

## INTRODUCTION

It makes a refreshing change to write about the UK dairy sector with a degree of optimism (albeit cautious). Increasing farmgate prices have seen a return of confidence that had drained away over the preceding couple of years. Whatever their merits, the widely-publicised 'super-dairies' at least show an industry that is prepared to invest in its future.

## PRODUCTION

The UK finished the 2009-10 milk year almost 1.8 billion litres (12%) below quota. Indeed, talking about production in relation to quota seems like something from a different age already. The limiting factor on output is now the ability of farmers to produce a profit at the prices being paid.

The first three months of the milk year has seen production 2% up on last year, and the highest for the April-June period for 3 years. Some have heralded this as the reversal of the long decline in UK production which dates back to 2003. Despite better prospects for the sector, it seems premature to believe the industry is now so infused with confidence that it is again pushing output. It seems more likely that factors such as a late spring and low butterfats have skewed the figures. The dry weather has affected forage stocks which may depress output later in the year.

If the downward trend in UK milk production is to be halted, it will take a *sustained* period of higher profitability to encourage producers to make the necessary investment.

## PRICES

The optimism in the sector stems largely from the recent increases in milk prices. To a large extent this is the result of a recovery in global milk product values, assisted by a favourable exchange rate. There are signs that global markets may have peaked: although demand is still strong, there is ample supply coming forward. Any significant strengthening of the Pound against both the Euro and Dollar would also pressure prices.

Even if global markets and currency were to turn unfavourable, there is no reason why UK farmgate prices should react. Prices paid to farmers have been very 'sticky' on the way up: only a small proportion of commodity market increases have filtered down to producer level. There still appears to be plenty of margin left, part of which could reasonably be expected to find its way to farmers.

With over half of the UK's milk production going into the liquid market, it can be argued that commodity prices should not be as influential as they are. However, there is an expectation that liquid contracts should deliver a 'premium' above commodity values. This can conflict with the cost-plus pricing model (e.g. the Tesco 'tracker') if costs are falling at the same time as market prices are rising. But, even pure liquid processors are linked into the commodity markets through their cream sales. As an example, rises in the value of this 'waste' portion of the milk over the past 12 months are worth the equivalent of 0.8ppl.

One worry is that retailers may increasingly use milk as a weapon in their 'price wars', with the cuts eventually finding their way back down to farm level. Fierce competition on the middle ground market (petrol stations, small stores etc.) is already blamed for depressing prices. Despite this, Andersons believe there is good justification for milk prices to continue moving upwards over the coming 12 months.

## POLICY

The coming 12 months will see negotiations on the next reform of the Common Agricultural Policy (CAP) really gather pace. This will be looking at support for the 2013 Single Payment (SP) year onwards. With money tight across Europe, the budget for the next 7-year period to 2020 may well reduce. There could also be a redistribution of aid: between countries, policies, and individual farm businesses.

The signs are that the SP will be retained through to 2020, but Andersons believe by then its value could be halved, with all UK countries having moved to a flat rate per hectare system similar to England's. Could you remain profitable at today's milk prices with half of your current SP? This should be seen as a key indicator of long-term business sustainability.

Closer to home, there is much talk of a new 'age of austerity' in the UK, as the coalition administration grapples with the massive budget deficit. All aspects of Government spending will come under review. This may see a culling of the many agencies agriculture deals with, which many will regard as a positive. More worryingly, funding for Rural Development programmes which include agri-environmental schemes, and grant aid, may fall. It may pay to get applications in quickly.

The requirement to save money may see proposals for disease cost-sharing move up the agenda. This might be accepted by the industry if it were part of a larger package that

included positive action on TB control (including a badger cull). However, with the recent court challenge to the Welsh trial cull, all UK administrations are likely to be wary of moving on this issue.

One area that should be safe from spending cuts is the schemes to support renewable energy production. This is because it is power users rather than the government that pays for policies such as feed-in tariffs. It means that this new area of potential revenue for farmers should continue to provide good opportunities.

## PERFORMANCE

The profitability of a dairy farm is seldom determined simply by its milk contract or the size of its Single Farm Payment. The thing that differentiates highly profitable businesses from the rest is the management's focus on the factors within their own control. This often includes concentrating on a few key performance targets, whilst having a 'strategic' plan for the overall growth of the business.

The gap between the very best businesses and the 'also-rans' in the industry is widening. But there are often few fundamental reasons why the majority of UK dairy farmers shouldn't aspire to the performance levels currently achieved by the top 20% of producers.

## PROFITABILITY

To illustrate the profitability trends in dairying, Andersons have a 'model' farm: Friesian Farm, is a notional 100 hectare holding in the Midlands running 150 cows. It has a liquid milk contract. The table below shows the farm's performance for the previous 2009-10 milk year, based on actual returns and costs. An estimate is given for the current 2010-11 year, and a budget for 2011-12.

<b>FRIESIAN FARM</b>	<b>2009-10</b>	<b>2010-11</b>	<b>2011-12</b>
<b>ppl</b>	<b>Result</b>	<b>Estimated</b>	<b>Budget</b>
Milk Price	24.8	26.1	26.8
<b>Total Output</b>	<b>27.2</b>	<b>28.6</b>	<b>29.1</b>
Variable Costs	11.8	12.3	11.4
Overheads	10.5	10.6	10.9
Rent, Finance, Drawings	5.0	5.0	5.2
<b>Total Cost of Production</b>	<b>27.3</b>	<b>27.9</b>	<b>27.5</b>
<b>Margin from Production</b>	<b>(0.1)</b>	<b>0.7</b>	<b>1.6</b>
Single Payment and ELS	2.6	2.4	2.3
<b>Business Margin</b>	<b>2.5</b>	<b>3.1</b>	<b>3.9</b>

For 2009-10 the business dipped into negative returns from production (both the previous years had produced a positive margin of around 1.7-1.8ppl). This was primarily due to the fall in milk prices. However, costs also rose – fertiliser prices were high, and overheads went up for 2009-10 as Friesian Farm invested in NVZ compliance.

Recent price rises, with hopefully more to follow, should help achieve an average price for Friesian Farm 1.3ppl more than last year. Variable costs will be slightly higher this year compared to last – due to extra concentrate, straw and bulk feed costs (partly to offset the effects of this summer's drought). The rise in variable costs would have been higher, but for an offsetting fall in fertiliser prices.

The net effect is a positive margin from production. Friesian Farm has been in the ELS and is planning to renew its agreement for a further 5 years. The Single Payment is budgeted to fall somewhat due to a stronger Pound than last September. This support, when added to the margin from production, produces a reasonably healthy return.

Looking to the future, it is believed the yearly average milk price may firm further for the 2011-12 year (dependent on currency). If 2011-12 is a more 'normal' weather year, then variable costs should fall. We may also see Base Rates starting to increase, which pushes up the farm's financing charges. Overall though, profitability is predicted to increase compared to the current 2010-11 year. However, a margin of around 4ppl still only represents a 3.7% return on capital for Friesian Farm. Would other parts of the dairy supply chain accept such low returns?

## CONCLUSION

There are still plenty of challenges for the dairy sector, amongst them securing a fair share of retail prices, controlling cost inflation, animal disease issues, potential reduction in support payments, and, of course, the British weather. But at least with recent milk price increases there is the possibility of well-managed businesses producing returns that go some way to compensate the proprietors for their investment in time and money.

Andersons' consultants can help individual businesses make the right strategic decisions, and improve business performance. We 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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