PRESS INFORMATION from

The Dairy Group

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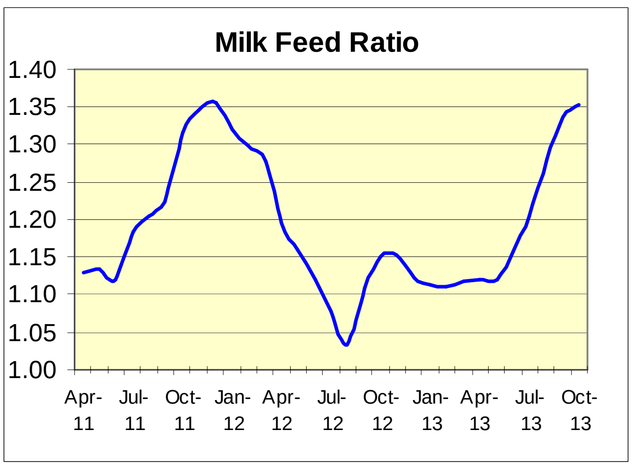
The Market Price Equivalent (MPE) Update December 2013

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

2014 Challenge: Cut The Cost of Production To Less Than 30ppl

"The final year of milk quotas is just ahead and yet they are having a significant effect on global markets" says Nick Holt-Martyn of The Dairy Group. He goes on to say "the recovery in production around the world has meant that over the next 6 months all areas are likely to exceed previous production records, completing the recovery from 2012. This will put global markets into new territory that will be dependent on the sustainability of demand and further supply growth. EU production having been shackled up to March 2014 will be once again released from the 1st April and given favourable climatic conditions in 2014 further growth seems likely given the prevailing economics of milk production.



Source: The Dairy Group and Defra

The graph shows that the combination of rising milk prices and weakening feed costs has lifted the ratio between a litre of milk and a kg of feed to its highest level of the last 2 years at a ratio of 1.35. In the US this is a key indicator of future production levels and the latest feed outlook is for feed prices to soften on a large stock carryover into 2014. With milk prices firm the Milk Feed Ratio can only improve further, although remain below the record of 1.7 achieved 10 years ago.

On the demand side the global recovery in GDP points to sustained increased consumption, although it is only the western world that has been struggling, whilst most of the developing and smaller nations have enjoyed GDP growth, albeit at slower pace than previous levels. Increased demand from China seems likely due to problems in their domestic supply, although investment plans for new large scale dairying have also been reported suggesting this is a passing issue. The latest Fonterra auction shows current prices are being sustained through to June 2014 contracts, suggesting traders at least feel markets will remain stable.

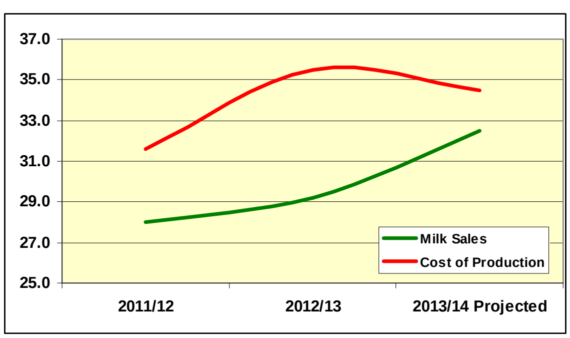
The outlook for 2014 is for the current positive dairy economic picture to be sustained, with milk production profitable for most. This in itself will lead to increased supply in most dairy areas, including the EU, subject to the quota limitation in January to March 2014.

The profitability of milk production will only add impetus to the significant dairy investment taking place in many parts of the EU to take advantage of a post-quota world which will lead to a sustained production increase, so long as the economics are maintained. It is not just Ireland that has ambitions for an increase in milk production, with increases expected in Germany, Netherlands, Denmark, Belgium, Poland and even the UK under current economics. In the year to 2016 the EU alone could increase production by 3 to 5% (4 to 7 billion litres).

It is suggested that New Zealand cannot expand milk production as there is a limit to the land available for its intensive pasture systems. This is of course true but with a milk price sustained above 30 ppl their dairy system is likely to evolve in a similar way to Australia or even Ireland/UK where grazing systems are integrated with forage/concentrates to produce higher yields per cow. New Zealand only dairy the way they do because historic economics have dictated that is the only way to be successful. Higher milk prices and a shortage of land to convert changes the balance towards a more northern hemisphere system. Therefore New Zealand could see production continuing to increase by 0 to 5% (0 to 1 billion litres) annually depending on the seasonal weather. Meanwhile the US is much more stable with steady increases of 0 to 2.5% (0 to 2 billion litres) annually.

Post quotas in 2016 there is the potential for an increase in milk production in the 3 biggest trading blocks of 7 to 10 billion litres, with the market downturn in 2012 caused by a 13 billion litre increase in the preceding 2 years. The likely effect on markets after production increases in 2013 to 2015 is obvious; the current levels of market returns are unlikely to be sustainable after 4 years of rising production. This won't happen overnight and will tend to be progressive. It will begin with weakness in powders in mid to late 2014 before spreading into all sectors in 2015. What happens next will depend on the response of EU farmers without the constraint of milk quota. If production increases slowly and there is adverse weather in either the US or NZ then price adjustments are likely to be modest. Stronger production will mean lower prices.

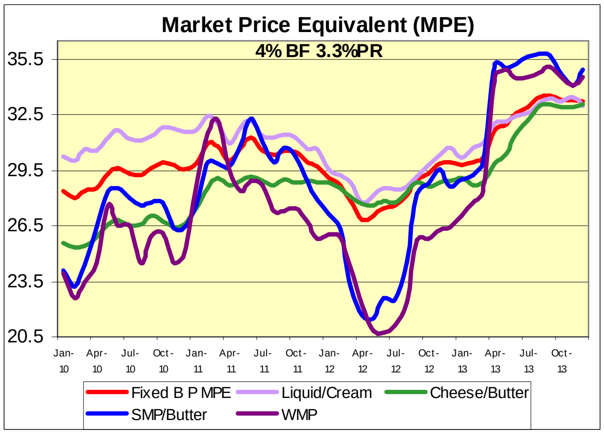
So if you know that your milk price is likely to fall over the next 3 years the logical response is to cut your cost of production to a sustainable level. The graph below shows how production costs have performed in the last 2 years and are likely to ease in the current year, which when set against rising milk sales gives the feeling of better profitability.



Source: The Dairy Group

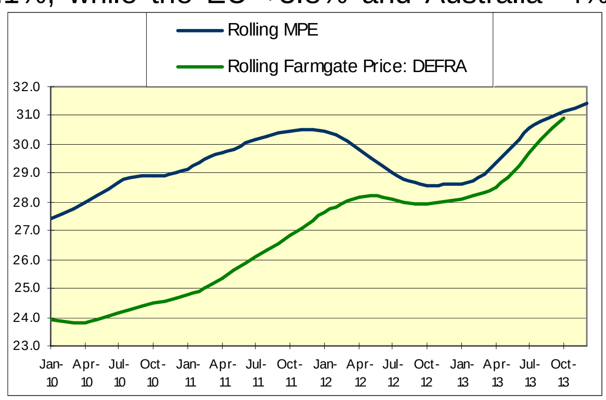
Against this back drop of current profitability, but an expectation of weaker times ahead the key thing is to cut the largest cost contributors which are feed, forage, power and machinery, which account for 58% of production costs. We know silage is twice the cost of grazed grass and concentrates four times, so tilting feed back towards grazing will be key. As the intensive graziers demonstrate, well managed grazing will support up to 20 litres for 8 months of the year. For cows at higher yields grass can make a significant contribution, albeit as part of a balanced ration.

Use the profits of 2014, once the debts of 2012/13 have been met to set up the business to survive once quotas are gone. The Commission's market management will have little effect and there won't be time or profit available once we get to 2015/16 to act later. 2014 is the year for management action, by knowing your production costs and by developing a strategy for reducing production costs to less than 30 ppl.



Market Prices

The Market Price Equivalent (MPE) has softened slightly, at 33.2 ppl with falls in Cream and Butter outweighing a rise in SMP and WMP. The range across the sectors remains narrow, but firm powders should keep some pressure on cheese prices. The latest Fonterra auction was up just +0.2% with SMP showing +1.7% gain, while WMP slipped -1.5%, with the contract prices stable through to June 2014. The MPE has finished the year up 3.22 ppl and up 0.55 ppl since June 2013. New Zealand production is catching up 2012, running +5.4% in October, -1.2% on the year and still forecast at +5%. The US is running at +0.1%, while the EU +3.8% and Australia -4%. Globally production is rising, but markets look set to remain firm while quotas hold the EU back in the final quarter to March 2014.



Farm Gate Prices

The graph shows the rolling MPE continuing to climb on the back of sustained market returns. The farm gate price has been above 30 ppl for the last 12 months and the forecast is for the rolling figure to reach 32 ppl by mid summer. The weather, while very wet, remains relatively normal, although the forecast is to get cooler towards the end of January. The economics suggest with good milk prices, decent supplies of forage and better feed prices, UK milk production should continue to rise. UK production is soaring ahead of 2012 and looks set to exceed the 5 year average for the rest of the quota year. The 2013-14 production forecast is up 4.5% to 13.6 billion litres, up 600 million litres on 2012-13 and just below the 2011-12 total.

- Ends -

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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.