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Dairy Market Update

Will the growth of discounters keep the lid on retail milk prices?

Discounters are set to show strong growth over the next five years according to recent forecasts by The Institute of Grocery Distribution (IGD). This creates the potential to further erode the market share of the 'Big 5' retailers (Tesco, Asda, Sainsbury's, Morrisons and the Co-operative) and maintain the need for them to offer competitive prices – a sentiment supported by Asda's CEO Andy Clarke in his recent statement that the retailer aims to further reduce the price gap with the discounters.

Household budgets have been stretched over the past five years with the average food bill increasing by 27% (£655) to £3,085/year. Over the same period, average wages have only risen by 7%. As such, decisions on where consumers shop continues to be dominated by price.

Discounters have steadily increased their share of the retail milk market over the past four years at the expense of the 'Big 5' multiples. In order to retain market share, the 'Big 5' have had to offer competitive prices to encourage consumers into their stores. This has led to a steady decline in the average retail milk price and driven some value out of the liquid milk market.

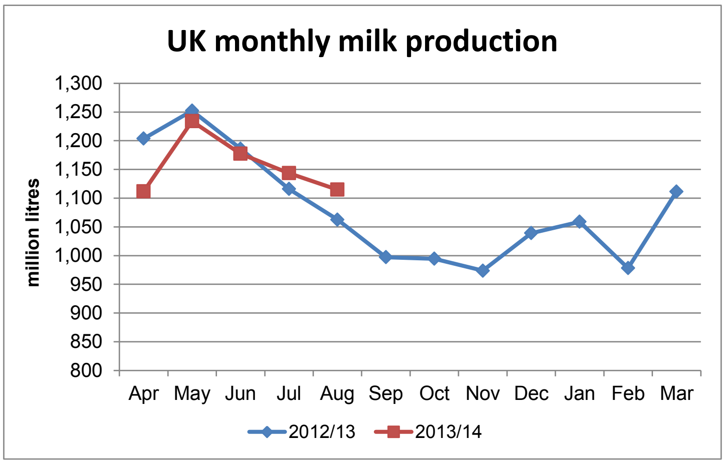
	Change in liquid milk market share (2009-2013)		Average selling price (ppl)*	
	Volume share	Value share	2009	2013
'Big 5' multiples	-0.8%	-1.3%	0.68	0.60
Discounters	4.7%	3.1%	0.57	0.47
Milkman	-2.3%	-1.2%	1.00	1.24
Other retail	-1.6%	-0.6%	0.72	0.70
Total retail	Not applicable		0.70	0.62

*average for 52 weeks ending August *Source: Kantar Worldpanel*

In context: The pressure on liquid processors' margins is likely to remain if retailers look to keep retail milk prices relatively in line with discounters. The high level of competition among liquid milk processors to retain high volume retail contracts, due to increased processing capacity in the sector, will add to this pressure. However, farmgate milk prices are not directly affected by retail price levels but rather by the competition for milk among processors for use in different products. Therefore, liquid processors will still need to pay a competitive price to farmers in order to guarantee sufficient milk supplies to fulfil contracts. The pressure on their margins arising from the retail situation may delay price increases to farmers but it is unlikely to prevent them for long.

Healthy milk production prospects

The recent rise in monthly deliveries combined with indications that production may stay strong in the next month or so, could mean a better-supplied UK milk market this winter than last year.



August milk deliveries were 52m litres (5%) higher than August 2012 following good grazing conditions. This has helped UK production to catch up with last year's levels on a year-to-date basis. Looking forward, the average dry matter figure of 33.2% for first-cut grass silage is 2.4 percentage points higher than last year, which should support higher intakes and milk production during the winter. Also anecdotal evidence suggests that second-cut silage currently looks better than last year. Equally, feed costs are lower than last year – with UK wheat futures currently over £50/t below the same point in 2012 - while the July Defra farmgate milk price was 5ppl higher than July 2012. This could further encourage production from those farms that buy-in a significant amount of feed.

October milk price increases

There have been a number of recent price increase announcements for October. Significant announcements include Müller Wiseman's formula contract, which will see a milk price of 34.55ppl from 1 October, as well as the Müller Wiseman Milk Group (MWMG), who will receive a price increase of 1ppl from 21 October, taking its standard milk price to 32.5ppl. On 1 October, farmers aligned to the Sainsbury's Dairy Development Group (SDDG), which reviews prices through a cost of production model, will receive an increase of 1.97ppl, to 34.15ppl.

Are AMPE/MCVE fit for purpose?

The AMPE and MCVE market indicators are increasingly being used in farmgate price formulas and negotiations but recent discussions in the industry have asked if they are accurate enough because product uses and efficiency have

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changed. **[AMPE]** (Actual Milk Price Equivalent) is an indicator of the factory gate value of a litre of milk used for butter and SMP while **[MCVE]** (Milk for Cheese Value Equivalent) assesses returns from mild Cheddar and whey powder/butter. Whilst some aspects of AMPE and MCVE are not under scrutiny, the level of processor costs in the calculation of them has long been a particularly contentious issue.

In order to address this, DairyCo have recently commissioned a review of AMPE and MCVE. The review will seek to establish how UK processor costs and yields have changed and what representative figures for these would be. The conclusions of the review will be reported early next year. We will not change the AMPE and MCVE calculation without consultation with the industry.

The fact that the indicators are being widely used shows indicators like this have real value. Although they are not intended to be correct for every plant – there are instead designed to be typical of the industry – it is important that they are updated from time to time as technology and costs develop.

New review for Scottish dairy sector

The Scottish Government has launched its strategic review of the Scottish dairy industry, which establishes recommendations for achieving sustainable economic growth for the sector.

The Scottish Dairy Review: 'Ambition 2025' was commissioned by Rural Affairs Secretary Richard Lochhead. Led by the chief executive of Scotland Food & Drink, the review lays out a series of 19 recommendations for the Scottish dairy sector. It encompasses all parts of the supply chain, with the ambition of increasing Scotland's milk production by 50% by 2025, to 1.6billion litres.

It explores the potential for production and processing in Scotland, as well as which markets to target both within the UK and overseas. Ambition 2025 is launched at a time when a number of EU states are also reviewing post-quota milk production.

Global dairy top-20 emphasises importance of Chinese markets

The latest Rabobank annual survey of the world's top dairy companies for 2012 shows the progression of those who have invested or are based in China. Despite there being no Chinese companies featuring in the top-20 until 2008, there are now two Chinese companies in the top-15 and Rabobank is now forecasting for at least one of them to enter the top-10 by 2014. Equally, Nestlé, the top company for dairy sales, has significant involvement in Chinese markets.

This reflects the growing importance of Chinese markets to the global dairy industry. In contrast, the rankings of US companies have declined since 2012. With many growth opportunities for dairy outside of the US, reliance on their domestic market and lack of consolidation could see US firms pushed further down the list.

Considering processors operating in the UK, Müller slipped two places this year to 20th, while Arla Foods gained one place within the top-10. The full Rabobank global dairy top-20 can be found on the DairyCo website here.

Feed prices (range £/tonne)	**Intensive energy rations**	**High protein concentrates**	**Exchange rate £/€** (av. 5-19 Sept 13)		**UK average farmgate milk price: July** (ppl)			
Aug 13	279-294	373-380	0.8410		**2013**	31.37	**2012**	26.32
Wholesale prices and market indicators	**AMPE** (ppl)	**IMPE** (ppl)	**MCVE** (ppl) (Milk for Cheese Value Equivalent)	**Cream income*** (ppl)	**Butter** (£/t)	**SMP** (£/t)	**Mild Cheddar** (£/t)	**Bulk cream** (£/t)
Aug 13	39.5	18.6	38.6	9.83	3,650	2,800	3,400	1,720
Jul 13	39.3	18.6	37.5	9.70	3,600	2,800	3,325	1,690
Aug 12	25.9	16.8	31.5	6.42	2,350	2,000	2,900	1,100
Retail prices	**Liquid Milk (4 w/e 18/08/13)** (£/litre retail)		**Doorstep (4 w/e 18/08/13)** (£/litre)		**Butter (11/09/13)** Branded (p/250g)		**Mild Cheddar (11/09/13)** Non-branded (p/kg)	
Latest month	0.60		1.32		170		566	
% change v 2012	2.8%		13.8%		3.3%		-0.2%	

*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.