Contract milker agreement with top-up linked to milk price

Description

The contract milker (CM) is paid a set price per KgMS, and pays for certain costs, but there may be a top-up payment should the milk price rise.

Background

There has been a significant shift towards contract milking (CM) agreements in recent years. These agreements typically pay a flat rate per kgMS produced. The CM is typically responsible for wages, shed and power costs, and motorbike costs. However, as the CM agreement is simply a contractual agreement between two parties, the expense payment clauses vary.

CM agreements are lower risk than VOSM agreements, as a VOSM is accepting the risk of milk price volatility. CM contracts offer some income security to milkers in low milk price years, but do not offer the same profit opportunities in high milk price years as VOSM contracts.

On the larger-scale farms, CM businesses can be very successful at allowing progressing farmers to generate enough surplus for further dairy industry investment. At the smaller end of the farming scale however, the profit margins for the CM are sometimes not sufficient to allow them to build equity and progress through the dairy industry. To overcome this CMs may need to negotiate a higher rate, or seek a more profitable business structure to help with progression. If a higher rate is negotiated, this can leave the farm owner exposed to a higher cost of production if the milk price drops significantly.

For example:

$1.40/kgMS is 23% of a $6.00 milk price
$1.40/kgMS is 35% of a $4.00 milk price

There is an opportunity to provide a CM agreement that offers an agreed fair rate for a 'normal' farm gate milk price, but provides the CM a top-up payment should the milk price exceed this. This option allows the farm owner to offer a more profitable contract and attract talent, while not increasing the financial risk to the business should the milk price drop.

For this option to work, the base rate must still be set at a level that allows the CM business to remain viable and pay all costs throughout the year. This is important as this will be the only income the CM receives during the season. Any top up payments will be received when the final milk price is known, which is usually after the end of the season.

Advantages and considerations

Advantages

Contract milker with top-up payment

- The top up payments provide an extra boost to progressing farmers
- A contract milker requires minimal equity
- Certainty of some income to ensure costs can be budgeted for

Farm owner

- Allows farm owners to increase the contract rate in good years which makes their position more attractive to quality Contract Milkers in a competitive market.
- Evens out the risk of having to offer a high $/kgMS in low milk price years.

Considerations

- The top-up payment will be paid from the farm owner's account and not by the milk company. This should be allowed for in farm budgets.
- Setting the level for top-up payments too low will require top-ups to be paid most seasons and holds cashflow at a low level for the CM during the season.
- The CM payment structure is much lower risk for the milker than a VOSM structure. For this reason, it would be realistic to expect the returns as a percentage of the milk income to be slightly lower.
- Fonterra farms must wait until the following October before the milk price is confirmed and top-up payments can be made. Most other dairy companies can confirm the milk price upon the completion of the season.

Keys to success

- It is important the base contract rate is set at a fair price for the work and costs provided by the CM. Setting this rate too low would cause the CM to rely on the top up payment to remain viable. For this reason, it is recommended that the base milk-price be no lower than the average of the last three seasons.
- Like any CM agreement, good budgeting is essential to understand the costs and profitability of the CM business.
- The farm owners and the CM should agree in principle a basic annual farm plan including expected fertiliser, nitrogen and supplement feeding inputs. This will ensure both parties understand what inputs can be expected throughout the season and have confidence in the milk production target.
- The top-up calculations should be attached to the contract and signed by both parties. Top-up payments will not be linked to any other measures other than milk price.

Skills required

The contract milker will need:

- farm management skills
- financial management/budgeting skills
- people management
- health & safety knowledge
- environmental compliance and regulations for region

Financial

Drivers

The main drivers from this option are cash returns. These are driven by the negotiated contract rate and top up payment and total milk production.

Equity required

A contract milker requires minimal equity. They will typically provide farm bikes, general hand tools and enough working capital to pay for staff, fuel and shed costs for the first three months until milk income starts coming in.

Financial returns

Will vary depending on contract rate.

For example, the base rate is associated to a 'normal' or average milk price such as $6.00/kgMS. Top up payments can then be calculated for any increases in the final milk price.

Example of top up:

Base CM rate: $1.20/kgMS (135,000 kgMS produced)

Milk price	Top-up rate	Total CM rate	Top-up value
$6.00/kgMS	$0	$1.20/kgMS	$0
$6.50/kgMS	$0.10/kgMS	$1.30/kgMS	$13,500
+$7.00/kgMS	$0.15/kgMS	$1.35/kgMS	$20,250

CM payment = 135,000 kgMS x $1.20/kgMS = $162,000 during the season regardless of milk price.

The CM would receive $175,500 if the milk price reaches $6.50/kgMS and $182,250 if it reaches $7.00/kgMS.

Note: The above values are examples only. Parties must negotiate their own top-up rates.

Example:

The below budget is an *example* from a 300 cow, position in the Waikato with a 22 aside herringbone. Make sure you do your own budget for your situation.

Income	
135,000 kgMS x $1.20/kgMS	$162,000

Expenses	
Permanent Labour	$35,000
Relief staff	$4,000
Bike costs (quad and two wheeler)	$5,500
Fuel	$2,800
Cleaning materials and costs	$1,000
Rubberware, milk filters etc.	$3,000
Tools	$500
Safety clothing	$500
Electricity	$13,000
ACC	$3,200
Insurance	$1,800
Accountant	$2,200
Communication	$1,800
Total Costs	**$74,300**
Cash surplus for CM (pre-tax)	**$87,700**
Total Package including accommodation valued at $14,000	**$101,700**

Notes:

- Depreciation on farm bikes needs to be taken into account. If a quad bike is purchased for $12,000 and worth $2,000 after 4 years, this has cost the CM $2,500/yr in depreciation.
- Make sure there is sufficient cashflow in the business to cover the first three months of expenses as there may be no income over this time.
- Always have some cash spare in the budget for contingencies like bike breakdown or other unexpected cost.

How easy is it to enter/exit agreements?

Contract milker agreements are simple and easy to enter and exit and are often on a one year rolling contract for this reason.