Department of
Primary Industries and
Regional Development

GOVERNMENT OF
WESTERN AUSTRALIA

The **Sheep Industry Business Innovation** Project

Forward supply contracts for the Western Australian sheep meat sector

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Increased use of forward contracts within the physical supply chain of the Western Australian sheep meat sector could result in greater supply chain integration and investment.

The Western Australian (WA) sheep market functions primarily on spot, short term marketing at both ends of the physical supply chain (production to processor / live export). However more stable and consistent price and production conditions could be supported by market mechanisms, for example forward contracts of between two and six months for out-of-season supply of lamb.

The use and adoption of forward supply arrangements and contracts by the WA sheep industry supply chain could assist supply chain participants and future investors to:

- manage risk
- alleviate peak seasonal production supply
- increase supply chain infrastructure utilisation
- produce higher quality meat to customer specifications (branded high value programs)
- grow total output supply aligned to customer requirements
- obtain alternative sources of finance
- support the attraction of new capital investment (from existing and new participants).

The intention should not be for the WA sheep industry to become dominated by forward supply arrangements and contracts as a means of selling all sheep and lamb. There will always be a place for spot markets due to the large number of producers, the extensive means of production across vast distances in WA that is subject to significant annual climatic variability, and the dynamic shifts that occur year by year in land use allocation by producers and their consultants due to global grain market conditions.

However, the opportunity for greater supply chain integration through an effective forward supply arrangement and contracting system can provide benefits to all participants along the supply chain. To achieve this a proactive, positive and creative approach to addressing the core challenges, constraints and barriers is required along with long-running collaborative industry leadership and willing participants.

Commodity marketing arrangements

In Australia, the majority of sheep market sale transactions are made on a spot market basis either at livestock saleyards through the public ‘open cry’ auction system conducted by livestock agents or through the online livestock sales platform AuctionsPlus, or as on-farm negotiations between producer and purchaser.

The Australian sheep industry generally does not have a well-developed and consistent physical forward contracting system beyond the short-term range (between one and four months) that involve producers and either the processing or the live export sector. However, there are forward contracts (of between one and four months) offered by sheep processors to attract the required supply of sheep in months that are historically difficult to supply or to supply specific market demands. The live export sector may also offer producers forward contracts (of between one and six months) to ensure the supply of specific classes of sheep required for religious events in the Middle East.

Forward supply chain arrangements can refer to agreements between relevant parties in the physical sheep supply chain for the delivery of physical sheep supply at specified standards and protocols at some time into the future. These physical supply chain arrangements may include specific contracts or ongoing agreements, or arrangements as agreed between parties.

Key impacts of forward contracts are:

- consistent supply, quality, volume and timing to specification
- long term investments along the supply chain
- the major retailers operate a direct carcase procurement model from processors. This demonstrates that hitherto, this model is working to the optimum advantage for the WA sheep industry, major retailers and processors.

Price discovery and risk management

The presence and availability of open saleyard market auctions is a distinguishing feature of the sheep and cattle sectors in Australia for the purpose of price discovery, transparency and market reference indicators. Saleyards create and promote spot market transactions for price discovery and marketing comparison purposes. Open saleyard auctions do not play as significant a role in other agricultural commodity sectors in Australia that operate with forward supply contracts, namely pigs, dairy, horticulture, and grains.

The primary functioning of the WA sheep market upon spot, short term marketing makes supply and associated pricing relatively volatile and unpredictable with an absence of future price discovery beyond typically one to two months. In the sheep supply chain, in the majority of cases, the producer takes on production risk, the processor or live exporter takes on receiving adequate supply and price risk and the wholesale, retail and importers take on price risk to meet customer specifications.

The WA sheep industry production is highly seasonal due to climatic, management and economic factors. The WA and global sheep industries do not have a hedging market or suitable commodity cross hedge to guide future price discovery in the months outside of peak supply that can facilitate price and financial risk management for both ends of the supply chain, from producer through to processor and end wholesale and retail customers.

The lack of a futures market in the sheep industry is important, because in the absence of a liquid and operating futures market, the central management decision challenges of price discovery and financial risk management require alternative and innovative approaches for the development and design of forward supply arrangements and contracts within the industry.

Challenges to developing forward contracts

There are a number of risks and challenges to creating and sustaining longer-term forward contracts beyond six months.

Geographic isolation and a relatively small domestic consumer population make WA heavily export dependent and exposed to variations in currency, trade and market access, and international logistical supply chains. Commodity forward contracts were found to be far more common in domestic markets due to lower risks and complexities in delivering product to the end customer. With over 4500 producers with sheep flocks in WA, supply chain fragmentation is also an issue.

From a processor and end-buyer perspective, there are several potential barriers to medium term forward supply arrangements and contracts including securing consistent and certain contracts with customers, the lack of a derivatives market, and guaranteeing the physical delivery quantity and quality of sheep and lambs.

There are a number of advantages and disadvantages of forward contract arrangements that have been identified with potential to impact on either the seller or buyer (Table 1).

Table 1 Key advantages and disadvantages of forward contracts

Key advantages	Key disadvantages
• Manage risks	• Reduced market flexibility
• Remove uncertainty, building market security and confidence	• Price risk assumed by processor
• Reduce volatility for entire supply chain	• Production risk for producer
• Income stability, providing improved budgeting and financial management	• Spot market price deviates from forward contract price
• Enable infrastructure investment planning	• Purchaser obtaining back to back commitments
• Enhance productivity and efficiency value through delivery to specifications	• Potential market concentration
• Facilitate coordination among stages of production, and build value chain relationships between producer and downstream processor (aids information and data flows)	• Risk of reduced competition in spot markets – greater use and adoption of forward contracts reduces the participation of buyers in spot markets. (However, this is potentially offset by reduced supply in spot markets.)
• Increase supply chain infrastructure utilisation	• Loss of price information –increased use of contracting may reduce availability of publicly available pricing transparency.
• Increase confidence to grow sheep supply and assure adequate supply	• Risk of not being paid
• Improved quality control	
• Potential alternative sources of finance and improved access to capital through income stability	
• Reduced transaction and financial costs	
• Intellectual property protection	

Source: various sources and industry engagement

The challenges to the development and implementation of a functional and effective medium term (six to 12 months) forward contracting supply system have been sufficiently overcome in other agricultural commodity sectors operating with and without derivative markets. Specific examples include the Australian pig and dairy industries and the growing use of short term (less than six months) physical forward contract arrangements in the beef and lamb industries in Eastern Australia.

Marketing arrangements in other commodities

Examination of seven agricultural sub-sectors (United States red meat; New Zealand sheep; Australian beef cattle, pigs, dairy, grains (wheat), and horticulture (vegetables) sectors) and Australian sheep found that the overarching impact of contracts common in the sectors was demonstrated as:

- price stability and certainty
- producers delivering production that the market and consumer demands
- guarantee for offtake and processing
- wholesale and middleman bypass
- the ability to generate finance and investment along the supply chain particularly when contracts are with strong credit rated counter parties.

A comparison of marketing arrangements commonly used for different commodities is presented Table 2.

Table 2 Marketing arrangements by different commodity agricultural sectors

Industry	Spot market	<12 months	1 to 5+ year	Operational derivatives[(a)]
Australian Sheep				
New Zealand Sheep				
Australian beef				
Australian pigs				
Australian dairy				
Australian grain (wheat)				
Australian horticulture (product specific)				
USA red meat				

Notes: [(a)]Markets including Over the Counter (OTC) and Exchange

Source: various

The key learnings and experiences of what has worked well as discovered through this examination essentially highlight the elements that will contribute to an effective and sustainable forward contracting system in agricultural commodities relevant and applicable to the WA sheep industry.

Recommendations

Implementation activities for this project

- Deliberate and clear ongoing industry engagement.
- Support the development and implementation of trial 'AuctionsPlus' forward contract sales for slaughter lamb delivery out to six months with forward contract template information and best practice learnings obtained through this study.
- Support the development of new technology and market information and trading platforms for the sheep industry; and facilitate and support the development and promotion of alternative longer-term sheep breeder finance products by banks and financial providers.
- Consider completing a study into sheep processing benefit utilisation, productivity and quality standards based on the theoretical increased use and adoption of forward contracts including different market volume and timing scenarios

WA sheep industry leadership bodies

- Advocate and promote, including: for Australia/ WA to obtain a dedicated United Kingdom (UK) lamb quota following the exit of the UK from the European Union (EU); the adoption of physical forward contract agreements longer than three months; to the banking and financial services sector for the creation of livestock breeder finance products; the development of additional specific live export market information prices per category; and the development of trading platforms in the WA sheep industry.
- Develop an alliance with an independent dispute resolution and arbitration service for forward contracts.
- Develop an alliance with an Australian agricultural industry body that has successfully developed a framework for implementing and maintaining a comprehensive contracting system in an Australian agricultural commodity.
- Increase industry governance standards and perception through appointment of an independent Chair.

Regulation

Department of Primary Industries and Regional Development (DPIRD) and WA Government to consider:

- Advocating for legislation for greater supply chain information through legislation or voluntary industry similar to the USDA Livestock Mandatory Price Reporting Act.
- Engaging with Grain Trade Australia or other industry body to work with and support the WA sheep industry to develop a robust dispute resolution system and contracting framework.
- Advocating for the delivery of a minimum industry standard Code of Conduct with regard to agents and other key stakeholders.

This publication is a summary of a report commissioned by the Department of Primary Industries and Regional Development's Sheep Industry Business Innovation (SIBI) project. To view the full report go to agric.wa.gov.au/forward-supply-contracts-wa-sheep-meat-sector

This project is supported by Royalties for Regions.