

**GROWER MARKETING RISK HANDBOOK  
ISSUED BY THE**

**AUSTRALIAN COTTON  
SHIPPERS ASSOCIATION, INC**

**Incorporated under the  
Associations Incorporations Act 1981  
(Queensland)**



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## **1.0 Introduction**

The challenge for cotton producers in Australia is not confined to managing the many environmental risks that may be presented during the growing year. Given the combination of futures prices, currency rates and basis levels that determine the price of a cotton crop, it is important growers understand how these pricing elements impact on their bottom line.

In response to the challenges presented by financial markets and overseas mill markets, merchants have developed several different grower contracts, for the purpose of alleviating some of the risks for the growers. Through various means, such as derivatives trading, a merchant is able to manage the risk it takes on when contracting to purchase a grower's cotton.

This document gives a general overview of the pricing dynamics resulting in the Australian dollar price per bale, some of the innovative contracts devised to purchase cotton from growers, as well as other elements of cotton contracts and marketing.

The material is intended for general information only and must be considered with the disclaimer at the bottom of this page.

## **DISCLAIMER**

The material within the ACSA Handbook is intended only to provide a summary and brief overview on cotton marketing and risk. The content of this ACSA Handbook is not intended to provide the reader or anyone else with cotton marketing, risk or financial product advice. Prior to engaging in any form of cotton marketing we recommend that you obtain independent advice from your solicitor, accountant and financial adviser or any other relevant professional adviser including where appropriate a licensed Australian Financial Services License Holder and that you read any relevant Product Disclosure Statement or other relevant disclosure documentation. ACSA is not responsible to the reader or anyone else for any loss suffered in connection with this ACSA Handbook. To the maximum extent permitted by law we exclude completely all liability to any person for loss or damage of any kind (however caused; including by negligence) arising from or relating in any way to the use of this Handbook. Where any law implies a warranty which may not be lawfully excluded, then to the maximum extent permitted by law, our liability for breach of the warranty will at our option be limited to the supply of the services again, or to the payment of the cost of having them supplied again. By receiving this document you acknowledge and agree that the document is provided on the basis that this disclaimer will be retained at all times in this document and drawn to the attention of any other person to whom the document is provided.

## 2.0 Marketing Risk Overview

**A definition of risk:** Chance of loss, to put in jeopardy, take a chance of.

Production and marketing of raw cotton involves aspects of risk. Risk management is where the decision maker, the cotton grower in this case, narrows the range of outcomes possible in the management and marketing of their crop. Managing the risk for a cotton farming enterprise includes but is not limited to recognising risk, isolating risk, measuring the likely effects and implementing a management practice to minimise the adverse effects of risk or doing nothing.

There are trade-offs with risk management. Firstly, when seeking opportunities for profit, there is always the risk losses may occur. Secondly, there are costs involved in managing risks to avoid losses. When the cotton grower makes a decision to plant a crop, they are taking a physical position in the market, from this they will begin to have an opinion on production, quality and price if these issues were not already part of the decision making process prior to committing to growing cotton. The impacts from any of these three risks have the potential to change the profit margin of the business – in some cases dramatically.

### 2.1 Price Risk

Price risk for the cotton grower is a result of crop production not being one hundred percent sold and the value of the unsold production being affected by changes in prices.

Most cotton in Australia is priced in Australian dollars per bale. The Australian Dollar (AUD) cash price is made up of three components; the Intercontinental Exchange (ICE) Number 2 Cotton Futures Contract (formerly the NYBOT contract), AUD/USD currency and USD basis.

#### ICE Number 2 Cotton Futures Contract:

One ICE cotton future contract represents 50,000 lbs or one hundred running bales of SLM 1-1/16, G5 micronaire US cotton on a Rule five basis (free on truck ex certified warehouse). Although ICE cotton futures best represent US cotton risk, it normally correlates sufficiently well with non-US origins that it can be used as a hedge to assist in managing price risk.

Cotton futures pricing is driven by two principal factors, being, a) fundamentals and b) technical factors. Fundamentals refer generally to supply and demand of physical cotton and technical factors refer to historical price behavior being an indicator of future price behavior. The main participants in the fundamental pricing of the market are producers, consumers and merchants. The technical participants are mostly speculators in the form of managed funds.

Fundamental analysis is largely centered on a stock to use ratio, which is total uncommitted stocks at the year end divided by total use, which is domestic use plus exports.

Technical analysis is largely centered on market trends and patterns. In many cases, the technical outlook will call for lower prices if the preceding 30-60 days have been trending lower and visa versa.

In respect to the medium term USD value of physical cotton, the majority of the movement in price is a function of futures movement and the balance is basis oriented.

#### AUD/USD Currency:

Cotton is internationally traded and priced in USD. As such, the USD price is converted to AUD for domestic Australian pricing. The USD price is converted at the spot AUD/USD rate for spot purchases and converted at the relevant forward AUD rate for forward purchases. Given the USD price is unchanged, the AUD price per bale will increase if the AUD depreciates against the USD and visa versa. Valuation of the AUD/USD rate is a function of economic factors.

#### Basis Risk:

Basis is best discussed in USD as US cents per pound (us cents/lb). Basis is the difference in price between the value of a physical bale and the underwriting futures contract price. The basis value for a physical bale is a function of quality, location, availability, demand and competition (other growths and subsidies).

## 2.2 Production Risk

From a marketing perspective, overall production risk is separated into yield and quality risk. Yield risk is characterised as the exposure created as a consequence of changing yields. Changing yield may put the grower in the position of overproducing or under producing against the commitments already made. In the case where production is greater than the commitments and the contract price is higher than the current market price, the grower has an opportunity loss. If production is less than the commitments and the contract price is lower than the current cash price, the grower is obligated to either deliver on the contract or to request an “invoice back”, which is the equitable cancellation of an incompletely delivered contract, which will be a material loss to the grower.

## 2.3 Counterparty Risk

Counterparty risk is the risk of default on contract performance or contract payment (delivery and payment) by either buyer or seller. Default value on contract performance refers to the difference between the contract price and the cash price on the day of the default by the number of bales committed. The larger the market difference and the more bales involved the greater the dollar value of a contract performance default. Contract payment default refers to cotton already delivered and title passing from the seller to the buyer and payment from the buyer to the seller not forthcoming.

Contract performance is paramount for ongoing forward contracting. The sanctity of all contracts is critical in order to protect the mutual interests of the counterparties and provide a safe marketing framework for Australian growers and to achieve price efficiency.

## 3.0 Pricing Dynamics

**In this and subsequent sections we refer to various products used in the management of risk in cotton marketing. As stated at the outset, the purpose of this handbook is not to provide you with advice, and in particular financial product advice, but rather to provide information about risk management mechanisms and products you may encounter in relation to cotton marketing. We do not express any opinion or make any recommendation in relation to such mechanisms or whether you should use such products and you should obtain your own advice from your professional advisers, and where appropriate, a licensed financial services provider, before using them.**

The components of the Australian dollar price per bale are ICE cotton futures, basis and the AUD/USD exchange rate. The three components work together in the calculation below to make the AUD cash price per bale;

$$\text{AUD/Bale} = \frac{(\text{Cotton Futures} + \text{Basis}) \times 5}{\text{AUD/USD Rate}}$$

$$\text{e.g. AU\$450/Bale} = \frac{(66.00 - 3.00) \times 5}{.7000}$$

## 3.1 Cotton Futures

A futures contract is a binding agreement between a buyer and a seller through an exchange and clearing house to make and take delivery of an underlying commodity or financial instrument at a specified future date. Each contract has a buyer and a seller. The buyer, known as the *long*, agrees to take delivery of the underlying asset. The seller, known as the *short* makes delivery. The futures market is an organised forum for the trading of forward contracts, to promote liquidity with standardised terms. The prices at which futures contracts are struck are determined by free competition amongst market participants. Futures provide producers, consumers and merchants a means of price risk management.

Futures market participants are merchants of physical goods, producers, consumers - generically known as hedgers (and commonly called “the trade”) who use the market to hedge or offset a physical exposure and speculators who speculate for profit (commonly called “the funds”).

A hedger's principal economic activity is production, trading, processing and consuming physical commodity. The purpose in using futures is to reduce price risk. A hedger protects themselves against unfavourable market movements. Speculators do not have a vested interest in the underlying commodity but seek to profit from market volatility. Involvement of speculators in the market is important in order to provide liquidity for hedgers.

A futures contract has a buyer and a seller. The term *long* and *short* is often used and denotes a participant's position. Long describes a participant that has bought a futures contract and short is a participant that has sold a futures contract. The long futures contract participant agrees to take delivery of the underlying commodity at an agreed forward date at an agreed price that is set at the time the contract is entered into. The short futures contract participant agrees to deliver the underlying commodity at an agreed time in the future at an agreed price.

A cotton grower that produces 1,000 bales has an exposure to price movement. If prices soften, the grower loses income opportunity, if prices firm, the grower increases income opportunity. A grower would be a seller of cotton futures to hedge the 1,000-bale risk. A hedge will not eliminate 100% of price risk but reduce the outright price risk. The grower should be mindful that selling futures to hedge production risk covers the futures component of pricing, however, leaves the currency and basis components floating.

#### Cotton Futures Contract Specifications:

Contract Size:	1 contract = 100 bales of 500 pounds per bale or 50,000lbs net weight
Contract Symbol:	CT (eg, May 2009 Cotton futures symbol is: CTK9)
Daily Limits:	3 cents above or below previous day's settlement price prior FND (expanding given certain market conditions)
Base Quality:	US Origin, Strict Low Middling, 1-1/16 staple, 3.5-4.9 micronaire
Delivery Location:	At Certified US warehouses
Delivery Date:	As per Contract Months
First Notice Day:	Five business days from end of preceding month
Last Trading Day:	Seventeen business days from the end of spot month
Minimum Price Movement:	1/100 <sup>th</sup> of a US cent = 1 point
Point Value:	1 point per pound = US\$5.00 per contract
Trading Months:	March (H), May (K), July (N), October (V) and December (Z)
Deliverable Origin:	US cotton only

### **3.2 Basis**

Basis is the difference between the price of a physical commodity of a specific quality at a specific time and location and the price of the underlying futures contract. Basis links the physical and the futures market bringing a real price to the grower. Interior basis refers to the basis price at an interior point where the commodity is produced and sold by the grower. In Australia interior basis refers mostly to FOB gin terms. Influences on interior basis are predominantly supply and demand within the interior market. Exterior basis refers to the global market mostly on CIF (delivered cost, insurance & freight) destination terms. Exterior basis is a function of competing growths and supply & demand for each quality of Australian cotton.

Basis is the cash price in US cents per pound (US cents/lb) less the futures price. If US cents/lb cash price is 66.00 cents and the ICE Futures market is at 63.00 then basis equals  $(66.00 - 63.00 = +3.00)$  3.00 US cents/lb ON futures. The buying basis that a grower is bid might be calculated from the sale price bid from end export consumers. An Asian cotton mill may buy Australian base grade cotton for 73.00 US cents/lb, costs are say 10.00 US cents/lb to move the cotton from FOT gin Gwydir Valley, Australia to CIF (landed cost, insurance and freight) Asia Main Port. The breakeven purchase price from the grower is then 63.00 US cents/lb. If the NY futures May contract is 66.00 US cents/lb then the purchase basis is -3.00 US cents/lb OFF ICE futures May 08 contract, FOT Truck.

In summary:

Sale price CIF Asia Main Port	73.00 US cents/lb
Basis CIF Asia Main Port	7.00 US cents/lb ON (sale price less futures price)
FOT Gin to CIF	10.00 US cents/lb
Purchase price from grower in Gwydir	63.00 US cents/lb
ICE May 08-contract close	<u>66.00 US cents/lb</u>
Basis FOT Gin	-3.00 US cents/lb OFF (purchase price less futures price)

The FOT gin to CIF Asia cost is local freight, insurances, interest, storage, commissions, ocean freight and handling.

Note: the above assumes the same base quality has been bought and sold and assumes no profit for the merchant.

### 3.3 Foreign Currency

Australia is a net exporter of cotton and therefore prices should always reflect export parity in USD terms. USD's are the currency of the international cotton trade thus Australian export receipts are US\$ denominated. Growers in Australia predominantly operate an AU\$ denominated business and prefer to have their sale receipts in AUD. USD cotton export values must be converted into AUD values to better suit the local grower, as a consequence, the AUD/USD rate has a large impact on the AUD price locally. The local AUD per bale price increases as the AUD rate softens against the USD and visa versa.

When managing currency in forward periods, forward points will be quoted on or off the spot AUD/USD rate. Forward points essentially reflect interest rate differentials between Australia and the US. If Australian interest rates are higher than US rates then forward points to purchase AUD in future years will reward this with a lower forward rate and vice versa. In the event of forward AUD/USD rates being at a discount to spot rates, forward AUD per bales prices are higher than nearby prices, all other things being equal.

The majority of contracts between merchants and growers are an AUD cash price per bale where the grower assumes no currency risk. However if using an on-call contract, or contracts where a grower fixes the three components of pricing (futures, currency and basis) separately, growers as a result hold and manage a currency risk. It is critical to note that a partially priced contract can create greater risks than being totally unpriced or wholly priced. In the event currency is fixed and USD cotton values decrease, the grower may have an over-hedged currency position that may create a greater risk of loss.

Any risk management tools that the grower uses to progressively or partially price production should be regularly measured against current market values in order to ensure exposures are not greater than what is appropriate.

### 3.4 Options

The trading of options is a very complex subject and its full treatment is beyond the scope of this document. A more thorough explanation can be found in the books listed in the reference list. The two most common option strategies for producers are to a) buy puts against unsold production and b) buy calls against sold production to create a floor price.

A bought option is the right but not the obligation to buy (in the case of a call option) or to sell (in the case of a put option) a futures or currency contract at a predetermined price on a specific date. The price paid to own the option is known as the *option premium*. The level at which the trader chooses to buy the option is known as the *strike price*. Converting the option into a buy or sell futures contract at the strike price is known as *exercising the option*. An option contract can give the buyer the choice to fix a favourable price without being obligated to accept the price. For example, the purchase of a put option gives the buyer the right but not the obligation to sell futures at the strike price. If however, the futures market advances above the strike price, the option owner can sell the futures at the higher price and either sell the option back for its residual value or let the option expire worthless. When buying an option, the most the grower can lose is the option premium.

Bought options are used in marketing strategies as a hedge tool or to enhance the price of an existing strategy. Like futures, options can be used for speculation or as a hedging instrument. Bought options can be thought of as insurance. A premium is paid to own them which allows the buyer the 'option' of taking a futures or currency position. However similar to most insurance, they often expire worthless. Bought options become profitable (when considered in isolation from a physical exposure) when the strike price is in-the-money thus increasing the value of the option premium.

#### Option definitions:

At-the-money: When an option strike price is the same as the current trading price of the underlying futures/currency

In-the-money: An option with intrinsic value  
a) Calls – the strike price must be below the current market price  
b) Puts – the strike price must be above the current market price

Out-of-the-money: An option with no intrinsic value  
a) Calls – when the strike price is above the market price

b) Puts – when the strike price is below the market price

Intrinsic value: The amount by which an option is in-the-money

Time value: The portion of the premium that exceeds the intrinsic value. This reflects the probability that the option will move in-the-money

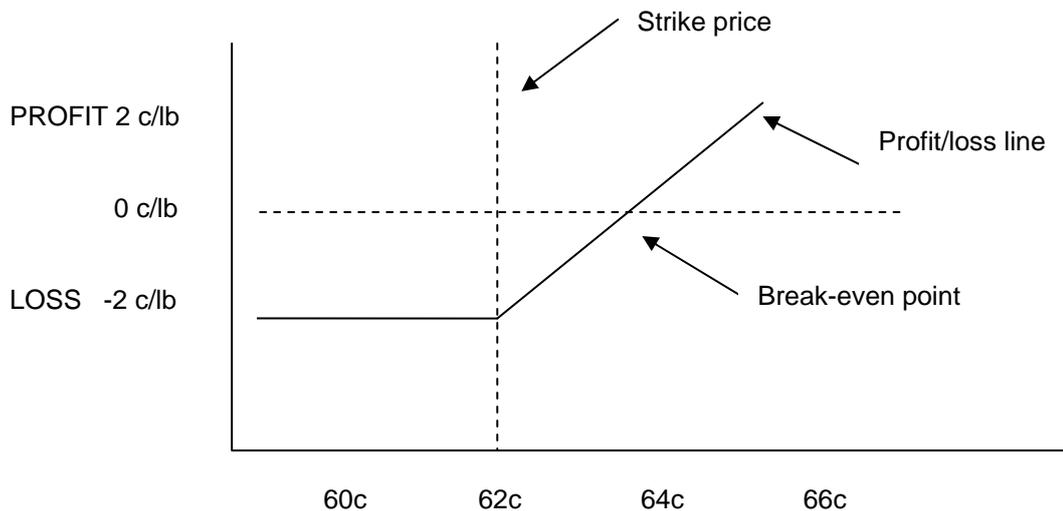
Time decay: The option premium (value) deteriorates, all else being equal, given that there is less time for the option to advance in-the-money. The rate of decay of an option is not linear. An option's time value decays much more rapidly in the last few weeks of its life

Delta: The incremental price change in the option's premium to the incremental price change in the market

Call Option:

By purchasing a CALL OPTION the buyer has the right but not the obligation to receive a **long (buy)** futures contract at the strike price. The buyer pays a premium to own the option. A call option is bought with the general expectation of a rise in futures prices.

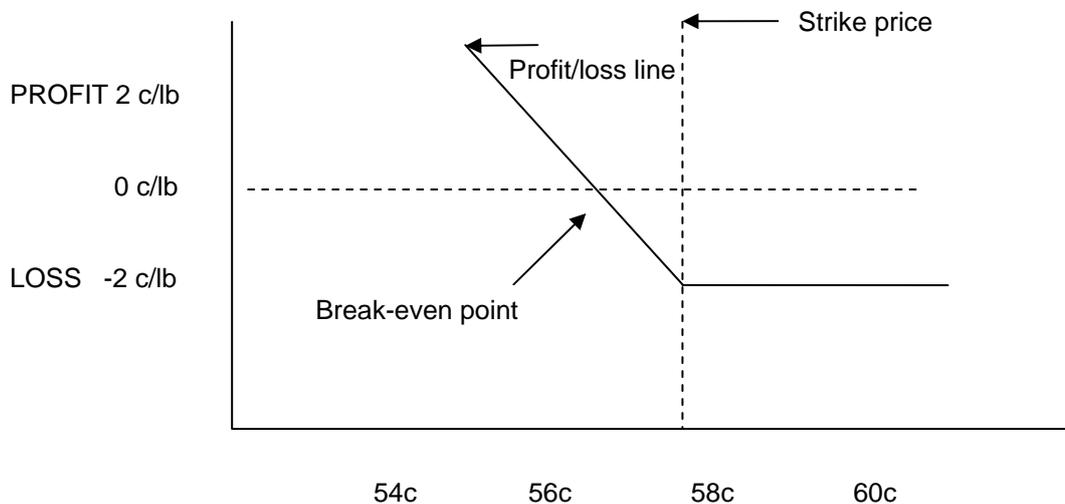
Profit/Loss graph: Long Call Option



The purchase of call options is often used as a price enhancement technique once a cash sale has been fixed. Locking in a cash price and then buying a call option retains upside exposure in any rally in the futures market once the futures market exceeds strike price plus the cost of the option on expiry.

### Put Option:

By purchasing a PUT OPTION the buyer has the right but not the obligation to assume a short (**sell**) futures contract at the strike price. The buyer pays a premium to own the option. A put option is bought with the general expectation of a fall in futures prices.



Put options are often used as a method of protection from the futures market falling by creating a floor, but leaves the opportunity to benefit should the futures market rise.

Buying an option gives the buyer the right but not the obligation to buy or sell a futures contract. The most that can be lost is the option premium paid for the option. With the purchase of an option there is limited cost and, theoretically, unlimited profit potential. Selling an option is a considerably different risk to buying an option. With the sale of an option, there is theoretically an unlimited loss and limited profit potential (premium). Many merchants will only allow the selling of options with an offsetting option bought.

### Further Reading:

A Complete Guide to the Futures Markets : Fundamental Analysis, Technical Analysis, Trading, Spreads, and Options by Jack D. Schwager

Option Volatility & Pricing: Advanced Trading Strategies and Techniques by Sheldon Natenberg

Options, Futures, and Other Derivatives (5th Edition) by John C Hull

### 3.5 Premium and Discount Schedules

Premium and Discount (P&D) sheets are designed to allow a single price representing a base grade to be quoted for growers with variable qualities being deliverable. The P&D sheet represents the market value of various qualities. In summary, premiums are paid for higher than base grade qualities delivered and discounts are deducted for lower than base grade qualities delivered. P&D sheet values are set based on international market values for various qualities.

International market values for the various qualities fluctuate over time and are affected by supply and demand factors for each quality group causing P & D values to change respectively.

## 4.0 Marketing Options

Merchants and banks offer many different types of contracts that enable growers to structure their marketing and risk to a range of specifications and payment terms. Contracts vary from fixed cash price to pricing the three components independently, to price enhancement strategies and pool payment options. Below is a breakdown of the most common available marketing options, do bear in mind that each merchant has their own unique contracts offered on a regular basis or according to market opportunities.

Growers should be mindful that contracts must be delivered in chronological order according to the date cotton has been contracted.

### General Contract Specifications:

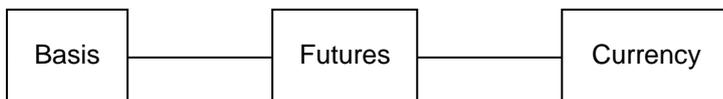
- Seller's name: Legal entity responsible for production and sale of cotton
- Buyer's name: Merchant purchasing the cotton
- Quantity: Number of 227 kg bales
- Quality: Base grade
- Price: Whether fixed or unfixed, the price arrangement must be specified
- Payment: Must be specified whether it is AUD or USD and time frame
- Bale Sequence: Bale identification for shipment

### 4.1 Cash Contract

- The simplest and most common marketing method
- Fixed price per bale (basis grade), final price subject to quality differentials
- Fixed bale amount must be nominated
- Delivery period confirmed on contract
- Payment is usually 14 days from date of ginning.

### 4.2 On Call Contract (may be referred to as Call Pool Contract)

- The on call contract enables the grower to lock in the three elements of the pricing independently, ie the basis, futures and currency.



- The merchant provides assistance where needed, however the timing and locking in decisions are in the hands of the grower. Deferred payments apply as with the pool payment contract. Return is unknown until all elements of the contract are locked in, although it is possible to estimate returns.
- This contract is often used when the grower wants to take advantage of one or more of the pricing components, however, not complete the entire price. Often in the case when they are bullish on one or more of the components. An example of this is to lock in AUD and Basis yet leave the futures component to a later date.
- The grower commits a fixed bale amount to the merchant.
- A delivery period is confirmed and a date at which the contract must be fixed. This date is usually the day before the first notice day before the underlying futures contract, usually being May, July, or December futures contract.

### Fixing the price elements:

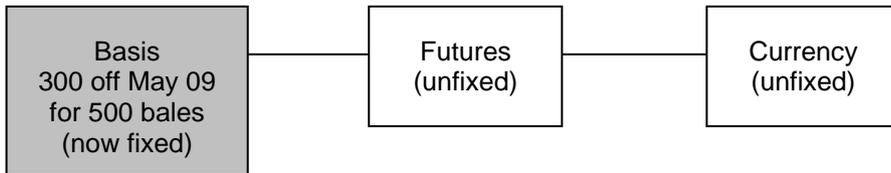
In January 2009, a grower has 500 bales to sell. They would like to commit the bales to a merchant and use the On-Call contract to try to maximise all components of the price at a level where they think is more suitable than the going forward cash price of AUD \$450. At this stage futures are at 66.00 c/lb, basis is tracking at -300 Off May 09 and the AUD is at 0.7000.

- The grower is satisfied with the basis level and locks it in at -300 Off May 09. He/she contacts the merchant with an order to:

Fix the basis for 500 bales at -300 off May 09

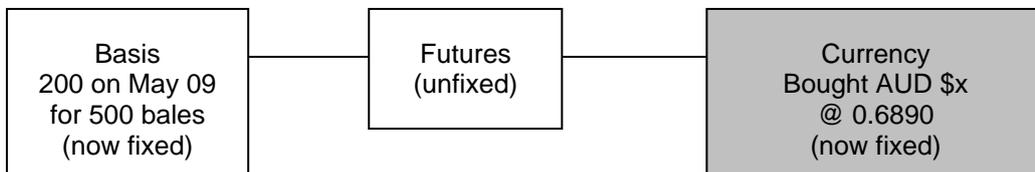
- The merchant confirms the fixation.

January:



- In February the AUD has come off 1 cent and is now trading at .6900. The forward points out to May 09 are (10 points), leaving the AUD at .06890. The Grower would like to take advantage of the lower level and fix the AUD/USD.
- Before locking in the currency rate the grower must have a target cash price in mind for the cotton in order to know how much AUD to hedge. The grower nominates \$520 per bale as achievable, hence fixed the rate at 0.6890 for a total AUD amount of AU\$260,000 for the 500 bale contract. Therefore the grower sells US\$179,140 and buys AU\$260,000.
- The fixation is made, the merchant confirms the currency element is fixed.

February:



- In April the NY Cotton Futures are now tracking at 72.00 c/lb, a level near the target of 74.66 c/lb (74.66 is the level the NY futures need to be at to achieve \$520 per bale). The grower decides to lock in the futures component should they reach this target level.
- Grower places an order with the merchant to sell Futures at 74.66
- In the next two weeks the market rallies and the order is filled for the merchant and the futures element is locked in at 74.66.
- The fixation is confirmed and the grower is informed of this.

April:



- All three components of the price are now fixed and the grower achieves a cash price of \$520. As the grower achieved the target cash price, there is no over or under hedging of the AUD on the merchant's part.

#### Rolling the basis

- 1.80 c/lb. If the grower decides to roll the contract to July, they would have to pay the cost of the spread, which in this case would be 1.80 c/lb. This would be discounted from their basis once the roll is confirmed.

#### On call contract administration fees

- The On-Call contract involves certain costs to the merchant, in the form of administration, licensing and qualifications as well as the brokerage cost for hedging its exposure as a result of the grower's decisions. As such, an administration fee may be added to the contract. This fee will be deducted from the basis level and will be stated by the merchant before entering into the contract. For example, if a merchant charges a fee of 0.50 c/lb (50 basis points), and cash basis is tracking at EVEN, then the basis for the contract will be 0.50) c/lb or (50) basis points off.
- Quantity: Generally a minimum of 1000 bales per contract.
- Payment is usually 14 days after the date of fixing the price but not before delivery of cotton.

### 4.3 Seasonal Pool Contract

- A pool opens, several growers place their cotton into a pool, the pool closes with or without notice.
- A fixed bale amount must be given.
- An indicative price range is given throughout the life of the contract eg. \$450 - \$480.
- When the pool is closed and the price is finalised the grower receives the price.
- The final pool price is a function of the average price of sales over the course of the pool liquidation, less costs.
- Several pools may be run throughout the season with different price ranges.
- Delivery period confirmed on contract.

*Example: A seasonal pool is proposed by the merchant in September 2007 as planting begins. Estimated pool returns are based on a range of \$380 - \$430 per bale, delivered at gin. Grower believes this pool price is reasonable and commits 50 ha. to the pool at a yield of 9.1 bales/ha.*

### 4.4 Guaranteed Minimum Price (GMP) Contract

- A guaranteed minimum price contract does exactly what it says. The aim of the contract is to place a floor in the spot price while leaving room for possible upside in the price. A guaranteed minimum price is quoted and received should the market drop. Growers use this contract when they want to lock in a floor price yet are friendly on the market and would like to take advantage of upside without receiving a price lower than the GMP.
- Delivery period confirmed on contract.
- Payment is usually 14 Days from date of ginning or Pool Payment.

### 4.5 Hectare/Area Contract

- The grower nominates a specific hectare amount on their farm and an anticipated acreage to commit to one merchant for a particular year. The grower provides the merchant with property map highlighting the fields committed to that merchant.
- Fixed price per bale (base grade), final price subject to quality differentials.
- A maximum yield (dryland or irrigated) is agreed on by the merchant and grower. For example, the grower can deliver *everything up to* 4.0 bales for dryland and 10.0 bales for irrigated per hectare from the nominated fields). If the grower produces above the maximum yield, the bales are theirs to market.
- If growing conditions comply, the grower must plant cotton on the designated hectares.
- If conditions do not comply, (eg a drought hence no water) and the grower is unable to plant cotton on the acreage, the contract has a force majeure clause attached.
- Delivery period confirmed on contract.
- Due to the risk involved for the merchant regarding lack of production, this contract usually comes at a discount to the cash market.

### 4.6 Balance of Crop

- The grower sells the remaining bales in their crop, giving the merchant an estimated number. This contract is commonly used towards the end of picking when a grower is unsure of their final numbers of bales, however still wants to commit it to a merchant and take advantage of a price.
- The merchant may request module numbers.
- If cotton is in module form an approximate or average turnout percentage may be used e.g 38% lint to calculate the likely bale outturn. Different varieties will give different turnout, this is just a rough gauge).
- Fixed price per bale (basis grade), final price subject to quality differentials.
- Delivery period confirmed on contract.
- Payment is usually 14 Days from date of ginning or Pool Payment.

### Tax Disclaimer for all contracts

**It is strongly recommended that growers seek tax advice in respect to the tax implications of payment methods. Merchants make no undertakings as regards the tax suitability of any contract type or payment method.**

## **5.0 Contracts**

### **5.1 Appeals & Arbitration**

- Arbitration between the buyer and the seller must be done so as per the arrangement on the relevant cotton contract, and will be specified in the contract Terms and Conditions. In most cases arbitration will be required to be put in writing and delivered personally, posted, or received by facsimile, followed by confirmation of receipt of documentation.
- Appeal of Classing disputes:
  - Refer ACSA Rule 10.2
  - If discrepancies can not be settled in house, then the cotton may go to review with the Cotton Classers Association of Australia (CCAA).
  - The CCAA committee will consist of CCAA members with at least 5 years Australian classing experience and a grower association chairman appointee.
  - Reviews will be held on either technical or grade disputes.
  - Fees are associated with the review process of approximately \$4.00 per sample for grade and approximately \$5.00 for technical. There is a minimum charge of \$1000.00.

### **5.2 Standard Terms & Conditions**

- With the issue of a purchase contract from a buyer, the grower will receive a copy of Terms and Conditions applicable to that contract. Whilst the ACSA terms and conditions are the foundation of a buyer's terms and conditions, each merchant may vary slightly or have additional contractual conditions. Within the Terms and Conditions will be information regarding the following topics:
  - Contract rules
  - Fulfillment of contracts
  - Notification and access to cotton in the gin yard
  - Merchantable and deliverable cotton
  - Packaging and tare standards for delivery
  - Weights for delivery
  - Delivery and shipment of cotton bales
  - Information required on bale tags FOB gin yard
  - Title to goods and payment terms
  - Settlement of disputes
  - Fraudulent practices
  - Prosecution
- It is very important to have read the Terms and Conditions of the contract prior to signing the contract. The agreed contract and its T&Cs will override all other terms and conditions if merchant's T&C's are in conflict.
- Growers should seek independent legal opinion before agreeing to any contract T&C's

### **5.3 Transfer of Title**

- Refer to ACSA Trading Rule number 9.1 attached herewith.

### **5.4 Delivery of Contracts**

- When making a sale of cotton, a grower must consider the amount of cotton previously sold to all merchants/buyers in order to not over commit their cotton, hence be in a position where he/she is unable to deliver the cotton. To avoid the issue of over commitment of cotton, and according to ACSA Trading Rule number 1.3;
- At the time of picking and ginning, when allocating contracts to merchants, the cotton must be committed to the merchants in the chronological order they were contracted (in accordance with ACSA Trading Rule number 2.1). The grower must fill the earliest dated contract first, through to the last dated contract being filled last, regardless of price and quality.

## 5.5 Commitment to Contracts

### At what stage of a contractual agreement is a grower committed to a merchant?

*Answer: The moment they confirm verbally or in writing to deliver bales to a merchant.*

- Irrespective of what type of contract the grower is entering, as soon as a grower enters a contract for commitment of bales to a merchant verbally or in writing, they have a legal obligation to deliver those bales, unless otherwise stated in writing and agreed upon by both parties. The follow up contract between the buyer and seller is a formalisation of the agreement already verbally made and sets out the terms. Examples:
  - If a grower enters an On Call contract, locking in only the currency component, they have made a commitment to deliver the bales against the contract, unless other arrangements are agreed upon by both parties.
  - If a grower enters a Cash Price contract, they have made a commitment to deliver the bales against the contract. If the crop fails, and the seller is unable to deliver on the contract the buyer may enact default provisions as set out in their terms and conditions.

## 6.0 Regulatory Issues

The use of some products in cotton marketing, such as futures contracts or options and other derivatives may attract the application of financial services regulation as set out in Chapter 7 of the Corporations Act, as administered by the Australian Securities and Investment Commission.

When using or making available such products whether or not in conjunction with physical transactions you should consider the application of the Corporations Act and any relevant licensing and disclosure requirements and obtain legal advice as appropriate. Generally a straight forward physical trade in eg cotton, not involving the use of derivatives will not have licensing implications.

You should also consider the application of any other legislation such as the Trade Practices Act as administered by the Australian Competition and Consumer Commission.

## 7.0 Glossary

**Please note that the meaning of market terms and in particular order types, may vary between markets and particular brokers and you should be careful to understand the meaning of orders given in particular circumstances.**

**Abandon:** The act of the option holder (owner or taker) in electing not to exercise his order.

**Actuals:** The physical or cash commodity, as distinguished from commodity futures.

**All-or-none order:** An order that is designated to be executed only if entire order can be executed.

**American option:** Options that may be exercised on or before the expiration date.

**Ask:** Also called an "offer". Indicates a willingness to sell a futures contract at a given price.

**Assignment:** Notification by The Options Clearing Corporation to a clearing firm member and to the writer of an option that the owner of the option has exercised the option and that the terms of settlement must be met.

**At-the-money:** An option whose exercise price is equal to the current market price of the underlying security.

**Back months:** The futures or options on futures months being traded that are furthest from expiration.

**Backwardation:** Market situation in which the futures prices are progressively lower in the distant delivery months.

**Basis:** The difference between a cash price and a futures price.

**Basis Position:** The difference between the amount of cotton that is owned, or committed to buy, and the amount of cotton sold.

<b>Bearish:</b>	An opinion, or event, perceived to cause lower prices.
<b>Bid:</b>	An offer to buy a specific quantity of a commodity at a stated price.
<b>Broker:</b>	A company or individual that executes cash, futures and options transactions on behalf of individuals and/or financial and commercial institutions.
<b>Bullish:</b>	An opinion, or event, perceived to cause higher prices.
<b>Buy on close:</b>	To buy at the end of a traded session at a price within the closing range.
<b>Buy on open:</b>	To buy at the beginning of a traded session at a price within the opening range.
<b>Call Option:</b>	An option which gives the option buyer the right to purchase (go long) a particular futures contract at a specific price. If the buyer exercises the call option, he will acquire a long futures position and someone who has sold an option will be assigned a short futures position at the same time.
<b>Cash Market:</b>	Market for delivery of and payment for physical commodities.
<b>CFR:</b>	Cost and freight.
<b>CIF:</b>	Cost, insurance and freight.
<b>Contango:</b>	Market situation in which prices are progressively higher in succeeding delivery months than in the nearest delivery months. (Sometimes called a "Carry-charge market")
<b>Contract Month:</b>	The month in which futures contracts may be satisfied by making or accepting delivery.
<b>Day Traders:</b>	Speculators who take positions in futures or options contracts and liquidate them prior to the close of that same trading day.
<b>Delta:</b>	A measure of how much an option premium changes, given a unit change in the underlying futures price. Delta is often interpreted as the probability that the underlying futures price will move in-the-money by expiration.
<b>European Option:</b>	An option that can be exercised only at expiration.
<b>Exercise:</b>	The process by which the holder of an option notifies the seller of intention to take delivery of the underlying in the case of a call, or make delivery in the case of a put, at the specified exercise price.
<b>Strike price:</b>	The price at which the holder (buyer) may purchase or sell the underlying futures contract upon the exercise of an option. Sometimes referred to as the "exercise price".
<b>Expiration:</b>	The date an option contract becomes void. All holders of options must indicate their desire to exercise by the business day preceding the expiration date. It is the last day on which an option can be exercised. If not exercised the option may become worthless.
<b>Expiration Month:</b>	The month which the expiration of an option occurs.
<b>Extrinsic Value:</b>	The price of an option less its intrinsic value. The entire premium of an out-of-the-money option consists of extrinsic value. This is often referred to as the time value portion of option premiums. This is the full price of a commodity as quoted in a cash market (i.e.: Futures + Basis).

<b>Flat Price:</b>	This is the full price of a commodity as quoted in a cash market (i.e.: Futures + Basis)
<b>Fill-or-kill:</b>	The type of order that requires that the order be executed completely or not at all.
<b>First Notice Day:</b>	The first day on which the clearing house notifies clearing members of delivery allocations.
<b>Force Majeure:</b>	Events caused by an act of God, such as hail, flood or storms or other circumstances such as acts of Government etc which are outside the control of a party.
<b>FOB:</b>	Free On Board.
<b>Forward:</b>	In the future.
<b>Fundamental Analysis:</b>	A method of anticipating future price moves by the studying of supply and demand information.
<b>Future:</b>	A contract to buy or sell a predetermined quantity of a commodity or financial product for a specific price on a given date.
<b>Good Till Cancel order:</b>	An order to fix a security that will remain in effect until the order is executed, cancelled or invalid.
<b>Hedged Position:</b>	A position established with the specific intent of protecting an existing position.
<b>Hedger:</b>	An individual or company owning or planning to own a cash commodity (cotton, corn, soybeans, wheat, bank bills, wool etc.) and are concerned that the cost of the commodity might change before either buying or selling it in the cash market. A hedger achieves protection against changing cash prices by purchasing (selling) futures contracts of the same or similar commodity and later offsetting that position by selling (purchasing) futures contracts of the same quantity and type as the initial transaction.

<b>Initial Margin:</b>	Customer's funds put up as security for a guarantee of contract fulfilment at the time a futures market position is established. (Same as "Original Margin").
<b>Interest:</b>	Charged levy for the privilege of borrowing money.
<b>Intrinsic Value:</b>	The amount by which an option is in-the-money. Out-of-the money options have no intrinsic value. Intrinsic value is the difference between the exercise price or strike price of an option and the market value of the underlying security.
<b>In-the-money:</b>	An option with intrinsic value (buyers) a) Calls – the strike price must be below the current market price or futures price. b) Puts – the strike price must be above the current market price or futures price.
<b>Limit (Up or Down):</b>	The maximum price advance or decline from the previous day's settlement price permitted in one trading session.
<b>Long:</b>	Means that you have bought something or own something and haven't yet sold it.
<b>Margin:</b>	The amount of money or collateral deposit by a client with his broker, or by a broker with the clearinghouse, for the purpose of insuring the broker or clearinghouse against loss on open futures contracts.
<b>Margin Call:</b>	A communication to a trader asking them to pay cash to cover an adverse movement on a futures position.
<b>Mark-to-market:</b>	The daily adjustment of margin accounts to reflect profits and losses.
<b>Market-if-touched:</b>	A price order that automatically becomes a market order if the price is reached.
<b>Market-on-close (MOC):</b>	An order to buy or sell at the last price on the close.
<b>Nearby Month:</b>	The futures contract closest to expiration, also referred to as spot month.
<b>Offer:</b>	An indication of willingness to sell at a given price.; opposite of bid.
<b>Open Interest:</b>	The sum of futures contracts in one delivery month or one market that has been entered into and not yet liquidated by an offsetting transaction or fulfilled by delivery.
<b>Open Order:</b>	Order to broker that is good until cancelled.
<b>Option (bought):</b>	The buyer of an option acquires the right and not the obligation, to buy or sell an underlying commodity under specific conditions in exchange for the payment of a premium.
<b>Out-of-the-money:</b>	An option with no intrinsic value (buyers) a) Calls – when the strike price is above the market price. b) Puts – when the strike price is below the market price.
<b>Over-the-counter:</b>	Non-exchange traded forward contract.
<b>Pit:</b>	Historically the area of trading floor where futures and options on futures contracts are bought and sold. Pits are usually raised octagonal platforms with steps descending on the inside that permit buyers and sellers of contracts to see each other. Cotton futures and options are now principally traded electronically.
<b>Position:</b>	An interest in the market, either long or short, in the form of open contracts
<b>Premium:</b>	a) An amount paid for Quality, Time or Location differentials b) Basis, as in the difference between cash and futures prices c) The amount paid or received for an option bought or sold
<b>Put Option (bought):</b>	The right but not the obligation to a sell futures contract. The <i>option</i> to sell a specified amount of a commodity at an agreed price and time at any time, until the expiration of the option. The buyer pays a premium to the seller of the option. The buyer has the option to sell the option contract, or enter into a short futures position if the option is exercised.

<b>Rally:</b>	An upward movement in prices following a decline.
<b>Settlement Price:</b>	The official closing price at the end of a trading session.
<b>Short:</b>	This means you have sold something without having ownership of that item(s) or you have a requirement for that item(s) without having purchased it.
<b>Speculator:</b>	One who attempts to anticipate price changes and, through buying and selling futures contracts, aims to make profits; does not use the futures market in connection with the production , processing, marketing or handling of a product. A spec trader has no interest in delivering or receiving the physical.
<b>Stop:</b>	An order to buy or sell at the market when and if a specified price is reached.
<b>Strike Price:</b>	The price at which the futures contract underlying a call or put option can be purchased (if a call) or sold (if a put). Also referred to as exercise price.
<b>Spread:</b>	Price difference between two separate cover months.
<b>Technical Analysis:</b>	Appraise future price movements using historical prices, trading volume, open interest and other trading data to study price patterns.
<b>Tick:</b>	The smallest allowable increment of price movement for a contract. Also referred to as minimum price fluctuation.
<b>Time Value:</b>	The amount of money option buyers are willing to pay for an option in the anticipation that, over time, a change in the underlying futures price will cause the option to increase in value. In general, an option premium is the sum of time value and intrinsic value. Any amount by which an option premium exceeds the option's intrinsic value can be considered time value. Also referred to as extrinsic value.
<b>Time decay:</b>	What happens to the value of the option as time goes by; non-linear rate as the option nears expiration.
<b>Underlying Commodity:</b>	The commodity on which a futures or option contract is based.
<b>Volatility:</b>	A measurement of the change in price over a given time period. It is often expressed as a percentage and computed as the annualised standard deviation of percentage change in daily price.
<b>Volume:</b>	The number of purchases or sales of a commodity futures contract made during a specified period of time, often the total transactions for one day.

## 8.0 Website References

Australian Cotton Shippers Association	<a href="http://www.austcottonshippers.com.au">www.austcottonshippers.com.au</a>
National Cotton Council of America	<a href="http://www.cotton.org">www.cotton.org</a>
United States Department of Agriculture	<a href="http://www.usda.gov">www.usda.gov</a>
Futuresource	<a href="http://www.futuresource.com">www.futuresource.com</a>
Barchart	<a href="http://www.barchart.com">www.barchart.com</a>
Meridian Foreign Exchange	<a href="http://www.meridianforex.com.au">www.meridianforex.com.au</a>
New York Board of Trade	<a href="http://www.nybot.com">www.nybot.com</a>
Cottonworld	<a href="http://www.cottonworld.com.au">www.cottonworld.com.au</a>
Bureau of Meteorology	<a href="http://www.bom.gov.au/weather">www.bom.gov.au/weather</a>
National Weather Services	<a href="http://www.nws.noaa.gov">www.nws.noaa.gov</a>