

### Latest market information

Milk production in both the United States and New Zealand continues to outperform previous year levels, adding to the global oversupply situation. US milk production showed a 2.5% increase in August compared to volumes produced last year, as weather conditions are more favourable in most of the country. Continued drought in California has limited some of the production growth. In NZ, milk production in July was up 5.4% on last year.

	Latest data	Date	Change	From
<b>US milk production</b>	7.6bn litres	Aug-14	↑ +2.5%	Aug-13
<b>NZ milk production</b>	189m litres	Jul-14	↑ +5.4%	Jul-13
<b>Exchange rate (€/£)</b>	1.267	7 days ending 24/09/14	↑ +1.2%	7 days ending 17/09/14
<b>Big bale hay</b>	£51/tonne	Aug-14	↓ -22.7%	Aug-13

Sources: USDA, DCANZ, OANDA, British Hay & Straw Merchants' Assoc./Defra

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### Why do UK milk prices follow global markets?

It is often asked why prices paid to dairy farmers in UK are affected by global markets when the vast majority of the milk we produce is sold in the domestic market. An examination of the basic factors underlying how farmgate milk prices are set can shed some light on this link.

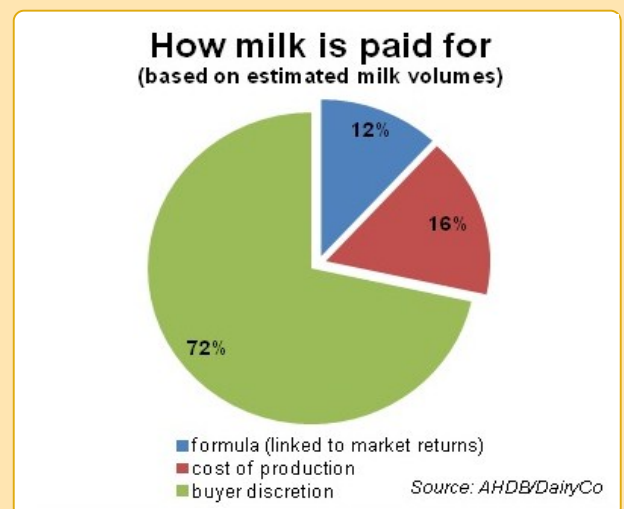
Buyers set milk prices in one of three main ways: 1. on the basis of costs of production, 2. using a formula which incorporates market prices and/or input costs or 3. on a discretionary basis. The most predominant method, as shown in the graph, is buyers' discretion.

As the domestic market buys most of the milk produced in the UK, and prices paid to farmers for this milk are predominately set at the discretion of the buyer, why do changes in global markets affect pricing in the UK?

The answer lies in the simple fact of competition – the same that occurs with prices at petrol stations, where they all need to keep prices in line with competitors or buyers will fill up their tanks elsewhere.

In order to secure sales, manufacturers of dairy products

must offer a price to retailers and food manufacturers which is in line with other sellers. With manufactured dairy products such as cheese, butter and powders, competing sellers operate on EU and global markets. It is this relationship which links domestic milk prices to events on global markets. *Continued on next page*



If commodity prices for exports and imports fall on wider markets, the price of our domestically produced commodity (and hence the farmgate price for milk supplied to that commodity) must fall if our processors are to remain competitive and able to sell the product. On the surface, this does not seem to apply to fresh milk which is sold exclusively in the domestic market and does not face competition from imports. However, those milk buyers who operate in this market will still face the competitive pressure to pay a milk price in line with other buyers. If they pay too much higher they would risk being undercut by other suppliers who bought cheaper milk that would otherwise go to the commodity market. The one exception to this is those markets where the end buyer has effectively guaranteed they won't switch to a cheaper

supplier and are paying on a cost of production contract (i.e. aligned retail contracts). As such, changes to farmgate milk prices tend to be instigated by milk buyers exposed to global markets, but are then followed by the remainder of the industry. The result is that milk prices tend to follow each other because all buyers are avoiding either being undercut or over paying.

It is of course more subtle than this article suggests, with time lags, premiums, previously negotiated contracts and other factors also influencing milk prices. Ultimately however, if others abroad will sell dairy products more cheaply, then that puts pressure on the companies active in the GB market to drop prices or have no one willing to buy the product.

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## Latest dairy industry information

### EU Commission closes Private Storage Aid for cheese

As of 23 September, the Private Storage Aid (PSA) scheme for cheese has ended. In response to the Russian sanctions imposed at the start of August, the EU Commission opened PSA to provide storage for displaced butter and SMP, with the [extension of the scheme to cover certain cheeses](#). Despite only coming into effect on 5

September, the Commission's decision to close the scheme for cheese was due to it being 'disproportionally used by producers in cheese from areas traditionally not exporting significant quantities to Russia'. EU dairy exports to Russia in 2013 were worth €2.3 billion, with €1.0bn from cheese. PSA will remain open for butter and SMP.

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### How will EU milk production respond to lower milk prices?

EU milk supply has continued to grow in recent months and in the first six months of the year milk deliveries were 5.1% higher than the same period a year earlier. Growth appears to have been driven by attractive returns to milk production in the early part of the year, but with milk prices under pressure on the back of declining wholesale markets, what are the prospects for milk supplies in the coming months?

The average EU farm gross margin, as reported by the EU Commission, climbed steadily through 2013 and into 2014, in response to rising milk prices. The optimism generated through favourable market conditions in the 2013/14 milk year, as well as the imminent removal of quotas, has led to some herd expansion, which could keep supply strong through the next few months.

Further into this year, the margin boost started to instead come from falling operating costs rather than rising milk price. As feed prices are low, it is anticipated that many countries will keep feed usage at usual levels, despite the

lower milk prices. For farms maintaining a good gross margin in the major producing countries, the only significant thing currently holding them back will be the threat of superlevy.

However for some, lower milk prices could result in a steeper seasonal decline in production. The most up-to-date EU data for production runs to June 2014 and therefore does not encompass the market reaction to the Russian ban. This may lead to lower milk production, particularly in those countries for which Russia was a key export destination.

As we head into the last quarter of 2014, production prospects will be weighed up against the possibility of another mild winter and early start to spring. Even assuming similar conditions, the pace of milk production growth relative to last year is likely to ease through the second half of the year, given stronger year-on-year comparables.

## Fonterra forecasts reduced milk price for 2014/15 season

Following the publication of its annual financial accounts for 2013/14, showing its highest-ever cash payout to farmer shareholders, Fonterra have revised their forecast farmgate milk price 2014/15 to NZ\$5.30 per kilograms of milk solids (kgMS). The record payout this year of NZ\$8.50kgMS comprised of a farmgate milk price of NZ\$8.40kgMS plus a dividend of 10 cents per share.

Fonterra have lower its forecasted milk price due to “an uncertain outlook for the global economic environment” and the impacts of increased price volatility. Milk

production is expected to increase in all of the major producing countries in 2014/15, while global demand growth is currently impacted by high inventory levels in China and the Russian import ban on dairy products. The impact of this imbalance between supply and demand will directly affect returns on Fonterra’s Reference Commodity Products (WMP, SMP and their by-products), which account for approximately 75% of the cooperative’s product sales and are used to calculate the forecasted farmgate milk price.

## Dairy Crest look to cheese and whey for profits

Dairy Crest expects to report that overall profits for the first half of the 2014/15 financial year will be roughly in line with last year’s pre-tax profits of £19.7m. Performance in its cheese division is reported as strong, despite falling consumer expenditure on food. Profits from property sales are expected to support overall profits this year, while its investment project in specialist whey ingredients is reported as being on track to support profits in the year ending 2015/16.

The liquid division is expected to report a loss for the period. While sales of Frijj flavoured milk are growing, the

downward pressure on fresh milk selling prices, combined with reduced returns from commodity markets have contributed to this situation.

As part of its strategy to reduce costs by £20 million per annum, the company has announced the proposed closure of two additional production sites. These include its glass bottling dairy in Hanworth, West London and a specialist cream potting facility in Chard, Somerset.

Dairy Crest will release its full Interim Results on 6 November 2014.

## English dairy herd returns to growth

Latest figures published by Defra show the first year-on-year growth in the English dairy breeding herd for 15 years. The total dairy breeding herd on 1 June 2014 had increased by 2.6% on a year earlier, to 1,143 thousand head. The AHDB/DairyCo Farmer Intentions Survey 2014 identified increased confidence in the future of the industry, with around a quarter of GB dairy farmers planning to take on more cows over the two year period from 2014 to 2016.

Cow numbers had been steadily decreasing over recent years, but these latest figures suggest a further boost to GB milk production, with dairy cattle in England accounting for just under 75% of the total GB population. The number of dairy heifers aged between 1 and 2 years fell slightly between the two years, but a rise in the number of youngstock suggests the potential for further growth in cow numbers longer-term.

Dairy female cattle (thousand head)	2013	2014	% change
<b>Aged 2 years or more</b>			
Breeding herd	1,113	1,143	2.6
Other female cattle	235	238	1.5
<b>Aged between 1 and 2 years</b>	327	325	-0.7
<b>Less than 1 years</b>	336	341	1.4

Source: Defra

## IFCN publishes top 20 milk processor list

The International Farm Comparison Network (IFCN) has published the top 20 global dairies based on milk intake in 2013. Co-operatives Dairy Farmers of America and Fonterra topped the list, collecting 3.7% and 2.9% of global milk production respectively. European processors including Arla Foods follow, with all of them reported to have increased output by more than 40% since 2007. Milk collected by processors in China and India also grew. The

Chinese Government has a target of almost doubling milk production from the current 36 million tonnes to 64 million tonnes by 2020, while India is also looking to grow and improve its dairy sector with its industry-led Dairy Vision 2030 plan. Although processors in these key emerging countries are growing, the IFCN states that global demand for dairy will continue support opportunities for production and processing.

<b>World's leading processors by milk intake 2014</b>			
	Milk intake, in mln tonnes of milk equivalents	Estimated turnover per kg milk, in USD	Market share as % of global production
Dairy Farmers of America (USA)	27.8	0.5	3.7
Fonterra (NZ, others)	22.0	0.7	2.9
Lactalis (incl Parmalat, France, others)	15.0	1.3	2.0
Nestlé (incl Switzerland, others)	14 -15*	1.25*	2.0
Arla Foods (Denmark, Sweden, UK)	12.7	1.1	1.7
FrieslandCampina (Netherlands, others)	10.3	1.1	1.4
Dean Foods (USA)	10.1	0.9	1.4
Danone (France, others)	8 - 9*	1.9*	1.1
California Dairies (USA)	8.1	0.7	1.1
DMK (Germany)	6.8	1.0	0.8
Saputo (Canada, USA, others)	6.0	1.1	0.8
Glanbia (Ireland, USA, others)	5.4*	0.7	0.8
Land O'Lakes (USA)	5.2	0.7*	0.7
Sodiaal (France)	4.8	1.0	0.7
Amul (India)	4.5-5*	0.5	0.6
Yili (China)	4.4	1.6*	0.6
Müller (Germany, UK, others)	4 - 4.5*	1.5	0.6
Mengniu (China)	4.4	1.6*	0.6
Bongrain (France)	4.2	1.4	0.6
Darigold (USA)	3.6	0.6	0.5

Source: IFCN

Notes: Data represents in most cases the year 2013, \* estimated

## Data out next week

- **UK daily milk deliveries**
- **Fertiliser prices**
- **England and Wales dairy producer numbers**
- **UK retail prices**
- **Argentina milk production**

## Upcoming events

- **Leadership and team skills development, 29 September, Darrington, West Yorkshire**
- **DIY AI training, 29 September-1 October, Derbyshire**
- **The Dairy Show , 1 October, Shepton Mallet in Somerset**



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