Circulation:	NFU Advisers	Date:	22nd November 2010
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Food price inflation update and impact on retail prices

Food prices have remained under the media spotlight through the autumn. Food inflation has edged upwards, with the latest CPI figures indicating that food and drink prices have increased by 4.5 % over the last year. The 2010 harvest has been characterised by rising wheat prices, with supply issues largely driving the price increases. The NFU examined the impact of rising wheat prices, inflation and the links between farmgate and retail prices earlier in the year (available here). This briefing updates the food inflation analysis, compares this with the farmgate price trends and considers some of the points made in the British Retail Consortium's latest Shop Price Index release[1]. The key points are summarised below.

- The October figure for annual inflation stood at 3.2%, an increase from 3.1% in September
- Although food and drink prices recorded a 4.5% annual increase in the CPI, food accounts for less than 10% of our overall household expenditure and contributed only 0.5 percentage points to the overall CPI.
- Changes to meat, dairy and cereal prices at the retail level are less than those recorded across the food and drink category overall. Fish, fruit, and oil & fats have recorded the largest year on year price changes.
- Prices of oils & fats, fruit and fish are all increasing at double the rate of the food category as a whole. By contrast, meat and dairy prices are increasing at rates below average CPI inflation.
- The increase in bread and cereal prices is 3.4% over the last year, and is less than that recorded in the food category as a whole over the last year. The low farmer share of bread products means that the 60% price change in wheat at the farmgate level is considerably diluted by the time it reaches the retail shelf.
- The increase in agricultural commodity prices in the UK has not been universal, with beef and pork prices actually showing declines over the last year. Defra data has also indicated that farmgate commodity prices are currently generating some downward pressure of retail prices. This is contrary to the view presented by the British Retail Consortium's latest Shop Price Index.
- Higher feed costs are already a reality for many farm businesses, with other key inputs such as fertiliser and fuel also recording year on year increases.

Food inflation

As measured by the consumer price index (CPI), annual inflation stood at 3.2% in October 2010, up from 3.1% in September. This means that the cost of a basket of goods is 3.2% higher than a year ago. The food and drink category has undoubtedly played a part in this, recording price increases of 4.5% on average over the last 12 months. This increase in food and drink prices has contributed only 0.5 percentage points to the overall CPI given that food and drink expenditure is only one part of our overall spending.

[1] http://www.brc.org.uk/details04.asp?id=1824&kCat=54&kData=2

Within the CPI basket there are a number of other spending areas that contribute to the annual inflation rate. At present, CPI is reflecting the increase in private transport costs. The transport category accounted for 0.9 percentage points of the overall CPI. A combination of factors contributed to this increase, with higher fuel prices and higher air fares both recording increases of 11.4% and 18% respectively over the 12 month period.

The other large contributors to annual CPI have been the increases in hotel and restaurant prices, adding 0.4 percentage points to the cost of the basket of goods since October last year. Table 1 shows the contribution of major spending categories to the overall annual CPI of 3.2%.

Table 1: Contribution to annual CPI by category

Category	Annual CPI Contribution (% points)
Housing & household services	0.06
Health	0.06
Clothing and footwear	0.06
Education	0.10
Communication	0.10
Alcoholic beverages and tobacco	0.25
Furniture& household goods	0.19
Recreation and culture	0.23
Miscellaneous goods and services	0.29
Restaurants and hotels	0.39
Food and non-alcoholic beverages	0.49
Transport	0.93

Although the above data relates to annual CPI, the latest CPI briefing saw the monthly CPI rate increase by 0.3% on the September figure. Month on month, the food category recorded a 0.4% increase in October. Bread and cereal products also contributed to this increase with prices rising by 1% between September and October.

However, from an analytical perspective, it is particularly important to look at year on year price trends rather than monthly or quarterly shifts. Seasonality is obviously important from both a supply and demand perspective, and this is reflected in retail pricing shifts through the course of the year.

The annual price changes for specific good groups are listed in table 2. Prices of oils & fats, fruit and fish are all increasing at double the rate of the food category as a whole. This also contrasts sharply with meat and dairy prices, where the latest annual inflation figures suggest increases of just 1.4% and 0.5% over the last year.

Table 2: Annual price increases of specific food groupings

Category	% change in last year
Milk, cheese and eggs	0.5
Meat	1.4
Food products (nec)	2.6
Coffee, tea and cocoa	3.1
Bread and cereals	3.4
Sugar, jam, syrups, chocolate and confectionery	5.1
Vegetables	5.4
Mineral waters, soft drinks and juices	7.9
Fish	8.9
Fruit	11.2
Oils and fats	12.1

The increase in wheat prices through the second half of 2010 has been well documented. These price increases are evidently filtering through to processed products at the retail level. However, despite raw material price increases, the increase in bread and cereal prices is less than that recorded in the food category as a whole over the last year. Food prices have risen 4.2% on average. It should also be remembered that the farmgate share of any food product tends to be relatively low when measured against the retail price. The share of wheat as a percentage of a loaf of bread is actually one of the lowest farmgate shares, averaging just 8% over the last five years according to Defra statistics[2]. This is because of the degree of processing and distribution involved in manufacturing bread. With such a low share of the final

[2] http://www.defra.gov.uk/evidence/statistics/foodfarm/general/auk/latest/excel/documents/Table-7-2.xls

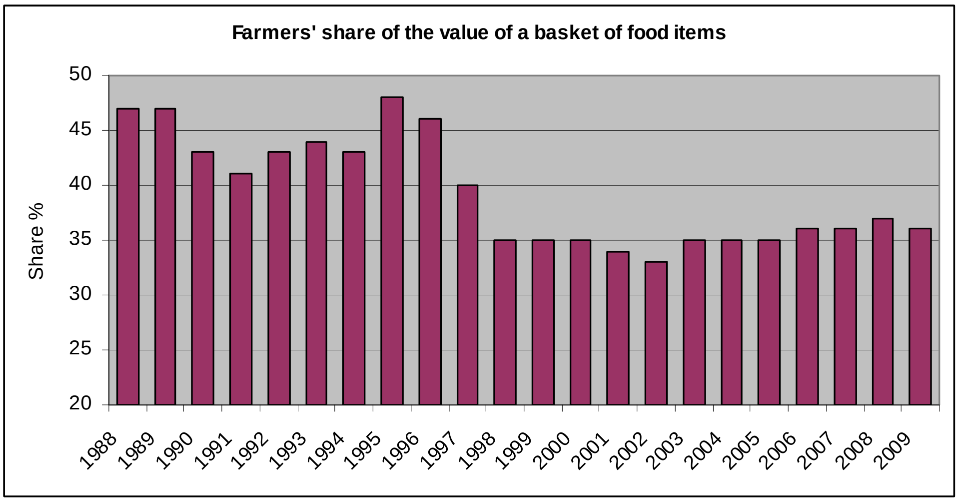
product value, it means that a change in wheat price at the farmgate is considerably diluted by the time it reaches the retail shelf.

Farmgate commodity prices and the impact on food prices
The following prices are taken from Defra's weekly commodity price dataset and illustrate year on year and monthly changes.

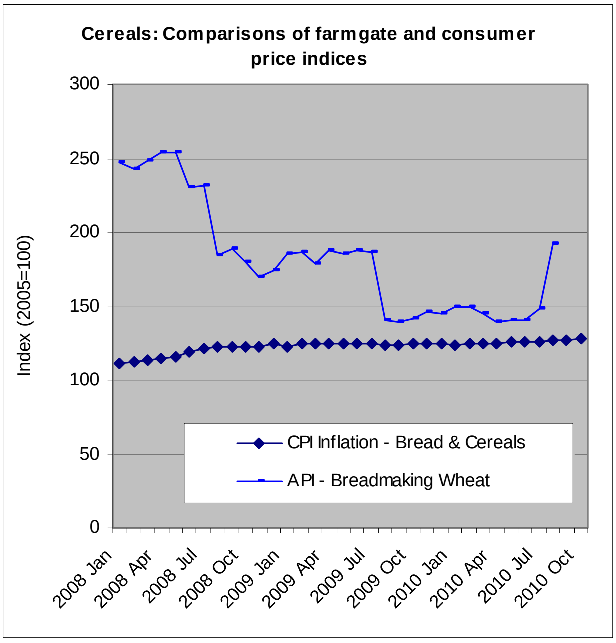
	Price (at 6th Nov)	Change over month	Change over year
Wheat	£159 per tonne	+7%	+61%
Beef	144.7 p/kg (livewt)	+2.2%	-2.3%
Pork	136.8 p/kg (deadwt)	-2.2%	-4.1%
Lamb	354.0 p/kg (deadwt)	+10.6%	+22%
Potatoes	£133.1 per tonne	+0.5%	+40.5%

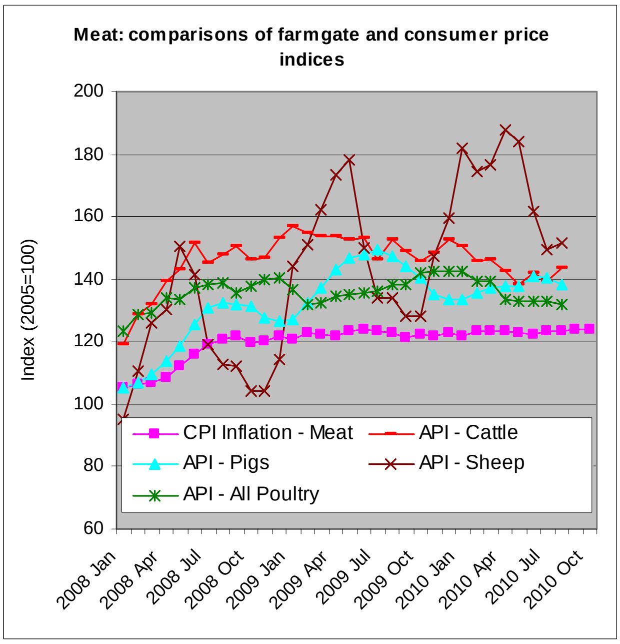
For any commodity, a combination of factors will influence pricing levels and shifts over time. That said, the wheat prices is clearly reflecting shifting market fundamentals in the global grains market, whilst potato prices have been impacted by the circa 6% reduction in the UK potato crop forecast for 2010.

However, as mentioned in the previous section, farmgate share represents a small proportion of consumer/ retail prices. Farmers' share of a basket of retail foods stood at 36% in 2009. This figure has declined considerably over the last two decades, pointing to a weakening of the link between retail and farmgate prices as illustrated below.



Of course, trends in farmgate commodity prices do feed through to retail prices. However, it is important to recognise that they are more considerably more tempered in their scale and are also likely to lag behind farmgate changes. Pricing strategies do not solely reflect the shifts in farmgate prices and therefore retail prices do not mirror changes to commodity prices. This is indicated in the two charts over the page that compare CPI data for cereals and meat with an index of agricultural commodity prices. Bread and cereal prices did not track the decline in breadmaking wheat prices from their 2008 peak, whilst the overall CPI for meat has remained relatively static compared to the trends in meat prices.





BRC Shop Price Index

The rising wheat price has obviously diverted much of the attention when considering agricultural commodity prices. This was certainly the case in the British Retail Consortium's latest Shop Price Index release which highlighted rising wheat prices as a factor in the highest shop price inflation since January. However, the full release also pointed to higher cattle (+17%) and pork prices (+16%) alongside the higher grains prices. Whilst these may reflect global market trends, these figures are obviously contrary to the UK farmgate price trends seen over the last year. Defra's latest food and farming brief provides further opposing evidence, actually stating that farmgate commodity prices are currently generating some downward pressure of retail prices.[3] The BRC claim that retailers are shielding customers from the full impact of increasing commodity costs appear do not appear to stand up to scrutiny.

The BRC report also references higher feed costs working their way up the supply chain. Higher wheat prices are already impacting on animal feed prices and margins. Whilst many would dispute the extent to which those prices are currently being transmitted across the supply chain and to the final customer (few supply chain arrangements operate on a strictly 'cost plus' basis), their impact on key agricultural sectors cannot be ignored. For example, compound poultry feed averaged £206 per tonne at the start of the year but is likely to end the year around its 2008 peaks of £240 per tonne. In the absence of higher farmgate prices, it is farmers that will directly shoulder higher costs. It should be remembered that feed is just one of the inputs farmers face; energy and fertiliser prices are also increasing. Year on year increases of 14% for red diesel and 19% for fertilisers were reported by Defra in October, and fertiliser prices have continued to strengthen since then. All will continue to negatively impact farm profitability in the coming months.

Input prices were identified as a key concern in the recent NFU Confidence Survey. Even though the survey was conducted prior to the major shift in wheat price earlier in the year, some 63% of farmers surveyed were wary of the potential negative impact of input prices on their farm business. UK farming has seen more favourable conditions over the last two years than during the preceding decade. This has built confidence about the medium term prospects for agriculture. Confidence encourages farmers

[3] http://www.defra.gov.uk/evidence/statistics/foodfarm/general/monthlybrief/documents/FarmFoodBrief-October2010.pdf

Formatted: Font: (Default) Times New Roman to invest in their businesses and secure a more competitive industry. As with any sector, this confidence is likely to be undermined where rising costs, variable margins and even periods of trading at a loss are experienced by farm businesses.

The BRC report highlights that the grocery sector is using unprecedented levels of discounting and promotions to drive sales. In the run-up to Christmas, they are likely to maintain their significant role in what is the most important trading period of the year. Retailers evidently see a benefit from investing in discounting and promotions. Such promotional tactics will inevitably remain an important as retailers seek to demonstrate value to their consumers and compete for shopper footfall. Yet the reality is that if the costs of producing food do increase, marketing tactics that focus on effectively lowering prices to shoppers are unsustainable in the long term. Perhaps retailers would be better placed investing some of their efforts in understanding what is driving commodity prices shifts and evaluating the economic impact on their suppliers. If some of the value placed on ‘shielding customers’ could be targeted at understanding and safeguarding suppliers, wouldn’t that help mitigate against price volatility in the long term?