

11 Views of other interested parties

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Government departments

Ministry of Agriculture, Fisheries and Food

Marketing of raw milk

11.1. MAFF said that the structural defects and inappropriateness of the UK milk marketing system had caused increasing tension between suppliers and processors during the late 1980s and early 1990s.

11.2. The system of end-use pricing in place under the MMB regime had meant that manufacturers of high value-added products had to pay higher prices for milk than did manufacturers of low value-added products, such as butter and SMP. MAFF had agreed with a consultant's report commissioned by the EWMMB, that end-use pricing had discouraged innovation and investment in new products and, coupled with the managed market, contributed to stagnation in the milk industry by shielding it from the normal disciplines of competition.

11.3. MAFF said that the Government had therefore decided to abolish the MMBs and with them the obligation on producers to sell to a particular purchaser. The EWMMB had pressed for a single successor body to purchase milk. This had become Milk Marque. There had been no explicit prohibition on Milk Marque achieving a dominant position in the market, but the Government had made it clear that (unlike the MMBs) it would be subject to UK and EC competition law. However, provision was not made for a regulator of the milk market. (In the Government's view, this would have replaced one bureaucratic process with another and would have been incompatible with EC rules for the common organization of the milk market.)

11.4. At deregulation Milk Marque had urged farmers to join it because it would produce good returns. Milk Marque's competitors had done the same. Processors, for their part, had tried to recruit direct suppliers by offering to pay more than Milk Marque.

Milk Marque's selling system and contract structure

11.5. MAFF said that it had played a significant part in the approval of Milk Marque's initial selling system. The Agriculture Act 1993 required the Minister to decide whether, at deregulation, the EWMMB's proposals for a selling system took account of the interests of the purchasers. After various changes had been made to the selling system at MAFF's suggestion, the Minister felt able to conclude that they did. MAFF had seen no reason to object to Milk Marque's use of a volume-related auction system. However, the processors were clearly not happy with it, and both sides of the industry would have to be satisfied with any replacement if it were to have a chance of success. There ought to be no return to the system as operated by the MMBs, since its defects were well established.

Prices

11.6. MAFF said that deregulation had led to marked rises in producer prices. There were four causes:

- (a) As vesting day approached milk purchasers had contracted with dairy farmers for direct supply. Some dairy farmers had formed producer groups to negotiate better terms for supply to processors. Competition to source direct supplies had driven up producer prices.
- (b) A proportion of producers had not contracted with any purchaser until late in the day. This had probably led individual purchasers to conclude that they would achieve a lower share than proved to be the case. In the meantime some offered extra incentives.
- (c) Sterling had weakened against the ecu. This had led to increases, in sterling terms, in the intervention prices for butter and SMP. Also sterling's weakness had made imports less competitive and UK products more attractive on export markets.
- (d) A surplus of processing capacity, particularly for butter, milk powders and cheese, had exacerbated the intense competition for supplies of raw milk. This overcapacity had been encouraged by artificially low milk prices under the old marketing arrangements, but it continued well beyond vesting day.

11.7. MAFF said that, although the sharp rise in milk prices at deregulation had been expected, it had been greater than could be justified objectively. Since January 1997, the price of milk had fallen. Most processors seemed now to have secured the level of direct supplies they wanted and were

therefore no longer actively recruiting dairy farmers. MAFF suspected that many processors now realized they had paid too much to secure direct supplies at deregulation.

11.8. Sterling had appreciated dramatically in 1997 and 1998. This had led to cuts, in sterling terms, in support prices for butter and SMP; had encouraged imports; and had made UK exports less competitive. The BSE crisis, quite separately, had affected export markets. There had, too, been many closures of processing plants.

11.9. MAFF said that, nonetheless, tensions between processors and producers, including Milk Marque, had not diminished to the extent hoped. Milk Marque's selling system satisfied neither side: producers blamed it for low prices, and the dairy industry for being uncertain and unpredictable, with consequent disadvantages for planning and investment.

11.10. MAFF believed that Milk Marque was now an efficient organization, contracting to sell milk and transport it. It had reduced its size to take account of that limited role. However, with a market share exceeding 40 per cent, it probably had enough market power to influence milk prices.

Intervention prices

11.11. MAFF believed that the proposed reduction in EC intervention prices and the new measures of direct support, if agreed and implemented, would cause milk prices to go down. This in turn would lead to a reduction in the number of farmers, but should, in itself, have no impact on processors.

Relationship between raw milk prices and retail prices

11.12. MAFF noted the widely-held view that producers were being paid less for their milk but that consumers were not offered comparably reduced prices. It said that the intense competition between supermarkets kept consumer prices down. MAFF thus suspected that less efficient organizations in the dairy industry were inclined to blame supermarkets for low producer prices. Doorstep sales were not affected by the present structure of the milk industry. If there was demand for it, then milk would be delivered to the doorstep; if there was no demand for it, retailers would not sell in that way. MAFF would not seek to distort the market to maintain doorstep deliveries.

Transport arrangements

11.13. MAFF believed that the transport argument was of no relevance to the present problems. It was reasonable for Milk Marque, as a wholesaler of milk, to take responsibility for its transport and to include the cost in the price of the milk.

Vertical integration

11.14. MAFF said that vertically integrated co-operatives had not become established in the UK mainly because of the existence of the MMBs. At deregulation, the Government had agreed with the European Commission that Dairy Crest should not be transferred to Milk Marque. Various options had been considered but MAFF believed that the chosen course, of separation and flotation on the Stock Exchange, was correct. There were arguments that it would be useful for farmers to have a stake in the processing of milk. This was the situation in many other EC states. However, with Dairy Crest it had not been merely a question of vertical integration. At deregulation Dairy Crest processed about 30 per cent of the milk in England and Wales, and Milk Marque had about 75 per cent of the milk market as the successor body to the EWMMB. If Milk Marque had then owned Dairy Crest it would have been difficult to ensure fair competition between Dairy Crest and other processors purchasing milk from Milk Marque.

11.15. Milk Marque had not been explicitly banned from processing at deregulation because the Government wished to minimize regulatory controls. But MAFF had not expected Milk Marque to be permitted to develop its processing capacity further while it remained a strong force in the supply of raw milk. Accordingly, MAFF was concerned at Milk Marque's acquisition of Aeron Valley. Though it was not a large company, Milk Marque had publicly stated that it intended to increase substantially its involvement in vertical integration. It was not clear how equality of competition could be ensured between Aeron Valley and its competitors.

The structure of the dairy industry

11.16. MAFF said that, despite rationalization and increased efficiency, the UK dairy processing industry remained fragmented and relatively small compared with its European counterparts.

11.17. UK cheese production was also relatively small-scale. Small units might be efficient in exploiting niche markets, but most of the larger companies were small in international terms. The UK remained a substantial net importer of cheese, despite its attractive, diverse and numerous cheese products. The UK trade deficit in cheese reflected in part the small scale of UK cheese manufacturers. Unless they acted together, manufacturers could not afford the high costs necessary to develop and exploit export markets on a large scale.

11.18. MAFF believed that the fragmentation and apparent lack of investment and dynamism in much of the UK dairy industry was also a factor behind the rapid increase in overseas companies purchasing and processing milk in the UK in recent years. This inward investment had benefited the UK dairy industry. There had been little comparable outward investment by UK dairy companies, many of which were acting innovatively in sectors other than the dairy industry but for some reason appeared to lack initiative in the milk processing sector.

11.19. MAFF thought the tension in the UK dairy industry between producers (including Milk Marque) and processors contrasted sharply with the co-operation observed elsewhere in the EC. The difficulty in the UK was that the two sides of the industry were pulling in opposite directions, devoting management resources to unproductive wrangling. MAFF had hoped the structures put in place after deregulation would have remedied this defect. But although the new system had produced some distinct advantages and other marginal improvements, the relationship between Milk Marque and the processors represented by the DIF was poor.

11.20. MAFF believed that foreign-owned companies had expanded in the UK because of the opportunities presented by the structural problems of the UK industry. It was difficult for companies in some other countries in the EC to invest and expand because most milk quotas were held by vertically integrated co-operatives and milk was simply not available. (The same constraint applied to UK firms wishing to invest in other EC member states.) In the UK the structure allowed processors seeking milk to outbid their competitors.

11.21. MAFF believed that if Milk Marque's position in the market was strengthened giving it greater bargaining power, many UK processors would lose confidence, perhaps selling out to overseas interests. If their confidence could somehow be increased, they might become more dynamic and enterprising.

11.22. In MAFF's view milk production and processing would thrive in the UK only if the talents of the people concerned were allowed to flourish. The industry's present structure appeared to prevent that. MAFF would prefer to see an energetic and dynamic industry that was UK-owned. Second best would be an energetic and dynamic industry that was foreign-owned. Worst of all would be to have a moribund industry.

The UK market in relation to the EC dairy regime

11.23. MAFF said that the principal ways in which the EC dairy regime currently affected the UK market were through the quota system and the relatively high support prices, notably the intervention prices for butter and for SMP. The Milk Management Committee, chaired by the European

Commission, also had an impact on the market through its role in setting aid rates under the various schemes for disposal of the EC's structural milk surplus.

11.24. The quotas of most other EC member states generally exceeded their consumption levels leading to surplus dairy products in the EC. In recent years, the EC had been the main exporter of dairy products to the world market.

11.25. Current EC support prices were at least 50 per cent higher than the world prices for the products concerned. Those prices, determined annually by the Agriculture Council, set the target price, until the end of 1998 in ecus, and now in euros, for milk and the intervention prices for butter and SMP. They had last been changed in 1994 when the butter intervention price had been cut by 3 per cent. The SMP price had been left unchanged. The changes in the intervention prices agreed during the annual price fixing by the Agriculture Council had an impact on producer prices.

11.26. Concessionary imports from third countries were another major influence on the UK market. Before the UK's accession to the EEC in 1973 it had relied substantially on imports of dairy products from Commonwealth countries, in particular New Zealand. These imports had continued subsequently albeit at reduced volumes. Access to the EC market was now governed by various tariff quotas negotiated by the WTO. For example, New Zealand currently had a reduced levy quota arrangement for butter which, if the maximum tonnage of imports came into the UK, was equivalent to about 30 per cent of the UK's butter consumption.

11.27. The present WTO agreement would progressively limit the quantities of exports of dairy products from the EC that could be subsidized. The limited quantities were relatively generous for low-value dairy products but for cheese, and other dairy products such as yogurt, cream, condensed milks and composite milk products, the limits were more restrictive and already were beginning to have an effect on EC exports. To remain within the WTO limits, the European Commission had had to reduce the export refunds payable on exports of these products. MAFF believed that the present high EC prices, combined with uncertainty over the future level of export refunds, served as a disincentive to international companies to invest in the EC to meet growing world demand for dairy products.

11.28. In March 1998, the European Commission announced proposals to reduce intervention prices for butter and SMP in the four years starting in 2000/01. This would be combined with the introduction of a direct aid payment to farmers, partly to compensate for the resulting reduction in their returns. MAFF said that the Government would have preferred to have seen a price reduction of about 30 per cent over a five-year period to enable world prices to be reached and quotas to be abolished at the end of that period.

11.29. MAFF believed that the quota system, WTO constraints, and high EC support prices acted as disincentives to investment in the UK dairy industry. These were particularly unfortunate given the UK's advantages of climate and farm structure. MAFF wanted UK milk production and processing to thrive as part of an innovative and internationally competitive dairy industry.

Welsh Office

11.30. The Welsh Office said that dairy farming was an important part of Welsh agriculture and Welsh farms accounted for about 10 per cent of all liquid milk sold in Great Britain. The predominant milk-producing area was West Wales. Any further downturn in the producing or processing sectors of the dairy industry would have serious implications for the local economy and for rural communities.

11.31. Welsh food strategies were based on a need to maximize high value-added niche markets and branding. Although several producers were successfully processing farmhouse cheeses, they were generally reluctant to expand their businesses outside of family ownership and their overall impact on the economy in West Wales was limited.

11.32. The Welsh Office said that after Dairy Crest's closure of its Whitland plant, about one-third of the annual milk production in West Wales had had to be transported out of Wales for processing. This had disadvantaged Welsh producers, particularly in view of the increasing pressure for transport costs to be reflected in milk prices. The Welsh Office believed that if Milk Marque had to divest

Aeron Valley, it would be unlikely to stay in the market as an independent processor unless it established a profitable niche market. If it were to close, the impact on the local community would be devastating.

11.33. The Welsh Office had been in favour of Milk Marque's acquisition of Aeron Valley because the expansion of the plant would greatly reduce the need to transport milk out of Wales. Without Milk Marque's acquisition Aeron Valley would have been unlikely to have made the necessary move into processing higher value-added products. This development of processing facilities in West Wales would help to stabilize the milk market and promote development in an area which had been hard-hit economically. Moves to enable the company to expand were therefore very important for the Welsh dairy industry. But the Welsh Office recognized that competition concerns might arise.

Other organizations

Plunkett Foundation

11.34. The Plunkett Foundation (the Foundation), a charitable trust established in 1919 and mainly concerned with user-controlled rural enterprises, gave evidence. It told us that it had long been involved with agricultural co-operatives and had undertaken a series of comparative studies into the organization of milk producers in the run-up to deregulation. The Foundation organized annual conferences of producers' groups in the UK, and was in regular contact with over 50 producers' organizations.

Vertical integration

11.35. The Foundation said that milk was an internationally traded commodity; the UK dairy industry operated in a global market. Producers' organizations were important in most large milk-producing countries. If producers were to remain economically viable in the face of international competition, they needed to share in the added-value and operating efficiencies which vertical integration brought. An opportunity had been denied to UK producers because of the system of MMBs and the compulsory separation of Dairy Crest. It was essential to the prosperity of the industry that pricing arrangements ensured a fair share for primary milk producers. Producers' organizations had to develop their own processing capacity to become more price competitive internationally.

11.36. The Foundation believed that a declining UK milk market since deregulation had resulted in a lack of new investment in both processing and added-value manufacturing. This would lead to UK milk producers and the dairy industry being less able to compete in international markets. Internationally, the dairy processing industry was becoming even more concentrated. In the UK, substantial parts of the milk processing industry and liquid milk distribution were now directly or indirectly in the hands of businesses owned by producers' organizations in other EC member states. UK milk processing costs were higher than those of the integrated producers' organizations elsewhere in Europe.

11.37. The Foundation believed that producer co-operatives offered the only means of countering the market power of the retailers and processors. Dairy produce markets were highly volatile, most recently demonstrated by the fall in milk prices in the 18 months to March 1998. The Foundation thought the behaviour of the market confirmed that Milk Marque had no monopoly power. Under EC law, primary producers could co-operate to counterbalance buyers' power. Prospects for the UK dairy industry would be extremely bleak unless UK producers could combine to negotiate prices collectively.

Milk Marque's selling system and pricing

11.38. The Foundation said that modifications were required to the existing Milk Marque selling arrangements, but only to the extent that producers were able to sustain their businesses. The 90 per

cent threshold had depressed prices; increasing milk quotas was likely to depress them further. If demand continued to fall there would be further downward pressures on prices. This would cause long-term damage to the UK milk industry.

Scottish Landowners' Federation

11.39. The Scottish Landowners' Federation (SLF) said that after deregulation producers selling through a co-operative such as Milk Marque or Scottish Milk had been denied the opportunity to process their milk. Now, when all sectors of agriculture were trying to gain a value-added advantage, the exclusion of producers' marketing organizations from vertical integration would be contrary to fair competition. A dynamic and profitable dairy sector was in the consumer's interest. Milk Marque's prices set a benchmark for Scottish co-operatives' milk price, and they should be able to undertake processing. Producers should also be able to choose to whom they sold their milk. The SLF would be opposed to any restrictions on co-operatives' selling systems.

11.40. With relatively few buyers purchasing about 80 per cent of all milk sold, the SLF was concerned that a processors' cartel could develop. Major retailers now sold over one-half of all liquid milk, and they had considerable influence over price as shown by the differences between prices paid to producers and processors and supermarket prices. Despite a marked decline in the farm gate price during the last year, supermarket prices had remained static. The SLF believed that the MMC should take action to improve the competitive situation in the milk supply, processing, distribution and retail chain.

Retailers

Asda Stores Ltd

11.41. Asda Stores Ltd (Asda) said that traceability was an important issue. Its suppliers kept records of the supply chain for milk and milk products and this information was available for audit as required. Asda regarded animal welfare and farm assurance as crucial to the safety and quality of the milk it sold. Milk Marque now allowed independent audit of its supplying farms and records and Asda's processor suppliers were arranging a schedule for this which would be in operation by September 1999.

Retail prices of dairy products

11.42. Asda said that it sought to offer its customers competitive and value-for-money prices. It obtained all its milk, butter and cheese direct from processors. Asda's negotiations with the processors over cost prices took account of farm gate prices, packaging, distribution, manufacturing and equipment running costs.

Marks & Spencer plc

11.43. Marks & Spencer plc (Marks & Spencer) told us that it did not have any serious concerns about the supply of milk in Great Britain. It had not experienced any problems, for example over price or availability, that had affected its ability to offer its customers high-quality, value-for-money products.

11.44. Marks & Spencer said that for many years it had regarded traceability of its food products as a fundamental requirement and it expected to be able to trace the producer of a particular carton of milk. Marks & Spencer was content for this information to be held by the supplier (for example, Milk Marque) provided Marks & Spencer was satisfied that the necessary systems were in place and operating correctly.

11.45. Marks & Spencer also considered proper standards of animal welfare to be essential in the production of its food products. Farm assurance required each farm supplying milk to confirm compliance with agreed standards. Although the schemes being discussed within the trade went some way towards meeting these expectations, the pace of change was too slow and therefore Marks & Spencer was making its own arrangements in conjunction with its suppliers.

Retail prices of dairy products

11.46. Marks & Spencer said that its policy was to offer foods which were good quality and good value. It did not seek to have the lowest prices. Nevertheless it had to remain competitive and could not ignore changes to its cost prices. Marks & Spencer had been able to keep reasonable control of cheese prices in recent years but liquid milk and butter markets had been more volatile. Marks & Spencer's retail prices had not always moved in line with every change in the costs.

Safeway Stores plc

11.47. Safeway Stores plc (Safeway) said that traceability was central in providing customer reassurance. In the event of a quality, safety or hygiene problem, a product's source needed to be precisely identified so that only that product needed to be withdrawn. Traceability also provided feedback to producers on quality performance. Safeway did not keep records of milk traceability but required its suppliers to do so. It was satisfied with the arrangements for traceability which existed with its suppliers where milk came from direct supply. It understood that Milk Marque had arrangements to ensure traceability but Safeway did not have access to what these arrangements entailed. It was concerned that delays could occur in obtaining information.

11.48. Safeway's market research showed that consumers placed emphasis on dairy cattle welfare. The issues consumers raised had prompted Safeway to develop its own farm assurance standards in consultation with its milk suppliers. It set additional standards to those in the National Dairy Farm Assurance Scheme.

Retail prices of dairy products

11.49. Safeway said that in setting retail prices for liquid milk and dairy products it followed the market, monitoring the pricing levels of its competitors. Historically, Safeway agreed prices bi-annually with processors. The prices it charged for liquid milk and dairy products were significant in the context of the company's overall level of business. It maintained competitive prices in order to give customers the best deal. It had not sought to loss lead.

J Sainsbury plc

11.50. J Sainsbury plc (Sainsbury) believed that the current Milk Marque selling system was not as effective in clearing volume and delivering sustainable income returns to dairy farmers as the end-use pricing system in place before deregulation. The processors' use of the selling system had led to recent low average producer prices. The long-term effects of this could be severe for the farming community, and could lead to a serious long-term impact on employment. Sainsbury believed there should be a more independent mechanism for the supply of milk, not a free market, but a managed system to establish the market price.

11.51. Sainsbury regarded traceability of milk as vital. It expected the ultimate supplier (for example, Milk Marque) to have records identifying the farms from which each tanker had collected and it reserved the right to audit these records. Milk Marque's system currently met Sainsbury's requirements.

11.52. On the issue of farm assurance, Sainsbury said that it had agreed a long-term comprehensive programme with its suppliers and their producers which incorporated components including: food safety; animal welfare; animal feed; veterinary medicines; and environmental protection and enhancement. Over the past four years, since its dairy welfare policy had been introduced, Sainsbury had worked closely with its suppliers and associated organizations like Milk Marque. All its suppliers met these requirements from December 1998.

Retail prices of dairy products

11.53. Sainsbury said that it endeavoured to price its food products competitively against other leading retailers. This applied to dairy products, including milk. It had not lost on any of these products in the last five years.

Somerfield Stores Limited

11.54. Somerfield Stores Limited (Somerfield) considered that traceability was essential for quality reasons and to allow it to understand the milk chain and to have some input on issues such as animal welfare. Given the calibre of the processors it dealt with and of Milk Marque, Somerfield was content for them to keep the records, providing it had access to them.

11.55. Somerfield said that animal welfare and farm assurance were of increasing importance to consumers. It worked in conjunction with the industry to promote a more welfare-friendly system.

Retail prices of dairy products

11.56. Somerfield said that it set its prices to remain competitive with other leading high street food retailers. Farm gate prices had a limited bearing on retail prices, although they were instrumental in Somerfield's conversations with its suppliers regarding costs. When determining profit, Somerfield took account of store overheads and distribution charges only on a category basis rather than on individual lines and therefore found it difficult to define loss leading. However, Somerfield said that at times during the last five years its margins on fresh milk and butter had been low.

Tesco Stores Ltd

11.57. Tesco Stores Ltd (Tesco) considered traceability to be an important part of its obligation to customers in the interests of product safety. For milk and milk products it kept records of the supply chain back to the processor which was itself required to keep records of individual producers. Animal welfare and farm assurance were also important issues.

Retail prices of dairy products

11.58. Tesco said that its policy was to reduce prices while improving quality and customer service. Dairy products (including liquid milk) were an integral part of its business and it was important that the prices of these goods remained competitive. The importance of these products to consumers, and the competition between retailers, meant that shelf prices varied over time. Market pressures could be such as to require a competitive response. The object of 'so-called' loss leading when applied was to ensure that Tesco's prices met that need. Its aim was at the least to cover costs although sometimes it might have to take a loss for a period. Tesco never lost in an effort to exclude a competitor from the market.

Tricon Restaurants International

11.59. Tricon Restaurants International (Tricon) told us that as a long-standing customer of the dairy industry in Great Britain it purchased in excess of £20 million worth of cheese annually for its European Pizza Hut business. Until recently, it had purchased all its cheese in England and Wales. But in the past two years Tricon had bought some cheese from Continental suppliers, in part because of the strength of sterling, but also because of the unpredictable and high prices of milk in Great Britain.

11.60. Tricon believed that Milk Marque's selling system had made cheese prices in Great Britain uncompetitive and unpredictable, bearing little relation to underlying market forces. It told us that it understood Milk Marque had sold part of its available milk to butter manufacturers at a lower price than that offered to other customers in the August bidding round of the summer 1998 selling process. This policy, with contract processing and Milk Marque's infrequent auctions, meant that UK cheese was more expensive than elsewhere in Europe, and dearer than Tricon believed market forces could justify. In Tricon's view, Milk Marque was exploiting its monopolistic position and going against both the interests of its customers and members.

11.61. Tricon believed the UK should be its long-term cheese supplier. However, if Milk Marque's selling system remained in place, Tricon would expect to buy more, and possibly most, of its cheese from the Continent. It required a milk supply that was secure, transparent, predictable and cost competitive.

United Norwest Co-operatives Limited

11.62. United Norwest Co-operatives Limited (United Norwest Co-op) purchased 70 per cent of its milk from AWG and 30 per cent from Milk Marque. It believed traceability was important because problems could then be isolated to a particular source and quick action could be taken. Although at present its suppliers of milk and milk products kept records of the supply chain, United Norwest Co-op was currently reviewing the process of record-holding for all the products it sold.

11.63. United Norwest Co-op considered animal welfare and farm assurance to be important issues and these elements too were currently under review. It believed that industry-wide standards on animal welfare would be beneficial; it did not regard this as a legitimate area of competition.

11.64. United Norwest Co-op said that it negotiated cost prices with its suppliers and set its retail prices in line with the market.

Waitrose Limited

11.65. Waitrose Limited (Waitrose) said that the current quality standards for Great Britain's liquid milk were among the best in Europe and it would not wish to see them jeopardized. Waitrose believed that Milk Marque's selling system had encouraged processors to hold back from bidding for Milk Marque's milk and forced prices down, close to intervention levels. In turn this put severe pressure on Milk Marque and its members, and could possibly lead to a break-up of its business. Although in the short term this might create a more competitive situation for consumers, retailers and processors, it could lead to farmers taking short cuts. This could lower standards and potentially lead to poorer welfare practices. In the long term, with less competition, prices would be likely to rise.

MPs

Mr Cynog Dafis

11.66. Mr Cynog Dafis, MP for Ceredigion, expressed concerns that the DGFT had decided to make the reference to the MMC at a time when milk prices had declined by 20 per cent in a year. He noted that, during this period, processors' profits had increased and retail prices had been static.

11.67. Commenting on our hypothetical remedies, Mr Dafis questioned any possible finding that Milk Marque had a dominant position, particularly as producers' co-operatives in other European countries were far more powerful. He was opposed to structural reform, believing that dividing Milk Marque into smaller regional bodies would weaken its negotiating power. Mr Dafis said that milk producers, many of whom were small, needed the strength of a large-scale co-operative to represent their interests. He could not see how Milk Marque could be operating anti-competitively given the current low price of milk.

11.68. Mr Dafis said that Milk Marque's acquisition of Aeron Valley had encouraged producers in West Wales, who had feared that processing facilities would be taken out of the area, and that this would bring about the detrimental effects of increased transport costs. Mr Dafis said that Milk Marque now had a reduced share of the total milk for the liquid milk market and should be allowed to continue processing. The removal of its ability to engage in processing could have serious consequences for the long-term security of producers, particularly in West Wales.

Mr David Drew

11.69. Mr David Drew, MP for Stroud, said that he was closely involved with the local farming community, many of whom were becoming increasingly concerned about the future of their industry. He took an interest in our inquiry and forwarded the views of producers who had written to him. Their comments are included in the summary of producers' views in paragraphs 9.289 to 9.336. Mr Drew was particularly concerned that we should consider the potential impact that processors and large retailers had in setting retail prices for milk. He believed that any outcome must provide a more sustainable, fairer and permanent solution to what was currently an unacceptable situation.

Mrs Ray Michie

11.70. Mrs Ray Michie, MP for Argyll and Bute, said that milk prices in her constituency had dropped by 5 ppl over a six-month period in 1997/98. Producers in the Kintyre area were going out of business and this was damaging the fragile economy. Mrs Michie believed that the market was not as competitive and transparent as it should be. Despite the drop in raw milk prices, retail prices had remained the same and processors' profits were increasing.

Other MPs

11.71. Mr Derek Foster, Mr Oliver Letwin, Mr Owen Paterson and Mr Christopher Ruane all expressed interest in our inquiry. These MPs asked questions about the extent and timing of our investigation and forwarded letters from farmers in their constituencies whose views are included in the summary in paragraphs 9.289 to 9.336.

Trade union

Transport and General Workers Union

11.72. The Transport and General Workers Union (T&G) said that it had about 12,000 members working in milk processing, distribution and manufacturing. It was also the main trade union representing agricultural workers. The T&G said that its prime objective was to protect its members' job security. The T&G was satisfied that Milk Marque was making every endeavour to ensure that it maintained an arm's length relationship with MMD.

Others

Mr S Bates

11.73. Mr Bates from the Department of Agricultural Economics, Wye College, University of London, who had been part of a team which compiled a report on Milk Marque's selling system for the OFT in April 1997, commented on our hypothetical recommendations.

Reform of Milk Marque's selling system

11.74. Mr Bates said that Milk Marque's current selling system had shortcomings but he questioned whether the type of auction system operating in Northern Ireland would, alone, be appropriate in Great Britain, as the Northern Ireland system had itself been subject to recent criticism.¹ He said that the original Milk Marque selling mechanism had been independently audited but this had not satisfied the milk purchasers. It was not so much adherence to the rules as the rules themselves which the DIF objected to. Thus, further auditing alone was unlikely to address the core problem. The operation of the system by a neutral party, whilst possible, would be a difficult task, particularly as the party would have to mediate between the DIF and Milk Marque. If it had to be audited or supervised, the system would likely prove bureaucratic and complicated.

Vertical integration

11.75. Mr Bates believed that a change to the selling system or the structure of Milk Marque would be preferable to the prohibition of its processing operations. He said that the value-added service aspects of Milk Marque's system had been bypassed largely because, increasingly, milk purchasers were obtaining their priority milk requirements direct, often buying only the lower-value milk from Milk Marque. Yet Milk Marque had to add value to its milk in order to give its members a reasonable return. It could do this by processing. In the past, the DIF had argued that milk could not be processed at the IMPE and that the IMPE calculation was incorrect. Milk Marque had argued that the calculation of the IMPE was correct and that it was only the inefficiency of the processing sector that prevented them from buying milk at this level. Thus Milk Marque ought to be allowed to buy milk for its butter and milk powder operations only at the IMPE, in order to prevent it bidding up the price for milk. As such, any profits from processing ought to be paid back to farmer members as a return on processing, rather than through the milk price.

Transport charges

11.76. Mr Bates thought that maintaining Milk Marque's current selling system and unbundling transport charges would not be a satisfactory solution in itself (as this did not appear to be the core

¹As reported in *Dairy Industry Newsletter*, 3 November 1998.

problem). It might make prices more transparent. However, there was still a need for the type of transport service Milk Marque provided. The question was how much the service should cost.

Structural reform

11.77. Mr Bates said that there appeared to be three issues at stake: Milk Marque's size, its selling system and its capacity to process milk. Adjustments to the selling system to date had proved unsatisfactory to all parties. However, that selling mechanism was an issue only because of the size of Milk Marque. Equally, processing was an issue only because of the size of Milk Marque. Therefore, as a simpler solution, one could argue for the division of Milk Marque into a number of smaller milk groups. The selling system and processing capacity would then no longer be an issue. Any newly-formed groups would then be able to sell milk or process as they wished. However, if this solution were to be adopted the scale efficiencies of Milk Marque would be lost. There would also be problems in dealing with ownership of Milk Marque's processing capacity (and other assets) under such a scenario. In addition, Mr Bates commented that there was concentration in the processing sector so that if Milk Marque were divided, the balance of negotiating power between processors and producers would probably tip in favour of the processors. Mr Bates was also concerned that any newly-formed bodies might selectively recruit producers in areas convenient to the dairies to the detriment of the marginal farmers.

Mr J Empson

11.78. Mr Empson, now in retirement, was a former Director of Marketing at the EWMMB, and Chief Executive of its commercial divisions (the forerunner of Dairy Crest). He is an agricultural economist and has been a consultant on dairy development in developing countries. His submissions provided information on the background and history of the UK milk supply industry, international co-operative marketing and the competitive structure of the EC.

11.79. Mr Empson said that because of the way the UK dairy industry had grown, the structure of the processing companies appeared somewhat fragmented and weak. Much larger European competitors had moved in to establish themselves as major buyers of milk. He believed that, after being under the influence of milk marketing schemes for 60 years, UK processing and marketing needed further rationalization and reorganization in order to compete effectively in an EC environment. He supported the development of vertically integrated co-operatives such as those which operated elsewhere in the EC and in the world, believing that co-operatives could not operate successfully without manufacturing facilities.

11.80. Commenting on our hypothetical recommendations, Mr Empson said that if we were to conclude that a monopoly situation existed in favour of Milk Marque, it would be difficult to demonstrate that Milk Marque had materially influenced price and that damage to the public interest had resulted.

11.81. Mr Empson did not support the recommendations relating to the reform of the selling system. He said that Milk Marque's members, because of milk's characteristics, felt at a disadvantage in selling their product. Unlike a joint stock company, Milk Marque guaranteed its members an outlet and so could become a market of last resort. It also set a floor to its members' prices. The hypothetical recommendations set limits on what Milk Marque might do; defined and restricted the means by which it could sell; and fundamentally varied the role and purpose of a co-operative and its relationship with its members. The recommendation that a neutral party should sell the milk indicated a compulsory replacement of Milk Marque. It appeared that the neutral party would not be responsible to the producers or, indeed, to anyone else.

11.82. Mr Empson said that structural change was the best way to remedy any possible adverse effects. Dividing Milk Marque should be a final decision. It would prevent further discussions about its selling system and what it could do. This solution would maintain the co-operative principle of acting on behalf of the members, and the resulting organizations would presumably be free to sell their members' milk and to engage in processing as they wished. Any constraint on them should be

avoided. The new bodies would need to be of a size sufficient to command the financial resources required for development, and in keeping with modern developments in the industry's organizational pattern. Although this solution might duplicate resources, new investment in the manufacturing side of the industry was probably required. In any event, in Mr Empson's view, effective competition could not be secured without duplication. The limiting factor on newly-formed groups might be the financial resources the producer members could raise and it was principally for this reason that Mr Empson believed the new bodies should not be too small.

Dr R Pool

11.83. Dr Pool, a consultant, told us that his views represented those of an informal group of milk producers and producer/processors. He believed that many of the problems in the industry arose from the way in which the successor bodies to the MMBs had been funded. Monies retained from all producers had been used to fund the successor bodies, but not the independent producers or producer groups. Many producers felt that these assets had been unequally distributed and the only way to retain a claim on them was to join the successor bodies. They then found themselves unable to leave without penal losses. Milk Marque's members had their freedom further restricted when they voluntarily converted their certificates of entitlement into preference shares. Scottish Milk's practice of changing its thirteenth balancing milk payment into a loyalty bonus was another sort of leaving penalty.

11.84. Dr Pool recommended that the monies used to fund the successor bodies should be returned to the producers. In each case the producer would be free to use this money as he chose without his decision affecting, for a substantial time, the price offered for his milk by the successor body. And, should the producer wish to leave the successor body, his milk payments should be unchanged for at least a year, preferably two, to avoid distortions caused by seasonality payments. In addition, those producers who did not choose to join on vesting day should be able to do so later without incurring a penalty. In Dr Pool's view these distortions in the market needed to be remedied so that all concerned in the market could compete. He had no objections to the successor bodies developing their own commercial dairy activities, provided they were funded only by their members.

11.85. In response to our hypothetical recommendations, Dr Pool:

- (a) noted that a producer's choice would be limited if it were not permitted to sell to a milk group outside its region; and
- (b) did not support the formation of a regulatory body for the dairy industry. He said that the marketing of milk did not create a natural monopoly and should be left free of regulation. Once all producers had been given the opportunity to stay with, or rejoin or leave the successor bodies, free of constraints, there would be no need for further remedial action. Dr Pool believed that change within the market was slowly correcting current defects.

Mr R E Williams

11.86. Mr Williams, now in retirement, was the Chief Economist and Director of Economics at the EWMMB from 1971 to 1992. He told us that since his retirement he had taken part in various inquiries into the milk industry. He provided us with background information including a study on the CAP in the dairy sector which he had undertaken for the Food and Agriculture Organization of the United Nations (FAO) in 1996/97.¹

11.87. Mr Williams told us that by European standards the price UK producers received for milk was relatively low, which he believed resulted from the way the industry had evolved. Deregulation, and the establishment of Milk Marque, had brought the first attempt to establish competitive purchasing for 60 years in an industry whose management had been given little time to prepare for it. Mr Williams said that although the current low price of milk was partly a result of the high level of

¹*The political economy of the common market in milk and dairy products in the European Union*, FAO Economic and Social Development paper 142, 1997.

the sterling exchange rate, it was also a result of the marketing system, the high transaction costs involved in selling milk and the overall low level of efficiency of the processing industry. Mr Williams said that elsewhere in Europe the focus was on the conversion by producer-owned co-operatives of the raw material into consumer products and marketing them with maximum efficiency to maximize returns to the producers. In Great Britain, Mr Williams believed, the focus of the privately-owned processing industry was on returns to the shareholders, which could be increased most easily by reducing the price of milk, the principal cost.

Mr Barry Wilson

11.88. Mr Barry Wilson, publisher of the biennial *UK Milk Report* and editor of *Dairy Industry Newsletter*, said that since the late 1960s he had worked mainly as a political and economics journalist, latterly primarily in agricultural economics. He was also joint editor of the free-sheet, *British Dairying* magazine, which was circulated to all dairy farmers in Great Britain.

11.89. Mr Wilson said that he had taken a special interest in the deregulation of the milk industry. He had favoured the abolition of the MMBs—mainly because they penalized producers in terms of milk price, and prevented innovation in the processing industry. This inertia had continued to the present day; the industry was still insular compared with, for example, Italy where the processing industry was dynamic although imports of dairy products were even higher than in Great Britain.

11.90. In Mr Wilson's view the enmity within the UK milk industry went back many years. Before deregulation the only discussions between producers and processors on resolving milk price issues had been through the Joint Committees (see paragraph 3.6). And there had been no statutory requirement to consult processors about deregulation. Processors had never approved of MMBs engaging in processing, and the MMBs had not been interested in obtaining processors' views about the reorganization of the industry.

11.91. Mr Wilson said that the EWMMB had been very powerful. The debate about its replacement had been muted and, rather than taking the lead itself, the Government had left it to the EWMMB to decide how its successor body should be organized. Vertical integration had only been ruled out if it were to be linked to a single broking co-operative. It appeared that the majority of producers had believed a monopoly broker would give them more power than several vertically integrated co-operatives.

11.92. Mr Wilson believed that Milk Marque had inherited the ethos of the EWMMB. It was not interested in consultation with its customers. Its aim to become a major processor, as well as a dominant milk seller, was aggravating the dispute with the processors and penalizing Milk Marque's members.

11.93. Mr Wilson told us that the first Milk Marque selling process in 1994 had shaken the industry. Because the processors had panicked, prices had risen. This had been disastrous for processors but a success for producers. Increasingly, processors sought direct suppliers to avoid dealing with Milk Marque whose selling mechanism, in Mr Wilson's view, allowed it to charge unrealistically high prices. Having entered into direct contracts with producers at a high premium over the Milk Marque price, processors had been forced to maintain these prices.

11.94. In Mr Wilson's view, if Milk Marque were to disappear completely, the demand for milk would tend to increase prices above current levels through the need to increase prices paid to current Milk Marque members. At the same time there would be a reduction in the prices processors paid direct suppliers.

11.95. Mr Wilson believed that consumers were largely unaffected by raw milk prices. The major issues at stake were the strength of British dairy farming and, probably even more importantly, the efficiency of milk processing which needed stability and predictability in the pricing and supply of milk.

11.96. Commenting on our hypothetical recommendations, Mr Wilson said that in his view the status quo was unacceptable. Since Milk Marque had made the decision not to abide by the 90 per cent

threshold a new ad hoc system had emerged which was unlikely to deliver fairer milk prices. Also the system was almost totally non-transparent. It involved shipping milk overseas in an unsuccessful attempt to support prices for the rest of Milk Marque's milk. Commodity butter and SMP prices in many parts of Europe were being destabilized through Milk Marque and its agents 'dumping' products that they had to sell. One possible solution would be to allow Milk Marque to implode, as now seemed possible. But this could take time and would be damaging to the short-term future economic prospects for both farmers and milk processors.

11.97. Mr Wilson believed that the falling clock auction system as used in Northern Ireland was the only viable alternative selling system. There was general agreement that this was working well. However, the system in Northern Ireland had evolved because of a growing goodwill between seller and buyers. Because of the poor relationship between the two sides of the industry in Great Britain, an open auction system might have to be operated by a regulator, and heavily audited. This outcome would be particularly important if Milk Marque remained, and was allowed to expand into milk processing and effectively to become a buyer in its own auction.

11.98. It seemed perverse to Mr Wilson that producers supplying milk to Milk Marque should be prohibited from processing their own milk, especially in view of the low prices they were now receiving. Without a processing arm, and in view of its size, Milk Marque could not be guaranteed the IMPE if processors unilaterally decided to take out capacity. Mr Wilson thought such an eventuality was a genuine fear held by Milk Marque. At some stage Milk Marque was likely to lose its dominant market position and would then, presumably, be permitted to process. But this would probably be too late.

11.99. In Mr Wilson's view Milk Marque should be allowed to engage in processing but only if it were prepared to accept an open auction system without reservation. Its processing business should be separated from its brokerage. The two Milk Marque companies should have entirely different boards of directors, and be based in different offices. MMD should accept new shareholdings and have an entirely different capital structure. The current operations of MMD (as with DQF in Northern Ireland) should be audited and scrutinized. This would not be as difficult as some dairy companies might suggest, and seemed now to be a minor concern in Northern Ireland. Such a structure should provide MMD with the required commercial incentives. This solution might be favoured by Milk Marque's members who had lost faith in the selling system and now seemed interested mainly in entering processing.

11.100. Mr Wilson believed that it would be problematical to divide Milk Marque into a number of smaller bodies. It would be difficult to decide which members should go in which group and some groupings would be stronger than others. There would also be the problem of the sharing of assets. In addition, there was no guarantee that a divided Milk Marque would not enjoy similar market dominance in some regions.

D P B KINGSMILL (*Chairman*)

A T CLOTHIER

C DARKE

P A GEROSKI

G H STACY

P A BOYS (*Secretary*)

26 February 1999