By Kim Morison, Colly Cotton

KEY POINTS:

- **Sell crop in Australian dollars (don't speculate in foreign exchange or the futures market)**
- **Consider area (acreage) pool contracts with a reputable pool manager**
- **Don't sell something you haven't got. (ie. Don't forward sell)**

Marketing Alternatives for Dryland Producers

To achieve successful and profitable dryland cotton production, growers must be prepared to manage the marketing of their production.

The main aim of this section is to present the important features of the marketing alternatives available to cotton growers. To fully understand the alternatives it is necessary to understand the marketing risks and risk management tools involved.

This section is not intended to be a "Do It Yourself" marketing kit, rather it serves to introduce a range of concepts and terms with which you will encounter in marketing your crop successfully. All growers should seek advice on marketing matters from cotton marketing companies and/or consultants with proven records in their fields of expertise. It also helps to talk to established cotton growers to share their experience.

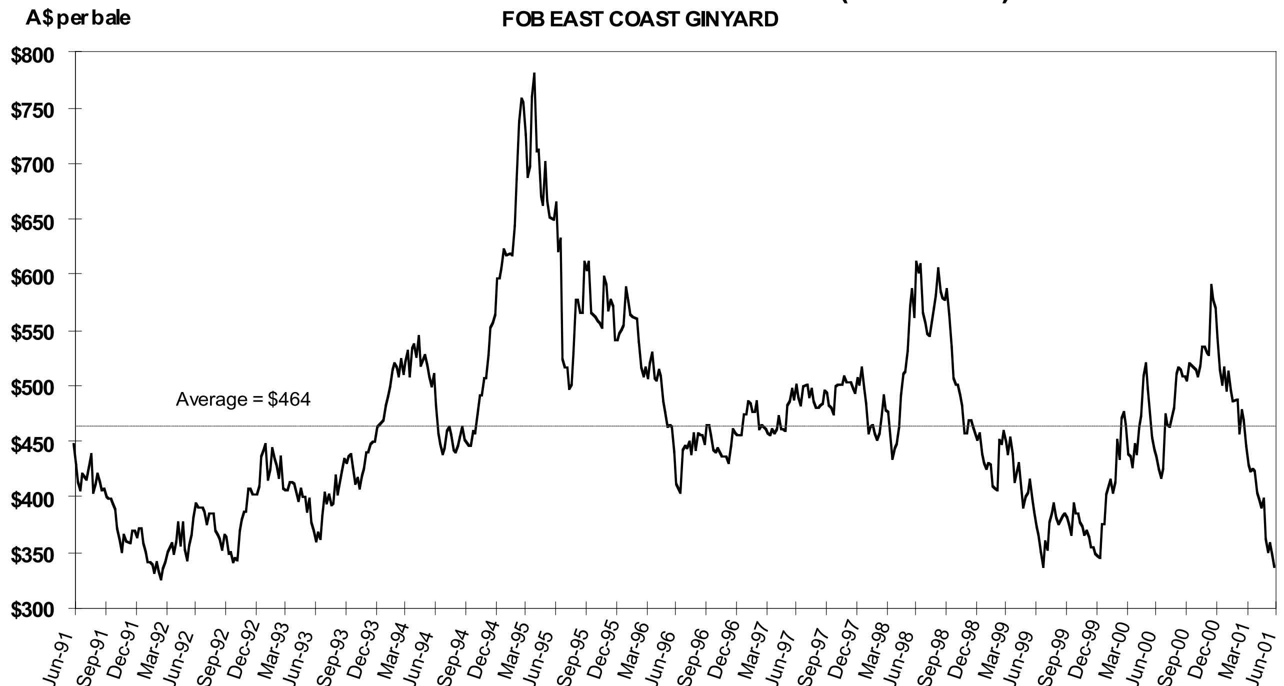
BACKGROUND

As shown in **Figure 30** the Australian dollar price per bale of cotton fluctuates considerably. The Australian dollar price changes on a daily basis depending on movements in the underlying international cotton price and movements in the Australian dollar exchange rate.

Annual and short-term price fluctuations can create major uncertainties or risks for cotton growers when deciding whether to plant cotton and when to sell. In addition, growers face the inconsistencies of seasonal conditions and the complexities of successfully growing cotton. The uncertainties of seasonal conditions are particularly important for dryland cotton growers.

If all those uncertainties, were not enough, new growers can also be daunted by the wide range of marketing alternatives now available from a wide range of buyers. However if properly used, these alternatives and the price competition available each day can work to the growers' advantage.

Figure 30:



For many years now the Australian cotton market has benefited from an active forward market. For growers this involves the use of marketing alternatives to fix or lock in a price on all or part of the expected crop before the cotton has been harvested. The ability to lock in returns before harvest can be a major advantage for some growers, because of the large investment needed to grow and harvest cotton. However, fixing prices before harvest may also be risky, especially if production levels are uncertain. These and other marketing risks are examined briefly in the next section.

MARKETING RISKS

Marketing for a cotton grower is largely a question of managing production and price risks. These risks are not only complex, but personal, and vary from situation to situation and over time. Growers need a clear understanding of these risks and how they relate to their operations before making marketing decisions.

Production risks broadly relate to quantity (yield and area) and quality.

Quantity risk is the possibility that production may differ significantly from original expectations. This is particularly so for dryland cotton production. If a grower enters into a contract to supply cotton at a future date before the crop is planted, there is uncertainty about the area to be planted (because of seasonal conditions) and the level of yield that will be obtained from the area actually planted. If a contract is entered into after planting, the yield risk still exists.

There is also the risk that the **quality** will not be as expected as a result of seasonal conditions, pests, diseases, poor management practices etc. Typically cotton sold forward is sold on a **base grade** description of USDA standard Middling grade, $1\frac{3}{32}$ inch staple length, micronaire in the range of 3.5-4.9. Once the cotton is ginned it is then classed and the final price to the grower is adjusted by a premium or discount depending on the actual quality compared to the base grade.

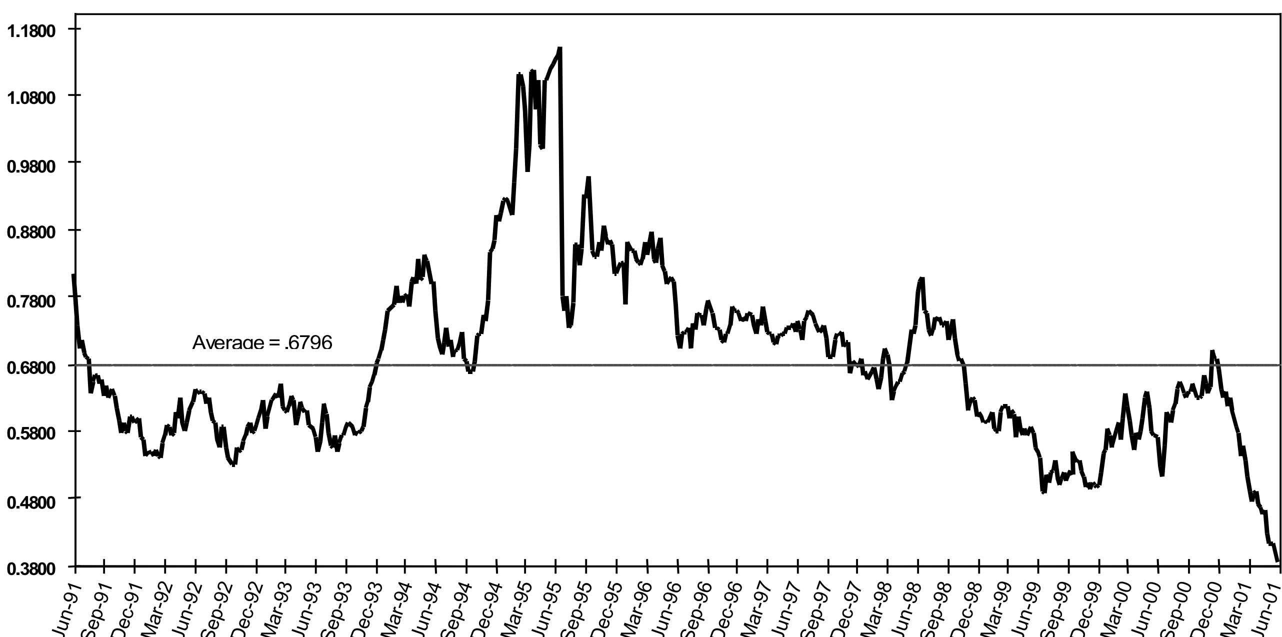
Price risks broadly relate to the international price of cotton and the exchange rate to convert the international price into Australian dollars.

Over 95% of the Australian cotton crop is exported each year. Therefore Australian domestic cotton prices reflect the international price of lint cotton, which is traditionally traded in US cents per pound.

The international benchmark for cotton price discovery is the New York Board of Trade cotton **futures** contract. The NYBOT futures market trades the price of US cotton for delivery in the months of March, May, July, October and December each year going forward for 18 months.

Australian cotton merchants use the NYBOT cotton futures contract to hedge their exposures in trading Australian cotton. As such, changes in the futures price for May and July futures in particular usually have a high correlation with Australian cotton prices each day.

Figure 31: NYBOT SPOT COTTON FUTURES (10 YEARS)



The futures market trades the price of US cotton delivered to US warehouses. As such there are some adjustments required to equate Australian cotton price to daily changes in NYBOT futures prices. The difference between Australian cash prices expressed in US cents per pound and the May or July futures price on any one day is commonly known as the **basis**.

The basis may be broadly defined as the premium or discount to the New York futures price for cotton being sold at any point in time at any particular location. The basis generally takes account of differences in quality and transport costs between New York and the place where the cotton is being delivered.

Generally, Australian growers are only interested in revenue in Australian dollars. As the majority of Australian cotton is exported, Australian growers do face price risks associated with the exchange rate from US dollars to Australian dollars. This risk should not be underestimated, as it plays a major part in influencing returns.

The extent to which the NYBOT futures price and the AUD/USD exchange rate fluctuate are shown in **Figures 31 and 32**. Each shows the weekly change in prices over the last 10 years.

Cash prices for cotton at the gin-yard in Australia are a product of New York futures, the basis and the Australian dollar exchange rate. 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.

Although production and price risks have been treated separately in this article, the link between the two cannot be over-emphasised. For example, if a grower decides to enter into a contract (either before or after planting) to sell a specified quantity of cotton at a specified time for a fixed price this results in exposure to several risks.

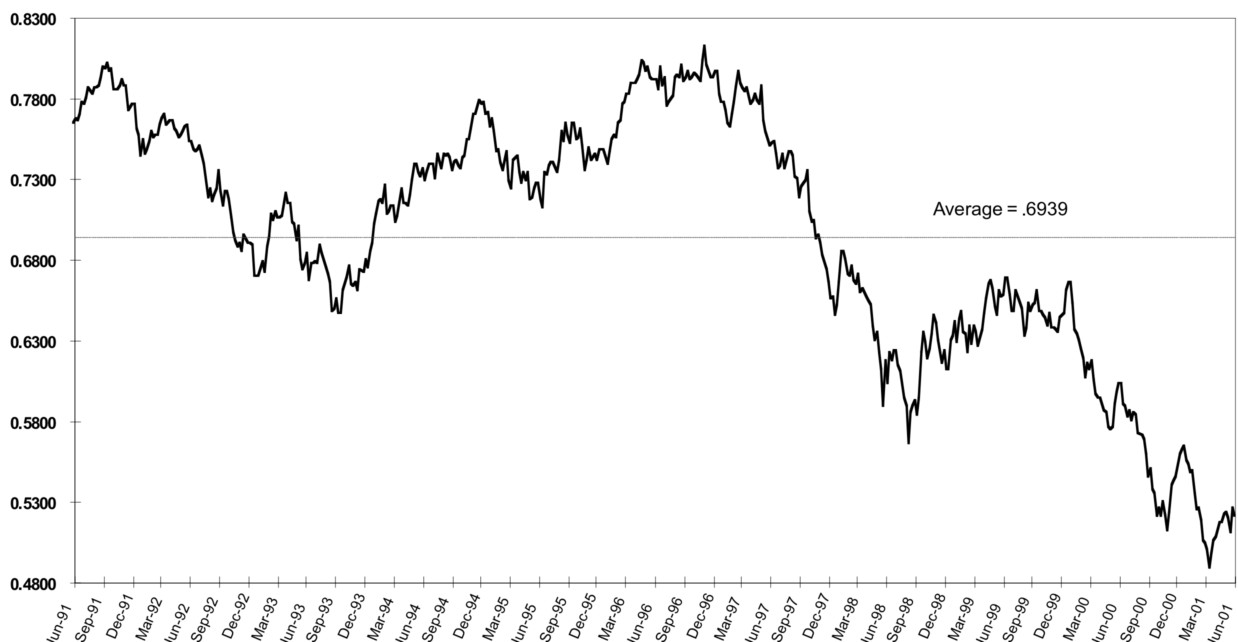
One risk, or opportunity cost, is that if the grower had waited and actually sold the crop later, a higher price may have been achieved. Another is that not enough cotton may be produced to meet the contract requirement. In this instance, if prices go up, then the grower has to go out in the market and buy at a higher price to replace the shortfall. This inevitably reduces returns (sometimes considerably). Of course, the opposite risk of prices falling and production being greater than expected must also be considered.

MARKETING ALTERNATIVES

The Australian cotton market is well serviced by a range of cotton merchants and marketing co-operatives. Each marketing organisation competes daily to buy cotton from growers and sell into the international market.

Some of the marketing organisations have their own gins and can arrange both ginning and marketing services for the grower. In general however, marketing and ginning tend to be viewed as independent operations and it is the growers responsibility to have the cotton ginned ready for sale or delivery against existing contracts.

Figure 32: AUSTRALIAN DOLLAR (10 YEARS)



The names used by merchants to describe their marketing alternatives differ somewhat and so to do the detailed terms and conditions associated with their alternatives. Growers should therefore check the details of each merchant's alternatives carefully. The most appropriate alternative or combination of alternatives will be determined by many factors including individual circumstances and market conditions.

The marketing alternatives available from most merchants have been examined and are summarised below.

1. Fixed Priced Contracts

Fixed prices contracts may be entered into before or after the cotton has been harvested.

Forward contracts are simply agreements between buyers and sellers to trade specified amounts of a specific commodity at a specified time for a specific price. All marketing organisations in Australia offer forward price contracts. These contracts may be for a fixed number of bales, or may specify all bales produced from a specific area of cotton planted.

Under a **fixed bale forward price contract**, the merchant agrees to pay the grower a fixed price for a fixed number of bales. The contracted quantity must be delivered to the merchant, however there are usually clauses in each contract to cover a non-delivery event.

The financial advantage of fixed price contract is that the final price for base grade cotton is known when the contract is made. Payment is typically made within 14 days of ginning or classing of the cotton.

Payment for cotton can also usually be arranged in Australian dollars or US dollars per bale.

Some merchants offer **area or yield risk contracts** that do not require the grower to supply a specified quantity. In such cases, the merchant expects the grower to supply all the cotton from the particular area contracted.

All merchants also offer fixed bale cash price contracts for cotton that has already been ginned and classed. These can often be known as **spot price contracts**, for cotton for immediate delivery, or on the spot.

2. Pool Contracts

The pooling concept is well known to grain growers and is also used by many cotton growers. The main features of pools are:

- The individual grower's cotton is marketed together with that of other growers in a pool.
- The pool manager markets the pooled cotton using a variety of marketing methods over the season.
- The growers receive an equalised net return adjusted for the quality of each delivery made to the pool.

The pool manager is responsible for managing the price risk of the cotton in the pool.

In most instances the grower has to contract to deliver to a specific pool. The grower must nominate in advance the area or quantity of bales which is going to be delivered to the pool. For **fixed bale pools** there may or may not be penalties for no-delivery. For **area or yield risk pools** there are usually clauses which pass the yield risk to the pool manager and exclude penalties for non-delivery caused by crop failure, low yield, hail and flood events etc.

Area pools have two advantages for growers. First, the price risk exposure is managed by experts in the industry and second, the yield risk is reduced for the grower. Perhaps one of the disadvantages of the pool system is that the final return to the growers is not known until the pool is finalised. The final return will depend on the total number of bales delivered to the pool, the sales and hedging strategies used by the pool manager, and the costs associated with delivering all bales to their final end user markets. During the season most organisations operating pools estimate what the final pool return will be on a regular basis. Payments for pools are usually made over several months coinciding with the shipment of bales to their final destination. The sales and shipment period can stretch out until March in the year following ginning.

3. On-Call Contracts

As we have outlined, the price of Australian cotton is determined by three price variables: futures, basis and the AUD/USD exchange rate. Under an **on-call contract** the grower is entitled to call on the merchant to hedge each individual price leg at different times, hopefully coinciding with the optimum level for each price element. The main features are:

- The grower must undertake to deliver a certain quantity of cotton at a certain time
- The grower can decide at any time prior to specific contracted dates to lock in a price

- via the New York futures market price, the AUD/USD exchange rate and the basis for Australian cotton
- All three price legs must be fixed prior to final payment

Some merchants offer the grower an average basis achieved over the season that is then combined with the grower's fixed futures price and exchange rate.

The main advantage of an on-call contract is the ability for the grower to price different price elements at the most advantageous times with the aim of achieving optimum prices.

4. Guaranteed Minimum Price Contracts or Pools

These contracts are a variation on the fixed price or pool contracts. Under a Guaranteed Minimum Price (GMP) contract, the merchant will guarantee a minimum price for the contract. Normally, the grower is required to supply a fixed number of bales. These contracts are mainly based on the use of **options** (see below) to allow the merchant to guarantee a minimum price. The GMP alternatives are usually priced at a discount to the fixed price contracts. The advantage of the GMP contract is that it will allow the grower some participation in upward price movements after the contract has been agreed.

PRICE RISK MANAGEMENT TOOLS

Independent Hedging

All of the alternatives covered above involve a contract to a merchant to sell cotton, but growers may also hedge independently using futures contracts, forward currency contracts and options organised through their marketing organisation or merchant, or through other futures brokers and banks. The actual sale of the cotton to a merchant is still necessary at some point in time, however the underlying price of futures and the exchange rate can be hedged independently.

As mentioned, Australian cotton merchants use the NYBOT futures market to hedge Australian cotton price exposures. Growers can also use this market independently, but it is not recommended unless you have a thorough understanding of the operation of the market and the risks and costs involved.

Futures hedging is complex and is considered beyond the scope of this manual. However, one of the more advantageous tools that can be used to hedge price exposures for a grower is through the use of options on futures contracts and options on the AUD/USD exchange rate so we will include a brief explanation here.

A futures *option* is the right, but not the obligation, to buy or sell a futures contract for a particular price and delivery month. For this right, the buyer or the seller pays or receives a premium. Options can be a very useful and flexible risk management tool for the grower. For example, options can be used to allow growers who have not forward priced their cotton, to insure or guarantee a futures market price; enhance forward sold cotton in a favourable moving market; or even to ensure futures prices without production risk.

MAKING THE DECISION

Despite the wide range of marketing alternatives available to growers, the choice of suitable alternatives is influenced by many factors. In the case of dryland producers, who face greater production uncertainty than irrigated growers, some marketing alternatives may not be available.

New dryland growers, in particular, should be conscious of the likely high risk of their production not being as planned, and should be very cautious in their attitude towards price risk management. They may well be best advised to consider using area or yield risk pools in order to hedge price and yield exposures.

When deciding how and when to use the range of available marketing alternatives, the following key issues should be addressed and understood before making decisions.

Marketing policy and strategies

All growers should have a clear marketing policy and strategies in place to achieve their objectives. Even if this just involves selling through a seasonal pool, the reasons for this strategy should be known and the forecast price should be assessed relative to other alternatives.

Seeking advice

Because marketing can be so complex, growers should seek advice from marketers and consultants with proven track records, and also to seek the advice – and benefit from – the experience, of other growers. Growers should also look carefully at the results of using particular marketing methods/hedging strategies in previous years.

Tax considerations

Growers should consult their tax adviser before setting a marketing strategy. Pools are generally finalised, and therefore pay the majority of income, in the financial year following ginning, which enables the grower to declare this income in that fiscal year. Cash contracts are usually paid 10-14 days after ginning. Consequently this may be assessed as taxable income in the year of harvest/ginning.

Module and bale loans

Most merchants offer the growers a payment advance or loan on cotton in a module form and waiting to be ginned. This gives the grower some cash flow around harvest time as cotton lint payment may be delayed while the cotton waits to be ginned or the cotton is sold into a pool.

Taking account of all risks

Both production and price risks are very real to cotton growers. Either may cause financial losses and therefore the risks should not be underestimated. Given their total reliance on seasonal conditions, dryland growers should view production risk as critical in their planning. Also, when looking at the price risk, growers should be careful to take account of both the commodity price and the exchange rate.

Understanding financial implications

Growers should fully understand the financial implications of the marketing alternatives available to them. As outlined above, these can vary enormously.

Understanding terms and conditions

All terms and conditions of any marketing contract should be fully understood before the contract is signed. In signing a contract, growers should bear in mind the substantial differences which often exist between contracts offered by difference merchants.

Maintaining close contact with the merchant

Having entered into a contract with a merchant, the grower should maintain close contact with that merchant throughout the season. If things do not go as expected in terms of production or market prices it may be possible for the merchant to recommend some solutions to the resulting problems which would not be immediately apparent to the grower.

Monitor and review

Growers should continually monitor, review and, where necessary, revise their marketing policy and strategies during and after a marketing season.