BESTPRAC

Case study series – No. 11

Wool basis contracts: insurance in a shifting market

Youtube: http://youtu.be/5NfVF6Z_YxI

Doug Caley, Walgett NSW

BACKGROUND:

Doug Caley is clear about the reason he uses basis contracts to sell his 450-500 bale clip – he has enough volatility in seasonal conditions to deal with, without having to be at the mercy of price fluctuations in the wool market.

For the past eight years he's taken out a basis contract to deliver around 60 percent of his wool clip for auction in Sydney, on a specific date for a specific price, and for seven of those years he's emerged financially better off.

All the same, he's quietly adamant that he's not doing anything remarkable. He considers the basis contract an insurance policy that puts a 'floor' in his sale, in a similar way to the long-defunct Reserve Price Scheme of the 1980s, and is happy if he makes above 950 to 1000 cents a kilo.

As for why none of his neighbouring woolgrowers use basis contracts, he thinks that might be attributed to a hangover from the demise of the floor price, and a natural wariness about getting mixed up in share trading or forward selling.

THE CALEYS' STORY:

The Caley family, Doug and his wife Pam, their son Scott and his wife Amanda, run up to 18,000 fine/medium wool Merinos on 28,000 hectare Bangate Station and the adjoining property Bil Bil, 115km north of Walgett and 50km from the Queensland border.

Up until a few years ago they bred for bright, stylish finer wool, using mainly Merryanbone bloodlines. In a drought year in 2013, the entire flock tested 19.7 microns and cuts varied between 5.2kg and 6kg/head at shearing.

But the Chinese preference for large quantities of broader micron fleece wool has Doug looking to breed heavier cutting sheep, around 20 to 21 microns. For the past three years he's bought rams from North Ashrose stud in South Australia, and last year invested in 200 stud ewes as 'a bit of an experiment'.

He first heard about forward marketing more than a decade ago at a field day at the Nyngan RSL Club, where one guest speaker delivered a piece of advice that stuck in his head: 'You're better off having a piece of paper in your hand and the money in the bank than wool stored in the shed'.

That made sense to Doug. The decade following the devastating market crash of the late 1980s was a rollercoaster ride for wool prices, with growers left trying to second-guess the peaks and in some cases, storing wool on farm for years in the hope of an improved return.

Doug dabbled with a 21 micron futures contract but felt like an ill-informed speculator. A futures contract requires the grower to meet tight specifications for wool strength, yield, micron and level of vegetable matter. And the contract is tied to the daily physical market so fluctuates accordingly, which requires a much closer level of monitoring than the 'done and dusted' basis contract.

In the early 2000s, Doug's local Landmark agent Phillip Lipscombe came out for dinner and suggested a basis contract, which Doug felt more aptly described his type of wool and didn't require him to be on top of the daily price fluctuations, the way a futures contract did.

The Caleys decided a basis contract was a logical choice, allowing them to secure a price for a portion of the clip, keep down debt and speculate if they wanted.

While Doug regularly reads the Wool Weekly and tracks the Eastern Market Indicator, he relies on expert advice about when to lock in a price, liaising with Landmark Walgett agent, Brett Smith.

Brett appreciates Doug's 'pro-active' attitude to marketing, and says the basis contract has helped woolgrowers to counteract price shifts in the market.

The basis contract price is set six to nine months out from sale. To set the price, agents and growers can access information on percentile bands that's correlated by the Australian Wool Exchange, AWEX, from the past 10 years of wool sales.

The bands take into account the top and bottom price for wool types over the past 10 years, comparing current prices to the historical market to determine the likelihood of achieving a particular price. For example, if 21 micron is selling for 1100 c/kg in the auction room, it's in the 70th percentile - meaning the price has been higher than that only 30 percent of the time in the past decade.

The agent liaises between buyer and seller to fix the basis contract, using an electronic offer board which posts prices and the types and quantities of wool required.

A basis contract also allows the Caleys the option of splitting the sale of their clip. They shear in winter and sell in spring, and while the basis contract has to be delivered on a certain date at a specified price, Doug can sell the rest of the wool into the physical market at any time.

RESULTS:

Doug has only had one 'off' year in the eight years he's taken out a basis contract.

The year it didn't work in his favour – 2011 – Doug took out a contract in late January, only to see the Chinese buyers push the market well beyond the price he'd locked in. That's why he's careful not to commit too much of the clip, usually contracting around 60 percent.

Brett Smith estimates about 10 percent of large woolgrowers in his region use basis contracts regularly to market their wool, and 80 percent of those contracts have come out on top.

He attributes the low uptake to a lack of understanding of the mechanics of the system.

As a low risk production system, Brett says wool is the ideal commodity to sell forward, allowing the grower, be they in a low or high rainfall zone, to insure against the risk of selling the entire clip on one day into one market.

For Doug, the benefits of using basis contracts to market his wool are clear – from the first year they've delivered pricing certainty and meant he hasn't had to hold on to wool in the hope of achieving a better price.

They've also been a valuable addition to annual budgeting, prompting the Caleys to assess their production costs, set a price for 60 percent of the clip, and know that the return on that portion of the clip is guaranteed.

WHAT YOU CAN DO:

1. Assess your cost of production, then investigate the options for taking out a basis contract for a portion of your wool clip to guarantee a sale price.
2. Determine your average wool production figures and shearing and selling times to decide on an optimal price.
3. Seek expert advice and use percentile bands, the Micron Price Guide which lists prices for each wool category based on sales, and the electronic offer board to determine the likelihood of achieving a target price in a particular month.
4. If the physical price is higher at the time of sale, you will not be out of pocket because only a portion of your clip was locked in, and the remainder is sold in the stronger physical market.
5. By using a basis contract that has been timed to coincide with shearing, a grower is able to sell wool immediately for cash flow purposes, without having the price solely dictated by the market at the time.

MECHANICS OF A BASIS CONTRACT:

A woolgrower chooses to take out a basis contract to provide some protection against any price downside on a portion of their clip.

A contract is written for 2000 kgs clean (approx 15 bales) of 20 micron for September delivery at 1000 cents/kg.

Scenario One: When the contract expires in September, the 20 MPG is reported at 1050 c/kg clean.

The grower's total clip of 100 bales sells for 1060 c/kg clean.

For the 15 bales that were hedged, the grower receives the contracted price of 1000 c/kg, plus 10 cent basis (the difference between the actual MPG and the actual sale price) = $1010c/kg.

The remaining 85 bales sell for the higher market price = 1060c/kg.

***In the grower's opinion, this was well worth it to guarantee that some income was protected**.

Scenario Two: When the contract expires in September, the 20 MPG is reported at 950 c/kg clean.

The grower's total clip of 100 bales sells for 960 c/kg clean.

For the 15 bales that were hedged, the grower receives the contracted price of 1000 c/kg, plus 10 cent basis (the difference between the actual MPG and the actual sale price) = 1010c/kg.

For the remaining 85 bales he receives the market price = 960c/kg.

*__From the grower's point of view, the hedge worked well. The 15 bales received a higher price – in his mind, he wishes he hedged more at the time.__