SEPTEMBER 2007

The Impact of Feed Costs on the British Pig Industry

Quality Pork Standard

BPEX British Pig Executive

Contents

Foreword

There is a strong public interest in ensuring that pig farmers and processors in this country receive a higher price from retailers for their pigs.

The British pig industry operates to world class standards of welfare and production. Pig producers receive no subsidies and have consistently introduced the latest technologies. Consumers have demonstrated a preference for high standards of pork through their purchase of Quality Standard Mark pork, bacon and ham - the QSM is independently audited to international standards at all stages of the production process.

However, the British pig industry is now under extreme and growing pressure caused by increases in feed prices - these account for almost half the cost of producing a pig. The doubling of feed costs has led to rises in the cost of pork production that are unsustainable for farmers.

British pig farming has already seen an overall decline of about 40% in the past ten years, partly due to farmers' commitment to high welfare standards and the increased costs these bring. Now they face making a loss on every pig they produce - a situation that is threatening the very existence of pig farming in Britain.

There is a strong public interest in ensuring that pig farmers and processors in this country receive a higher price from retailers for their pigs. Quality Standard pork, bacon and ham is produced to extremely high standards - a failure to pay a higher price and for retailers to resort to cheap imports will mean the import of pork, bacon and ham where the animals may have been treated in a way which would be illegal in the UK. Furthermore, supporting British farmers is a vital component in ensuring a quality, stable food chain in this country and local, sustainable meat production.

Higher prices for pigs are needed now if British farmers and processors are to ensure the survival of the British pig industry. Retailers have the opportunity to demonstrate a clear and genuine commitment to quality produce, and to consumers' preference for quality assured QSM pork, bacon and ham.

To overcome these problems, the supply chain has to pay pig farmers a higher price for their produce. Producers get only 30% of the retail price so a modest rise at retail could make a big difference at source - that will help protect a vulnerable supply chain.

I commend this report that sets out the background and economics of the situation and why British pigs are worth it.

Stewart Houston Chairman BPEX

Executive Summary

Feed represents the biggest single cost that pig producers face. On average it accounts for half of total costs. Recent rises in feed costs are threatening the sustainability of British high welfare pig production and processing.

The principal ingredient of pig feed is wheat, the price of which has been rising dramatically due to poor harvests in many parts of the world and growing demand, not least in the production of bio-fuels. The price of other ingredients such as Soya has also increased.

In the past year the price of wheat has more than doubled to over £160 / tonne. The futures market indicates that this high price will continue for the next 12 months. This will result in an increase in feed costs of 76% and total production costs of about 34%.

These feed price rises are a global phenomenon driven by global factors. Pig producers all over the EU will be threatened by significant cost increases in the coming 12 months.

At present the price received by pig producers is 110p/kg or about £85 for an average weight pig. This price is under downward pressure as abattoirs try to cope with increased costs.

Unless there is an increase in the price of pigs British producers are facing the prospect of losing an average of £26 on every slaughter pig produced over the next 12 months. That is the equivalent of £3.9 million a week or £196 million a year. The processing sector is also currently facing losses of £4 a pig even though export markets have reopened in the wake of foot and mouth and this is worth £600,000 a week or £30 million a year.

Failure to ensure that adequate prices are passed down the chain from retailers and food service buyers could have a devastating impact. History shows that losses at relatively modest levels in comparison with those possible in 2007/08 resulted in a decline of one third in the size of the British pig herd

An increase in price to farmers and processors that would ensure survival is achievable while minimising the impact on consumers. A significant increase in price at farm level would mean only a modest rise in retail pack prices.

Introduction

1 Feed is the single most important component in the cost of producing a pig.

2 In Great Britain and the rest of the EU feed consists mainly of wheat and some barley to provide carbohydrates and Soya for protein. Some producers use alternative feed sources such as food co-products (bread, biscuits etc) the prices of which are closely linked to the feed grain and protein markets.

3 In the past year the price of feed wheat has doubled as a result of a combination of relatively poor harvests, increasing import demand from fast developing countries and the global rush towards biofuels. The price of Soya has also increased for many of the same reasons and it is apparent that high prices are set to last for at least another year.

4 This report examines the recent and future trends in feed prices in Great Britain and the rest of the EU along with the factors driving the market. It then examines the impact this will have on the cost of pig production in this country and looks at what is necessary to mitigate the impact over the next 12 months. The report concludes with an examination of the potential impact on the British pig industry of a failure to address high feed costs, looking at the impact on the sector the last time profit margins came under severe and sustained pressure.

The Feed Market in 2006/2007

Feed Grains

5 The feed grains market started to move up in price from August 2006 following a relatively poor harvest in Europe. The very hot weather that affected most parts of Europe in the summer of 2006 resulted in EU-25 production falling by 4% compared with a year earlier.

6 Following a few months of stability, prices started to accelerate, with the weather having an adverse impact in major producing countries such as Argentina and Australia. In addition demand continued to rise with countries such as India and China importing significant quantities of wheat.

7 Against a background of tightening global supplies, world grain prices moved sharply higher in August. Markets were also underpinned by strong demand from importers seeking to safeguard their needs, as supply forecasts from some major producing countries were revised downwards.

8 These pressures were reflected in prices in the UK. In addition concerns over this year's harvest due to the wet summer weather had an impact. By the end of August 2007 the delivered price of feed wheat had reached £166 /tonne, 106% higher than a year earlier. Feed barley prices were also higher, up by 77% to £144 /tonne.

Soya

9 The Soya market has also been rising although not to the same extent. Production of Soya in the United States and Brazil was high in 2006 and combined with the weakening dollar it prevented prices in Britain rising by as much as feed grains. Nevertheless by the end of August the spot price of Liverpool HIPRO bulk Soya pellets was £185, an increase of 29% compared with a year earlier.

Feed Prices in 2007/2008

Cereals

10 World grain production is forecast to be higher in 2007/08, although there has been some downward revision to forecasts in August. The International Grains Council forecasts world grain production will increase from 1.568 million tonnes in 2006/07 to 1.653 million tonnes in 2007/08. United States production is forecast higher and the southern hemisphere harvests of Australia and Argentina are also expected to recover from the drought-affected conditions of the 2006/07 season.

11 Despite this higher production, the current indications are that world cereal prices will again be higher in the 2007/08 season due to increased world demand and continuing low stocks.

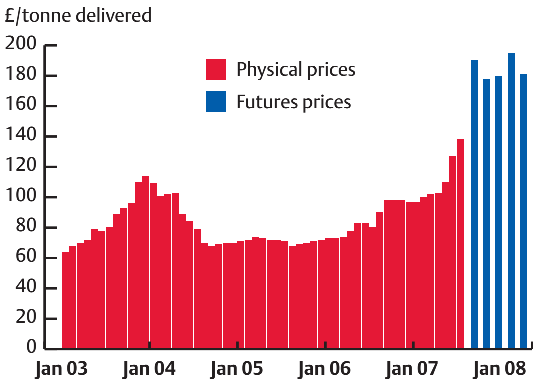
12 Additional drivers of world grain prices in 2007/08 will be:

- High import demand from India and China
- High maize prices in the United States caused by the increasing switch to industrial use, which will have a knock-on effect on cereal prices worldwide
- Potential export ban by the Ukraine, as a result of drought conditions. No details have emerged yet in Kiev, but the authorities were prepared for an arbitrary halt to exports last year
- Russia has cut 1.5m tonnes off its wheat export potential
- Sharply higher freight rates

13 The 2007 harvest in the United Kingdom and some other parts of Europe has not been helped by the very wet weather during June and July, which has had a negative effect on yield and quality. Average wheat yields in the UK are 10-15% down, leading to expectations of the lowest wheat harvest since 2001.

14 Futures prices on the UK's Liffe market have strengthened in recent months. Prices on 31 August 2007 for all of 2007/08 are well ahead of a year earlier, peaking at £187 for May 2008. Futures markets elsewhere in the EU are seeing the same trends.

UK feed wheat futures prices*



*As at 31/08/07

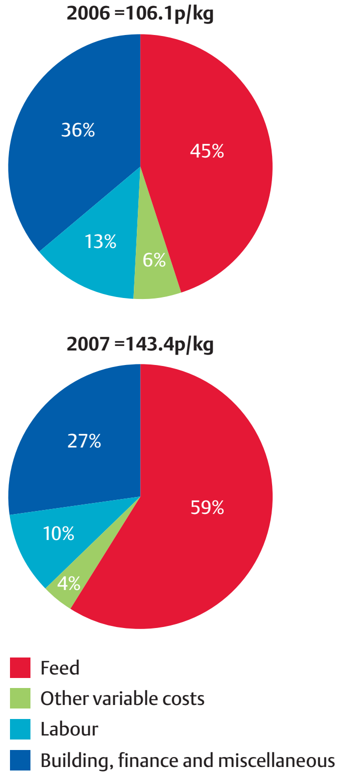
Soybean prices

15 US Soya bean prices are beginning to be affected by the increase in biofuel production. Bioethanol production in the United States is based on maize (it is based on wheat in the United Kingdom) and the increased demand for maize is being partly met by a switch in land use away from Soya production. Soya plantings this autumn are consequently forecast to be down.

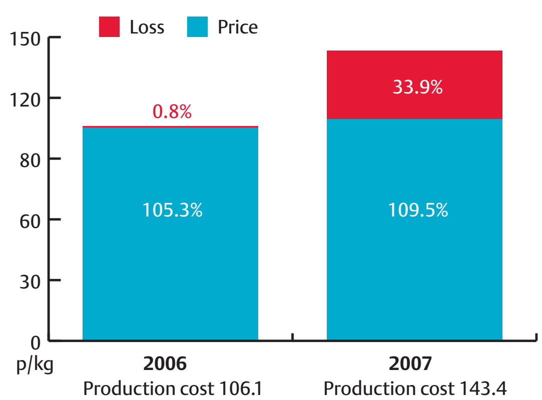
16 Futures prices in Chicago (as at 31 August 2007) were £160/tonne for September and £170/tonne for July 2008.

The Impact on Pig Production Costs

The cost of producing a pig



Profit and loss on British pig production



17 Feed is the single biggest component in the cost of producing a pig. In 2006 the average cost in Great Britain was 106p/kg dw (source: BPEX/Agrosoft). Total feed accounted for just over 45% of total costs. This was followed by buildings (including depreciation) finance charges and miscellaneous at 36% of total costs. As feed prices rise they will become even of greater significance in terms of total costs.

18 The increase in feed grain and Soya prices seen so far in 2007 and expected over the next 12 months, along with other feed ingredients such as milk powder and lysine, will result in finished pig feed costs rising by 76%. This would mean that total production costs for a finished pig would increase by 34% from 106.1p/kg to an average of 143.4p/kg.

19 The impact on the profitability of pig production will depend on the prices received for finished pigs. In 2006 British pig farmers averaged about break-even with market prices at 105.3p/kg. In August 2007 the average pig prices was 109.5.p/kg. If the pig price remains at this level and feed costs rise as predicted the average loss to a British pig farmer would be about 34p/kg or £26.25 per finished pig.

20 The exact impact on individual farmers will vary depending on a number of factors. For example, some use alternative feed sources such as food co-products including bread, biscuits, cakes and distillers grains. However, the price of such feed materials tends to move in line with wheat and Soya. As a result the impact is likely to be similar.

21 Many farmers and processors have tried to manage price risk. Many producers had forward feed contracts as a means of fixing feed costs for six months or even a year. However, many of these contracts ran out over the summer leaving producers to face not only the accumulated price rises of the last 6 or 12 months but also the prospect of covering the next 6 to 12 months at prices double those of a year ago. The impact is a like coming off a fixed rate mortgage and being faced with future increases

22 The industry wide impact on pig farmers of the expected rise in feed cost, based on 150,000 pigs slaughtered a week, would be losses of £3.94 million a week or £196 million if these losses persisted for a year.

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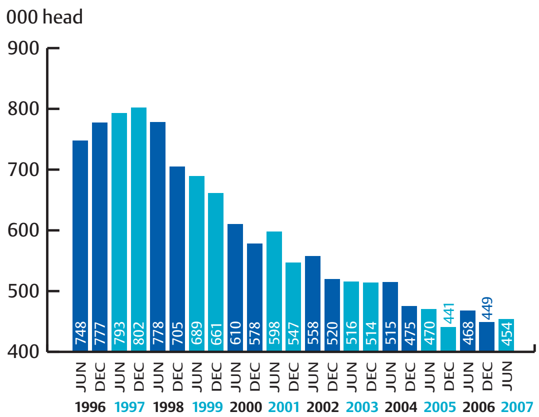
The Potential Impact on British Pig Production

Breeding herd trends



23 It is also worth considering the losses being experienced by the pig abattoir sector. Many of these businesses have been seeking to build sustainable supply chains with their producers. This has included, among other initiatives, factoring in pig cost of production rises when calculating payments to pig producers. In the vast majority of cases, these rises have not been reflected in the wholesale prices being paid by supermarkets. When this is combined with the extra cost of disposing of offal and residual products that were exported to non-EU countries prior to the Foot and Mouth outbreak, it is reported that abattoirs are losing up to £4 for every pig slaughtered. If this is repeated across the whole sector it indicates additional losses of £600,000 a week or £30 million a year.

24 It is impossible to assess the precise outcome that such a large rise in costs will have on pig production in this country. This will depend to a substantial degree on whether pig prices increase to cover all or part of these costs.

25 Nevertheless, reasonable parallels can be drawn from the recent past. Between mid-1998 and late 2000 there was a run of very low prices, much of the time in common with the rest of the EU. Over that time net profit margins as recorded by MLC Pig Plan were consistently negative, resulting in accumulating losses. In addition farmer confidence was undermined by outbreaks of Classical Swine Fever in 2000 and Foot and Mouth Disease in 2001.

26 The result was that the breeding herd in this country fell from 802,000 head in December 1997 to only 547,0000 head in December 2001. A decline of 32% in only four years (the industry subsequently has fallen further to only 454,000 head).

27 While it might be argued that the current industry is much smaller and probably better structured than 10 years ago, the potential scale of losses now facing the industry is much greater in the coming 12 months than in the late 1990s. The MLC Pig Plan data recorded average net losses, which peaked at about 12p/kg in 1998/99 compared with potential net losses of 34p/kg in 2007/08. Even allowing for some differences in recording methodology between MLC Pig Plan and Agrosoft, particularly in the treatment of depreciation of assets, the implication is stark.

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A Potential Solution

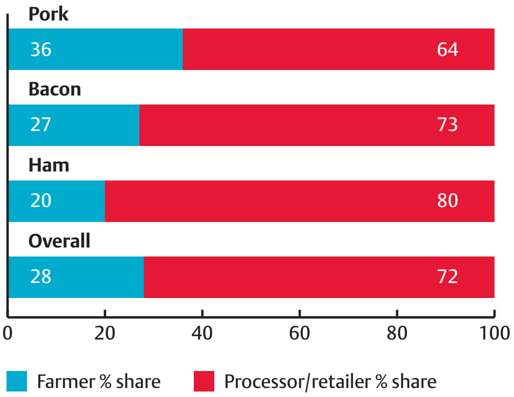
28 While there are a number of things that farmers can and will do to try to improve efficiency further, little can be done to reduce overall costs in the face of such a massive rise in feed costs.

29 The only sustainable solution is for farmers to obtain a higher price for their pigs and as the vast majority of British pork, bacon, ham and pork products are sold through retailers this means obtaining higher prices from supermarkets.

30 There is concern about the impact that this may have on consumers and the demand for pork and pork products such as bacon and ham. As the feed price pressures will also affect those EU farmers that supply the British market such as Denmark, Netherlands, Germany, France and so on, it is reasonable to assume that all pork and pork product prices would be affected.

31 An analysis of the share of retail expenditure that producers receive shows that there is considerable variation depending in general on the degrees of processing of the product. Overall, the farmer receives on average 28% of the retail price. So for example if the pig price increased by 35 pence and this was passed directly to the retail price without any extra margin being taken then retail prices would only rise by an average of 10%. In terms of the impact on retail prices this indicates a rise of between 7p and 17p on the pack price of typical pork and pork products.

Farmers' share of retail prices



Conclusion

32 The current escalation in feed grain prices and the strong market in Soya driven by low stocks, increasing demand for food and non-food use and poor weather, are threatening the sustainability of the British pig sector and those of the rest of the EU. With this situation likely to last for at least the next 12 months there is a need for a substantial increase in the price paid to producers and abattoirs. A failure to do so will result in substantial losses and, if history is a guide, a considerable reduction in the production capacity here and elsewhere in Europe.

33 Farmers, processors and some retailers have invested heavily in recent years to improve their supply chains and deliver high welfare, quality assured, increasingly locally produced pork and pork products to meet growing consumer demand.

34 A failure to act in the face of this challenge from high costs could result in that investment being completely undermined. The only solution is a modest rise in retail prices across the range of pork and pork products that is passed down the chain to secure the future of pork processors and especially pig farmers.