With a vast range of performance between dairy businesses it is sadly inevitable that some at the bottom of the scale will continue to be forced to exit the industry. But this frees up resources for others. As well as allowing existing businesses to expand, higher prices might even encourage some brand new blood into the industry with new ideas and new enthusiasm.

PROFITABILITY

Andersons example business 'Friesian Farm' has an output of 1.125 million litres and a liquid contract. The table below shows how milk price, cost increases, and reducing support payments impact on the profits of this example farm.

Figure 1 ~ Friesian Farm Budget

ppl	**2006/06**	**2007/08**	**2008/09**
Milk	18.5	21.5	25.0
Culls & Calves	1.5	1.5	1.5
Output	**20.0**	**23.0**	**26.5**
Costs (incl. drawings)	21.4	22.5	23.9
Production Surplus	**(1.4)**	**0.5**	**2.6**
SPS (and ELS)	2.4	2.2	2.1
Surplus after SP	**1.0**	**2.7**	**4.7**

It can be seen that if the better milk prices we hope for can be achieved, then there is the possibility of the industry returning to real profitability. But this only happens in our model because costs within Friesian Farm are kept under control. On many holdings, some of the surplus generated will need to be reinvested in the infrastructure of the holding if milk production is to continue in the long term. This will include catching up with a backlog of investment in many cases, plus the need to comply with new requirements such as NVZ storage rules.

CONCLUSION

We hope that autumn 2007 will be seen as the turning point when widespread profitability began to return to the industry. But for many producers there may be a tough winter first. With some light at the end of the tunnel, producers should be thinking about their long term plans in the industry.

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DAIRY BRIEF

2007

A Positive Future

September 2007

ANDERSONS

the FARM business CONSULTANTS

INTRODUCTION

The past 6 months have highlighted the uncertainty of dairy farming. The weather, first dry and then very wet, has made managing forage difficult, both grazed and conserved. Then markets for agricultural goods have taken off. Whilst holding out the prospects of better farmgate milk prices, this also looks set to put up costs.

Faced with such uncertainty it is tempting to do nothing until things 'settle down'. But producers still need to think strategically about their businesses whilst responding to the day to day challenges. This article provides some background on the five 'P's: Prices, Production, Policy, Performance and Profitability that will drive the industry in the short and long term.

PRICES

The big story in the dairy sector is, of course, the increase in milk prices. It is doubtful that anyone in the industry (ourselves included) saw these coming to the extent seen. UK prices are being driven upward by strong demand on European and World markets, reduced output and low stocks.

However, producers have been frustrated that booming commodity and spot prices have been slow to translate into improved farmgate returns. To give milk buyers the benefit of the doubt, many are locked into long term supply contracts. With a large proportion of UK milk effectively committed, the spot market is quite 'thin' and processors looking to secure supplies can soon create a price surge.

Rather than what is happening to spot prices, what will be important to most producers is what happens when existing contracts come to an end. There are some encouraging signs that both processors and retailers acknowledge the market realities and are looking at solid increases in prices. The alternative would be losing significant amounts of volume as producers vote with their feet and resign supply contracts.

On this basis we believe the average farmgate price should be 25ppl by the New Year (some producers will obviously be receiving much better than this average). On a rolling 12 month basis this should improve prices for the 2007/08 milk year to 21½ ppl.

Looking into the 2008/09 milk year the fundamentals appear reasonably strong (although spot prices may fall from recent headline levels). We believe it should be possible to maintain a rolling average price of around the 25ppl level.

PRODUCTION

As a result of low returns over a prolonged period the production base of UK dairying has contracted over the last few years. Most importantly the national herd size has shrunk. But low profits have restricted investment and means that the remaining cows are not as productive as they might be. This milk year the weather has also played its part. It has already affected current production and the effects will continue to be felt through the winter in low quality forage and poor cow condition. Hence it looks likely that there will be a record production shortfall against quota. Higher milk prices will encourage increased output, but extra cows can't be produced out of thin air, and we expect production to be significantly below quota next year too.

POLICY

With booming prices, dairy farmers may be more sanguine about the forthcoming 'Health Check' of the CAP. This may signal further cuts in EU support prices for milk products. The hope is that this will be academic as actual market prices continue to be strong. The review will almost certainly also confirm the end of milk quotas in 2015. UK producers have had a taste of this over the last few years with quota values falling to almost inconsequential levels. But many other EU nations still have strong quota markets. It remains to be seen whether cross-border trading will play a part in the phase out of production controls.

One bonus for dairy producers is the lowering of the set-aside rate to 0% for 2008. Many farms have been lumbered with this inconvenience since 2005 and will be glad to return to full cropping. Hopefully the 2009 Health Check will see it removed permanently.

Less good news is the likelihood of increased environmental legislation. A consultation is currently underway proposing to increase the area designated as NVZ, and also to tighten the NVZ rules. This will require additional capital investment by the industry in storage and treatment facilities, and greater ongoing compliance costs. On top of this, further measures may be introduced to comply with the Water Framework Directive which aims to improve general water quality. These too may impact on the industry.

Dairy farmers also need to recognise that the last Single Payment they received (for the 2006 year) is likely to be the largest they ever get. For almost all but the most extensive producers the move to a regional average (in England) and increasing deductions (everywhere) will see the payment reduce through to 2012. From 2013 onwards the EU 'Budget Review' could well result in far less money for the SPS. It is not inconceivable that by 2020 area payments under the SPS could be down to £60-£80 per Ha (£24-£32 per acre).

PERFORMANCE

With volatile markets, reducing support and increasing legislation it is important that farmers focus on the factors that they can control within their own businesses. These are mainly cost control and technical performance. With the prices for many inputs having risen strongly in recent times, every drop of output needs to be squeezed out of them. This calls for the best technical efficiency.

Larger units can bring economies of scale, but this does not mean there is no place for the traditional family farm. Many will continue to prosper – but only if there is rigid attention to detail. Relying on 'cheap' family labour (and capital) is not a long term recipe for success. Such businesses will have to be innovative in how they resource their business. There are still many opportunities to take costs out of the industry through joint ventures and collaboration.