5 REASONS WHY LIQUID MILK FARMERS NEED STRONG WINTER PRICE PREMIUMS IN 2012/13

Introduction

Though this may have changed in recent times, liquid milk has historically been a good source of cash flow for co-ops involved in the market, often compensating for poorer returns from commodities.

Specialist liquid milk producers maintain herds calved in spring and autumn to ensure adequate quantities of high quality milk from freshly calved cows year-round. Their remuneration has, until recently, reflected the contribution of liquid milk to co-ops, and the significantly higher costs incurred.

Most liquid milk pricing arrangements are now pegged to manufacturing milk prices, so that adequate premiums are more crucial than ever in guarantee continued supplies of appropriate quality.

With recent severe manufacturing milk price cuts having impacted liquid milk producers directly, fast rising input prices and weather-related increased usage of bought in feed, farmers will need to secure increased winter premiums relative to 2011/12 to cover their costs and generate a sustainable income.

5 Reasons why liquid milk farmers need strong winter price premiums in 2012/13

1 – In the context of a challenging retail environment, unsustainable prices have become the norm all the way along the chain, after dairies gave away margins from 2009 in an attempt to drive volume. Some of these margins must be recouped to return to a sustainable system and secure quantities and quality of fresh milk.

In the last 18 months, margins at every level of the chain have been squeezed to unprecedented levels.

The main dairies (Glanbia, Connacht Gold, Arrabawn) do not provide detailed financial information to show the evolution of margins/returns from liquid milk sold through the retail trade. However, a number of statements included in their annual reports do prove the point:

From the Glanbia 2009 annual report ***"The recession in Ireland led to a strong consumer focus on price and weaker sterling increased sterling-based competition. Consumer Products (division of Glanbia) responded to this trading environment by reducing wholesale pricing, improving store-by-store sales force coverage, sustainable cost reduction initiatives and improving operational efficiency… This programme is ongoing in 2010"***

From the Glanbia 2011 annual report ***"Higher global dairy markets during the year resulted in increased milk costs for Consumer Products and while some modest price increases were implemented, margins were still lower year-on-year."***

Immediately preceding the introduction of a new, secondary type of liquid milk contract to source increased amounts of private label milk for Tesco, from the Connacht Gold 2009 annual report: ***"The market environment was extremely difficult ... Our brand has withstood the test well, but the Northern processors now have a significant share of our market, making the relevance of some of our structures questionable."***

From the Connacht Gold 2011 annual report: ***"The market backdrop is one of recession and of consumers looking for value… Milk is obviously affected by this and average selling prices are at their lowest for a number of years."***

From the Arrabawn 2009 annual report: ***"We plan to grow and develop this business (fresh milk products) by taking an aggressive approach in the market place during the year…"***

From the Arrabawn 2010 annual report: ***"…there is an intense competition in the marketplace between all suppliers who are fighting for market share. Obviously, this is further eroding margins all round."***

From the Arrabawn 2011 annual report: ***"…in a static market we have succeeded in retaining our volume share and we believe that this business will play an important part in our future growth."***

2 – Input costs have risen significantly since 2009, eating into the margins of every milk producer despite the base price increases of 2010 and 2011. Producers being the last link in the chain, higher primary production costs must be built into the remuneration of producers.

The Teagasc e-Profit Monitor shows that the most efficient winter producers experienced a 5.8% increase in total costs between 2009 and 2011.

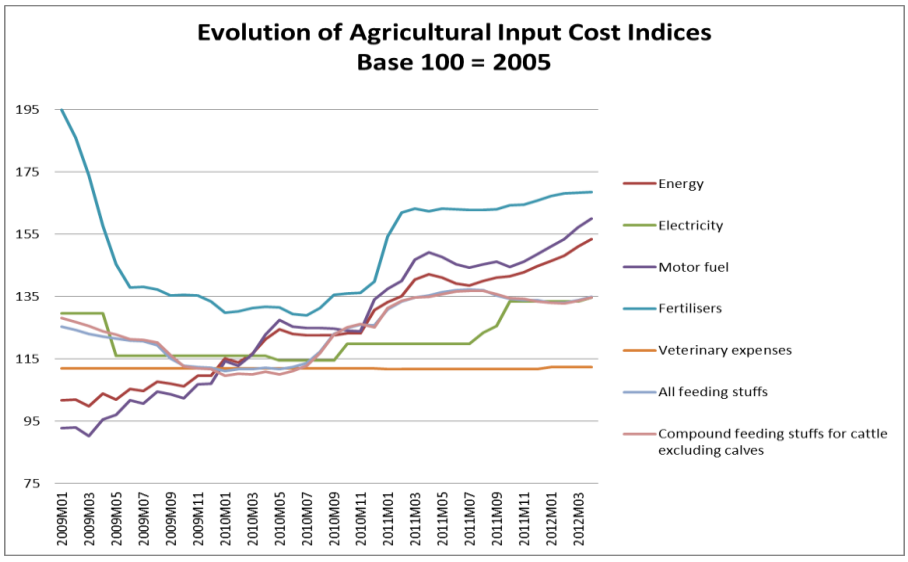
However, what is far more worrying is the current rising trend in most input prices, as revealed in the graphs below, which show high percentage increases for the majority of inputs. Further significant increases in energy, fertiliser and feed costs in particular – which are all higher constituents of liquid milk producer costs compared with other dairy farmers' - are bound to impact severely the profitability of liquid milk producers, whose margins will already be squeezed by lower base milk prices.

Feed costs are a particular concern, as they account for a substantial part of the additional costs inherent in specialist liquid milk production. In the last 12 months, Soya prices have increased by 2/3rd from €300/t to €500/t. Wheat prices have gone up 19% to €260/t, and barley prices up 21% to €245/t. A typical pre-mixed dairy mix or dairy nut, with 16 to 18% protein, used during winter months to feed milking cows cost €249/t in 2010, and rose by 18% to €293/t by the end of 2011 (source: CSO). Anecdotal evidence is that the same dairy mix/nuts this month (July 2012) would cost in excess of €350/t - a further 19.5% increase. Hence, the cost of milking cow feed has increased by 40.6% in the last two years.

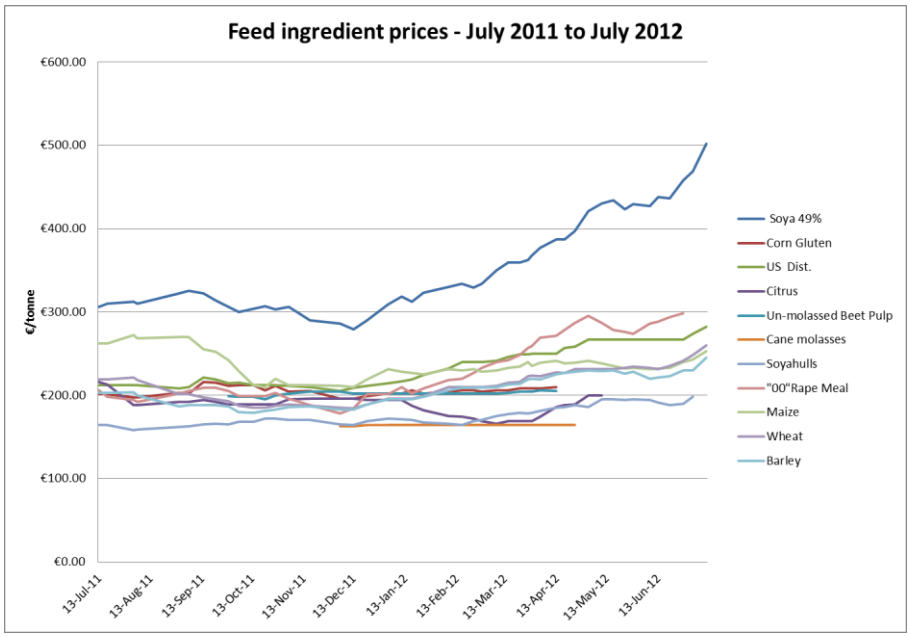
In addition, appalling summer weather has reduced the silage harvest, damaged its feed quality, and will force farmers into purchasing greater quantities of concentrate or straight bought-in feeds for the remainder of the summer and, crucially, for winter. Not only is the unit cost of feed dearer for producers, but the quantities used will also increase substantially, compounding the hit on incomes.

Futures trends for energy and fertiliser prices indicate expected continued price increases, while futures trends for grain – which would underpin feed costs – are up significantly due to the impact of the US heatwave on expected 2012 harvest.

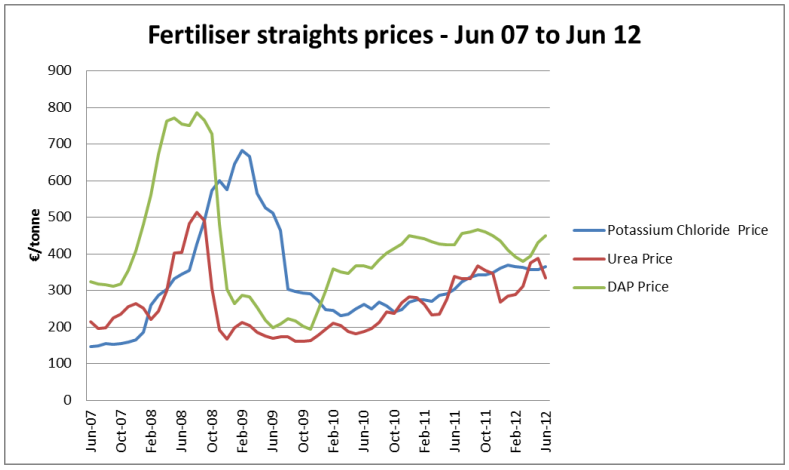
The recently published (24/07/12) revised Teagasc income outlook for 2012 suggests an increase of 10% in direct costs for all dairy farmers, and an increase in feed costs of 25%, due to a combination of higher unit prices and increased usage.



Source: CSO



Source: IFA weekly surveys



Sources: ICIS and World Bank

3 – Specialist liquid milk producers incur structurally higher costs than spring manufacturing producers, especially over the winter months. This too must be acknowledged and built into the remuneration of producers.

The updated costing in Annex I shows that producing liquid milk cost farmers around 6c/l more than the most efficient winter milk producers (as per 2011 Teagasc e-Profit Monitor) , and around 5c/l more than the average spring creamery costs of around 24c/l for 2011 (as per Teagasc Outlook 2012/ NFS 2011).

The cost of producing liquid milk under daily contracts in 2011 was around 29c/l before any provision for the farmer's own labour, not to mention any on-farm investment.

Based on our updated costing model, and using the Teagasc revised cost and income outlook published in July 2012, which suggests a 10% increase in dairy farmers' direct costs and a 25%

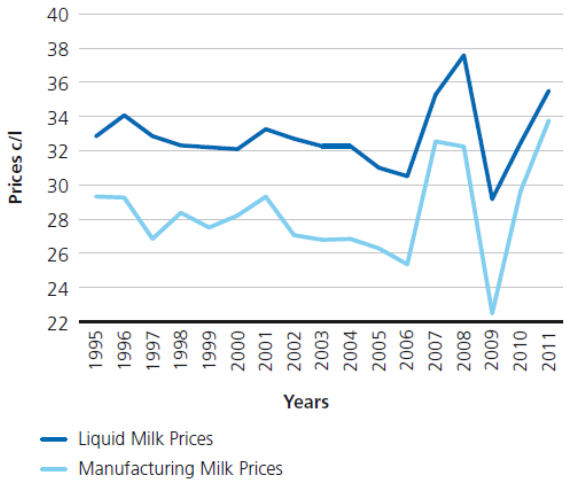
increase in feeding costs alone due to higher unit prices and weather-related increased usage, we expect 2012 liquid milk production costs to rise by around 3.7c/l to 32.37c/l. This is before remuneration of the farmer's own labour – which would require 7c/l to achieve average industrial earnings for an average size producer, or 6c/l as per the Teagasc profit monitor.

Much of this additional cost is incurred in off-peak production, and would historically have been recognised through a premium paid over a number of up to 7 winter months.

However, this premium has been severely eroded in recent years. Annualised average liquid milk prices around 35c/l in 2011 left farmers with 6c/l margins on liquid milk, slightly less than they would need to generate an average industrial wage for themselves after covering costs.

The best evidence of this erosion is the fact that the differential between manufacturing and annualised liquid milk prices has narrowed consistently over the last 7 to 8 years, as documented by the National Milk Agency in the graph below. The differential fell in 2011 to 1.7c/l, a fall of over 1c/l compared to 2010, and the lowest differential on record. Indeed at certain points of the year, manufacturing milk prices have exceeded contracted liquid milk prices.

FIG. 3.11 PRODUCER MILK PRICES – ANNUAL AVERAGES – LIQUID MILK/MANUFACTURING MILK 1995-2011



This year, the bad weather impact will affect liquid milk producers on the double, as they too will have too little poor quality silage saved and will rely on increased quantities of dear bought in feed.

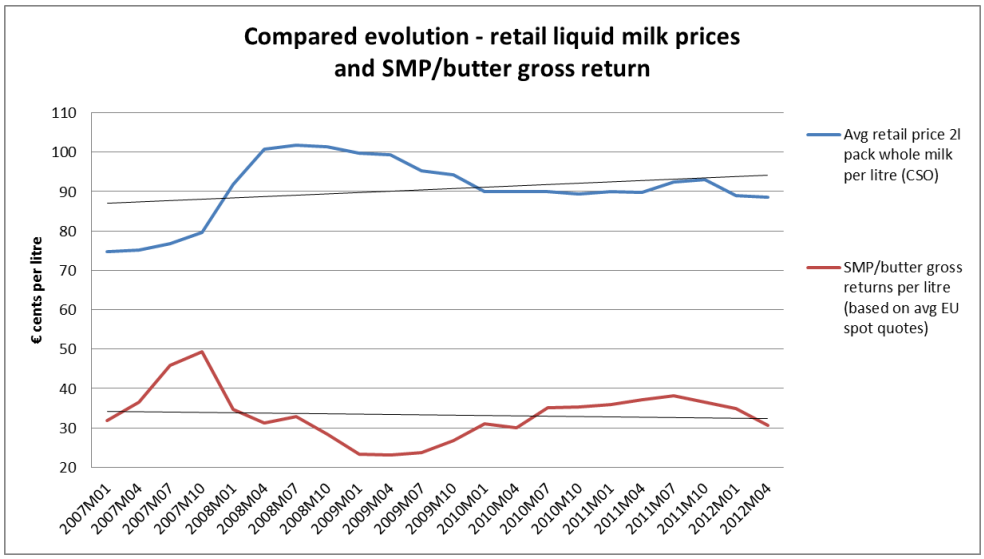
To secure necessary quality fresh milk supplies, 2012/13 liquid milk winter premiums will have to reflect this and increase substantially to make up for the reduced base price.

4 – Market returns from the retail trade, while challenged by narrower margins, remain significantly more stable, and higher, than those from internationally traded commodities. These higher and more stable returns must be used to underpin sustainable premiums for liquid milk producers.

The graph below illustrates this clearly. While the average retail price per litre of a 2 litre pack of whole milk as reported by CSO has varied up or down by around 15.5%, the gross (pre-processing cost) returns from butter and SMP combined, have oscillated by up to 41.5% either side of the average over the last five years.

Furthermore, the average retail return for liquid milk over the same period has trended steadily upwards, even allowing for some retail price adjustments in recent years, and has been about 3 times the average butter/SMP gross return.

Of course, dairies do not receive the retail price, but have to share margins with retailers, and in some instances, distribution agents – and there is evidence that those margins have been significantly eroded at the processors' end (see point 1).

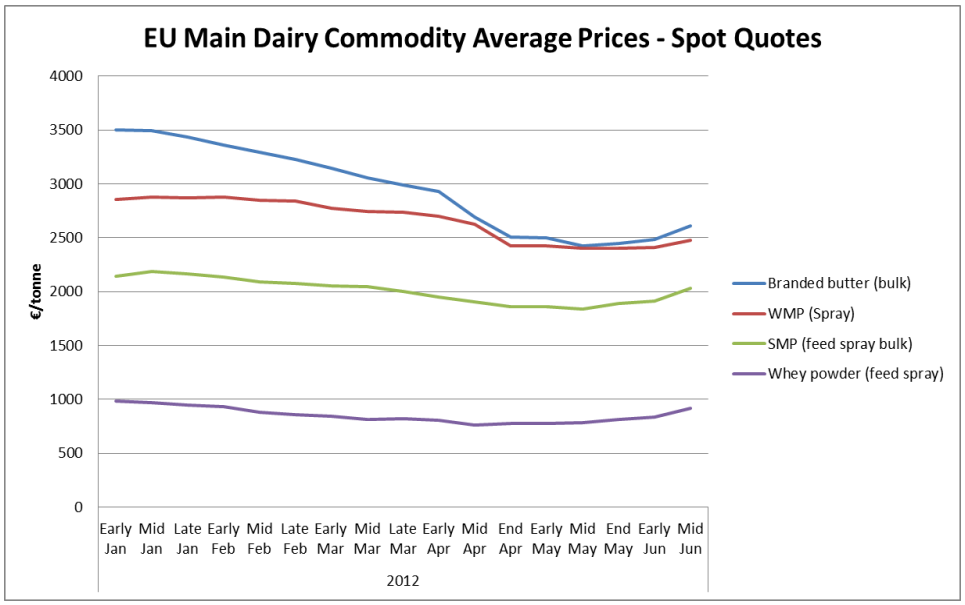


Source: CSO + IFA own work based on EU average spot quotes

5 – International markets, which condition the base price available to all milk producers, including specialist liquid milk producers, have stabilised after major falls, and are now bottoming out. Hence the pressure on the base price will first ease, and then base price increases will automatically translate into rising liquid milk prices.

With all liquid milk producers now receiving a payment for contracted liquid milk pegged to a manufacturing milk price base, the evolution of international markets has become far more relevant, despite the different outlet for the product.

Global dairy markets have weakened considerably in the last 9 months, as growth in supplies outpaced demand growth internationally. However, recent developments have shown a stabilisation in supply growth, and international dairy commodities are showing early signs of recovery, which will in time impact manufacturing milk prices – the base of all liquid milk producers' remuneration - first by marking the end of price cuts, then by providing scope for price increases.



Conclusion

Roughly ten percent of Irish milk production is consumed each year in drinking form by Irish consumers. This milk is on the shelf within 48 hours of production, and despite recent margin pressures still represents a sizeable contribution to the business of the co-ops involved in the market. Allowing the total displacement of this amount of milk by imports would be extremely damaging, not only to the specialist farmers involved, but to the entire Irish dairy sector.

While it is clear that price, cost and weather factors mean that liquid milk producers will need increased winter premiums to cover costs and pay themselves a sustainable income in 2012/13, a specialist payment system with built-in premiums secured from the liquid milk retail market place will need to be sustained for the long term, even allowing for the expected post 2015 milk production expansion.

Most of that expansion will arise from spring-calving milk producers – it is the most cost efficient way of producing milk – and while they may increase shoulder milk production with incentives from seasonality schemes designed to blunt peak production, late lactation milk is not of suitable quality for the drinking market in the winter time in particular.

Sustaining specialist liquid milk production systems will prove an asset to the country, and guarantee Irish consumers constant supplies of high quality, locally produced fresh milk year-round.

To secure milk supplies for the short and long term, dairies must engage, in advance of the 2012/13 winter, in constructive discussions and negotiations with producer groups to deliver sustainable winter premiums covering costs and allowing farmers to generate a viable income.

ANNEX

LIQUID MILK COSTING MODEL

Based on work by Teagasc 's Joe Patton - Selection from the Winter e-profit monitor of 78 farms (54 in 2010) which most closely match the liquid milk production profile

Cents per litre	54 selected farms 2010	Adjusted for representative liquid costings*	78 selected farm 2011	Adjusted for representative liquid costings*	Forecast representative liquid costings 2012	Assumptions on 2012 costs#
VARIABLE COSTS						
Feed	6.06	6.06	6.14	6.14	10.15	+4.01c/l
Fertiliser	1.51	1.51	1.67	1.67	1.72	3%
Vet	1.13	1.13	1.08	1.08	1.09	1%
AI	0.52	0.52	0.56	0.56	0.56	0
Contractor	1.47	1.47	1.61	1.61	1.61	0
Other	1.63	1.63	1.70	1.70	1.70	0
Total variable	12.32	12.32	12.76	12.76	16.83	
FIXED COSTS						
Machinery	1.53	1.90	1.80	2.23	2.46	10%
Car/ESB	0.99	1.23	1.10	1.36	1.50	10%
Depreciation	2.09	2.59	1.98	2.46	2.70	10%
Hired Labour	1.75	2.17	1.77	2.19	2.41	10%
Leases	0.89	1.10	0.82	1.02	1.12	10%
Other	2.41	2.99	2.58	3.20	3.52	10%
Total fixed	9.66	11.98	10.05	12.46	13.71	10%
Total costs	21.98	24.30	22.81	25.22	30.54	
Additional cost diluted by manufacturing milk production**		3.40		3.44	4.31	25%
Minimum liquid milk price needed just to cover costs***		**27.70**		**28.67**	**34.85**	

***** Liquid milk producers have been found by Teagasc to have fixed prices approx 24% higher than creamery winter producers. This is due to higher use of machinery, energy and labour.

****** Cost of liquid milk obligation, to produce a contracted quantity each day, is around 3.44c/l - mostly feed related. Currently diluted by manufacturing milk production.

******* The above minimum liquid milk price needed to cover costs does not include the farmer's own wages. An additional 7c/litre is required to deliver just the average industrial earnings of €35,000 - assuming 500,000 litre production - i.e. a price of nearly 42c/l

as per Teagasc Mid-2012 outlook, published July 2012. This has been revised upwards since, especially on feed.