

Contractual relations between milk producers and dairies

Traditionally, long-term contracts that specified a delivery and purchase commitment were widespread in the dairy industry. Private enterprises created strong emotional ties to their milk producers whilst the milk producers themselves felt a close kinship with the enterprise and were part of the family. A basic price, which was adjusted via surcharges and a subsequent payment depending on the revenue, served as a basis for price negotiations. In co-operative associations, milk producers are usually members of the association with long notice periods and strong ties. The price paid depends on the revenue generated.

Today, milk producers want to sell their milk but not supply it. The long-term, good relationship between the milk producer and the association turned slightly sour and the termination of the delivery contract has been the focal point of a whole host of negotiations ever since. The contract period has therefore become part of the conflict between security and flexibility. The milk producer wishes, that in future, the regulation of quantities should be in their hands and the milk price should be negotiated based on the producer's requirements.

The study conducted at Georg August University by Prof. Dr. A. Spiller confirms the development that can be found throughout Germany: Especially large enterprises change hands more frequently, demand price negotiations during the year and use termination as a means to exert pressure. Long-term ties and traditional contractual arrangements are incompatible with the preferred contract period of 1-2 years. Flexibility in quantities and milk pricing are important factors when deciding whether to enter into a commitment with a dairy.

Weakening the relationship between dairies and milk producers might seem appealing when the market trend is favourable and appear to hold out hope of a higher milk price. But in the long run this independence entails a risk for milk producers and requires that they assume responsibility - especially in the liberalising milk market.

Integral parts of the contract

Apart from various formalities, the milk purchase contract specifies, above all, the price, the duration and termination of the contract and sanction mechanisms. Other matters, such as the quality, legal provisions, arrangements on collection etc. are incorporated into the contract or possibly into delivery regulations. The milk quantity is currently fixed via the quota. The expiry of the quotas in 2015 is causing a great deal of uncertainty among milk producers and at companies. <<Quantity control - yes or no?>> is being considered in depth by those involved, has created mistrust and provides scope for passionate debate.

Duties of milk producers

The key task of milk producers is to produce raw milk to the required quality. This also involves the obligation to supply the entire quantity of milk to the dairy

Kaiser-Ludwig-Platz 2
80336 München

Postfach 15 21 04
80052 München

Telefon
(089) 53 07 50 - 50

Telefax
(089) 53 07 50 - 55

e-Mail
info@vbpm.de

Steuer-Nr.
143 / 236 / 80559

Duties of dairy companies

Dairies are obliged to collect all of the milk produced to the required quantity, arrange for its best possible utilisation and to sell it. Milk processors are also responsible for billing the milk, conducting quality inspections and developing innovative products.

Contract period

Depending on the market situation, milk producers and dairies are interested in different contract periods. The contract period and milk pricing influence each other. The philosophy of the individual entrepreneur affects preferences as regards the duration of the contract. The growing individual responsibility of enterprises in terms of coping with foreseeable sharper market fluctuations and the capacity planning required to depict competitive costs make mutual dependability necessary. A closer, long-term commitment is in the interests of both the milk producers and the dairies. At the same time, it is clear that insisting on delivery reliability and strict quantities will not suffice all by itself. Closer forms of informational integration, individual contractual solutions and, among co-operatives, also more variety in the financial participation in capital expenditures and revenues with stepped degrees of decision-making powers must promote the transparency of transactions which will thus increase the appreciation and understanding of milk producers willing to enter into a commitment.

Sanctions in case of non-compliance with the contract

Sanctions are agreed in the event that one of the contracting parties fails to comply with set rules. For the sake of fairness, these sanctions must actually be imposed and applied - a new challenge in the co-operation between the contracting parties.

Milk pricing - one of the sector's parameters

Sharp fluctuations in revenues generated from different net utilisations, new legal and technical possibilities for dairies and a larger number of milk buyers have complicated milk pricing. The loss of trust between the parties to a contract and sharp fluctuations on the milk market are forcing flexible regulators (who transcribe the market) to be put in place to protect the milk price. However, it is problematic if, for example, a comparative price is applied with selected dairies which is exceeded by certain amount. This is how prices spiral upwards - particularly if the enterprises compare themselves with one another - completely detached from their operating results. Ultimately, this endangers all of the contracting parties.

The market for the products of an individual enterprise is crucial for the trend in the price paid for the milk. Ideas of various milk producers and their representatives play only a minor role in this environment. Prices achieved by political means do not last for long and the current rivalry between milk producer representatives has once again proven to be a huge impediment.

Milk price systems must be sustainable and be oriented to the operating result of the dairy. The revenue of dairies is subject to significant fluctuations as a result of the disappearance of any policy for market control and is largely influenced by the range of products of enterprises. In future, differences in supply and demand trends will directly affect market prices.

There are new operational challenges for the stability of utilisation and milk price efficiency and thus for the competitive position in securing raw materials. Milk price continuity is an independent performance criterion that is gaining weight for the investing milk producer operating with growing capital requirements.

Regulation of the quantity is currently the focus of discussion

Since 1984, the quantity has been fixed by the quota whereas before this excess quantities were sold in the intervention. Now that those involved have become aware that the quota is soon to expire, there is a hot debate about what will happen after 2015. All known models are based on the idea of planning the quantity. However, after the quota has expired in 2015 there will be no standardised model in the EU, in Germany or Bavaria and the producer's current respective quota will not have any influence on the supply quantity in future. The milk purchase contract cannot act as a substitute for the quota but how the delivery quantity is to be handled either for an individual establishment or at the level of milk producer associations or delivery co-operatives will be individually specified - or it won't be. In future, co-operative delivery relations will aim at fulfilling market responsibility for members. Solutions with a control or restriction of quantities for the entire market cannot be provided by the co-operatives. They will continue to adhere to the business model based on their constitution. The German Farmers' Association (Deutscher Bauernverband) also sees market players having sole responsibility for the task of regulation.

Challenges entailed in the liberalisation of the milk market

The development of milk producers and dairies has obviously moved on and particularly the liberalisation of the milk market is taking its toll on supply relations. To support these relations, it is essential that mutual trust is restored and the two sides co-operate in an objective manner. The current situation on resolutions of the EU Commission is the starting point for the orientation of the dairy industry in the future. The global market, consumer behaviour and climate disasters are having a major impact on the risks and rewards of the milk market. Only extensive knowledge of these basic conditions permits an objective discussion to be held which will allow the continued development of both milk producers and dairies alike along with Europe as a dairy location. Misinformation and catchy slogans get us nowhere they simply create and exacerbate fears.

All medium and long-term forecasts predict good opportunities for Germany and Europe as a dairy location. The difficulties entailed in coping with the liberalisation of the milk market must be faced and overcome by all those involved. Particularly fluctuations in revenues are putting market players to the test.

The dairy industry is confronted with a sweeping and far-reaching change in the economic and agrarian policy framework. The agrarian policy adopted in the EU is clearly oriented to a complete liberalisation of dairy industry policies, which started with the Agenda 2000 and was confirmed by the Agrarian Reform 2003 and the health check in 2008.

A decisive factor for the sustained success of the dairy industry and thus for stable levels of income for milk producers are competitive structures throughout the value-added chain from milk production right through to processing and marketing. These must be tailored to market realities because even the best structures cannot counteract market rules.

Above all, business enterprises will have greater individual responsibility for market stabilisation in future. On the one hand, this will involve organising and financing the compensation of temporary fluctuations in quantity. On the other, it is necessary to attach greater importance to achieving stabilisation in utilisation in the interests of the enterprises and milk producers. Wider product ranges of enterprises and the ability to serve a broad array of market segments can serve as important contributions towards cushioning fluctuations such as these in sub-markets. Larger, diversified companies or companies related to one another through close co-operations will succeed more easily in exploiting cost advantages and financing the necessary investments.

Coping with fluctuations on one's own and serving border markets require more intensive, viable market connections. However, a high level of costs is entailed in taking suitable steps to adjust towards building up these strategic potentials. Not only that possible effects will only be noticed after a certain delay, which must be taken into account. This requires that milk producers are prepared to participate in these crucial steps.

Producer associations in milk production

The driving factor behind the great success achieved in the areas of fruit and vegetables in recent years has already been applied in the dairy industry. Milk producers joined forces in co-operatives or producer associations decades ago and benefit from the guaranteed purchase of their milk. Fierce competition for milk was and is used to push the price and contractual conditions upwards.

For instance, the Farmers' Association recently attempted to pool existing producer associations in what is referred to as the >>Bayern MeG<< (*society of Bavarian milk producer associations*), to align contracts and standardise pricing talks so that negotiations could be held on equal terms. The planned >>Bundes MeG<< (*national society of milk producer associations*) has not yet been established and the success in Bavaria is long in coming.

Other groups even went as far as to set up the >>MeG Milchboard<< in which the milk producers - without having any supply obligation - a basic milk price of 40 ct/kg is promised, as soon as a sufficient amount of milk (around 80%) is tied.

But stray milk has hampered the required further development of dairies in recent years as it automatically led to a reduction in the processing and marketing intensity. It also caused capital spending on processing to be cut back which has to be oriented to the reliable raw material basis. Consequently, more stray milk results in a trend towards less processing, reduces the level of utilisation, and hence causes a decrease in the value of the raw material and thus the price of the milk.

The idea that milk producers will join in marketing the milk has been practiced by co-operatives for a long time. However, they ensure that tasks and responsibilities are clearly allocated. Selling raw milk from Bavaria to Italy directly has caused lasting damage to the spot market that has been flourishing since the 1980s. The sales quantities of the >>fair milk<< are far lower than the number of press releases.

The "price" paid to again buy into even scarcer processing and marketing capacities in phases when there are excess quantities is so high that stray milk immediately falls to the bottom end of the utilisation scale when comparing utilisations. >>The dairy hopping << may appear to be an attractive, exciting solution for certain producers and associations' officials who are out of step with the market but

it is not suitable as a general utilisation strategy. Under the laws of the free market, it is more risky than at times of extensive governmental responsibility for quantities, i.e. unlimited intervention guarantee.

Who makes a profit on the milk?

Milk has hit the headlines due to the massive protests by milk producers following price fluctuations as a result of the liberation of the milk market. (Not only positive when I think of the tractors that spread liquid manure, milk, lime and water mixtures over fields). Consumers have often said that they would pay higher prices for milk if the money went to the farmers. But the refrigerated shelves of supermarkets tell a different story: the consumption of butter and milk dropped sharply in the second half of 2007. Retailers are under fierce pressure to reduce prices so that they can continue to survive in their battle to win customers. Dairies are positioned between milk producers and retailers and are responsible for obtaining the best price for milk producers. In Germany, 2/3 of the milk is processed by co-operatives attempting to enhance the price paid to members. Private enterprises are usually located in the south and withstand tough competition for the raw material. This is one of the reasons for the gap between the average, German price paid for milk and the average Bavarian price paid for milk. Hence, it is possible to document over the years that milk producers have always benefited from revenues generated on the market.

Outlook

It will not be possible to standardise contracts due to the broad diversity of dairies and milk producers. I can certainly confirm this for Bavaria and Germany and as far as I know this also holds true for other EU states. Producer associations are useful for dairies and for milk producers, but one should not overestimate their degree of effectiveness.

Stable basic conditions and the consistent implementation of EU policy resolutions are essential for all market players. But still - every effort must currently be made to master the liberalisation of the milk market. Therefore the control instruments still in place should be carefully used and at least be available for emergencies.

Much as I sympathise with the milk producers and their difficult situation, it is important to me to appeal to those who see dairies as their opponents and take action against their own peers. Joint efforts are needed to cope with the liberalisation and to promote the EU's position in the global milk market.

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Susanne Nüssel