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Dairy Market Update

Cost of production pricing – is it the answer?

Presently, many would probably answer this question with a 'yes'. With input cost inflation continuing, and commodity markets yet to recover to last year's levels, cost of production (COP) pricing models can provide (for those producers on them) a solution to the squeeze on dairy farm profits.

However, there are a couple of points to bear in mind. With the price paid to the farmer linked to production costs and not market returns, a COP based contract will not reflect increasing commodity values such as those seen 18 months ago. At that time, returns from butter and powder markets were higher than in other parts of the dairy market. It is also important to consider that a COP based contract does not in itself promote efficiency. It therefore opens up the possibility of another group of farmers, either in the GB or from overseas, stealing business away by being more efficient and potentially under-cutting in the future.

In context: With discussions taking place regarding milk pricing mechanisms within contracts, processors and farmers will need to decide what system is used. While farmers may prefer the stability that a COP based price offers, this system may not work in every case and the final choice needs to work for all involved.

The system chosen will need to consider the following. Firstly, what is your processor making and who are they selling it to? Secondly will be the attitude towards the risks of price volatility by both the farmer and processor. Those who want less risk would prefer a COP system, although this would need to be supported by the end customer (e.g. retailer) as the price paid would not necessarily reflect market values. If there is a greater acceptance of risk regarding price volatility, price models linked to markets may be preferred. Whatever choices are made, there will always be the need to maintain competitiveness to ensure long-term sustainability of the industry.

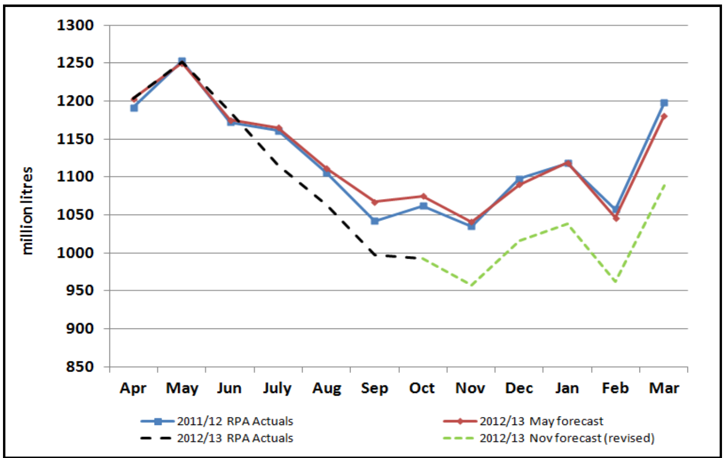
2012/13 production forecast diminished by new lows in daily deliveries

At a meeting organised by DairyCo, regional and national milk production forecasts for the 2012/13 milk year were discussed. Forecasts made earlier in the year indicated potential difficulties for grass-based systems based on issues regarding wet weather and forage quality. With the wet weather and lack of sunshine extending into the autumn, the problems have been compounded and are affecting the whole industry.

Estimated milk production for the 2012/13 milk year has been revised down by 4.8% to a total of 12.9bn litres from the earlier estimate of 13.5bn litres. Independent consultants presented regional views on the outlook for production in the remainder of the 2012/13 milk year. The common theme that emerged was that milk production would remain low as a result of low quality forage, high feed costs (relative to milk price) and increased cull rates.

Year-to-date milk production (Apr-Oct) dropped by an average of 2.2% compared to last year. However, the biggest change in milk yields occurred in September and October when average daily deliveries fell by 4.3% and 6.5% respectively.

The revised annual production estimate is based on the assumption that average daily milk production will average 33.6m litres per day, for the remainder of the milk year a reduction of 7.3% on previous year levels and the lowest daily average recorded for over 15 years. It is however expected that production will exhibit 'normal' seasonal patterns with some recovery in the spring should more seasonal weather patterns prevail.



In context: With milk production unlikely to recover to year earlier levels for the remainder of the 2012/13 year, supplies will remain tight going into the spring flush. With demand from buyers not expected to change, competition for scarce milk supplies should support farmgate prices.

Further forecasts and market information highlighting the important factors affecting your business in the next year will be presented at the upcoming AHDB Outlook conference, which takes place on Wed 13 February 2013 in London. Further details can be found in the Events section of the DairyCo website.

UK wholesale prices continue to rally despite reduced seasonal activity

UK wholesale markets continue to show increasing prices in the run up to Christmas. However, the amount of actual trade has been very small. The main mover during this period has been cream, with November prices up by £130/tonne (9.6%) compared with October, bringing them higher than previous year levels for the first time in 2012. Butter also saw an increase in value although not to the same extent as cream with trade described as slow. EU butter stocks continue to remain tight with the c. 50,000 tonnes in PSA (as of 23 November) expected to go early in the New Year.

Powder market prices also increased slightly although very little trade is taking place. In addition, there is also the possibility of some downward pressure in the market, particularly as European powder prices have recently eased slightly.

Increases in wholesale markets have meant that AMPE and MCVE increased between October and November to 32.00ppl (+3.1%), 32.41ppl (+0.5%) respectively. Cream

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income to a liquid processor rose by 9.9% from October to 8.67ppl, its highest value since October 2011.

In context: While prices increased in November, there was very little activity in the market. In December, wholesale markets often operate in two distinct phases due to the Christmas period, particularly for cream. Up to the week before Christmas, demand will build as manufacturers look to fill orders. Therefore, prices typically rise seasonally. However after this and going into early January, there is likely to be some easing in prices as demand falls away. How much prices fall will be dictated by the degree of this drop in demand relative to supply levels, and milk production is expected to continue to be below previous year volumes as highlighted by the production forecasts.

What Risk Management options are available for dairy farmers?

With growing interest around risk management tools in agriculture, for example futures and options markets, what are the choices available to dairy farmers?

Futures and options markets are commonly referenced types of risk management tools, which were pioneered for use by the dairy industry in the United States. While the availability of tools to manage dairy product price risk is limited in the UK, there are tools available to help manage input costs.

DairyCo estimates that purchased feed, for dairy cows only, makes up between 20% and 30% of total economic costs depending on the type of system. A useful first step in managing input price volatility can be to monitor input costs more closely, using information on how markets have moved since your last purchase as a starting point for discussions with your supplier(s).

DairyCo now publishes weekly commentary on how and why grain and soybean / soyameal prices have changed to complement our existing range of monthly input price data. The UK (LIFFE) feed wheat futures market can provide a useful indication of how UK wheat prices are changing on a daily or even hourly basis. These prices can be followed via one of our sister sector's websites: www.hgca.com/markets.

An overview of the most common tools used to manage input costs, their advantages and drawbacks, and things to consider when building a strategy will be covered in the December issue of the DairyCo Monthly Report. If you do not currently receive the Monthly Report, you can subscribe to it here.

UK farmgate price ranks one of the best in Europe

Recent EU data show that the UK average milk price in September 2012 ranked seventh highest of the 27 European Member States. This was the highest rank the UK has achieved for more than ten years.

Following the slump in global markets during 2012, the UK milk price did not fallen as fast or as low as those in mainland Europe, therefore improving its relative position. In September 2012, the average UK farmgate milk price was just 1.6% below year earlier levels at 27.59ppl. In contrast, the weighted average price for the EU-27 fell faster and to a lower level with the September 2012 price of 26.33ppl, 15.7% below the same month a year earlier.

The UK remains partially insulated from world markets due to the products produced from UK milk. Butter and milk powders account for the majority of global dairy trade, but in the UK just 11% of milk is processed into these products. In Europe as a whole, the proportion processed into butter and milk powders is just over one third (35%) of milk production while in New Zealand it accounts for 65% of total milk produced.

Selected country rankings (average milk prices of 27 Member States)

	Sept-09	Sept-10	Sept-11	Sept-12
Germany	20	11	11	13
Netherlands	7	8	9	11
Ireland	13	9	6	8
United Kingdom	12	19	21	7

Source: EU Commission (in ppl equivalent)

In context: Given the large proportion of UK production which is traded on domestic markets, the influence of movements in world markets is diluted. While this can limit the downside of the market, as is currently being seen, it is also likely that UK milk prices will not reach the highs seen elsewhere in Europe during commodity price booms.

Feed Prices (Range £/tonne)	Intensive energy rations	High protein concentrates	Exchange Rate €/£ (aver. November 2012)		UK Average Farmgate Milk Price: October			
October 2012	278-291	371-380	0.8033		**2012**	29.06	**2011**	29.09
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)
November 12	17.2	32.0	32.41	8.67	2,850	2,400	2,925	1,480
October 12	17.3	31.0	32.26	7.88	2,750	2,350	2,925	1,350
November 11	18.5	31.1	32.68	8.30	3,150	2,150	2,925	1,450
Retail Prices	**Liquid Milk (retail)** (4 w/e 28/10/12)		**Doorstep** (4 w/e 28/10/12)		**Butter (28/11/12)** Branded (p/250g)		**Mild Cheddar (28/11/12)** Non-branded (p/kg)	
October 2012	0.59		1.16		167		562	
% change v October 2011	-2.21%		1.8%		1.6%		-0.7%	

*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.