European Milk Board

Evaluation of the "Improving Market Outcomes" report
of the Agricultural Markets Task Force

Can the recommended measures stabilise the dairy sector?

Summary

The "Improving Market Outcomes" report published by the Agricultural Markets Task Force in November 2016 puts forth recommendations to improve the position of farmers in the supply chain. Against the background of severe crises in the dairy sector and as an organisation representing European milk producers, the European Milk Board (EMB) essentially welcomes the recommendations to improve the situation. This document evaluates how much the recommended measures can actually contribute to positive developments in the sector, while focusing on the most important aspects. **The evaluation has shown that the recommendations by the Task Force are not enough to achieve the required degree of stability in the EU dairy sector.**

Market transparency
It is positive that the report talks about increasing market transparency. However, it does not address a key element - when production costs are considered, they must include a fair income for producers. It erroneously assumes that transparency alone will motivate producers to undertake actions that are in tune with market needs. However, this requires additional measures, like voluntary production cuts, in order to elicit appropriate market reactions.

Risk management instruments
In the context of risk management instruments with regards to agricultural prices, the EMB recommends that the Task Force pay closer attention to their effect on, firstly, producers and, secondly, the market. Instruments should ensure that producers face less risks and thus suffer lower income losses. However, it is also important that these instruments stabilise the market and do not act as an additional burden on it. The Task Force report does not give these two points sufficient consideration.

Futures markets
The use of futures markets as a risk management instrument does not include the need to restore a degree of balance in the real market (spot market) to allow for cost-covering producer prices.
The EMB analysis, and to an extent the Task Force report as well, shows that futures markets can, in fact, somewhat flatten out price peaks and troughs under certain conditions, but they cannot change the actual price level. Furthermore, an effective tempering of price fluctuations is only possible when projections on the spot market are positive - something that is very rare in the dairy sector. In addition, *cost-covering* prices can hardly be expected on the spot market and as a result, no such assurances can follow on the futures market either.
Even if you want to exploit the very limited advantages of futures trading: Producers require high liquidity and the trading of futures contracts only makes sense upwards of a production volume of 1 million kg milk. This means that a large number of EU producers are excluded from exploring this possibility. Farmers are also no trading experts and they cannot take the risk of net-loss trading lightly. Therefore, futures contracts cannot be considered a solution for the dairy market crisis.

EU-level framework against unfair trading practices
An EU-wide legislative framework to avoid unfair trading practices in the supply chain is welcome. However, this must definitely include a law against unfair competition that prohibits the sale of raw materials below cost price.

Contractualisation
As France has shown, contracts in themselves are not enough to strengthen the position of producers. The Task Force report does state that contracts can only have a limited effect on the same. However, it fails to mention the following possibility: Contracts could play a key role if EU-wide mandatory contracts included the contractual linking of prices to production costs.

Producer organisations
The Task Force has correctly observed that there is insufficient collective action by producers. In addition to resolving regulatory confusion, as mentioned in the report, the following points - not mentioned by the Task Force - must necessarily be considered as well to encourage association: raising grouping thresholds, including milk from cooperatives in collective negotiations as well as creating incentives to join producer organisations.

Easier access to finance
Financial bottlenecks are problematic in times of crisis. Nonetheless, the Task Force should clearly state that easier access to finance alone cannot be the solution. Furthermore, it is important to ensure that this money does not end up acting as an additional burden on the market, delaying the adjustment of supply to demand. Bridging loans also only make sense if producers are in a position to pay them back in the foreseeable future.

Direction of the CAP
If the CAP were to maintain its correct direction, as recommended by the Task Force, the marginalisation of many stakeholders will only become stronger. Therefore, the CAP should pay greater attention to balanced growth. The EU needs factors that bring people and nations stronger together. Agriculture can help to implement such drivers.
For the dairy sector, for example, this would be instruments that do not act as a burden on the sector but allow producers to actually generate their income from the market. The implementation of voluntary production cuts this year has been a first step in this direction. However, a standard instrument set up in an EU-wide legal framework is still necessary.

This legal framework must:

1. Include a market index implemented through the MMO;
This index would be determined by factors like developments in product quotations, milk prices and producer costs (margins).

2. Permit sanctions;
During voluntary production cuts in times of crisis, the remaining production must be capped. In this regard, the possibility of sanctions is vital. Without a cap, there is a great risk that the achieved reductions will be neutralised by increased production by other producers.

3. Allow for the collection of a levy from producers to finance the crisis instrument.
With such a levy, producers also take on a financial responsibility for the programme.

Observe the market - predict and prevent crises!

Market transparency

The Task Force report states[1]:

5. The Commission should take further steps to increase market transparency so as to foster effective conditions of competition along the supply chain. Bigger and better-equipped up- and downstream operators usually have a clear view of the market while farmers - often fragmented and small – frequently do not. This information asymmetry creates mistrust, in particular in relation to price transmission and the distribution of value added along the chain. Among other things, this report recommends mandatory price reporting to cover existing information gaps in the chain - and dissemination of the collected data in duly aggregated form to increase transparency.

6. The Commission market observatories and dashboards are commendable steps in the right direction but there is room for improvement, in particular as regards the timeliness and the standardisation of data collected from Member States. It should be examined whether consumption data and producers' input prices could be integrated into existing market information systems. The Commission should create a platform for better communication and exchange of information between Member States concerning how market data is collected and how national food chain observatories work. 'Food euro' calculations at EU level and Member State level for all major food products could provide useful information for the public at large, including consumers, about the distribution of the value added along the chain. The Commission should step up the adoption of modern and easy- to-use communication formats (such as web- based applications). Member States should be encouraged to seize the opportunities which 'big data' offers for the benefit of farmers, and facilitate initiatives that help farmers make sense of the wealth of data generated on and off farm.

1. An improvement in market transparency is an important aspect for the dairy sector. However, the Task Force does not address it sufficiently. If the aim is improving the position of producers, the reporting of production costs that include a fair income for producers is an essential element of market transparency. Only once the costs are clear is it possible to realistically evaluate the market situation. Unfortunately, this point does not feature in the Task Force report.

2. Market transparency alone cannot resolve problematic situations. It can only contribute to market stabilisation in conjunction with effective measures.

This can be easily demonstrated using two possible scenarios on the dairy sector. Let us assume that based on market data, producers see that:

Scenario 1) Butter prices are dropping - producer prices will also drop soon

> Realistic producer reaction: Most producers react only when farm-gate prices actually drop. However, production reduction across the board becomes impossible by this point. Many producers actually increase production precisely due to falling prices in an attempt to compensate for price losses. Of course, there are also producers who reduce production. But not to a sufficient degree so as to balance the market and often only after the price has reached its lowest point, by which time the sector has already suffered greatly.
> This producer reaction has proved itself repeatedly in the past and clearly shows that individual rationalisation in the face of price drops does not lead to the desired cumulative market reaction.

[1] http://ec.europa.eu/agriculture/sites/agriculture/files/agri-markets-task-force/improving-markets-outcomes_en.pdf (Downloaded on 22.11.2016)

Scenario 2) Butter prices are rising - producer prices will also rise soon

> Realistic producer reaction: Producer reactions are hardly driven by quotations and projections. Many producers only react once price increases become tangible, for example, when they are reported by dairies. Especially in periods with high-loss trends and significant price drops - as is currently the case, producers try to quickly boost production on farms, in an attempt to compensate for at least a part of the experienced losses.

As described above, improved transparency alone does not lead to the desired market reaction to reinstate stability. On one hand, reactions do not occur until real price increases or decreases are observed. On the other, behaviour in the case of price drops do not have a market stabilising effect.

Therefore, transparency must be combined with measures to elicit the desired market reaction. One example would be implementing the Market Responsibility Programme, where market data is analysed and measures are then implemented to motivate producers to react appropriately. In times of crisis, for example, a collective volume reduction could be achieved through voluntary production cuts. This would be the timely reaction required by the market in order to reinstate a balance.

Risk management instruments

With regards to risk management instruments, the report summarises as follows:

7. The uptake of EU risk management tools by farmers has been modest. The Commission should make the EU's risk management toolkit more attractive and coherent with instruments set up by Member States so as to enable farmers to manage risk ex ante. Ideas include the mandatory inclusion of measures in Member States' rural development programmes. This step could be accompanied by monitoring and evaluation systems that map all relevant data linked to the occurrence of risks. Minimum thresholds applying to crop losses for insurance purposes could be revised to make the tool more attractive to users. The added value of EU co-financing of reinsurance schemes should be assessed.

8. This could imply a resource shift towards a genuine integrated risk management policy at EU level. In order to keep control regimes cost- effective, the possibility of using simplified loss calculation and reimbursement options should be taken into account. The Commission should set up an EU platform - including Member States and stakeholders - allowing the exchange of best practices concerning agricultural risk management. Certain tools and systems which are already effective in Member States may thus become more widely known and used. Member States could also use this platform to exchange information about existing practices of tax averaging, to assess the potential usefulness of these practices for agricultural producers across the EU.

Risk management instruments are very important to stabilise the dairy sector. There must be a clear analysis of the extent to which a proposed instrument fulfils the following conditions in terms of agricultural price risks:

1. It prevents sudden drops in income for EU producers and
2. It does not worsen the market imbalance.

Two simple examples of risk management or crisis prevention measures

Insurance systems that pay compensation in the case of price collapses do not, per se, fulfil both these conditions.

1. The paid money can compensate for a price collapse in the short term, but it, in fact, leads to the continued generation of surpluses.
2. It goes against market stabilisation and worsens the problem instead.

➔ However, pay-outs from insurance policies could be coupled with production reductions - this could reduce the market imbalance. It can only be completely solved if at least a cap in production is applicable to all producers during crises.

In comparison, the measure of voluntary production cuts, for example, fulfils both conditions.
1. Compensation in exchange of reduced supply means that participating producers receive money and all producers can benefit from increasing prices.
2. If the market imbalance - the surplus - is reduced or corrected, the problem is not worsened or simply bridged. A complementary production cap for all producers during crises is, however, essential.

To check if risk or crisis management tools are appropriate, they should always be checked for their compliance with conditions 1 and 2.

Futures markets
What are they capable and incapable of delivering?

Specifically on futures markets as a risk management instrument, the report's comments include:

9. Futures markets can be an important risk management tool for farmers in times of increased price volatility. In this area in particular, awareness-raising and training measures in the farming community and farmers´ organisations should be prioritised. Price data collection and dissemination by the Commission under the heading of market transparency can stimulate futures markets by providing reliable and credible price references which are instrumental for settling futures contracts. The report also invites the Commission to volunteer expertise to the legislator in matters - such as EU-level financial regulation - which might have unintended negative consequences for the liquidity of futures markets.

How does futures trading work?

In futures trading, two markets are important:

1. Spot market: This is the real market on which goods (i.e. milk and milk products) are traded. The milk producer receives his farm-gate price from this market (through dairies).

2. Futures market: This is where futures contracts are traded.

Relation between spot market and futures market:

Real prices on the spot market influence prices on the futures market. *Thus, the futures market is but a reflection of the spot market.* If prices or price projections on the spot market are high, prices on the futures market are also high. If spot market prices are low, this is also reflected in futures market prices.

1) Can futures markets reduce price fluctuations?

To show if futures markets can effectively reduce price fluctuations for milk producers, let us consider an example. In October 2016, a producer sells 12-month contracts on the futures market accounting for 10 percent of his annual production at that rate of 34 cents/kg milk (calculated in butter contracts and skimmed milk powder contracts)[2]. He thus 'freezes' his milk price for this volume at 34 cents/kg.
In October 2017, he buys his contracts back. If the real spot market price (= farm-gate milk price) is now higher than 34 cents/kg, the producer will also pay more on the futures market for this buy back. Thus, he experiences a trading loss which is, however, compensated by the higher milk price on the spot market (paid milk price). He would thus maintain a price of 34 cents/kg. (Without futures contracts, he would have earned a higher price/kg.)

Conversely, if the real milk price on the spot market has dropped, he would pay less on the futures market to buy back his contracts as compared to the price in the previous year. Thus, he makes a trading profit. This is compensated by the lower milk price (spot market price) as compared to the previous level of 34 cents/kg. (Without futures contracts, he would have earned a lower price/kg.)

Thus it is clear that in theory, it is possible to temper price fluctuations.

However, there are the following problems in practice:

a) If price prospects are positive, the producer can also sell his contracts for a higher price. Buyers, after all, expect to make a profit on the buy back by producers.
   If price prospects are negative, the producer will not be able to sell any contracts for higher prices because buyers do not expect to make any profits on the futures market.
   -> This means that in the case of negative price prospects, which are a very common on the dairy market, there is a low possibility of effectively ensuring prices.

b) By using futures contracts, the milk price is tempered to some extent over time, as both price troughs and price peaks are flattened out. In the long term, however, the producer does not earn more by trading on futures markets.

c) The entire production volume of a farm should never be traded in this way. For example, when supplying milk to a cheese-producing dairy, it should be maximum 50%.

d) To trade on the futures market, very high liquidity is a must. For example, a producer wishing to trade a production of 3.5 million kg would need about 400,000 euros. Not many producers have such liquidity. It is very questionable if the credit and guarantee funds recommended by the Task Force will actually solve this problem.

e) Furthermore, an annual production of about 1 million kg is necessary to participate on the futures market in the first place. As not many producers have such volumes, they too get excluded. In Germany, for example, over 85 percent of farmers produce less than 1 million kg and thus do not qualify[3].

---

[2] E.g. on the Eurex in Frankfurt, raw milk contracts are not traded; it is only done in the form of butter and skimmed milk powder contracts. Producers can merely achieve a price guarantee through such contracts. This assumes that the respective contract values for butter/skimmed milk powder correspond to a certain raw milk value and that raw material prices, contract prices and milk prices paid by dairies all evolve in parallel.

[3] Source: Federal Statistical Office

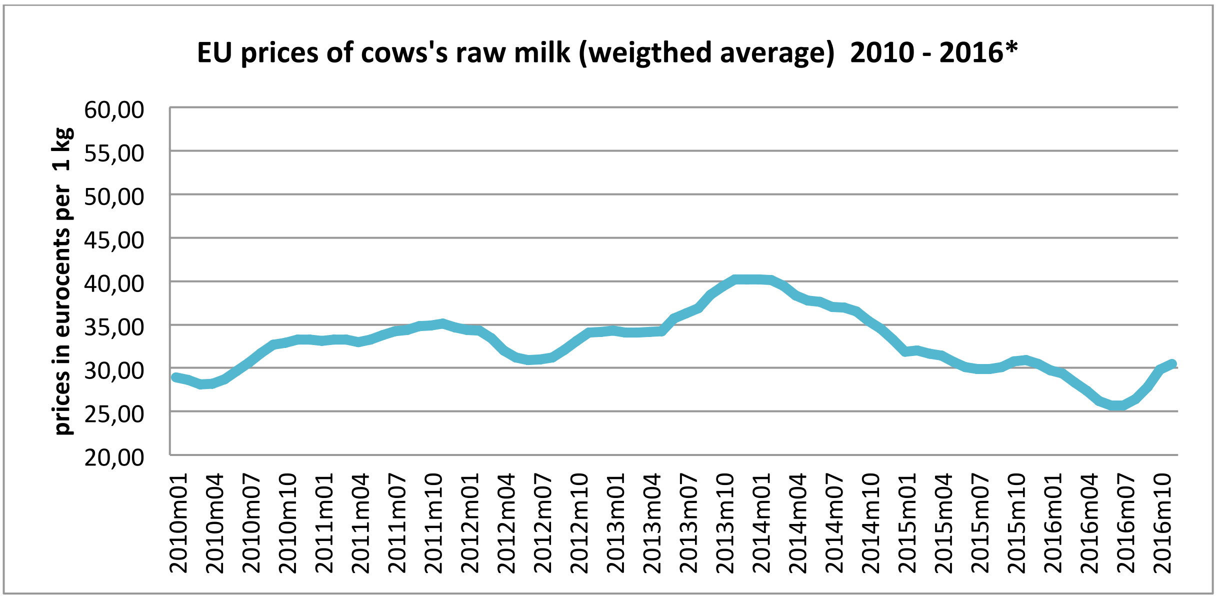
f) Trading on the stock market requires expertise. Farmers are not trained for complex futures trading. Even though the Task Force recommends further training programmes, you cannot afford to forget that being a farmer is already a highly-demanding, full-time job.

g) Both trading gains and trading losses are on the table. It is a risky endeavour where a negative outcome could be an additional burden for farms.

2) Can futures markets ensure cost-covering prices?

To cover milk production costs, prices over 40 cents are a must.
Futures markets are connected to real markets i.e. spot markets or are oriented according to real price projections. Since spot markets rarely or never reach cost-covering prices, it will also rarely or never be possible to ensure cost-covering prices on futures markets. The Task Force is correct in stating that futures markets can have no effective impact during long periods of low prices.

The problem becomes clear when you look at EU milk prices (=spot market prices) in the last year and check how often they were under and over a cost-covering level (between 40-45 cents EU-wide.



* based on historical price series of Milk Market Observatory (EU Commission) (http://ec.europa.eu/agriculture/market-observatory/milk_en)

Overview: Number of months where EU prices were over or under a given price level*

Prices:	Months in 2010	Months in 2011	Months in 2012	Months in 2013	Months in 2014	Months in 2015	Months in 2016**
Under 30 cents	6	0	0	0	0	2	10
Under 35 cents	12	11	12	5	2	12	11
Over 40 cents	0	0	0	2	2	0	0
Over 45 cents	0	0	0	0	0	0	0

* Based on weighted EU monthly average price, self-complied
** Prices were available for only 11 months when the table was complied.

It is clear that prices on the spot market are often under 35 cents, i.e. very low prices significantly below the cost-covering level of 40-45 cents are the norm. In fact, prices under 30 cents are not uncommon. They however never go above 45 cents and very rarely over 40 cents - thus the spot market as a base market is rarely at a cost-covering level. As the futures market is simply a reflection of the spot market, assured cost-covering prices are impossible on the futures market as well.

This proves that the underlying issue with the dairy market, i.e. paid milk prices are significantly below cost-covering levels, cannot be compensated with futures markets. It is necessary to solve the problem on the real dairy market!

EU-level framework against unfair trading practices

The Task Force summarises its approach to unfair trading practices as follows:

10. As regards unfair trading practices, voluntary initiatives have been useful to a degree. They have, however, not been able fully to address the 'fear factor' which often arises when an operator is considering making a complaint, and they have fallen short of introducing effective and independent enforcement. The report recommends that framework legislation be introduced at EU level - to cover certain baseline unfair trading practices (for instance maximum payment periods) as well as to mandate effective enforcement regimes in Member States - such as an Adjudicator. Such enforcement regimes should include the power to conduct own- initiative investigations, as well as the possibility for victims of unfair trading practices to lodge anonymous complaints. A mixed approach of statutory and voluntary rules including at EU level, as far as agricultural products are concerned, would be appropriate and timely. It can accommodate well-functioning enforcement systems existing in Member States. By the same token, the voluntary Supply Chain Initiative facilitated by the High-Level Forum on the Better Functioning of the Food Supply Chain has had positive effects; it should be continued and improved.

It is true that the aim has to be an EU-wide legal framework instead of voluntary initiatives. This is the only way to reduce unfair trading practices across the board.

Within such a framework, the following point is key: **A law against unfair competition must be enforced at producer level. Forbidding the sale of products below cost price should apply for raw milk and agricultural raw materials as well.** The background for this demand is the fact that in some cases, milk production is forced to use unfair practices to survive. Especially on family farms, there is no way to account for labour costs and they use income from other activities like biogas production to keep their milk production going. This leads to distortion of competition and other farms are, thus, undermined. By prohibiting sales below cost price or real production cost, this market imbalance would disappear.

Contractualisation

The Task Force addresses contracts in the report as follows:

11. Cooperation in the supply chain via 'contractualisation' can allow non-antagonistic commercial relationships to develop which could meet consumer demand for innovative products, while also responding to public expectations concerning sustainability. Successful arrangements such as dedicated supply chains, tripartite agreements and similar initiatives exist and should be publicised better as examples for best practices. The Commission should facilitate this, allowing operators to come together and learn from each other.

12. The absence of written contracts is often a disadvantage for the weaker party in a commercial transaction. Farmers should be able, under EU rules, to request and obtain a written contract. This would complement the existing general possibility for Member States under the CMO regulation to make written contracts mandatory.

132. (...) However, one needs to acknowledge its limitations. It will not be able to fully redress the asymmetric bargaining power of operators in the food supply chain.

Experiences in France, where agricultural contracts are widespread, have show that contracts in themselves cannot in any way solve the problem of weak market position of producers. Only if contracts become mandatory EU-wide (and also apply to members of cooperatives) and also include conditions will they be helpful in determining milk prices on the basis of production costs.

Producer organisations

The Task Force report mentions producer organisations in, for example, the following context:

14. As regards producer cooperation, the report brings to light a lack of clarity concerning the rules which apply to collective action by producers. Different concepts underlying classical competition law and agricultural derogations in the CMO regulation have given rise to regulatory confusion. The 2013 reform has introduced further approaches to dealing with collective action by farmers. While the intention was to strengthen the position of farmers in the chain, the new provisions may have exacerbated the legal complexity. Rules should be made clear and workable, so that farmers do not need to hire legal counsel when planning to cooperate. The Commission should unambiguously exempt joint planning and joint selling from competition law if carried out by a recognised producer organisation or association of producer organisations. Safeguards should ensure that competition is not eliminated and CAP objectives - such as reasonable consumer prices – are not jeopardised. Such clarification will further the CAP's policy orientation of encouraging producers to organise and help themselves. Pure 'bargaining associations' between producers should be allowed up to certain market thresholds, so that such joint selling will not affect competition. Moreover, the 'dormant' Article 209 of the CMO regulation should be 'revived' and the possibility of obtaining legal security up-front (comfort letters) introduced. The scope of the 'crisis cartel' provision, which allows agreements between producers (including producer organisations and interbranch organisations), should be adjusted.

It is correct that collective action - collective price negotiation - by producers does not occur often enough. There are many reasons for this. Firstly, the Milk Package exempts milk from cooperatives from such negotiations. This means that a large section of producers EU-wide are excluded from the possibility of collective bargaining from the start. Furthermore, the grouping threshold is too low to allow negotiating with dairies as equals. Even the regulatory confusion mentioned by the Task Force could lead to difficulties for producer organisations. As a result, milk producers are not sufficiently optimistic that joining a pre-existing producer organisation can improve their economic situation significantly. This is based on the persistence of old economic relations.

Strong, effective promotion of collective action by raising grouping thresholds, including milk from cooperatives in collective negotiations as well as political measures like creating incentives for producers to join producer organisations is necessary. Steps toward practicable and clear legislation are also required.

Easier access to finance

The Task Force report says the following about better access to finance:

15. Measures to facilitate access to finance for farmers should be stepped up, in particular by the European Investment Bank Group (EIB Group). The current risk aversion of commercial banks is liable to lead to underinvestment and affect the competitiveness of the agricultural sector. The Commission should encourage the roll-out of pilot projects by the EIB for the agriculture sector as well as the development of targeted financial instruments (e.g. addressing young farmers or price volatility) that leverage CAP money on a guarantee basis and thus attract private-sector funding.(...)

Even in this context, it is important that finance for milk production does not lead to a worsening of the issue of surpluses.
Producers can make the best use of investments when the market is balanced, and profits can be used for investment or loans can be taken on one's own strength. Loan programmes are definitely helpful for young farmers. However, the standard approach in the dairy sector cannot consist of pumping money into a highly unstable market, thus boosting overproduction and keeping prices for all producers well below a cost-covering level. It must essentially be about stabilising the market so that financially-sound investments can be made. Producer confidence in investments has suffered significantly in recent years because the growth promised post the abolishment of quotas has not occurred. A stable market can win back lost confidence in investments.

Direction of the Common Agricultural Policy

The Task Force report deals with this important issue in the following sentence:

17. The Task Force posits that the policy direction which the reformed CAP has taken should not be reversed. A modern CAP should continue along the path taken. (...)

We can only criticise this recommendation by the Task Force as it does not correspond to realities in the EU.

The Task Force does, nonetheless, also say that a modern CAP should not disregard producers who do not participate in international trade or specialise in any way. However, that is far from enough to ensure a healthy agricultural sector across the EU. The current CAP can only work - that means ensure a shared Europe with vibrant rural areas, sustainable production and social equality, together with prosperity, animal welfare and food security - if the "bigger and more is better" approach is altered.

The losers in such an orientation are:

- Producers in the EU as well up and downstream sectors,
- Majority of rural areas due to loss of jobs in the region and environmental problems due to more intense production in other regions,
- Consumers, who must increasingly depend of industrialised foodstuffs due to the absence of a balanced agricultural model,
- Producers and citizens outside Europe, whose livelihood is threatened due to surpluses produced in the EU, as well as
- Dairy cows as their living conditions will worsen due to a lack of resources, shorter life cycles etc.

The winners in such a policy direction are:

- Companies in the food industry who have access to extremely cheap raw materials due surpluses and can thus increase their market share, especially outside Europe. This has become very clear in the recent milk crisis years. While farm-gate prices for milk producers reached their lowest values ever and producers were under major pressure, dairy companies managed to increase their profits[4].

This is not about preventing food companies from growing or increasing their market share. However, in its current extreme form, this occurs at the cost of important economic stakeholders and the citizens within and beyond Europe. Growth is possible in a balanced market as well and it would, in fact, benefit more stakeholders.
That is what the CAP must stand for. In the future, there will be an even stronger need to bring the people, populations and nations of Europe together. Therefore, the new motto of the CAP must be "Together against economic marginalisation".

[4] For example, operating profits for FrieslandCampina in 2015 increased by 17.8% to 576 million euros as compared to the previous year.