

Supply chain and price risk management

Australian Wool Innovation Limited's response to recommendations from two commissioned reports

Introduction

In 2005, Australian Wool Innovation Limited (AWI) commissioned two studies in the broad area of supply chain and price risk management:

1. The Merino Company (TMC) was contracted to conduct a study assessing the viability of supply chain business models, and to advise on the suitability of the model for Australian woolgrowers.
2. Independent Commodity Services (ICS) was commissioned to complete a report on Wool Marketing and Risk Management.

AWI's intent in commissioning these studies was two-fold:

- As an input into internal planning and strategy development processes.
- As a resource for interested parties in the wool processing pipeline, recognising the high level of interest in these areas.

AWI staff have examined the advice received in both studies, and are in the process of finalising a strategy for this investment area. However, recognising industry interest in the TMC report, AWI has decided to release both reports, and a set of interim responses to the recommendations made. Both reports are now publicly available on the AWI website (www.wool.com.au).

AWI encourages industry participants to provide us with feedback on the two reports. As part of this feedback AWI will hold a workshop to discuss the recommendations.

For those who wish to provide feedback please contact Dr Paul Swan via email – paulswan@woolinnovation.com.au.

NZ Merino Supply Chain Business Model for Australia

Aim

The aim of the research was to define practical alternative models for wool marketing and risk management that could be implemented across the supply/demand chain to improve the efficiency and profitability of Australian woolgrowers.

The research was to be completed using a combination of desk research, focus groups and telephone interviews with growers, and interviews and a telephone survey of pipeline participants. The Merino Company (TMC) and the New Zealand Merino Company (NZM) were selected to conduct the research, based on their experience in New Zealand.

Summary of findings

The survey of 465 growers found:

- Growers are very supportive of the concept of targeted marketing schemes involving growers, similar to the NZM model.
- 89% of growers involved in focus groups, and 42% of growers involved in a wider telephone survey said that they would pay a fee averaging 3% of gross income to participate in such schemes.
- Willingness to participate in such schemes is tempered by a requirement for accountability and performance.
- Few growers have direct experience with use of forward contracts to supply processors, and the auction system is the overwhelmingly dominant method of supplying wool to processors. There is little evidence among growers of dissatisfaction with the current auction system, and hence no strong evidence of a key driver for change among growers.
- Three major barriers to widespread adoption of alternative demand chain and risk management models:
 1. Low levels of dissatisfaction with the current system.
 2. Low levels of understanding as to what an alternative system may provide.
 3. Poor connection of extension messages about risk management and forward contracting to the needs and perspectives of various sub-segments in the grower population.

The survey of 32 pipeline partners found:

- There is in general little interest among the post-farm pipeline participants, including retailers, for targeted marketing schemes involving growers, and interest declines as one moves along the pipeline from farm gate to retailer.
- There is little interest among processors for additional mechanisms for managing price volatility.

Responses to individual recommendations:

The report makes 16 recommendations for AWI to consider, and these are dealt with individually below.

In framing responses to the individual recommendations made, AWI concurs with the major findings of the report - that there are major structural impediments to widespread adoption of

grower 'pushed' supply chain initiatives. AWI can and does play a role facilitating individual demand-driven targeted marketing activities, where clear linkage is made to retail level, and there is clear evidence of co-investment by the commercial parties involved in the demand chain.

Recommendation 1

AWI should facilitate commercial activity within the broad area of demand generation. This should be focused on targeted support of a broad range of activities and catalysing and supporting commercial participants activity within the area of demand generation.

Response:

AWI agrees with this recommendation and points out that AWI is already very active in this area, as part of its business to business (B2B) strategy which enables AWI to work closely with the key decision makers in global clothing markets and target its innovations towards market demand.

Examples of these activities include:

- developing productive relationships with retailers and brand partners in key market segments;
- active participation in international trade shows such as SpinExpo, Pitti Filati, and ispo;
- working with designers such as Jayson Brunson, Josh Goot, and Akira to develop Merino-focused collections; and
- creation and operation of the *Merino Innovation* website (www.merinoinnovation.com) and *woolontheweb* website (www.woolontheweb.com) to convey information both technical and marketing information to brand partners, retailers and manufacturers on the superior qualities of Australian Merino. These sites are available in English and Mandarin versions.

Recommendation 2a

AWI should commission a project to map seasonal variability of wool production and key quality parameters across a broad array of production regions and enterprise types (i.e. reliance on wool production, scale etc). The project should analyse the impact of seasonal variability on grower ability to supply into forward contracts and/or its impact on other risk management tools.

Response:

AWI supports the recommendation to map the seasonal and regional variation in wool production and key wool quality parameters, and has been investing grower funds to this end through initiatives such as the Australian Wool Production Forecasting Committee (AWPFC), and related research projects.

However, AWI does not support the recommendation that further research is needed to analyze grower ability to supply wool to forward contracts – commercial entities such as major wool selling brokers and others already offer risk management tools which allow growers the ability to offset this risk.

Recommendation 2b

Should the impact of seasonal variation be found to undermine the ability to use forward contracts and for other risk management tools, AWI should commission work to examine the creation and adaptation of existing risk management tools which are more flexible in dealing with seasonal quality variation.

Response:

AWI does not agree with this recommendation, as there are many effective risk management products currently commercially available to woolgrowers. There is little evidence of market failure in the area of creating or improving risk management tools – rather, there is strong evidence that the structure of the wool production industry (large numbers of grower, most with very high levels of equity), high levels of reliance and general satisfaction with the auction system, and low level of liquidity in the futures market are major impediments to the use of these commercial tools.

Recommendation 3:

AWI should commission in-depth work that analyses the impact of risk management on farm financial performance and overall farm management and ensure extensive and effective communication of those impacts to the grower base.

Response:

AWI does not agree with this recommendation, as widely accessible farm financial performance benchmarking studies address price risk management as a contribution to income. For example, the widely available AgInsights series of publications of Holmes Sackett and Associates identifies the contribution of price risk management (“hedged position”) to farm profitability.

Recommendation 4a

The key themes of ‘risk proofing’ production and financial performance should be developed for project assessment and contribution to those themes should be reported as part project outcomes.

Recommendation 4b

Contribution of AWI technologies to assisting growers in the areas of ‘risk proofing’ production and financial performance should be reported in fact sheets and other relevant communication.

Response:

AWI recognises the importance of the ‘risk proofing’ theme, and will consider adding ‘enterprise risk proofing’ as a standard criteria used in the assessment of investment proposals.

Recommendation 5

AWI should undertake a detailed analysis of grower attitudes across a range of production and market related issues to identify key points of alignment or interest between the various grower subsets and AWI’s various communication activities. This would allow communication strategies to be better targeted to the needs of the various groups and their particular interests and outlooks.

Response:

AWI already conducts shareholder surveys from time to time, in relation to a range of issues, and for a range of purposes including refinement of communication strategies. However, we recognise the need to constantly improve communication with our shareholders and stakeholders, and will continue to work to this end.

Recommendation 6

AWI should investigate its ability to catalyse and co-ordinate commercial parties to enable direct linkage arrangements between growers and manufacturers with respect to the commercialisation of AWI technologies and platforms.

Response:

AWI agrees with this recommendation and has taken steps through our B2B strategy to foster the adoption of AWI-funded technologies and products by industry, for the benefit of AWI shareholders and our retail, brand, and processor partners. This is seen as a critical priority in AWI's product marketing efforts.

Recommendation 7

Upon receiving any proposals for projects relating to market linked activity or facilitation of commercial players, AWI should develop and complete a benefit appropriation analysis to ensure projects outcomes will provide clear and transparent transferal of benefits back to growers.

Response:

AWI agrees with this recommendation, and has in the past conducted analyses of benefit capture arising from AWI post-farm investments. However, no method is perfect and AWI seeks to continuously refine investment assessment criteria.

Recommendation 8a

AWI should develop initiatives to work alongside key broker staff to identify which of AWI's programs would add value for brokers' businesses.

Response:

AWI recognises the importance of wool selling brokers as an important element of the wool demand chain, and will continue to work with brokers, where appropriate and beneficial to both parties, as part of an ongoing research and development, corporate communication and B2B strategies.

Recommendation 8b

AWI should build effective education/extension programs to work with broker staff and to equip them to take the key messages to woolgrowers clients in a manner that helps drive both the broker and grower client businesses.

Response:

AWI agrees with this recommendation, and is already conducting this type of involvement with key brokers in areas such as management of Dark and Medullated Fibre Risk, and the AWI Shearer and Wool Handler Training Program.

Recommendation 9

AWI should clearly and consistently communicate the manufacturing and consumer benefits of using Australian wool and equip post-farm participants to take wool's key consumer benefit messages to the market place.

Response:

AWI agrees with this recommendation, and undertakes a number of activities to this end through our B2B strategy, *Merino Innovation* website (www.merinoinnovation.com) for retailers and designers, and *woolontheweb* website (www.woolontheweb.com) for processors. Reflecting the importance of Asia as a global wool hub, both of these websites are now available in both English and Mandarin.

Recommendation 10

AWI should commission further case study work to develop the other industry case study analyses undertaken in the project. This additional work would determine the drivers that initiated changes at producer and retail level and assess the applicability of those drivers to the wool industry and their fit with current supply chain participants.

Response:

AWI has conducted in-depth research into competitor fibre industries such as cotton, and will consider funding further research in this area.

Recommendation 11a

AWI support of grower groups should be focused on those with the long term desire and ability to deliver products and services described in the case studies, if support is to be provided to traditional grower groups at all. Basic upskilling and education of grower group leaders should be initiated and partnership with organisations that provide other complementary services should be developed.

Response:

AWI agrees with this recommendation, and has developed a set of criteria to use to assess supply chain proposals arising from grower groups. However, education and training initiatives for grower group leaders are considered a low priority for AWI.

Recommendation 11b

AWI should consider and evaluate the analysis in project EC740 [Wool Marketing and Risk Management Scoping Study] and earlier work with respect to grower groups, their successes and failures, and use that to help direct AWI policy and future directions.

Response:

AWI agrees with this recommendation.

Recommendation 12

AWI should identify two key technologies within existing product platforms and facilitate commercial organisations to pilot an alternative demand chain approach linking those technologies back to a supply base. This would enable a 'learning by doing' approach to be developed and specific growers and chain members to be engaged to participate and develop the systems.

AWI's role would be two fold in such a project:

- **To identify the technology and partners from grower supply through to end product, and facilitate their linkage; and**
- **To provide supporting information at each stage which facilitates demand generation, e.g. education and training re clip preparation and effective management at the on farm stage, right through to technical support re machine settings and processing efficiency, to retailer education and marketing collateral.**

Response:

AWI agrees with the general thrust of this recommendation, and a number of initiatives in this area are underway, or have been completed. An example of the latter is the *PoshMerino* initiative, involving the fashion retailer Kookai and Gostwyk Group Pty Ltd as the supplier of Merino fibre. However, it is critical that these initiatives be driven by demand 'pull', and not from a technology or grower 'push', in order to be effective and sustainable.

Wool Marketing and Risk Management Scoping Study

Aim

The review was to deliver:

1. A report assessing wool marketing and risk management options currently available to Australian woolgrowers and pipeline participants through to early stage processing.
2. Recommendations for potential AWI research and development initiatives to address market failures identified within the wool marketing and risk management product offering.

Summary of findings

The study concluded that while there are a range of relevant price risk management tools available to growers that there are substantial structural and practical impediments to the development of the wool price risk management industry in Australia. These include:

- The structure of the production system – large number of producers, high proportion of non-specialist growers, high equity in production and low income risk compared to capital base. These combine to make price risk management at best a low priority for many growers.
- The level of production risk (e.g. volume and quality) is much smaller for woolgrowers than for croppers, for example.
- There is a high degree of commitment to, and reliance on, the auction system from both buyers and sellers.

Against this backdrop, the report recommended a number of actions AWI might consider. These are dealt with individually in the following section.

In framing these responses, it is worth noting that, overall, AWI concurs with the major finding of the Report, that "...the marketing, education and administrative implications of dealing with a large number of small growers makes risk management an unattractive proposition for many commercial operators". AWI concludes that there is little evidence of market failure, and hence justification for AWI investment in this area.

Responses to individual recommendations

Recommendation 1

Establish a Wool Industry Risk Management Committee (WIRMCO).

Response:

In the light of industry feedback following release of the TMC and ICS reports, AWI will consider formation of a Research and Development Advisory Panel specific to supply chain issues.

Recommendation 2

Review the viability of exchange traded futures contracts.

Response:

AWI does not agree with this recommendation. The operation and future viability of exchange traded futures products is the responsibility of those commercial entities involved in these products, not AWI.

Recommendation 3

AWI review wool industry risk management education processes.

Response:

AWI does not support this recommendation. Further reviews of price risk management are not needed. Responsibility for education and marketing of price risk management tools lies with those businesses or commercial entities that provide risk management products to woolgrowers.

Recommendation 4

AWI undertake a risk mapping process for the value chain.

Response:

AWI does not support this recommendation. This specific issue was addressed by an earlier AWRAP-funded study, and it is not clear what commercial outcome or benefit will arise from redoing this work.

Recommendation 5

AWI fund fundamental research to facilitate improvements to the GrassGro and related production models.

Response:

AWI has a history of contributing to the development and application of production models, such as GrassGro, and is currently funding development of a new modeling approach to augment the work of the Australian Wool Production Forecasting Committee. Prospective future investments in this area, especially those of a fundamental nature, will be carefully considered and need to be strongly justified and consistent with priorities.

Recommendation 6

AWI invest in applied research to develop a comprehensive understanding of wool production risk at the farm level.

Response:

AWI does not support this recommendation, and contends that there is a well defined and widely available body of knowledge as to production risk factors, including environmental and price risk management factors.

It is worth noting that AWI has produced and makes freely available to growers a number of resources relevant to management of production and price risks, including:

- *Woolcheque* (www.woolcheque.com.au) – a web-based wool pricing service allowing growers to determine the value of their wool clip based on daily or historical prices.
- *Planning for Profit* – a practical guide to assist woolgrowers recover from drought.
- *Managing Sheep in Droughtlots* publication
- *Managing Fodder Prices for Drought* publication
- *Which Sheep do I Keep?* publication
- *Review and Outlook for Fine and Mid-Micron Wool* reports.

AWI is also in the process of developing a Best Practice Package for the Sheep and Wool Industry, in collaboration with Meat and Livestock Australia. Management of production and price risks feature in the component modules of this resource.

Recommendation 7

AWI to investigate the feasibility of commercial solutions to farmer counterparty risk in conjunction with the meat and grain industries.

Response:

AWI does not support this recommendation. The sourcing of credit insurance by commercial providers of risk management tools to farmers is a matter for those providers of risk management tools.

Recommendation 8a

Prior to any AWI funding of supply chains or grower marketing initiatives, groups should undertake a two day workshop on value adding and risk management.

Recommendation 8b

Grower group members be required to fund their own attendance at the workshop, with costs refunded should their project application to AWI be successful.

Response:

AWI does not support these recommendations.

AWI has developed a set of criteria to use to assess supply chain proposals arising from grower groups. One important criteria is the degree of commercial experience and 'nous' of the proponents.

Recommendation 9a

Using the Hassall & Associates questionnaire as a basis, determine the required responses to the questions in order to assist with the screening of grower groups seeking funding.

Recommendation 9b

AWI should investigate the development of a benefit-cost model for grower marketing initiatives which allows an ROI to be determined with respect to the investment of grower levy funds in such initiatives.

Response:

AWI does not support these recommendations.

AWI has developed a set of criteria to use to assess supply chain proposals arising from grower groups.

Recommendation 10

AWI should investigate and seek copyright approval for documents not owned or managed by them to make the Annotated Bibliography Reference source documents available to the industry for future use.

Response:

AWI does not support this recommendation.

Recommendation 11

AWI should investigate ways of improving processors' understanding of risk via a commercial rather than a technical focus.

Response:

AWI does not support this recommendation. Risk management is the responsibility of wool buyers and processors, who for the most part are deeply experienced in the field of risk management.

Recommendation 12

AWI should investigate the use of data contained in The ABARE Profile of Australian Wool Producers to effectively segment the grower base for the effective provision of extension messages.

Response:

AWI does not support this recommendation, as we are not convinced the ABARE survey data effectively segments the grower base. It is worth noting that AWI no longer contributes to the ABARE Producer Survey.
