

the organic milk
market report
2010







“We are confident that overall consumer demand will continue to head in the right direction”



1. Introduction

Welcome to the latest edition of the OMSCo Organic Milk Market Report, which outlines the key developments in the industry over the last 12 months and gives an overview of the challenges that lie ahead.

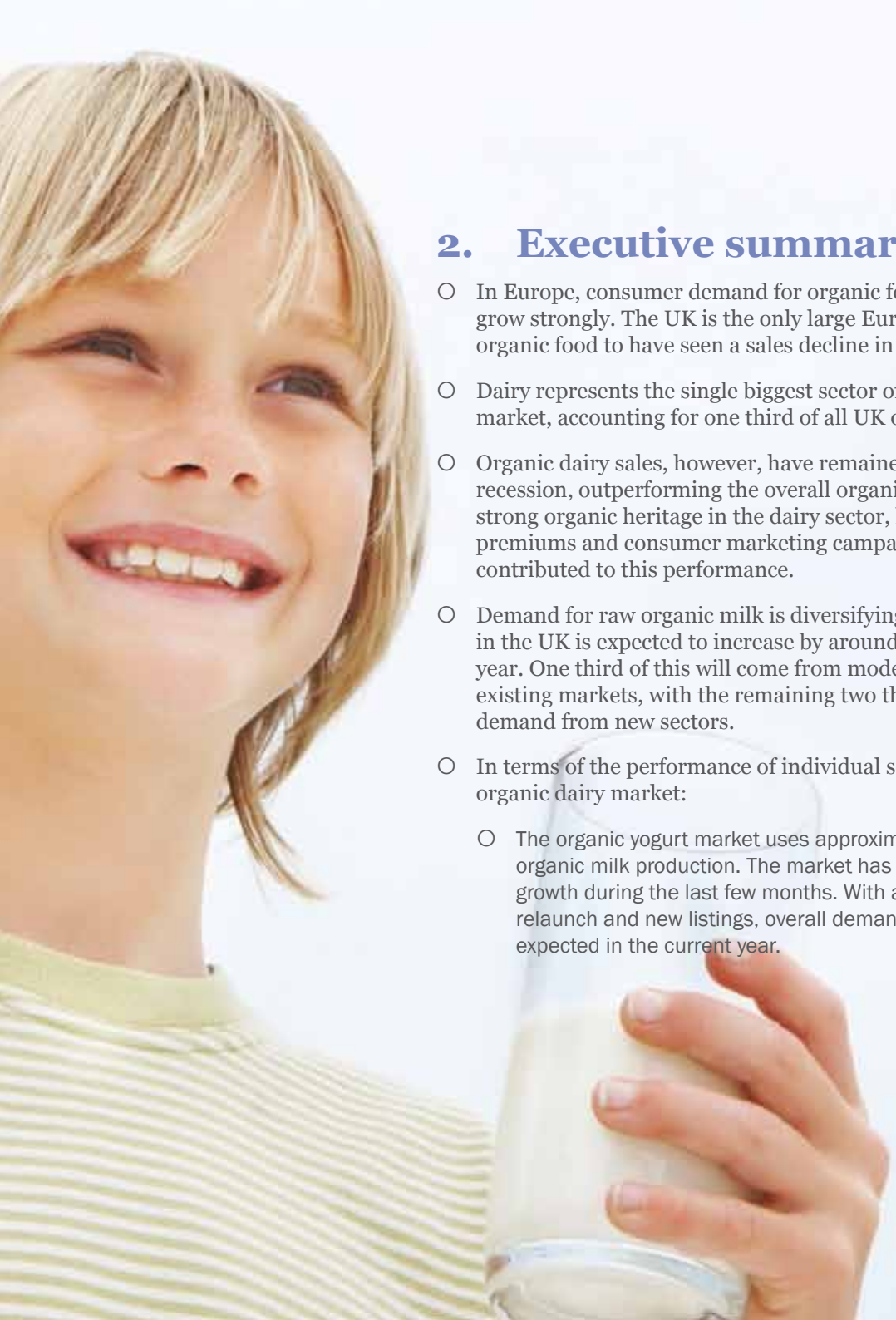
Whilst the 2009/10 milk year remained challenging for the wider organic food industry, optimism emerged as the year progressed. The dairy sector was almost unique in maintaining robust sales through the worst of the recession. The performance was all the more remarkable given it is also by far the largest organic sector, and therefore perhaps had most to lose. There were a number of reasons behind this – a low shelf premium and strong market penetration, particularly in yogurt and liquid milk – along with brand developments and continued marketing investment have contributed to stable sales. In addition, new markets have started to emerge. As the organic industry matures, demand for organic ingredients has continued to grow and developments in foodservice have also led to higher sales.

The result has been steady underlying growth for organic raw milk since a low point in the spring of 2009. However, increasing consumer choice in the milk aisle, and new competition from ‘premium’ milks, means the organic brand will need to reassert its benefits if it is to prosper. With the success of marketing investment during the last year, increased activity is planned from both branded producers and OMSCo’s generic campaign for the coming 12 months. We are confident that overall consumer demand will continue to head in the right direction.

On the supply side, the situation remains quiet but underlying concerns remain about the viability of organic production in a climate of rising conventional prices. A significant number of organic producers left the industry at the start of 2009, although this was outweighed by the arrival of the final round of new converters during the year. Since then the situation has stabilised but recent increases in conventional prices are starting to show through in increasing exit rates, which is outweighing expansion from existing producers. Cost pressures and lower returns over the year have resulted in little interest in conversion, indeed no new producers are currently in the pipeline.

The increase in overall raw organic milk demand, combined with lower supplies and the low appeal of organic conversion is expected to result in a gentle but steady upward pressure on milk prices as the market tightens in the months ahead.

Nicholas Saphir, Executive Chairman



2. Executive summary

- In Europe, consumer demand for organic food continues to grow strongly. The UK is the only large European market for organic food to have seen a sales decline in the last year.
- Dairy represents the single biggest sector of the organic market, accounting for one third of all UK organic sales.
- Organic dairy sales, however, have remained resilient during recession, outperforming the overall organic market. The strong organic heritage in the dairy sector, low organic premiums and consumer marketing campaigns have all contributed to this performance.
- Demand for raw organic milk is diversifying. Overall demand in the UK is expected to increase by around 9% in the current year. One third of this will come from moderate growth in existing markets, with the remaining two thirds derived from demand from new sectors.
- In terms of the performance of individual sectors of the UK organic dairy market:
 - The organic yogurt market uses approximately 17% of raw organic milk production. The market has seen a return to growth during the last few months. With a major branded relaunch and new listings, overall demand growth of 4% is expected in the current year.
 - Organic cheese uses approximately 11% of raw organic milk production. The performance of organic cheese has been disappointing. Although sales of own label increased during the year, a sharp decline in branded sales, driven by supermarket delists, outweighed the growth in own label. A decline of 5% is anticipated in the current year.
 - The organic liquid market uses almost 60% of raw organic milk production and continues to demonstrate slow but steady improvement in consumer demand. Latest 12 weekly data shows a recovery in this position and the latest four weekly data shows a moderate growth. Demand growth of 2% in the year ahead is anticipated.
 - New market sectors, including solid demand from export customers, now utilise around 15% of estimated UK production of raw organic milk, and continues to increase.
- The performance of the organic dairy category has varied dramatically between retailers. In most cases a performance - whether it be good or bad - is reflected across all three of the key segments – liquid, yogurt and cheese.
 - Sainsbury's have retained a focus on organic and have benefitted from strong growth across the dairy category.
 - A number of other retailers have diverted focus to other offers and performance has suffered as a result.

Demand for raw organic milk is diversifying, and is expected to increase by around 9% in the coming year

Supply is expected to decline by around 3% in the current milk year, the first decline in overall output for more than six years



- The combined Co-op/Somerfield group has suffered particularly badly, with a noticeable share decline in all segments. In the case of organic liquid milk, the market would have remained in growth throughout last year if the effect of the Co-op performance is removed.
- Consumers continue to struggle to identify the value of organic, and as such it is vulnerable to being seen as poor value for money. The diversity of organic benefits is the sector's biggest strength. Its inability to create a single, identifiable message around these benefits is its biggest weakness.
- The benefits of organic milk are less well understood than for organic food in general - the avoidance of pesticides being a main driver of organic fruit and vegetable consumption. However, the lower price premium of organic milk is also better understood.
- Organic milk often follows the choice of organic baby food and has become the main entry point for families into the organic category, supported by the low price premium. Marketing activity and consumer education is therefore a vital component of future growth.
- The weight of organic marketing will increase with the announcement of a new EU-funded organic marketing campaign for 2010, the first of its kind in the UK.
- Organic milk supply in the UK has peaked. The arrival of the final group of converters last year resulted in supplies increasing by more than 13% in 2009/10.
- Supply is expected to decline by around 3% in the current milk year, the first decline in overall output for more than six years.
- This decline is driven by the full year effect of last year's exits outweighing the expansion of existing producers, and the lack of any new converters entering the market.
- The exit rate has slowed in 2010 but risks increasing as recent conventional price rises feed through into lower organic farm gate premiums. Current organic farm gate prices do not provide an economic incentive to farm organically.
- Overall, growing demand and a leisurely reduction in supply means the market is expected to continue to tighten in the year ahead. This will place some upward pressure on milk prices which is required in order to halt the exits from the industry.
- A key priority is to halt the exit rate, whereupon the natural expansion of existing producers will ensure that sustainable supplies capable of meeting expected demand growth can be maintained without resorting to new conversions.
- The structural inefficiencies of seasonal production, a high proportion of 'flat' demand and the costs of downgrading organic milk to conventional means the cost of balancing in the organic market is much higher than in the conventional industry. There is great potential to improve farm gate returns through improving organic cheese market performance and by ensuring access to ingredients manufacture to make efficient use of seasonal supply.





3. Organic demand

The market for organic food

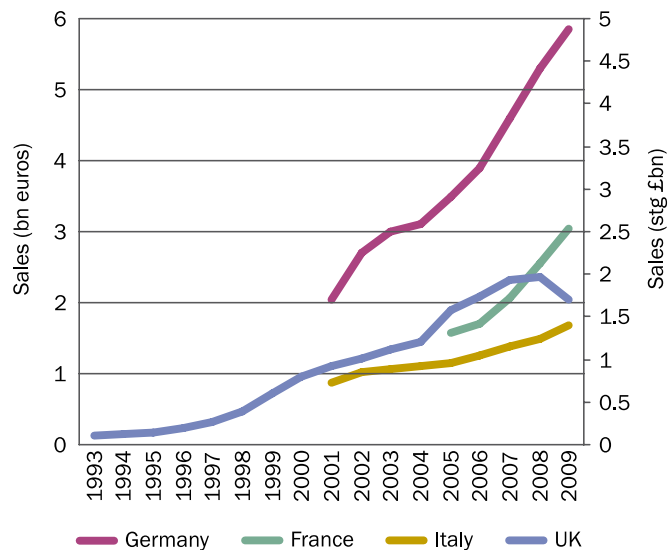
The benchmark study for the performance of the organic industry within the UK is published annually by the Soil Association. In the year to December 2009, sales of organic products fell 12.9%.



The rapid emergence of new markets is a key factor in the increasing demand for raw organic milk



Total organic sales in largest EU markets

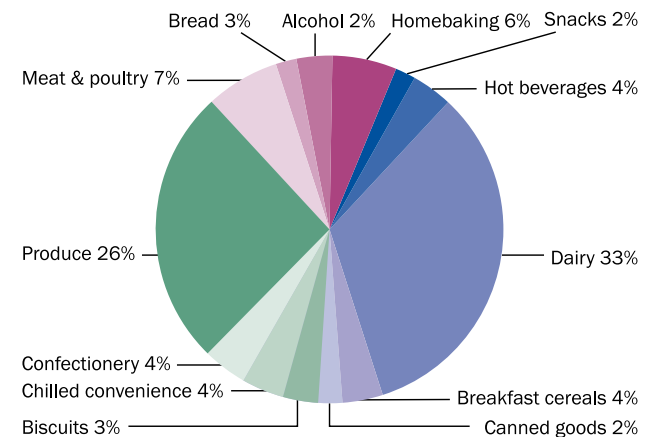


Source: EU organic market review, 16th July 2010

Whilst many sectors have subsequently improved sales, the UK market performance is at odds with the EU average, where strong growth is forecast to continue according to the EU Organic Market Review published 16 July 2010. There are a wide range of reasons for this, including lower overall penetration of organic foods in some countries, but it is worth noting the more favourable guidance given by official bodies to the benefits of organic products in a number of EU states, which has supported demand during the recent economic downturn. To date this has not happened in the UK, and is undoubtedly a factor in a declining UK performance relative to the other big member states, all of whom continue to see strong growth.

The organic market in the UK remains dominated by primary produce in the form of dairy, fruit & vegetables and meat. This reflects the early development of the organic industry, and that these sectors reflect the organic attributes with which consumers tend to identify most readily. Indeed, there is research showing that consumers value organic attributes less favourably the more they perceive a product to be processed. The chart below shows the breakdown of the market by value, excluding baby food, for the 2009 calendar year.

Sector share of total organic sales



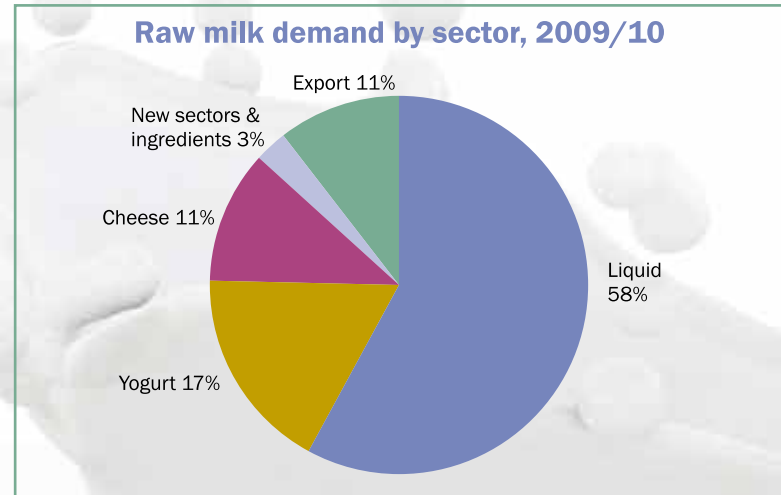
Source: Soil Association organic market report 2010

The decline in sales in the wider organic market has been well documented, but the performance of different organic sectors has varied widely. Range and space decisions by the major multiple retailers have had a significant impact on the fortunes of different sectors, as recession has seen space devoted to value offers increase at the expense of premium and organic lines. The extent to which this impacts different organic sectors varies, as has the amount of focus placed on organic ranges by the different retailers. This has translated into big performance differences not only between the different organic categories but also between the retailers themselves.

The market for organic dairy products

The use of organic raw milk in the dairy sector is shown below. Whilst the liquid milk market still dominates, the rapid emergence of new markets is a key factor in the increasing demand for raw organic milk, and now accounts for around 15% of all sales. Indeed, these have grown to such an extent that demand for raw organic milk, once very closely linked to retail performance of liquid and yogurt, is showing a marked divergence to the traditional measure of organic sales via Kantar and Nielsen.

Sector trends



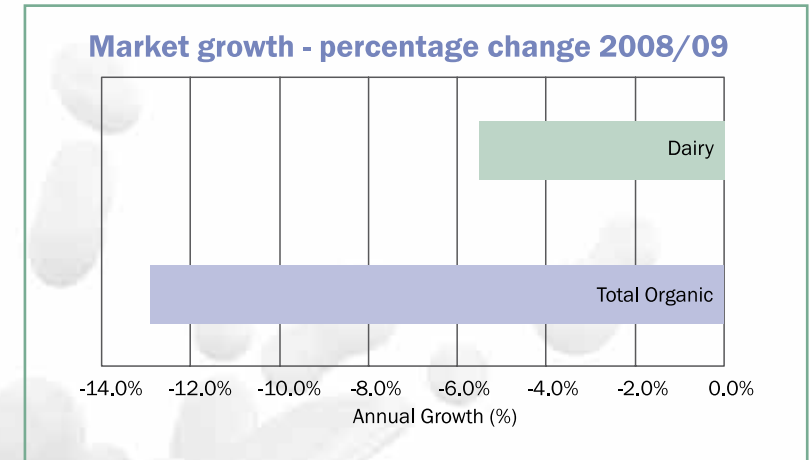
Source: OMSCo estimates

Meanwhile, the organic dairy market remains a very small proportion of overall dairy sales. The table below shows the share of the three primary sectors that make up 85% of the total demand for raw organic milk.

Sector	Organic share of total sector (%)
Liquid Milk	3.2%
Yogurt	6.4%
Cheese	1.3%

Source: Kantar June 2010

The 2010 Soil Association annual report highlighted the performance of different organic sectors in the year to December 2009. Organic dairy fared much better than most other organic sectors during that time and as the largest organic category, it has been an important beacon for the industry.



Source: Soil Association annual report 2010

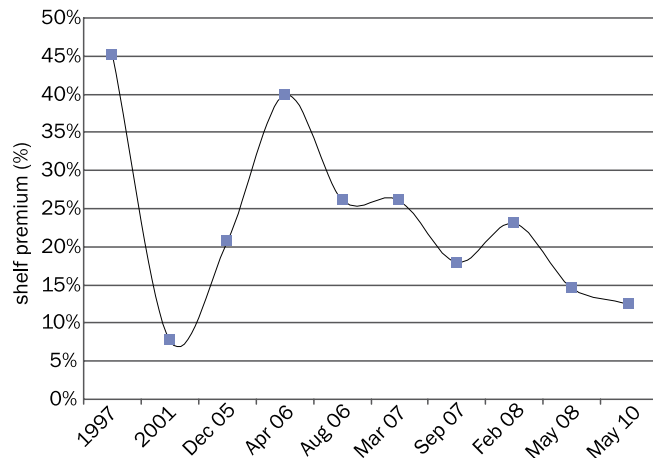
There are a number of reasons for this. Firstly, organic milk and yogurt have been leading the development of organic sales for many years, as a result of which they have one of the highest shares of their respective market sectors. They have therefore become part of the shopping habits of millions of people in a way some other categories have not. Strong brands in the case of the organic yogurt market and habitual purchasing in the case of liquid milk have played their part in retaining customer loyalty. Secondly, price premiums in the organic dairy sector are generally lower, as can be seen from the graph below, and it is therefore not an obvious area to economise during recession. Finally, marketing developments in terms of generic and branded advertising have played their part in maintaining demand.



The organic dairy sector fared much better than most other organic sectors during recession



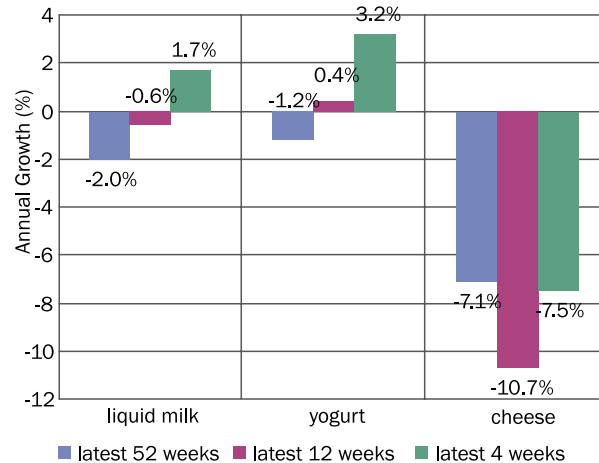
Organic shelf premium of 4 pint standard milk



Source: OMSCo research

Since the start of 2010, organic dairy sales have improved. The top two sectors, liquid and yogurt, account for 75% of sales and here the decline has slowed to 2% and 1% respectively for the year to July 2010. More recent 12 weekly data shows the organic yogurt market back in growth and organic liquid not far behind. With

Growth rates by key organic dairy sector



Source: Yogurt data: Nielsen scantrak/homescan June 10. Cheese & milk data: Kantar June 10

a major relaunch of the UK's largest organic yogurt brand and increased advertising pending for the autumn in the liquid market, future prospects are encouraging.

Despite these positive trends, cheese remains a challenging market, with the growth achieved in 2008 being largely reversed as a result of lower promotional activity and a significant amount of instore range rationalisation by the big retailers. Although the organic cheese market uses only around 10% of raw milk output, it is nevertheless an important market for balancing raw milk supply.

Retailer trends

In terms of trends in retailer performance, sales trends in organic dairy, and particularly in liquid milk, have followed a similar pattern across all retailers, who tended to benefit in unison from overall market growth. However, in more recent times, there has been a marked difference of the fortunes of organic dairy products within each retailer's dairy category, as seen in the table below.

	Share of total dairy 2009	Organic Yogurt change YOY (%)	Organic Cheese change YOY (%)	Organic Liquid change YOY (%)
Tesco	27.5%	-3.5%	-25.8%	-8.7%
Sainsbury	23.6%	+5.7%	+41.4%	+8.8%
Waitrose	17.4%	+19.6%	-11.6%	-4.2%
Asda	9.2%	-25.9%	-46.2%	-0.6%
Morrisons	6.4%	-15.8%	-38.2%	13.1%
Co-op	4.0%	-24%	-46.9%	-39.9%
Others	11.9%	+27.8%	+3.2%	+2.1%

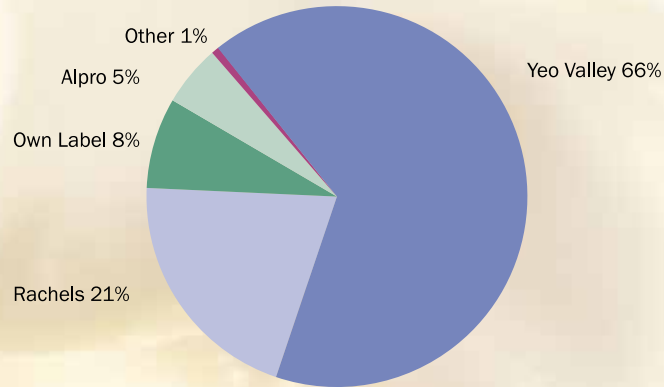
Source: 1st column Kantar Dec 09, other data: Nielsen/ Kantar June 10

What is clear from the data is that where retailers show a solid performance in one area of organic dairy, it tends to be reflected in the other main market sectors as well. The change reflects the strategic focus placed on organic ranges during recession by the retailers concerned.

The organic yogurt market

The organic yogurt market has returned to growth during the last quarter, with a latest 12 weekly performance of +0.4%, a performance that is accelerating. This is a solid sign of progress in a market which has long had a strong organic presence – more than 6% of yogurt sales are organic, double that of liquid milk and five times that of cheese. The organic yogurt market remains unusual in that it is dominated by brands. Branded share of liquid milk is less than 10% of total sales, in the cheese sector, branded sales have fallen back to just 19% of the market. In yogurt however, brands are strengthening their position, accounting for more than 90% of total sales.

Annual share of organic yogurt



Source: Nielsen Homescan June 10

Yeo Valley volume increased more than 8% in the last year, and although Rachels has declined over the same period, the most recent 12 weekly data shows a strong reversal of this trend, with a 19% growth over the equivalent period in the previous year. Own label continues a rapid decline from a small base, driven principally by range rationalisation in the key retailers.

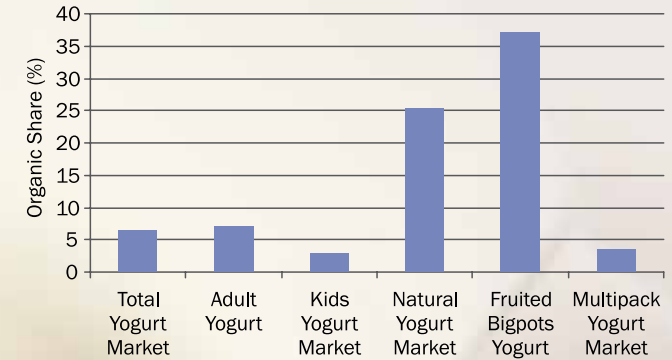
Annual Volume Change (%)

Yeo Valley	+8.4%
Rachels	-4.8%
Own Label	-37.6%
Alpro	-14.4%

Source: Nielsen Homescan June 10

The organic share of different sectors of the yogurt market varies dramatically. The organic presence in natural yogurt and in big pot sales is very strong, whereas in the children's and multipack segments of the market, organic presence is weak.

Organic share of yogurt market segments



The apparent gulf in organic share between the 'family fodder' and the more indulgent product reinforces the notion that the organic values in the yogurt sector are reflected in the taste, use and eating occasion of the product.



The organic yogurt market has returned to growth in the last quarter



Retailer data shows that where distribution and promotional activity have been maintained, organic cheese sales have performed well



The organic cheese market

The organic cheese market has suffered an overall downturn of 7% in the last year, following a period of strong growth in certain segments during the previous year. There is a trend towards own label which is growing, and a trend towards cheddar which is also seeing improved performance.

The branded organic cheese sector suffered a 40% fall in volume, following a 25% increase the previous year. Own label, with a more stable on-shelf presence fared much better, growing by 6.4%, and now accounts for more than 80% of total organic cheese sales.

	vol (tonnes)	share of sales (%)	% change year on year
Total Organic cheese sales	3341		-7.3%
Brands	632	19%	-40.3%
Own Label	2709	81%	+6.4%

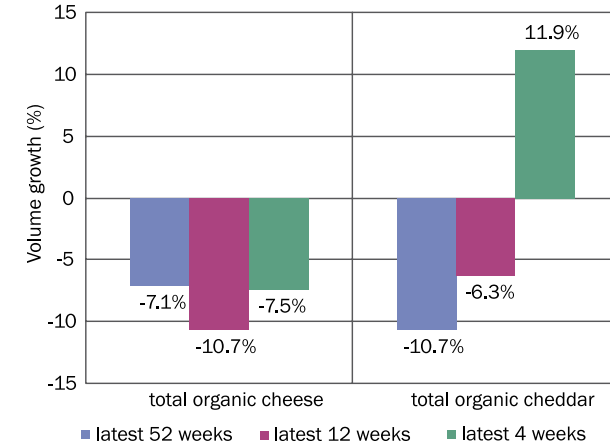
Source: Kantar June 10

A range of factors have contributed to this. Firstly, distribution has suffered in a market where much range rationalisation has taken place. This has impacted particularly on branded offers, which account for just 20% of total organic cheese sales. Secondly, the increasing frequency and depth of promotional activity in the conventional market has stunted the potential for organic cheese in all segments. For example, promotions now account for two thirds of conventional branded cheese sales, compared to just 4.5% in the organic market.

The other noticeable trend is the continued migration to block cheddar, growing to 56% of the organic cheese market. This is for similar reasons to the migration towards own label – a more stable product range amongst the retailers and a more assertive promotional push has led to improving performance in the last few months.

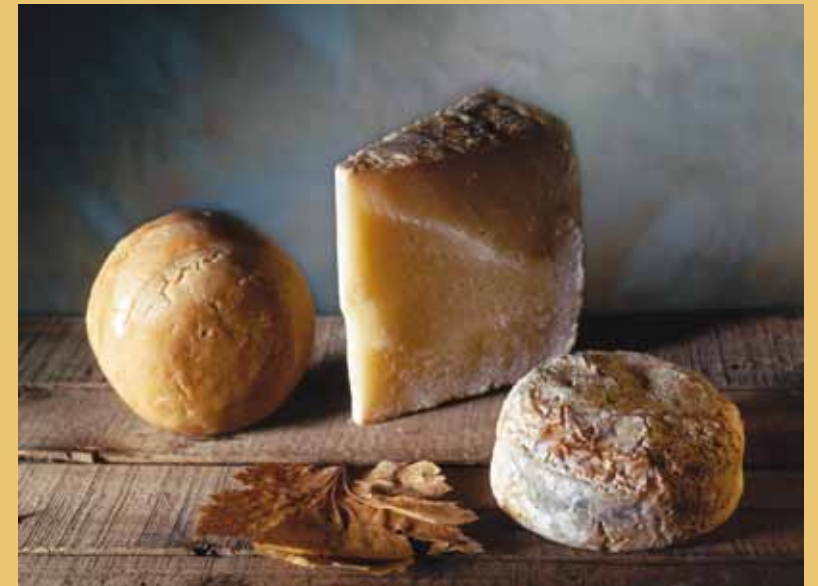
Retailer data shows that where distribution and promotional activity have been maintained, organic cheese sales have performed well. Sainsbury's has been unique amongst the major retailers in retaining its promotional focus and has seen strong sales growth, with organic cheese volume increasing 41% on the year.

Organic cheese performance



Source: Kantar June 10

The organic cheese sector is perhaps the most obvious example of the impact that recession and changes to the instore environment can have on the performance of an organic category, as well as highlighting the continued growth potential where the support for range, space and promotional activity is maintained.



The organic liquid milk market

Key Trends

The organic liquid milk market is the single biggest organic sector within food. The liquid milk market has also remained highly resilient in the face of the economic downturn, with only a marginal decline in the annual sales to June and stronger performances still in recent months.

Recent consumer trends towards understanding where food comes from, improving school and hospital food, and growing food at home have translated into new consumer behaviour in the shops. Spurred by recession, consumers are rediscovering cooking at home, with categories such as homebaking enjoying a resurgence.

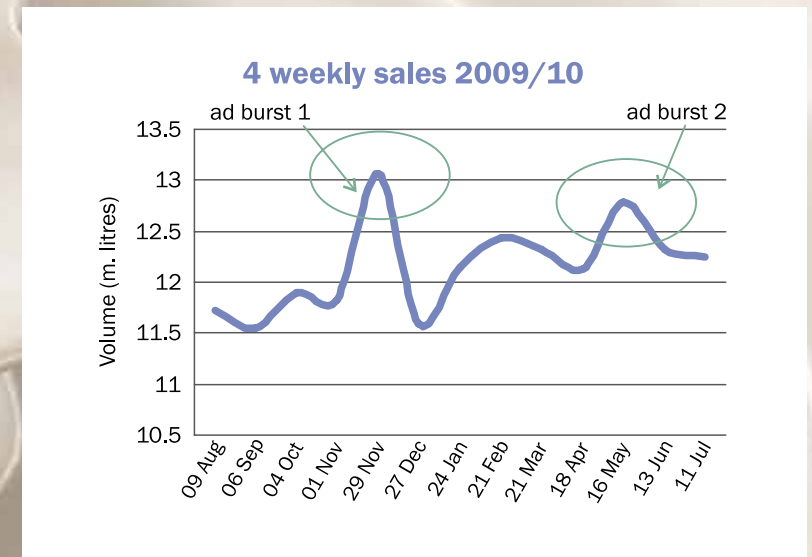
Milk in particular is well placed to benefit from this trend - the data below illustrates the new diversity of usage occasions when it comes to liquid milk.

	Average pint	
	2009	2010
milkshake	4.0%	5.6%
baking	4.0%	5.5%
kids	7.0%	7.0%
cooking	7.0%	7.3%
drinking	12.0%	12.0%
coffee	17.0%	16.5%
tea	22.0%	19.5%
cereal	27.0%	26.6%
	100.0%	100.0%

Source: OMSCo research

Consumer choice has continued to diversify in the liquid milk sector. Growth in the filtered milk category has been maintained, with strong backing for both the Cravendale brand and Tesco Pure, whilst Channel Island has also enjoyed a resurgence of late, albeit off a much smaller base. Sales of modified milks have petered out in the last year, and the overall UHT market has also reversed the growth achieved during 2009. At the same time, the increasing availability of the 'value' milk offer in the major multiples means the entry point is lower. Offers targeting specific welfare and environmental attributes are being introduced by multiple retailers, whilst the concept of 'local' milk has also taken a back seat, featuring much less prominently on the shelves than was the case a year ago.

The effect of these developments is to raise the bar once more – it will need the organic 'brand' to continue to reassert its positioning if it is to prosper. In this regard, mainstream marketing initiatives are a relatively new feature of the organic milk market and the evidence of their effectiveness is encouraging – the chart below shows sales against the two latest bursts of OMSCo TV advertising.



Source: Kantar June 10



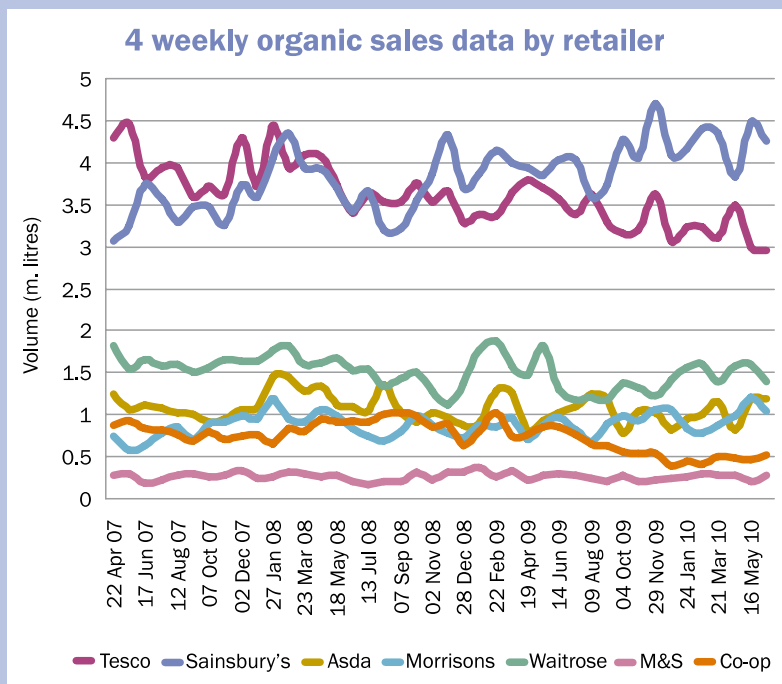
Sainsbury's has continued to generate strong growth off a high base and remains the primary driver of volume in the market at present



Existing channels of distribution

In the last few months sales have started to recover. Latest 52 weekly data shows market growth of -2.1% for the 52 weeks to July, but the latest 12 weekly data shows the decline has slowed to -0.6%, with the latest four weeks back into year on year growth. This is a similar trend to the yogurt market and is an encouraging sign for the year ahead.

Retailer performance has been varied. The graphs below show the dominance of Sainsbury's and Tesco and the big switch in performance between the two in the last year. Sainsbury's has continued to generate strong growth off a high base and remains the primary driver of volume in the market at present. Morrisons have also grown successfully.

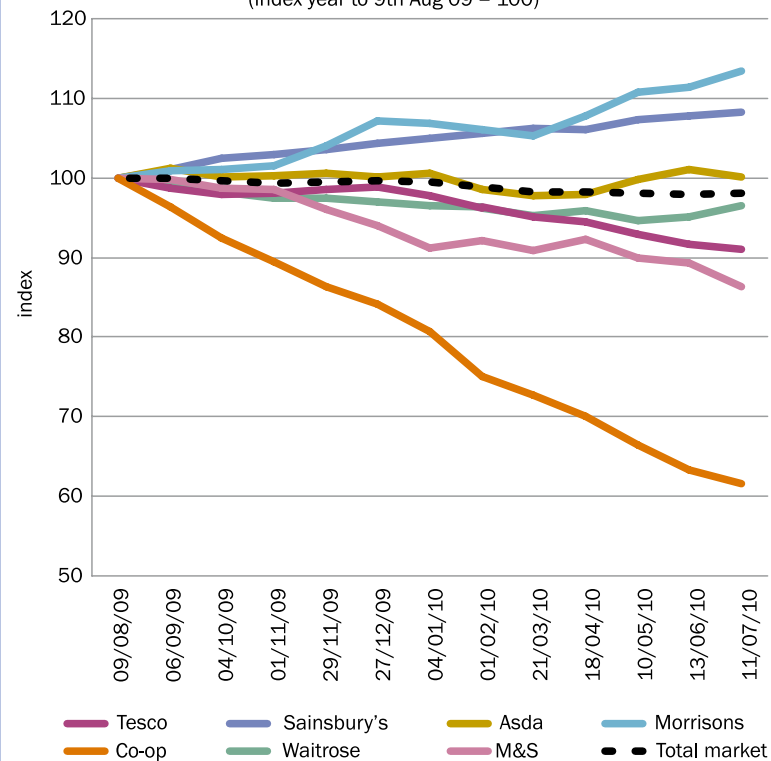


Source: Kantar June 10

The following graph shows the indexed sales of organic liquid milk by retailer, illustrating the big reduction in sales at the Co-op in particular. Indeed, the overall market would have remained in growth throughout last year if it were not for the Co-op's performance.

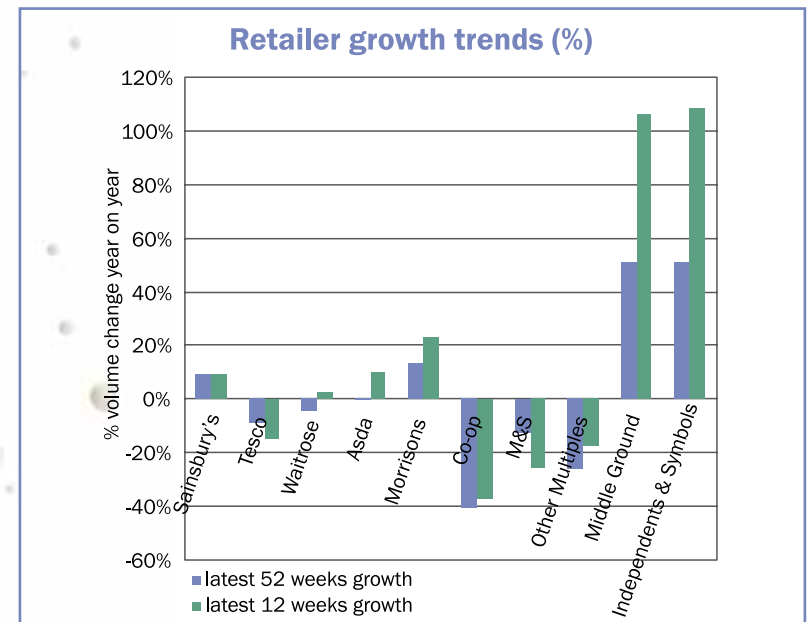
Index of annual organic sales trends by retailer

(index year to 9th Aug 09 = 100)



Source: Kantar June 10

Looking at the changes to growth rates over time also shows a marked difference in performance between retailers. Sainsbury's, Asda and Morrisons are all growing ahead of the market, and a recent performance improvement at Waitrose suggests they will soon be back at parity. The middle ground and independent sectors are also growing strongly, as distribution of organic milk increases in these channels. The two notable negative performances are Tesco and the combined Co-op/Somerfield group – the former because of the size of the volumes involved and the latter due to the speed of decline currently being experienced.



Source: Kantar June 10

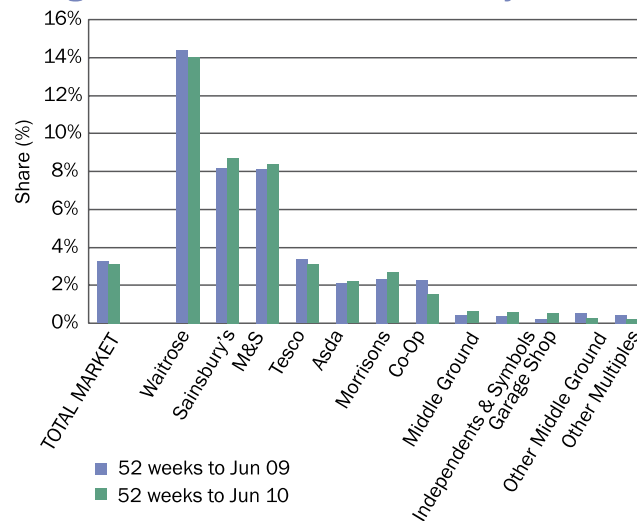
Growth potential for organic milk remains huge. Sales still account for less than one in 30 pints sold, although the organic share of milk sales amongst the top five has actually increased to 4.1% during the last year, with lower performances in Tesco, Waitrose and the Co-op outweighed by increased shares in Sainsbury's, Asda, Morrisons and M&S. This can be seen in the next graph.



Growth potential for organic milk remains huge



Organic share of total milk sales by retailer



Source: Kantar June 10

New channels of distribution

The foodservice sector in the UK has continued to develop, notably in the larger supply chains where centralised distribution makes for cost-effective delivery. Outside of McDonalds and Pret a Manger sales are still relatively small, but this is a theme that is expected to continue as businesses search for differentiation and the infrastructure develops further. Foreign demand has also increased during last year, fuelled by a range of factors including strong underlying sales growth on the continent and a much more sophisticated demand base looking for a range of added-value organic ingredients products.

New markets

Until recently the UK organic dairy industry has largely been a supermarket business, with the vast majority of sales in the organic liquid, yogurt and cheese markets traded through the multiples.

In the last couple of years there has been a marked diversification in demand, driven principally by the ingredients market and by export opportunities. These markets are not well measured by traditional forms of market data and the effect has been to push up overall demand for raw milk to levels well in excess of domestic consumer demand.

UK Ingredients

The UK organic ingredients market has historically been supplied from abroad, a situation born out of necessity in the early days of the organic milk market in the UK. However, with increasing availability of raw milk supplies in the last two years and a continued push towards UK provenance, more and more of the UK demand for organic dairy ingredients is being repatriated.

Export

Supply of organic milk in continental Europe has struggled to keep pace with overall demand, which has stayed in strong growth throughout the recession. In addition, increasing demand on the continent for organic dairy ingredients reflects the continued strong EU performance of organic food in general, and the natural diversification into new markets that results.

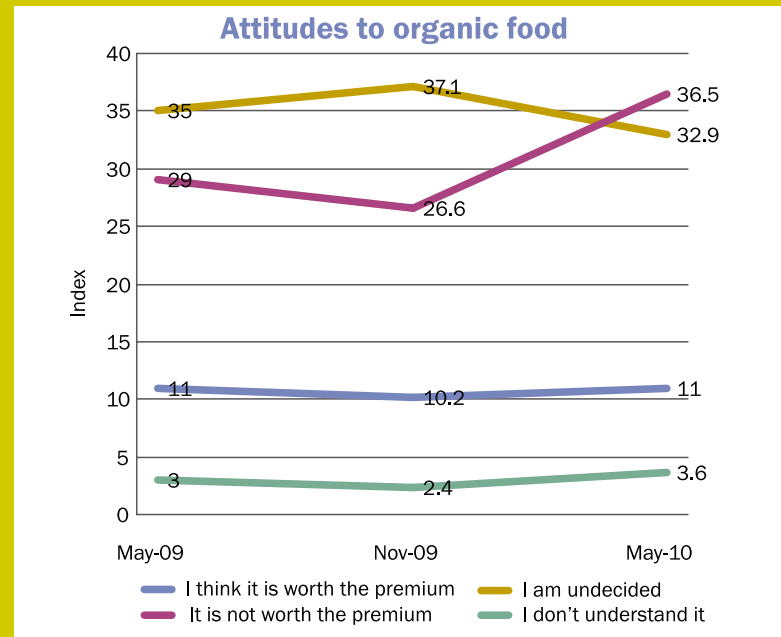
The UK is increasingly seen as a credible long term source of supply for these markets and this will exert increasing influence on the supply/demand balance of organic raw milk within the UK.

4. Consumer trends

Attitudes to organic food

Recent OMSCo research as part of its own consumer marketing programme clearly demonstrates recent changes in the attitude of consumers to organic food.

Notably, consumers are making their minds up and, in the short term at least, less of them perceive the organic offer as representing good value for money. This is clear from recent organic food sales and is perhaps unsurprising in an era of harsh economic circumstance.



Source: OMSCo research

However, there are some positive trends in the research. Firstly, the hard core group of converted remain resolute in their purchasing habits – the number has remained unchanged year on year. Secondly, consumers are trusting the organic offer more – the numbers believing ‘it’s a con’ continue to fall, suggesting the sector retains a great deal of consumer goodwill. Thirdly, more than a third of consumers remain undecided – there remains therefore huge potential to convince consumers of the benefits.

Over the last year, the lacklustre performance of the organic sector has spurred major players in the industry to form the Organic Trade Board to co-ordinate marketing activity and promote the organic message across a range of categories. Understanding the consumer motivations has been an important aspect of this work. The top consumer motivations for buying organic are set out below:

Top 10 reasons for buying organic	
Naturalness/unprocessed	40%
Restricted use of pesticides	34%
Better taste	30%
Better for my wellbeing	28%
Better for the planet	25%
More care in farming	24%
Kind to animals	22%
GM free	18%
Encourage wildlife	16%
Helping climate change	12%
Smarter/posher	2%

Source: OTB online survey Jan 10

Nevertheless, the research underlines the job that needs to be done to convince consumers that the diverse benefits of organic food are worth paying for.

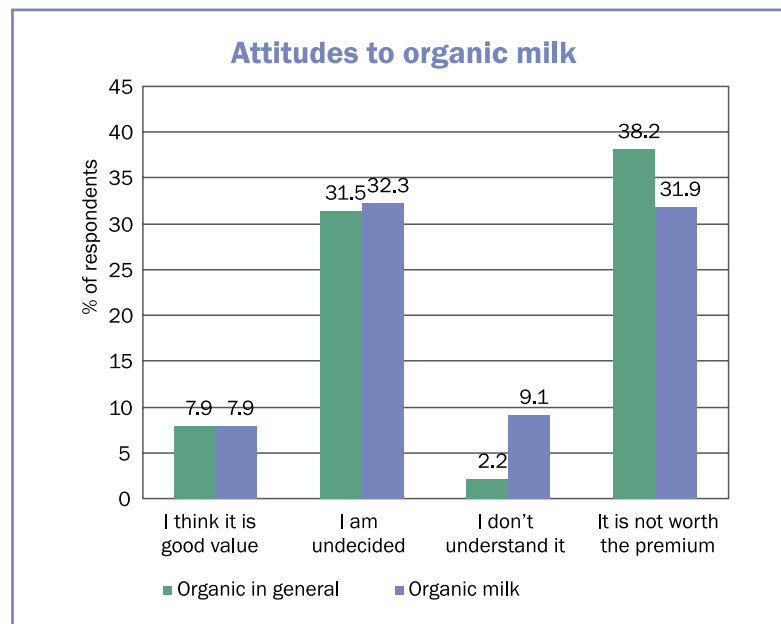
It is well known that consumers over-estimate the cost of ‘going organic’, and the research above reinforces the view that consumers are struggling to identify the benefits, rather than being unconvinced that a value exists. Part of this is down to a lack of consumer understanding of what organic farming is, and part is down to wide range of benefits of organic products. Indeed, this wide range of organic benefits is the sector’s biggest strength, yet the difficulty in communicating such a diverse message is the sector’s biggest weakness. Where consumers are overestimating the cost, have little understanding of the organic system and are struggling to see the benefits, it is perhaps no surprise that organic consumers are deciding, for the time being at least, that organic does not offer them value for money. The challenge remains

The challenge remains to educate consumers that organic food does not have to be expensive, that the benefits are real and can have a value to them

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Consumer attitudes to organic dairy

When comparing consumer attitudes towards organic milk with their attitudes towards wider organic food, there are two notable differences. Firstly, there is less of a perceived value problem. Secondly, a much higher proportion fail to understand the benefits. Why? The lower cost of going organic in milk, and the fact this has been a major feature of recent advertising, is one obvious explanation as to why fewer consumers perceive a value problem in the dairy sector. The lack of understanding of what makes organic milk different from conventional milk demonstrates that the industry must do a better job of educating consumers as to what is different about the organic dairy system.



Source: OMSCo research

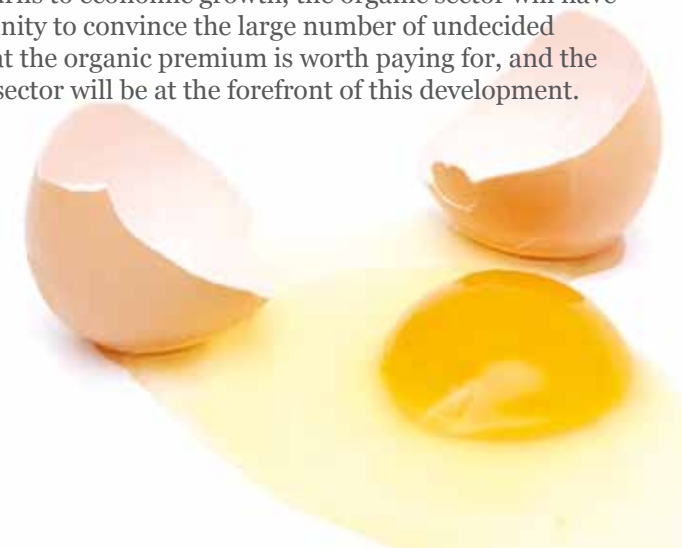
OMSCo research has also shown that over the last nine months, dairy has become the number one entry point for consumers into the organic category, assuming the position from fruit & vegetables.

Rank of organic entry points by categories			
	Sep-09	Apr-10	Change in rank
Fruit/Veg	1st	5th	-4
Meat	2nd	2nd	0
Dairy	3rd	1st	+2
Eggs	4th	4th	0
Bread	5th	3rd	+2
Cereals	6th	=6th	0
Tea/Coffee	7th	8th	-1
Confectionery	8th	=6th	+2

Source: OMSCo research

Much of this is down to the increased awareness of the low price premium attached to organic dairy products, particularly liquid milk, and extensive marketing from branded producers, including Yeo Valley and Rachels. It is also part of the explanation as to why the category has held up so well in the face of recession.

As the UK returns to economic growth, the organic sector will have a new opportunity to convince the large number of undecided consumers that the organic premium is worth paying for, and the organic dairy sector will be at the forefront of this development.





5. Trends in organic milk supply

Over the last three years, organic milk supply has increased by around 50%, adding around 160m litres to annual UK production, driven by the new converters recruited in the period 2006-2008. There are now three distinct factors involved in determining the current supply trend – rate of conversion, rate of exit and like for like volume growth.



With no new converters coming through the system...the rate at which producers leave organic production in the months ahead will be the key determinant of future availability

Conversions

The vast majority of conversions started in 2006 and 2007, prior to the increase in price of conventional milk. More recently, conversions have tailed off to zero, and there is currently no economic incentive for this to change. As a result there are no new converters in the pipeline and it will be at least 2013 before any are able to come on stream.

Entered conversion	Due for completion	Volume (litres)
2005	2007	7.7m
2006	2008	93.3m
2007	2009	52.9m
2008	2010	16m
2009	2011	nil
2010	2012	nil

Source: Soil Association/OMSCo estimates

Not all converters complete on schedule within the two year period, and many will supply for only part of their initial milk year as organic producers, therefore the impact on overall supply tends to be spread over an extended period.

Expansion of existing producers

Existing producers continue to expand at an estimated annual rate of 4-5%, adding approximately 20m litres to annual supplies.

Exits from organic dairy production

During the 2009/10 milk year the rate of exit increased sharply as higher costs, lower relative returns and incentives to revert to conventional production all had an impact.

Approximately 20m litres exited organic production during the year, but the main impact will only be felt in the current (2010/11) milk year, when supply will be hit by the full year effect of these exits.

A number of incentives that were in place to aid reconversion were withdrawn and for a time market prices for both conventional and organic milk stabilised. The rate of exit has fallen, but the full effect of last year's departures and ongoing exits in the current year are expected to result in a total of 35m litres leaving the industry in the 2010/11 milk year.

The end result over the last two years is an exit rate that is 19 million litres higher than the rate of expansion on existing farms. With no new converters arriving on the market these factors amount to a fall in available milk supply of 3% in the current year.

Supply	09/10	10/11
Base UK supply	425	482
Planned Expansion (%)	4%	4%
Supply from existing producers	442	501
New entrants	60	0
Exits	(20)	(35)
Gross supply available	482	466
Utilisation	98%	98%
Total available supply	472	457
Change year on year (%)	+13.7%*	-3.3%*

*Denotes change year on year in utilisable milk supply

With no new converters coming through the system, and a relatively predictable rate of expansion, the rate at which producers leave organic production in the months ahead will be the key determinant of overall availability of future supplies. As conventional prices have once again started to increase, there is a risk a new round of exits could occur.

A black cow and a brown and white calf are grazing in a green field. The calf has a yellow ear tag with the number 701464. The background is slightly blurred, showing other cows in the distance.

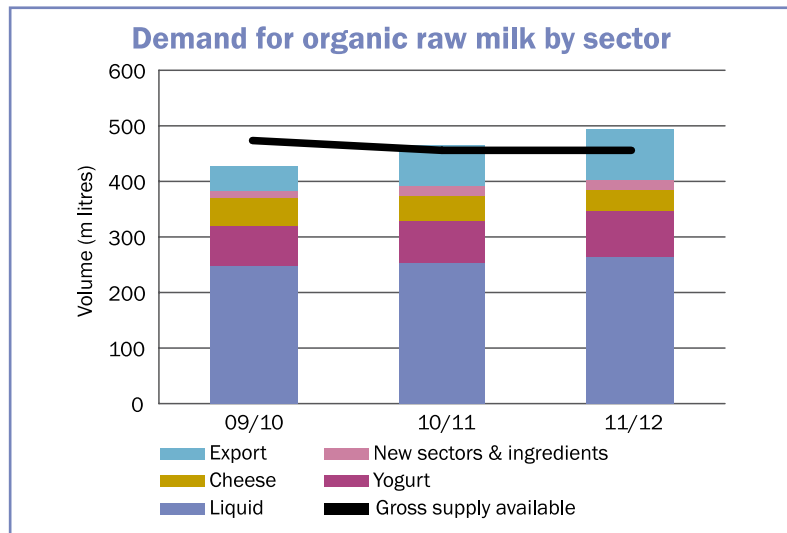
6. Outlook

Supply/Demand balance

The general tightening of the supply/demand balance will continue. New diversity of demand means that although there is a lacklustre liquid milk market performance in supermarkets, overall demand for raw organic milk continues to increase at around 9% per year.

New marketing initiatives from the Organic Trade Board and a continuation of the marketing programme for OMSCo is intended to drive new growth in core domestic sales. Whilst this is undoubtedly a challenge, the market is still under 4% of total liquid sales, so growth potential remains enormous.

On the supply side, the last set of new converters started supplying the market in the last year, which contributed to supply growth of over 11% in the year to March 2010. There are now no new conversions in the pipeline, and over the last two years the industry has lost more than 10% of its annual output back to the conventional market. Expansion on existing farms has made some of this up, but overall UK organic milk production is expected to fall by 3% in the current milk year, the first decline since the early 2000s.



Source: OMSCO estimates

The insufficient organic farm gate premium is the main driver of the exit rate, and is the root of the problem of sustainability. It is paramount therefore for prices to increase to restore the equilibrium - halting the exit rate is the key to a stable forward supply – and with a naturally expanding supply base, the market would be able to sustain moderate growth with little need for the extra incentives to encourage further conversion.

Seasonal balancing

The challenge of managing seasonal surplus in the organic system remains acute. As a more forage-based production system, it is well understood that the annual supply profile in the industry is marginally greater than that of the conventional industry. Whilst this is an issue, it is small compared to the real challenge, which lies in the structure of demand in the industry.

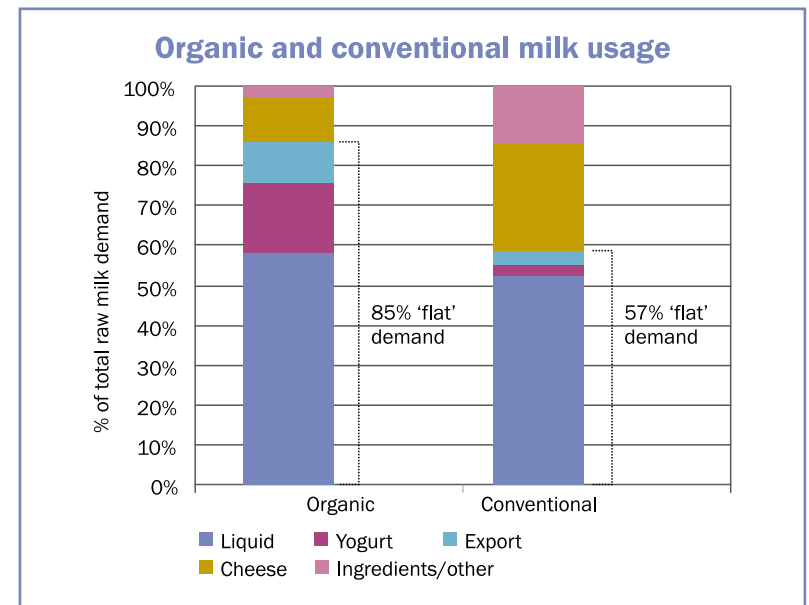
The table opposite shows the usage of the organic and conventional milk pools within the UK and shows how markets which typically require milk on a flat profile throughout the year make up 85% of all organic milk demand, compared to just 57% of the conventional market. There are two big strategic issues.

First, the big difference between organic and conventional demand is the market for cheese, which is the ideal balancer and yet represents just 10% of UK demand. Several initiatives have



been attempted to grow the organic cheese market in an effort to improve balancing efficiency, which have met initially with some success. Latterly, range reductions and aggressive activity in the conventional cheese market has largely reversed initial progress. This remains a key problem for the market to address.

Second, the repatriation of much of the UK's organic dairy ingredients demand is undoubtedly a positive development given the balancing potential of this sector. However, it is still only 3% of total demand and it could be higher. The major issue here is the lack of access to production facilities, notably powder-making, at key times of year which has limited the growth potential in the market and creates needless competition for milk supply at other times of year. Future access to production facilities is an important and necessary development for the organic dairy industry.



Source: DEFRA, DairyCo

A combination of a more seasonal production profile, a very high proportion of flat demand, and the high cost of downgrading organic milk to conventional is a toxic combination. A great deal of organic value can be eroded in the balancing process, thus addressing these strategic issues is a necessary step to improving the value of balancing milk in the long term.





7. Profile of OMSCo (The Organic Milk Suppliers Cooperative)

Background

OMSCo was formed in Somerset in 1994, when five like-minded organic dairy farmers joined forces to sell their organic milk. Now with around 500 members, OMSCo is the largest and longest established organic milk supplier in the UK, with a milk pool of some 340m litres per year, around two thirds of the UK's output.

OMSCo only markets organic milk, and with farms stretching from Cornwall in the south to Pembrokeshire in the west and Inverness in the north, it is the only organic milk supplier with a national presence.

OMSCo is managed by farmers, for farmers, giving them a collective voice and enabling them to get a fair price for their milk.

The OMSCo family

OMSCo is a nationwide family of organic dairy farmers. Like any other family, it takes special care of its youngsters by offering study bursaries to encourage and assist them into organic farming.

Being a farmer can often be a lonely experience. OMSCo offers advice, technical help, and creates opportunities for our farmers to come together and share their knowledge and experiences.

OMSCo knows that supporting their farmers means supporting their businesses too. OMSCo actively encourages diversification into other areas, such as holiday accommodation and school visits. OMSCo also supports those members making their own dairy products to sell directly and at local markets.

Customers and products

OMSCo still works today with its two original customers, although its customer base has expanded to more than 50, ranging from regional producers buying a few hundred litres to those purchasing in excess of one million litres a week. OMSCo has now moved into continental Europe, and its product range has been extended to include bulk powders, concentrates, cream and butter.



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