House of Lords:

EUROPEAN UNION COMMITTEE
Energy and Environment Sub-Committee

RESPONDING TO PRICE VOLATILITY:

CREATING A MORE RESILIENT AGRICULTURAL SECTOR

Call for Evidence:

Submission from the Agriculture and Horticulture Development Board (AHDB)

31 December 2015

Summary

The Agriculture and Horticulture Development Board (AHDB) is a statutory levy board, funded by farmers, growers and others in the supply chain. It raises levies from the meat and livestock sector (cattle, sheep and pigs) in England, horticulture, milk and potato sectors in Great Britain and the cereals and oilseeds sector in the UK. The AHDB's remit covers 75% of total UK agricultural output.

Unmanaged volatility is seen as a real threat to the competitiveness and economic sustainability of UK agriculture. It is for this reason that AHDB has a strategic role offering leadership and helping catalyse innovation in this complex and challenging area. As such, AHDB will be launching its Volatility Forum in January 2016 to put a long-term focus on finding sustainable mechanisms and improving knowledge exchange within the industry.

AHDB does not believe there to be a one size fits all solution to volatility. The Volatility Forum aims to take a broad and deep look at mechanisms across six main themes.

Key points summary of AHDB's response to the call for evidence:

- Mandatory price reporting would aid commercial innovation and better farmer management of price volatility.
- The long term nature of farming production systems and investment makes responding to price movements challenging for farm businesses.
- Better sharing of information across the supply chain is critical to improved management of volatility.
- Evolution of the CAP has meant that farmers and the supply chain have to actively manage their price risk, but despite some developments there are unlikely to be sufficient commercial mechanisms at present.
- Farmers need upskilling in the business aspects of understanding risk.
- Different commodity dynamics means a 'one size fits all' approach to managing price volatility will not work.
- Insurance schemes need robust systems and good quality data. Premiums are unlikely to be commercially viable, requiring them to either be supported by or underwritten by the CAP. Until widespread commercial solutions are in place, there is likely to be an explicit role for CAP in managing volatility.
- There is a key role for AHDB's Volatility Forum to look at a number of the issues raised in this enquiry.

The AHDB

The Agriculture and Horticulture Development Board (AHDB) is a statutory levy board, funded by farmers, growers and others in the supply chain.

Its' purpose is to equip levy payers with independent, evidence-based information and tools to grow and become more competitive and sustainable.

AHDB raises levies from the meat and livestock sector (cattle, sheep and pigs) in England, horticulture, milk and potato sectors in Great Britain and the cereals and oilseeds sector in the UK.

The AHDB's remit covers 75% of total UK agricultural output.

The funds raised from each commodity sector are used only to the benefit of the sector from which they were raised. Levy is invested in a wide range of activities including R&D, marketing, exports and market intelligence.

Because the levy is statutory, AHDB is classified as a Non-Departmental Public Body and comes under the sponsorship of the Department for Environment, Food and Rural Affairs.

AHDB and volatility

The presence and longer term threat of volatility in agricultural markets and impact on farming incomes is a big risk facing the competitiveness and economic sustainability of the industry. As such, the AHDB sees volatility management as a key strategic issue in which it can be involved through offering leadership and helping catalyse innovation. As part of this strategic approach, AHDB will launch its Volatility Forum in January 2016.

The objective of the AHDB Volatility Forum will be to maintain a long-term focus on developing sustainable volatility management tools. This approach involves looking 'broad and deep' at possible mechanisms across six main themes:

1. Forward contracts
2. Formula pricing
3. Derivatives
4. Co-operation and integration
5. Strategic business
6. Government backed

A key part of the AHDB Volatility Forum will be to improve knowledge exchange between the industry, supply chain, allied industries, policy and academia.

Enquiry questions and AHDB's response

1. *What is the role of public policy in mitigating the impact of potential price volatility? To what extent should the response be a shared endeavour between the EU institutions and Member State governments? What are the differing roles of industry on the one hand and individual farmers on the other?*

AHDB response:

1.1 Over the last 25 years the CAP has evolved from stimulating production, then managing production through to now being largely de-coupled from production. This evolution has meant that farmers and supply chains are exposed to free market forces i.e. volatility. Historically, when many of today's farming businesses were in their infancy, the CAP provided much of the price risk management required meaning the business could focus purely on optimising the physical attributes.

1.2 Now though, farm businesses need skills and tools beyond the physicality of farming, although it is appreciated that direct payments made via the CAP are likely to contribute to resilience.

1.3 It is possible that at the farm level, the CAP has evolved faster than the ability of businesses to adapt, given the far broader skillset required. Policy that supports professional development of skills to cope with the free market world is important to help farmers keep pace with an evolving CAP.

1.4 Stronger understanding around cost competitiveness i.e. benchmarking, price volatility, the broader 'commodity cycle' and the need to manage it has the potential to embed mitigation at an individual business level. The modern role of the farmer is to ensure they have a competitive business. Due to variation in weather and physical farm systems, competiveness can't be measured on a short term i.e. 1 year basis, so a long term approach to benchmarking of costs and inputs is required. Additional tools to mitigate price volatility are also available if a long term view is taken i.e. using the good times to prepare for the bad.

1.5 Five-year profit averaging for tax purposes, as announced by the Chancellor earlier in 2015, could be a key piece of policy to help farmers use years of plenty to mitigate periods of poorer return.

1.6 At the market level, policy needs to allow and indeed support the evolution of commercial instruments e.g. mandatory price reporting would allow more transparent pricing, upon which portions of contract pricing could be based.

1.7 Price volatility is a global and pan-European issue and the nature of trade means that member state market prices are closely related. It is also the case that in order to ensure liquidity a number of markets are only viable on a European basis and not at individual member state level. On this basis a coordinated response is favoured, supported by both EU institutions and Member State governments. At the same time though it is important that policies do not contradict. Whilst the CAP is exposing farmers to more of a free market, policy areas such as the Markets in Financial Instruments Directive (MiFID), could well make it more challenging for farmers to use formal market-based instruments.

1.8 Industry needs to ensure a suitable commercial environment is present which provides the right tools for a competitive business to manage risk. The farmer end of the supply chain is anticipated to carry most of the risk so integrating and smoothing the risk through the supply chain is important, without compromising its competitiveness. Sharing of information from the processor back to the grower/producer to enhance understanding, build trust and create efficiency is one example of this. Industry leaders have a responsibility to communicate through both high and low price cycles the need for a long term business view and to manage price volatility.

2. *Should public policy responses make a distinction between support for the resilience of the industry as a whole, support for the resilience of specific sectors and support for the resilience of individual units of activity?*

AHDB response:

2.1 Support for industry resilience as a whole is key, however any public policy must be appropriately flexible in order that it can be fairly accessed by all sectors or segments of the market. Identifying where most risk is carried and therefore most impact can be made is important to ensuring that grass roots improvements are achieved.

3. *Currently, what are the key elements involved in the industry's management of price risk? What further tools are needed?*

AHDB response:

3.1 Volatility, ease of management and indeed impact vary by agricultural sector. This combined with different market dynamics e.g. perishable (milk) versus non-perishable (grain) means that there is unlikely to be a one size fits all solution to volatility across agriculture.

3.2 In cereals and oilseeds, forward markets are well established with pricing largely driven by futures markets in the UK and in Europe. The existence of these means that merchants are able to offer products to farmers that allow them to mitigate price volatility by locking in a price, setting a maximum and minimum value, buying the option to trade at a later date etc. Despite these tools being available, uptake could often be described as variable. In some situations it is not a case that tools are not available but that they are not understood by farmers, and hence not accessed appropriately. Further support to gather the benefits of these would be beneficial.

3.3 In other commodities, forward markets are far less established and challenging to establish along the lines of formal futures markets. This is due to the nature of the underlying goods (e.g. their scale and perishability) and the ability of farmers in different sectors to access and use such markets.

3.4 Also the lack of transparent and robust price data is a key consideration in establishing the price even before that price risk can be managed by the businesses in question. However, where there is mutual benefit through the supply chain, there has been development of formula-based approaches e.g., liquid milk contracts based on costs of production. AHDB's Volatility Forum could well look at what the next generation of formula price contracts look like and what data is required for their success with the aim of making such an approach more accessible and sustainable for all involved.

3.5 In input markets e.g. fertiliser it is often possible to buy ahead but transparency in the markets at local level is challenging and it is not always straightforward to lock in an input cost at the same time as an output cost to secure a margin. Interestingly, this appears to be a global phenomenon, which could be covered by the AHDB Volatility Forum.

3.6 Many businesses are currently likely to manage volatility via income rather than price management. They do this through reducing costs of production or living costs (living within the business) and by having a diverse number of income streams including direct payments. Farmers that own their land may well borrow more money during periods of low prices. The ease and viability of doing this though depends on the direction of land markets, interest rates and the attitude of lenders.

3.7 Over the long-term, the cost of producing agricultural goods should be expected to rise in line with demand for agricultural inputs as global food demand grows. In addition, as agriculture embraces new technology, continued long-term investment is required. Volatility aside, this increases the amount of short and long term investment required in order to build competitiveness and productivity. Unmanaged volatility would threaten the return on this investment thus reducing confidence of those either lending or investing.

3.8 Managing volatility in increasingly un-regulated markets will most likely require commercial innovation and a supportive policy environment. This needs to manage volatility in a way which doesn't distort the market or prevent market signals reaching the primary producer.

3.9 In order for free markets to work effectively, producers need to be exposed to price signals, understand what the signal is and have the ability to respond. Given the lead time to production and long-term investment required, the ability of farmers to respond to low prices by reducing production is very challenging.

3.10 In essence, this means that during a period of low prices a farmer's best option may well be to keep producing at existing levels to maintain cash turn-over albeit at a net-loss. This could well be deemed as market failure. Policy tools to manage this need to be well thought out and targeted to avoid distorting the market.

4. *What effect has the commoditisation of agricultural goods had on the ability of farmers to respond to risk effectively? How are farmers to mitigate the on-farm effects of volatile global commodity markets and currency fluctuations?*

AHDB response:

4.1 On a global basis, agricultural goods have always been commodities and have always been volatile. Evolution of the CAP has essentially removed protection given to EU markets, which are now increasingly subject to the long-running global volatility.

4.2 De-regulation of the EU Agricultural markets has meant that farmers have to now actively manage their own price risk. At least a generation of farm businesses have had their price and subsequent income risk managed for them by the CAP. Clearly this is a huge challenge for the industry, which requires a broader and new set of management skills, beyond the traditional physical skills.

4.3 There are no quick individual fixes to volatility. AHDB is undertaking a long-term, 'broad and deep' project with key industry experts to identify suitable ways of managing volatility for the modern industry.

5. *What are the barriers to more effective on-farm price risk management, including longer term pricing mechanisms, diversification, co-operative working and leasing? How can those barriers be overcome and what is the role of EU and national public policy?*

AHDB response:

5.1 Part of the AHDB Volatility Forum is to identify barriers to better risk management. With agriculture continuing to transition from managed to free markets, many farm businesses are unlikely to have the required management skills at present to actively manage price risk.

5.2 Essentially, many businesses still take a very physical rather than a business approach to periods of low prices. This prevents the business from identifying and responding to market signals – for example it is often said that dairy farmers will 'milk through' low prices to maintain short-term cash flow – rather than making and taking more challenging business decisions.

5.3 This ‘farmers will keep producing at any price’ phenomena removes a lot of incentive from the supply chain to help manage the price risk. If say, policy was tailored to help farmers respond better to market signals, for example targeted payments to farmers that make alternative use of their natural resources then supply chains would see more of an incentive to help manage volatility.

5.4 Lack of innovation on pricing in supply chains could also be a barrier although there is some evidence of good practice in this area e.g. contracts based on costs of production. However, it’s important that any tool is fully evaluated for pros and cons. For instance, a supply chain that pays farmers based on costs of production is clearly working in favour of the farmer. However, in a period where market prices fall, the supply chain in question then becomes uncompetitive and risks losing demand.

5.5 The fiercely independent nature of many farm businesses often stifles cooperation both vertically and horizontally and is in stark contrast to what is seen in many competitor countries e.g. France, New Zealand.

5.6 Price ‘discovery’ is a potential barrier. Essentially how can the price be managed before the price is even known? Provision of independent data is important here and mandatory price reporting is a key consideration for policy makers. There is a clear difference between the EU and the US, where market transparency operates at a higher level due to support from the USDA for independent price reporting.

5.7 Under the new US Farm Bill, public money is used to support yield, production and margin insurance. However, this is very generic, so doesn’t account for local issues e.g. localised flooding, requires very robust data and there is some debate over market distortion.

6. *How ‘fit for purpose’ are market-based instruments? Could the marketplace help to mitigate risks by providing ways of smoothing out the impact of volatility? Are there ways in which EU and national public policy could encourage, and reduce the risk of introducing new financial products?*

AHDB response:

6.1 Some innovations have been seen, such as cost of production contracts, but they inherently come with some downsides as described previously.

6.2 Market-based mechanisms are unlikely to have kept pace with the de-regulation of the market and with the ‘farmers will keep producing at any price’ phenomena, there is little incentive for the market place to help farmers. The market place is probably the biggest potential source of price risk management for farmers though.

6.3 Simple supply chain measures such as smoothing the price over a period of months rather than battling with a daily price would help the farmer stay out of the bottom market and help the processor/retailer/consumer avoid the top of the market.

6.4 Ability to do this though comes down to availability of data – as discussed previously. Mandatory price reporting would help price discovery, enable the market signal to the farmer and assist commercial risk management contracts to be created based on truly independent data.

6.5 Purely ‘financial’ instruments are unlikely to be of much use to farmers with business size and regulation preventing direct access. Such approaches come with an increasing amount of regulation to ensure they are not misused by speculators which itself may on occasion give rise to additional volatility.

7. *How realistic are terms for access to investment finance? What role is there for the European Investment Bank to support on-farm investment at a low cost? What other instruments could improve access to finance in a volatile environment?*

AHDB response:

7.1 There is no clear evidence to suggest that access to finance is an issue, but could be in some cases and could be more of an issue when interest rates start to rise. However, the risk of volatility and limited tools available to manage it, could be a huge barrier to making longer term investments. A loan system where repayments are linked to the output price is an interesting concept, but this moves risk from the farmer to the loan provider/ investor, which might be commercially challenging but perhaps an opportunity for state-backed schemes.

7.2 Banks appear to be fairly keen to lend to farmers that own their land as debt to asset ratios look generally favourable. However, for farmers with limited assets such as tenant or contract farmers, ability to secure finance and the impact of volatility are more pressing issues. This is important as anecdotally, the businesses / individuals that farm the land are becoming increasingly detached from land ownership. With this in mind, lending longer-term into agriculture could be more challenging and less informal than, say, overdrafts. This may well challenge the industry to think how commercial finance to agriculture works and how it flexes around the commodity cycle. In effect, products that allow farmers to save efficiently in good times to offset the bad are an interesting proposition and one the AHDB Volatility Forum could investigate further.

7.3 Crowd funding is sometimes referenced as an alternative to more mainstream sources of finance, but limited willingness to cooperate could be a significant barrier in UK agriculture.

8. *What level of information is available to farmers to engage with market-based instruments and to consider alternative options for on-farm actions? How might knowledge availability be improved? How can farmers be encouraged to acquire the skills needed to operate a modern business-like operation?*

AHDB response:

8.1 Interactions between farmers and their suppliers/supply chains is largely transactional – trading based on today's price. So this limits the ability to engage with more sophisticated products. To justify use, larger volume trades are typically required, which is where a level of co-operation would help.

8.2 AHDB's Volatility Forum could be one avenue to help volatility, with the potential to lead to a shared knowledge hub with tools and innovation for the industry. AHDB's Monitor Farm Programme which currently runs in the cereals and dairy sectors is also an important tool which uses 'real time' examples to encourage farmers to engage with business planning skills.

8.3 Linking base level business planning skills e.g. identifying costs of production with direct payments, would act as a significant incentive. Skills remain very much focused around the physicality of farming rather than business skills. The basics of cash flow planning can be very useful as well as considering more sophisticated skills such as margin sensitivity to changing prices and full risk likelihood/impact assessment.

9. *What role should innovation play in creating a more resilient agricultural sector? Should more be invested in scientific research which could have the potential to transform agricultural practices?*

AHDB response:

9.1 Business/ economic innovation at the supply chain and farm level is critically important to tackling volatility – to enable the industry to build a sustainable approach. However, as mentioned before, there is little incentive for supply chains to innovate due to the 'farmers will keep producing at any price' phenomena**.** Business innovation in the farm business to enable market signals to be interpreted and acted upon with more responsive production is important, but likely to be limited.

9.2 Scientific innovation helps build competitiveness and productivity, but is likely to do little to help manage volatility and if physical innovation requires greater investment then it could in fact amplify the impact of volatility. Although, competitiveness and productivity are important in broader industry resilience. Investment via AgriTech for example, should provide further scientific innovation to help build competitiveness and so resilience.

9.3 With a key element of market failure being the inability of farmers to economically 'switch-off' production during periods of low prices; the importance of non-market distorting policy innovation is likely to be an important factor.

10. *How effectively does EU agricultural policy currently assist farmers to mitigate the impact of potential price volatility? Is there a need for management of price risk to be an explicit objective of the Common Agricultural Policy?*

AHDB response:

10.1 Volatility is likely to remain a key threat to EU agriculture going forward, and to farm businesses could be argued to be more significant than climate change – although the two in some regards can be linked.

10.2 Any policy involvement with managing volatility should be careful not to distort the market. Although the ambition should be to find as many solutions to volatility in the commercial world as possible the physical lead in times to production may well mean that policy-based tools are also required to achieve a satisfactory level of management.

10.3 Volatility should be expected to remain a challenge in the long-term. Until satisfactory commercial approaches can be seen to be widespread in the industry to help farmers with the 'thick end' of the risk in the supply chain, perhaps there is more of an explicit role for the CAP.

11. *What long term changes should be made to the Common Agricultural Policy to support the agricultural industry in responding to price risk more effectively? Should insurance schemes play a more prominent role?*

AHDB response:

11.1 As it stands the CAP provides passive volatility management / resilience in the form of blanket direct payments. If there was a desire to make the CAP role in managing volatility more active, there are likely to be a wide range of options available, depending on how much innovation is catalysed and the level of political intervention in the negotiation process. With this in mind, what the CAP can achieve on volatility management shouldn't be underestimated. Insurance schemes could play more of a role, but it is important that possible solutions could come from beyond this arena.

11.2 Margin, yield, income and other types of insurance are a popular approach in the US, but would need good quality data and robust systems. As in the US, premiums would most likely need to be subsidised. With traditional insurance the policy covers high impact, low likelihood events. In insuring volatility though, the events are high impact, high likelihood, which would make premiums commercially unviable. This would likely require the CAP to subsidise premiums and/or underwrite the risk.

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