

Managing price risk

- Lot Feeders

Coping with market uncertainty and price volatility is a constant challenge for the Australian beef industry.

Producers, lot feeders, processors and other industry participants are now able to protect against the risk of adverse price movements by using MLA/SFE Cattle Futures and other price risk management tools to secure prices in advance.

- Managing price risk is not about picking market highs and lows.
- It is about obtaining a degree of price certainty, irrespective of where the market goes.
- This protection gives you an increased ability to plan for business requirements, property expansion and family needs.



“Managing price risk can give you peace of mind.”

What are futures?

A futures contract is an obligation to **buy** or **sell** a **specific quantity** and **quality** of a commodity on a **specified future date**. The price is determined by the futures market when entering into the contract.

Futures contracts may be cash-settled (settlement by cash payment) or deliverable (settlement by delivery of the physical commodity). The MLA/SFE Cattle Futures contract is cash-settled only.

Futures contracts allow buyers to secure a buying price and sellers to secure a selling price for a commodity.

Can cattle futures help me secure supply?

Yes, they can.

Until recently, buyers have had a limited ability to secure their supply of cattle in advance. Cattle buyers such as lot feeders and meat processors have been unable to offer forward contracts without taking on additional price risk.

Now, buyers can **offer forward contracts** to their suppliers, and offset the price risk using cattle futures.

Forward contracts can be fixed-price, or alternatively, use the futures market price as the underlying price. The latter are called basis contracts and an example is shown adjacent.

Basis contracts have an advantage over fixed price forward contracts in that they give both the buyer and seller the power to set their own price in the forward contract independently of one another, and at a time that suits them.

Under a basis contract, the producer supplier and the buyer do not have to agree on the full price, removing the main stumbling block to the perfect supply relationship. This creates a 'win win' situation which then allows both parties to focus on producing and securing the best quality animals.

Example of a Basis Contract

1. A feedlot supplying short-fed cattle for the Japanese market is willing to pay 20¢/kg carcass weight (cwt) over the EYCI (cattle futures indicator) to secure the right quality and consistency of supply of feeder cattle.
2. The feedlot offers its suppliers a contract to buy cattle at 20¢ above the EYCI at a specified date in the future, assuming the animals meet the specification outlined in the agreement. The difference between the physical cattle and futures market (or EYCI) prices, in this case 20¢/kg cwt, is called the basis.
3. The feedlot and the supplier agree on the basis and enter into the forward contract agreement.
4. After setting the basis, the only unknown left is the EYCI. The feedlot can choose to buy cattle futures to fix the purchase price of cattle or alternatively, leave the price floating to enjoy any fall in market price between setting the basis and taking delivery of the cattle.
5. The supplier can also choose to secure their sale price independently of the supply agreement by participating in the futures market, or leave the price floating.
6. Delivery of the cattle to the feedlot occurs at the agreed time.

Are cattle futures relevant to me?

Anyone exposed to cattle price risk should consider using futures. However, before incorporating cattle futures into your business, make sure you understand their relevance to your specific enterprise.

An important part of this understanding is knowing the relationship between your prices and the futures market, and how this relationship changes over time. This relationship is called **basis**.

What is basis?

Basis is the relationship between physical cattle prices and the cattle futures market. In the case of the Australian cattle industry, the futures market is represented by the Eastern Young Cattle Indicator.

MLA/SFE Cattle Futures contract specification

Contract size	5,000kg carcass (dressed) weight of young cattle, as represented by the EYCI
Contract months	Jan, Mar, May, July, Sept, Nov, up to 18 months ahead
Settlement	Cash-settled

The EYCI, and therefore the MLA/SFE Cattle Futures contract, has close price relationships with many physical cattle prices. Figures 1 and 2 illustrate several of these.

As such, cattle futures have potential application for many beef industry participants, including lotfeeders.

Figure 1. EYCI vs VIC domestic trade steer, QLD Japan ox prices

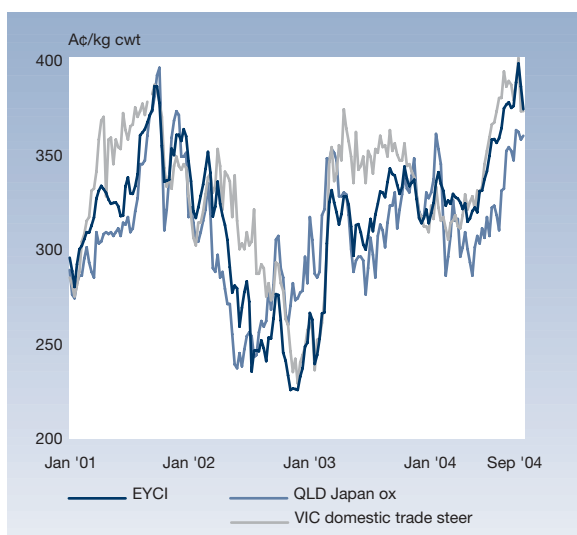
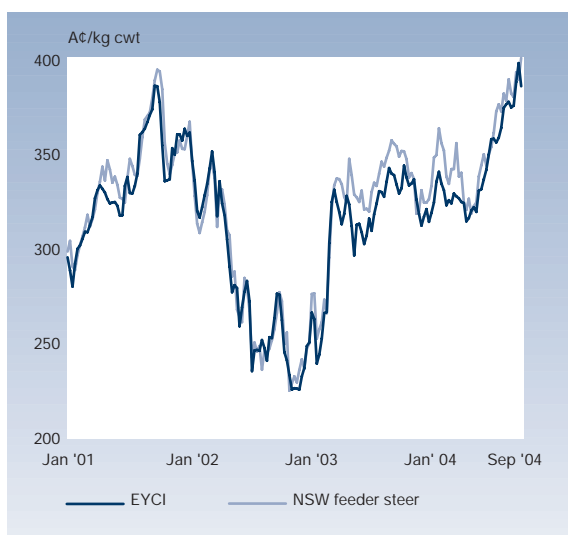


Figure 2. EYCI vs NSW feeder steer prices



What is the Eastern Young Cattle Indicator?

The Eastern Young Cattle Indicator, or EYCI:

- is a seven-day rolling average;
- includes vealer and yearling heifers and steers, grade score C2 or C3, 200kg+ liveweight from 26 saleyards in NSW, Queensland and Victoria; and
- is expressed in cents per kilogram carcass (or dressed) weight (¢/kg cwt).

More information on the EYCI is found in the brochure called [Eastern Young Cattle Indicator](#).

Where do I go from here?

1. Seek advice from a licensed futures advisor who knows the cattle market. The advisor can help you put in place a price risk management strategy tailored to your business. This strategy may incorporate cattle futures, forward contracts or a combination of both.
2. Know how your prices move in relation to cattle futures prices (ie your basis).
3. Engage a futures broker, the choice of which will depend on the level of service you require.
4. Subscribe to regular cattle futures market analysis produced by licensed futures advisors and brokers.
5. Attend an EDGENetwork Effective Pricing Workshop to learn how you can manage your price and supply.
6. Subscribe to receive news and updates on the Cattle Futures contract from MLA.

Contact MLA on (02) 9463 9367 for further details on any of the above.

More information

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