PRICE VOLATILITY IS NOTHING NEW!

Promar National Dairy Consultant Derek Gardner considers how dairy farmers should approach management in a volatile world.

Price volatility is nothing new. All traded commodities are subject to the laws of supply and demand. However for many years the UK dairy farmer was insulated to the full extent of price volatility. The pooled milk prices schemes operated by the Milk Marketing Boards allowed a smoothing of price fluctuations. More recently exchange rates have helped to insulate the UK from changes in global commodity prices.

But those days are now gone and we have to live and run businesses in an increasingly global market where price fluctuations can be significant. For example in one day last month soya price swung by $17/t. Wheat price swung by £6/t one day this week, when traders used to get excited with a 50p/t change! The August Fonterra milk powder auction price rose by 25.8%, having fallen 3% in July. These are huge swings in prices and while hopefully herald better profits moving forward, it does demonstrate the conditions that farmers have to be contend with.

It is also interesting to consider the factors that can drive prices. The increased demand for milk in Asia at a time when supply couldn't keep up had created a global shortage leading to higher prices. China had been a big growth market but when melamine illegally got into baby formula milk leading to 300,000 babies being poisoned, the country was turned off milk consumption and the market crashed.

Meanwhile the US, New Zealand and Australia had been expanding to meet this market, so the milk shortage of 2007 became a global surplus in 2008 and world market prices fell quickly.

The global recession has also had an impact. Seven of the top ten countries importing milk products are petro-dollar rich countries who were using higher oil prices to fund imports of milk powders to help feed their poor. When oil prices fell so did their ability to pay as much for milk powder. Recession has also changed consumers buying habits.

When learning to live with volatility, the first thing is probably to forget the notion of 'average'. Now that UK milk contracts are largely driven by their end use for milk the difference in price per litre is marked. Each price will move differently depending on the factors that drive that sector.

UK milk contracts can be split broadly into four categories. At one end we have farmers directly aligned with a retailer such as Waitrose, M&S, Sainsbury and Tesco. Supplying their liquid market direct brings a premium price and some stability. Increasingly these contracts have some acknowledgement of the farmer's costs of production.

In the middle aground are the non-aligned liquid market contracts such as from Wiseman, Arla, Dairy Crest and those supplying the higher value cheese sector such as mature cheddar, stilton and other territorial cheeses. The co-ops are broadly within this sector.

At the bottom end are contracts for milk sold to the commodity product market including milk sold into Westbury.

The current range of milk prices is from 18p up to 28p and this has a huge impact on how businesses are managed. Farmers supplying the dedicated retailers are benefitting from a degree of price stability, and can consider investing for the future growth of their business. They can also look to higher priced diet ingredients to boost production where there is a marginal return. The opportunities to derive significant profits from high milk price: lower production cost systems are considerable.

Farmers at the lower end of the price spectrum don't have that luxury of choice. Some diet ingredients that have a marginal benefit over their cost with milk at 28ppl look rather different at a lower 18ppl, yet all ingredients are generally marketed at the 'average' producer. Farmers in this situation have to adopt lower cost production systems and it a responsibility of all in the industry to understand where farmers are on the price scale and to help them develop appropriate systems.

Wherever farmers are on the price spectrum, it is crucial that they understand where they are and what it means for the business. Then the choice of the appropriate cost system coupled with high levels of management can drive returns.

Figure 1 using data derived from over 1200 Promar recorded herds shows the yield response to concentrate input and shows that at any given level of feed input per cow there is a significant range in milk sales achieved, showing the scope for change that exists. And given that feed is still 35% of the cash cost of dairy farming on average, the impact on returns can be considerable.

Figure 2 shows the relationship between milk and feed prices for Promar Milkminder herds over the last 25 years. At the peak, one litre of milk paid for 1.8kg of feed while currently it will pay for 1.3kg, reflecting changes in types of feed used, increased use of feed supplements, and overall ingredient costs.

With increased price volatility it will be important to understand how costs of production relate to milk price and ensure your system allows you to develop a robust, sustainable system. Farmers who do so will be able to weather the situation when milk prices fall and reap the benefit when prices rise as they inevitably will.