

DairyCo

Dairy
UK

Investment Prospects for British Dairy Farmers

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Contents

Foreword	4
Executive summary	5
Introduction	6
1. Pricing of milk for products made from British milk	7
1.1 Milk pricing in Great Britain	7
1.2 Future pricing of raw milk	8
1.3 Conclusion	8
2. The commodity pricing cycle	9
2.1 Volatility and the liberalisation of the common agricultural policy	9
2.2 The commodity price cycle	9
3. Input and margin	11
3.1 Cow prices	11
3.2 Feed price	12
3.3 Fertiliser price	12
4. Future profitability	13
4.1 Global industry supply	13
4.2 Future prices	13
5. Long term supply/demand balance	14
5.1 Demand growth	14
5.2 Supply growth	15
6. Other factors	16
6.1 Currency	16
6.2 Processing	17
6.3 Local factors	18
6.4 Conclusions	18
Contact information	19

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Foreword

Milk production is falling because dairy farmers lack the confidence to invest in the future. This report is a step towards restoring that confidence. It is a first for the sector, with Dairy UK and DairyCo both bringing their expertise to bear. This spirit of co-operation has produced a document which aims to be realistic about the position in which farmers find themselves and offer a useful analysis of the future.

Producers should be encouraged by this and other studies which show the UK is one of the most competitive and efficient milk producers in the EU. That's why competitive dairy farmers supplying dynamic processors should be confident that average prices will in the medium and long term return profits. In a world where demand for dairy is growing, EU milk supply will remain important, indicating that efficient farms will remain commercially viable.

There is no doubt that these are difficult times for dairy farmers. And though there are challenges ahead on bovine TB, regulation and market volatility, producers should draw confidence from the fact that they are supplying a processing sector that is growing in scale, efficiency and innovation. If we can also build and strengthen more mutually profitable relationships between retailers, processors and farmers, then there is every reason to be positive about the future.

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Executive summary

- Competitive dairy farmers supplying efficient, competitive and dynamic processors who manufacture fresh products and products sold on provenance should be confident about their future. This is because, although prices will fluctuate in the short term, over the medium and long term average prices should return profits to competitive farmers.
- For farmers supplying raw milk for commodity products, the volatility of these markets means that at any given point in time prices do not provide a reliable guide to where average prices will be in the future. In a de-regulated industry milk and commodity prices can be expected to move in a cyclical pattern.
- A more meaningful guide to commercial viability than the milk price is margin, so both prices and input costs need to be looked at to make an assessment of whether or not to invest. In the future, with some time lag, farmgate prices may move more in line with fluctuations in feed costs.
- The importance of EU supply in meeting global demand will probably ensure that in future prices will be at a level that will reward efficient European dairy farmers. Although prices will fluctuate and be volatile in the short term, as British dairy farms are among the most competitive EU farmers, then they should be commercially viable in the future.
- Although we are currently at the bottom of a volatile price cycle at present, this situation should reverse in the next 12 to 18 months.
- Rising population and economic growth will underpin continued growth in world demand whilst supply growth in low cost countries should not undermine the competitiveness of Great Britain.
- Currency trends have favoured Great Britain. Dairy farmers should also have confidence that they will generally be supplying an increasingly efficient, dynamic and competitive processing sector.
- Given the broader long term picture an efficient British dairy farmer can expect to prosper in the future and that is why we would encourage farmers supplying efficient, competitive and dynamic processors who want more milk to consider investing in their dairy units.

Introduction

It is in everybody's interest that the level of milk production in Great Britain is stabilised. Declining production damages the industry's supply base and its processing capacity. At the heart of falling milk production is a lack of confidence by farmers to invest in their businesses because of uncertainty over future prices and profitability, combined with a lack of committed and mutually constructive relationships in some supply chains.

For dairy farmers to make investment decisions they need to understand the market they are in, both for their product and for their inputs, including how much and what type of milk is, and will be, wanted by milk buyers. The problem for the dairy industry is that the commercial environment is now much more volatile. Whilst some agricultural sectors are used to it, the scale of volatility we have seen recently is new to dairy. This makes it harder to separate short term fluctuations from long term trends.

To help farmers make investment decisions this publication puts the British dairy industry in its wider commercial context and sets out its long term prospects.

The factors influencing the formation of prices in the European Union and Great Britain are changing. The industry is moving towards a new framework that is less dependent on the Common Agricultural Policy and more exposed to global influences.

Nevertheless, the economic rules governing the dairy sector are fairly straight forward, based as they are on the interaction of supply and demand. It is possible to have a look at the structure of the market and reach some conclusions on how British dairy farmers are likely to compare against their competitors. If they are supplying efficient and competitive processors it is possible for British dairy farmers to have a successful and bright future.

The conclusion is that the environment for investment in the entire dairy supply chain is generally favourable.

1. Pricing of milk for products made from British milk

The situation facing dairy farmers supplying raw milk for products that have to be made from British milk is different from those supplying raw milk for commodity products. Efficient farmers supplying efficient, dynamic and competitive processors producing fresh products and products sold on provenance should be confident about their future.

1.1 Milk pricing in Great Britain

Historically the trend price for all raw milk has been set by commodity markets. This is because when returns from commodity markets fell, raw milk could be switched into higher value markets. Likewise, when commodity markets rose, other markets had to pay a premium to secure priority of supply.

In the future, within dedicated supply chains and similar arrangements, market forces will ensure that the prices paid for products that have to be made with British milk should be enough on average to cover the costs of production for farmers selling the raw milk used for these products. Prices will have to be high enough to ensure security of supply to meet demand for these products. This means that, although still present, the link to commodity markets will be weakened. However, for their dairy businesses to be sustainable farmers need to be able to more than cover costs of production to be able to invest, therefore there is a continued need to strive to be as efficient as possible.

Products that have to be made from British milk include fresh products and products sold on the basis of being produced exclusively in the Great Britain, eg, provenance.

Fresh milk

Fresh milk has to be made from British raw milk because, within certain limits, it is not economic for fresh milk to be imported into Great Britain, or for fresh milk to be made from imported raw milk. In both cases the year round transportation of milk (whether raw or pasteurised) into Great Britain is not normally cost effective.

The fresh market is likely to remain a large and relatively secure market for some time. Because of the level of heat treatment used UHT milk is never likely to be seen as tasty enough to be a substitute for fresh milk, and there is no sign that the British consumer will switch to any another product to put in their cup of tea or on their cornflakes in the morning.

Provenance

Another example of products that have to be made from British raw milk are those products that are marketed to the consumer because they are made from raw milk from a particular region within Great Britain, eg, Welsh cheese, etc.

Selling products on the basis of provenance is being increasingly exploited by the dairy industry as it responds to growing consumer interest in where food comes from.

It is true that provenance can only command a certain premium as in the end any product has to be competitive with its substitutes. But in so far as GB provenance is valued by the consumer, then this can provide the basis for a premium that can help to safeguard production in Great Britain.

1.2 Future pricing of raw milk

Through the setting up of dedicated supply chains, that ensure priority of supply whilst tailoring milk supplies to the requirements of particular markets, fresh products and products sold on provenance have increasingly different pricing arrangements compared to milk for commodity products.

The declining link to commodity markets

Currently there is still the ability for milk used for commodity markets to be switched into fresh product markets resulting in prices being driven by trends in commodity markets. Even in this situation, the need to obtain security of supply ensures that fresh products will command a premium from retailers and consumers. However, the evolution of the industry's supply arrangements means that it will be increasingly difficult to switch commodity milk into fresh product markets. Fresh product markets require a flat supply profile and increasingly the industry is developing dedicated supply chains in which milk from commodity markets cannot be used. Dedicated supply chains therefore insulate some supply chains from commodity market trends.

While the influence of the commodity markets may be reduced for farmers supplying products that have to be of British origin, it cannot be removed altogether. This is because the production of many dairy products also results in the production of by-products, such as cream from liquid milk, which are either traded as commodities, or the price of which is influenced by commodity markets. While these only constitute a small proportion of the total return per litre, it should be recognised that some volatility will remain.

Development of dedicated supply chains

The 'integrated supply' arrangements put in place by several of the major retailers to secure their supplies of fresh milk is the clearest example of the evolution of dedicated supply chains. The pricing mechanism adopted by some retailers already recognises the need for dairy farmers to cover the average cost of production.

These supply arrangements have some way to go before they ensure that the costs of production are always met for all producers supplying these markets. Within fresh product markets the biggest difficulty are middle ground retailers who do not yet wish to commit themselves to integrated supply chains. Despite this, clear progress is being made in the direction of differentiating milk supply and contractual arrangements first by product type (manufacture versus liquid), then by individual processing plant, and then by individual customer. For products sold on provenance, the extent to which they are linked to a specific set of producers will also ensure that the influences of commodity milk on price setting will be further reduced.

1.3 Conclusion

In the long run, within dedicated supply chains and similar arrangements, market forces should ensure that the prices paid for products that have to be made with British milk should be enough to cover the average costs of production for farmers selling the raw milk used for these products. Prices will have to be high enough to ensure security of supply to meet demand for these products.

Overall therefore, any uncertainty surrounding the future of the dairy industry should not be a major issue for farmers supplying products that have to be of British origin and which are being processed by efficient, dynamic and competitive processors; they should be reasonably confident about their future and consequently they should have the confidence to invest if individual circumstances allow.

The uncertainty over the future is primarily for farmers supplying raw milk for products that have to compete with imports, ie, commodity products.

2. The commodity pricing cycle

For farmers supplying raw milk for commodity products the commercial viability of investments is a more complex issue. Commodity product prices have become more volatile and are likely to remain so. As a result prices at any given point in time do not provide a reliable guide to where average prices will be in the future. In a de-regulated industry milk and commodity prices can be expected to move in a cyclical pattern. Although the industry is currently at the bottom of a volatile price cycle at the present, this should begin to reverse in the next 12 to 18 months.

Understanding the pricing of raw milk for commodity products requires a look at the origins of the increasing price volatility in the commodity sector which is probably here to stay.

2.1 Volatility and the liberalisation of the common agricultural policy

Commodity products are becoming more volatile because the Common Agricultural Policy (CAP) for the dairy sector is gradually being dismantled. The CAP used to stabilise farmgate prices by managing the market place for raw milk and dairy products in the European Union (EU).

This stability was achieved through a variety of mechanisms, the most important of which was quotas. Quotas were introduced to manage the supply of raw milk in the EU. These are supplemented by a number of subsidy schemes, including export refunds, which manage the demand for EU products.

The EU is now committed to getting rid of quotas. This is to be achieved by a phased series of quota increases between now and 2015. Even now the milk production in the majority of EU Member States is no longer constrained by quotas. This means there is now much greater variability in the supply of raw milk in the EU.

The absence of effective quota constraints means that demand management mechanisms, such as export refunds and other consumption subsidy schemes, are less effective at influencing the overall price level in the EU. In the long run the European Commission also wants to get rid of export refunds for a variety of political reasons. The Commission is adamant that their recent re-introduction is only a temporary measure. If a WTO agreement is finalised then the EU will be under a legal obligation to abolish export refunds. Abolition of refunds will create another source of volatility as the EU market will have to have a closer relationship with the world market. The world market is notoriously volatile and the feedback from the world market to the European market will be amplified without export refunds.

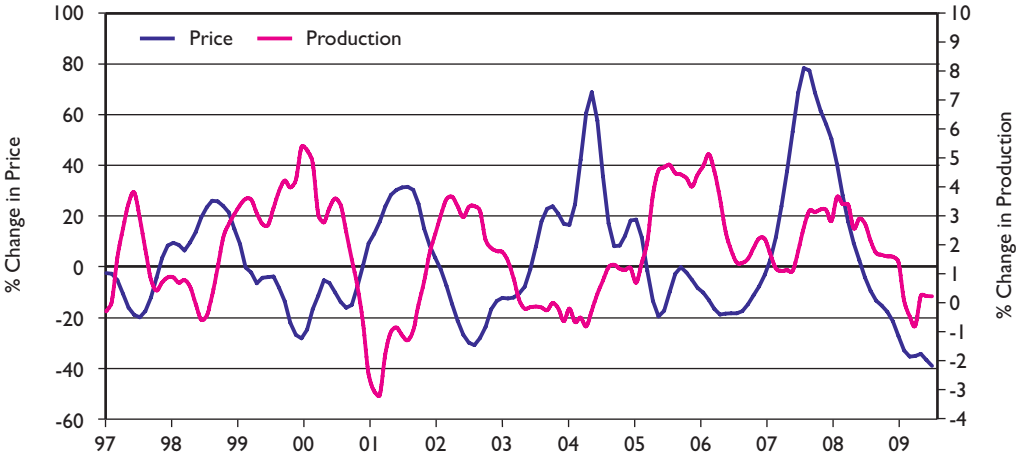
2.2 The commodity price cycle

Without the effective management of the European dairy market by the CAP commodity prices will start to follow the normal agricultural price cycle; price increases will induce a rise in production as farmers buy more feed, this will increase milk supply, which will drive down market returns for commodity products, and as farmgate prices fall back milk production will contract as farmers are less able to afford to buy feed. The decline in supply will then increase prices and the cycle will resume.

The length of any cycle will also be influenced by the use of intervention purchasing to place a floor in the market place and the effect on the market of the disposal of accumulated stocks. The EU has indicated it wants to keep a safety net intervention system, but there is no intention at present to operate it at a level that would smooth out all price variations.

The experience of the USA is a good indicator of the type of price variations that can be expected in a less regulated market. The USA has an intervention system and direct payments to farmers if prices fall below a certain level, but there is no quota system.

Graph 1 – US prices and production: Annual percentage change



Source: National Agricultural Statistics Service (NASS) of the United States Department of Agriculture (USDA)

The graph shows that, given the relatively constant demand growth in the USA, changes in price are driven by small changes in output. This is because demand for many staple dairy products is relatively unresponsive to price, so changes in supply tend to drive changes in price resulting in a price cycle of about every three years. Assuming the American experience is indicative of the current market situation then the industry is currently at the bottom of a price cycle at the present and this should reverse in the next 12 to 18 months.

Volatile commodity prices can be expected to stay because it is unlikely that markets will be re-regulated to remove volatility entirely. With farmgate prices constantly changing the price prevailing at any given point in time is not a reliable guide to where it will be in the future. Consequently prices on their own are not necessarily a reliable guide to long term commercial viability. It therefore becomes imperative to base investment decisions on margin.

3. Input and margin

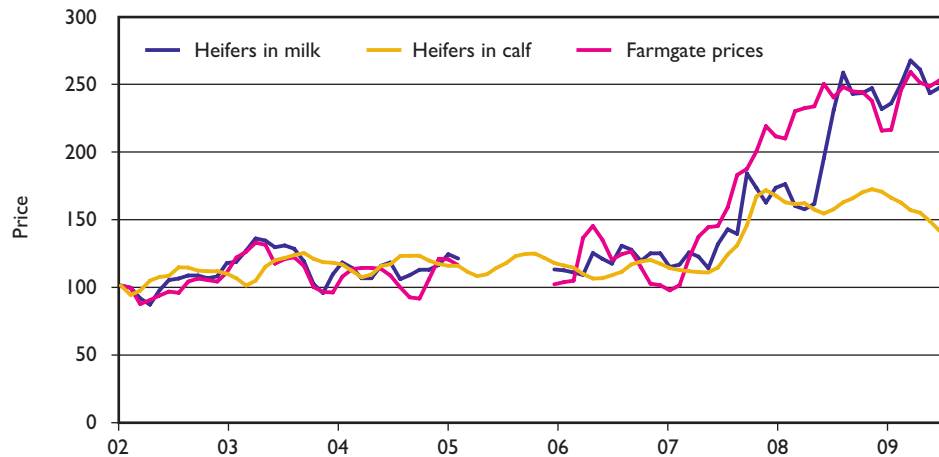
In a volatile price environment a more important guide to commercial viability than the milk price is margin. This means that both prices and input costs need to be looked at to make an assessment of whether or not to invest in dairy farming. In the future farmgate prices may move more in line with fluctuations in feed costs.

Whilst margin is a more important measure of viability than price, the issue is further complicated by the volatility in the cost of farm inputs. The price of all key farm inputs fluctuate with varying degrees of volatility. Some show a clear cyclical pattern, and some are directly related to the performance of dairy farming.

3.1 Cow prices

The price of heifers is usually closely related to the milk price.

Graph 2 – Heifer prices versus milk prices: Index April 2002 = 100



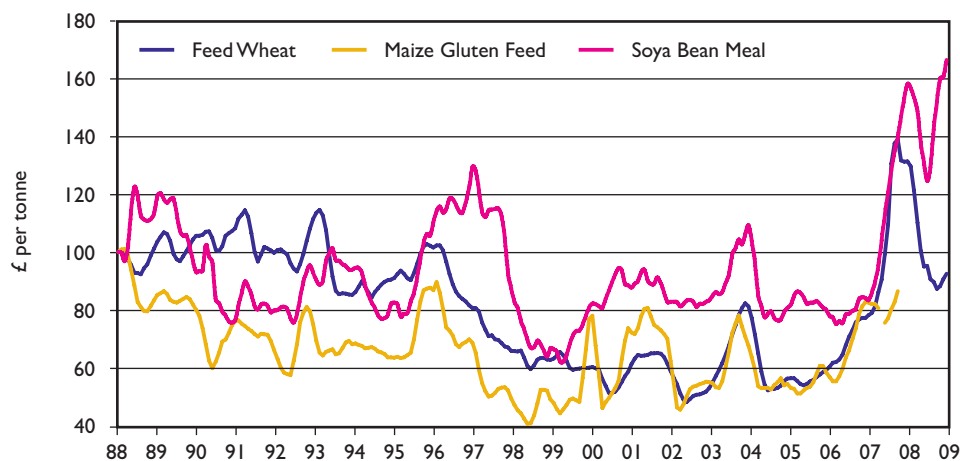
Source: DairyCo Datum and Defra

This graph shows that heifer prices have moved broadly in line with the farmgate price of milk.

3.2 Feed price

The costs of the main types of feed used in dairying are subject to price volatility and some show a cyclical pattern of varying degrees of regularity. This is shown in the graph below.

Graph 3 – Feed input prices: £/tonne: Index April 1998 = 100



Source: Defra

Feed price movements are not necessarily synchronised with fluctuations in dairy farmgate prices. However, it may be the case that in the future there will be a much closer relationship between milk prices and feed prices. Feed is the single biggest cost input for dairy farming. Because the price of feed is increasingly driven at the global level by world market trends, then variations in feed prices directly affect dairy farm profitability and the ability of dairy farmers to produce milk around the world.

In particular, feed prices will affect the supply of dairy products to the world market. This is because America is becoming a major player with US exports now accounting for around 30% of supply to the world market. The prevalence of feed lot systems in America means that US output is strongly influenced by feed prices. So, as the world market plays an increasing role in driving EU prices, then the underlying driver will be feed prices determining the supply of product from the US.

However, whilst there may be more synchronisation between feed and milk prices in future, this may be with considerable lags between the two which will cause fluctuations in margins and in cash flow. This will be a challenge to manage for some businesses, but experience from other sectors suggests that risk can be managed successfully through using tools such as futures markets, options and managing risk. Potentially some of these tools can already be used, and others developed specifically for the dairy market.

3.3 Fertiliser price

The price of fertiliser tends to move separately from agricultural price influences as it is strongly driven by the price of energy. The cost of natural gas makes up about 90% of the cost of producing ammonia.

Energy costs are now recovering which will place greater importance on the efficient use of inorganic fertiliser.

4. Future profitability

It can be assumed that the importance of EU production in meeting global demand will ensure that in future average prices must be sufficient to reward efficient European dairy farmers. As UK farms are among the most efficient EU farmers then they should be commercially viable in the future milk pricing environment.

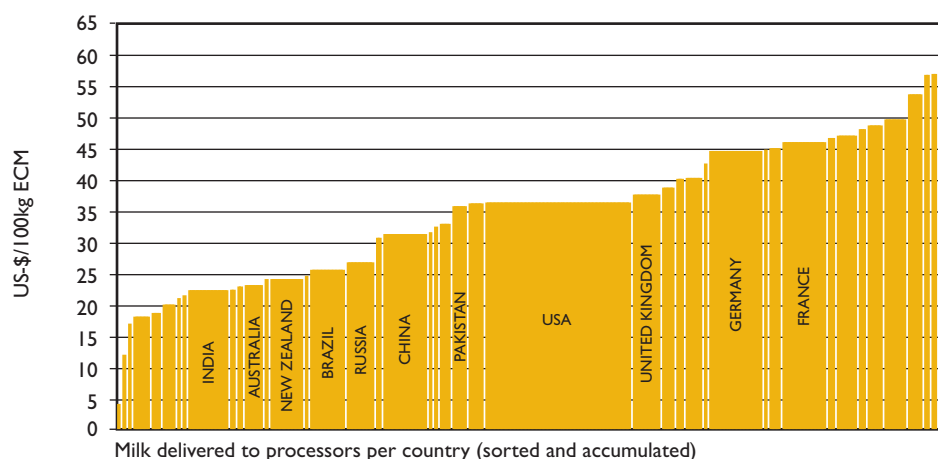
Given the greater exposure of GB and European commodity markets to world market forces, as discussed earlier, to get a view on the future profitability of British dairy farming, global milk prices have to be compared against British production costs. Global milk prices will be determined by global supply and demand.

4.1 Global industry supply

Information on global supply can be drawn from the International Farm Comparison Network (IFCN). The network collects data on representative efficient dairy farms for almost all the major milk producing countries in the world. When placed in rank order and adjusted to show milk delivery volumes, this shows how much milk can be commercially produced in the world at any given price.

Graph 4 – Larger farms – milk delivered supply curve 2007

Based on the larger typical dairy farms analysed and milk delivered



Source: IFCN

4.2 Future prices

The IFCN data allows a view to be taken as to where average milk prices will be in the more open international market place in which the industry will be operating. Demand for dairy products is relatively unresponsive to changes in price (dairy is now too much of a staple product in many countries for people to radically restructure their diets in response to changes in price). As a result dairy prices are sensitive to relatively small changes in supply. It is clear that the output of the European Union is vital to meeting total global demand. The EU contributes nearly a quarter of total global production. Prices everywhere in the world would rise significantly if there was a large fall in EU production. This allows the conclusion that in the long run, given the scale of EU production, future global prices must be at a level that rewards efficient EU producers. If they weren't, there wouldn't be enough supply to meet global demand and prices would have to rise. As British dairy farms are amongst the most efficient in the EU, then they should be commercially viable in the future milk pricing environment.

5. Long term supply/demand balance

Rising population and economic growth will underpin continued growth in world demand whilst supply growth in low cost countries should not undermine the competitiveness of Great Britain.

The very long term future of the industry rests on developments in the global supply/demand balance. Whilst there is data that allows a robust view to be taken of future demand growth, there is some uncertainty in respect of supply.

5.1 Demand growth

The two basic factors that drive the growth in demand for dairy products are:

- Population size
- Economic growth

Table 1 shows the Gross Domestic Product (GDP) and percentage population growth for major milk consuming countries along with the overall forecast growth in the consumption of dairy products in these countries.

Table 1 – Drivers of world consumption (Annual percentage growth 2009-2018)

Country/Region	Dairy Product Consumption	GDP	Population
USA	2.02	2.60	0.87
EU-25	1.00	1.89	0.09
India	4.46	6.83	1.30
China	2.50	7.64	0.54
Japan	0.20	0.95	-0.19

Sources: OECD-FAO Agricultural Outlook

Translating these two factors into future demand for dairy products the overall growth of world demand between 2009 and 2018 is predicted by the OECD to be 16% with an annual growth rate of almost 2.0%

Table 2 – OECD consumption forecasts for dairy products* (thousand tonnes)

	2009	2018	% change
World	37,815	45,093	19.2
OECD	20,552	23,178	12.8
Non-OECD	17,263	21,914	26.9
EU-27	11,703	12,868	10.0
United States	5,855	7,036	20.2
Japan	526	536	2.0
China	1,995	2,494	25.0
India	4,291	6,204	44.6
Australia	395	428	8.4

	2009	2018	% change
New Zealand	98	97	-1.1
Mexico	648	788	21.5
Sub-Saharan Africa	525	536	2.0
Argentina	570	655	14.9
Algeria, Egypt	1,255	1,638	30.5
Brazil	1,354	1,711	26.4
Russia	1,809	2,079	14.9
Ukraine	382	526	37.9

Source: OECD

** = dairy products include butter, cheese, SMP and WMP

In the short term the industry will be subject to the effect on demand caused by the recession and the downside of the current commodity price cycle. However, it should take only a relative small adjustment in the rate of growth of global milk production for markets to rebalance themselves.

5.2 Supply growth

On the supply side of the equation dairy farming will present an opportunity for many regions around the world and it is conceivable that there could be a rapid growth in production around the world in low cost producing countries, particularly Latin America and Ukraine, that would drive down world prices to a level that would induce a contraction in the EU industry.

Whether or not the potential for output growth in low cost countries is translated into actual output depends on a large variety of factors such as competing demand for land for biofuels, environmental constraints, political factors, alternative land uses, availability of capital and skilled labour.

Furthermore, implementing changes in farm structure in any country is generally a slow process that does not produce radical transformations in comparative cost efficiency or output as all countries are simultaneously undergoing the same process of restructuring. Realistically it is therefore difficult to conceive of a development in global supply in the medium term that would render milk production in Europe unimportant to the global supply/demand balance. Consequently the consensus opinion amongst most commentators is that demand will outstrip supply in the medium term.

Longer term, there has to be less certainty over supply trends, given the number of variables involved. However, if it ever became the case that growth in low cost countries meant that the EU was less relevant to global supply, it is inconceivable that this would ever be the case for the USA. Consequently if the UK industry can match US production costs, which it should be able to do with its greater reliance on grass as opposed to the US reliance on feed lots, then the UK dairy industry is likely to remain competitive.

6. Other factors

Recent currency trends have favoured Great Britain. Dairy farmers should also have confidence that they will generally be supplying an efficient, dynamic and competitive processing sector.

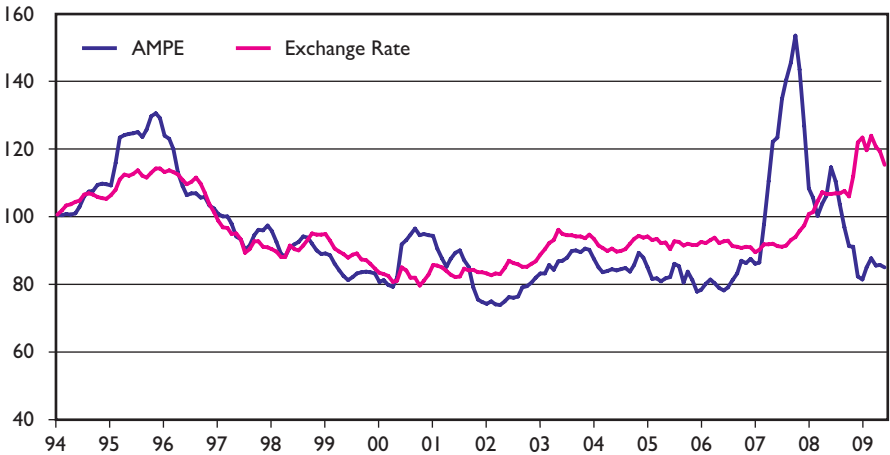
There are a range of other issues affecting the industry's future commercial environment, but the factors of most significance to British farmers are currency volatility and the competitiveness of the processing sector.

6.1 Currency

Fluctuations in the value of sterling against the Euro and the US dollar affect Britain's relationship with the EU and world markets. Given the importance of the EU market in setting overall commodity prices, then the Sterling/Euro exchange rate is a significant driver of overall industry returns.

This is demonstrated by the graph below which compares changes in the Euro/Sterling exchange rate with changes in the combined market returns for butter and skimmed milk powder converted to their Actual Milk Price Equivalent (the raw milk price equivalent of returns from the sale of butter and SMP). The returns for these two commodities have tended to determine the trend in prices for all other products.

Graph 5 – Index of Sterling/Euro and actual milk price equivalent: 1994 = 100



Source: Dairy UK

The graph shows that there is a strong underlying correlation between commodity prices in Britain and movements in the exchange rate.

Sterling has fallen against the Euro as a result of concerns over the future of the UK economy. If this trend were to continue then commodity markets, and consequently the overall milk pricing environment, should operate at a higher level than seen over the past decade.

6.2 Processing

For UK farmers to prosper they also need to be supplying efficient and competitive processors, otherwise the industry as a whole will not be able to compete against imports.

There has been significant investment in processing facilities over recent years and many efficiency gains have been made.

Table 3 – Capital expenditure by five largest UK dairies: £m

Financial year ending	
2005	121.6
2006	104.5
2007	119.1
2008	139.2
2009	131.2

Source: Dairy UK

Following the rationalisation of the liquid milk sector and the sustained investment by dairy companies such as Dairy Crest, Robert Wiseman Dairies and Arla Foods UK, the UK now probably possesses some of the most efficient, well invested liquid milk processing facilities in the world. Of more concern is the efficiency of the manufacturing sector which competes with imports. Here there has also been sustained investment in existing facilities, but there are likely to be further efficiency gains that can be made.

Continued investment by the UK dairy industry in both liquid and manufacturing can be expected. However, it is interesting to note the confidence foreign companies have in the future of the UK dairy industry, which is demonstrated by the £60m yogurt processing facility recently completed by the Austrian dairy company NOM Dairy in Shropshire.

Equally as important as investment in plant is the investment in the marketing of dairy products. The vast majority of this expenditure is now focused on branded products. These deliver added value and in many cases, by default, they deliver provenance.

Table 4: Total expenditure on the marketing of dairy products in the UK

Yr to March	
2004/05	£98.6m
2005/06	£118.6m
2006/07	£102.4m
2007/08	£123.0m
2008/09	£114.9m

Source: A C Nielsen

This level of expenditure demonstrates the confidence and commitment of the UK dairy industry to adding value to British raw milk and should give producers confidence that they will be supplying a dynamic, vibrant, forward looking and competitive processing sector.

Less tangible but equally important as capital and marketing expenditure is the ability of the processing sector to enter into equitable partnerships with the industry's biggest customers, the major retailers, to maximise value from the market place. The durability of many processor/customer relationships and the development of integrated supply chains demonstrate, in some cases, the processing sector's ability to do so.

It is imperative for the entire supply chain to be profitable and competitive for a sustainable future. Before farmers make the decision to invest they will want to be sure they have a successful, competitive milk buyer who wants their milk. Equally processors will also want to ensure that they have successful, competitive farmers supplying them before they invest.

6.3 Local factors

For an individual producer there are a host of other local commercial factors that affect their prospects and the viability of investments. They include alternative land uses, local planning restrictions, the availability of labour, the number and type of purchasers competing for milk supplies in the area, the contracts on offer (the way they apportion risk and transmit price changes) and uncertainty within the supply chain etc.

These are all of critical importance in making any final decision on investment and farmers are advised to obtain further business and financial advice that takes these factors into account before proceeding with an investment. However, these factors are outside the scope of this publication, which is mainly concerned with the wider national and international economic environment.

6.4 Conclusions

In the long term the commercial prospects for the industry are positive. This is widely recognised by a range of commentators. The industry is currently in the downswing of a commodity price cycle but this is a short term situation. The depth and duration of the fall in price may be exaggerated by the effect of recession on demand, but it should only take a small adjustment in global output levels to rebalance markets and set prices rising again.

Given the broader long term picture it is clear that an efficient dairy farmer can expect to prosper in the future and that is why we would encourage farmers supplying efficient, competitive and dynamic processors who want more milk to consider investing in their dairy units.

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