



House of Commons
Environment, Food and Rural
Affairs Committee

Milk Pricing in the United Kingdom: Replies from the Government and the Office of Fair Trading

Thirteenth Special Report

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The Environment, Food and Rural Affairs Committee

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THIRTEENTH SPECIAL REPORT

The Environment, Food and Rural Affairs Committee reported to the House on *Milk Pricing in the United Kingdom* in its Ninth Report of Session 2003–04, published on 8 June 2004 as HC 335. The Government's Reply to the Report was received on 26 July 2004. We also received a Reply from the Office of Fair Trading (OFT) to Recommendation 20, which was made specifically to the OFT. Both replies are appended to this Report.

Government response

Introduction

The Government welcomes this report. It has raised awareness of the need to improve relationships within the dairy supply chain. The Committee's report has also highlighted the need for the industry to work together to solve the problems caused by low farmgate prices and the current uncertainties in the dairy sector. The Committee has rightly noted the complexities of the milk pricing system, the poor transparency, and the challenges which face the industry, not least through the reform of the Common Agricultural Policy. The Committee has also raised some interesting issues with regard to the power of supermarkets relative to their suppliers.

The Office of Fair Trading have responsibility for competition law and the supermarket code of practice. This response has been agreed with them and also with the Devolved Administrations.

Recommendations 1–3 and 5–7

We accept Defra's evidence that, although retail prices for liquid milk rose by 2 ppl between October 2002 and October 2003, the average farmgate price in fact rose by 1.46 ppl, as against the 0.6 ppl that might be expected. We therefore conclude that the July and September 2003 retail price increases *were* transmitted to farmers. (Paragraph 40)

However, we are concerned about the way in which the price increases were achieved: despite the indicators in the dairy market in 2003 suggesting that farmgate prices should increase, the major supermarkets appear to have increased their prices only when political pressure was applied by farmers. We are also concerned about the way in which the price increases were transmitted. The transmission was uneven: some farmers have benefited more than others. The transmission was also delayed: it took

The events of 2003 suggest that market-based information which particularly reflected known changes in the cost of production and currency movements had little influence on the pricing decisions of the major milk buyers. If the milk market is to work efficiently, signals on factors affecting price must be responded to without the need for application of external political pressure. (Paragraph 43)

We urge the dairy companies to examine the means by which they communicate with their producers and, where they feel that there is a legitimate reason for delaying transmission of price increases on to farmers, to ensure that this is communicated effectively to farmers. Constructive dialogue between dairy companies and producers is obviously to be preferred to direct action. (Paragraph 47)

Given that we know that dairy companies are making no more than about 3 ppl profit, the evidence we have received suggests that about 18 ppl of the retail price of a litre of liquid milk is being taken up by the dairy companies' costs. The dairy companies will of course need to use some or all of that 18 ppl in collecting and transporting raw milk and then processing it into liquid milk. We believe that the dairy companies should provide dairy farmers with a detailed justification of why it is that they appear to need to take such a significant chunk of the retail price of liquid milk to cover their costs. (Paragraph 56)

When added to the complex structure of the dairy sector, the lack of transparency in the dairy supply chain means that farmers have been unable to identify conclusively what proportion of the 2003 retail price increases has passed back to them by way of increased farmgate prices. (Paragraph 58)

The Government welcomes the Committee's conclusion that the retail price increases were transmitted to farmers. The Government shares the Committee's concern about the way the retail price increases appear to have been achieved. Whilst the frustration felt by many is understandable, we do not support farmer protests. The Government agrees dialogue is preferable to direct action.

The Government recognises the thrust of the Committee's conclusions about the way prices increases were transmitted and how the expectation of farmers that they would receive the retail price increases in full was not fulfilled. However, given that milk sold by farmers can be used in a number of different end products with different returns on each, it is unrealistic to expect that all farmers would get the full amount, unless their raw milk was sold to a supplier that only supplied the major retail outlets with liquid milk. It is therefore not unexpected that farmers will get different proportions of the retail price increases precisely because their supplier may be involved in the production of different commodities or the supply of different outlets and therefore exposed to different markets whose performances differ.

The Government does not believe there is sufficient evidence to support the Committee's conclusion that about 18 pence per litre of the retail price of milk is taken

up by dairy companies' costs. However, this uncertainty over costs does serve to illustrate the lack of transparency in the dairy supply chain.

The Government does not consider that price transparency in itself, will improve farmgate prices. However, more openness along the supply chain could help foster trust and thereby promote collaborative action that helps address some of the underlying causes of low prices (improving co-operation is of course part of the rationale underpinning the Dairy Supply Chain Forum). The Government would therefore welcome any moves by dairy processors and others in the supply chain to improve the way they communicate with producers. The work of the Food Chain Centre on value chain analysis in the dairy sector, which is being supported by a grant of £0.5m from Defra, could be more helpful. It should not only help participants understand the costs of others in the supply chain, but also help them work together to eliminate cost and improve margins for mutual benefit.

Recommendation 4

We recommend that the Milk Development Council commission research into the reasons why farmers are pulling out of the dairy industry. In particular, it should ascertain whether farmers who sell their milk through the farmer-owned co-ops, rather than directly to the dairy companies, are over-represented in the group of farmers pulling out of the industry. We consider such information vital in tracking the development of the dairy industry. (Paragraph 46)

Decisions on what research are to undertake are for the Milk Development Council (MDC) itself, within the limits of its statutory remit. The MDC has already conducted a useful survey into farmer intentions, which will be repeated later this year. Defra will also be funding survey work for next spring (2005) to follow up the report by Professors Colman et al on the economics of dairy production in 2002/03.

Recommendations 8–10 and 14

From the evidence we have heard in the course of our present inquiry, we are extremely concerned by the poor state of relations in the dairy industry. We have seen evidence of suspicion and mistrust, preoccupied self-interest and a lack of constructive dialogue. Some of the answers we received to our questions were at best opaque, if not disingenuous, making this a difficult enquiry to undertake and to conclude. We can only agree with Dairy Crest's description of the dairy sector as characterised by an "engrained adversarialism and blame culture". Sadly, there has been no evidence of an improvement since the Agriculture Committee inquiry. (Paragraph 59)

We commend the Government for the initiative it has shown in setting up the Dairy Supply Chain Forum. (Paragraph 61)

We have serious doubts about the wisdom of the Government's intention to withdraw from its role as facilitator of the Dairy Supply Chain Forum. We are not confident that relations within the dairy industry are sufficiently advanced as to be capable of constructive dialogue and action without the facilitation of the Government. We recommend that, rather than withdrawing from the forum, the Government should instead continue to chair the forum in order to demonstrate the importance that it places on the dairy sector and the need for further change within the sector. We recommend that the Government use the forum as a means to:

- **take immediate action to establish what proportion of the retail price of liquid milk and other dairy products is retained by each of the participants in the relevant supply chain in order to improve transparency in the dairy supply chain**
- **improve the information about the dairy market that is available and communicate that information to dairy farmers by way of regular, formal communication; such information should explain how retail price increases are transmitted down the dairy supply chain and provide case-specific data in respect of recent retail price increases**
- **address, in an open and constructive way, the engrained adversarialism and blame culture that continues to characterise the dairy industry. (Paragraph 63)**

We have been struck by the divergent views within the dairy industry about what factors do, in fact, determine the price of milk. We recommend that the Dairy Supply Chain Forum take the lead in seeking to build a consensus within the industry about the factors that are determinative in this matter. (Paragraph 78)

The Government agrees that relationships within the dairy supply chain can be difficult and that there is sometimes mistrust between the different parts of the chain, particularly with regard to prices. Nevertheless, there is good evidence that the industry can and does work together to address issues of mutual interest. Recent examples include the shared use of transport between producer groups and processors to reduce costs and the work on seasonality, which has seen producer groups and processors talking openly about costs, and together coming up with guidelines for the industry. Through the Dairy Supply Chain Forum, there have been encouraging signs of more openness and a greater collective will to cooperate in order to increase efficiency, address the challenges facing the industry and develop collaborative solutions.

The Government is grateful to the Committee for its comments on the setting up of the Dairy Supply Chain Forum.

The Government's intention has always been to chair the Forum until an apposite point when ownership would be transferred to the sector itself since success must ultimately lie in the industry taking charge of its own future. Nevertheless, we recognise that the transition to industry ownership of the Forum can only occur when the industry is in a position to collaborate effectively to take on its work. The Government therefore intends to continue to chair the Forum for as long as the industry finds it of benefit, and

additional Government resources have been allocated to the Forum and its sub-groups in this financial year to develop its work. Even when the point is reached when a non-Government chair can be found for the Forum, Defra officials will still be willing to take part in the Forum's activities if the industry feels this would have value.

At its meeting on 21 July, the Dairy Supply Chain Forum discussed the Committee's main recommendations. The Forum acknowledged that discussions about price are the most likely to become adversarial. Price is inevitably the subject of negotiation, rather than collaboration, and therefore is not and has never been an area which the Forum could usefully (or indeed should) consider directly. Nevertheless, members of the Forum did agree that greater transparency about costs and prices would be useful to build trust and reduce tensions. Increased transparency would not in itself increase the farmgate price of milk, but further improving trust could in turn help with collaborative approaches to address some of the causes of low farmgate prices. Ongoing work by the MDC (for example, their planned Annual Report on dairy supply chain margins following up last year's KPMG report on milk pricing) and work by the Dairy Industry Association Ltd in response to the Committee's report, may be of some use in addressing the issues about transparency. On issues other than prices, the Forum noted that there is constructive engagement between the different parts of the supply chain.

Recommendation 11

We see no compelling evidence in favour of setting up a regulatory body to oversee the dairy industry supply at this stage. (Paragraph 64)

The Government supports this conclusion. It is difficult to see how a regulator could determine a fair price other than by reference to a market price. A price regulator would almost certainly be incompatible with EU competition law, or with the common organisation of the market in milk and milk products.

Recommendation 12

Experience to date suggests that the UK dairy sector is yet to exploit fully the benefits that could arise from greater horizontal and vertical integration. (Paragraph 71)

The Government agrees that the industry has not yet exploited the benefits of greater integration. However, achieving greater vertical integration is the clear aim of the major dairy farmers' co-operatives and there have been some positive developments in some areas of vertical integration and also in moves toward added value products.

Recommendations 13, 15 and 16

The disparity between the major supermarkets and the primary producers results in an uneven distribution of power along the dairy supply chain, with the balance of power being weighted towards retailers. This uneven distribution of power may account for the dairy market being slow to react to upward pressure on retail prices,

as it was in 2003, when prices increased only following direct action by farmers. (Paragraph 75)

We welcome the decisions of the supermarkets to increase the retail prices of liquid milk and cheese last year while specifying that the price increases must be passed along to farmers. However, on the basis of the evidence we have received in this inquiry and the findings of the Office of Fair Trading's review of the code, we agree with the Office of Fair Trading and the Competition Commission that there remains a fundamental imbalance of negotiating strength between supermarkets and most of their suppliers. The code appears to have been ineffective in redressing this imbalance, at least in respect of the dairy supply chain. Supermarkets should carefully examine the way in which they exploit their buying strength and establish whether this is compatible with their oft-stated aim of supporting British agriculture via supply chain partnerships. (Paragraph 83)

We urge the supermarkets to place more weight upon their social responsibility to ensure, at the least, a sustainable farmgate price for British dairy farmers. If supermarkets are genuinely concerned about the farmgate prices received by all farmers, we suggest that they aim to establish a balanced spread of suppliers by increasing the proportion of products such as liquid milk that they buy from farmer-owned co-ops. (Paragraph 85)

The disparity in size between dairy farmers on the one hand, and the major processors and supermarkets on the other, is not in itself necessarily a cause for concern. However the Government accepts that a combination of factors has led to a situation where there is an imbalance in negotiating strength within the dairy supply chain. Were this to be exploited in a way that harms competition, this would be a matter for the competition authorities. But while the existence of buyer power may put one party in a negotiation at a disadvantage, it does not inevitably lead to competition problems.

UK dairy farmers appear to be disadvantaged in terms of bargaining power in comparison with their counterparts in other prominent EU dairy farming countries, in part by the weak presence or involvement of UK producers (including through co-operatives) in processing. The Government believes that the further development of farmer-owned co-operatives has the potential to help dairy farmers improve their position. We are seeking to facilitate this through, for example, our support of English Farming and Food Partnerships. We also believe that the work of bodies such as the Food Chain Centre (which the Government also supports) and the Dairy Supply Chain Forum can contribute to the creation of an environment which fosters co-operation and collaboration between farmers, and between farmers and the rest of the food chain.

Whilst we can support the Committee's call for supermarkets to consider the impact of their purchasing policies on the sustainability of a viable dairy farming industry in Britain, the Government believes that it would be wrong for it to seek to dictate that

supermarkets should purchase products from one type of business in preference to another.

Recommendation 17

We are particularly concerned about the impact on dairy farmers of their financial support being reduced under the CAP reforms while milk quotas remain in place until at least 2015. Necessary restructuring within the industry is likely to be hampered by the inflexibility of quotas. We consider that eliminating milk quotas would be economically worthwhile for the UK and for the EU as a whole and we encourage the Government to continue its pursuit of this policy aim. It is most disappointing that some other EU member states have opposed the initiative to phase out EU milk quotas. (Paragraph 93)

The Government supports the Committee's assessment of the impact of milk quotas and will continue to press within Europe for their abolition. Within the constraints of the current system, the Government has acted to reduce the burden as far as possible. For example, we have taken steps to make transfers of quota without land simpler to help restructuring. Nevertheless, milk quotas still add considerable costs for those wishing to enter the industry or expand their current business. For milk quotas to be abolished, support prices will need to be reduced down to the levels of world prices to remove the artificial incentive to overproduce.

Recommendation 18

If dairy farmers were to join together, in order to make the process of raw milk retailing both more unified and more dynamic, it could well go some way towards redressing the uneven distribution of power in the supply chain. We would hope that CAP reforms will spur farmers to greater co-operation and to further development of value-added products. (Paragraph 94)

The Government as part of its *Strategy for Sustainable Farming and Food*, is supporting, through English Farming and Food Partnerships, the development of farming co-operatives to improve the bargaining power of farmers and help them access a greater proportion of the value added to their produce. However, the Government believes that individual farmers should determine the type of relationship they want based on what they decide is best for the long term development of their business.

The Government believes that in the long term the decoupling of subsidies from production under the reforms of the Common Agricultural Policy agreed at Luxembourg will bring considerable benefits to all UK farmers, including dairy farmers, by encouraging them to produce for profitable markets, rather than subsidy. Nevertheless, due to the impact of support price cuts, the dairy sector will need to address the challenge of a lower price environment. Through the Dairy Supply Chain Forum, participants from all parts of the supply chain have been working together to identify how the sector might adjust to meet this and the other challenges it faces, and

thereby allow individual businesses to make informed decisions on their future development.

The Government strongly supports the Committee's recommendation on value-added products. The Government supported the conclusions in last year's KPMG report the *Prices and profitability of the British dairy chain*, that one of the reasons for milk prices in the UK being consistently well below the EU average was because of a lack of product innovation, an over-reliance on the production of bulk commodities and an insufficient emphasis on added value products.

Recommendations 19–21

We urge the Government to ensure that greater emphasis is placed on communicating directly to the dairy industry, especially to farmers, information about what forms of vertical integration can be carried out under current competition law. The Government must take steps to foster an environment that is conducive to greater vertical integration. In its capacity as chair of the Dairy Supply Chain Forum, the Government should work towards achieving a balance in the dairy industry so that the interests of UK domestic consumers are not protected to such an extent that UK dairy producers are detrimentally affected. (Paragraph 102)

We encourage the Office of Fair Trading and the Competition Commission to take all possible steps to ensure that the dairy sector knows that the competition authorities are not opposed to vertical integration in principle and are open to approaches from within the dairy industry. The Office of Fair Trading and the Competition Commission should be sending clear signals on this point. (Paragraph 103)

We urge those dairy farmers who are not members of farmer-owned co-operatives to consider carefully their decision to remain outside the co-op framework. Although co-op membership may be a less financially attractive option for farmers in the short term, it is the most effective long-term option available for farmers to gain greater control over when, to whom and at what price they sell their milk. If farmgate prices are to increase, farmers must act to redress the uneven distribution of power currently in the dairy supply chain. (Paragraph 106)

The Committee's report refers to the steps that the Office of Fair Trading (OFT) has already taken to inform farmers and others in the food chain about competition law. These include meeting with farming interests, the publication on its website of answers to frequently asked questions on competition matters, and the provision of confidential advice to those considering mergers or joint ventures, including those involving vertical integration. Defra will consider with the Dairy Supply Chain Forum what more might be done and whether the Forum might be used as a means of reinforcing the OFT's advice and disseminating it throughout the chain.

To repeat the points made earlier about co-operatives, the Government is supporting the development of farming co-operatives to improve the bargaining power of farmers and help them access a greater proportion of the value added to their produce. However, the Government believes that individual farmers should determine the type of relationship they want based on what they decide is best for the long term development of their business. This could include a range of partnership models with down-stream elements of the supply chain.

Department for Environment, Food and Rural Affairs
26 July 2004

Office of Fair Trading response

You will recall that I gave evidence to the Committee with Colin Farthing of the Competition Commission on 31 March. I was grateful for this opportunity to set out the OFT's role generally and in relation to the particular competition issues that arise in the milk sector. I attach a note setting out the OFT's response to the Committee's recommendations.

1. The Committee recommended that the OFT should take all possible steps to ensure that the dairy industry knows that it is not opposed to vertical integration in principle and is open to approaches from within the industry. We are happy to accept this recommendation. Vertical integration does not usually cause competition problems unless one or other of the merging businesses has market power. There is no reason why the dairy co-operatives should not establish or extend their processing activities. The competition aspects of qualifying mergers would, of course, be assessed under the merger provisions of the Enterprise Act 2002. Several mergers of this type have been cleared recently by the OFT. The OFT is ready to give confidential advice to parties considering a merger or an agreement.
2. The OFT will publish guidance on its website at the end of July in the form of Frequently Asked Questions (FAQ) on agricultural co-operation and competition law. There was a need for this guidance in the context of the Curry Commission's recommendation that collaborative ventures in agriculture should be promoted. The FAQ address a wide range of questions about what sort of competition issues might arise from co-operation among farm businesses. Most forms of co-operation do not cause competition concerns and our aim has been to give the agricultural community a clear steer on what is permissible and what might cause problems, so that they know how they stand in relation to the law.
3. The OFT would be happy to consider other lines of communication with the agricultural sector. Defra will consider with the Dairy Forum whether the Forum might

be used to disseminate the OFT's advice. While the OFT has a responsibility for enforcing the law it also has an important role in raising awareness throughout the business community.

4. More generally, the OFT notes the Committee's view that the dairy industry in the UK is being damaged by poor relations between different parts of the supply chain. To the extent that better relations between different parts of the supply chain will improve the efficiency of the supply of dairy products to the benefit of all participants, including consumers, the OFT would welcome them. However, we would be concerned if, in the interests of improving their relationships, producers, at any level of the supply chain, were to enter anti-competitive agreements which had the effect of forcing consumers to pay higher prices than would otherwise be the case.

5. In a similar vein, any increase in communication between participants in the dairy supply chain, including greater transparency of cost information, as recommended by the Committee, will need to be implemented with caution. While a greater flow of information may in some circumstances help markets to perform better, it can also assist or encourage collusion between suppliers at the expense of consumers. The OFT would be concerned if this were the outcome of an increase in communication and transparency in the dairy sector.

6. The OFT agrees with the Committee that there is no compelling evidence for setting up a regulatory body to oversee the dairy industry at this stage. Generally, competition is likely to produce greater benefits than regulation unless there is some failure of markets that cannot be rectified by other means.

7. On the supermarket code, the OFT notes the Committee's view that the code has been ineffective in redressing the imbalance in negotiating strength between supermarkets and suppliers, at least in respect of the dairy supply chain. The aim of the current audit of supermarkets' dealings with suppliers is to establish the facts about supermarkets' compliance with the code, as a basis to determine what future action, if any, may be appropriate.

Penny Boys, Executive Director
Office of Fair Trading
29 July 2004