

ppl	2005/ 06	2006/ 07	2007/ 08
Milk	18.8	18.0	18.0
Culls & Calves	1.2	1.6	1.7
<b>Output</b>	<b>20.0</b>	<b>19.6</b>	<b>19.7</b>
Costs (incl. drawings)	20.6	21.4	21.9
<b>Deficit from production</b>	<b>(0.6)</b>	<b>(1.8)</b>	<b>(2.2)</b>
SPS (and ELS)	1.6	2.4	2.1
<b>Surplus (Deficit) after SP</b>	<b>1.0</b>	<b>0.6</b>	<b>(0.1)</b>

calves - the result of a strong beef market following the end of the OTMS and the lifting of the beef export ban. Output still falls by 0.3ppl. Costs (including depreciation, rent and interest and drawings) rise relentlessly over the period by 1.3ppl so that the deficit from production increases from -0.6 to -2.2ppl. It is only after bringing in the SP (and ELS) that Friesian Farm shows a profit in 2005/06 and 2006/07 of 1ppl and 0.6ppl respectively. Because in England the SP will have peaked in 2006, the business is budgeted to show a loss in 2007/08 after SP.

Is it too cynical to suggest that part of the reason for the large price cuts was to clawback some of the dairy premium (compensation for the institutional price cuts)? Compensation that English producers are progressively losing under the regional average Single Payment. The industry needs to reinstate the milk price cuts to return some confidence to the sector. Meanwhile, although an above average performer, this business clearly needs to take action to improve cost efficiency further.

#### CONCLUSION AND ACTIONS

- Many farmers are trading at a loss without the SP/ELS
- With a declining SP in England at current costs/returns many will be in loss even after the SP
- There is a lack of confidence in milk purchasers
- Dairy farmers are questioning their future in the industry
- Need for a joined up industry to:
  - foster efficiency through innovation and re-investment
  - divide margins in the supply chain more equitably according to effort and capital employed
  - reduce the proliferation of paperwork.

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DAIRY BRIEF

## Policy, Prices and Profitability

September 2006

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## INTRODUCTION

UK dairy farmers are once again caught up in a dreaded cost/price squeeze. Milk prices started to tumble in recent months while input costs have been escalating for over a year. The weather has not helped; a long cold winter, followed by a very wet spring and then a summer drought will force many farmers to enter winter with low forage supplies. The industry continues to restructure both on and off farm, but future stability does not appear imminent. Many ask the question “have we reached the bottom and will we turn the corner in the coming months?” This article looks at some of the issues involved, and at future farm profitability levels.

## POLICY

Farmers in Wales and Scotland received most of their 2005 Single Payment (SP) last December/January, whilst the delay for English farmers has caused severe cash flow deficits and added cost – some still await the final top-up. In England the 2006 payment looks increasingly likely to be split between an early (December 2006?) part payment (80%?) followed by a March 2007 (?) top-up. Maybe the full SP for 2007 will be paid in December 2007, but don't count on it.

Deductions for modulation and financial discipline are unknown, and the UK government is in some difficulty as the draft legislation does not allow different rates of modulation in the UK regions. But rates can only increase and for most English dairy farmers the 2006 payment will be the greatest, and then begin to shrink as the payment moves to a regional basis. English Farmers must plan future income requirements without the substantial ‘cash injection’ that is received currently. With the SP having no link to production, the economics of milk production must stand alone.

New Rural Development Programmes, partly financed by modulation, are being worked on by all the regional administrations for implementation in 2007 and it is the agri-environmental schemes that are likely to be of interest to most producers. Cross compliance and other regulations continue to tighten: the Agricultural Waste Regulations came into effect in May 2006 and further NVZ and Water Framework Directive regulation is on the horizon for some farmers.

The EU itself is planning a ‘health check’ on the current CAP starting in 2007, but not likely to be implemented until 2009. There is currently no appetite for another wholesale reform so the present system may well emerge largely unscathed from the health-check. Adding to this likelihood is the fact that there is the major review of the whole EU budget (including the CAP) scheduled for 2008-09. It seems unlikely that any big changes will be agreed by Farm Ministers until they know future CAP funding levels. Possible changes include an increase in EU compulsory modulation, and further reductions in butter and skim milk intervention prices – the final cut under the Fischler reforms takes place in July 2007.

However the failure of the world trade talks may make further downward movement in EU commodity prices less urgent in the short term. The Doha Development round talks were suspended this year following a failure to make progress in the agriculture negotiations. Any restart may well be put off until 2009. In the medium term globalisation of dairy trade is unlikely to go away and Europe's intervention prices, tariffs and export refunds will all be targeted for reduction.

## PRICES

The average weighted farm gate price for the 2005/06 milk year was 18.46ppl, similar to the 2004/05 price of 18.41ppl. This period of stability in farm gate price (while retailers were pocketing large increases – see table) has now been shattered by substantial cuts, by all major purchasing dairies, of 0.5 – 1.0ppl. These are now showing up in monthly average prices with June 2006 being down 0.5ppl on last year with further reductions in the pipeline. The rolling 12 month average is likely to dip below 18ppl to 17.85ppl by March 2007 unless recent cuts are restored

	Retail Price - 4 Pint Polybottle	Equivalent Retail - ppl	Farmgate 12 month ave. ppl
June 2002	93p	41	18.6
June 2003	98p	43	17.2
June 2004	103p	45	18.5
June 2005	111p	49	18.4
June 2006	111p	49p	18.4
% increase	+19.5%		-1.3%

Source: MDC/DEFRA/Andersons

urgently. There is currently a strong case for this as EU commodity prices and returns from cream have strengthened significantly. Farmers are once again being left to shoulder the burden of cost increases up the supply chain (processing and transport) whilst having substantial increases themselves in fuel, fertiliser, labour and now feed. One answer being mooted is to reduce milk production so that only liquid and high value added demand is satisfied. A recent MDC report refutes this suggestion, quite rightly pointing out the pain required to remove up to 30% of production and 20-40% of producers. Why would the industry want to voluntarily surrender such a large chunk of UK production? The UK is nowhere near self-sufficient as it is. Besides the UK should be better placed than most climatically, and in terms of herd size, to be competitive in milk production in Europe. Farmers need to work with their milk buyers to supply what is wanted in terms of constituents, seasonality and quality and to adjust their production systems to produce what is required at least cost.

## PROFITABILITY

Net Farm Income (NFI) assumes all farms are tenanted and that all tenant-type assets are owned by the farmer. It represents the return to the farmer and spouse for their manual and managerial labour and on tenant type capital in livestock, crops, machinery, etc. The provisional UK average NFI for dairy farms in 2005/2006 was £26,000, a rise of some 9.7% over the previous year. Although an increase, it is still a relatively poor return on capital compared to other industries – in fact, if NFI is taken as a wage for farmer and spouse, there is no return to management or capital. Of course, averages should be taken as a guide to identify trends – there is a vast range of performance across dairy businesses.

What is distressing the industry at present is the outlook for profitability, and many are asking whether their capital would be better employed elsewhere? The table overleaf shows the results for 2005/06 and the budgets for the next two years for Friesian Farm – a Midlands example farm with 1.125m litres of quota and above average levels of performance.

The budgets show an expected 0.8 ppl drop in milk price partially offset by better returns from cull cows and