PRESS INFORMATION from

***The* Dairy Group**

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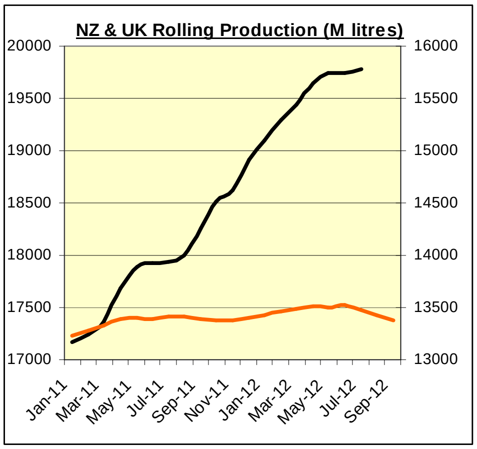
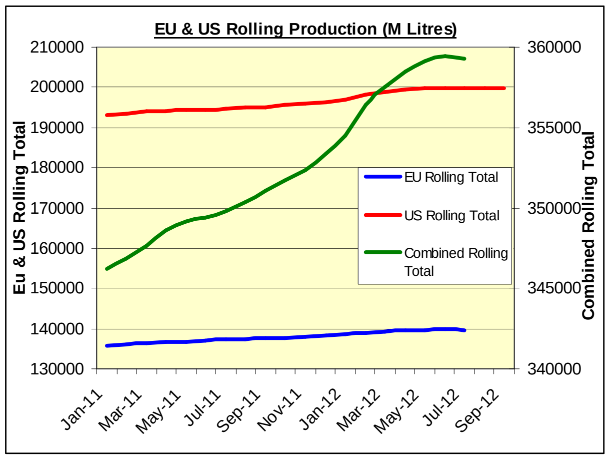
The Market Price Equivalent (MPE) Update October 2012

***By Nick Holt-Martyn,* The Dairy Group**

Milk Shortage: A Local Difficulty!

"Expectations of up to a 20% jump in milk prices next year may be a little optimistic given the actual level of market returns and the level of milk supply globally, despite the increasing cost of milk production" says Nick Holt-Martyn of The Dairy Group. He goes on to say "while the UK supply is on a trend that is likely to show a fall of 500 million litres (-4%) this quota year the EU and US are only just falling behind last year. Meanwhile New Zealand and Australia are powering on.





Source: The Dairy Group

As the graphs shows the scale of US and EU production is such that their combined growth since January 2011 is equivalent to the UK annual production, which illustrates the fine margins that global dairy trade operates on. Or put another way, 1% growth in the EU is equivalent to 7% growth in New Zealand. In a period when all major dairy exporters were expanding by between 2 and 10% it is easy to see why markets tumble as plentiful supply satiates steady demand. If the EU or US decline then the reverse is true. However, due to the diverse nature of EU dairy systems and geography a decline is less likely, as supply difficulties in the UK and Ireland are compensated by expansion in eastern countries like Poland. While relaxing quotas allows some flexibility, regional balancing is limited, so the EU is likely to follow the US with flat or a slight fall in production this winter. Sharp declines like in the UK and Ireland are less likely to be seen elsewhere.

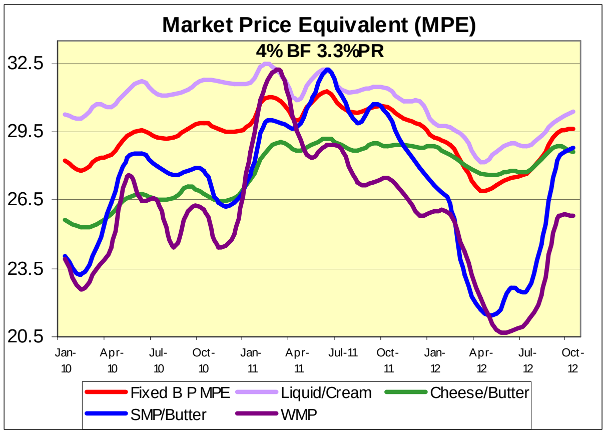
For the UK the prospects of a 6% decline in the winter supply has certainly perked up the spot market to around 40ppl and increased the competition for supply. However, with liquid unlikely to exceed 60% of utilisation and cheese/powder prices failing to provide a high value alternative just yet, there is a limit to the upside as milk switches from the lower value commodities to satisfy the higher value liquid and cream markets.

Worldwide, despite prices rising on the Fonterra global trading platform they are still below the UK/EU/US levels and lower than 2 years ago, so better than they were, but a boom in commodity values has yet to occur. With contract periods stretching 6 months ahead there is no sign of rises in 2013 with values completely flat through to the spring. Both

New Zealand and Australia are having a good milk season with plenty of grass and production matching last year's record levels, so product supply in the southern hemisphere remains good.

A supply deficit in the EU and US this winter brought on by adverse weather and steep rises in production costs will cause northern markets to rise, but limited by the southern hemisphere supply. Markets will rise as EU and US exports contract at the expense of meeting domestic demand, so the battle for higher market returns will be a domestic issue. In the UK this means reduced import competition combined with reduced domestic supply leading to higher UK prices. With the key element of seasonal growth in supply from December, a slow upturn in supply would cause prices to rise, particularly in cheese which is very slow to respond to raw milk supply issues. With cheese strengthening there is every hope that milk price rises can then be sustained across all commodities this winter, which will be needed to help offset production cost increases.

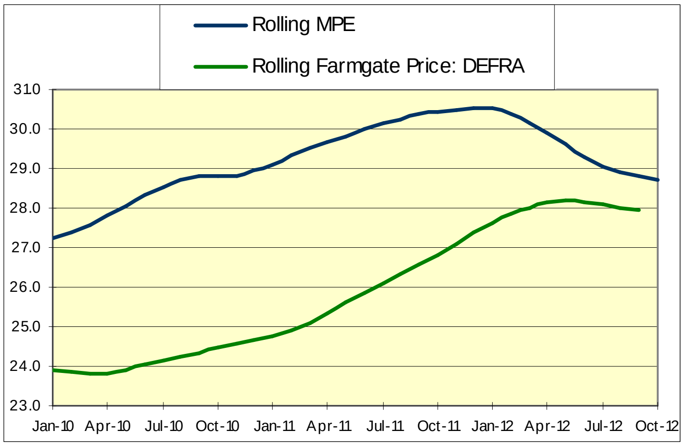
Despite production cost pricing in the aligned liquid sector, rising market returns are needed to replicate these price levels across the whole UK dairy industry. So far only Morrisons has lifted the retail liquid price, with the other retailers remaining at around 52ppl for 4 pints, while Asda and Iceland are still discounting at 44ppl."



Market Prices

The Market Price Equivalent (MPE) edged up again by 0.3 ppl to 29.97 ppl due to the rise in butter, SMP and Cream. The decline in Whey and lack of movement in cheese is confirming the impression of markets stabilising until US and EU production levels are known. The latest Fonterra auction saw a rise of 1.8%, firming values across all contracts. The MPE is now down 1.0 ppl on the year but up 2.9 ppl since June 2012. EU and US supply is set to be weak throughout the winter while New Zealand is matching last year so far. Commodity returns have recovered to those of cheese and liquid sectors, but are not yet forcing those sectors higher in competition for supply. Cream looks set to be firm until Christmas which will pull the market up, but doubts remain for early 2013.

Farm Gate Prices



The graph shows rolling MPE levelling out at 28.5 ppl while milk prices start to drop below 28 ppl. The floor price of 29.5 ppl will arrest the decline in farm gate prices if applied to all liquid milk. It is not certain that commodity markets will increase sufficiently for prices to rise for those not benefiting from the floor price. Weak profitability will affect confidence which will increase pressure on processors and more importantly retailers to permit dairy product inflation on the back of rises in production costs. 2013 will see higher prices or the 6% decline through the winter months may well extend in to the summer as well.

- Ends -

<u>For further information please contact:</u>

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- **Visit www.thedairygroup.co.uk**
- The MPE is calculated from the weighted actual wholesale prices for liquid milk, cheese, butter and powders after the normal processing costs. The MPE accounts for 90% of the UK market utilisation of milk. The MPE is calculated from wholesale market values, whereas IMPE (Intervention Milk Price Equivalent) accounts for just 11% of UK milk production and is effectively determined by the Council of Ministers and the prevailing exchange rate. The MPE provides a far superior indicator of the wholesale value of milk and therefore the likely market returns available to the dairy farmer.