FINANCE FOR THE FUTURE AWARDS

Sustainability | Leadership | Innovation

ACCOUNTING FOR SUSTAINABILITY

ICAEW

2014 WINNER CASE STUDY

LESSONS IN DRIVING BUSINESS SUSTAINABILITY

MILKING THE BENEFITS

Protecting dairy farmers from market price volatility makes long-term milk production more sustainable.

THE BUSINESS

Sainsbury's operates over 1,200 supermarkets and convenience stores in the UK, employing 161,000 staff. Its wide range of products include food, household goods, clothing and it also provides financial services. In its all-important fresh food business, Sainsbury's seeks to balance the needs of customers for quality food and competitive prices with those of suppliers for fair prices and reasonable terms.

THE IDEA

For years milk production on Britain's dairy farms has suffered from uncertainty caused by volatile prices. Sainsbury's believes it has found a way to make milk production from its own suppliers more sustainable. Its **cost of production** (COP) model seeks to protect dairy farmers from market volatility. It focuses on two key areas of volatility – the price paid for milk and major dairy farm costs. The model moves dairy pricing away from standard market pricing to an open book cost-based approach which uses data independently collected from 320 farms in Sainsbury's Dairy Development Group (SDDG).

'The challenge and opportunity was to give our dairy farmers the stability and confidence to invest in the future of their businesses and protect them from market volatility,' says Stuart Lendrum, Head of Sustainable and Ethical Sourcing at Sainsbury's. 'In doing so, we could ensure consistent, resilient milk supplies whilst ensuring a sustainable future for the SDDG farmers.' It's all about building a sustainable supply chain for the future.

> 'Successful projects tend to be ones with a set of objectives collaboratively built and agreed, followed by a shared work plan.'

Sainsbury's spent 18 months working with SDDG farmers and Kite, an independent dairy accounting specialist, to develop COP. All costs apart from the 'three Fs' – feed, fuel and fertiliser – are fixed for 12 months. Every quarter, the three Fs are adjusted to account for actual market fluctuations. Lendrum says, 'The COP model serves to strengthen the long-term commitment we have made to the SDDG as it guarantees them a sustained business margin which is something a market price is unable to do.'

Ian Garnet, dairy farmer from Cheshire and member of Sainsbury's Dairy Development Group

THE INNOVATION

COP is a major innovation in making the volatile milk market more sustainable. Instead of uncertainty, COP sets a quarterly price based on reliable data. This, Sainsbury's believes, has increased the financial resilience of both its own business and those of SDDG farmers.

Since May 2012, the SDDG milk price has varied from its lowest to highest point by 3.85ppl (pence per litre) but over the same period the average market price has varied by 6.86ppl. Market-watchers suggest that the removal of milk quotas in Europe from March 2015 could make market prices more volatile. Sainsbury's argues the COP model provides certainty – and, thus, sustainability – in a way that no market-based pricing model can.

The company believes that a key element of COP is the 'business margin'. This encourages SDDG farmers to invest in their businesses. Its aim is to ensure long-term profitability – the key to a sustainable future. However, beyond this, the model also includes a bonus element for excellence in animal welfare standards as well as high performance in carbon efficiency. These factors are assessed respectively by EBVC, an independent veterinary consultancy, and AB Sustain, which measures the carbon footprint of all SDDG farms. By ensuring that the environmental and animal welfare elements of SDDG farms are measurable, Sainsbury's can track the benefits delivered by COP and make adjustments to ensure that it and its farmers are receiving and delivering the benefits that all are looking for.

FINANCE FUNCTION LEADERSHIP

Sainbury's finance function has been at the forefront of COP's development. The finance and commercial teams actively led the initiative together with the agriculture specialists who are responsible for day-to-day contact with farmers.

Sainsbury's believes that COP has had significant implications for both its own business and SDDG farmers. It has, effectively, decoupled its milk price negotiation from the market and linked its costs to a different set of volatile inputs beyond its control. Of course, the farmers have also decoupled their price negotiation from the market. This far-reaching change required strong buy-in from Sainsbury's Operating Board and SDDG farmers. Sainsbury's believes the quality of the financial model – and the data, governance and processes that underpin it – provided the confidence and established the trust that was necessary to get all the businesses involved to buy into COP.

There was a clear sustainability driver to the project. The British dairy industry has shrunk with many farmers leaving, so there was a clear commercial reason for safeguarding UK milk supplies. The challenge and opportunity, as Sainsbury's saw it, was to give its dairy farmers the stability and confidence to invest in the future of their businesses and protect them from market volatility. In doing so, it could ensure consistent, resilient milk supplies while also ensuring a sustainable future for SDDG farmers.

POSITIVE LONG-TERM IMPACT

COP could deliver sustainability and economic benefits far into the future. On the economic front, COP strengthens Sainbury's long-term commitment to SDDG farmers. That is because COP guarantees them a sustained business margin – something a market price is unable to do. The business margin element is a fundamental part of COP because it encourages investment and profitability, notes Lendrum.

Sainsbury's believes COP secures that all-important sustainable future for its dairy farmers. Financial certainty

Stuart Lendrum, Sainsbury's Head of Sustainable and Ethical Sourcing

gives its farmers the confidence to invest in farm buildings, handling equipment and proactive herd health planning with their vet. Investments such as these have already resulted in improvements to 'cow comfort' which, in turn, contribute to Sainsbury's commitment to deliver higher animal welfare standards on farms by 2020. Environmental and welfare improvements feed back into increased production efficiencies. In the long term, these cut the cost of milk production and reduce its environmental impact – while keeping farms profitable.

LESSONS FROM THE CASE STUDY

There are important lessons from COP for other companies working on collaborative projects with supply chain partners in almost any industry.

The first, suggests Lendrum, is the importance of engaging and communicating with potential partners right from the outset and all the way through the project.

The second is about how to set up the project in a collaborative way. 'Successful projects tend to be ones with a set of objectives collaboratively built and agreed, followed by a shared work plan,' says Lendrum. 'The communication and engagement from the outset is a key step in a transparent, open, trust-building approach which further supports the likelihood of success.'

And, finally, making the sharing of benefits truly transparent ensures that all partners are likely to want to continue buying into the project in the future. 'I'd suggest an equitable approach to the resource, activity and benefits,' adds Lendrum.

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