



Managing risk in a volatile dairy market

Comparing processor milk prices with commodity markets

October 2016

In recent weeks there has been considerable frustration among some dairy farmers at the pace of milk price increases from non-aligned mainstream processor contracts when compared to international markets and spot prices. This frustration is, perhaps, inevitable, but it is easy to have a short memory and forget how mainstream milk prices compared to international markets when prices were falling.

As such, Kite Consulting has undertaken a review of non-aligned processor prices and compared them to Actual Milk Price Equivalent (AMPE) prices. AMPE is the key UK milk price indicator used for following movements in commodity butter and Skimmed Milk Powder (SMP) prices as they relate back to milk price.

Context

It is now widely accepted that volatility is the new norm – something that every dairy producer must adapt to. With volatility comes rapid increases in milk price as well as rapid decreases in milk price. These swings in price will always affect commodity markets more quickly and dramatically than value-added markets. Volatility is hard for everyone involved in the milk supply chain to adapt to and, therefore, many processors aim to mitigate some of the volatility in the markets by spreading sales over a wide range of markets and by forward selling to smooth the peaks and troughs in the market.

Unsurprisingly, human nature is such that when prices are falling few are looking for their own price to fall as quickly as the commodity markets, yet when commodity markets start to pick up, everyone wants to benefit from the upturn immediately.

Analysis

Kite Consulting has undertaken a review of key mainstream non-aligned contracts over the last five years to determine performance compared to commodity market returns (as indicated by AMPE price).

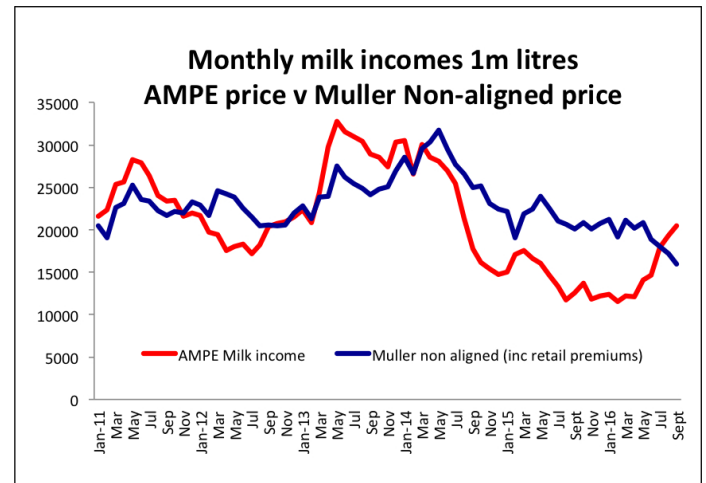
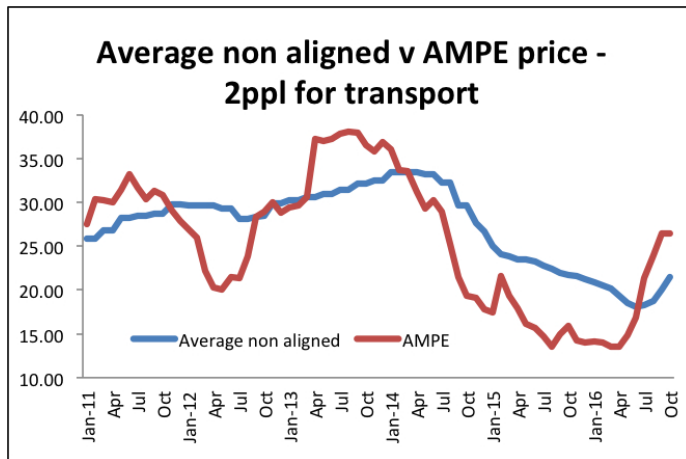
We have compared the following contracts:

- Arla (AML)
- Arla (AMCO)
- Muller non-aligned (including retail premiums)
- Dairy Crest liquid (Direct Milk) (including retail premiums)
- Lactalis (non profile option)

All prices are based on milkprices.com standard litre prices for that period, assuming a 1 million litre per year producer, producing milk on the national profile. Because AMPE price doesn't include an allowance for transport costs, we have assumed a transport cost of 2 pence per litre (typical range 0.9ppl – 4.8ppl).

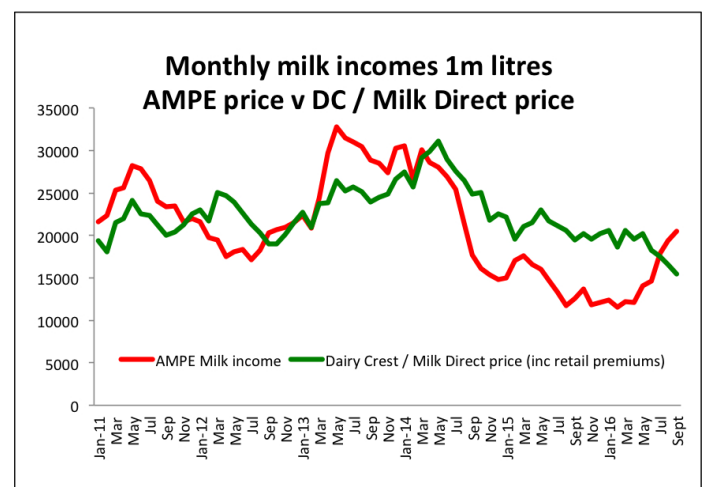
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Average non-aligned price v AMPE



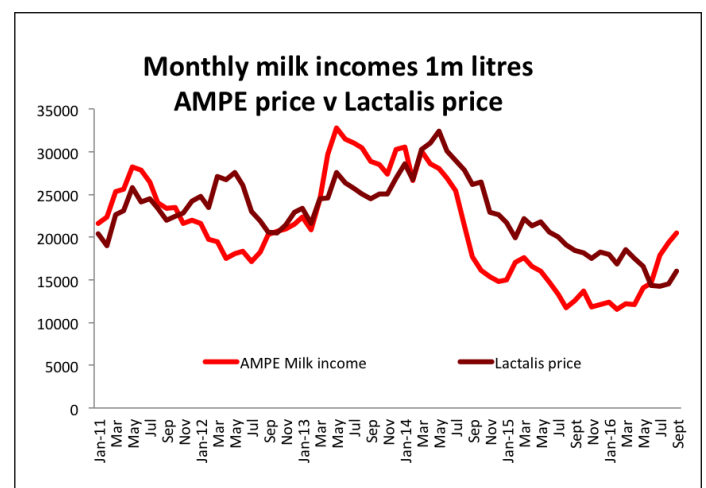
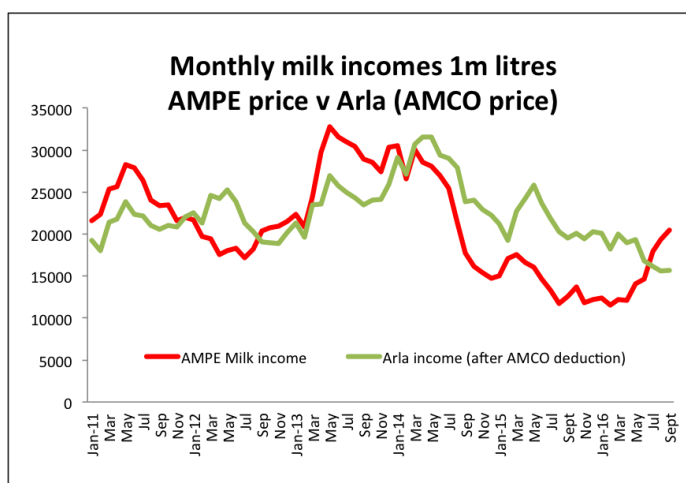
The graph above clearly shows how, on average, mainstream milk contracts have, to some extent at least, smoothed volatility in the last five years, and particularly over the last two years.

If we then compare individual non-aligned milk contracts (as outlined above) against AMPE prices over the same five-year period, we see that all of these mainstream contracts have outperformed AMPE. Whilst there are short periods where AMPE prices are higher, these are outweighed by long periods when AMPE prices are lower. For example, in the last twelve months, mainstream contracts have outperformed AMPE by between 16 and 36 per cent.



Milk income graphs from 2011:

(AMPE -2ppl for transport. Based on 1m litre per year volume, produced on the national profile.)



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Milk income differential v net AMPE scenarios:

Notes:

- AMPE is net price and includes 2ppl for transport compared to listed AMPE;
- Figures assume milk is produced on National profile;
- Accurate to +/- 5% on milk volumes on that profile;
- 2011 to 2014 milk prices recorded every two months; 2015 to 2016 every month;
- AML price 2011 to 2014 uses Milk Link price, including allowance for capital deductions, and including 13th payment for 2014 and 2015 at 0.83p and 0.79ppl respectively;
- AMCo price includes allowance for capital deductions, payment holidays, and negative butterfat adjustments in 2014 and 2015, and including 13th payment for 2014 and 2015 at 0.78p and 0.77p respectively;
- Price takes no account of volume bonuses, seasonality or milk quality;
- Use as a guide only.

Date range Jan 2011 to Sept 2016				
Volume		Difference £	% Diff	Notes
1,000,000 m l				
AMPE Income	1,452,862			
Arla Income (AMCO)	1,551,185	98324	6.77	Inc capital & holidays, butterfat, & 13th payment
Arla AML	1,546,343	93482	6.43	Inc cap deductions and 13th payment
Muller income	1,585,485	132624	9.13	Inc retail premiums
DC / Milk Direct	1,550,186	97324	6.70	Inc retail premiums
Lactalis	1,581,200	128339	8.83	

Date range Jan 2014 to Sept 2016				
Volume		Difference £	% Diff	Notes
1,000,000 m l				
AMPE Income	588,710			
Arla Income (AMCO)	748,796	160085	27.19	Inc capital & holidays, butterfat, & 13th payment
Arla AML	758,282	169572	28.80	Inc cap deductions and 13th payment
Muller income	754,277	165566	28.12	Inc retail premiums
DC / Milk Direct	738,414	149703	25.43	Inc retail premiums
Lactalis	720,129	131418	22.32	

Date range Jan 2015 to Sept 2016				
Volume		Difference £	% Diff	Notes
1,000,000 m l				
AMPE Income	307,134			
Arla Income (AMCO)	419,279	112145	36.51	Inc capital & holidays, butterfat, & 13th payment
Arla AML	428,766	121632	39.60	Inc cap deductions and 13th payment
Muller income	428,053	120919	39.37	Inc retail premiums
DC / Milk Direct	417,618	110484	35.97	Inc retail premiums
Lactalis	385,851	78717	25.63	

Date range last 12 months				
Volume		Difference £	% Diff	Notes
1,000,000 m l				
AMPE Income	172,482			
Arla Income (AMCO)	220,763	48281	27.99	Inc capital & holidays, butterfat, & 13th payment
Arla AML	226,276	53794	31.19	Inc cap deductions and 13th payment
Muller income	234,207	61724	35.79	Inc retail premiums
DC / Milk Direct	227,405	54922	31.84	Inc retail premiums
Lactalis	200,605	28123	16.30	

All comparisons based on production of 1 million litres per year

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Summary

At the current time emotions are running high when it comes to milk price increases, following a period of sustained low prices. Farmers need increases quickly and are understandably frustrated when they see commodity prices running much higher than their own milk price.

Yet, whilst it can be difficult, it is important to maintain perspective. Over the last five years all mainstream non-aligned contracts have significantly out-performed a net AMPE price over time, and this is especially the case over the last two years. Without doubt, there are times when AMPE prices significantly out-perform mainstream contracts for short periods of time. However, anyone thinking about leaving one of the mainstream processors to supply on an AMPE-related contract needs to be able to ride extreme volatility in the market, or have well established risk management strategies in place, probably with professional input.

Of course, past performance is no guide to future performance, yet history shows us that those on mainstream contracts have seen less extreme volatility in prices and, overall, better returns over the last five years.

What must also be remembered is that throughout the last five years the UK was a member of the EU, and therefore able to access the safety net of intervention to mitigate volatility. Moving forward, Brexit will remove our ability to access this safety net, potentially exposing UK markets to more extreme volatility.

It is, therefore, our view that the safest place for most dairy farmers is to enter or stay in supply chains with well-established businesses that offer greater security. In our opinion, businesses that trade internationally offer some risk mitigation, as they have access to different markets and can alleviate currency movements.

Those farmers that enter into AMPE-based contracts should only do so if they have solid risk management strategies in place, including hedging tools and professional advice, to help manage volatility or they must have a mindset and a robust enough business to ride out the excesses of volatility.



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