



# Dairy Supply Chain Margins

2004-05

Who made what in the dairy industry and how it has changed

Executive Summary

economics

# 1 Executive Summary

This year's report has revealed that there has been some improvement in the dairy market over the past year. Branded dairy products seem to be increasing with new product launches in the liquid milk market helping to increase sales, with sales of branded liquid milks increasing by 23% compared to 2003, and sales of branded cheese increasing by 11%. In addition the retail liquid milk market has seen growth for the first time in thirty years.

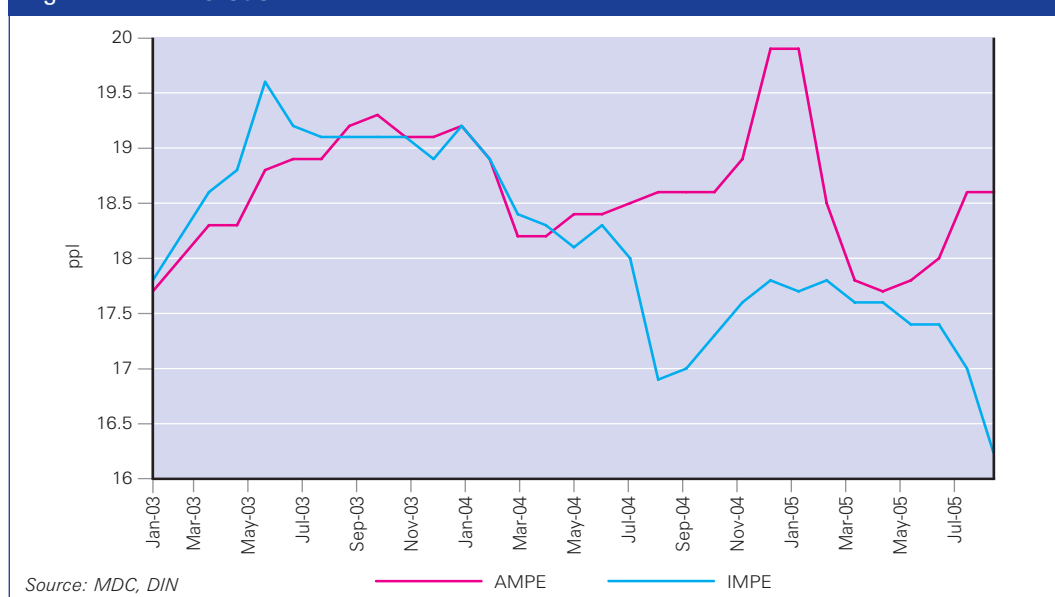
This year's investigation into supply chain margins reveals that retailer margins generally increased slightly during 2004 and are likely to be higher in 2005. However, the UK is not alone, with retail gross margins for dairy products increasing in many other EU countries.

Also revealed in this year's report is the continued worsening of the trade deficit in dairy products suggesting the UK is still losing added value markets to competitors. In addition, the UK appears not to be reacting to changing markets as quickly as some other EU countries who are cutting back their commodity production and increasing the amount of fresh products and cheese they make. These factors combined are potentially weakening the UK's future competitive position.

## 1.1 Markets

The markets for dairy products in 2004 were not significantly affected by the one factor everyone thought would have an impact at the beginning of the year – CAP Reform. Strong world demand, and low world milk supply meant that the markets for dairy products did far better than expected.

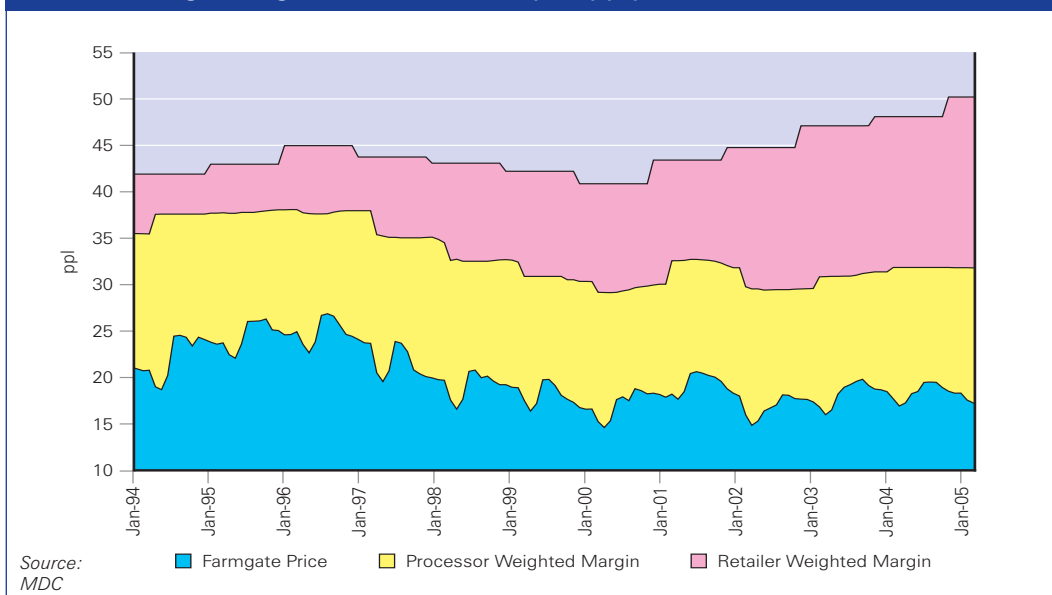
Fig. 1: IMPE versus AMPE



Despite relatively firm prices in commodity and cheese markets for much of the year, and low milk production over the year, farmgate prices fell as 2004 progressed. Despite these price falls, average farmgate prices still managed to be higher than in 2003. This was due to the high prices at the beginning of 2004, and better milk quality leading to higher prices on contracts that nominally had a lower value. Competition for retail contracts, especially in the liquid milk market, saw farmgate milk prices fall on direct liquid contracts as processors competed to win business.

## 1.2 UK Margins and Profits

Fig. 2: Average Margins across the Dairy Supply Chain



During 2004, retail gross margins increased slightly on liquid milk and mild cheddar but fell slightly on mature cheddar (although remaining high compared with typical gross margins). Processor gross margins have remained stable or increased very slightly, while farmgate prices were also higher on average in 2004 than in 2003.

Early indications in the liquid milk market for the first five months of 2005 suggest increasing retailer margins – partly as a result of intense competition to supply multiple retailers, and partly because of the retail price rises in March 2005 (see Table 1). The changes in margins across the three markets can be seen in aggregate in Fig 2.

Table 1: Comparison of Liquid Milk Margins 2003, 2004 and 2005<sup>1</sup>

	2003		2004		2005*	
	ppl	Margin	ppl	Margin	ppl	Margin
Farmgate Milk Price	18.1		18.5		18.4**	
Operating Costs and Processor Margin	15.6	46%	15.9	46%	16.1	47%
Processing Selling Price	33.7		34.4		34.5	
Operating Costs and Margin	12.9	28%	13.1	28%	15.6	31%
Retail Price	46.6		47.5		50.1	

Source: TNS, MDC, DIN, DEFRA  
 \*First five months of 2005 only \*\*Based on a rolling 12 months including first five months of 2005

## 1.3 EU Margins

The UK dairy industry is not alone in witnessing a growth in retail margins. This phenomenon appears to be happening across some other EU dairy markets, although there are some noticeable exceptions (e.g. the German liquid market). In addition the growth in retail margins has not necessarily been as large as in the UK. The growth in retail margins appears to be being facilitated by asymmetric price transmission which means that when wholesale prices and farmgate prices fall, retail prices do not fall by the same amount. Asymmetric price

<sup>1</sup> The figures for the first five months for 2005 are based on current information. It is likely that by the end of 2005, the average retail price will be slightly higher and the wholesale price i.e. processor margin will be lower. This does of course depend on what occurs during the second half of 2005.

transmission can be caused by several factors including: market power, menu pricing, differing cost/efficiency changes at different levels of the chain, differing amounts of value added at different levels of the chain.

In the cheese market there is variation in processor and retailer margins across the EU but it is notable that over the past decade the UK cheddar market has seen the largest increase in the retail gross margin (albeit from a relatively low base).

**Table 2: Distribution of Retail Price in EU Cheese Markets\*\***

	Farmer		Processor		Retailer	
	1995	2004	1995	2004	1995	2004
German Gouda	45%	44%	18%	11%	37%	45%
Netherlands Gouda	49%	39%	10%	10%	41%	50%
Irish Cheddar	37%	27%	8%	7%	55%	67%
UK Mild Cheddar	69%	50%	10%	11%	21%	39%
UK Mature Cheddar	48%	32%	11%	12%	41%	56%

*Source: Eurostat, ZMP, Dutch Dairy Board, Agra Europe, CSO, DEFRA, MDC, DIN*  
 \*\* All percentages are in terms of the retail price

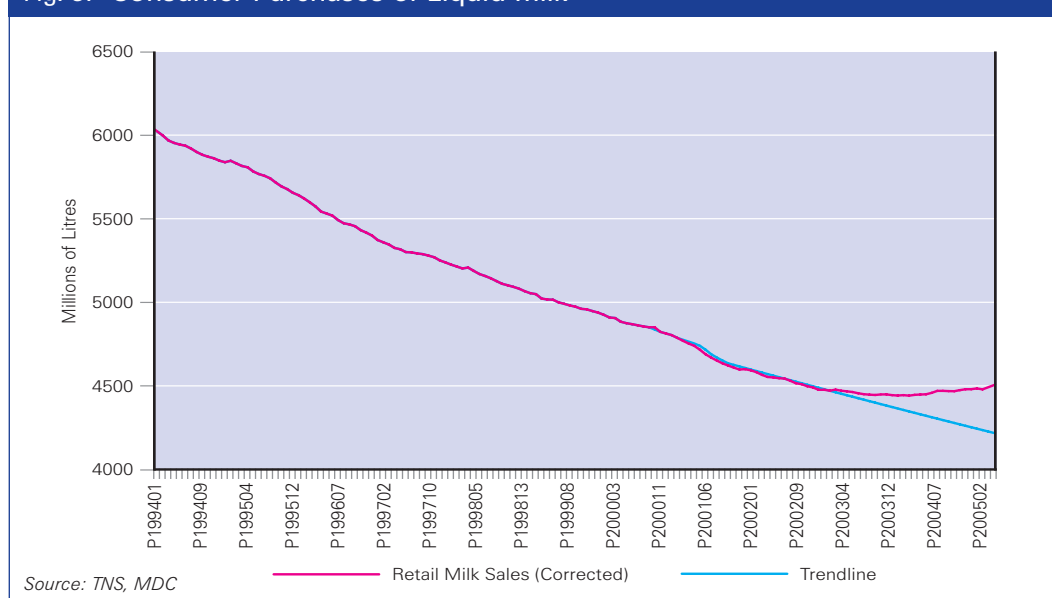
In general, countries producing greater amounts of commodity products appear to have seen farmgate prices decrease over recent years, while farmgate prices in those producing lower proportions of commodity products have come under less pressure.

## 1.4 UK Consumers Market

There have been some significant changes in the consumer market during 2004 with branded sales driving the growth in the dairy market. New product launches in the liquid milk market helped to increase sales, with sales of branded liquid milks increasing by 23% compared to 2003, and sales of branded cheese increasing by 11%.

Liquid milk retail sales have begun to increase for the first time in thirty years due to new branded products, growth in organic milk and increases in sales of breakfast cereals and coffee/tea. Mature cheddar has seen growth of 6% between 2004 and 2003 especially in branded cheeses where there has been significant promotional activity. However, growth in imports of speciality cheeses continues unabated as the consumer looks to new products and varieties.

**Fig. 3: Consumer Purchases of Liquid Milk**



## 1.5 UK Trade

Trade has continued to worsen, with the trade deficit increasing by 8% to £744 million in 2004. In addition to this, MDC analysis suggests that the UK is not reacting to changing markets as fast as some other EU countries and is falling behind some in the EU in terms of its investment in growing added-value markets. This may mean the UK is being left behind and these factors are possibly weakening the UK's future position.

% Change 96 vs. 04	Butter & Butteroil	Powders	Cheese	Fresh Products
Germany	3	-29	22	26
France	-12	-38	14	n/a
UK	17	-4	0	3
Italy	-3	n/a	17	18
Netherlands	-14	16	-4	-2
Spain	n/a	-9	19	92
Ireland	-6	-39	14	n/a
EU average	-2	-20	14	56

*Source: European Commission*

**For a full version of this report please contact MDC on 01285 646510  
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