WHAT WILL BREXIT MEAN FOR THE UK DAIRY SECTOR?

FEBRUARY 2018

Introduction

Brexit is the single biggest factor to affect British agriculture for many generations. Its impact on trade relations, the form of future farm support, access to foreign markets and currency will be huge. Kite Consulting has put together this report to outline the possible ramifications of different forms of Brexit on the UK dairy industry, and to draw conclusions on the likelihood of each scenario.

In this report, we look at four potential Brexit outcomes, two each for both a soft and hard Brexit, and identify the key factors that will be most affected by the type of Brexit the UK ends up with.

Setting milk price and tariff rate

We have modelled the potential outcomes of the Brexit negotiations, based on a 10-year world milk price historic average, which gives a UK equivalent price of 25.6ppl, which is also close to the Defra 10-year average UK price. The cost comparison uses three years of Kite Consulting recorded cost of production data for a typical 1.5m litre UK herd, with the larger herd average at 4m litres.

Where a trade tariff was applicable, a 10% rate was used, as this is the average paid on all agricultural products imported and exported to the UK. Higher tariffs are applicable to some products but this typically results in little or no trade. The UK currently imports more dairy products than it exports, but relative prices in the UK post-Brexit may see levels change.

What is a...

Hard Brexit

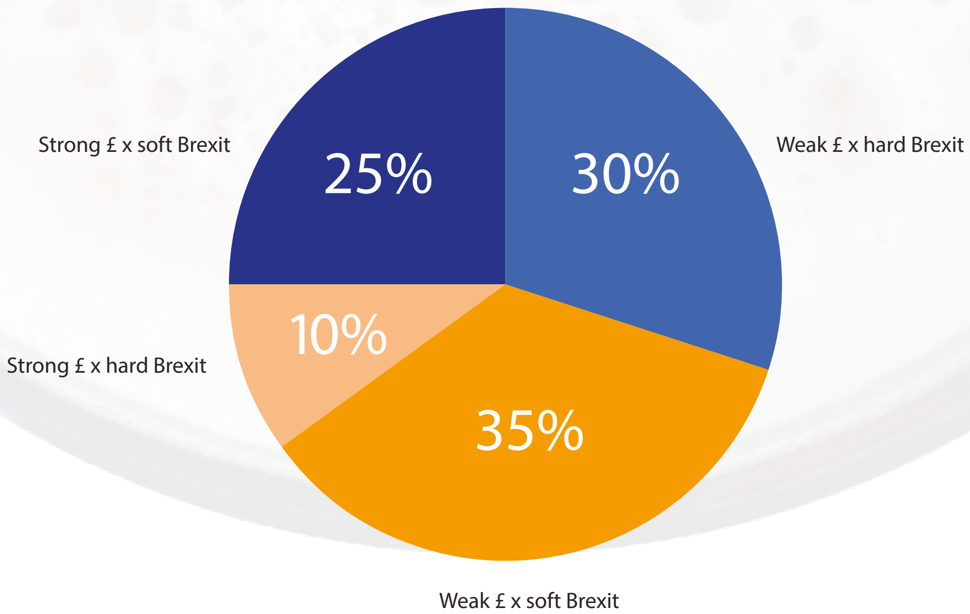
- Strong border and immigration controls
- Restrictions on non-UK ag workers
- No access to Intervention
- World Trade Organisation rules and tariffs
- New international trade agreements taking three to five years.

Soft Brexit

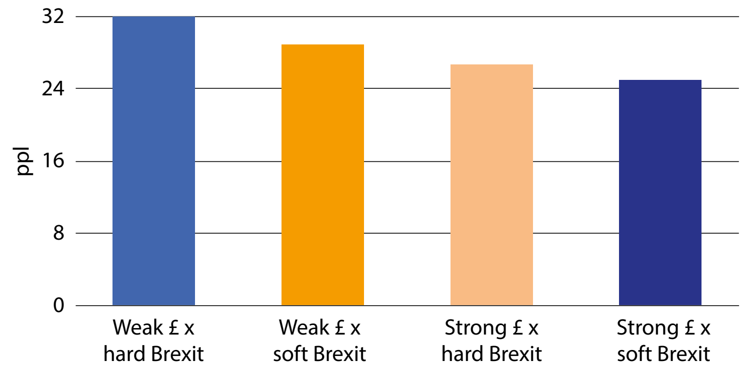
- Light border and immigration controls
- Free movement for EU workers
- No tariffs with EU
- Access to or influence over Intervention
- Trade agreements still integrated with EU.

The diagrams on this page illustrate the probability of Brexit outcomes and their likely impact on milk price. They refer to the four scenarios on the following pages.

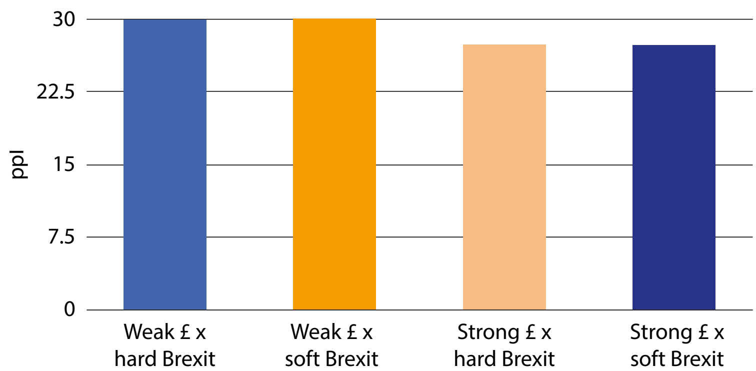
The probability of the four Brexit scenarios covered in the report being the final outcome for the UK



The predicted impact on the milk price of the four possible Brexit scenarios



The predicted impact on production costs of the four possible Brexit scenarios



Brexit Farm Sce

Ha

Weak £ x Hard Brexit

Currently a 30% probability

(Kite spring 2018 prediction)

- Trading is subject to World Trade Organisation rules – expect 10% tariff on imports and exports.
- The UK economy performs poorly with higher inflation.
- Milk prices to be boosted to 32ppl, but production costs are also higher.
- A retained profit about 2ppl on 1.5m litre herds and about 3.5ppl on larger (4m litre) farms.
- Farmers will respond by increasing production by more than 3bn litres, but the lack of export opportunities will demand more level year-round supply.

Weak

Weak £ x Soft Brexit

Currently a 35% probability

(Kite spring 2018 prediction)

- The UK leaves the EU with a strong market agreement and no import or export tariffs.
- But the economy performs poorly and inflation is predicted to rise to 5%.
- A forecast milk price of 29ppl, but with high production costs.
- A retained profit of about -1ppl for 1.5m litre herds or about 0.5ppl on larger farms.
- The slight chance of a small decrease in UK milk production level.
- The closest to today's industry position.

So

nario Summary

rd

Strong £ x Hard Brexit

Currently a 10% probability

(Kite spring 2018 prediction)

- Tariffs of 10% will help counter a strong currency with milk prices forecast to fall to 27ppl.
- The economy performs well so a strong currency will help keep input prices down.
- A retained profit about -1ppl on an average farm and about 0.5ppl on larger farms.
- There will be an incentive to produce more milk, but with tariffs needing that to be competitive, it is likely UK production will remain stable.

Strong

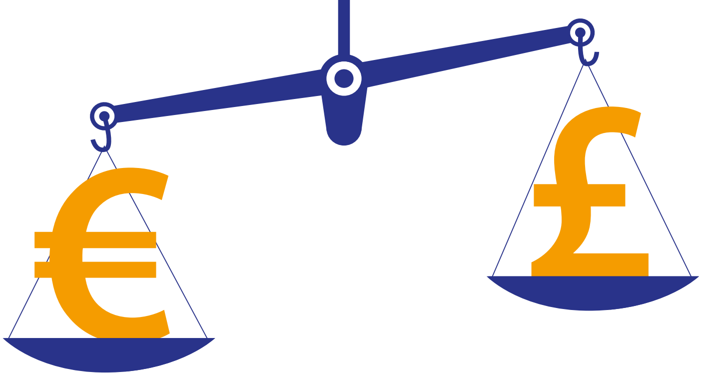
Strong £ x Soft Brexit

Currently a 25% probability

(Kite spring 2018 prediction)

- The UK leaves the EU with a good trade agreement, so there are no tariffs and people can move freely.
- The rest of the UK economy does well, so currency is strong and inflation is likely to be as low as 2%.
- Imports of milk are cheap, so milk price is predicted to fall to 24.6ppl.
- There is some relief from lower input costs, but retained profit is poor at about -3ppl on average, and about -2ppl on larger farms.
- The dairy industry is in the situation seen in the early 2000s. UK production is likely to fall and to favour low cost, spring calving systems.

oft



Should a soft Brexit occur, the best scenario for farmers is that it is coupled with a weak currency effect. This will be close to the current scenario with the average farm making a loss of 0.93ppl. Yet if more certainty is created then it is probable that the currency will be strong, increasing losses to 3.28ppl for an average farm and a loss of 1.8ppl on larger 4m litre farms.

Currency will have greatest impact on dairy farm incomes.

The currency exchange rate level, which will be influenced by Britain's exit from the EU, will have a greater impact on UK milk prices and dairy farm profitability in the five years after exiting the EU than anything else.

Milk price predictions by Kite Consulting reveal a 7.4ppl difference between the four scenarios (combining hard v soft Brexit with weak v strong currency) for a typical 1.5m litre output herd. The best price, at 32ppl, will come from a weak currency and a hard Brexit, and the lowest, at 24.6ppl, with a strong currency and soft Brexit. Some volatility in milk prices is still expected.

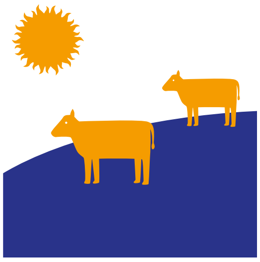
Currency rates also drive the price of many farm inputs, particularly the main dairy farm inputs of feed, fertiliser and fuel, which are imported or follow world market prices. Livestock sale and purchase prices will also change more than most other inputs and labour costs will rise, with both inflation and a shortage of supply.

Kite Consulting predictions indicate a 2.5ppl difference in production costs between a soft exit - without trade tariffs - or a hard exit - with world trade tariffs. In reality, this is smaller than the up to 8ppl variation in costs seen in recent years.

Whether it's a hard or soft Brexit, currency could either strengthen or weaken, depending on how the UK economy fares. However, a poorer UK economy will be good for dairy farmers and a good UK economy is likely to mean harder times, without the support of the Basic Payment Scheme (BPS). This is an opposite effect to most other industries because the UK is a net importer of dairy products and a strong currency means imports can come in cheaply. The dairy industry is also too insignificant to impact on the national economy overall.

In terms of profit, the best outcome in the short term will be a weak currency and hard Brexit. It's the only scenario in which average dairy farm profits are positive and at least 2ppl above recent years. However, taking into account the political situation at present, it seems marginally more likely that a soft Brexit will result.

Subsidies



Subsidy levels will be important to profitability, but less so than the effect on milk price and costs. Subsidy was just 1-1.5ppl of turnover in the three years of cost of production data used to consider the impacts on profit. Given a likely reduction in future subsidy levels and the statement from Michael Gove, Secretary of State for Environment, Food and Rural Affairs at the Oxford Farming Conference in January that subsidies will be closely tied to the environment, the Kite analysis used an estimate of one-third of recent levels for all four scenarios considered and we expect that most of this payment will be used to cover costs of delivery for environmental goods.

Production systems

UK production and systems may change post-Brexit depending on the scenario which results. One reason for this is that much of the processing capacity for seasonal excesses of UK milk is in Ireland and it is unclear how the border between the EU and Northern Ireland will operate.

The UK imports up to 2bn litres worth of dairy products a year, this trade is predominantly with four countries, with Ireland being the largest. If prices rise to 32ppl, as with a weak currency and hard Brexit, production may increase to fill this gap in as little as 2-3 years, but without a large increase in processing capacity, this will need a level year-round supply profile.

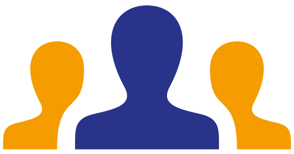
Other possible factors

There are other factors which could have some impact on these scenarios which are very difficult to predict. In particular, the UK government may intervene to keep food prices and inflation low, or supermarkets may change sourcing policies to offer competitive prices to their customers.

The style of Brexit could also be as important as the final outcome, as the negotiations will be monitored by financial markets, seeking clues on the eventual outcome. This will impact on currency during this period of uncertainly, directly impacting on the short-term viability of UK agriculture.

Looking beyond the five years post-Brexit, trade deals could be done which will influence the longer-term future. However, the need and progress of such deals will depend on which post-Brexit scenario is actually seen. These are impossible to predict now, but they will evolve over the coming years and so this will be less uncertain than the UK exit from the EU in March 2019.

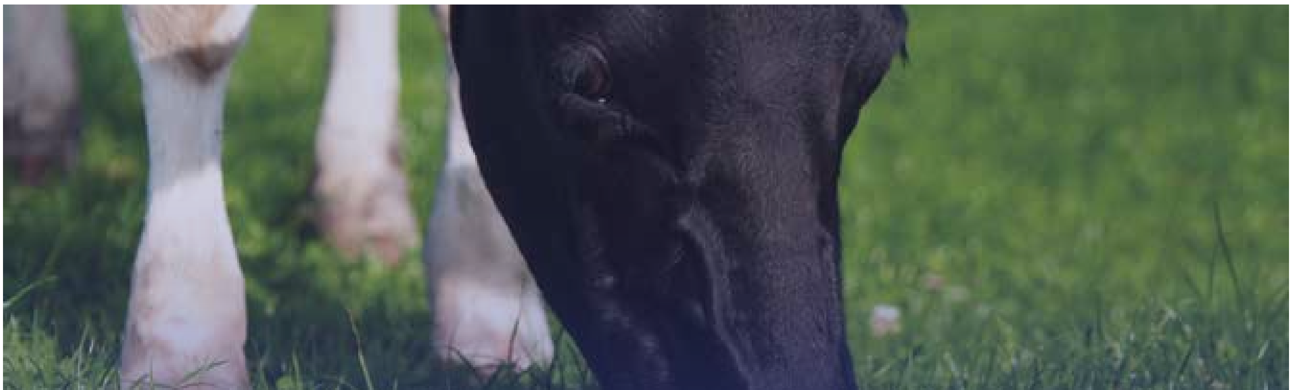
Labour Issues



A continuing and worsening shortage of labour and rising labour costs are the only post-Brexit effects which can be predicted with any certainty at the current time. Kite Consulting predicts at least an 8% increase in labour costs post-Brexit.

The Brexit vote has brought uncertainty, already encouraging people to return to their home countries, as well as stopping new people coming to the UK. Post-Brexit restrictions on immigration could make employing foreign workers even more difficult. In addition, the currency exchange rate, which will be affected by Brexit, will alter how wages compare with other countries.

Staff recruitment will become increasingly competitive and finding ways to retain good staff, which is often about factors in addition to the wages offered, will be crucial. Therefore developing good people skills will be crucial to developing longer term resilience in dairy businesses.



Summary and action points

Brexit is a rapidly moving and ever-changing position and we won't know the exact outcome for some months. The type of Brexit the UK will experience is not certain, although Kite Consulting believes, at this time, a soft Brexit with a weakened currency is the most likely outcome. Wherever the UK is heading there will be a period of uncertainty and volatility ahead.

The Brexit the UK adopts may well not be at the very extremes of each spectrum (soft or hard, weak or strong currency) but somewhere on each axis, and to cover the multiple scenarios associated with these options would be impossible. However, what is clear to Kite is there is only one scenario explored in this report in which dairy farmers make the level of profit necessary for a sustainable business – hard Brexit and a weak currency. It is with this in mind that Kite will continue to talk to DEFRA, NFU and other key organisations about how to maintain a sustainable, efficient dairy industry post-Brexit.

Dairy farmers and the industry have some time to plan and prepare. Below are some action points for dairy farmers as they prepare to meet the challenges Brexit represents to the industry and the wider agricultural community.

Action points for dairy farm businesses

- Plan for no support or less support for delivery of environmental goods.
- Aim to become a more resilient dairy operator with better business and people skills.
- Consider how to adapt and manage volatility in your business.
- Be as technically efficient as you can become with your system.
- Ask your milk processor questions about their preparation for Brexit.
- Consider what milk supply profiles will best suit your milk processor in the future.
- Do not rely on a weak currency to be the saviour of your business.

Kite Consulting LLP
The Dairy Lodge, Dunston Business Village,
Dunston, Staffordshire, ST18 9AB

01902 851007
enquiries@kiteconsulting.com
www.kiteconsulting.com