

MILK SUPPLY PROCUREMENT MODELS PROJECT REPORT

April 2017



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1. Introduction

- The aim of the project was to collect information from dairy farmers identifying what they considered to be the required features of a milk supply model that would be most useful and advantageous to their businesses.
- Interactive sessions with farmers were carried out at several sites across South East of SA and Western Victoria in November 2016.
- Power point presentation included discussions in relation to the current state of world dairy trade, political and economic factors affecting the current commodity prices, volume of global milk supply in various geographically significant milk production regions (EU, US, NX, AUS) as well presenting the milk tension index that has been shown to reliably project a relationship between short-mid term market movements in commodity prices and world volumes of dairy product in storage.
- The presentation was followed by an interactive session to facilitate open and frank discussions with farmers, regarding their views on the current milk payment models offered by other large milk processors. At this point in the meeting, mind mapping techniques and recordings of the farmers thoughts and views were taken to collate for further consideration by The Riddoch Group.
- Firstly, farmers were asked to introduce themselves to the group, incorporating an answer the following questions:
 - Who they are?
 - What is their motivation to attend the forum?
 - What are three words that come to mind in relation to choosing a customer for their milk?
- After introductions, the following 2 issues were covered in detail with the group, and participants empowered to contribute to discussions ad libitum:
 - Farmers thoughts and views with regard to existing milk payment models from other dairy manufacturing companies, what they like, and what they do not like, what works, and what does not work from a practical and principle point of view (Pricing and incentive structures of WCB, Lion, MG, Fonterra were displayed on the projector screen).
 - Farmers thoughts and views with regard to any considerations for a new milk payment model that they would consider useful or advantageous to their dairy business, and for the industry generally. At this point of the discussion, several factors were presented for consideration to the group, and their comment, thoughts, and feelings recorded.
- Finally, the mind map was revisited to confirm all issues had been aired with the group, and everyone was in consensus with the summary of thoughts, ideas and themes that were presented in the session.

2. Farmers motivation to attend the Forum

First question to farmers related to their motivation to attend the forum, their objectives within their own dairy farming business, and three words to summarise the most important factors when selecting the customer for their milk. The themes identified below summarise the general nature of the responses, additionally several quotes of farmers' responses illustrate the context of the themes

Motivation to attend the forum:

- Weighing up options
- Interested in the Joint Venture's business plans, seeking information
- Disillusionment with the current status quo
- Loss of trust with their current company customer
- Would like to voice their concerns in the forum
- Would like to see stability in the industry

Quotes from Farmers regarding this point:

- "We are currently assessing our options"
- "We have gone through farm expansion recently, but would like to know where we are heading"
- "I have been in the industry for 55 years, and it has gradually moved over time to favour processors more than farmers"
- "I never thought that change would be an option due to my loyalty to Murray Goulburn, but...."
- "We are keen to see what Midfield has to offer us"
- "We have been encouraged to grow our milk supply by the processor, but beyond volume incentives there has been no ongoing support for us"
- "Why do large farmers get paid more for their milk than us, it's the same milk"
- "Loyalty is a 2 way street, we are not feeling it"
- "We have been taken for fools" (Regarding the MG clawbacks and 3 year contracts without pricing references)
- "The Processors have been transferring risk down the value chain to farmers via milk pricing"
- "Our kids see the outcome of the current trouble in the industry and the effect it has on us, they have no interest in making a career of dairy farming as a result"

3. Farmers current objectives in their businesses

Objectives within their own farming business:

- Create sustainable Growth within their business
- Establish a future for younger generations to facilitate farm succession
- Expand their farming operations if and when an opportunity arises
- Gain clearer visibility on milk pricing, and how it affects their cash flows and planning
- Reduce seasonal variances in cash flows
- Create more certainty within their farming operation
- Lower or divest risk from the farming business

Quotes from Farmers regarding this point:

- "I doubt whether it is viable to lose money in August – Jan (Peak Milk) and pick it up later on in the year"
- "We want more certainty on price, and how much we get paid"
- "We incur most costs when the milk price is lowest"
- "We can't take advantages of opportunities like cheap feed in the spring due to cash flow constraints as a result of spring milk discounts"
- "Why do you need a volume/growth incentive, the industry would grow organically if we were able to sell our milk for a fair price"
- "We can't budget effectively when so many factors in our business are variable"
- "I lock in a percentage of input costs when I see there is a margin" (with reference to fertiliser, grain, chemical)

4. Relevant factors in selecting a milk processor

Words relevant to important factors in choosing a processor customer (words of similar meaning or theme have been grouped under general headings)

Fair and Transparent Dealings

- Trust
- Relationship - clear signals
- Transparency
- Honesty
- Communication
- Fairness
- Integrity



Summary: Farmers are wanting a relationship with a processor that is open, transparent, fair and communicative. The comments around the topic of honesty, transparency and trust were the focal point of many farmers responses to this question, and were discussed at every meeting with farmers.

Practical Business Considerations

- Security (Offtake & Price)
- Price
- Reliability
- Service
- Consistency
- Sustainability (Relative to both farms and industry)



Summary: Farmers are wanting security for their business, through sustainable pricing and good service from their milk processor. Sustainability was a word that was recorded in every meeting with farmers, both sustainable in the sense of the success of their individual businesses as well as the overall dairy industry.

Industry Factors and Considerations

- Competition
- Growth
- Choice
- Options



Summary: Farmers want more competition between dairy processors, the ability to be able to choose a different processor without penalty, and they want to see the dairy industry grow organically through sustainable pricing for farmgate milk.

5. Existing Milk Payment Systems – 1

- Fat/Protein Ratios, Step-Ups, Geographical Price Variations

Farmers were given the opportunity to comment and discuss the features of milk pricing models currently used by other processors in order to assess their merits and shortfalls. We have summarised below:

Feature: Ratio of Protein to \$1/kg fat

Group Consensus: Indifference **Comments made by Farmers:**

“We focus on producing protein, because we get paid nothing for fat”

“Changing our farming structures to produce more fat would take some time, as our herd is 100% Frisians now, we got rid of Jersey cows a long time ago because the feedback from processors was produce more protein. You can’t change your dairy herd composition in just 6 months” (on the currently high world market fat prices, relating to farm gate milk prices)

Feature: Step Ups

Group Consensus: The application of step-ups/downs has caused uncertainty for farmers business **Comments made by Farmers:**

“People have struggled with the step down, but it may have been necessary to avoid a low opening price in the following season”

“Step-ups that do not materialise before the end of season have hurt us in the past”

“Why can’t they pay us a flat milk price, it would make it a lot easier to budget”

Feature: Differentiation by location

Group Consensus: Can make for an unfair playing field depending on type of enterprise, i.e irrigated or dryland farming, volume charges etc.

Comments made by Farmers:

“Incentives in SA are different to incentives in Victoria”

“Collection charges are higher in SA than in Victoria”

“Input costs such as energy are higher in SA than in Victoria” (with respect to input costs for irrigated dairies in SA vs Victoria, using a flat milk models)

6. Existing Milk Payment Systems – 2

Growth Incentive, Volume/Productivity Incentives, Volume Charges

Feature: Growth Incentive

Group Consensus: It is unfair to smaller and younger farmers, and can send the wrong signals over the long term. Growth can be achieved by means other than an incentive.

Comments made by Farmers

“If we were paid a fair milk price, we wouldn’t need an incentive to grow because we would be have a better cashflow and would be able to grow in our own time”

“We were always told by the field reps that the only way to go is to get bigger, but they are incentivising us to take on a huge financial risk to chase higher milk prices”

“How can a young farmer be expected to grow year on year and carry higher debt/equity level than older farmers”

Feature: Volume/Productivity Incentives

Group Consensus: They distort the farmgate milk price, creates disadvantage for smaller and younger farmers.

Comments made by Farmers

“How can the milk up the road be worth so much more than mine, it’s the same milk”

“We never make the average quoted prices \$kg/ms, because we don’t get as much of the volume incentives that others do”

“We do well out of the volume incentives”

Feature: Volume Charges

Group Consensus: Incorporate the charge into the milk price

Comments made by Farmers

“My main concern is what goes into the bank, not the volume charges”

“Just take it out of the milk price so I don’t have to worry about it”

“Don’t tell me that you are paying me more than I am getting at the bottom of the statement, that is meaningless to me”

7. Existing Milk Payment Systems – 3

Collection Charges, Seasonal Incentives

Feature: Pick Up/Collection Charge

Group Consensus: Incorporate it into the milk price

Comments made by Farmers

“We were told that the volume charge is because they don’t want to buy our water in the milk”

(The comments from “volume charges” above are also reflected in Collection charges, these 2 issues were considered by farmers to be one in the same)

Feature: Seasonal Incentives

Group Consensus: Works for seasonal producers, but overall not the majority of year round producers

Comments made by Farmers

“We have a major issue with being broke for 4 months of the year”

“We never have any money at Christmas time”

“Why do they pay us least when our costs are significantly higher” (regarding irrigation and silage costs in the spring, when milk pricing is at its lowest point)

“They (processors) have caused farmers to change their practices, chasing incentives for milk that is more expensive to produce”

8. Features of Milk Payment Systems – Options to Consider

Flat Milk Payment Rates, Growth Incentives, Volume & Collection Charges

Feature: Flat Milk Payment Rates – Announced Annually

Notes from meetings:

- Most farmers were receptive to the idea that they would be paid a competitive rate for their milk all year rather than seasonal variations or step ups (which are uncertain)
- A flat milk payment system would make it more advantageous for farmers to buy hay and fodder when it is at its cheapest (in the spring, early summer – off the paddock etc)
- Would make it a little easier for younger farmers who have less equity to finance inputs with cash, rather than finance from overdraft for the spring/summer period – under a flat model.
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Feature: Removal of Growth Incentive/Volume, Collection Charges

Notes from meetings:

- Farmers were receptive to the idea that a pricing signal to grow milk supply is not always the most appropriate in all circumstances, especially when large businesses are more able to grow milk supply than smaller business due to their scale. They were generally in support of not having a growth incentive.
- Farmers were very receptive to the removal of charges and facilitate a payment system that is easier to understand. They would rather be paid a milk price net of volume and collection charges than have a milk payment which to work through on a statement that have to “add this and deduct that”
- A young farmer commented “why do they pay us more and then take it back in collection charges, just pay us a milk price which factors in volume and collection charges”
- Another younger farmer commented “if you can pay us a competitive milk price, we won’t need a growth incentive because we will grow our businesses over time if we can afford to”

9. Features of Milk Payment Systems – Options to Consider

Market Based Index, Partially Fixed & Floating Milk Price

Feature: A market index based approach to milk pricing

Notes from meetings:

- Farmers were generally receptive to a milk payment structure that had an element of sharing the risk when it is referenced to an index (eg. Price movements on the GDT index), although some farmers were adverse to this idea given their recent loss of trust with certain processors, and their perceived risk of prices being manipulated etc.
- Farmers were keen to understand what are the drivers of price on the index, and how can they understand the impact for their business.
- Farmers were a little cautious as to how much exposure they could tolerate on the downside, additionally how they could share in the upside.
- Farmers were also cautious in relation to what index could be referenced and how reliable the index is relative to world markets.

Feature: Partially Fixed Pricing Mechanism

Notes from meetings:

- Farmers were generally receptive to the idea that they could benefit from having security of minimum price for a % of their milk, with a % of the price variable (based on index above) to enable sharing of risk and upside if world prices are favourable.
- The farmers conveyed that they would rather have less variation in milk pricing over the longer term, rather than high peaks and low troughs in the milk pricing cycle. This would provide for more stability in their businesses.
- This would most likely need to be facilitated via multi period milk contracts (2 or 3 years) which some farmers are adverse to due to the current situation with MG and their 3 year contracts, MSSP program, and the current low levels of trust between farmers and processors.

10. Features of Milk Payment Systems – Options to Consider

Factory Finance, Market Intelligence

Feature: Factory Finance, Short-term Lending **Notes from meetings:**

- Farmers are conscious that using factory finance leaves them vulnerable to and at the behest of milk processors, restricts their ability to change processors in some circumstances and is a more risky option than bank lending.
- Farmers conveyed that they would rather see a milk processor be just that, rather than a bank, trading company, etc. One farmer said that “they are trying to do everything, they should focus on processing milk”

Feature: Market Intelligence **Notes from meetings:**

- Almost every group made comment to the effect that they would like to see some information and commentary from milk processors in relation to the world markets for milk commodity.
- They also commented that some expert analysis as to how they can relate that back to decisions made on farm would be helpful, they do not have the time or ability to read and disseminate data from many sources to make meaningful views on how it affects them as farmers.
- The farmers expressed that they are disappointed that they do not currently receive anything in this regard from their current milk processor, especially given that the milk factories have marketing arms of the business and that they could provide insight to farmers if it were a priority.

11. Summary

- In summary, the farmer discussion groups were considered by the Riddoch Group to be a success, as they provided useful insight into the farmers views on what features a milk payment model would provide that would be advantageous for them.
- The 5 main ideas/issues that generated the most discussion in the farmer groups were the following
 - Payment of a fair price for milk, which allows for farmers to survive, and grow in the industry
 - Mainly flat/fixed pricing models are preferable for farmers as opposed to seasonally adjusted, highly incentivised/distorted models.
 - Elimination of Volume and Growth Incentives, Collection Charges - it distorts average prices, and does not reflect their business models currently, farmers cannot grow supply as it is under the current pricing arrangements.
 - Elimination of Claw-backs – they are not fair to farmers, and are totally inappropriate.
 - Provision of Market Intelligence to farmers in relation to changes in the world markets, and the meaning - to enable them to make better on farm decisions.
- The discussions have resulted in a comprehensive list of qualitative data that relates to the intangible aspects of the supplier/processor relationship. An understanding and empathy in consideration of these intangible aspects of the supplier/processor relationship is an important factor for factories in recruiting new milk, maintaining supply.
- Finally, the discussions have covered respondents from a diverse range of dairy farming systems, from irrigation to dryland, both large farmers and small farmers, and of various supply curves. It is apparent that there will be no milk payment model that fits all of these groups, however the discussions have revealed that there are some points that are relevant and common to all. It is important that Riddoch Group addresses these concerns in their milk payment model.