

**Australian Milk Price Initiative
Submission to ACCC Perishable Agricultural Goods Inquiry
September 2020**

Overview

- **At the 2018 election the Morrison Government committed \$560,000 to Australian Dairy Farmers for the Australian Milk Price Initiative (AMPI):** a project to “design new milk pricing and marketing concepts for the dairy sector, aiming to deliver farmers better leverage, more transparency from the supply chain and more choices on how and when they price their milk.” This work aims to build on the ACCC dairy review.
- **AMPI has designed a milk market which can deliver** fairness, competition and transparency for all members of the supply chain and increase confidence and investment in the Australian dairy industry. The market is based on contracting practices seen in other Australian agricultural markets such as grains, oilseeds, sugar and fibres. **The market will require changes to current processor-farmer contractual agreements, building on the Mandatory Code of Conduct.**
- **AMPI benefits include:**
 - Fair milk market for all industry participants:** the ability for buyers and sellers to lock in a milk price in an open market out the next 3 years for some portion of their milk
 - Trustworthy and transparent price signal:** there is no more transparent price signal than an open market price
 - Better risk management across the supply chain:** back-to-back pricing from customer to processor to farmer, providing the ability to lock in margins across the chain
 - More investment:** Better margin and risk management enable better planning, driving investment and growth across the supply chain - a strong dairy industry
- **AMPI is a market-based solution, not a subsidy, tax or market floor.** It can generate forward price certainty for farmers, based on market prices and what prices farmers are willing to offer based on their own cost of production and risk management plans. In this way, it can send a signal from the farmgate to milk buyers on what is needed to keep the Australian dairy industry producing.

Interaction with the Mandatory Code of Conduct

- AMPI is proposing the development of a **financially settled hedge market based on a physical auction settlement mechanism**. This proposal has been generated based on existing market mechanisms which exist in various commodity markets, including those involving perishable commodities such as sugar cane and electricity. Consultation with stakeholders from across the supply chain is ongoing and is in the final stages of agreement.
 - More detail on this proposal can be obtained by contacting one of the AMPI representatives listed at the bottom of this submission
- For farmers and processors to fully realise the benefits available from the development of such a risk management tool, **it is necessary for physical prices paid and received under Milk Supply Agreements (MSAs) to fluctuate with the financial hedge settlement mechanism**. This will allow the payments received or paid via the financial hedge to perfectly offset movements in physical milk prices, leaving the financial hedge users with the fixed price outcome they desired when they entered the hedge contract.
- It is important to note that this requirement for physical milk prices under MSA to fluctuate with the financial hedge settlement **is only relevant for farmers who are using the financial hedging instruments, and only for the portion of their milk production they are hedging**. AMPI has been designed to allow for farmers and processors to move incrementally towards hedging, via mutual agreement, with specific portions of milk being moved away from the 'normal' milk price and towards the hedging market. **As such, the proposals which follow are only for what we will call 'hedging milk'**.
- The requirement for hedging milk prices to fluctuate with the financial hedge settlement mechanism **becomes an issue if and when hedging milk prices fall below the minimum price defined in the MSA**. Under the current drafting of the Mandatory Code this is not possible unless it is defined as a prospective step down, which is justifiably limited by s28 of the existing Code.
 - Note that hedging milk prices falling will not be an issue for the net outcome of the farmer if they have used the financial hedges to lock in a fixed price for their hedging milk – the proceeds on their financial hedges will offset the decline in physical milk prices received on hedging milk.

- The AMPI team is proposing that any **hedging milk be granted an exemption from minimum price requirements under the Code**. This would allow hedging milk prices to rise and fall with the financial hedge settlement mechanism, meaning the payments received or paid via the financial hedge perfectly offset movements in physical milk prices. In turn, this would leave the financial hedge users with the fixed price outcome they desired when they entered the hedge contract.
- Given the minimum price requirement was a key protection delivered by the Mandatory Code to farmers, **it is important to reiterate that we are proposing this exemption only for hedging milk i.e. only for farmers who are using financial hedges, and only for the portion of milk on which they wish to hedge**. The remainder of milk supply would still be protected by the minimum price provisions of the Code. **In addition, we would suggest that proposal and acceptance of such an exemption is at the farmer discretion, providing a level of protection against abuse.**
- **Without such an exemption, an opportunity for market development via the AMPI proposal will be made more difficult and impact market adoption.** We do not believe this was the intention of the Government when the Mandatory Code was implemented, as evidenced by s38 of the Code.
- The AMPI team recognises that there may be apprehension when evaluating the potential for creating such an exemption to the minimum price requirements of the Code, given how fundamental the protections they provide to farmers are. **The AMPI team is confident a solution can be achieved which retains these protections whilst enabling the transformative market development AMPI is proposing. We invite discussion on this topic and can be contacted via the details at the bottom of this submission.**

Why support AMPI?

- **The dairy industry is in crisis**, with ongoing declines in Australian milk production and a farming and processing base under severe pressure as a result. With global dairy markets in turmoil, as evidenced by falling milk prices and milk dumping in the EU and US, the Australian dairy market is likely to come under increased pressure in 2020.
- The **ACCC identified “a range of market failures** resulting from the strong bargaining power imbalance and information asymmetry in farmer-processor relationships.” The ACCC also commented that **“these features of the industry result in practices which ultimately cause inefficiencies in dairy production.”**
- **The AMPI market concept can deliver a fair milk market for all industry participants.** By developing a more trustworthy price signal for the industry, the AMPI market can enable better margin and risk management for the supply chain, driving a stronger dairy industry as a whole (see attachment A).
- The AMPI market will enable:
 - **Improved industry efficiency** via year-round trade
 - **Price transparency** and true price signal for industry participants
 - **Risk management and funding** options to fit diverse farmer and processor needs
- **AMPI already has widespread support across the industry value chain, including those looking to invest:** feedback providers agree that improved industry efficiency, better price signals and transparency, and better risk management will:
 - **Provide support and fairness to an industry in crisis**
 - **Increase confidence, investment and growth in the Australian dairy industry**
 - **Generate flow on benefits, including stimulus to rural communities from both a financial and mental health perspective, support to innovators looking to enter the market and an increased flow of exports**
- **AMPI aims to deliver a better outcome for all industry participants:** it is about giving rights to milk buyers and sellers which enable choice and better industry outcomes; it is a market-based solution, rather than the introduction of a subsidy, tax or market floor.

- **AMPI can benefit milk producers in all regions of Australia, both in domestic-focused regions as well as export-focused ones.** Dairy farmers across Australia run a variety of production systems, from 100% pasture to 100% grain-fed - all of them with different costs of production and seasonal milk flows. AMPI can bring the following benefits to farmers across all these regions:
 - **Access to the highest value market for milk at all times:** milk from most regions will be aggregated into one market, letting farmers access buyers from outside their region.
 - **Price transparency:** will let farmers compare prices from buyers in their region to prices available across the country
 - **Splitting supply across more than one buyer:** can give a farmer less risk exposure to any single customer (credit, price, contract)
 - **Forward pricing:** lock in a price up to 3 years out for some portion of a farmer's milk, allowing them to plan, invest and grow with certainty
- **With the required changes to farmer-processors contracts, AMPI can be ready to deliver an on-screen milk market by Jan 2021.**

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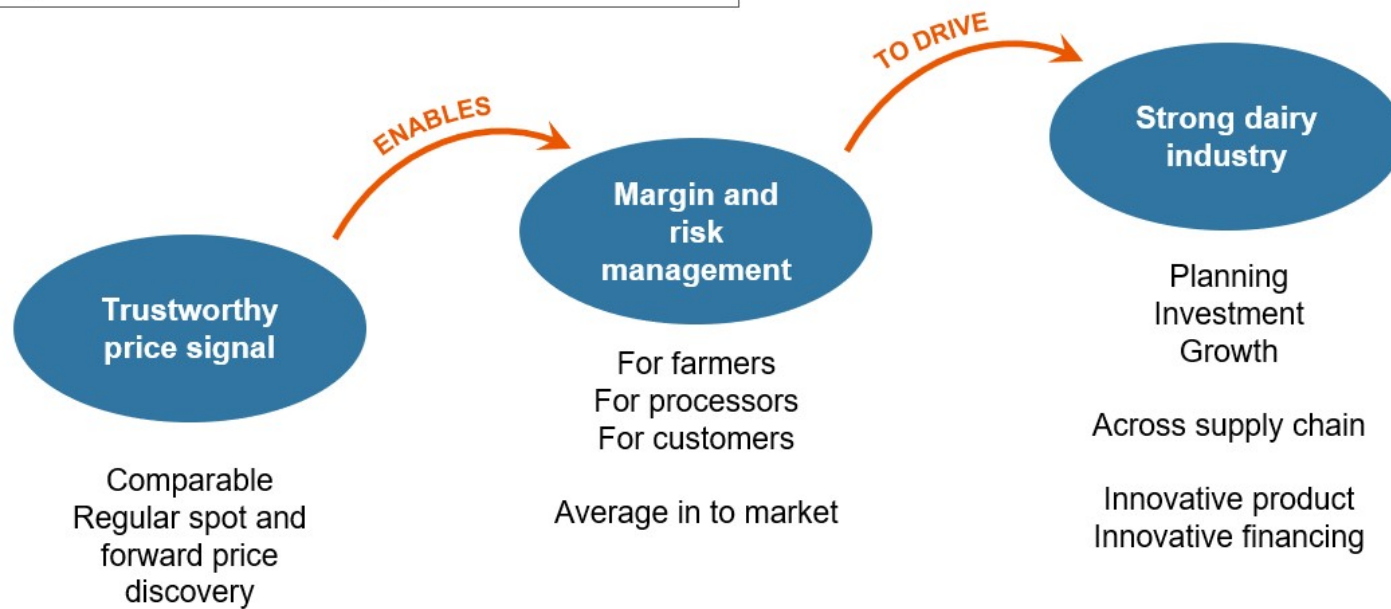
AMPI Project Sponsor – Australian Dairy Farmers

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Power of price

AMPI objective

Design a milk market which enables better risk management for the industry as a whole





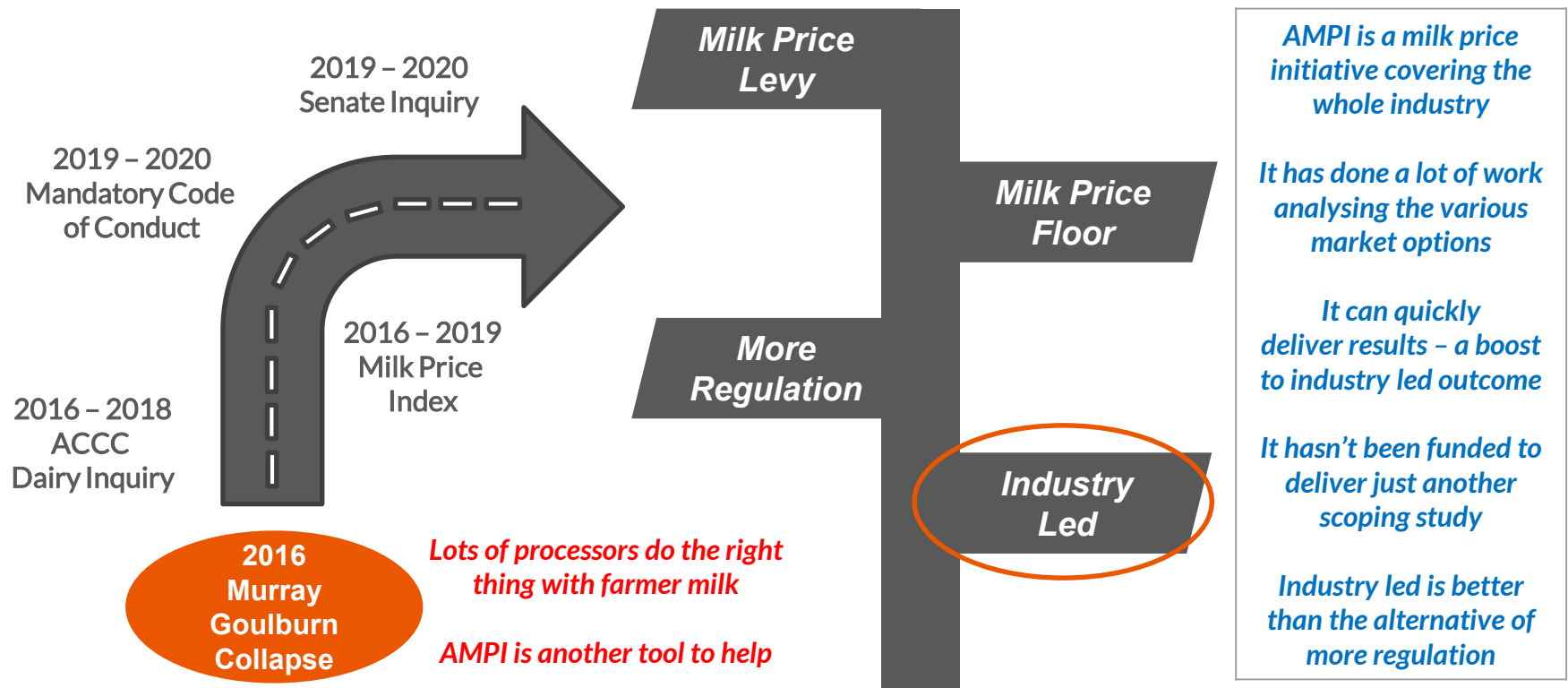
**Australian Milk Price Initiative
Financial Market Design - Summary
September 2020**

Additional materials

- The following is a short summary of the work conducted by the AMPI team to date with key issues to be confirmed. It builds upon the following documents:
 - **The Need For Change:** why Australian dairy needs better risk management delivered by a better milk market
 - **Market Alternatives Analysis:** how risk management and market concepts seen in other global dairy markets apply to the Australian industry
 - **Initial Market Design:** a framework for introducing better price transparency and better risk management into the Australian dairy industry
 - **Financial Market Design Detail:** detailed analysis of how a financial hedge tool can be delivered for the industry

For more detail please contact an AMPI team member (contact details are on the final page)

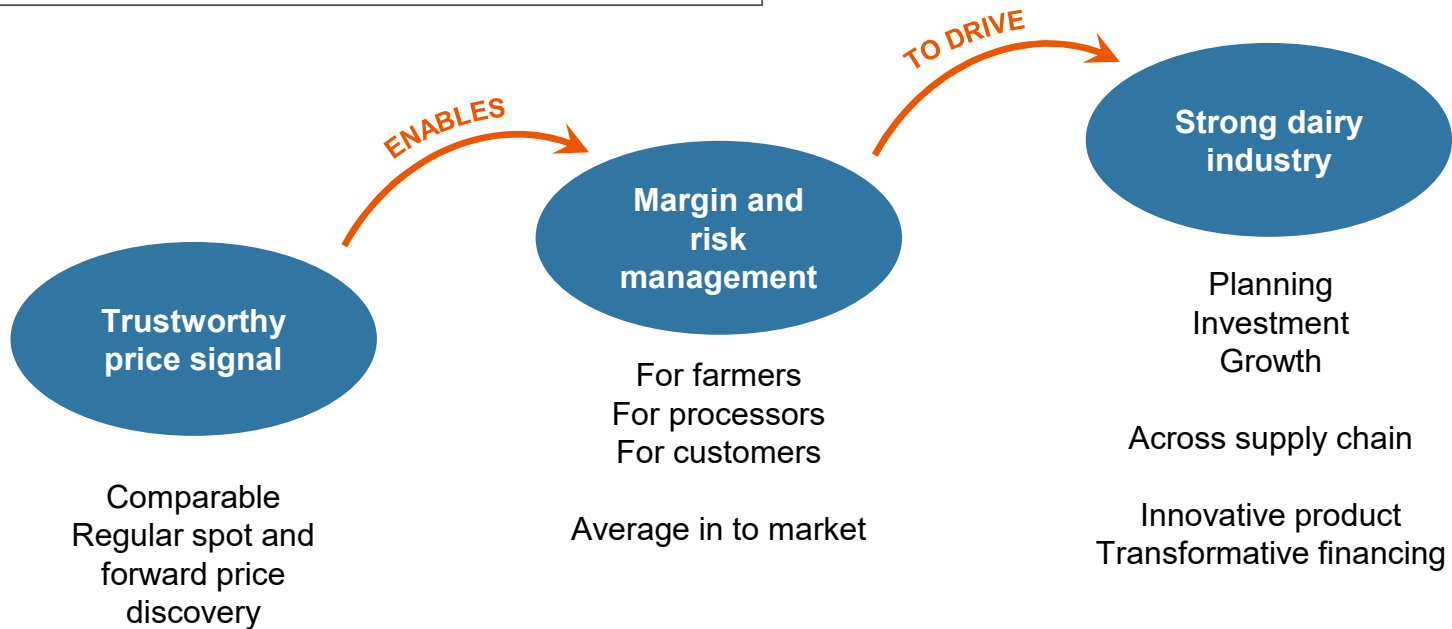
AMPI is an opportunity for the industry



Power of price

AMPI objective

Design a milk market which enables better risk management for the industry as a whole



AMPI can help with industry culture

- Regular spot and forward trading on a reliable market **decreases arguments about milk price**
 - It isn't even a debate – the market has spoken - people can buy / sell if they disagree
 - US dairy, Aus. grains / sugar / cotton / wool – all the same
- Move past debating price and move **towards discussing how to manage it**
- Provides transparency of price across the supply chain – **breeds trust**

AMPI so far

1. There is agreement on the need for new risk management tools

Cross supply chain support on the need for pricing tools which:

- Allow margin and risk management for both the current and forward seasons
- Accurately reflect the value of milk at all times
- Send a forward price indicator beyond the current season

2. We are finalising the market settlement mechanism

AMPI team has proposed development of a milk auction

Auction results can then be used to settle the forward hedge market – like GDT settles NZX

Alternative settlement mechanisms have been examined – rely on regulation or are less effective hedge tools so less usage likely

3. Educate and embed for benefit

Supply chain participants can include mechanisms which enable price risk management in MSAs and customer contracts

Cross supply chain agreement that there is a need for further education on how to generate industry benefit from price risk management

Competitive necessity

NZ / US / EU already developed and using



Finalise market design

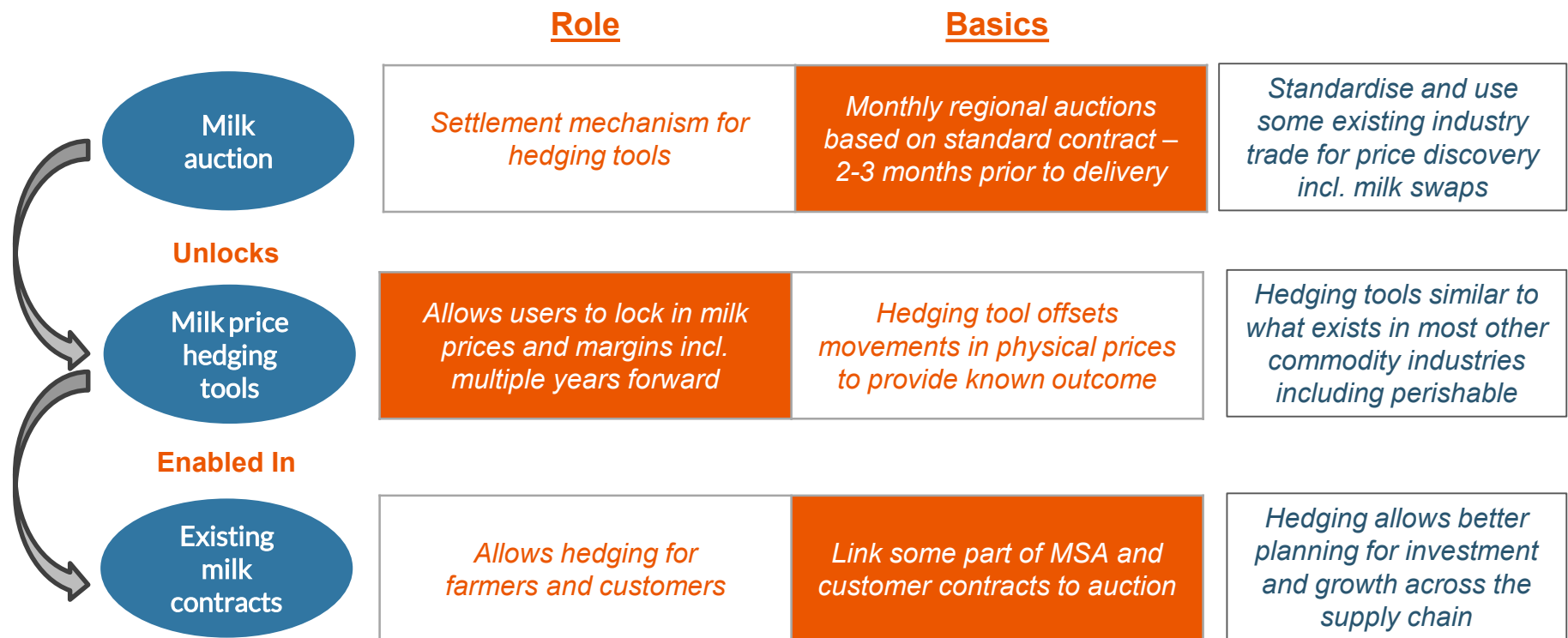
*Minimal time investment
No obligation to use*



Generate benefits

Pace of uptake driven by demand and competition

How it all fits together



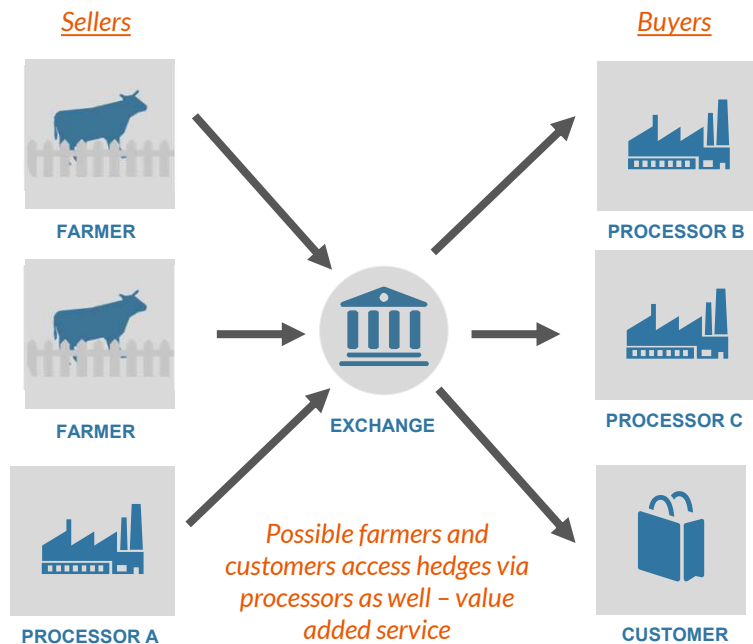
Hedging is as simple as....

<i>When</i>	<i>Where and what</i>	<i>Buyer</i>	<i>Seller</i>
<i>January 2021</i>	<i>In the hedging market</i>	<i>Buys August 2021 milk hedges for \$7.00/kgMS</i>	<i>Sells August 2021 milk hedges for \$7.00/kgMS</i>
<i>August 2021</i>	<i>Auction for November delivery milk settles at \$6.50/kgMS</i>	<i>Pays \$6.50/kgMS for physical milk</i> <i>(either at auction or via auction linked contract)</i>	<i>Receives \$6.50/kgMS for physical milk</i> <i>(either at auction or via auction linked contract)</i>
<i>August 2021</i>	<i>Milk hedges settle</i>	<i>Pays \$0.50/kgMS</i> <i>(Bought hedges at \$7.00, auction settled at \$6.50)</i>	<i>Receives \$0.50/kgMS</i> <i>(Sold hedges at \$7.00, auction settled at \$6.50)</i>
<i>August 2021</i>	<i>Net payment for the milk</i>	<i>Pays \$6.50 + 0.50 = \$7.00/kgMS</i>	<i>Receives \$6.50 + 0.50 = \$7.00/kgMS</i>

How industry can use forward market

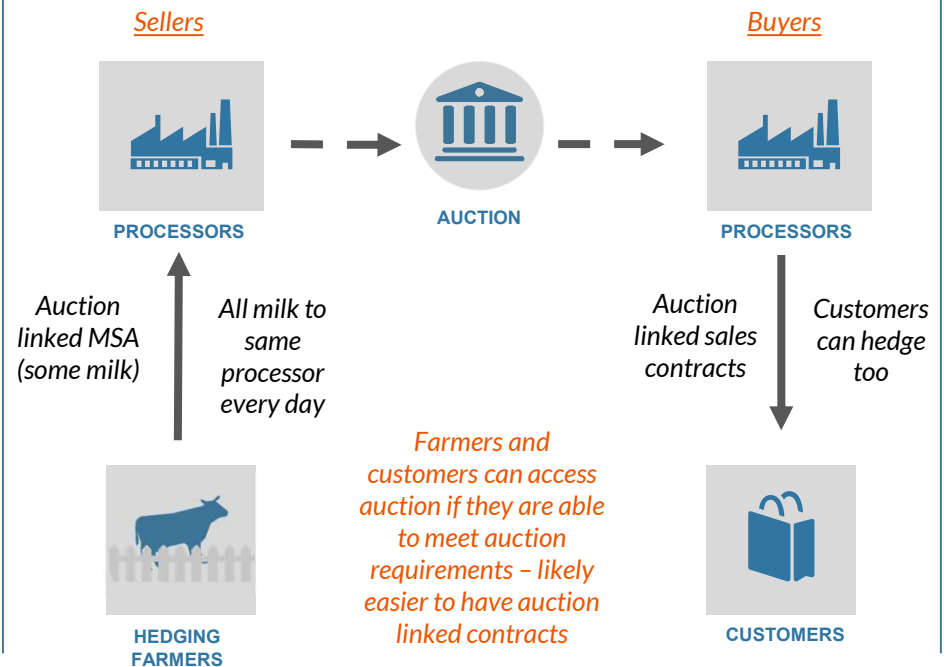
Forward hedging market

Financial hedge instruments which settle to the auction result - lock in known outcome



Auction market

Provides a settlement price for the hedge tools, and allows participants to trade physical milk, including against hedges and auction linked MSAs / customer contracts



Common questions

Do I need to do be involved?

AMPI team will work with industry to develop standard contract of trade and auction

No obligation to use beyond that for farmers, processors or customers

Uptake will be driven by demand for price risk management

Like any new development – leaders and followers

Why would I link some milk price to an untested auction?

It is likely that in the early stages farmers only link milk price to the auction at the same time they execute their hedges

So they won't be exposed to the auction – physical and financial prices will offset

We have a strategy for adding trust to the auction – see below

Isn't this overly complex?

Standardised trading relies on robust contracts and markets to then create simplicity

Once everyone agrees on a contract form, it comes down to agreeing price – all the hard work is already done

The AMPI model is based on various other robust market models, including those used for perishable commodities like sugar cane and electricity

Standardised trading allows for standardised price discovery and transparency, sending the right signal to the industry and enabling price risk management

How do other countries make it work?

	USA	NZ	EU	AUS
What is the milk price structure?	Monthly	Annual	Monthly	Annual
Are milk prices or data regulated in some way? (Red = heavy regulation)	✗	✗	—	—
Are milk prices fairly comparable?	✓	✓	—	✗
Is there regular price discovery on spot and forward basis?	✓	✓	—	✗
Are price risk management (PRM) tools available?	✓	✓	—	—
Do PRM tools allow regular hedging and averaging in?	✓	✓	✓	—
Can farmers use PRM tools to manage margin?	✓	✓	✓	—
Can processors use PRM tools to manage margin?	✓	—	✓	✗
Do milk price structure and PRM tools help the industry win customers?	✓	✓	—	✗
Do PRM tools enable innovative financing?	✓	✓	—	✗
Does milk price structure enable product innovation?	—	—	✓	✓

Detail can be found in 'Market Alternatives Analysis'

A powerful risk management tool

The hedge and the auction are linked

The auction settles the hedge market which ensures hedgers a strong outcome vs. what they expected when they entered the hedge

This linked auction / hedge mechanism is used in various other commodity markets – and it deals very well with perishability of milk

The AMPI team arrived at the auction proposal after significant analysis of other dairy hedging markets

	<u>Selling</u>	<u>Buying</u>
One year ago for Dec 20 auction hedges	Sold hedges for \$7.00	Bought hedges for \$7.00
Dec 20 the auction happens	\$6.00	\$7.75
What you pay or receive in the auction	Receive \$6.00	Pay \$7.75
What you pay or receive on your hedges	Receive \$1.00	Receive \$0.75
What you net pay or receive	\$7.00/kgMS Exactly as expected when you entered the hedge	\$7.00/kgMS Exactly as expected when you entered the hedge

Adding trust to the auction

1. Start quickly with milk swaps

We can use *some of the milk under existing milk swap agreements* to ensure volume at the auction

We can ensure *no change to milk supply or price for participating processors* – unless they find the auction gives them a better result

We are *asking for this support as a commitment to improving price risk management in the industry* – it isn't necessary, but it will speed up the process

2. Further sources of auction trade

There is always a price at which we would buy or sell milk in order to maximise returns for the supply chain – *prices can be traded in hedge markets and then executed into the auction*

Processors can look to *buy milk to fill capacity or sell milk based on lowest margin stream returns*

Milk co-operatives and brokers can be *offering farmer milk onto forward market same way they do now with physical milk*

Innovative farmer risk management providers can assist groups of farmers to forward hedge multiple years out

We will ask market participants to assist via *market making* – *typical new market development strategy*



Alternative hedge settlement mechanisms

- Why not link hedging to:
 - The average milk price of the top 3 processors?
 - A benchmark commodity milk price calculation based on typical sales baskets, commodity prices and costs?
 - A survey of milk prices from across the state?

Imagine hedges based on average milk price



Lost opportunity of poor hedge markets

- Uncertain hedge settlement mechanisms mean hedgers can't know in advance how their *physical prices* will move relative to the *hedge benchmark*
- They can estimate – *but they will add a margin for risk* – buyers will pay less and sellers will ask for more
- The market trades less than it should– *a lost opportunity to hedge mutually beneficial prices*

Imagine a hedge market linked to the average of the top-3 processors

	<u><i>Selling</i></u>	<u><i>Buying</i></u>
<i>One year ago on hedge market</i>	<i>Sold hedges for \$7.00</i>	<i>Bought hedges for \$7.00</i>
<i>Now your physical milk price</i>	<i>Receive \$6.00 from processors</i>	<i>Pay \$8.00 to supplier</i>
<i>The average of the top-3 processors</i>	<i>\$6.20</i>	<i>\$7.80</i>
<i>What you pay or receive on your hedges</i>	<i>Receive \$0.80</i>	<i>Receive \$0.80</i>
<i>What you net pay or receive</i>	<i>Receive \$6.80/kgMS</i> <i>Less than what you expected</i>	<i>Pay \$7.20/kgMS</i> <i>More than what you expected</i>

Yes these examples could work to your benefit – but if so, they are probably at someone else's detriment and the same issue exists

Good hedge markets need good correlation

- The proposed AMPI auction market has a *direct link* between hedge results and physical prices
- This *cannot be replicated* by linking the hedge market to benchmark calculations or surveys
- Strong hedge markets will lead to *better hedge outcomes* as they remove the margin for risk
- Banks will need robust hedge mechanisms in order to *support lending against them*

The best hedge markets allow for known outcomes in advance

Imagine how hedging can change things

Current state

Underwrite 100% of milk price for full year at \$6.40

Generally based on market conditions in Apr-June

Try to manage that risk down as quickly and effectively as possible

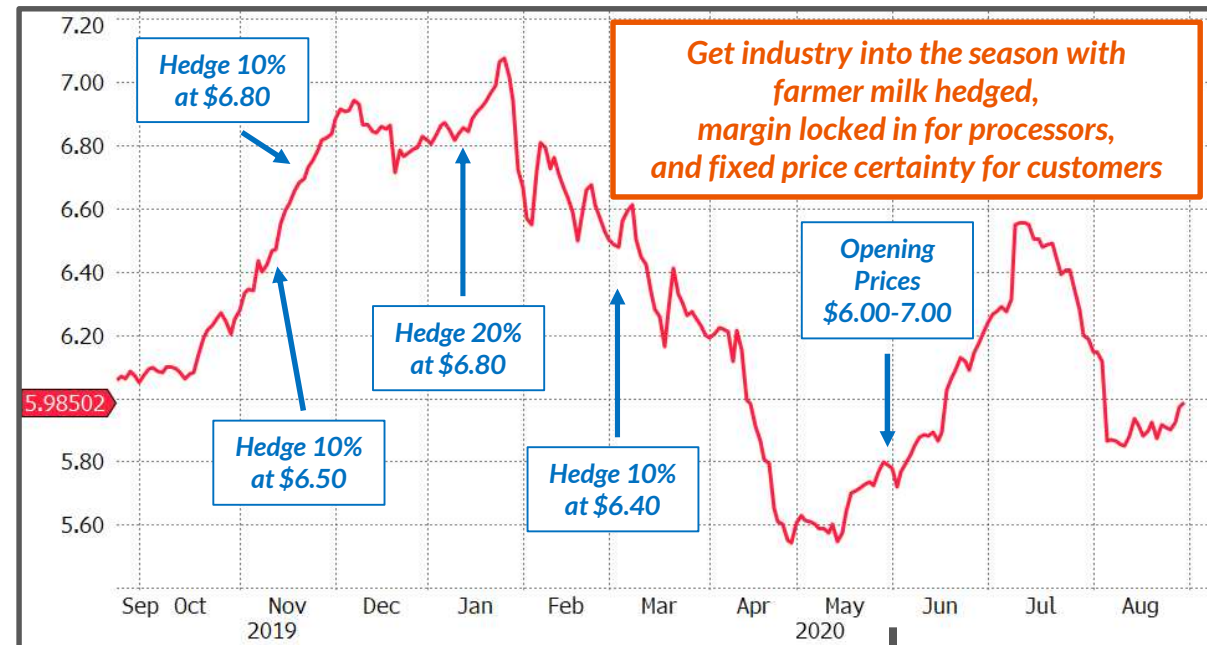
But always some exposure to downside volatility - commods fall, AUD rallies

Not sustainable - someone is always wearing this risk

This is not the norm in other commodity or dairy markets

NZX Milk Price Future - 2020/21 season - in AUD/kgMS
Source: Bloomberg

Typical AUS premium vs NZ milk price is \$0.20 - 0.50/kgMS
Not accounted for in this example



Even earlier...

New milk season

What hedging attracts

<i>Transformative investment and funding</i>	<ul style="list-style-type: none">• Farmers can get prepaid funds for investment over forward hedged sales – guaranteed revenue and margin• Processors can lock in milk supply and margin on new investments
<i>Customers who value risk management</i>	<ul style="list-style-type: none">• High value customers in consumer branded segments value longer dated pricing against their fixed shelf prices• Globally processors are making investments in risk management to deliver such solutions



What are the next steps?

1. Confirm standard contract of trade and auction mechanism with industry
2. Hedge market design and ASIC approval
3. Finalise fit to Mandatory Code of Conduct
4. List hedge tools on FEX
5. Education



Thankyou

Please contact any of us with any queries:

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