

Knowing your target price will help sustain your operation

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Since 2015, the price of milk has most definitely been a hot topic, and a number of producers seem to be struggling to cover their cost of production (COP).

A drop in price certainly hurts all producers, but the stress experienced by a producer trying to make ends meet every month is not the same as that of a producer who simply has to defer a planned upgrade by a few years.

When producers talk about the cost of production, they are most often referring to the cost reported by the Canadian Dairy Commission. Using a farm selection procedure and a methodology in keeping with the principles of equity (standardization of producer and family member salaries) and transparency (quota price is excluded), the CDC is able to establish a realistic picture of the dairy sector, and adjust support prices for butter and skim milk powder accordingly.

Why is it important to know your own COP?

Every dairy operation has unique characteristics that add up to a unique COP. Is it profitable to ship more milk at \$72/hl if it costs you \$78/hl to produce it? If your COP is \$71/hl, should you sell more milk, or choose to bring your cost below \$70/hl instead? Either way, the first step is to determine where you stand.

Now, what?

Once you know your target price, you might want to lower it. To do that efficiently, you'll need precise information, and you'll need to decide which expense to focus on first. This is where a detailed cost analysis and benchmarking become important. Whether you call on management professionals or choose to tackle this yourself, make sure you are using the same calculation bases as your benchmark operations are using. It's important to compare apples to apples.

Are smaller farms always at a disadvantage?

It is true that larger farms are able to spread their fixed costs over a greater production volume, thus benefiting from a dilution effect. Large farms also have access to economies of scale: doubling the capacity of a feeding system doesn't mean doubling its cost. Labour productivity is generally higher in larger operations as well. When an employee uses a machine that is twice the size to feed twice as many cows in the same amount of time as his neighbour, the cost of labour per cow fed is halved. Hence, the trend towards increasing farm size.

Even so, variable costs represent 50 to 55 per cent of an operation's total costs. In this regard, small farms are able to achieve returns equivalent to those of large farms, and are often able to do so for the same cost or less, simply by paying attention to

detail. Options such as cooperatives for the use of farm machinery (CUMA), farm labour cooperatives (CUMO) and contract work also allow small farms to capitalize on advantages generally associated with larger farms. By combining their needs, small farms benefit from the same savings while sharing the financial risk. The downside, however, is that decisions are made by the group rather than individually.

Conclusion

Knowing your cost of production or target price means knowing exactly where you stand in relation to the price you receive for your product. That knowledge makes it easier to evaluate the work required and plan the steps you need to take to improve your situation.

Controlling your costs is the best way to ensure the sustainability of your operation.

Simplified target price calculation

The farm target price is the receivable price required to cover all of an operation's costs, including producer salaries or withdrawals, equipment and building depreciation, and a fair return on invested capital. In economic terms, this is the break-even price. Below is a quick and simple method for estimating your target price using the information available in your financial statements. While not perfect, it will at least allow you to position your operation in relation to the price received.

SIMPLIFIED CALCULATION

Step 1: Identify the net cost to recover through milk sales (financial statements)

- A. Total variable costs
- B. Total fixed costs
- C. Costs for other agricultural productions
- D. Deductible income
(animal sales, variations in inventory, non-recurring revenues, etc.)
- E. Net costs to recover (A + B – C – D)

Step 2: Determine how much your capital should yield (financial statements)

- F. Equity
- G. Interest rate on investments
- H. Return on equity (F x G)

Step 3: Determine the volume of milk shipped (milk payment or PLQ extranet site)

- I. Milk shipments for the 12 months of your financial statements

Step 4: Calculate your target price

Net costs to recover ÷ shipments [(E + H) ÷ F]

Shown here is an example of the calculation for two farms

	Farm A	Farm B
Total variable costs	\$466,300	\$618,300
Fixed costs	\$173,000	\$206,200
Costs for other agricultural production	\$ –	\$ –
Deductible revenues	\$124,500	\$217,000
Net costs to recover	\$514,800	\$607,500
Equity earnings	\$1,500,000 x 0.75%	\$700,000 x 0.75%
Total to cover	\$526,050	\$612,750
Milk shipped (hl)	7,507	7,860
Target price (\$/hl)	\$70.07	\$77.96