



ASX

AUSTRALIAN SECURITIES EXCHANGE

Grain Futures & Options

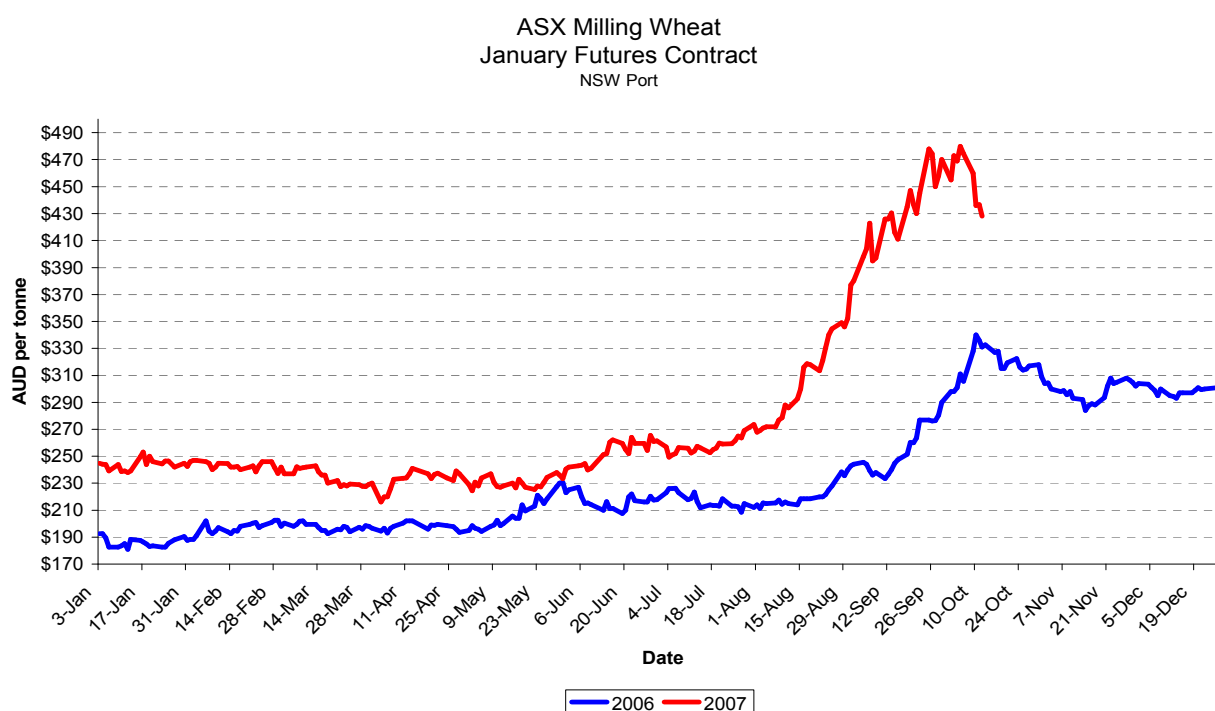
Helping piggeries hedge their feed grain price risk

There is no doubt Australia's pork industry is suffering. A lot of the pain has been caused by the dramatic increase in feed grain costs. The good news is that feed grain costs, which represent up to 60% of an average piggery's total operating cost, can be managed.

As Australia's wheat industry enters a new marketing framework, the importance of taking control over feed grain costs cannot be overestimated. The Australian Securities Exchange (ASX) provides a futures market that piggeries can use to manage their grain price risk. ASX offers futures and options contracts for wheat, feed barley, sorghum and canola in minimum 20 tonne parcels. A number of successful Australian piggeries are protecting their business from the adverse impact of drought and high global grain prices by utilising these tools.

Futures exchanges provide industries with a facility through which price discovery and risk transfer can take place. The ASX Grain Futures and Options market was established following the 2002 drought and has since traded in excess of seven million tonnes.

As you can see in the below chart, the price for wheat this year (red line) is much higher than what was experienced in the drought market last year (blue line). This year global grain stocks, particularly for wheat, are very tight. As we know, the Australian season has finished poorly and the market reaction has been severe.



Why use ASX Grain Futures to hedge grain price risk?

Your business requires you to buy grain. Your risk is that the grain price will increase before you buy it. Hedging this risk by buying futures contracts can help take greater control over your grain costs. A futures contract can help a piggery fix the purchase price of grain in advance. This provides price certainty as the profit/loss made on the futures contract should approximately offset the impact of unfavourable/favourable movements in the underlying physical market. Hedgers use futures markets to avoid risk and to protect their business.

How would a hedge have worked this year?

Assume your piggery has an annual grain requirement of about 700 tonnes which you prefer to buy at harvest. In early May this year, you were concerned that the drought was yet to break and that grain prices could be higher again next harvest. You wanted to protect your business from this risk. To hedge against higher grain prices and protect your business from counterparty credit risk you bought ASX futures. Each futures contract is priced in Australian dollars per tonne, is 20 tonnes (t) in size and is cleared by the Australian Clearing House.

To completely hedge 700 tonnes you bought 35 contracts. For simplicity I have assumed that sorghum is the entire grain requirement. The following table shows the actions and results that may occur had you hedged this risk.

Having a hedge in place on ASX will help protect grain end users from the impact drought has on grain prices. If prices trade lower, the hedge at \$220 per tonne will still be in place unless closed out by selling the futures. If prices trade below \$220 per tonne, the ability to access the cheaper grain will be limited until the hedge is closed out, for this reason it is unlikely any business would be 100% hedged.

Table: How your hedge has performed so far		Buy Futures	Sell Futures	Physical Market
Date	Action	ASX Sorghum May 2008 Futures Price	ASX Sorghum May 2008 Futures Price	Hypothetical Sorghum Cash Price
4 May 07	You want to hedge 700 tonnes (t) of sorghum for next harvest. You buy 35 ASX Sorghum contracts (20t each) for May 2008 delivery at \$220/t.	\$220/tonne (b)		\$260/tonne
11 Oct 07	The market has traded higher as the drought continues to adversely impact winter crops. If the hedge was sold now for \$336/t the hedge will return \$116/t.		\$336/tonne (a)	\$350/tonne (c)
April 2008	We do not know what the market will be trading at in April. What is known is the hedge has performed so far and will continue to protect your business if the drought persists.		?	
Result	At this stage, if the physical grain requirement was priced in October (\$350/t) for delivery in April next year, the final cost of the grain will be \$234/t. The hedge is protecting the business from the drought market.		Potential hedge return \$116/tonne (d) = \$336 - \$220 = (a) - (b)	Potential effective cash price for grain \$234/tonne =\$350 - \$116 = (c) - (d)

Next Step

The first step to improving risk management activities is to pursue further education and information about the tools available. For instance, you can read further about ASX Grain Futures and Options in the Australian Pork Newspaper. To find out more about this market contact Dougal Hunter, Market Development Executive, Agricultural Derivatives on;

Phone: 02 9227 0197

Email: grainfutures@asx.com.au

Website: www.asx.com.au/grainfutures

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