FACT SHEET

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GRAIN TRADE AUSTRALIA

Grain Contracts

A Guide to a Contract 'Washout'

This fact sheet provides information relevant to the production sector in the event grain cannot be provided to fulfill a contract commitment. It highlights how the Grain Contract is a risk management tool for both the buyer and the seller of the grain and describes the reasoning for specific actions.

A Grain Contract is an agreement between two parties for the delivery of a certain quality and quantity of grain at a specified time and for a specified price. Both the buyer and the seller are managing risk through locking in the current market price for a future delivery of grain.

COUNTERPARTY OBLIGATIONS

The seller using a Grain Contract has an obligation to provide a contracted tonnage to the buyer at the nominated time. The value of the contract to the producer is the provision of the ability to sell for future delivery at times that may be price advantageous. The Seller is managing the risk of negative price movements.

The buyer offering to purchase grain for a future delivery will be managing a position and is likely to have exposure to forward sales, for example to a domestic flour mill. A Buyer can manage the exposure to the flour mill forward sale by buying grain in the same market. The buyer is also managing the risk of price movements.

CONTRACT ISSUES

As soon as you suspect that you might have issues fulfilling any contract condition, including the provision of the quality and quantity of grain at a specified time it is imperative that you discuss the issue with the buyer as soon as possible. The earlier discussion can take place the greater the potential for addressing the issues and finding an amicable settlement.

As soon as the estimated grain production commences to fall to a level that makes delivery of the contracted volumes and quality uncertain discussion should commence between the seller and the buyer.

The Importance of early notification:
Given the buyer will have allocated the contracted grain to a sale (e.g., a domestic flour mill) the buyer is obligated to replace any grain that is in default. If the default is a contract for delivery of 500 metric tonnes the buyer will have to replace that grain by purchasing in the market at the time of notification. The greater the time available to make the arrangements is likely to be advantageous for negotiation and to prevent potential further exposure to a rising grain market.

CONTRACT DEFAULT OPTIONS

Once notified of the inability to deliver contracted quality and tonnage the seller and the buyer will be required to discuss the options that will result from the delivery default.

As discussed, the buyer will have planned to allocate the contracted tonnes against an existing sale and will be obligated to replace its defaulted tonnes at the current market price. Because of the producer delivery default the buyer may be exposed to a negative financial result being the difference in the original contract price for the sale into the flour mill and the current market price to purchase replenishment grain.

If for example the Grain Contract priced in February for delivery in November was for 500 tonnes of APH wheat for delivery into the Brisbane market. At the point in time the delivery default is raised and discussed the market is $45 higher than the February price for grain. This difference in price of $45 results in a differential of $22,500 across the entire 500 tonnes.

It is common for this difference to be termed the 'Washout' value. It is important to know the term 'washout' is not defined in the GTA Trade Rules. It is an industry term.

The 'washout' value is the additional cost for the buyer to replace the pre-purchased contract grain with current market valued grain.

How is the Washout Price determined?
The 'washout' price can be calculated in many different ways including the review of advertised bids on an agreed date or

potentially the actual cost of replacing the grain.

Where the seller and the parties are unable to agree on the values used to determine the 'washout' then either party to the contract can refer the issue to GTA for determination under the Dispute Resolution Service (fees apply). Reference GTA Trade Rule 17.10.

Do I have to 'washout' a contract?
A 'washout' is a way settling your obligations under a contract without reference to a Court or arbitration, and usually before the time for performance of your obligation falls due.

The "washout" will usually involve a payment from one party to the other party. While you cannot be forced to 'washout' a contract you should carefully consider such an offer as it may be in your interests to accept a 'washout' before the time for performance falls due. In General, if you don't think you will be able to perform your obligations under a contract by the due date and you know this ahead of time, it might be worth settling and performing a 'washout' to protect yourself against any further fluctuations in the contract price.

Is force majeur a 'get out' clause?
NO. Force majeure only extends the delivery period that a a counterparty has to meet their contractual obligations be they a seller or the buyer. Crop production failure is specifically excluded. A contract is not able to be cancelled due to invoking force majeure. Reference GTA Trade Rule 23

GTA TRAINING AND DEVELOPMENT

GTA offers unique grain industry specific Training and Development programs to increase your knowledge and skills across the grain value chain. These courses can be taken individually or combined into the Diploma in Grain Management.

There is a specific course Trade Rules and Contracts (DGMRUL501A) that will help all participants in the supply chain to better understand the risks involved in grain marketing.

Growers are encouraged to attend and participate in these programs. Just as it makes sense to undertake training and development in growing grain, it also makes sense to undertake training in grain marketing and risk management to minimise your business risk and improve profitability.

Key points

- Irrespective of where you are in the grain supply chain it is incumbent on you to understand the risks associated with entering into a contract
- Both the buyer and the seller are managing risk through locking in the current market price for a future delivery of grain.
- As soon as the estimated grain production commences to fall to a level that makes delivery of the contracted quality and volumes uncertain discussion should commence between the seller and the buyer.
- Understand the fundamentals of the impact of market movement on the settlement of a 'washout' value.
- Agreement to a 'washout' is not enforced.
- If there is not an agreement on the values used to determine the 'washout' then either party to the contract is able to refer the issue to GTA for determination under the Dispute Resolution Service

CONCLUSION

- Entering into a grain contract requires careful consideration. Exposure to production failure impacts on both parties associated with a grain contract.
- You have a responsibility to yourself and your counterparty to understand and communicate the impact of forecast production risk on the ability to deliver the contracted tonnage.
- Any failure on your ability to deliver grain will likely have a flow on impact to your buyer who will also have contractual exposure to the production failure.
- Throughout the contract period consider the locked in value of your grain contract against the daily market value to estimate the potential exposure to a 'washout'.
- Understand that a 'washout' is a voluntary process supported by the GTA Dispute Resolution Service. In general, if you don't think you will be able to perform your obligations under a contract by the due date and you know this ahead of time, it might be worth settling and performing a 'washout' to protect yourself against any further fluctuations in the contract price.
- Crop production is not a force majeure event.
- Improve your knowledge and understanding through training and development programs.

FURTHER INFORMATION

Visit the GTA website for further information including our publication *A Guide to Taking Out Contracts to Supply Grain*, Managing Insolvency, Dispute Resolution, Managing Counterparty Risk and industry briefing papers, GTA contract and agreement proforma's and professional development courses and training available.