- Price volatility has increased the potential risks and rewards of dairy farming.
- Farmers should expect milk price volatility to continue as the degree of market intervention by the EC reduces.
- Pressure on farmgate milk price is likely to continue in the short-term as dairy commodity prices look set to remain low against a backdrop of increasing world milk supply.
- There are good prospects for increasing consumption of dairy products in the longer term, as demand from the major dairy importers gradually recovers.
- Farmers should monitor cashflow very carefully during the early summer whilst monthly milk prices are relatively low and credit conditions are tighter.

The UK dairy sector has witnessed a significant level of price volatility within the past two years and this has brought rewards for some dairy farmers, whilst increasing risk for others. Over the next few years, it is predicted that price volatility will be a key feature within the UK dairy sector, as the UK milk supply base continues to wane, and fluctuating currency exchange rates play an important role in determining the volume of international trade in dairy commodities. Market conditions within the UK dairy sector are likely to remain challenging over the short-term, but with positive prospects over the longer term.

**Milk Prices**

During 2008 UK milk prices were on an all-time high, on the back of sustained improvement in price levels for dairy commodity products on the world market. Although dairy input prices were rising sharply during the year, most dairy farms witnessed improved profit margins in 2008 against the previous year.

Since the beginning of 2009 milk prices have fallen back sharply. By March 2009, average producer prices fell back to 24.38ppl from a high of 27.38ppl in October 2008 - down 10.96% in the space of six months. One Scottish milk purchaser has reduced its producer prices by 4.25ppl since the end of December 2008. This equates to a reduction in turnover of £42,500 for a farm producing one million litres of milk annually. Annual average prices for standard contracts in Scotland currently range between 20.50ppl up to about 24.00ppl, depending on milk quality.

When premium price contracts are taken into consideration, the gap between the top and the bottom market prices opens up even wider. Dairy farmers who supply Tesco via the Tesco Sustainable Dairy Group are currently receiving up to 27.43ppl for their milk between April and October 2009. The selection of supply contract is therefore highlighted as one obvious area where some dairy farmers could improve their return from milk sales.

**Price outlook**

With UK milk output peaking in May each year, the effect of seasonality adjustment means that many dairy farmers will currently be receiving their lowest monthly milk price for over a year. Coupled with the effects of the financial crisis in the wider economy and the tighter restrictions...
on the availability of credit, dairy farmers will need to budget very carefully over the next few months in order to avert any shortfall in cashflow. Less than 20% of farmers are estimated to have secured fixed price supply contracts for a standard term (e.g. Tesco contracts). Consequently, only a small minority of UK dairy farmers have any degree of short-term protection from the effects of the downturn in farmgate milk prices.

Recently, dairy commodity prices have managed to stabilise following a period of decline, but stability has been achieved by implementing interventionist policies (intervention buying of butter and SMP) rather than as a result of any significant improvement to commodity price levels on the world market. Looking to the future, as the degree of market intervention reduces (one of the EC commitments to free trade), the expectation is that dairy farmers will experience greater price volatility.

The role of the exchange rate on export trade will also have a key role. At present, there are considerable stocks of dairy commodity product sitting in EU stores, and it will take some time for these stocks to clear, even in a recovering world market. This is likely to mean that downward pressure on dairy commodities may endure a while longer. If the pound continues to make a recovery against both the euro and the US dollar, UK commodity processors could be faced with difficult trading conditions when trying to export product to foreign markets.

Milk Output
The recent drop in milk prices has continued to fuel fears that more dairy farmers will decide to quit milk production. According to Dairy Co, producer numbers in Scotland stood at around 1,351 during June 2008, down 5.8% on the 2007 figure. The latest data available shows that there were 198,000 dairy cows in Scotland in June 2007, compared with 192,000 cows in June 2008. UK dairy cow numbers fell from 1.954m cows to 1.909m cows over the same period.

UK milk quota increased by 2% in 2008 and will increase by 1% annually between 2009 and 2013, as the EC attempts to de-capitalise milk quotas and ensure a “soft landing” when quotas are finally abolished in 2015. UK milk production has been under quota for the last five years.

Outlook for milk output
Although milk output has shown a small year on year increase of 3.2m litres to 1,142.60m litres for April 2009, the continuation of any downward pressure on farmgate milk prices could well start to have a significant impact on producer numbers and milk output. If this is the case, then a further decline in UK milk output can be expected during 2009-10.

On both the continent and the world market, milk production is expected to increase. Production is expected to grow particularly in Italy where quota was increased by 5% in April 2009. Although milk prices are expected to remain under pressure into 2010, DairyCo are forecasting that demand for dairy products will grow, as the world population is expected to increase from 6.5 billion to 8.0 billion by 2028.