) a decade ago and drew that conclusion. It provides a tidy explanation why agricultural futures in Australia generally have poor support from the farming community. The lesson we need to take from this is that any new market needs to provide clear benefits that outweigh associated costs and risks for both buyers and sellers. Such benefits need to be quantifiable and explicit.

¹ Risk Management Solutions Group (2005), *Wool Marketing and Risk Management Scoping Study (EC740)*, Australian Wool Innovation.

AWEX comes in for some tough questions in the WSSR. My response is that we should focus on the transparency of the Australian wool market and the key role that AWEX has in underpinning this. I have had an ex-New Zealand wool broker brag to me about how he was party to the shutting down of market reporting in the New Zealand wool market. He thought it was a clever piece of work while I was horrified. The lesson is that we need to be careful with important institutions such as AWEX, as they can be lost and with them the functions they perform.

Responses below are given to WSSR requests for feedback, where I thought something useful could be provided.

Wool Preparation

During the farm visitations is the wool broker able to provide the woolgrowers and/or classer with recommendations on how best to class and prepare the wool to meet with current customer requirements? Or is the classing advice designed to meet with the AWEX “Code of Practice” for classers?

Advice to classers is usually designed to meet the AWEX COP as there is little scope to adjust preparation to meet “market conditions” which generally consist of increased discounts for increased supply of faulty wool eg the large influence mid-break had on price for merino wool in spring 2014 due to the increased supply of high mid-break wool. In such cases wool preparation remains the same but exporters pay relatively less for the faulty wool as they struggle to accommodate it within their consignments.

A good wool broker keeps wool preparation in the wool shed on target – avoiding both under preparation where farmers seek to cut costs by lower staff levels in sheds and over preparation where wool is over skirted and over classed.

Do wool brokers have an expert understanding of market developments and implications for sheep husbandry and wool production?

Any market developments that have implications for sheep husbandry and wool production are going to be long term trends, rather than year to year issues. In this sense wool brokers are not in a position to advise on strategic husbandry and production issues, unless they are using good long term market analysis combined with sound farm business analysis.

In the last decade China has become the largest buyer of Australian wool taking nearly 80% of the total wool clip. This dominance has been accompanied by a more commodity based approach to wool usage as a fibre. Does this evolution present opportunities to create greater efficiencies at the point of shed preparation (for example larger lot sizes) and should the classing “Code of Practice” be reviewed to better suit this evolving processing consumer base?

We should be careful about the implications around China and its perceived dominance in the economic and political world. See the following extract from an article by John Lee.

*It might be the world's factory but export-manufacturing in China is dominated by foreign-owned and foreign-invested firms. This means that China is only the world's preferred sub-contractor -- a less exalted position. Over two-thirds of China's trade is processing trade, with advanced economy consumption markets in North America, the European Union and even Japan more important than China when it comes to being a source of net demand, which is what trade and global manufacturing is ultimately dependent on.*²

One change that should be considered with regards to wool sales is the development of unskirted fleece. Note that this change has nothing to do with China's role in the supply chain.

Unskirted fleece for both merino and crossbred offers improved efficiencies with wool sheds and lowered costs. It also has the potential to underpin shearing developments using shearing cradles.

However there are some issues with unskirted fleece that need to be addressed.

The first issue is that it needs to be clearly identified within the supply chain. At present any unskirted fleece is categorized as non-conforming and given a "D" certificate, which includes this wool with lots that come from a single source, on farm and are not prepared to the minimum standards of the COP or without a registered wool classer. There is no formal identification of well prepared unskirted fleece wool in the supply chain.

The second issue is that the AWEX COP needs to be adjusted to include unskirted preparation, specifying the presence of a wool classer as mandatory, to maintain quality control in the wool room. Wool brokers, AWEX and exporters are rightly worried that an acceptance of unskirted wool, without formal guidelines, would lead to a lowering of wool preparation standards. That is why this form of preparation needs to be included in the AWEX COP with the role of the wool classer explicitly stated as key to its success.

Fibre Direct demonstrated that unskirted fleece could be successfully used within the supply chain. To do so it must be recognized for what it is, allowing processors to adjust their blends and machines accordingly. If discounts become too great for this type of preparation then farmers will revert to the current standard AWEX COP.

There will be resistance to this suggestion from the wool trade as there was to the introduction of objective measurement and additional measurement. Hindsight now shows that resistance to have been wrong. Interestingly the ICAC plenary in 2014, some 40 years after wool introduced objective measurement, was still debating the introduction of objective measurement of raw cotton³.

² John Lee 'The cracks in China's political narrative' 7-Jan-2015 Business Spectator

³ ICAC press release 6th November 2014

Delivery and testing.

For a woolgrower to receive a fully certified AWTA test result on their wool they must first have delivered their product to a wool broker's store that has AWTA certified core and grab sampling facilities. Would there be any commercial benefits to the woolgrower in knowing their final test results prior to delivering their wool to a broker's store?

Growers can currently develop a very good idea of their likely wool test results by taking mid-side samples close to shearing and having these samples tested. Fibre Direct used this technique quite successfully two decades ago.

Commercial benefit is gained where the wool is not passing through the standard wool broker warehouse/testing system.

Can AWTA testing be performed on-farm or at another regional location of the woolgrower's choice if such alternatives are preferred?

There are some significant issues regarding on farm testing.

Cost

Farmers usually do not have storage for all of their clips so they would need to build storage sheds which by definition means the industry would be over investing in this asset.

Sending testing teams around to all farms rather than a centralized point would be expensive.

Lot Integrity

Once bales are tested who would be responsible for the integrity of the wool lot? Bales are allocated to lots and need to be delivered into the supply chain in specific lots.

Logistics

Can you imagine the chaos of a trucking firm running around the country side, down dirt tracks, collecting lots for shipping?

Counterparty Risk

The wool industry has a near bullet proof counter party risk procedure. Wool is not shipped out of store until paid for. This is in contrast to the grains industry.

Exporters would have to pay individual farmers and these payments be verified before the wool could be loaded onto the truck. It looks messy.

Wool Appraisal

Could woolgrowers exercise more discretion in the type of tests performed on their wool in order to save costs?

Brokers and exporters generally discourage length and strength testing on bellies. The price effect of additional measurement on bellies is difficult to assess as it is small. In principle the more wool is described the more transparent the market, which is why testing is discouraged. For farmers transparency is good while for traders it limits arbitrage opportunities, hence traders will generally lean to less testing – an old struggle as Bob Richardson recalled.⁴

This point raises another issue. There is no official regular analysis of wool prices as Woolmark used to publish quarterly. AWI has commissioned an analysis of wool prices using a 5 year period. This analysis, while useful, does not have the resolution to investigate smaller premiums and discounts in the market in detail.

Price realisation.

Are stakeholders able to draw examples of previously attempted selling alternatives and reasons for their lack of adoption to the Review Panel's attention?

Fibre Direct (1990s) – farmers selling wool as tops. Mis-match between the tops and greasy market caused massive problems.

The lesson here is that raw and processed wool markets can get out of “normal” alignment, for an extended period which usually means the processed market selling at discounts to the raw wool market in order to clear stock.

I suggest the committee seek submissions (if not already provided) from the following service providers.

The Merino Company (wool pools)

Merino New Zealand (supply chain services offered in New Zealand)

Do auctions in the different centres generally realise similar outcomes for the sale of specific wool types?

Changes in supply play a big role in pushing prices for a given type apart between centres. For example Sydney traditionally has had more high VM wool (itself a variable dependent on seasonal conditions) with discounts rising accordingly. As supply fluctuates, so does selling centre price differentials.

⁴ Bob Richardson The politics and economics of wool marketing 1950-2000 The Australian Journal of Agricultural and Resource Economics, 45:1, pp. 95-115

Demand responds to changes in supply also, but lags the change in supply by weeks. It appears it takes exporters a few weeks to adjust their orders to changed volumes of wool.

Invoicing and payment.

Is there potential for a more detailed breakdown of the individual selling and buying costs of wool to be made available to woolgrowers to facilitate more informed commercial decisions regarding the sale of their wool? Is there a need for an industry standard invoice or account sale format?

Why not simply add the post sale charge to the grower invoice? Encourage farmers to compare wool broker costs through a combination of BSC and PSC. Farmers can then make individual commercial decisions with regards to their choice of wool brokers

An alternative is for exporters as a group to publish the average PSC they pay by broker by centre. Brokers will soon pick up this information and relay it to the farming community.

General

AWEX undertakes a variety of tasks, including market reporting and ensuring accuracy in wool description, that help the wool market to perform efficiently. In a similar vein, AWTA supports market efficiency by providing critical data describing the range of wool characteristics. Would there be advantage in combining the activities of AWEX and AWTA?

The role of AWEX is to report on the wool market and maintain market transparency. The role of the AWTA is to provide testing services. The two roles are distinctly different.

In New Zealand the NZWTA (a subsidiary of the AWTA) does not provide detailed supply data due to competitive pressures from a rival company. The point this raises is that market transparency is not in the DNA of the AWTA.

In 2013-14 AWTA staff numbers peaked at 398, while AWEX has around 20 employees. What would spur the AWTA to maintain and develop such a small unit that generates little, if any, profits?

Of the southern hemisphere wool exporters only South Africa and Australia⁵ have transparent wool markets in terms of both prices and volumes. Both South America and New Zealand look to Australia for market information. The institutional structures that provide our market transparency need to be nurtured, not lost as they have been in New Zealand.

⁵ Andrew Woods, *Wool reporting in the southern hemisphere*, Mecardo website (www.mecardo.com.au), 23rd October 2014.

What are the benefits and costs of any move to centralise the sale of wool?

Mick Keogh⁶ determined the savings provided by centralisation of wool sales was in the order of \$2 per bale (two selling centre model). Politically, the NSW Inland Wool Brokers will not agree to shifting sales from Sydney to Melbourne, but possibly could be persuaded if Albury or Wagga were put up as the location for centralised sales. For these service providers any calculated savings from centralisation would be negated by logistical issues around accessing sales in Melbourne.

Politically, physically moving Fremantle auction sales to eastern Australia looks to be an even greater challenge.

Can Australian wool be appraised without physically handling a wool box sample? And if so would that appraisal be accurate enough to allow an exporter or processor to deliver wool in accordance with a specific mill or customer's requirement?

The short answer is yes for some categories of wool, and no for others.

If the current combination of objective measurements and subjective assessments was sufficient for sale by description then we should be able to take this information and model prices at the lot level successfully, within a given error. For 19 through 23 micron full length merino fleece without serious subjective fault that is feasible, as it is for full length crossbred fleece without serious subjective fault. The standard deviation of such modeling for weekly sales is in the range of 1-2%. Merino locks are also in the feasible category. That leaves ASF wool, short staple and cardings (generally) unable to be accurately described, with pieces, bellies and wool with serious subjectively assessed fault somewhere in between.

Beyond the technical aspects of describing wool is the question of who takes on the commercial risk in describing wool sold by description?

That is the view of an adviser valuing wool for farmers when selling wool. Exporters will have other views.

Selling Alternatives.

Forward markets require the supply chain to fuel them with liquidity not farmers, as the wool, beef and grain markets have found to their cost in Australia during the past 20 years. From this perspective forward markets need to be designed for the supply chain (exporters and traders) rather than farmers. It is then up to intermediaries to develop forward and direct contracts for farmers.

Some wool brokers offer up front savings for grower clients choosing an alternative method of selling.

⁶ The Australian Farm Institute "The Costs and Benefits of Alternative Selling Arrangements for Australian Wool" April 2009

It seems to be overlooked but wool requires blending for the purposes of processing, with auction sales providing a stable, transparent method for sourcing the available wool in the correctly blended consignments.

Private buying by firms requires them to take on risk from when they commit to buying and when they can sell, after testing, the wool. It is akin to buying a steer, having it butchered and then selling the component parts. This is the analogy for auctions – the farmer delivers a whole clip and it is sold in its component parts.

Traditionally more of the broad edge of the merino clip and the crossbred clip were sold privately. This makes sense as there was less price/quality risk – these categories are easier to value from a farmers' perspective and they carry less risk for the buyer.

[Do the above selling alternatives provide the same level of competition for woolgrowers' wool as traditional auction?](#)

Sometimes more and sometimes less, that is the risk. Auctions are transparent while private sales are by definition not, so the risk for farmers is that a private transaction provides a return less than the equivalent benchmark auction price.

[Forward selling and risk management](#)

[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.](#)

AWI project EC740 looked at forward sales in the wool industry and drew the conclusion that the price risk in the wool market did not translate into sufficient risk to the farm business to warrant active forward selling by a large section of the industry.

The MacKinnon Project looked at wool price risk and concluded that the volatility of wool prices was the main driver of change in wool income. While this affects cash flow (income), it has a much smaller effect on the farm balance sheet than for the cotton industry, which is often held up as an example for the wool industry to follow.

Assuming a wool grower does have risk from a fall in prices (perhaps a property is leased or a new purchase has been made which has lowered equity to minimal levels) what can be done by the farmer? Currently not much – perhaps hedging forward by 12 months. There have been some 3 year forward contracts during the past decade but generally the time horizon has been limited to 12-15 months forward.

Historical analysis shows that hedging forward by 12 months has little effect on long term returns. Various methodologies can be used but the result is generally the same⁷. Only cherry picking times (timing) to sell forward combined with a big dose of luck can give a positive result and these opportunities come up irregularly, which limits the liquidity contributed to the market by farmers.

⁷ Andrew Woods Independent Commodity Services - series of 3 articles in Holmes Sackett Australian Farm Business Review 2008 & 2009

Only long term forward contracts (5-7 years) show a potential beneficial effect when analysed using historical data.

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

There are currently MPG based cash settled contracts (on Riemann) and an irregular set of forward physical contracts, which occasionally include minimum price contracts.

The MPG contracts tend to cover the 19 and 21 micron merino MPGs and lately also the 28 and 30 crossbred MPGs.

Forward contracts are an ideal way for exporters and wool brokers to lock in throughput, but the lack of means for offsetting the price risk taken on limits the development of such contracts.

A forward contract has to offer both buyer and seller something that exceeds the cost and risk associated with such a private transaction. The industry tends to focus on forwards offering a means of offsetting price risk which seems impractical when the supply chain operates on short time horizons. An alternative way for forward transactions to develop may be for the buy side to let the price risk float and fix a particular basis (there are plenty on the wool market). This reduces a measureable component of the overall price risk for the seller and provides throughput to the buyer.

An example of such a basis contract would be where the discount for unskirted fleece was fixed and the base price floated. This would be attractive to farmers preparing such wool and a low risk way for exporters/brokers to lock in throughput. The risk in the basis varying from 7-8% discount to a 1% discount warrants some attention from the grower⁸. For a contract like this to develop, well prepared unskirted fleece has to become clearly identified in the supply chain.

AWI project EC740 recommended risk mapping of the value chain, which would be a precursor to any commitment of resources by the industry to forward markets. In general discourse about industries, price risk tends to be equated to business risk, which is not a valid assumption for extensive wool producers. There have been enough failures of forward markets in different commodities (wool, beef and grains) to suggest that insufficient work was put into understanding the major risks faced by market participants in agricultural commodities and the costs/benefits that forward markets would bring to these commodities.

⁸ Andrew Woods, Unskirted merino fleece discounts – fair value or not?, Mecardo website (www.mecardo.com.au), 24th September 2013.