

# Managing milk price risk

It would be in everyone's interest to develop a standardised over-the-counter derivative product

The NZX'S new NZ Milk Futures contract should in time provide the opportunity for large and small dairy farmers to proactively risk manage milk price movements and volatility.

The contract essentially replaces and considerably enhances the previous (and limited) Guaranteed Milk Price (GMP) contract for fixing the milksolids payout for one season and was only provided to Fonterra milk suppliers.

It is always a "chicken and egg" situation with a new futures contract. Potential users, being both speculators and hedgers, hold off as there is low market liquidity (buy/sell activity and open positions). The reason there is low liquidity in the futures contract is that the users are watching instead of trading.

International and local experience is that it can take up to two or three years for a new futures contract to gain traction, volume and liquidity.

## MARGIN CALL

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In the early days the market will need support from market-makers to ensure the contract's viability. The development of a milk price forward curve out over multiple years will be a major step forward for more prudent and sophisticated financial management in the industry.

Expectations would be that this benefits all concerned as risk, volatility and future uncertainty is reduced. If financial performance risk and volatility is reduced investment and borrowing decisions should be easier to make and thus all participants benefit.

There may never be an optimal time to start a new futures contract on a soft commodity such as milk and milksolids payout levels below \$5/kg will not see many dairy farmer suppliers racing to fix prices for multiple years.

However, the lower price conditions may mean the futures contract has time to build volume and liquidity so there is a market with some depth for dairy farmers to hedge into in, say, 12-24 months' time when global dairy prices may have recovered.

Financial service providers to the dairy industry have a responsibility to ensure dairy farmers entering such derivative financial transactions are fully aware of the implications of doing so in terms of cashflow, timing, credit risk, accounting, taxation and legal aspects.

The ins and outs of futures contracts need to be well understood before committing to opening an account with a futures broker. Scenario and stress testing the cash requirements for deposits and marked-to-market margin calls along the way with the futures broker would be an important first step.

Companies already hedging foreign exchange, interest rate and other commodity price risks have generally shied away from using futures contracts directly as their method of hedging. The

preference has been to hedge such price risks with "over-the-counter" (OTC) derivative products packaged up and offered by the banks.

They in turn off-lay their market price risk through the futures markets. Time will tell whether the Australasian banks will package up OTC "milk swaps" hedging products for larger dairy farming counterparties.

The banks may be understandably gun-shy about becoming involved in milk swaps from their experiences over past years of selling interest rate swaps to less sophisticated borrowers. So far it appears the banks may offer special debt financing facilities to cover the cash requirements of futures contracts.

Again, reliable liquidity and volumes would need to be established in the futures contract over a number of years before banking/broking intermediaries will package up tailored OTC hedge products for farmers not willing to use futures directly.

It would be in everyone's interest for the market to ultimately develop a standardised milk OTC derivative product that

milk suppliers of all sizes can use with confidence under a formal ISDA (International Swaps and Derivatives Association) legal arrangement; that is, no different to FX forward/options contracts and interest rate swaps.

A "contract-for-difference" (CFD) style derivative may equally evolve as the solution so milk price hedgers do not have the hassle and administrative burden of the regular cash deposits/margin calls in futures contracts.

It makes a lot of sense to have an agreed and formalised hedging policy in place rather than relying of a "seat of the pants" or "knee-jerk" decisions and price risk management approach. Exporters who have applied a longer-term and disciplined currency hedging approach against the volatility and vagaries of the NZ dollar over the past 30 years have survived and prospered.

Dairy farming entities will have the opportunity to learn from those experiences and to apply similar disciplined policies and limits to their milk price risk management.

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