



## Dairy Market Update

26 April 2012

Page 1 © AHDB 2012

### Dairy Crest loses Tesco liquid milk contract

Dairy Crest's contract to supply liquid milk to Tesco will not be renewed when it comes to an end in July 2012, leaving Arla and Robert Wiseman Dairies as the main suppliers of fresh milk to Tesco.

The company says that this will not jeopardise its relationship with the retailer and it will continue to supply branded products to Tesco. Around 3% of Dairy Crest's liquid milk sales in 2011/12 were made to Tesco, representing in the region of 50 million litres of milk.

Although the total volume is relatively small compared to its total liquid milk sales, Dairy Crest will need to find alternative destinations for this milk in a highly competitive market. In total, 78 farmers are directly affected by the loss of the Tesco contract; 24 on core contracts and 54 on seasonal contracts.

#### In context

All farmers on contracts aligned to Tesco received a 0.65ppl reduction to their milk price from April and the loss of the Tesco supply contract may mean that those on Dairy Crest Tesco contracts will see a further reduction to their milk price. Farmers wishing to transfer to another milk buyer would need to serve a 12-month notice period.

It is likely that the destination for the milk would include the highly competitive middle market, which accounted for 47% of Dairy Crest's liquid milk volume in 2010/11. According to the March DairyCo League Table, the difference between the average non-aligned liquid milk price and the average Tesco aligned milk price (core/profile contracts) was 1.30ppl.

### Sainsbury's launch new cost of production contract

Sainsbury's has announced that the Sainsbury's Dairy Development Group (SDDG) will be launching a new milk supply contract from 1 May for its farmers through Arla, Dairy Crest and Robert Wiseman Dairies. The new contract will be based on a cost of production model using figures supplied by the group of 324 farms through Kite Consulting.

The new contract will start with a price of 30.30ppl for a standard farm (producing one million litres, 4% butterfat, 3.3% protein). Of interest is that in addition to the full annual review on 1 October, which will use costings data collected by Kite, SDDG will conduct quarterly reviews in January, April and July each year. At these reviews fuel, feed and fertiliser costs will be reviewed using figures published by DairyCo Datum.

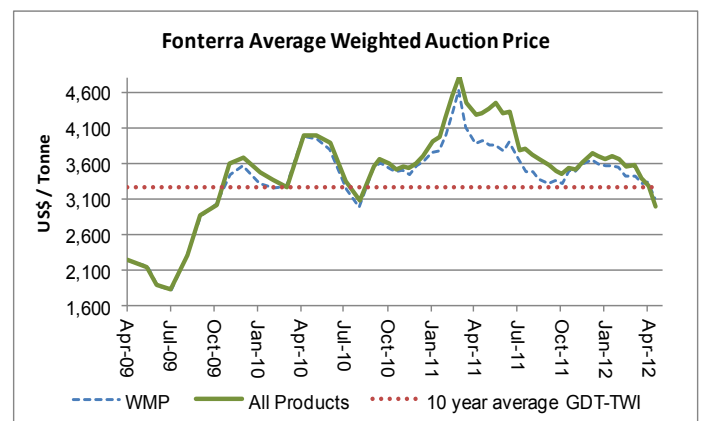
Adjustments in each of these elements will be made as follows: average movement over three months for fuel; average movement in six months for feed and; average movement in 12 months for fertiliser. This means that the next review will be on 1 July 2012.

#### In context

With the current volatility in market prices, the new contract should provide some stability in that it will be linked to costs of production. The SDDG model will also have the benefit of reacting to changes in input costs more frequently through the quarterly reviews. However, this contract will now mean that prices will move based on the cost of producing milk, not by the market value of milk. While there will be periods where the price paid will be above the market price, historical market trends demonstrate that there will also be times where this is not the case.

### Fonterra auction results reflect downturn in global commodity prices

Global commodity prices are continuing on a downward trajectory as supplies outpace demand. At the latest Fonterra auction held on 17 April, the all product global trade index fell by 9.9% to US\$2,983/tonne. This is the biggest decline in percentage terms between auctions since July 2010. The index has now fallen below its 10 year average to its lowest level since September 2009 when the world was recovering from the depths of the global recession.



Source: DairyCo Datum/globaldairytrade

With 20,000 tonnes of whole milk powder (WMP) on offer at the auction, prices fell 11% on average to \$3,098/tonne with nearby contracts showing the most weakness.

Skim milk powder (SMP) prices were down by 7.6% to an average of \$2,871/tonne with Arla Foods SMP



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Page 2 © AHDB 2012

sold at the lower end of this price range which is in line with current European SMP quotations. Analysts believe the latest price corrections are justified based on current international pricing.

### Retail brands under pressure from own label

In the current economic climate consumers are cost conscious and value for money remains a continuing theme. Supermarkets continue to invest heavily into expanding own-label ranges. According to UK food and grocery analysts IGD, price is currently at the forefront of consumer purchase decisions and there is a strong incentive for consumers to choose own label products over brands.

The grocery market as a whole has seen a shift from branded to own label products in the top four multiple retailers: Tesco, Asda, Sainsbury's and Morrisons. This shift has not only seen shoppers' preferences switch to own label but has also seen them move down the tiers of own label from premium to standard and value lines (Kantar Worldpanel, 12 w/e 18/03/12).

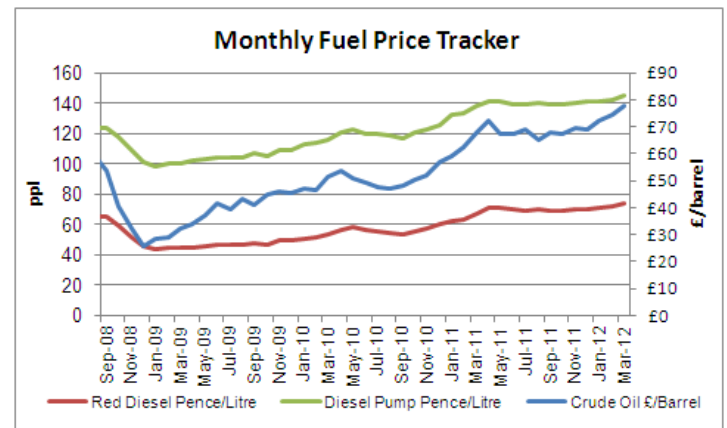
Own label cheese accounts for 57.2% of sales by volume, growing by 2.8% year-on-year whereas branded cheese sales have seen slightly slower growth at 0.7% year-on-year. This trend is also mirrored in the butter category with the volume of own label butter sold increasing by +11.7% (52 w/e 18/03/12) over the previous year while branded butter sales are down by 2.7%.

However, the power of brands shouldn't be underestimated. Branded products continue to attract large scale investment from the companies who own

them. As noted by IGD, 'shoppers continue to recognise the value of brands and some are willing to pay extra for their associated credentials'. Because consumers also look to minimise the risk this can mean that they will still favour known brands over own labels offering a price advantage.

### Fuel price tracker highlights upward price trend

Datum's monthly fuel price tracker indicates diesel and oil prices have hit a record high. Red diesel and crude oil prices in sterling terms have virtually doubled since December 2005. Red diesel has increased by 10% in the past 12 months and by 5% since the beginning of 2012.



Source: DairyCo Datum

These fuel price increases will be factored into feed and forage production costs going forward. Haulage and contracting charges are also likely to see increases.

Feed Prices (Range £/tonne)	Intensive energy rations	High protein concentrates	Exchange Rate €/£ (March average)		UK Average Farmgate Milk Price: February			
March 2012	235-246	330-338	0.8349		2012	28.92	2011	26.08
Wholesale Prices and Market Indicators	IMPE	AMPE	MCVE (Milk for Cheese Value Equivalent)	Cream Income*	Butter (£/t)	SMP (£/t)	Mild Cheddar (£/t)	Bulk Cream (£/t)
March 12	18.0	24.2	31.54	6.27	2,400	1,800	2,925	1,080
February 12	18.0	28.0	32.24	6.82	2,800	2,000	2,925	1,180
March 11	18.7	32.3	32.62	8.52	3,400	2,150	2,950	1,550
Retail Prices	Liquid Milk (retail) (4 w/e 18/03/12)		Doorstep (4 w/e 18/03/12)		Butter (04/04/12) Branded (p/250g)		Mild Cheddar (04/04/12) Non-branded (p/kg)	
March 2012	0.59		1.02		160		572	
% change v March 2011	No change		-1.9%		n/a		n/a	

\*Cream income = The cream income to a liquid processor is based on the value of the excess cream created because the average level of fat on liquid milk sold through the retail market (supermarkets, local stores and doorstep) is less than the level of fat in the raw milk they receive. It assumes all the cream is sold in bulk form.

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