

2008

## *UK Production in the Balance*

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**ANDERSONS**

*the*  
**FARM** *business*  
CONSULTANTS

### INTRODUCTION

Farmgate milk prices are still rising and dairy farm profitability in the 2007/08 milk year is likely to be significantly higher than in recent years. Yet, the UK dairy industry continues to contract with cow and producer numbers falling and total production at a record low. There is a long term trend of lower cow and farmer numbers, but the failure to produce anywhere near to quota is the consequence of past low prices and cost increases absorbing much, if not all, of the milk price increase.

The much needed reinvestment in the UK dairy farming industry is therefore very patchy and should be of concern in terms of the future stability and sustainability of dairy supplies. Most global indicators would suggest a positive long term future for milk produced from forage based systems. Something much of the UK is better placed to deliver than the majority of the EU.

### PRODUCTION

In the quota year to 31<sup>st</sup> March 2008 UK butterfat adjusted wholesale milk deliveries were 745 million litres under quota. This was the 7<sup>th</sup> year in the last 8 that the UK missed quota. Already in the current year deliveries are over 2% lower than last year and with total quota increasing the chances are for a deficit of 1.2 billion litres. High production costs and the shortage of breeding stock are limiting the expansion plans of efficient producers. Equally high cull cow and milking cow prices are encouraging others to leave the industry.

If milk prices can be maintained or increased and costs of production decline (at the time of writing fuel and wheat prices have reduced significantly) then we could see production getting back to 2007/08 levels in 2009/10 or 2010/11. But with the proposed continued increase in quota this is still likely to be a shortfall of 1.3 billion litres.

### PRICES

The boom in dairy commodity prices was slow to feed through to ex farm prices and the 12 month rolling price for the UK to the end of May 2008 has still only just reached 24pppl. By March 2009 it is estimated to reach 25.7pppl and 26pppl at March 2010. This assumes no downward pressure feeding back from recent retail price cuts started by Tesco and quickly followed by the other major supermarkets. With the shortage of supply in the UK, the retailers and processors would be foolish to try to pass the cost of these promotions back to the farmer through farmgate price cuts. What is actually needed to stimulate production is further price increases.

Dairy commodity prices have fallen back from the peak seen in the autumn of 2007 particularly for butter, SMP and bulk cream, but all have been rising again in recent months. There has been more stability in cheese prices with mild cheddar experiencing a step change at a consistent £2850 per tonne compared to a peak of £3100 and lows in early 2007 of £1900. With world stocks still low the fundamentals, particularly in the UK, indicate ex farm prices should remain strong for the foreseeable future. Certainly the UK improved its position in the European milk price league in 2007 with a 17.6% increase compared to an EU 25 increase of 15.1%.

For the farmer, feed and fuel prices may now be easing back but the major increases in fertiliser cost have yet to be felt in a full production year and this will happen in the 2009 growing season. The year on year increases at July 2008 were running at 140% for nitrogen, 234% for phosphate and 274% for potash. These increases coupled with other inflation, particularly in machinery, are still squeezing dairy margins. This can be seen in the profitability section.

## POLICY

There is not much to concern dairy farmers directly from CAP changes in the short to medium term. The Health Check should be concluded in late 2008 and will confirm the end of set-aside immediately and the end of milk quotas on 31<sup>st</sup> March 2015. Changes to the EU dairy support regime should not have much direct affect on UK farmers. The Single Payment should continue unchanged until after 2012 and any increased modulation is likely to be mitigated by the weakness of the £ versus the €. If the 30<sup>th</sup> September 2008 rate remains unchanged at 79p the currency affect will increase payments by 13% compared to last year. The apparent failure of the WTO talks means there will be no immediate change to the market access into Europe of potentially cheaper dairy products from the rest of the world. However, bi-lateral agreements are likely to continue to open up European markets.

Of more immediate concern to UK dairy farmers is the implementation of the NVZ regulations by UK Governments. In England the Government does appear to have listened to farmers, and some of the planned changes are not as severe as seemed likely. Final announcements, particularly on new NVZ areas, are due this autumn. Nevertheless, many farmers will have to invest heavily in more slurry/dirty water storage and disposal systems. Our example Friesian Farm is typical, requiring an investment of £80,000. Businesses will have important strategic decisions to make and already many are deciding to call it a day and are taking advantage of high cull and stock prices. Also of concern for some is the implementation of the Water Framework Directive measures for those in Priority Catchments. Disease issues, particularly bovine TB and Bluetongue, will also be a major anxiety for many in the next few years.

## PERFORMANCE

Farmers need to take markets and policy issues into account in making their strategic decisions, but day to day it is focusing on performance that separates the successful from those that struggle to make their businesses work. Efficiency has always been key, but with high input costs this is even more the case now. Cost control, and measures such as litres produced per man, and energy used per acre are as, or more, important than margin over concentrates or gross margins. Shortening the winter feeding period by lengthening the grazing season is working well for some and even with high fertiliser prices grass production is seen as key for successful dairy farming in the UK. Investments in NVZ storage need to be made with the aim of optimising the potential for utilising the nutrients in slurry and dung.

## PROFITABILITY

Andersons example business 'Friesian Farm' has an output of 1.125 million litres from 150 cows and their replacements. It receives a small premium from a liquid contract. The table below shows the 2007/08 result and estimates for the next two years.

*Figure 1 ~ Friesian Farm Profitability*

ppl	2007/ 08	2008/ 09	2009/ 10
Milk	23.2	26.2	26.5
<b>Output</b>	<b>24.9</b>	<b>28.1</b>	<b>28.3</b>
Costs (incl. drawings)	23.1	26.9	28.7
<b>Surplus from Production</b>	<b>1.8</b>	<b>1.2</b>	<b>(0.4)</b>
SPS (and ELS)	2.2	2.4	2.3
<b>Surplus after Support</b>	<b>4.0</b>	<b>3.6</b>	<b>1.9</b>

A year ago we hoped that higher milk prices would return this example business to real profitability, i.e. profit without support and giving a return on capital to encourage

reinvestment or even expansion. A year on and although the higher prices have been achieved, cost increases have eroded the surplus from production in 2008/09 and eliminated it by 2009/10. For the 2009/10 year if milk prices do not improve this business will be entirely dependent on the SPS and ELS for any profit. Beyond 2012 we expect the support from the CAP to reduce significantly.

In our estimates for 2009/10 we have taken into account recently reducing fuel and feed costs, but we have included an £80,000 investment in water separation and slurry storage to comply with NVZ regulations. This adds to the cost of production through depreciation and higher interest, although it is partly financed out of expected improved cashflow for 2008/09. If this investment is not made the surplus from production in 2009/10 would be 0.4ppl.

## CONCLUSION

The future of the UK dairy industry hangs in the balance. Although a few farmers with low costs of production are looking to expand, shortage of cows means significant expansion of UK milk production is not possible in the short term. Processors and retailers will have to decide whether they are prepared to accept a permanently reduced UK production base. Higher costs look here to stay, at least in the medium term. That being the case, milk prices need to improve to instil some confidence in farmers to invest in the future.

For individual businesses, Andersons' consultants can help to make the strategic decisions, particularly where NVZ investments are required. Our consultants also look forward to working with the whole industry to encourage best practice in production to improve performance levels to achieve long term profit.

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