

## Policy, Prices and Profitability

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disposal of non-natural waste such as silage plastic.

On the positive side, feed prices remain relatively cheap on the back of low cereals prices (although even here higher transport costs have been felt). Quota is cheaper, as it looks likely the UK will be under quota for the fifth time in six years. The price of cull cows should receive a boost when the OTM rule is changed. Interest rates remain at historically low levels, so servicing debt is not a problem for most businesses. For those on tenanted holdings, rents appear to be drifting downwards, and there is certainly a case to ask for a review if one has not been done lately.

For the post SP era we have budgeted an example farm: 'Friesian Farm' is a Midlands farm with a liquid market and above average levels of performance. Quota is 1.125m litres. We have allowed for the changes outlined above and the results are summarised below for two milk years.

Ppl	2005/06	2006/07
Milk, culls, calves	20.0	20.4
Costs of production (incl. drawings)	20.6	21.1
Surplus (Deficit) from production	(0.6)	(0.7)
SPS (and ELS)	1.6	2.4
Surplus after SPS	1.0	1.7

With milk price static the additional output from culls is expected to be eaten up by increases in feed, fertiliser and fuels on this well managed business. However the significant increase in the SP in 2006 will put this business into surplus of some £19,000 after drawings and tax.

### CONCLUSION

The industry is facing a downturn in profitability if the Single Payment is excluded. Reinvestment and growth are the key to the prosperity of dairy farmers. If the milk price does not rise, with a logical structure for future pricing mechanisms put in place, dairy farmers will cease production. Overall, production may be lost as the leavers' capacity is not replaced by others expanding. Those producers that remain must continue to minimise costs of production. There still remains a huge range of performance within the sector. Farmers must look to the factors they can control within their own businesses as well as working for better market conditions.

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## INTRODUCTION

The past few months for the UK dairy industry have seemed like a case of one step forward and two steps back. Price initiatives in the retail market have held out the prospect of higher prices, but the full value of these has failed to materialise at the farmgate, and producers have seen costs rise sharply. A period of quiet stability for the sector seems as far off as ever.

## POLICY

The introduction of the Single Payment Scheme (SPS) is behind us. It's now over to the paying Agencies to process the applications, inform farmers of their entitlement allocations, and finally send the cheque. This process will be much quicker in Wales and Scotland, and farmers should be reasonably confident of receiving payment in December. In England, the system is more complex, and the number of applications much higher, it may be best to budget on not receiving the payment until March.

Whenever the payment finally arrives, producers should be thinking about how to react to the new system now their entitlements have (hopefully) been secured. The most fundamental question with decoupled payments is whether to carry-on producing at all. The Single Payment will be received regardless of any output, so the economics of milk production must stack-up on their own. Those that decide to withdraw need to be aware that the SP is likely to reduce for most people. Deductions will rise, inflation will eat into it, and this is before Tony Blair tries to push through further CAP reform. How to meet future income requirements needs to be carefully considered.

In many ways dairy farmers are better-off than those in other sectors. They have not been used to receiving large direct payments. But it needs to be remembered that the SP is compensation for lower guaranteed prices. Farmers who are committed to the industry should use the payment wisely – perhaps investing for the future (either on-farm or off), or paying off borrowings. Some producers are also looking at the option of payment in Euros to 'ring-fence' the payment and take advantage of lower borrowing costs (currently 2¼% difference). Again, likely future reductions in the SP must be budgeted for.

Further off, any agreement in the World Trade talks will mean reduced tariff protection for dairy products and the eventual end of export subsidies. This will almost

certainly result in guaranteed internal EU prices being reduced further. What effect this has on UK prices will depend on local and world demand and production levels at that time.

## PRICES

The average weighted farmgate price for the 2004/05 milk year was 18.4ppl. This was very similar to the 18.3ppl seen for 2003/04. For the current year it looks likely that the average will end up nearer to 18ppl. Even this level probably would not have been achieved if it had not been for farmer protests. However, a succession of retail price initiatives has probably done more for retailers' margins than they have for producers';

	Retail Price - 4 Pint Polybottle	Equivalent Retail - ppl	Monthly farmgate 12 month ave. ppl
June 2000	83p	36	17.2
June 2001	93p	41	18.2
June 2002	93p	41	18.5
June 2003	98p	43	17.2
June 2004	103p	45	18.5
June 2005	111p	49	18.4
% increase	33%		7%

Source: MDC/DEFRA/Andersons

Since the political pressure for milk prices started in autumn 2000, it can be seen that most of the increases have actually been captured by the retailers. It is widely believed that the government allows the major retailers to wield such market power because they help a 'cheap food' policy. This has obviously not been the case looking at the retail price of milk over the last 5 years; but these increases can be justified because they 'help the farmers'. Such initiatives are increasingly looking like farmers receiving crumbs from the supermarkets' table, rather than long-term mutually beneficial trading arrangements.

Some are pinning their hopes on UK production falling post-reform. Buyers would then need to pay more to secure scarce supplies. But it should be remembered that around a third of the UK's milk still goes into commodity products that are, by their nature, easy to import. It would take a big drop in production to be left with just high-value, mainly liquid markets. (Although not the full third – as much of this production is seasonal).

Rather than hoping for a contraction in the industry (which helps no-one) it would be better to arrive at a situation where each part of the supply chain receives a fair share of the final product price. Although the farmgate milk price is, of course, partially related to its end use, prices in the commodity sector still tend to depress the whole market. A recent report suggested that the liquid market should be seen as the 'standard' market, and this should be made the base for milk pricing, rather than intervention. Unfortunately, this would appear to require consensus and co-operation across the industry that has been conspicuously lacking over the past few years.

As ever with milk prices, it is difficult to make any predictions on future direction because the situation is so 'political'. Producers must be realistic about prices they are likely to receive in the short and medium term. If they budget conservatively, and set their businesses up to be profitable at prices somewhat lower than present levels, then any increases will be a bonus. Looking further ahead, as world population grows, and becomes richer, demand for dairy products is likely to be strong.

## PROFITABILITY

Average Net Farm Income (NFI) for dairy farms in 2004/05 was £24,000, a rise of some 9% over the previous year. NFI imputes a rent for owner-occupied land, so it is the return to the entrepreneur for his/her management, manual labour, and all the tenant-type capital in the business such as stock, machinery, owned quota and equipment. NFI is therefore below the UK average wage of just over £26,000; and that is before any return to management or capital invested. Of course, averages hide a vast range of performance. Some farms will be seeing their net worth erode, whilst others continue to make good returns. *With typically British reserve, most dairy farmers making good money tend not to publicise the fact.*

Profitability in the current year is likely to be lower on average. Milk prices have drifted back, but there has also been a big rise in costs. High energy prices have seen both diesel and fertiliser prices increase. In many areas of the country the need to attract and keep good staff results in wages (and housing) costs continuing to rise. And increasing environmental regulation places more conditions on all sectors of farming. Later on this year the Agricultural Waste Regulations will outlaw the on-farm