

Marketing options

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The aim of this chapter is to give a general overview of the cotton pricing components and marketing alternatives available to Australian cotton growers. It is strongly recommended that growers seek advice from a reputable merchant about the alternatives suitable for their specific situation.

Background

Variability in the Australian cotton price is caused by fluctuations in the underlying futures prices, currency rates and basis levels. This variability can create major uncertainties (or risk) for cotton growers when deciding if to plant cotton and when to sell. It is important that growers understand the components of the cotton price, associated risks and available marketing options before they begin marketing their crop.

The ability to 'lock in' a commodity price for some or

FIGURE 1.

Eight years of 'cash' cotton prices available to Australian growers. (Courtesy of Namoi Cotton)



BE AWARE OF

- Seek advice from a reputable cotton merchant and talk to established cotton growers about their past marketing experiences.
- Cotton seed makes up a significant part of the income from a cotton crop, discuss pricing alternatives with your chosen ginning organisation.
- Profitability of a cotton crop is heavily reliant on the price achieved for marketing. It is critical for your business to understand the marketing risks and your choices to manage them.
- Yield risk also exists when a contract is entered into after planting, but before harvest.

all of a crop before harvest can be a major advantage for cotton growers. However, fixing prices before harvest can be risky, due to uncertain production levels. To understand the different marketing alternatives it is necessary to understand the risks.

Risk

A definition of risk: *Effect of uncertainty on objectives.* In this case returning a profit from the cotton crop is the objective and the primary areas of uncertainty (or risk) are:

- Production (quality and quantity of the cotton produced); and,
- Price (the movement of prices before they are set i.e adverse movements include an increase in input costs and decrease in commodity prices).

These risks are complex and vary between growers and over time, however marketing is one method for managing these risks.

Production risk is separated into quantity (yield and area) and quality. With the ability to enter into forward contracts before the crop is planted, there is uncertainty with both the area to be planted (due to seasonal conditions) and the yield that will be achieved. Yield risk also exists when a contract is entered into after planting, but before harvest.

Variable yields may result in a grower under or over producing against contracted commitments. If production exceeds commitments made and the contract price is higher than the spot or market cotton price, then the grower has an opportunity loss. If the grower under produced a fixed bale contract, then the grower may be obligated to fill the contract at market rates, which could result in a financial loss to the grower.

Varying quality is managed by merchants with all forward contracts priced on 'base grade'. Once the cotton is ginned and classed, the final price paid to the grower is adjusted with a premium when the grade is higher than 'base', or a discount in price when the grade is inferior. These pricing adjustments can be found on a merchants corresponding premium and discount sheet (for more information about quality see *Classing Chapter 22*).

Price risk in relation to a cotton grower is when all or a portion of the crop is not priced and the value is reduced due to decreases in the cotton price. Price variability is due to fluctuations in the three components of the Australian dollar cash price:

- ICE cotton futures;
- Basis; and,
- The AUD/USD exchange rate.

Cotton is internationally traded and priced in USD, using the Intercontinental exchange (ICE) Cotton No2 contract (previously managed by the New York Board of Trade).

Basis can be broadly defined as the difference in value (or price) between a physical bale and the futures contract price. Basis accounts for location, grade and local supply and demand conditions.



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Australian growers generally receive their income in Australian dollars, so the USD price is converted into local currency using the AUD/USD exchange rate. This may not be the spot exchange rate, rather the relevant forward rate for any forward contracts.

$$\text{AUD cash price per bale} = \frac{\text{Top Line: USD per bale price} \times \text{Converts price from pounds to bales} \times \text{Converts price from USD/bale to AUD/bale}}{\text{AUD/USD exchange rate}} \times 500 \text{ lbs}$$

eg AU\$500/bale = $\frac{(0.82 - 0.01) \times 500}{0.81}$

All three price elements can and do change on a daily basis. The price of cotton in Australian dollar terms is therefore subject to daily volatility. The major merchants in Australia publish their daily prices on-line or communicate their prices via fax, e-mail and text message. To be kept up to date with pricing movements contact the merchants and ask to be added to their daily price lists.

Marketing options

Australian cotton growers are well serviced by several cotton merchants who buy cotton from growers to sell in the international market. Due to the relatively small size of the Australian cotton market, it is often the cotton merchants approaching growers to buy cotton, thus creating a price competitive market.

Merchants involved in the cotton market tend to build robust relationships with clients and may contract cotton with these growers up to 4 years into the future, using forward contracts. A forward cotton contract is a customised agreement between two parties to deliver cotton on an agreed future date for an agreed price. Price will be determined in reference to the other terms of the contract – quality, quantity, and the time and place of delivery or the buyer may require a guarantee of a specific grade or quality of the commodity from the seller. From a grower's perspective this may mean selling the cotton before it has been harvested or even planted.

The most commonly utilised forward marketing options are:

AUD Fixed cash price: is a forward contract for delivery after ginning of the season specified (i.e 2010–11). Growers accept a certain fixed price and a fixed number of bales are agreed upon in the contract; thus, there is a fixed commitment to deliver.

Fixed bale pool: a commitment to deliver a specified number of bales to a 'pool' of bales with a particular marketing organisation. Both price risk and yield risk are borne by the grower, but the price risk is managed by the marketing organisation. Most pools have an indicative price attached and often once that price is no longer achievable, the pool will be closed. As with all pools, payment is spread over a period of time as delivery of cotton from growers, and sales to mills proceed.

Other pools may be offered by merchants with varying conditions. Some characteristics of a pool (or other customised contract) may include;

Hectare contract where the grower commits a particular acreage, all cotton produced from that area is covered by the contract. The contract may have a maximum yield deliverable to it (eg up to 10 bales/ha). Downside yield risk is managed by the merchant.

Some pool contracts may have a **guaranteed minimum price (GMP)**, with potential (but limited) upside. For these contracts the grower bears production risk and some price risk. Due to the hedging requirements for the merchant to guarantee a certain minimum return, these contracts usually come at a discount to the cash market.

Balance of crop (BOC) is a contract where the grower commits their remaining unpriced bales. These contracts are generally available towards the end of the season when the grower can make a reasonable estimate of their yield.

Force majeure (FM) 'compelling force, unavoidable circumstances'. When an FM clause is attached to a cotton contract it generally means that a production shortfall in the nominated bales set out in the contract need not be delivered. This variation is borne by the merchant.

Cotton seed

The value of cotton seed also makes up a significant component of the income from a cotton crop. Cotton seed is priced through the ginning company which may not be the same merchant the cotton is sold through. Cotton seed is priced in bales (based on the amount of seed that is produced in the ginning process of one bale, this is approximately 300kg of seed). Cotton seed has been worth up to \$120/bale, however a price closer to \$60/bale has been more common. The ginning organisation may quote the seed price as 'ginning plus seed' (i.e \$60/bale, may be quoted 'ginning plus \$5/bale', indicating that the seed price covers the ginning price of \$55/bale, with \$5 paid back to the grower). Talk to your preferred ginning organisation about current cotton seed pricing.

For further information on marketing your cotton talk to a merchant or you can find comprehensive marketing notes on the following websites:

Australian Cotton Shippers Association:
<http://www.austcottonshippers.com.au/downloads/GrowerMarketingRiskHandbook.pdf>

Cotton CRC:
http://www.cottoncrc.org.au/content/Industry/Publications/Economics/Cotton_Price_and_Marketing.aspx