

MHS - LONG TERM FINANCIAL PLANNING**EXECUTIVE SUMMARY**

1. When approving the MHS Transformation programme in July 2007, the Board endorsed a trajectory which sought to deliver MHS net cost of operations of £10m by 2012/13. This has been a key feature of the FSA's future financial planning, and continued reduction in the net cost of operations is an important factor in the FSA's ability to deliver its strategic priorities within a declining overall budget.
2. Delivery of this reduced subsidy is dependent on progress being made both to reduce costs and to raise industry income. Good progress has been made in reducing gross costs and staffing levels during the first two years of the Transformation process (highlighted in Information Paper FSA 21/04/09 – MHS Modernisation Update). We have seen less progress in increasing industry income, reflecting both declining levels of throughput, and a less favourable climate for increasing charging levels. In our view this means that it is no longer sensible to plan on the basis of achieving a net cost of operations of £10m by 2012/13; and this paper suggests, subject to further detailed work over the next 2-3 months, a revised planning trajectory.
3. In reviewing the trajectory, it remains our view that the £10m subsidy is a viable and achievable target for the future, albeit not within the original proposed timetable. It is important to communicate openly with industry and others about this, so that we can set future charging levels in context, avoid ambiguity and enable industry to plan effectively their business decisions in the medium and longer term. It is similarly important to have such clarity within the FSA, given the difficult future Spending Review discussions that undoubtedly lie ahead.
4. This paper has looked again both at opportunities for driving further cost reductions, and at the appropriate trajectory for increasing industry income. New and additional potential cost savings of around £3m have been identified (over and above the substantial savings already being planned). The new factors which we have brought into the equation are: lower than previously planned assumptions about future public sector pay increases; the merger of FSA/MHS Corporate Services; and reductions in unused contractual overtime, as a result of changes in terms and conditions.
5. However, reductions in gross costs alone will not deliver the longer term financial objective. Income from industry will also need to increase. Whilst the economy is in recession, we anticipate a more cautious approach to charging increases - even though livestock prices remain high due to the weakness of Sterling. However we believe that, as the economy recovers and further reductions in costs are realised, above inflation increases will be both justified and necessary

to enable the £10m subsidy to be realised. The context and arguments for increased charging levels are set out in the separate FSA Board paper on increases in charging levels in 2009/10.

6. On the basis of the assumptions set out in this paper, our assessment is that we could sensibly plan to yield a £10m net cost of operations by 2014/15. This would assume industry income increased in line with inflation for 2009/10 and 2010/11 before larger annual increases of around 7-8% apply. Subject to Board discussion on the proposed increases to charges in 2009/10, and any comments on this paper, more detailed analysis will be undertaken over the next three months to produce a detailed financial plan.

7. The Board is asked to:

- **note and endorse** the above approach, which reaffirms the £10m target subsidy for the MHS, whilst re-setting the trajectory for achieving that level of subsidy over the next 5 years.

FSA/MHS

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Background

1. Since the Transformation programme began in July 2007 there has been a major reduction in actual and forecast MHS gross costs (a real terms reduction of 32% by 2010/11). However, income from industry is not now expected to rise in line with original expectations and there remains a significant subsidy gap. This variance is at odds with FSA Board thinking when approving the transformation programme, and also reduces resources available for the delivery of wider FSA strategic priorities.
2. This paper reviews various aspects of the financial framework within which the MHS is likely to operate between now and 2014/15, and suggests a revised trajectory for subsidy reductions. Further work will be done to refine this analysis over the next three months. In particular, further modelling is required to confirm the forecast of future chargeable hours given the likely structural changes to the industry and its relationship to the MHS through the Optimisation process. However, subject to Board discussion, we do recommend that the overall approach on charging increases set out in this paper provides the new high-level planning assumption for both FSA/MHS and industry.

Discussion

Industry Prospects

3. The UK is in recession, and there are strong arguments from industry and others that now is not the time for increases in rates, especially if they are in excess of inflation. However, there are several points to consider:
 - industry is currently charged a fraction of what it has been charged prior to the introduction of the Maclean charging mechanism;
 - livestock prices are currently particularly strong, supported by a weak Sterling. Arguably there is sufficient profit in the livestock sector to fund increased industry charge-out rates (though the headage profit element may not always be apportioned between different livestock industry sectors on either a fair or rational basis);
 - It remains a source of frustration to the FSA that industry is either unable or unwilling to provide high quality total supply chain margin analysis to test 'affordability'
 - The cost of official controls remains very small in relation to the price of meat.

Reducing Costs

Operational Efficiency

4. Ongoing efficiencies are expected from an integrated programme of changes which are plant specific:
 - Optimisation, including the move to risk-based activities and FBO changes to their methods of working in plant (some of which may require significant investment by FBOs);
 - Working in partnership with FBOs on local business agreements, which identify effective planning and deployment to save industry costs and allow improved management of MHS resources. For every £1m gross cost saving from official controls work it is estimated that the net cost may be reduced by £500k. This assumes around 50% of the cost is recovered from industry, and overheads can be reduced in line with operational cost reductions. Government work is charged on a full cost recovery basis, and therefore gross cost reductions here have nil effect on net cost;
 - Introduction of time-based charging, which will focus attention by the FBOs on activity and associated costs to drive more effective MHS resourcing;
 - Continual improvement brought about from organising MHS resources on a cluster basis, including the deployment of Lead Veterinarians to manage plant activities; and
 - Implementation of the new contracting arrangements for Official Veterinarians and Meat Inspectors are targeted to promote performance improvement leading to resource reductions as well as providing significant cost savings (c. £6m p.a.). This saving has been incorporated into MHS future forecasts.

Unused contractual overtime

5. Unused contractual overtime is being actively managed down by Business Managers. Future annual potential savings of **£0.5m** are feasible and achievable.

Public Sector Pay

6. The MHS has yet to implement the August 2008 pay increase. However, it is being accrued for, with an estimated increase of around 3% anticipated. However, our latest guidance suggests that we should plan for an average pay increase of 1.5% this year, and continued downward pressure is likely to continue for the next few years. This would save costs of around **£0.6m** per year (**£0.4m** in 2009/10 if implemented in August) from previous forecasts; and this figure could grow over future years.

Merger of Corporate Services

7. The MHS is working with FSA colleagues to fully integrate our Corporate Service functions in order to provide efficient and effective services that meet the needs of its internal customers and external stakeholders. The formal Business Case is currently being finalised, but we will be aiming for efficiency savings of £1m-£2m in relation to current MHS costs.
8. In summary the above cost reductions may amount to **£3.1m** per year compared to current forecasts, when, and if, items 5 to 7 above are realised. Additionally, gross costs may reduce by a further £1m-£3m between 2012/13 and 2014/15 as government funded work is scaled down, though this has no effect on net cost of operations (because costs are recovered in full from government customers).

Industry Income

Hourly Rates

9. Following the proposed introduction of time-based charging in July 2009, hourly charge-out rates will need to increase significantly over the succeeding years to move towards near full recovery of costs from industry. The effect of percentage rate increases on income in 2009/10 is shown below. This table incorporates future estimated reductions in hours, which explains the more modest effect of increases on forecast income.

Table 1: Percentage rate increases effect

Industry Income 2009/10 % charge increase	Forecast Income
	£m
0%	24.5
4%	25.0
6%	25.2
9%	25.5

EC Minima

10. The EC Minima rates are set in Euros, and, as Sterling has weakened, this has led to calls of 'profiteering' from industry, although only a fraction of industry costs are recovered. The rates have moved as follows:

Table 2: Movements in the Euro Rate

Date	Conversion (1 Euro = £)	Base	Percentage Change on 2006
31/08/2006	0.674		
31/08/2007	0.678	Previous Base	0.6%
1/09/2008	0.812	Current Base	20.5%
31/03/2009	0.928	Potential Base for April 2010	37.7%

11. The MHS is required by European law to comply with the minimum headage charges set by the EC. These are uplifted in January each year in line with the exchange rate at the start of the preceding September. Recent instability in the financial markets has led to volatile Sterling/Euro conversion. The conversion rates almost reached parity at the end of 2008, but Sterling has strengthened since then. However, it must be remembered that a weak Sterling/Euro also presents a clear economic benefit to the livestock industry as a whole as exports become relatively cheap.
12. It is estimated that continuing favourable movement in the Sterling/Euro exchange rate would lead to additional income as follows (if the EC requirements were adhered to):

Increase in total charges from further depreciation of the £ from 1/9/08 levels by 10%, 15% and 20%

% depreciation	GB extra charges
10%	£0.588m
15%	£0.835m
20%	£1.069m

At the current 31 March 2009 exchange rate it is estimated that an additional **£0.8m** in charges to industry would be required from April 2010. However, it is worth reiterating that currency movements are notoriously difficult to predict.

Volume

13. MHS future year throughput figures are consistent with Defra expectations. However, the National Beef Association has recently highlighted that total UK beef and dairy cattle numbers have fallen below 10m for the first time. Slaughtering of heifers has increased which may lead to an increased shortfall in cattle throughput from the end of 2010.

Figure 1: Throughput by Species 2000-2013



Funding the MHS Net Cost of Operations

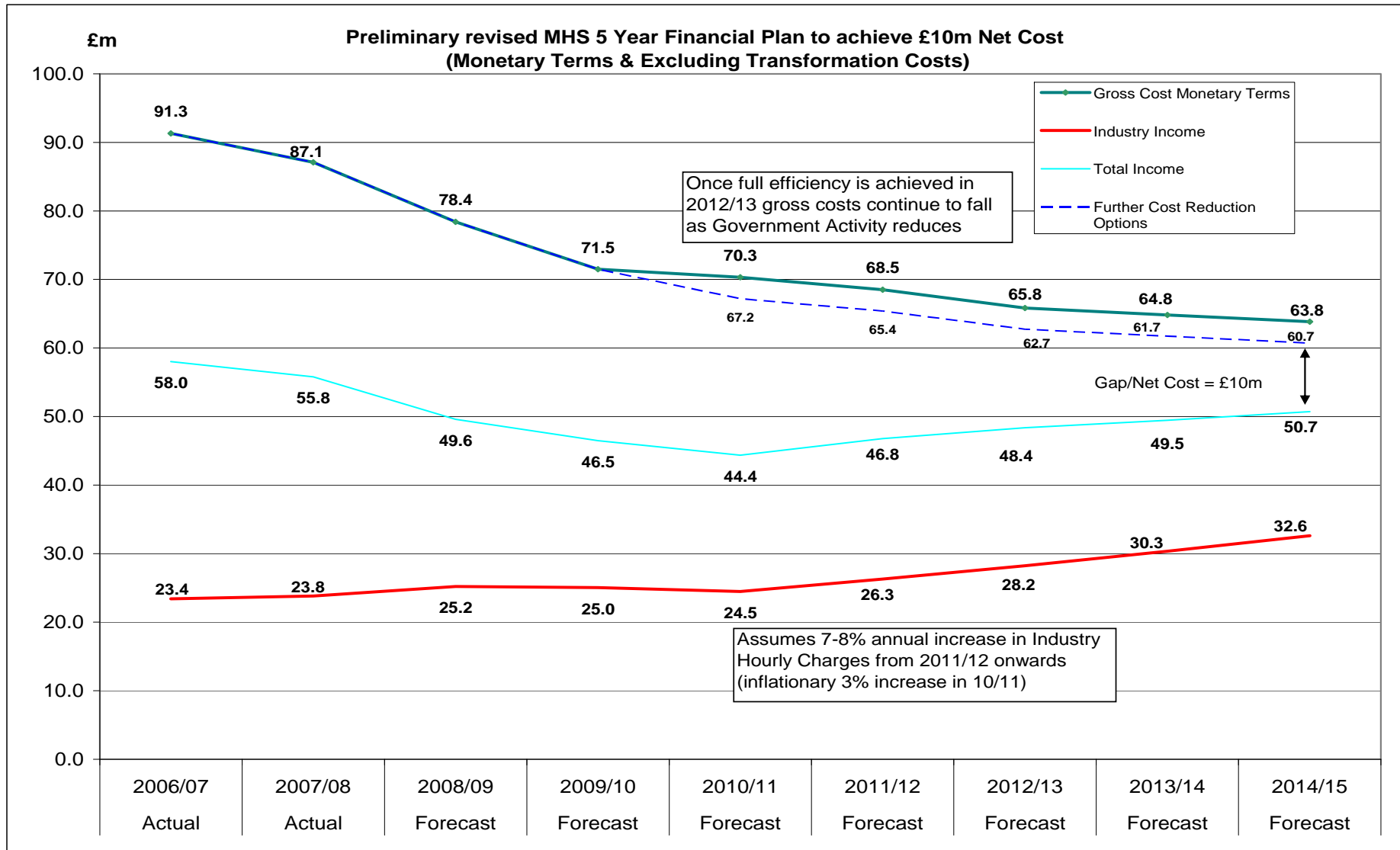
14. The net cost of MHS operations is funded by the Food Standards Agency. If the MHS net cost is not in line with expectations, there will be less funding available for delivery of other FSA strategic priorities. The FSA is developing a new Strategic Plan, and will want to ensure that future resourcing reflects the priorities within this.

15. Overall, Government finances are tight. The 2007 Spending Review implemented funding cuts on the FSA for the first time. The next Spending Review may impose similar, or deeper, future funding cuts. If the MHS net cost of operations doesn't reduce significantly, this will limit the FSA's ability to fund the new Strategic Plan. Currently around 32% of FSA funding is directed at meat hygiene enforcement and controls.

16. Figure 2 shows how net cost of operations of £10m could be achieved by 2014/15. This assumes inflationary increases in charges to industry of between 3% and 4% in 2009/10 and 2010/11 before 7-8% annual increases until 2014/15 (this assumes exchange rates remain constant). It is also contingent on £3m of additional cost savings being realised.

17. Previous analysis has confirmed that annual increases of around 20% would be needed from 2011/12 for the target to be realised by 2012/13 (similarly following inflation only increases in 2009/10 and 2010/11).

Figure 2: Preliminary Cost and Income Proposal



Conclusion

18. This paper suggests a revised timetable for the delivery of £10m net cost of operations for the MHS. Further potential cost savings have been identified. Industry income is forecast to increase in line with inflation for 2009/10 and 2010/11 before larger annual increases of around 7-8% apply. This would yield a £10m net cost of operations by 2014/15. Subject to Board discussion on the proposed increases to charges in 2009/10, and any comments on this paper, more detailed analysis will be undertaken over the next 2-3 months to produce a detailed financial plan.

19. The Board is asked to:

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