European Association of Dairy Trade
Europäischer Verband
des Handels mit Milcherzeugnissen
Association Européenne du Commerce
des Produits Laitiers et Dérivés

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Eucolait comments on futures markets to the Agricultural Market Task Force

Eucolait supports the development of dairy futures market in Europe because they can help our member companies – several of which already engage in futures trading – securing their margins. In addition to managing price risk, futures increase price disclosure, thus enabling better planning by all actors in the dairy supply chain.

Our replies to the questions posed relate exclusively to dairy futures.

1. **What are the main problems in the functioning of futures markets? How can problems with insufficient liquidity of some existing contracts be overcome (in particular poor take up of dairy and meat futures). How to increase the participation of farmers, commodity users and speculators in futures markets? How to address other obstacles, e.g. the costs of using futures contracts, size of holdings (are futures markets beyond the reach of small holdings?), cultural aspects, perception of futures markets as speculative instruments?**

Still more education needed

The greatest challenge for dairy futures in Europe is the lack of acquaintance which explains the low liquidity. From our point of view, the main remedy to the still modest uptake is education. Many market participants are still very sceptical when it comes to using futures to hedge their price risk. Often futures are associated with speculation, which is of course also needed, but primarily they are an instrument to manage the price risk by locking in a margin. This is not too far from the concept of an insurance.

With more convinced market players, liquidity will increase, the cost of the hedge will decrease and in turn attract more participants, including speculators which are needed for sufficient liquidity. This will allow the futures market to get more efficient, thereby improving price signals.

In addition, expectations need to be managed. Futures can constitute an efficient tool for managing price volatility but that is all they do. Futures will not change supply and demand fundamentals or issues relating to price transmission along the supply chain.

Futures can be used by all links in the dairy supply chain

Futures can and should in principle be used by all dairy actors: processors, traders and end users, also farmers but probably with the help of processors (who can use futures to offer new price models to their farmers) or producer organisations rather than directly. For small companies/holdings, participation may indeed prove more difficult as it takes a lot of time, resources and specialist knowledge to start trading. In this context, the size of the offered contracts also plays a role.

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Every actor has to decide for himself

The decision whether to use futures or not obviously has to be taken by every actor individually. A company, while fully aware of the ins and outs relating to futures trading, may decide it is not in its best interest to get involved, e.g. because it is not compatible with its business model or because of all the administrative work involved. Getting started is a long process as all key people within the organisation need to be convinced and trained.

Futures vs OTC

Liquidity could also be increased by moving business off the Over-the-counter (OTC) market and onto screen (into a regulated futures market). Over the last months we have already seen a shrinkage of the OTC market in favour of futures and the ratio is now estimated to be roughly 1 to 1, whereas a few months ago the OTC market was estimated to be about twice the size of what we see on the screen.

It takes time…

At the same time, one needs to accept that it takes some time to develop a functioning futures market, with the number of participants and volumes traded increasing gradually as users get more comfortable. The EEX SMP and butter futures were launched only six years ago in 2010 after the previous milk crisis. In the period of improved market conditions that followed, there seemed to be little interest in this risk management instrument, perhaps also because the milk quotas were still in place. Volumes have however increased every year and since the quota removal in April 2015, which was the last milestone in establishing an (almost) market oriented dairy policy, a clear increase in activity can be observed. As for the Euronext contracts with physical settlement, they have only been operation for about a year.

2. **Is there a need to develop new futures contracts for other products than those currently existing? What are the obstacles towards developing new futures contracts and what are the reasons for the unsuccessful introduction of new contracts in Europe; e.g. durum wheat contract in Italy, citrus contracts in Spain?**

In Europe, it is currently possible to trade butter, SMP and whey powder on EEX and Euronext. Outside the EU, CME offers contracts for cheese, non-fat dry milk, butter and dry whey as well as class III and IV milk (linked to US milk marketing orders) while NZX offers WMP, SMP, butter, AMF and has just introduced milk price futures and options linked to the Fonterra milk price.

In the EU, there would be demand for cheese futures but their development is rendered challenging by the huge variety of cheeses produced and the lack of common specifications.

There is also talk about milk futures but the main barrier for such a contract is the absence of a credible reference price and the time lag in the publication of milk price information. Milk prices can however also be hedged using SMP and butter futures (‘synthetic milk hedge’).

3. **What role can futures markets play in price transparency?**

Futures markets constitute a price discovery mechanism for the entire dairy sector. They contribute to price transparency by giving an indication of the possible price level in the future, e.g. in 6 months’ time, thereby reducing uncertainty to a certain degree and allowing for improved planning. In this sense, futures can constitute an early warning system for market crises. In addition, the price index (of a cash-settled futures market) can/should provide a credible indication of the current market price which may be used by market participants in their contractual relations.

4. **What is the impact of market intervention measures on developing futures contracts (measures providing for a substitute method of risk reduction)?**

Futures markets require a physical market that is as free as possible from government intervention that may disturb market signals. Therefore, a futures market for dairy in Europe would have been unthinkable before the successive CAP reforms and unnecessary as price volatility was limited. Today, the impact of the remaining CAP tools on market developments is limited. A safety net still exists but the low level of the intervention prices mean that the interference in the market is minor. In addition, the price floor is (almost) fixed and known to everyone. Looking forward, a high degree of policy stability is crucial. Sudden moves to for instance increase intervention prices or to cap supply might have a detrimental impact on the development of futures contracts.

5. **Possibilities for policy measures to:**

    - **improve market transparency to offer all market participants wide and equal access to market information before engaging in futures trading;**
    - **provide reference prices for cash settled futures contracts;**
    - **education - encourage the training on using futures contracts in the context of Rural Development programmes;**
    - **include the promotion of futures markets as one of the objectives under operational programmes for producer organisations;**
    - **further encourage the creation of producers organisation (cooperatives) that would be in a better position to use futures markets;**
    - **work on standardisation of products (marketing standards);**
    - **encourage exchanges to use more frequently market making function.**

The Milk Market Observatory (MMO) already provides a good degree of market transparency that is available to anyone interested. Of course there is always room for further improvement, for instance by including information on futures markets developments (prices and volumes).

The MMO could also provide a reference price for cash settled futures. Such a carefully designed index could be endorsed if it is seen by market participants as more accurate than the current EEX index consisting of an average of the Dutch, French and German quotations. Moreover, the procedure behind the setting of these quotations could be made more transparent.

In order the support the development of a futures contract for cheese, the Commission might consider starting work on an EU standard for (certain types of) cheese that could be incorporated into the Single CMO regulation.

Furthermore, we believe any measure taken by the Commission to support training and educational initiatives related to futures would be welcome.