

INTRODUCTION

Last year we wrote that UK milk production was in the balance. Much has happened since, and despite some optimism the industry is still tipping in the wrong direction. Farmgate milk prices are sliding, farmers are still leaving, production is still falling, and real confidence in the future is missing.

On the positive side dairy Farm Business Income for 2008-09 was significantly higher and some costs are now easing. But future profitability is being squeezed by declining milk prices and increased regulation. The whole dairy supply chain still needs to work better. The long drawn out demise of DFOB was not the best way to rationalise the processing sector. The dominance of the retail end is still very evident with liquid milk prices in the shops not falling in recent months whilst farmers' prices have reduced by 2-3ppl or more.

PRODUCTION

The UK finished the 2008-09 milk year over 1.4 billion litres below quota. This is approaching a massive 10% shortfall. Such a result is an accumulation of the trends of the past few years of producer exits and falling cow numbers. There is also evidence, in static or declining average yields, of a move to less intensive low-cost systems. These can be highly rewarding for those involved, but they may be contributing to falling UK output.

At the end of the first four months of the current milk year, butterfat adjusted deliveries in the UK were already over 650m litres below profile. Therefore the shortfall against quota looks like being even greater than last year. (*Within these figures it needs to be remembered that an extra 4½% quota has been given to farmers since 2005*).

Unfortunately, Andersons does not believe that the production decline will be reversed or even steadied in the short-term. Even if market signals were to encourage increased production, the statistics show that the number of heifers in the pipeline are not high enough to effect a quick recovery to the 14bn litres of the past. Indeed, production could well head closer to 12.5bn litres.

PRICES

The boom in global dairy prices which started in early 2007 was eventually felt in UK farmgate prices. The rolling 12-month average for the 2008-09 milk year was 25.7ppl – the highest for over a decade. But with the price cuts seen in the first part of 2009 the average 2009-10 price is forecast to reduce by around 2.5ppl.

The recent fall in milk prices has been driven by the collapse in world dairy prices. In fact, things would have been even worse in the UK were it not for currency changes. If the Pound had stayed at 2006-07 levels against the Euro, the Intervention Milk Price Equivalent would have been down below 14ppl, rather than the 19ppl seen over the last few months. Declining UK production has also probably played a part in stabilising domestic prices.

With over half of all UK production going into the fresh liquid market it is perhaps surprising that farmgate prices are influenced so much by global commodity markets. The future is likely to see a continuation of the trend for the 'milk market' to fragment according to end use. With a difference of up to 8ppl in the prices paid to UK farmers the concept of an 'average' milk price may have less and less relevance.

It is difficult to forecast with much certainty a recovery in milk prices. It will probably require a return to strong global economic growth, and the £/€ exchange rate would have to remain close to current levels. There are signs that the global market may have 'reached bottom', with recent milk auctions showing an improvement in values. But these rises will need to be sustained for a number of months before the effects are seen in UK farmgate prices. Therefore, only a very modest firming in prices is budgeted for the 2010-11 milk year.

A bright spot is a decrease in the price of inputs. Fertiliser values have come back a long way from their peak, and feed ingredient costs also look set to be lower. The sting in the tail is that these decreases will be picked up in the calculations for the 'Tesco tracker' milk price. This may precipitate a further round of price cuts in liquid milk contracts come October.

POLICY

The Health Check of the CAP had little direct effect on UK dairy farmers. Quotas will rise by 1% a year for five years (the first allocation occurred on the 1st April 2009) in preparation for the end of milk quotas after the 31st March 2015. In the UK, of course, this is largely an irrelevance (see previous section). The weakness of Sterling should give a welcome boost to producers' Single Payment cheques, as long as there are no major changes in exchange rates before 30th September.

Revised Nitrate Vulnerable Zone (NVZ) regulations came into force at the start of the year, as well as additional designations of areas. Many farmers are now grap-

pling with the implications of this legislation. The rules *are* complex, but once they are understood, and compliance systems are put in place, the requirements become more manageable. Unavoidably for some, the NVZ rules will involve additional investment.

Animal disease continues to be an issue. Government inaction on TB is a source of anger for many in the sector. Proposals for disease cost-sharing have also provoked a sharp reaction. For English readers, it is worth remembering that much of this policy is now devolved to the various parts of the UK. The administrations in Wales, and particularly Scotland, are perceived to be more farmer-friendly than DEFRA in Whitehall.

The buying practices operated by some retailers has seen the Competition Commission call for the introduction of a 'Supermarket Ombudsman' to police supplier relationships. Certainly, data on rising retail margins on dairy products over the last few years points to an imbalance in market power. Even in the last few months, whilst farmgate prices have reduced sharply, retail prices for many milk products have hardly moved.

PERFORMANCE

Individual farmers can do little to affect markets or influence government policy; what they can do is control the performance of their own businesses. There is no single 'right way' to run a dairy business – there are good, profitable businesses operating a wide variety of systems in the UK. The important thing is to choose a system that fits the circumstances of the farm and those running it. Then that system needs to be made to work – often by focusing on some key performance targets. As well as the familiar ones of gross margin or ppl cost of production, these might include litres per man or kgs of stocking per Ha.

Many businesses that fail to thrive have no clear business strategy, and a lack of day-to-day focus on efficiency. They often sit in a dairy 'no-mans-land' – not enough output to justify their cost levels, or conversely, an inability to cut costs enough to prosper with lower output.

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 overleaf shows the 2008-09 result and estimates for the next two years.

Figure 1 ~ Friesian Farm Profitability

ppl	2008-09	2009-10	2010-11
Milk Price	26.2	23.8	24.0
Total Output	28.2	26.0	26.0
Costs (incl. drawings)	26.5	27.3	25.9
Surplus from Production	1.7	(1.3)	0.1
SPS (and ELS)	2.4	2.5	2.4
Surplus after Support	4.1	1.2	2.5

At this point last year, the surplus from production for the current 2009-10 milk year was forecast to be zero. As the table shows, things look like turning out worse than that. This is due to the sharp fall in milk prices seen since the turn of the year. In addition, costs are expected to rise on average compared to 2008-09. Although feed looks like being cheaper this coming winter, this spring's fertiliser has been expensive. Overheads also go up for 2009-10 as Friesian Farm is investing £80,000 in water separation and slurry storage to comply with NVZ regulations, adding to the cost of production through depreciation and higher interest charges.

A small increase in prices, and a reduction in costs is forecast to bring milk production marginally back into profit for 2010-11. However, support is still required to give a realistic return to the business.

CONCLUSION

It is disappointing that so little seems to have changed in 12 months. It would be possible to simply reprint the conclusions from last year's Dairy Brief – that the industry is in the balance and that profitability needs to improve to instil enough producer confidence to invest for the future.

Perhaps this highlights that the sector cannot, and should not, expect too much help from external saviours – be they the world market, exchange rates, retailers, or politicians. Many producers have accepted that volatility is here to stay; they simply get on with the unheralded, and perhaps unglamorous, job of running a dairy business very well. Even in the current climate, some are producing excellent returns. This is not to say that a little outside assistance for the sector would not be welcome.

For individual businesses, Andersons' consultants can help to make the strategic decisions and improve business performance. Our consultants also look forward to working with the whole industry to improve the efficiency of the sector and achieve long term profit.

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