

# Role of Price Risk Management In Cotton Sectors



Presented to the Annual Meeting of the ITF  
Interlaken, Switzerland, May 19, 2005

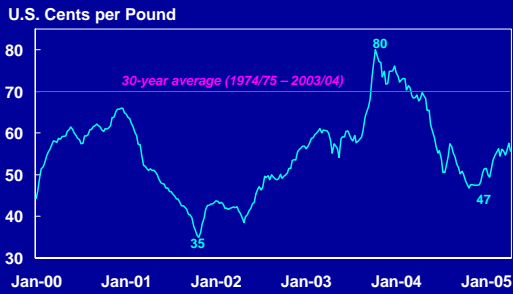
By Gérald Estur,  
International Cotton Advisory Committee

## Outline

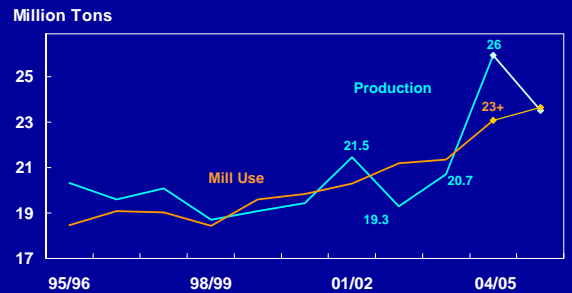
- Cotton Prices Volatility
- Marketing and Hedging Strategies
- African Franc Zone



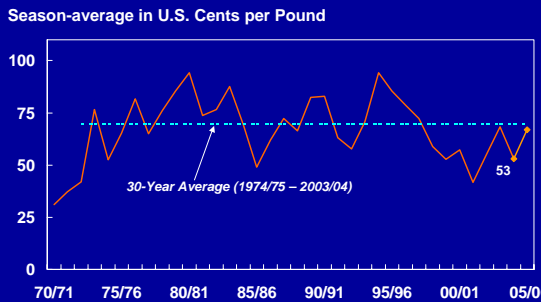
## COTLOOK A INDEX



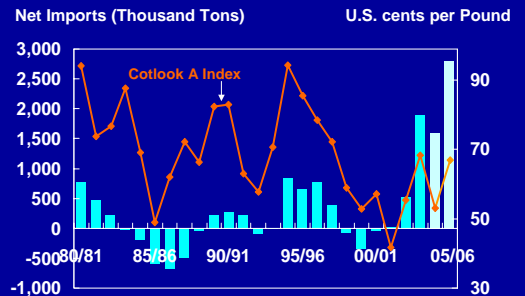
## WORLD COTTON SUPPLY AND USE



## COTLOOK A INDEX

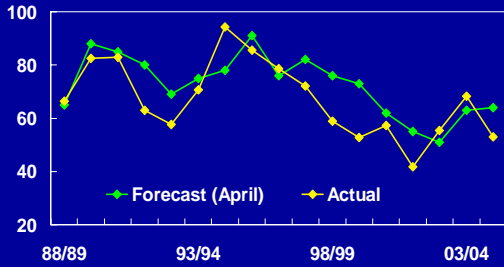


## CHINA (M) NET TRADE & PRICES



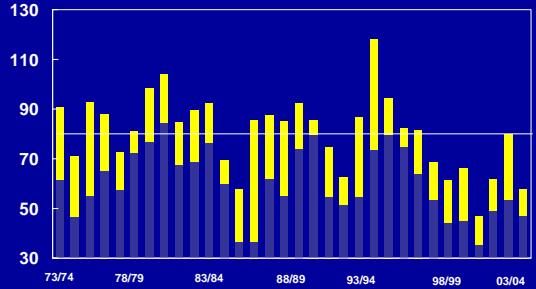
## ICAC PRICE FORECASTS

Season Average Cotlook A Index (U.S. Cents per Pound)



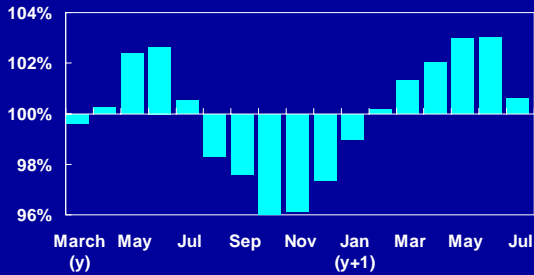
## COTLOOK A INDEX

Season High & Low



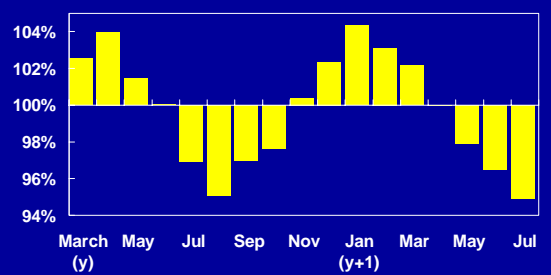
## SEASONAL PRICE TRENDS

Percent of Season Average Cotlook A Index (87/88 - 04/05)



## SEASONAL PRICE TRENDS

Percent of Season Average Cotlook A Index (00/01 to 04/05)



## Marketing Strategies

### Physical sales (fixed price):

- Spot during ginning (Dec y to April y+1)
- Crop averaging (March y to July y+1)
- Forward sales (March-April/May y)
- Price fixed at shipment (Jan to Dec y+1)

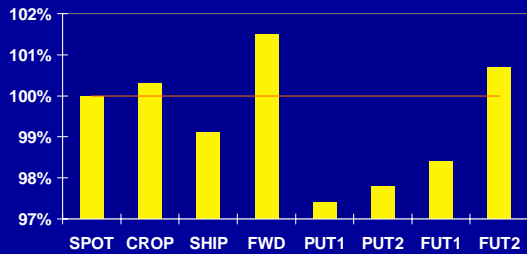
### Hedging:

- Options (buy Dec puts in April, exercise if needed when selling physical)
- Futures (sell Dec in April, buy back when selling physical)

Strategies	Risk Exposure (months)	Cost
Spot sales	8-12	0
Crop averaging	1-15	0
Forward sales	0	0
Price fixed at shipment	9-21	0
Put options	0	3-10%
Futures	0	Credit

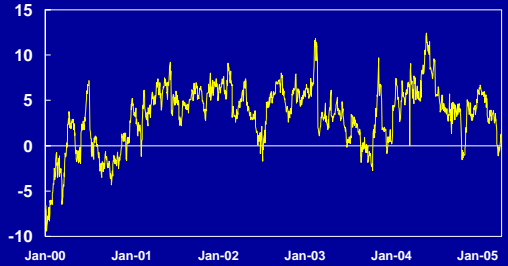
# MARKETING/HEDGING STRATEGIES

Average Selling Price 87/88 -04/05 (Percent of Spot Sales)



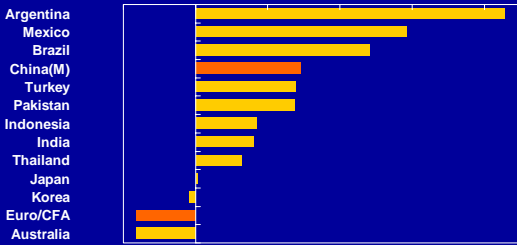
# BASIS

Cotlook A Index minus NYBOT Nearby Futures (U.S. Cents per Pound)



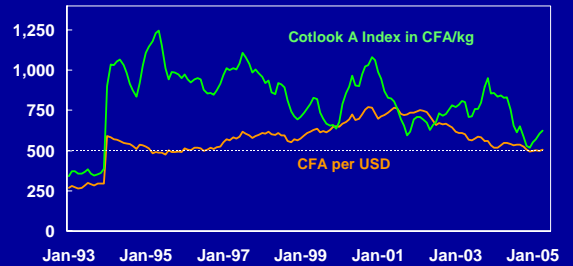
# COTLOOK A INDEX IN DOMESTIC CURRENCIES

% Change Feb 02- Mar 05



# DOMESTIC PRICES

Monthly Averages



# Price Risk

- Fixing seed cotton price before planting protects producers and transfers price risk to ginners
- Being able to lock in selling price of lint prior to fixing seed cotton price would reduce price risk to ginners  
However, locking in price of lint:
  - is not always possible (liquidity, market access)
  - is not always attractive (price level, cost)
  - is not risk free (volume, quality, exchange rate)
  - does not solve problem of inter-annual fluctuations

# Breakeven Analysis (04/05 lowest)

- Producer price: 175 CFA/kg seed cotton
- Ginning outturn: 42%
- Equivalent to: 415 CFA/kg lint
- Costs from farmgate to FOB: 250 CFA/kg lint
- FOB cost (WAF port): 665 CFA/kg
- Less profit from sale of cotton seed: - 40 CFA/kg
- Net FOB cost: 625 CFA/kg
- Exchange rate: US\$1 = 510 CFA
- Equivalent to: 55.5 US cents per pound
- Freight FOB to CFR: \$55 per ton: 2.5 cents/lb
- CFR cost (Far East): 58 cents/lb

All things being equal, breakeven in 2001/02 was 39 cents/lb FOB (US\$ averaged 725 CFA)

## Market in early April 2004

- . Current Cotlook A Index: 69 cents/lb
- . Forward Cotlook A Index: 70
- . December 04 futures: 66 cents/lb  
OI 14,400 contracts; daily volume 2,600
- . Dec Put Options:  
Strike 50 to 90 cents with premium 35 to 2,400 points  
OI 8,800 contracts; daily volume 260 contracts  
Strike 64 cents @ 382 points (6%); OI 1,000



## Marketing Strategies 2004/05

	Selling Price (CFA/kg CFR)
Spot sales	575
Crop average	646
Forward sales	834
Fixed at shipment	630
Put options	686 (761)
Futures	740 (815)

## Lessons Learned

- Although forward contracts widely used, ginners lack expertise & negotiating power to market cotton and manage price risk.
  - No. 1 risk is not to obtain the best price at a given time
  - Insufficient access to market information (merchant biased)
  - Price discovery sub-optimal (FOB sales to merchants)
  - Little understanding of price risk exposure
  - Psychological & language barriers
  - No silver bullet: NYBOT liquidity, cost of options

**Translates into lower producer prices**  
**Considerable demand for training & education**



## How to Optimize Prices?

- . Reduce the knowledge gap and the market gap
- . Educate ginners to strengthen their negotiating power
- . Facilitate access to information on markets & prices
- . Improve price discovery (tenders, exchange info, e-commerce)
- . Diversify contract types, direct sales to spinners
- . Master and use contract rules
- . Demystify price risk management, scale down expectations
- . Improve reliability of shipments
- . Improve quality (eliminate contamination, instrument testing)



## Role of Merchants

- Trade concentrates market knowledge & know-how
- Merchants have access to market instruments (however, basis risk and margin calls are inhibitors to hedging)
- Ginners should use market instruments through their physical contract arrangements with merchants taking advantage of the more flexible marketing & pricing arrangements to expand range of types of contracts they use



## Training & Education

- National & regional workshops for stakeholders focussing on general education about commodity risk management
- Technical assistance (indepth, specialized, customized) for interested parties, with a focus on management staff of ginners and banks lending to the cotton sector.
- Development of educational materials customized for ginners, banks & producers
  - . Risk positions, simulations, decision tools
  - . Price risk management manual and glossary in French
- Feasibility study of a price dissemination program
- Feasibility study of an internet-based trading platform for West African Cotton.

