

**Circulation**

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**The Great Milk Robbery****Background**

The NFU has undertaken work to assess farmgate milk price moves in relation to the price of key dairy commodities and other price drivers over the period May 2009 to May 2010.

The rationale for the research was borne out of increasing member frustration at the lack of any significant upward price movement in the dairy sector, despite the positive market conditions, which have led to a strengthening in the price of all dairy commodities over a sustained period. In addition, there is a growing, and legitimate, expectation among dairy farmers that milk prices will increase substantially later this year as the differential between farmgate milk price and the revenue generated by the strong dairy market widens further.

The work identified the main factors that impact on farmgate milk prices and analysed the relative performance of these factors over the specified period. Where farmgate prices have not been found to reflect market conditions sufficiently then reasons and suggestions are offered that might explain any disparity between farmers' price expectations and price realisations.

Our assessment looks at commodity market signals primarily. While the NFU maintains that liquid milk is not a commodity product, here, we have applied the same logic and rationale offered to farmers by milk buyers when farmgate prices drop to the situation we have now. In doing so, the figures suggest that commodity markets should be driving milk prices substantially upwards now.

Establishing the actual average returns from the market place to individual milk processors and manufacturers is exceedingly difficult as many factors vary, such as the product mix, the precise returns for some product areas, the individual costs of the dairy and many other variables. Given this, our analysis will necessarily rely on some broader assessments and generalisations which, it is hoped, can be taken as giving a good indication of how well the relationship between market prices and milk prices has operated over the stated period.

**Summary**

- It is clear that substantial **rises in the wholesale prices** of major dairy commodities in the UK **should have generated substantial increases in returns** for GB milk manufacturers.
- For much of **2009 and 2010 monthly processing revenue has been largely greater than January 2009** levels (when prices to dairy producers began to fall).
- A straight year on year comparison shows that the **total value of UK dairy commodities** today is **£0.5 billion greater** than at the same time last year. The equivalent figure for **Great Britain** is **£263 million, equivalent to 5.8ppl**.

- The NFU estimates that **revenues generated from cream were £34m higher in 2009** compared to 2008 and so far **in 2010 a further £36m** has been received from cream sales compared to the same period in 2009.
- **Cheese prices have only recently started to rise**, but have **increased by £13 million** in the last three months. £8 million of this was in May alone.
- Combining monthly wholesale prices with monthly utilisation volumes suggests that **actual revenue to processors in May 2010 was £19m higher than in May 2009**, equivalent to an **increase of 4.3 pence per litre (ppl)** on last year.
- For as long as the markets remain at their current level then the increase in revenue of £19m seen in May 2010 will return an **extra 4.3ppl to processors on every litre sold**. This equates to **£57 million every quarter**, or an extra **£223m over the next 12 months**.

### Wholesale and Farmgate Milk Prices

Although the British dairy market is heavily geared towards processing fresh liquid milk, dairy manufacturing utilises a large proportion of milk and adds significant value to its products.

Approximately 51% of UK milk delivered is utilised for liquid sales with the remainder utilised for processing. This large liquid market is also the source of a major volume of cream, produced as a by-product of processing whole, skim and semi-skimmed liquid milk. It is estimated by DairyCo that, in the pasteurised milk sector 63% of sales were of semi-skimmed milk, 24% were of whole milk and 13% were of skim. This suggests that the average fat content of UK liquid milk sales was around 1.9%. This compares with the national average fat content of UK milk of 4%. Therefore, just over half of all the fat from milk used in the liquid milk market is available for use in the cream market.

Cheese accounts for 27% of utilised milk and the remainder is used for yogurt, milk powder, condensed milk, butter and other products.

According to DairyCo and Defra statistics, as shown in Table 1 below, the wholesale prices of dairy commodities rose substantially between May 2009 and May 2010, with the price of bulk butter 68% higher than it was last year, cream up 67% and milk powder up 42%.

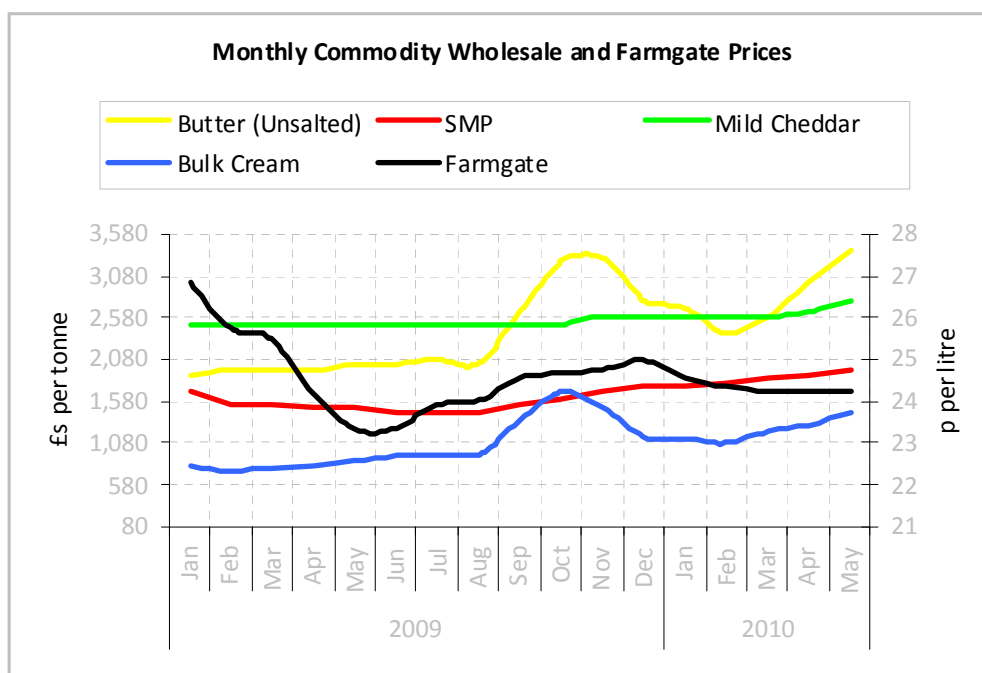
Table 1

Commodity	Wholesale price			UK production	Revenue change
	Dairy Co			Defra	Calculated
	May-09	May-10	Change	000s tonnes	£ millions
Bulk Butter	2025	3400	68%	119	164
Bulk Cream	870	1450	67%	252	146
Milk Powder	1550	2200	42%	202	131
Cheese <sup>1</sup>	2725	2875	6%	365	55
of which: <i>Mild</i>	2500	2800	12%	182.5	55
<i>Mature</i>	2950	2950	0%	182.5	0
Total				938	496

<sup>1</sup> Assumed 50% of UK production Mild and 50% Mature

Over the past year the commodity markets have been very volatile (figure 1), but have risen again this spring. It is clear that substantial rises in the wholesale prices of major dairy commodities in the UK should have generated substantial increases in returns for GB milk manufacturers.

Figure 1



In order to compare the changes in market returns with changes (if any) in milk prices, national average milk prices (as shown above) are too imprecise to have much meaning. Additionally, national figures lag behind by several months. A more relevant comparison can be made by selecting a small sample of large milk processors and comparing their current milk prices for May 2010 with those paid in May 2009. The sample provided in Table 2 below uses buyers with a liquid milk processing operation, those with cheese as the core of the business and those with a wider product mix.

Table 2 (Source: MilkPrices.com)

Pence per Litre	Main Processing	May 2009	May 2010	Change	Comments
<b>Wiseman (England)</b>	Liquid	24.02	24.32	+ 0.3	Increase August 09
<b>Milk Link (Manufacturing)</b>	Cheese	23.75	23.75	Nil	August 09 down 0.5 May 10 up 0.5
<b>Meadow Foods</b>	Mixed	23.72	23.02	- 0.7	Oct 09 down 0.7
<b>Dairy Crest</b>	Liquid	23.84	23.84	Nil	Cream Bonuses 0.2 in Nov 09 0.5 in Dec 09 Stopped Jan 10
<b>Dairy Crest (Davidstow)</b>	Cheese	24.79	24.29	- 0.5	Decrease 0.9 from Jul 09
<b>First Milk (Manufacturing)</b>	Cheese	23.10	21.62	- 1.48	Increase 0.5 from Jun 10

The results of this analysis of milk prices from a sample of milk buyers, which is believed to be representative, suggests that milk prices have remained largely unchanged since May 2009 and have not been increased as a result of recent improvements in commodity product prices, including bulk cream. The sole exception to date is the increase of 0.5p per litre by Milk Link from May 2010 which reversed an identical decrease in August 2009. A change of 0.5p per litre is equivalent to about £50 on a tonne of cheese.

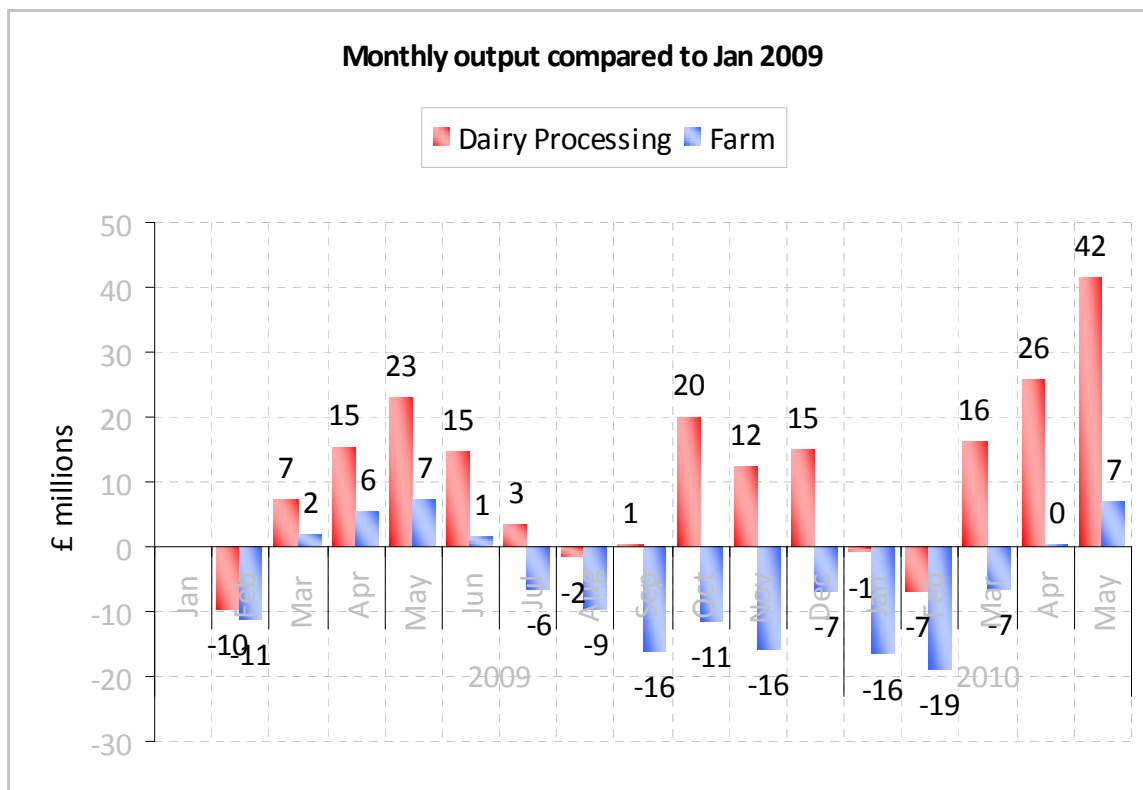
Given this, there is a strong and justifiable case for suggesting, so far, that milk producers have not yet benefited from the improvements in commodity market prices over the past three months.

**Increased Revenue to Milk Buyers**

Using rudimentary calculations, comparing the static price situations in May 2009 and May 2010, then applying UK production to the different prices, indicates a significant increase in value of commodities and revenue to dairy processors. Using this calculation, if all the UK dairy processors sold their output at May 2010 levels they would have made £496 million more than if they had done so in May 2009, a difference of 28%. The equivalent figure for Great Britain is £263 million.

Clearly, rudimentary calculations of this kind only provide an indication of potential gains. By combining monthly wholesale prices with monthly utilisation volumes and historical conversion factors, a more realistic demonstration of actual revenue generated by processors can be obtained (Figure 2).

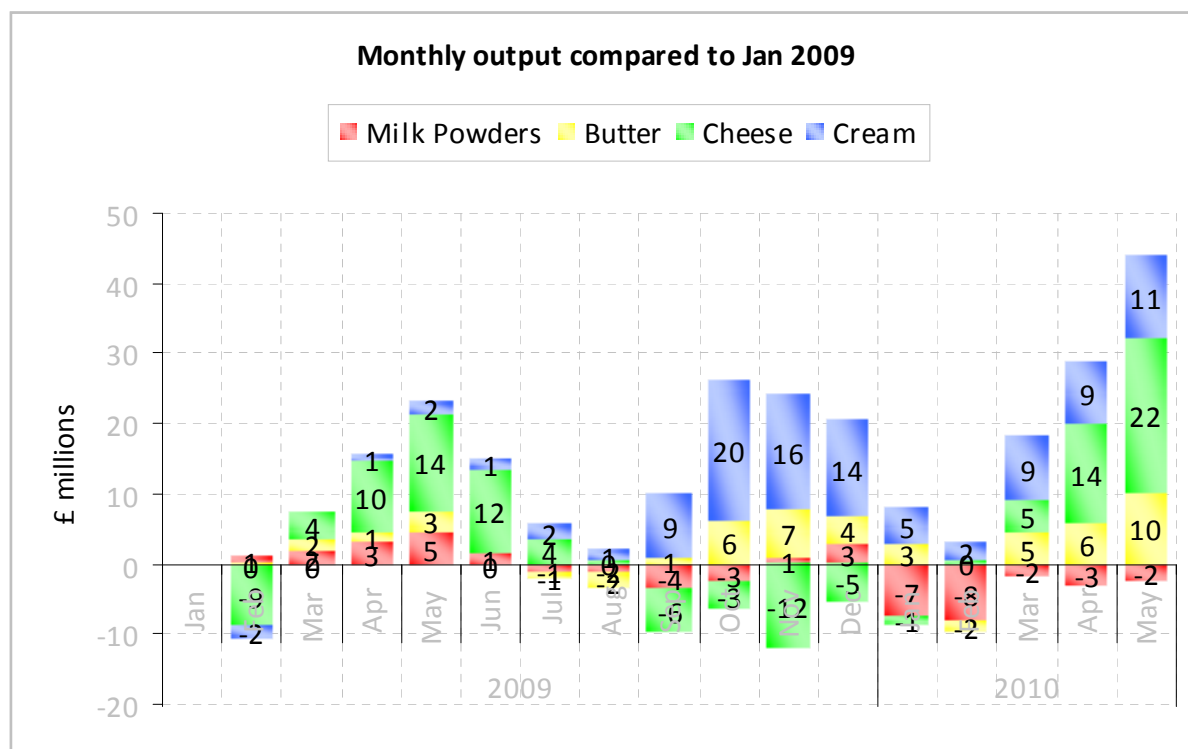
Figure 2



The data shows that for much of 2009 and 2010 monthly processing revenue has been largely greater than January 2009 levels (when prices to dairy producers began to fall). Most starkly, in May 2010 revenue to processors was £19m higher than in May 2009. The extra £19m of revenue generated in May equates to 4.3p per litre.

Looking at the difference in revenue, split by commodity (Figure 3), it is no surprise that cream, and more recently mild cheddar have driven the largest increases in revenue.

Figure 3



Cream

The graph shows that liquid milk and other cream manufacturers saw a big increase in revenue driven by soaring commodity prices in Q4 2009 (Oct – Dec). The NFU estimates that cream producers collectively received an extra £34m over 2009 compared to 2008. So far in 2010 a further £36m has been received compared to the same period in 2009.

According to Dairy Co, estimated cream income to a liquid processor increased by 11.6% (0.84ppl) to 8.11ppl between April 2010 and May 2010. This was 3.12ppl (62.5%) more than the value in May 2009, when it stood at 4.99ppl.

Mild Cheddar

Cheese prices, by comparison have only recently started to rise, but have done so significantly. The volume of milk going into cheese makes any movement in this market significant in driving up raw milk prices more generally. The seasonal nature of milk utilisation in cheese makes 2009 revenue equivalent to 2008 levels. However, 2010 is proving significantly better with a total increase of £13 million between March and May. Revenue in March 2010 was £1m higher than March 2009, April 2010 was £4m higher than April 2009 and May 2010 was £8m higher than May 2009.

Total revenue

For as long as the markets remain at their current level then the increase in revenue of £19m seen in May 2010 will return an extra 4.3ppl to processors on every litre sold. This equates to £57 million every quarter, or an extra £223m over the next 12 months.

By comparison, the year on year revenue figures for farmers have only just started to recover after prices started to fall in November 2008. To date no milk buyer has announced any increase of a scale that stands up against our analysis of what farmers should legitimately expect.

### Why are prices to farmers not going up?

The NFU offers several reasons to explain why milk prices may not yet have increased in line with farmers' expectations:

#### 1. Time lags

The market price assessments in this report are based on wholesale commodity and spot market realisations. The NFU accepts that a major part of the sales of some of the processors will be on a forward basis and spot prices do not always represent actual returns at the time on all their physical transactions.

Many products are also sold as branded retail items, and returns from branded products can experience a time lag before they reflect commodity market prices. However, farmers might question what the point of some so called 'branded products' is if they return little, or nothing extra over a commodity product.

In short, there will always be peaks and troughs in the market over the course of that year, and we recognise that there is a lag between wholesale prices rising and farmgate prices rising. BUT farmers are losing out because the speed of the drop is always greater than the speed of the increase.

#### 2. Processor Costs

Buyers also have to take into account their own costs. In recent months it is believed that costs of many items have been rising such as fuel, packaging and milk containers.

#### 3. Competition – for milk and between buyers

Competition for milk supplies in some areas is a major factor on price changes. Processors are normally anxious to maintain their volume of milk purchases. If rising commodity prices lead to rising milk prices for manufacturing use, then liquid market buyers may be forced to pay more in order to maintain their priority. Those buyers operating in commodity markets should be moving higher and faster.

There are concerning reports that some processors may not be pushing hard enough for increases in the middle ground. It is understandable that milk buyers might not be as willing, or as able to force immediate increases with their long term, and more valued customers (although even that has its limits), but middle ground customers who often receive dairy products at a cheaper price should be the first to be asked to pay up when markets strengthen.

#### 4. Sustainability of price increases

Some buyers may be reluctant to raise milk prices if they believe that currently higher commodity market returns are likely to be of short duration. In other words, they do not want to be in a position to reduce milk prices shortly after having raised them. While this is a very noble attempt to help

farmers manage volatility, if buyers are serious about managing volatility then fairer milk contracts which offer greater transparency on price determination and balanced rights and obligations on variation are the means to achieve this.

5. Loyalty – to farmers, shareholders or customers?

Private dairy companies have to consider their owners and shareholders. Unless competitive forces lead buyers to raise milk prices the first priority on a rising market would be to benefit the owners of the business, rather than to milk producers. However, co-ops don't have shareholders and their job is to get the best return possible for their members, which leads us to question why the co-ops, who also operate in commodity markets, are not the first to move on price?

6. The bottom line

Milk buyers will only pay the milk price they deem necessary to obtain the milk supplies they require. The consequences of this have to be judged both in the short term and over the longer term.

## Conclusions

1. Immediate and substantial increases in farmgate milk prices are needed to reflect the sustained strength of commodities and additional revenue to processors.
2. A fairer approach to milk contracts is needed that allows producers to share in the spoils - nobody wants to be having the same debate in 6 months or one year's time – and serious attention must be given to the way we price milk long term. The outcome of the European Commission's High Level Expert Group on Milk may well expedite this, as it will hopefully lead to legislation, or at the very least, will introduce a Code of Practice on contractual relations, which will most certainly include price determination and price variation.
3. For as long as the markets remain at their current level then the increase in revenue of £19m seen in May 2010 will return an extra 4.3ppl to processors on every litre sold. This equates to £57 million every quarter, or an extra £223m over the next 12 months.