ORGANIC DAIRY:

BATTERED, BRUISED, BUT BACK ON THE UP?

AUGUST 2024

Report Authors:
John Allen, Kite Consulting
Rob Daykin, Daykin Partnership
Chris Walkland, Walkland Partnership

INTRODUCTION

ACKNOWLEDGEMENT
Much of the milk volume analysis, and that relating to consumer demand in this report stems from data made available by AHDB.

Organic dairying has had a torrid time over the last two years, with soaring costs and unsustainable farmgate milk prices combining with the cost-of-living crisis that has seen organic shoppers trade down or across from organic brands.

Now it is potentially at a turning point with better times seemingly ahead for suppliers, amid reports of demand increasing again and food price inflation falling. Milk prices are rising on the back of this, which are restoring organic milk premiums over conventional, back to near their historical levels. However, the farmers that are left in organic are in it for the long haul, and need to be profitable to be able to invest in the infrastructure, technology and training that are required for future proofing. Their profitability is borderline at the moment, and many will need at least a year at profitable price levels to backfill the fiscal black holes created over the last few years.

There may be question marks over whether long-term damage has been done, and whether organic might get back to where it was before. This report considers the many and varied challenges organic dairy faces, while recognising that processors including Arla, Müller Milk & Ingredients, Organic Herd (formerly Omsco) and Calon Wen, alongside retailers such as Waitrose and McDonalds, remain committed to what is an extremely important sector for the UK dairy industry.

What is clear is that there are some fundamental structural issues that have to be faced, and which will undermine the sector if left unchecked – not least over seasonality of supply. Currently the organic milk market is faced with too much milk production in the peak months, and not enough in the trough months. This is important, especially when consumer demand for organic milk is relatively static.

Meanwhile the rise of regenerative agriculture can be seen as both an opportunity but also an additional challenge to the organic sector. While the exact specifics of regen have yet to be enshrined in official standards, as organic's are, it is likely to have a simpler message that consumers will potentially adopt more readily. Embracing and helping to drive what regen actually looks like, can therefore potentially be to organic's advantage.

While organic is strictly defined and enshrined in stone, regen can mean many things to different people, even within the farming sector. With organic brands already developing regen milk pools, it is crucial that organic dairying is a part of this journey, by better describing itself and its merits, and providing a narrative that consumers understand and buy into.

This report provides a "sit-rep" summary of where the organic sector is now, and offers some solutions as to how it might mitigate the current challenges and evolve for the future.

John Allen, Kite Consulting
Rob Daykin, Daykin Partnership
Chris Walkland, Walkland Partnership

August 2024

SETTING THE SCENE

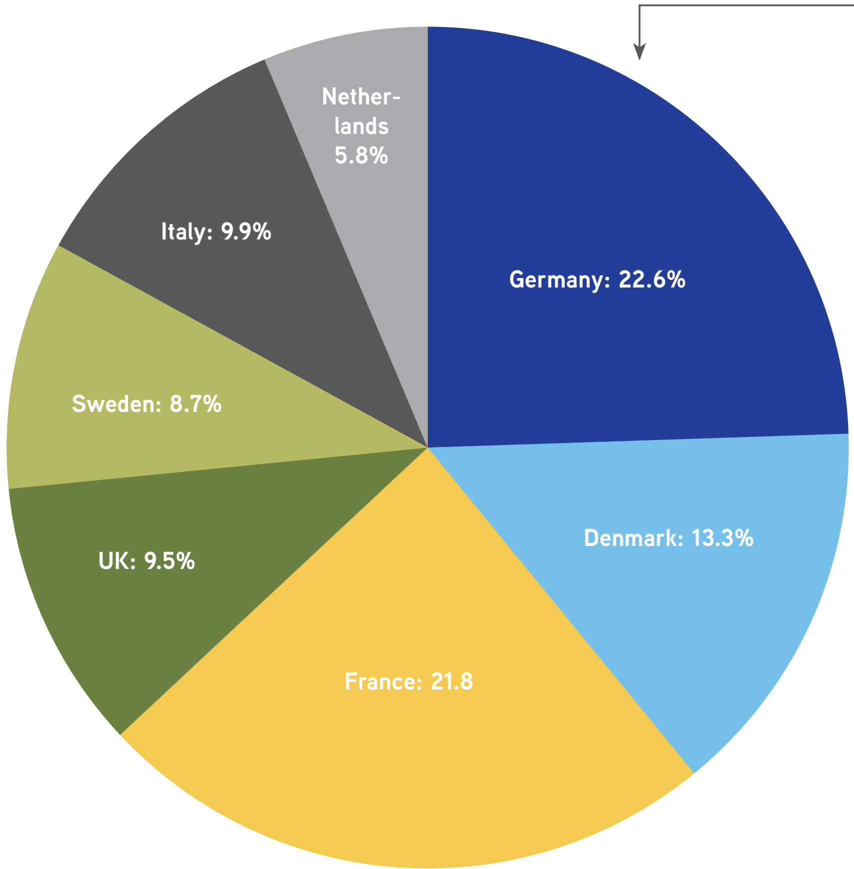
The UK organic dairy scene cannot be looked at in isolation. It must be looked at as part of the overall EU sector, as supply and demand factors there historically provided a useful and profitable outlet for exports of organic milk and dairy products by some UK processors, notably Organic Herd and especially when seasonal supply exceeded demand.

However, several notable events altered the dynamics in recent years, including Brexit trade arrangements and the increased complexity of trade barriers. Many EU customers want EU specific product, which ruled out UK purchases. For those less restricted, there remained the risk of tankers of expensive cream being held up at ports. In addition, before Brexit, processors could send tankers of milk/cream to Europe and effectively sell them 'en route', as there was no need to declare a final customer destination. After Brexit an end-use customer had to be declared, which stopped the ability to spot sell into Europe overnight, meaning the major way of balancing UK organic milk was no longer available.

With no organic spot market in the UK, and limited access to commodity/cheese production (as all facilities were full of conventional milk), surplus volumes were effectively being balanced at conventional milk spot prices.

On top of this, some EU states have significantly increased the amount of organic milk they have produced over the years, making them more self-sufficient and less dependent on imports:

LARGEST EU ORGANIC MILK COUNTRIES BY VOLUME
(Average over the last five years)



France is a particular example. Back in 2012 it produced less than 500,000 tonnes of organic milk. By 2022 this had risen to 1.38m tonnes, overtaking Germany in that year as the biggest producer of organic products. Over the same time period Germany increased from 682,000 tonnes to 1.3m.

In total the EU's (plus the UK's) production of organic milk increased from below 4m tonnes in 2013 to 6.8m tonnes in 2022. Of 26 states recognised as producing at least some organic milk only five cut their production over this period – the biggest country being the UK. As a result, the UK has gone from producing nearly 12% of the EU's organic milk in 2013 down to less than 6% in 2022. It will be lower again for 2023.

This rise in the EU's production and self-sufficiency, plus those Brexit impacts, resulted in declining opportunities for organic exports to Europe. At the same time increased transport costs made exports to another once lucrative market - the US – more challenging. This again limited the outlets that some UK organic processors had for their products.

As the sector negotiated these export obstacles, the Covid pandemic then brought a whole new series of unanticipated challenges. A short-lived retail uplift to organic, with consumers seemingly giving more consideration to health issues during lockdown periods, was more than off-set by decimated food service sales, a key market for organic milk.

The legacy of this has been the cost-of-living crisis that has dealt a further body blow to the sector, leaving it battered, bruised and with a crisis of confidence that it is only just recovering from now.

EU + UK ORGANIC MILK VOLUMES

% OF EU ORGANIC TOTAL PRODUCED BY THE UK

WHAT'S HAPPENED TO DEMAND FOR ORGANIC?

There is little doubt that the above factors mean that sales of organic dairy products have taken a major downfall over the last two years or so, not least because market opportunities fell away and because organic dairy products cost more than conventional ones. For example, the premium for four pints increased from 53p in 2019 and 2020 to over 60p in 2023 and 2024, although the percentage premium over conventional actually reduced from a high of 46% in 2019 and 2020, down to 40% for 2023 and 2024:

ORGANIC V CONVENTIONAL RETAIL MILK PRICES (4 PINTS)

Prices tracked by Kite:	2019	2020	2021	2022	2023	2024
Organic	1.67	1.67	1.67	1.85	2.12	2.08
Conventional	1.14	1.14	1.15	1.29	1.67	1.48
Organic Premium	0.53	0.53	0.52	0.56	0.64	0.60
% Premium	46.5	46.5	45.2	43.4	40.8	40.5

However, price increases were not returned to farmers in the same way or at the same speed that they were in the conventional market. This reduction in the price premium during the period of high inflation meant that many organic farmers had little choice but to revert to conventional, as the cost saving exceeded the loss of premium. It highlighted three main concerns inherent in the UK organic milk pool:

Firstly, the lack of transparency in market pricing for organic milk. There is no publicly available measure of the value of organic milk as there is with conventional AMPE or MCVE formulas.

Secondly, with the effective closure of EU spot markets and disposal routes, there is limited alternative or balancing market for organic milk in the UK, particularly at times of high volume, such as the spring flush. (An organic production run requires milk segregation, plant stoppages and clean downs, plus a change in packaging - all of which reduce efficiency and are unpopular with factory managers at times when production is to be maximised during flush).

Thirdly, there is no organic equivalent to the conventional global commodity market, as organic is primarily a retail product where consistent and constant supply is required.

With a limited ability to demonstrate the value of milk or remove it to alternative markets, the negotiating power of organic businesses was significantly reduced in comparison to conventional peers, and may explain why increased retail prices were not reflected in the farmgate prices.

As a result, organic milk sales dropped 14% for the year to 9 September 2023, according to figures from NIQ Homescan and published by AHDB. Yoghurt sales – the biggest organic category - dropped 16%. Together these products account for 97% of organic dairy sales. Organic cheese sales fell 18%, but despite the importance of the category to balance surplus milk, it remains a small category at retail level.

Currently organic dairy products have a price differential over conventional products of between 6% for butter to over 100% for yoghurt, although at the time of writing this report organic kefir is less than conventional due to special offers:

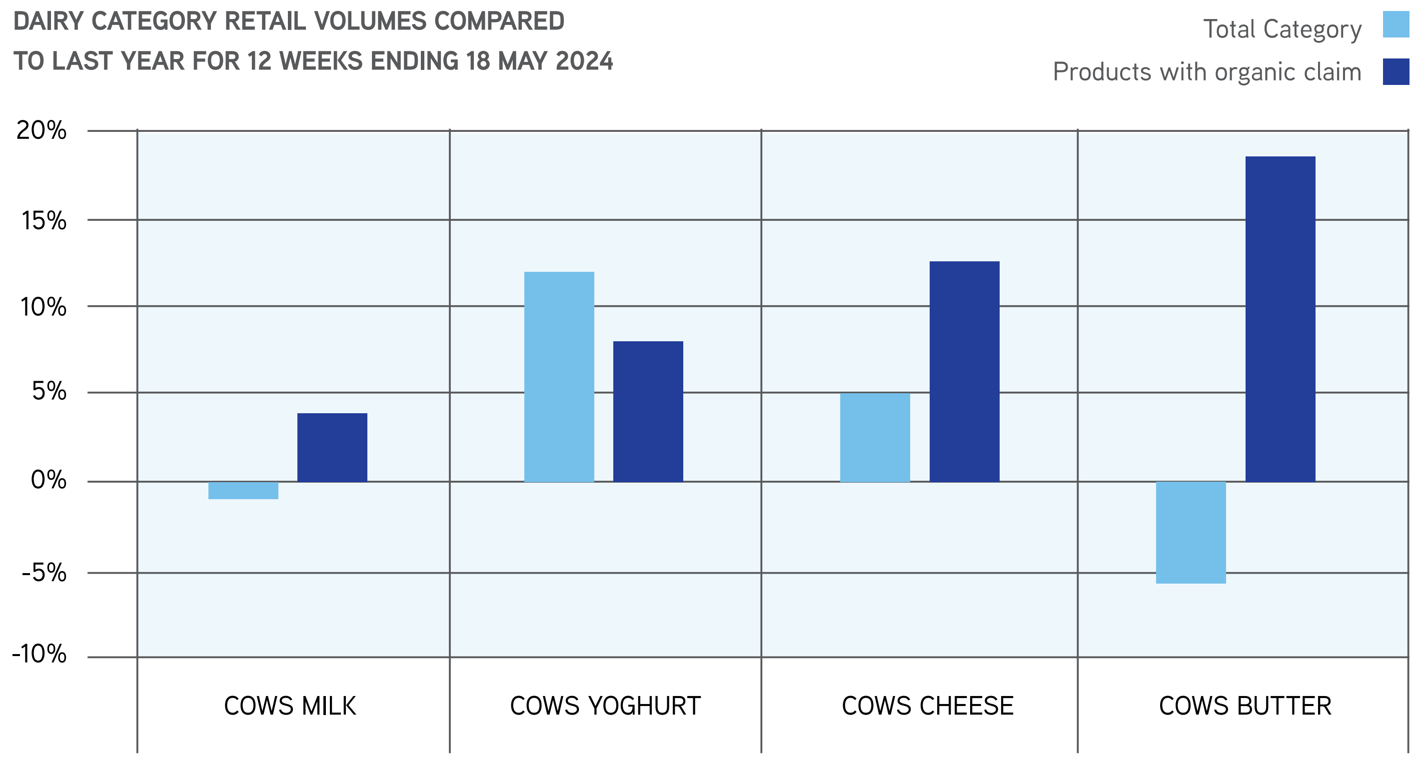
CURRENT PRICE DIFFERENTIALS - ORGANIC V NON ORGANIC £ PER 100g

	g/ml	Organic	Non-Organic	Diff	%Diff
Yoghurt	450	0.47	0.22	0.25	112.1
	950	0.38	0.20	0.19	97.0
Butter	250	1.20	1.14	0.06	5.7
	400	0.96	0.91	0.05	5.9
Kefir	350	0.59	0.68	-0.09	-13.7
	500	0.52	0.54	-0.02	-4.5
Cheese	245	1.29	1.14	0.15	13.3
	350	0.91	0.59	0.32	53.4
Cream	300	0.67	0.38	0.29	77.4

However, both Arla and Organic Herd have been reporting more positivity in organic sales recently, and these are borne out by other figures from Nielsen (also published by AHDB). For the 12-week period ending 18 May 2024, sales of organic milk increased by nearly 4%, in contrast to a slight decline for the total cow's milk category as a whole (including conventional).

Organic yoghurt, cheese and butter were all in growth, with the latter two outperforming their total categories. "Consumer confidence, while increasing, is fragile and further economic shocks and uncertainty could put a dampener on the return of demand," concluded the organisation.

DAIRY CATEGORY RETAIL VOLUMES COMPARED TO LAST YEAR FOR 12 WEEKS ENDING 18 MAY 2024

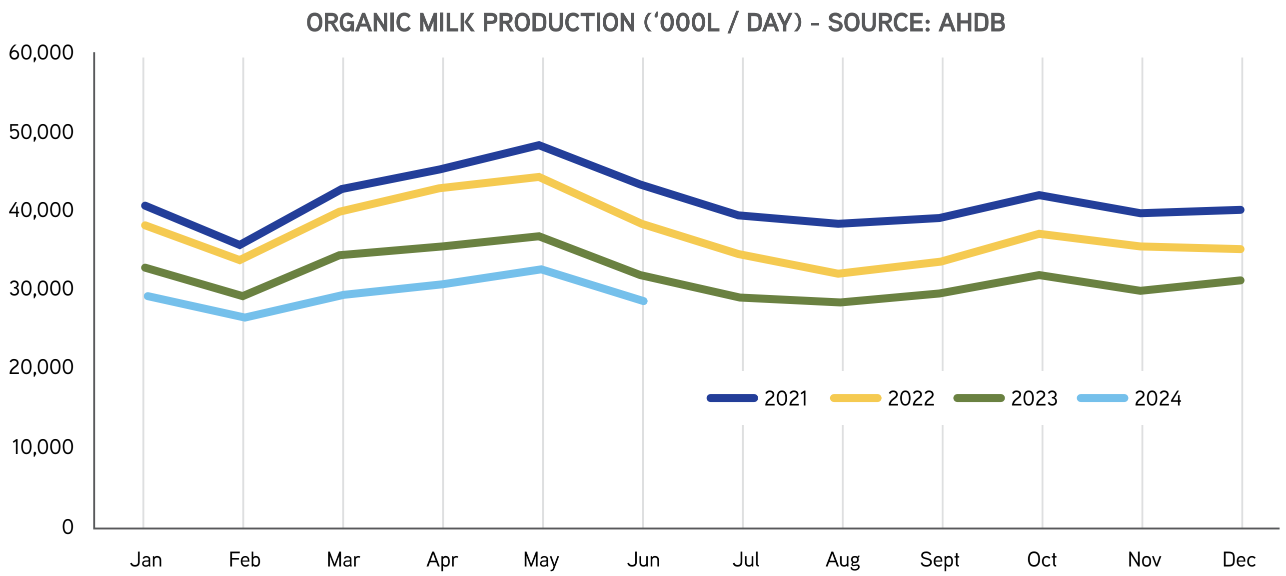


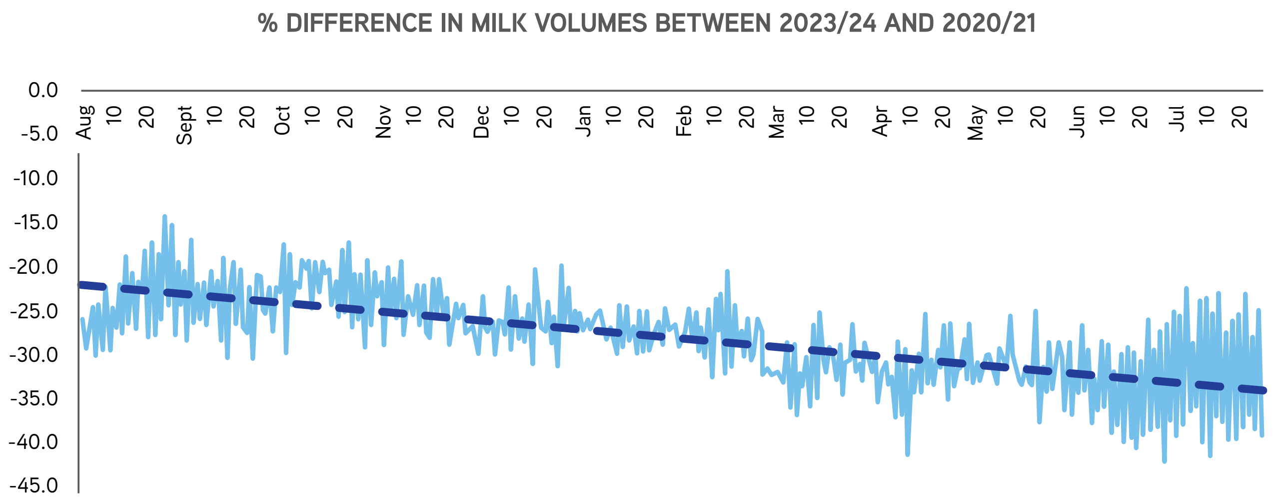
Organic Herd, though, is more positive. In its April milk price press release the firm stated that "our latest price rise reflects the growing demand we are witnessing for our organic milk in particular from core domestic dairy processing customers", and it reiterated that in its August press release, when it announced a 3p rise to 54p. "Our latest price increase reflects that domestically and in our major export markets demand for organic dairy is strengthening while supply remains relatively constrained," said its chief executive Martyn Anthony. "The positive demand-led picture for organic dairy is very much linked, we believe, to an upturn in consumer confidence as the impact of the cost of living crisis, and particularly food price inflation, has started to wane. This means that consumers are now not only focused on value when it comes to the weekly shop but also increasingly, they are looking for values in terms of how their food is produced, something that organic is well placed to respond to."

Whilst it appears retail volumes are increasing, the industry is yet to see the recovery of the lost volume.

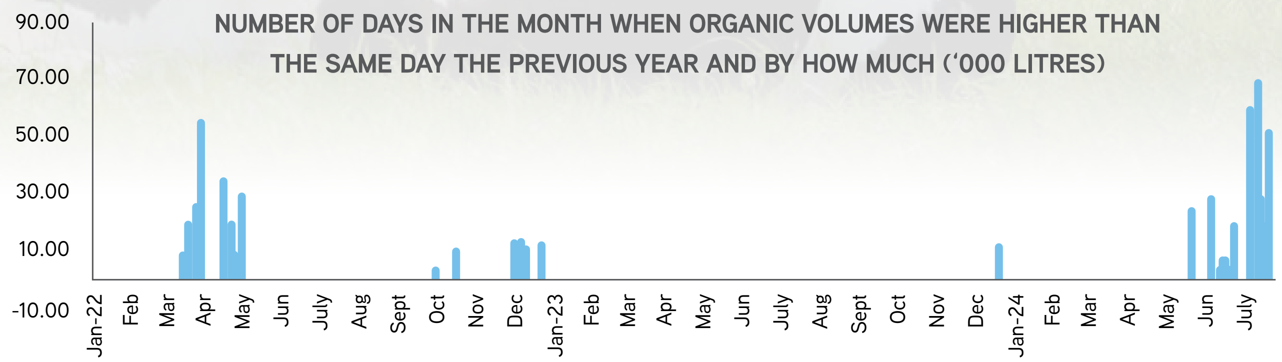
WHAT'S HAPPENED TO UK MILK VOLUMES?

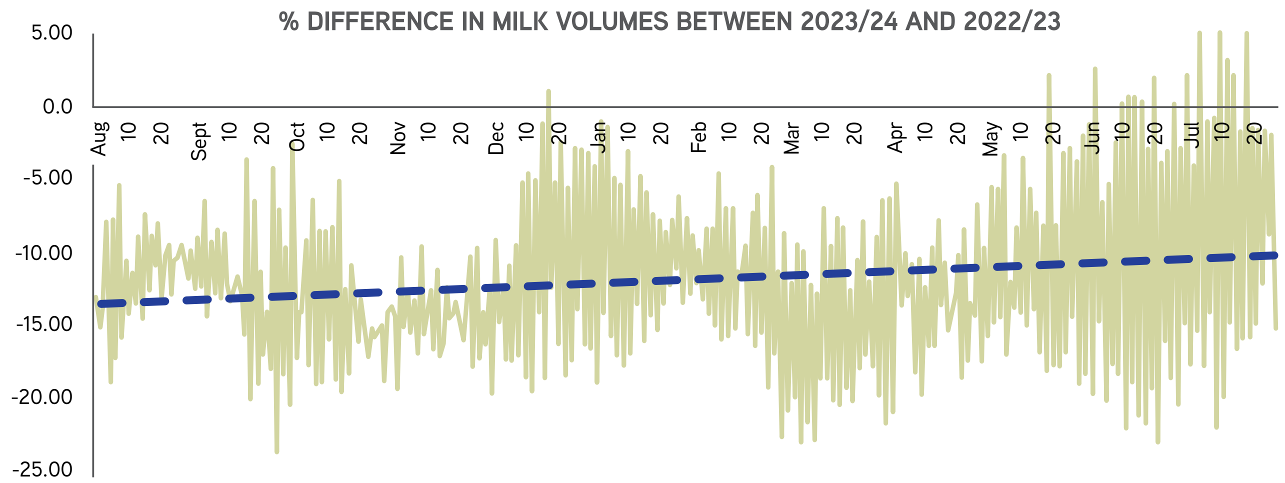
Milk volumes in the organic sector have fallen considerably since 2022 as organic farmers could not cope with the inflationary pressures and several either quit dairy farming altogether, or reverted to conventional farming. Current volumes are now tracking 30% below those in 2020/21, for example:





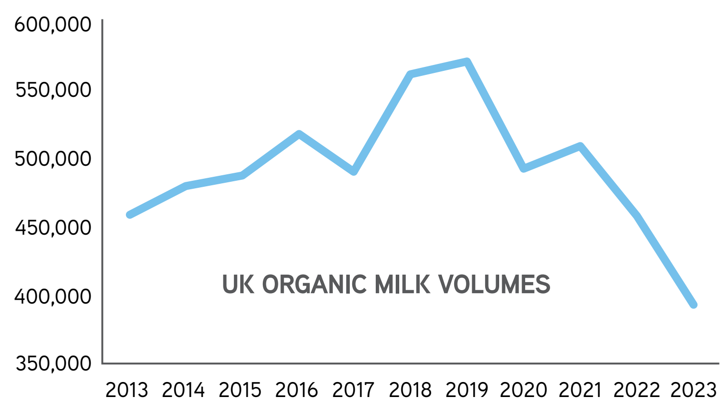
There are some signs of stabilisation now, however, as recent volumes compared to last year are now consistently exceeding last year's levels. It only happened once in 2023:





Nevertheless, the decline means that the UK is now producing less organic milk than it did back in 2013:

The question for the sector to determine is whether it is happy being a declining industry, or whether it wishes to start to grow its volume once again. Our best guess now for the 2024-25 season is for volumes potentially below 350m litres, based on current daily deliveries.



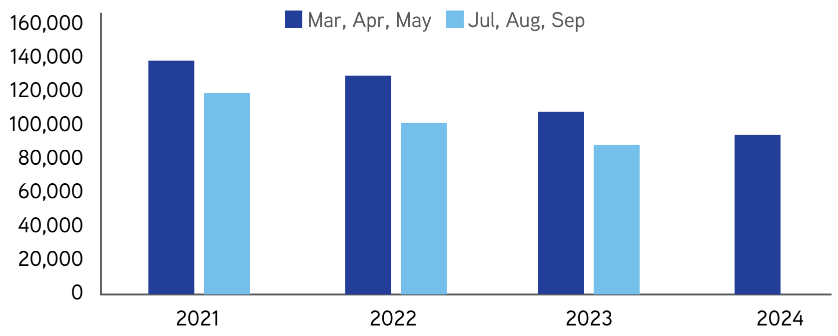
THE STORY WITHIN THE VOLUME STORY: THE PEAK TO TROUGH RATIO

The peak to trough ratio for organic milk production is the ratio of the volume of milk produced in the month with the maximum volume compared to the lowest. It is important because the higher the ratio, the greater the seasonal nature of milk production, and the greater the risks that supply will not meet demand in the trough months.

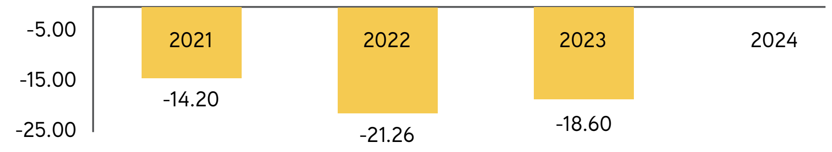
In 2021 the ratio was 1.34; in 2022 it was 1.39 and in 2023 it was 1.3. In contrast the conventional milk peak:trough ratio is consistently at 1.2, which shows a much flatter level of production through the year.

If we then take the total volumes produced in the highest consecutive three months (March, April and May) and compare that with the lowest consecutive three months (July, August and September) we can determine that there is up to 20% less milk produced in the lowest three months compared to the highest. For conventional milk the differential between the peak three months and the trough months is nearer 10%:

ORGANIC MILK - VOLUMES OF HIGHEST 3 PRODUCTION MONTHS V LOWEST 3



% DIFFERENCE- VOLUMES IN THE LOWEST 3 MONTHS V THE HIGHEST



As we exit the flush and enter the summer the extent of the shortfall in volume will become apparent. It is very possible that demand for organic milk will exceed production, and this could be damaging for the sector if it fails to satisfy customer requirements.

The obvious long-term remedy is to financially penalise seasonal production ever-harder, to ensure that, at worst, these levels do not deteriorate further and at best start to improve. But this is likely to be extremely unpopular with organic farmers as a spring calving system dominates in the sector over all-year-round calving systems, because it has lower costs and is more seasonally and environmentally logical. However, it is not market-logical due to the level profile of demand.

History also suggests it is very hard work to move the seasonality profile. Until the start of the 2023/24-year, Organic Herd had an exceptionally severe seasonality system, and still was unable to shift the production profile.

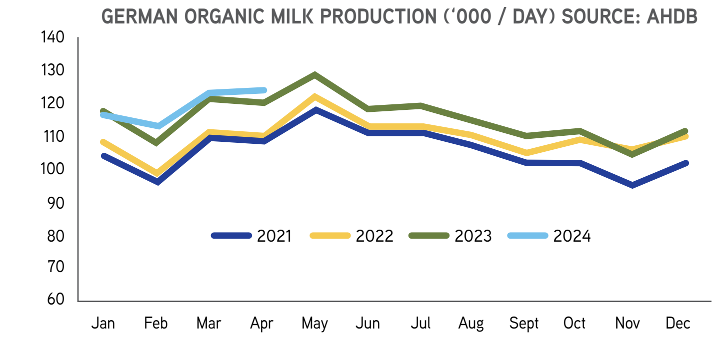
If there are fewer opportunities elsewhere to balance the surplus milk, it is inevitable that more and more organic milk will end up in premium-less conventional markets, and that ultimately will be reflected in lower milk prices for all.

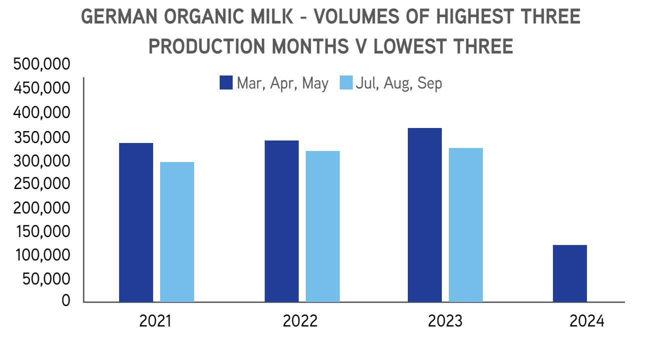
HOW DOES THIS SITUATION DIFFER TO OTHER EU COUNTRIES?

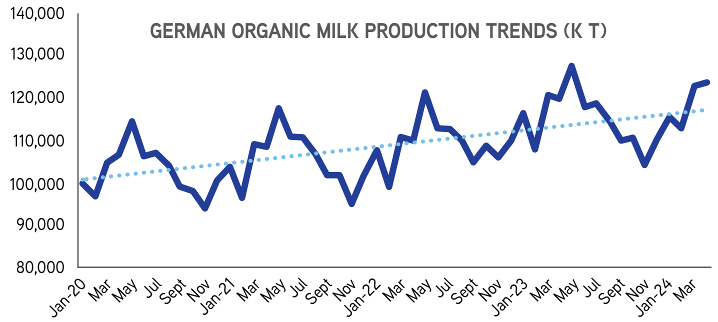
Germany and France are the two biggest countries in the EU for organic milk. Together with the UK the three countries account for half of Europe's total.

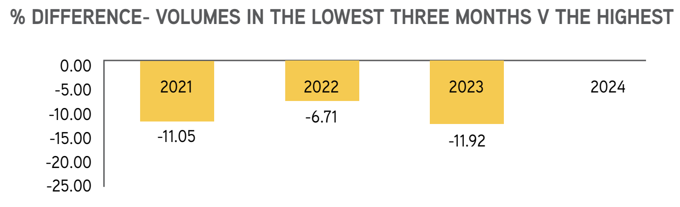
Germany is the EU's biggest organic milk producer, but its production profile is much flatter than ours, with a peak:trough ratio of 1.24 – similar to the UK's conventional ratio. A comparison of the top three months (March, April and May) against the lowest three (September, October and November) put the percentage differential at 7% to 12%. In comparison to the UK, German milk volumes have actually increased over time, rather than decreased.

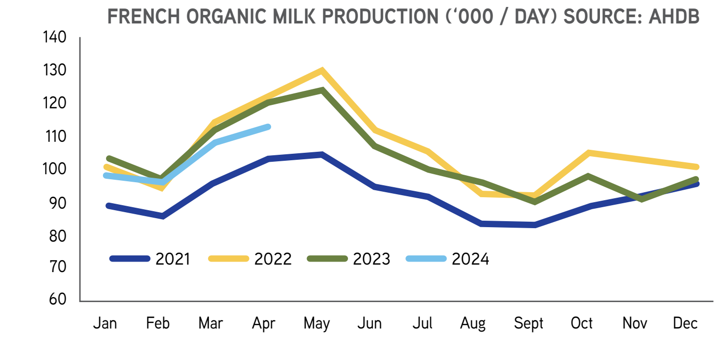
French organic milk volumes have been increasing over time, too, with a huge jump between 2021 and 2023. Like the UK, though, France also has a very seasonal profile - not least due to a very seasonal pricing policy. Its peak:trough ratio is around 10%, with the difference between the top highest three months and the lowest ranging from 17% to 22%:

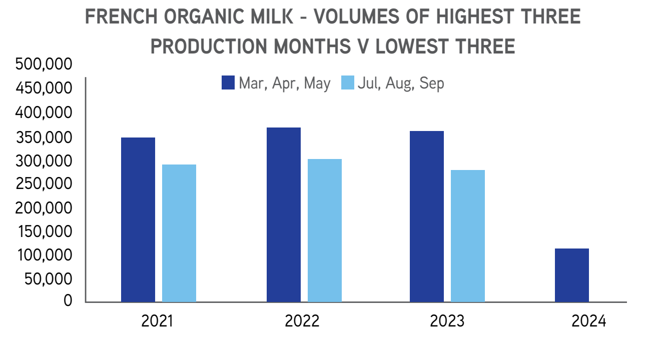


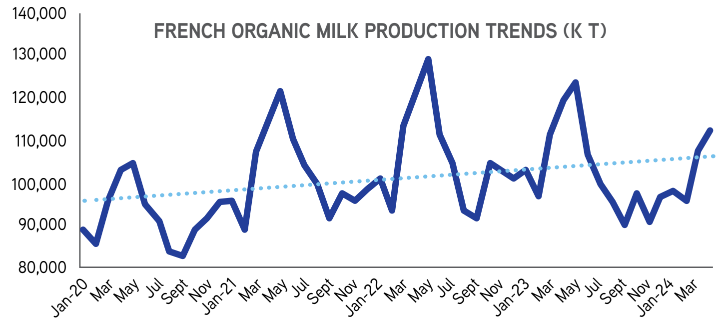


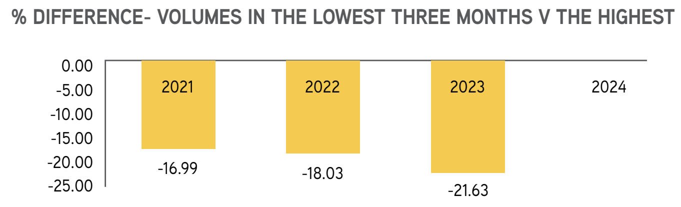












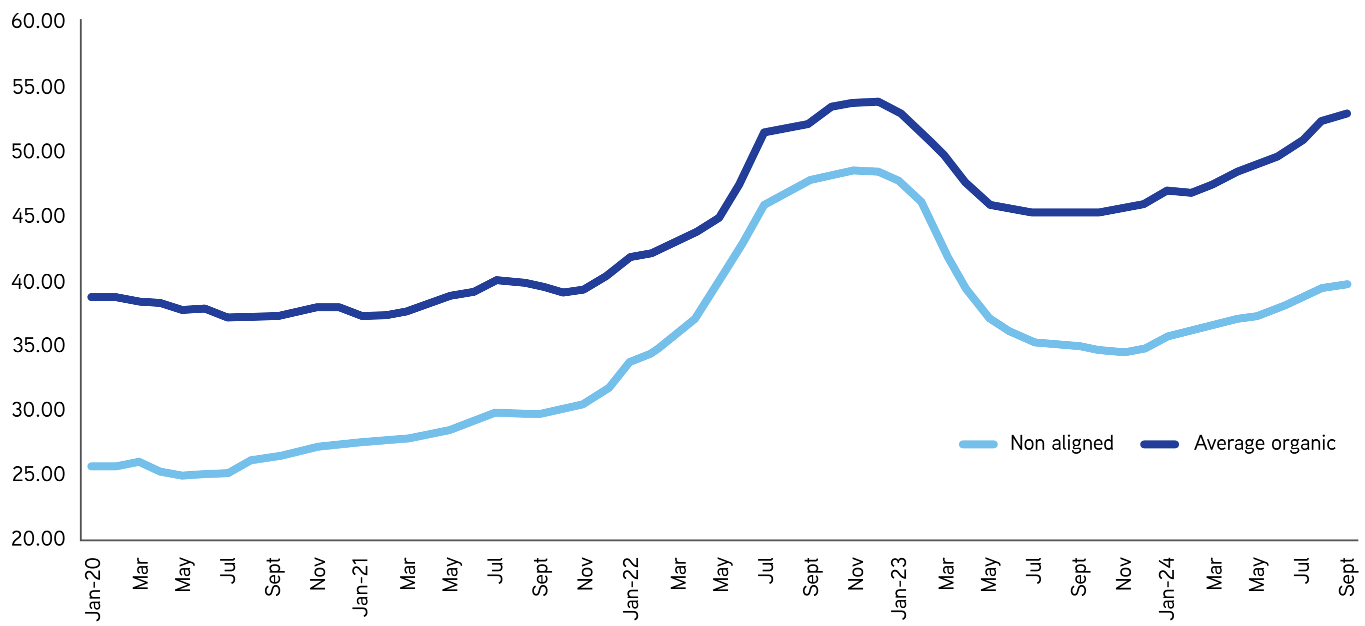
WHAT'S HAPPENED TO MILK PRICES?

The surplus of milk and lack of demand resulted in a crash in the milk price, most clearly defined from late 2022.

The drop-off in organic volumes is intrinsically linked to the lower milk prices – especially when twinned with higher production costs. Historically there has been a premium of 35% to 40% for the organic milk price compared to the conventional price, but this closed between April 2022 and March 2023 to a premium of less than 9%.

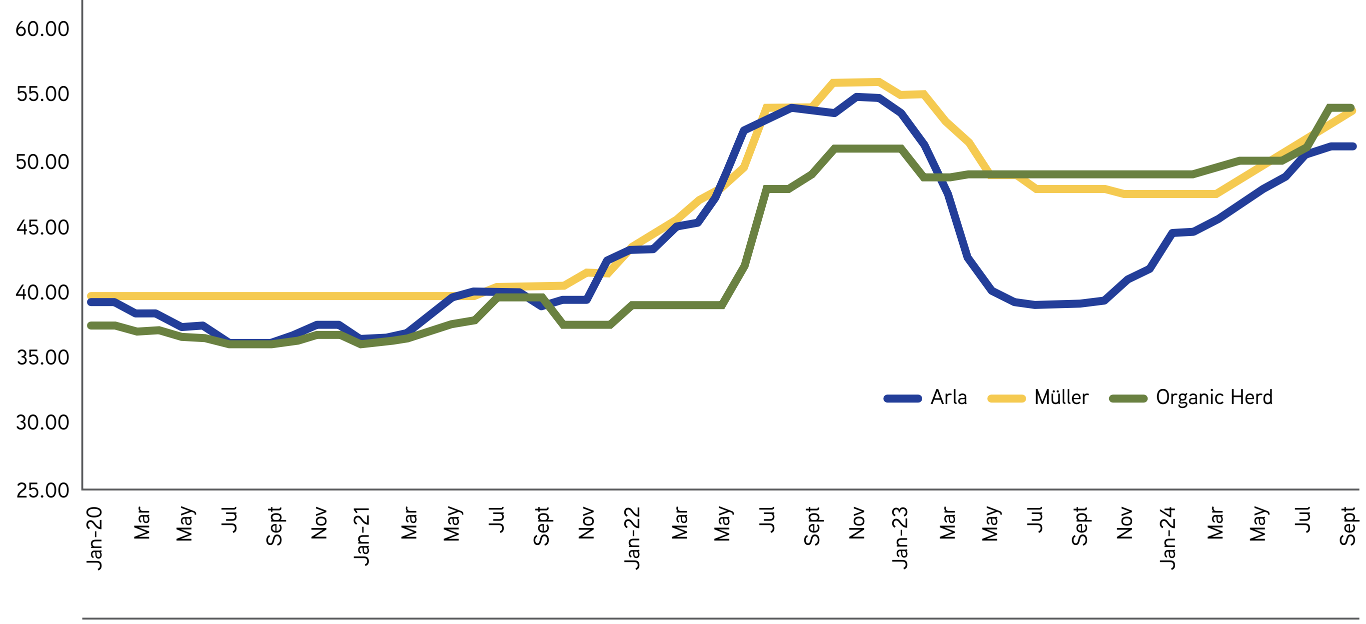
More recently, though, organic prices have increased proportionally more than conventional prices to lift the differential above the 30% threshold in April, and on to 35% for July:

NON-ALIGNED CONVENTIONAL PRICE V ORGANIC MILK PRICE (EX SEASONALITY) PPL



(Liquid standard litre prices)

ARLA V MÜLLER V ORGANIC HERD ORGANIC MILK PRICES



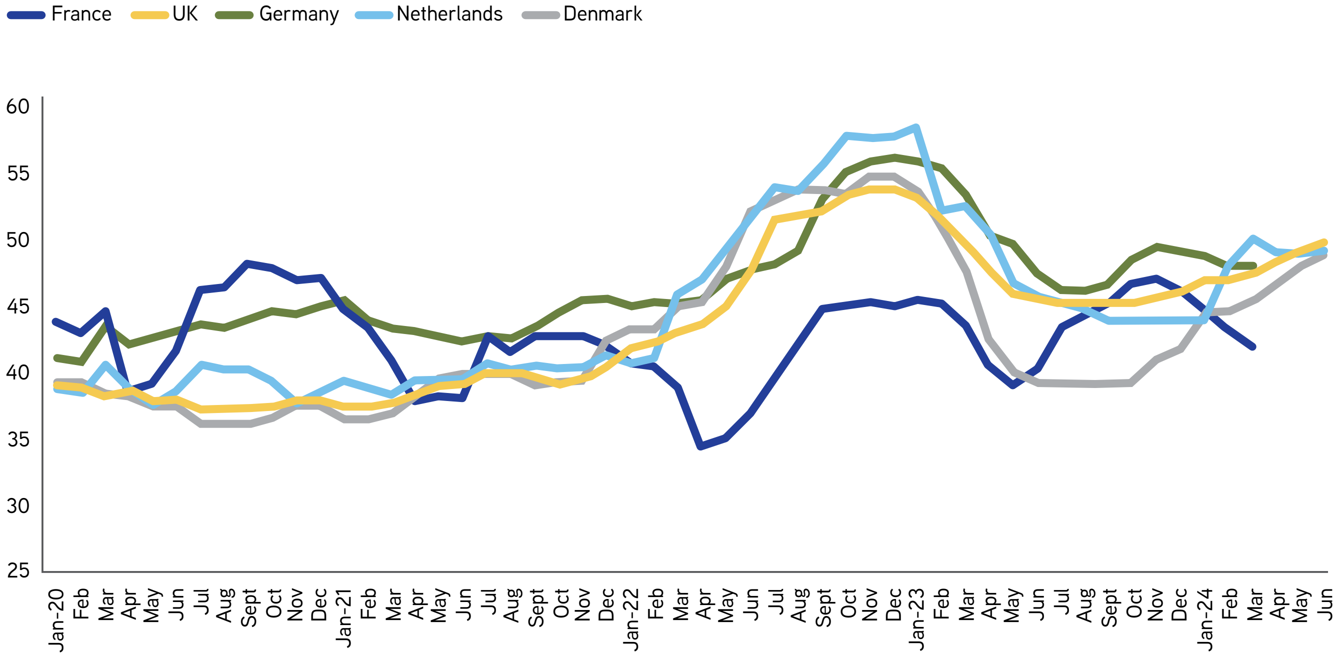
The Organic Herd price cut from September 2022 was effectively filled between January & March by retrospective payments to members based on better business performance.

WHAT'S HAPPENED TO DEMAND, PRICE & VOLUME IN OTHER EU COUNTRIES?

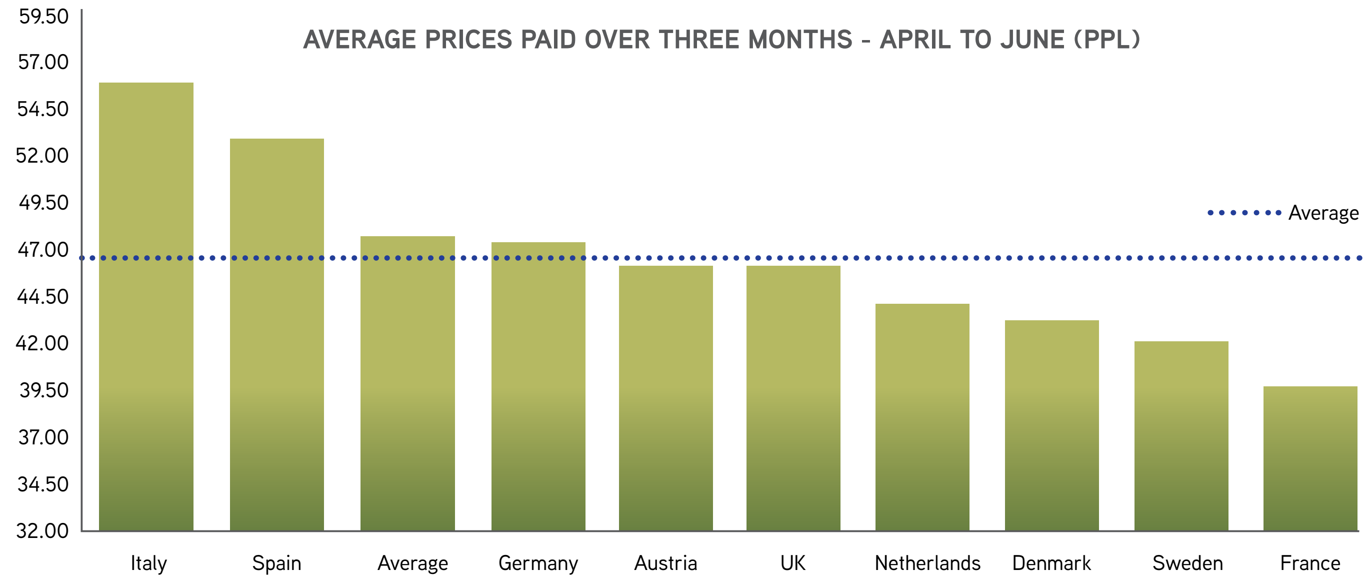
As discussed earlier, the UK organic market does not work in isolation. Some of the pressure felt by the UK organic market was also felt across Europe. In late 2021 Lactalis announced it had converted 650 farms from conventional to organic (it is not known what percentage that represents). Its organic volumes had increased 12% and at that time it was processing 20% of the organic milk into conventional products. It subsequently cut back on production.

Like the UK, many countries suffered from falling demand and over-production in the organic sector. Consequently, some other European countries saw even poorer milk prices, and greater reductions than the UK. But they, like us, are recovering again:

EU AVERAGE ORGANIC MILK PRICE TRENDS (PPL)



For the last quarter the UK has been mid-table on prices compared to other major EU organic milk producing states:



ORGANIC COSTS OF PRODUCTION

Another of the major issues that has affected the organic sector over the last few years has been production costs, not least feed, accounting for up to 60% of costs for those on year-round systems.

The availability and price volatility of organic raw materials has been affected by global politics and transport costs, alongside normal supply and demand factors. The challenges of Covid and the outbreak of the war in Ukraine, were two key factors contributing to a period of particularly high feed costs, in turn playing a significant role in the unprofitability of the sector in that year, and the subsequent collapse of milk volumes. Since then, though, raw material and thus feed prices have fallen to more normal levels:

ORGANIC FEED COST FOR 18% RATION (£/T)

However, costs are starting to increase again now (June 2024), and an 18% compound is now up £5 on the May lows, with freight the main driver. This is up significantly from the lows of October 2023, with the Shanghai to Rotterdam shipping route now costing as much as £180/t more for soya than at its lows. This will filter through to farm gate after the lag period ends. Overall soya is up £55/t on April lows due to exchange rates.

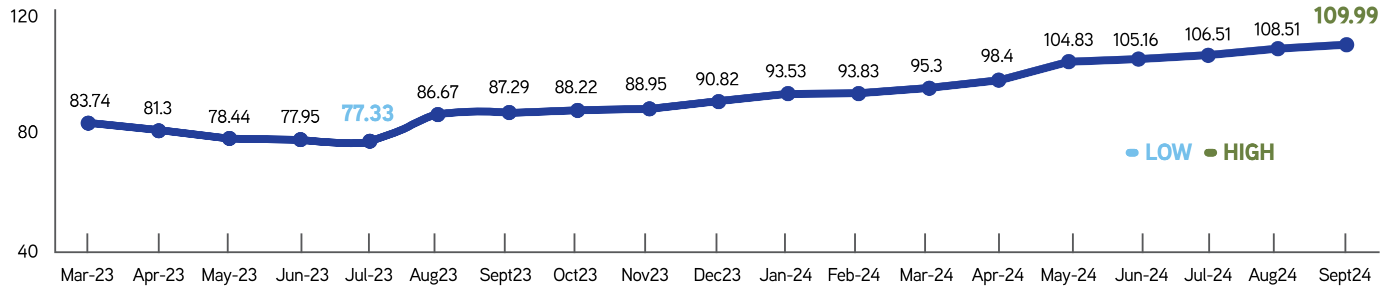
Currently costs range from the mid 40p range for spring block calver herds in the spring, to around 50p for autumn calvers, and to well over 50p and on to as high as 52p-53p (net) for all-year-round calvers delivering the flattest of production profiles, and with the total cost of production at nearly 60p.

MILK PRICE:FEED PRICE RATIO

The recent increase in milk prices and decline in feed costs puts the organic Milk Price:Feed Price Ratio at above 1 for the first time since we started tracking it in September 2022. This is above the medium-term average of 0.86. The higher the ratio, the more farmers are likely to justify feeding more organic concentrate, and to also feed nutritionally rather than to a budget, which will help to increase milk yields and put organic volumes back on the road to recovery.

However, the fact is that feeding is not going to be a solution to this year's volume problem.
Farmers may feed more, but not enough, and the cows will not respond enough to plug the likely gap later this year.

MILK PRICE : FEED PRICE



With this weeks price rises announced the predicted MP:FP ratio for September has increased again a rise of 1.36% on August.
We are now in uncharted territory and would have to dig deep in to the history archives to find the last time these levels have been seen.

WHAT CAN BE DONE ON VOLUMES IN THE SHORT-TERM?

If volumes this Autumn look as if they will fall short against demand, and feeding will not be enough to lift output, then the only recourse is to divert organic milk from other destinations. And there is an obvious one:

Currently organic farmers have to feed organic milk or very expensive milk replacers to organic calves for 12 weeks. Because of the cost of the latter, most farmers use their own organic milk instead. However, many of these animals - if not most of them - end-up in the conventional beef supply chain. If the certification bodies were to grant a derogation, or ideally a parallel regulation, allowing calves that will ultimately enter the conventional beef supply chain to be fed on conventional powder, then this could immediately free-up perhaps 11 to 12m litres of organic milk for the general market.

REGEN AGRICULTURE - THREAT OR OPPORTUNITY?

Organic's struggles over the years have also coincided with increasing scrutiny directed at conventional agriculture in terms of its sustainability and the impact it has on soils, biodiversity, rivers, air pollution and the environment as a whole.

With calls to find "a different way", this is, however, not necessarily the organic way. It takes years to convert land, it is not easy to source cows, feed is expensive, and the returns have recently been very challenging.

The half-way house between conventional and organic is deemed to be regenerative (regen) farming, which offers great potential for all farms, whether big or small, intensive or extensive, to improve farming practices and outcomes on the above factors.

Unlike organic, though, there are no clearly defined standards. These are likely to either come in time, or become better defined through standards organisations like SAI Platform (Sustainability Agricultural Initiative), and progress is being made.

There are certainly some significant names backing regen farming, notably First Milk in dairy which is calling itself the "regenerative co-op", and recognised organic brand Yeo Valley. In one of the biggest moves in the regen world in dairying, the two companies announced last June that they had agreed a new partnership to set-up a new regenerative milk pool in the Southwest of England as part of a "Naturally Better Dairy Group". The pool would be founded on the principles of "nature-positive farming" and would supply Yeo Valley with milk for processing. Farmers had to commit to deliver "ever better outcomes" for animal welfare, climate, biodiversity and local community. First Milk has completed its initial phase of recruiting interested farmers for around 50m litres of milk, and is now undertaking farm visits to determine which ones are most suitable to meet the pool's objectives.

The degree that regen will eat into organic dairy sales remains to be seen, but could be influenced by clarity of messaging. Regen could be seen as a challenge to what has been considered organic's unofficial mantra of being "better for the environment than conventional". It is likely to have a simpler message, and to be able to deliver that at a lower premium than organic, clearly an advantage in the market place as the 'cost of living crisis' has demonstrated.

With challenge is opportunity, and in fact embracing regenerative agriculture and helping to drive and shape what it actually looks like, can be to organic's advantage. Helping to avoid or reduce the risk of consumer confusion with regen messages, while repositioning and clarifying what it means to be organic, can bring benefits to the sector and the industry in general.

Traditionally, organic has not been good at describing itself and creating a narrative that consumers understand and can get behind. The emergence and rise of regen presents the opportunity for organic to address this. It needs to get better, and quickly, and above all, in a joined-up approach that highlights the positive, without creating division.

A commentary focused on organic being 'good' and conventional 'bad', with regen sitting somewhere between the two, serves no purpose other than to damage the whole farm sector. There is no right or wrong system, and the challenge and opportunity is to highlight the significant benefits of organic, and why it demands that premium, to the consumer.

CONCLUSION-THE FUTURE

This report's provocative title of "battered, bruised, but back on the up" sums up the last few years in the organic dairying world. A few years ago, processors had high hopes for growth, but those aspirations were knocked off course due to a multitude of factors outside the industry's control. Significant contraction of the industry has taken place, with the number of organic producers potentially dropping below 300, probably for the first time ever, and volumes dropping to potentially 350m litres from a high of 570m litres in 2019. The situation is similar in Europe, and other parts of the world too.

At the time of writing (July 2024) there is more cause for optimism amid rising consumer demand, as there are a large number of consumers who would like to shop sustainably but are confused about how to, and don't necessarily want to pay a huge premium for doing so. Milk prices and milk volumes are starting to lift again, but volumes are on a knife edge this Autumn and there is a risk that supply may not meet demand. The sector needs the certification bodies to be flexible, to allow the feeding of non-organic milk powders to calves destined for the conventional beef market, to free-up useful volumes of milk for the market.

In addition, processors have regrouped, rebranded in some cases, and are on the front foot again. There are seemingly good opportunities for growth. For example, the global market for organic milk was estimated by the research organisation Fact.MR to be worth $160m in 2022, having grown at 5% compound annual growth rate (CAGR) from 2018 to 2022, and is projected to grow at a CAGR of 6.5%, to reach a value of $320m, by the end of 2033. Demand for organic skimmed milk is projected to rise at a rate of 6% to $138m by 2023, it thinks, and UK sales are predicted to grow at nearly 6% to $23.6m by that time. The US and China are regions of particularly strong growth.

But it is critical for the success of the UK organic sector in the long-term that expansion is modest so that supply matches demand, and that the UK tries to move towards a flatter production profile. Expansion at the wrong time of year, resulting in a greater seasonal profile and higher peak:trough ratio, will only cause more problems and lower prices, as more surplus milk will be diverted from the organic market to the conventional one. It is also essential that organic does not attract those farmers who believe that converting to organic will save their flagging conventional business. If they can't make conventional farming pay, then they certainly cannot make organic pay.

It is also essential that the organic sector meets the challenges and opportunities of regen agriculture head on. Organic farmers have farmed regeneratively for years, and this can be used to address regen's reputational challenge to organic. The question has to be asked as to who in the dairy organic world will lead the charge and fly the flag for organic, promoting the merits over and above the regen surge.

Alongside that, as the cost-of-living crisis eases there is an opportunity for organic dairy to generically reposition itself in consumers' minds. It would be a lost opportunity if that fails to happen, although the question also remains as to who would do this, and what funds would be available.

There is a real opportunity for a processor or processors to take the lead in this space, and really drive the merits of organic dairy, but it remains to be seen who might step up.

As an industry organic dairy has much to shout about, but with few people currently doing the shouting, others are filling the void with their own stories. Organic may be on the up again now, with plenty of potential ahead of it, but with all the challenges in mind it is hard to know how high organic will climb, and to what degree the sector will return to its former glory, without also embracing these opportunities.

Kite