



House of Commons
Environment, Food and Rural
Affairs Committee

**Dairy Farmers of
Britain: Government
Response to the
Committee's Fifth
Report of Session
2009–10**

**Second Special Report of Session
2010–11**

*Ordered by the House of Commons
to be printed 21 July 2010*

Environment, Food and Rural Affairs Committee

The Environment, Food and Rural Affairs Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Environment, Food and Rural Affairs and its associated bodies.

Current membership

Miss Anne McIntosh (Conservative, Thirsk and Malton) (Chair)
Nigel Adams (Conservative, Selby and Ainsty)
Mr David Anderson (Labour, Blaydon)
Tom Blenkinsop (Labour, Middlesbrough South and East Cleveland)
Mr Thomas Docherty (Labour, Dunfermline and West Fife)
Bill Esterson (Labour, Sefton Central)
George Eustice (Conservative, Camborne and Redruth)
Mrs Mary Glendon (Labour, North Tyneside)
Neil Parish (Conservative, Tiverton and Honiton)
Dan Rogerson (Liberal Democrat, North Cornwall)
Amber Rudd (Conservative, Hastings and Rye)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via www.parliament.uk.

Publications

The reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at

www.parliament.uk/efracom

Committee staff

The current staff of the Committee are Richard Cooke (Clerk), Joanna Dodd (Second Clerk), Sarah Coe (Committee Specialist—Environment), Clare Genis (Senior Committee Assistant), Jim Lawford and Mandy Sullivan (Committee Assistants) and Hannah Pearce (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Environment, Food and Rural Affairs Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5774; the Committee's e-mail address is: efracom@parliament.uk. Media enquiries should be addressed to Hannah Pearce on 020 7219 8430.

Second Special Report

The Environment, Food and Rural Affairs Committee reported to the House on Dairy Farmers of Britain in its Fifth Report of Session 2009–10, published on 23 March 2010 as HC 227. The Government's response to the Report was received on 15 July 2010 and is published as an annex to this report.

Government response

Introduction

1. The Government would like to take this opportunity to express its thanks to the Environment Food and Rural Affairs Committee (EFRA Committee) for producing a Report on the Collapse of the Dairy Farmers of Britain (DFB) that was thoroughly researched, very clearly presented, and exceptionally wide-ranging in its scope. The issues raised by the Report include areas of increasing interest across Government. Both the Coalition Agreement, and the Queen's Speech, indicated the Government's intention to enhance the current role for co-operatives.

2. The EFRA Committee report made a number of recommendations, many of which relate to a range of Government departments' areas of responsibility, and the departments in question are working together on these issues. The one issue that resonated most significantly across departmental boundaries related to the need for a good governance structure for co-operative organisations. This is a complex area which the Government will seek to address.

3. There is full engagement across the departments concerned on addressing both the generic subjects within this report, and further interrelated legislative and regulatory issues that go beyond the scope of this report. It would be premature at this stage to set out what may or may not come out of those wider discussions across Government.

4. This response is structured to aid the reader by addressing the points made in the conclusions and recommendations to the report in a thematic way; the thematic arrangement will be as follows:

- Background to the Inquiry and Governance Issues
- Financial and Tax Issues
- Regulation, Audit and Pensions
- Issues specific to Defra

5. It should be noted that this response covers some policy areas that in Scotland, Wales and Northern Ireland are the responsibility of the Devolved Administrations, and others

that are not devolved. Full consultation has been made with all Devolved Administrations in the preparation of this response. In relation to the references in this report to the Financial Services Authority, it should also be noted that the Chancellor of the Exchequer, in his Mansion House speech on 16 June 2010, outlined the proposed reform of the institutional framework for financial regulation. The new regime will be in place by 2012. The FSA will be working closely with Government to determine the future arrangements for its mutuals' registration function.

Background to the Inquiry and Governance Issues

Background to the inquiry

The aftermath of the purchase

2. The way in which DFB went about pursuing its vertical integration strategy was over-ambitious, given the relative youth of the business and its financial constraints. This is clear in hindsight, but should also have raised concerns at the time. The purchase of ACC by DFB is indicative of the triumph of strategic ambition over financial reality. Farmers' optimism about taking control over their long-term future was a noble objective, but in this case it was severely hampered by decisions that turned out poorly in practice. (Paragraph 21)

11. In pursuing a challenging vertical integration strategy, with limited capital-raising ability, DFB's difficulties were compounded by a governance structure that did not function as well as its members were entitled to expect. (Paragraph 43)

The Board and the Executive Team

12. The lack of executive directors on DFB's Board was a weakness and should have been addressed, even if this meant a rule change. It is important for members of the Executive Team to be represented on the Board in farmer-owned co-operatives, as in other businesses. (Paragraph 45)

The 2009 contract with the Co-operative Group

4. Although it is reasonable to expect co-operatives to support each other to some extent, we recognise that co-operatives' prime responsibility should be to their own members. DFB lost the Co-operative Group contract because it could not make competitive bids in the relevant lots. (Paragraph 26)

The loss of confidence

5. We agree with Mr Smith's analysis that "The real reason for Dairy Farmers of Britain going into receivership was that as farmer members lost confidence in us, our other suppliers lost confidence in us and, most importantly, our customers lost confidence [...]" (Paragraph 30)

6. By late 2008, DFB was caught in a vicious circle in which lost confidence led to resignations, which in turn led to a further loss of confidence and more resignations. Its fate was not inevitable, but its continued survival grew increasingly unlikely during the early months of 2009. (Paragraph 31)

Farmer directors

13. Farmer directors have a valuable part to play on the Boards of farmer-owned businesses, although we are not convinced that they need necessarily make up the majority of the directors. It is vital that both they, and the non-farmer directors, receive regular and appropriate training—from both internal and external sources. The annual reports of agricultural co-operatives should contain a section detailing what steps have been taken to ensure that farmer directors are properly trained and supported for the important job they undertake. (Paragraph 49)

Specific concerns

14. The perception of a conflict of interest can cause damage, even if the individual concerned is satisfied that they have behaved responsibly. For this reason, we believe that advice and assistance, including project management, is best provided by companies and individuals that have no other connection with the directors of the business to which they are providing the service. (Paragraph 55)

The Members Council

15. The presumption should be that the Board will actively share information with the Members Council unless it is prevented from doing so by the need to preserve commercial confidentiality. It is hard to see how a Members Council could be in a position to approve changes to the ceiling on borrowing if it did not feel that it could ask detailed questions about banking arrangements. (Paragraph 60)

Communication with members

16. We recognise that it is difficult to strike a balance between providing an accurate picture of the state of a co-operative to its members and not revealing commercially sensitive information. However, we consider that the Board of DFB failed to strike this balance and that DFB members did not receive the quality of information that they were entitled to expect. This breakdown in communication encouraged speculation about the future of DFB and can only have contributed to the business's difficulties. (Paragraph 63)

6. The Government accepts that upholding open, honest governance, maintaining clear communication with shareholders, and ensuring that board members have the training necessary for the decisions they have to make, are factors that are essential to sustainable co-operative organisations, and that taken together, these represent a standard of good practice that all co-operatives should aim towards.

7. The Co-operative and Community Benefit Societies and Credit Unions Act received Royal Assent on 10 April. The Government is currently considering how and when it should be implemented. The Government intends to explore further how the legislative and regulatory framework to which co-operatives are subject can be further enhanced and modernised.

8. The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2010 (LRO), due to come into force later this year under Section 1 of the Legislative and Regulatory Reform Act 2006, and other ongoing activities across Government (many of which are referred to later in this report) will also aid the building of confidence in the operation of co-operatives.

18. The Financial Services Authority has an important role to play in relation to the effective functioning of industrial and provident societies. We welcome the fact that it is developing codes of practice to clarify what is expected of industrial and provident societies. (Paragraph 67)

19. We look forward to reading the conclusions of the group on the co-operative model to which the Financial Services Authority and Defra are contributing. The code of practice developed by this group should aim to create the best possible environment for decision taking whilst providing maximum protection for members' interests. Attention should be paid in the code of practice to the information requirements of structures such as Members Councils and of ordinary members if they are to be able to act as a check and balance mechanism on decision making by the Board. (Paragraph 68)

30. As the Department responsible for agriculture, Defra should be offering advice and assistance to support the growth of agricultural co-operatives... ..Defra should work with the Financial Services Authority to ensure that issues affecting agricultural co-operatives in particular are taken into account when developing best practice guidance for industrial and provident societies. (Paragraph 111)

9. The Financial Services Authority (FSA) is facilitating the development of a Code of Best Practice, with Co-operatives UK taking a lead role. The aim of the Code will be to uphold the integrity of the co-operative brand through the development of requirements for governance. This development will be of far-reaching impact for co-operatives in all sectors, not just those in agriculture, and will require a broad strategy to be developed, aimed at putting appropriate regulatory structures in place, with a particular emphasis on governance issues. Defra is fully engaged in this cross-Government process, and the partners with which Defra and FSA will be working in order to elaborate the Code are Co-operatives UK, English Farming and Food Partnerships and the Scottish Agricultural Organisation Society. Further participants may be invited to join the group once a broad outline of the Code has been agreed.

Financial and Tax Considerations

Tax treatment of contributions to co-operatives

9. Money that is retained by agricultural co-operatives and only notionally paid out to farmers should not be taxed at this stage. Instead it should be taxed on withdrawal, in a way that is analogous to the tax treatment of pensions income. We recommend that Defra pursue this with the Treasury as a matter of urgency. It is unacceptable to have a tax system that disincentivises investment in agricultural co-operatives. (Paragraph 39)

Her Majesty's Revenue and Customs

26. We accept that there are constraints on HMRC's ability to use the taxation system to mitigate the financial losses suffered by former DFB members. However, we urge HMRC, in liaison with the receivers, to reconsider whether the appropriate value of the shares that resulted from the March 2009 debt for equity swap is in fact zero. We regret that HMRC decided that income tax relief was not available in relation to the loss of these shares and urge it to reconsider this position. HMRC should report its stance on this matter as soon as possible to the Financial Secretary to the Treasury. (Paragraph 106)

30. As the Department responsible for agriculture, Defra should be offering advice and assistance to support the growth of agricultural co-operatives.... ..Defra must pursue the matter of the taxation of members' contributions to co-operatives with the Treasury. It is manifestly unfair that farmers should have to pay tax on money that is only notionally allocated to them and that is actually invested in their co-operative.

10. The Government recognises the importance of issues concerned with the raising of capital for the future well-being of the co-operatives sector, and Defra will work with the Department of Business, Innovation and Skills, HM Treasury and others to identify ways in which methods of capital raising might be clarified. The provisions of the LRO which, as noted in paragraph 8, is due to come into force later this year (2010) will support this aim.

11. The Government will continue to keep all taxes under review but does not believe the tax system disincentivises investment in agricultural co-operatives. The starting point for the calculation of taxable profits for any business is the profits computed in accordance with Generally Accepted Accounting Practice (GAAP). Where GAAP requires the full

amount of sales to be recognised as income, irrespective of whether some of the proceeds are retained, the income tax rules follow GAAP and include the full amount of sales in arriving at the taxable trading profits. This treatment is not confined to agricultural co-operatives and applies in any case where a trader operates under arrangements like the ones used by Dairy Farmers of Britain. Consequently, the tax system provides equitable treatment to businesses operating in similar ways; providing special treatment to agricultural co-operatives would raise state aid concerns.

12. The position regarding the losses of members is set out in HMRC's guidance published in February 2010 in Revenue and Customs Brief 05/10 <http://www.hmrc.gov.uk/briefs/income-tax/brief0510.html> On the basis of the information available to HMRC, there are no grounds for altering the view that the value of the shares at the time they were received was nil. As the Brief states, HMRC remains open to receiving any new information that might have a bearing on the issue. The Exchequer Secretary to the Treasury has been made aware of the position.

IPSs and insolvency legislation

21. We recommend that the Government amend the Insolvency Act 1986 and the Enterprise Act 2002 to ensure that insolvency appointments over industrial and provident societies—and the conduct of the ensuing insolvency—are made on the same basis and governed by the same rules as insolvency appointments over limited companies. (Paragraph 88)

13. A power was taken in the Enterprise Act 2002 which would allow the "rescue" procedures of the Insolvency Act 1986 to be extended to Industrial and Provident Societies (IPSs). To date this power has not been exercised; a further consultation document on this may follow in due course.

14. Section 55 of the Industrial and Provident Societies Act 1965 applies the Insolvency Act 1986 to IPSs, but with limitations. As the law currently stands the administration procedure does not apply to IPSs. This gap in the law can be resolved by exercising the powers at section 255 of the Enterprise Act 2002, which allows company insolvency law to be applied to IPSs.

29. No single factor—not even the purchase of ACC in and of itself—caused DFB's demise and its problems were not unique: the majority of them could affect any business. DFB experienced some bad luck. More significantly, it suffered from over ambition, a shortage of capital and, at various points during its existence, poor governance and poor communication. In its final year, it lost the confidence of its members and its customers. Hindsight certainly makes it easier to begin to understand what happened at DFB, but, as we have made clear, some of the issues we have discussed in our report should have caused concern at the time. Ultimately, DFB's members were badly let down. We have suggested some steps which we believe may reduce the chances of other farmers suffering a similar fate. (Paragraph 110)

30. As the Department responsible for agriculture, Defra should be offering advice and assistance to support the growth of agricultural co-operatives... ..Defra must co-ordinate the key players to devise solutions for overcoming the constraints on the capitalisation of agricultural co-operatives. The Legislative Reform Order that is currently before Parliament should be regarded as the beginning of this process, rather than a solution by itself.

15. The LRO will enable modifications to the provisions on minimum age for membership of an IPS and minimum age for becoming an officer of an IPS, the rules on share capital. It will modify the provision on fees for copy of the society's rules, it will facilitate easier dissolution of registered societies, it will give societies the flexibility to choose their own year-ends and remove the requirement on societies to have interim accounts audited. All of these changes will enable co-operatives to maintain their core aim of operating for the benefit of their members, which is the essence of what it is to be a co-operative.

16. The LRO, currently before Parliament, is part of continuing work across Government in modernising the regulatory and legislative framework for the mutuals sector.

Regulation, Audit and Pensions

8. We welcome the proposal in the draft Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2010 to remove the restriction on the maximum holding of non-withdrawable shares in a co-operative. This is a step in the right direction. However, we urge Defra to set up a task force comprising the Financial Services Authority, HM Treasury, members of the banking community and industry representatives further to investigate ways to overcome constraints on capitalising UK agricultural co-operatives. (Paragraph 38)

17. The Legislative Reform Order will, amongst other key changes, change the maximum holding in co-operatives and will also enable the Directors of a co-operative to be held responsible for the actions of the co-operative; this change in the law will increase public confidence in the operation of co-operatives.

18. The Government has considered carefully the Committee's recommendation that Defra establish a task force with the remit of investigating ways to overcome constraints on capitalising UK agricultural co-operatives. The Government sees considerable value in addressing the issue highlighted by the Committee, and accepts that establishing a task force could be a means of doing so. However a task force is not the only option.

19. The Government is committed to promoting the mutuals more widely across both public and non public services and is exploring how this can be achieved most effectively, including issues of capitalisation within the sector. The Government intends to examine ways of overcoming constraints on capitalising UK co-operatives, including agricultural co-operatives, within this wider context.

Governance and accountability

Registration and regulation

17. Documents filed by industrial and provident societies should be as easily obtainable as documents filed by companies. We urge the Financial Services Authority to improve the way in which it makes such documents available to the public. (Paragraph 64)

Auditing

20. DFB's decision to adopt some of the auditing standards that apply to listed companies was a move in the right direction. As the case of DFB illustrates, applying these standards cannot prevent the collapse of a business, but it is another way of ensuring that industrial and provident societies are subject to more rigorous evaluation. We recommend that agricultural co-operatives voluntarily adopt such standards wherever possible. (Paragraph 71)

20. The Government has recognised that the process for obtaining copies of documents relating to IPS needs modernising, and a project has already commenced to address this.

21. The FSA are working to phase in a web based document retrieval service that will allow the public to purchase and download documents online that pertain to IPSs in a similar manner to Companies House online document download facility; this will enable important documents such as accounts to become accessible for a fee.

22. The FSA has no promotional or supervisory role for co-operative societies and its functions in relation to societies are limited to their registration under the Industrial & Provident Societies Act. The Act does not define a co-operative, so the FSA must look to representative bodies such as Co-operatives UK to assist it in determining the essential characteristics of a qualifying co-operative and in developing the best practice for their governance. In this way, the FSA is able to reflect the views of the co-operative movement.

22. We urge the Government to clarify how the Pension Protection Fund, created under the Pensions Act 2004, applies to industrial and provident societies. People with pensions with DFB should not lose out because it is an industrial and provident society. The Government must also update the Industrial and Provident Societies Act 1965 to simplify and improve the exit routes from an industrial and provident society receivership. (Paragraph 89)

23. Legislation on the Pension Protection Fund (PPF) is contained for the most part within the Pensions Act 2004 and supporting regulations.

24. The policy objective is that schemes eligible for the PPF are required to pay the pension protection levy and the PPF administration levy, and that entry into the PPF is considered when eligible schemes have had a qualifying “insolvency event” as defined in section 121 of the Act and regulation 5 of the PPF Entry Rules Regulations 2005.

25. Regulation 5(1) (b) sets out when an insolvency event may occur in relation to a “relevant body”. Regulation 5(2) sets out that the term “relevant body” includes a society which is registered as an industrial and provident society under the Industrial and Provident Societies Act 1965.

26. Under regulation 5(1) (b) an insolvency event can be:

(i) any event listed within section 121(3) of the Act which occurs by virtue of the application of the Insolvency Act 1986 by or under any other enactment; or

(ii) an administration order that places the management of the relevant body into the hands of a person appointed by the court by virtue of any enactment that applies Part 2 of the Insolvency Act 1986.

27. Section 255 of the Enterprise Act 2002 contains an order-making power which could be used to apply parts of the Insolvency Act 1986 to registered industrial and provident societies. Such an order has not been made to date. As the law currently stands, the administration procedure does not apply to IPSs. But this can be resolved by exercising the powers as referred to above within section 255.

28. Under regulation 5(1) (e) dissolution of an industrial and provident society by consent of the members under section 58 of the Industrial and Provident Societies Act 1965 would also be a qualifying insolvency event. The question of whether a qualifying insolvency event has occurred and an individual scheme is eligible can only be determined by the PPF in the light of all the circumstances at the appropriate time.

29. With regards to the question of simplifying exit from the receivership procedure, the relevant sections are sections 55 and 58 of IPSA 1965, which give rise to the administrative problem that for any dissolution the consent of three quarters of the members of the society is required, testified by their signatures. An industrial and provident society cannot appoint an administrative receiver within the meaning of the Insolvency Act (and the Enterprise Act does not allow provisions on receivership for companies to be applied to industrial and provident societies), but exercise of section 255 powers would enable application of the administration procedure for IPSs. Such a procedure is gradually replacing receivership for companies and would probably constitute a valid alternative to receivership for IPSs as well.

Issues specific to Defra

The 2007 contract with the Co-operative Group

3. In entering milk processing on a large scale with the purchase of ACC, DFB was involving itself in a highly competitive sector alongside major businesses such as Robert Wiseman Dairies who DFB must have realised were likely to bid keenly to increase their market share. DFB was held back from the start by being tied into a loss-making contract that cost it millions and whose effect would make it less certain that DFB would be able to retain the Co-operative Group contract when it came up for renewal. (Paragraph 23)

The co-operative model

7. We agree that DFB did not fail because it was a co-operative. However, its failure draws attention to a number of ways in which UK dairy co-operatives could be strengthened, if they are to be able to compete successfully in the dairy sector. (Paragraph 32)

Consolidation in the UK dairy market

10. Further rationalisation in the UK dairy industry is not in our view an inhibiting factor to competition. In the liquids market, intense competition is provided at a retail level. The dairy industry as a whole operates in a European and in some cases a global market. Restricting consolidation in the UK makes it more difficult for the UK dairy industry to compete with these other players on both a European and global scale. (Paragraph 42)

Finding new buyers

23. There is a balance to be struck between achieving long-term relationships in the dairy supply chain and allowing farmers sufficient flexibility to change buyers if something goes wrong. A clause which allows farmers to terminate their contract with a month's notice in the event of their buyer going into receivership is sensible. Contracts which allow farmers greater flexibility to switch to another buyer in the event that an agreement cannot be reached on the milk price seem like a good way of strengthening the position of farmers in theory. However, we remain to be convinced about how they would work in practice. We recommend that Defra put this issue forward for discussion at the Dairy Supply Chain Forum, which it chairs, and that Defra commission a report within the next 12 months detailing ways in which contracts between farmers and buyers could be improved to ensure that both parties are treated fairly, particularly in times of distress. (Paragraph 95)

Facilitating discussion and co-operation

24. Defra orchestrated a positive response to the collapse of DFB. We commend the swift and effective action it took to facilitate co-operation and disseminate information. (Paragraph 98)

28. DFB did not fail because it was a co-operative. However, dairy co-operatives in the UK are comparatively young and there is much to be learnt from older, larger co-operatives in Europe and elsewhere. Defra should produce a report within the next 12 months examining governance and capital-raising arrangements in these co-operatives, together with the legislative framework that applies, and exploring the lessons these countries offer for dairy co-operatives in the UK. (Paragraph 109)

31. Clearly the immediate impact of the failure of DFB was a further questioning of confidence in the dairy industry. Defra must recognise this in its work to ensure that the dairy industry has a positive future that reflects the natural advantage of the grass-growing areas of the UK for producing milk. (Paragraph 112)

30. UK dairy Co-operatives are indeed young compared to many European or global examples but they were also formed and funded under different trading conditions. The current issues of governance, capital-raising, the legislative framework and more besides go much wider than Defra's remit, so would require a more expansive approach. There have already been meetings involving representatives of UK Co-operative associations and government departments, where these issues have been raised and we will be encouraging these discussions to continue so that conditions in which Co-operative trade are as equitable as possible.

31. Defra has, for some time now, encouraged the dairy industry to restructure and consolidate to become more market oriented and balance supply to meet market demands in the most efficient manner possible (reduce surplus production). However, the markets of mainland European and New Zealand should be compared cautiously with the UK in competition terms. Discussions in the European Commission's High Level Group on Milk have established there are clear differences between Member States' understanding and therefore interpretation of competition law. There appears to be confusion around determining 'the relevant market' for (consolidating) businesses and therefore whether they would have a dominant share. The relevant market is determined according to many variable factors, for example: the nature of product being marketed (raw milk for drinking, raw milk for general use, value-added products, commodity products); geographical & time (freshness) restrictions; socio-economic (trade) conditions.

32. The UK dairy market is restricted by geography and socio-economic factors to some degree, especially for milk intended for drinking. The market has already consolidated more than in most European countries and has many dedicated supply-chain agreements where milk-swaps cannot be done, leaving swaps for lower value including commodity trade only. There are fewer 'natural' restrictions to trade across mainland Europe making it a more open market than the UK experiences. New Zealand exports over 90% of production to the global market and the dominant company has to observe tight marketing controls (notably on the internal market) to avoid abusing their status.

33. The High Level Group report (released 15 June) invites the European Commission to provide producers with greater clarity on the scope of the relevant market for their sales of raw milk to processors. The report also requests a special exemption (within agricultural

law) from competition law to make it clear that producer-groups can be established and negotiate (including price) with processors.

34. When considering consolidation in the UK, it should also be noted that the Office of Fair Trading raised no objections to the proposed 2007 merger of First Milk and Milk Link. This demonstrated competition (law) does not inhibit the potential for rationalisation within acceptable parameters (market share, dominant positions or abuse thereof). Despite this favourable view which demonstrated how competition law can already promote collaboration to achieve efficiencies and increase competitiveness of the sector, the two co-operatives decided not to complete the merger.

35. The High Level Group on Milk has also discussed the dairy industry becoming more market oriented—balancing supply to consumer demand. So far as the United Kingdom is concerned this means moving away from the old marketing-board set-ups (which kept farm gate prices artificially high) and includes seeking new behaviours in co-operatives. They both have a tradition of taking every litre of production from their members at the same price—whether or not they have a market for that milk. That surplus tends to be marketed as cheap commodity products for which demand and price are generally lower with many sales made on wider European or global markets (where prices are usually lower) so overall profitability and competitiveness are dragged-down.

36. Further rationalisation of businesses in the UK dairy industry may well not inhibit competition—depending upon the market concerned—but this has already been possible and not completed as described above. Whilst the dairy industry does operate on a European or global scale, the UK industry markets its high-value drinking milk and most speciality products on the internal UK market. To become more competitive the UK industry could look to re-balance exports (of mainly cheap commodity products) and imports (of high added-value speciality products) as well supply to market demand more generally.

37. Defra has been engaging stakeholders actively through the Dairy Supply chain Forum (DSCF) Sub-Group handling our reaction and input to the High Level Group. As part of this work Defra commissioned a report by EFFP in January 2010 to explore contracts and discussions show significant consensus on most elements including coverage of one or other party running into serious trading difficulty or other unforeseen events. This work shows that improved contracts could be used to balance risk more equitably whilst still encouraging innovation and promoting competitiveness by establishing more transparent trading conditions which should give confidence through the supply chain for long-term planning. The sub-group is still exploring how best to allow parties the opportunity to terminate contracts within a reasonably short time-frame where trading terms or conditions change substantially.

38. There is however a delicate balance between welcoming potentially positive features in contracts and becoming too prescriptive so that contracts inhibit reactions to market signals or the natural progression of businesses to more efficient and competitive states. The DSCF stakeholder sub-group focussed on the key issues of balancing ‘variations’ clauses (notably price change) and related ‘terminations of contract’ to ensure all parties interests are represented reasonably.

39. In the light of the work on contracts in the High Level Group and in the DCSF subgroup, and the wider work across government on Co-operatives that Defra is engaged in, we do not propose to report back further in 12 months but will update EFRA Committee later in the year on any developments.

40. Defra welcomes the Committee's commendation of the positive response and actions immediately following the collapse of DFB. The co-operation between Government and devolved administrations and others that happened immediately following the announcement on 6th June 2009 was effective and we would seek the continuation of that close working.

Nitrate Vulnerable Zones

25. We recognise the sense in Defra's argument that it has to show the European Commission that the UK has committed itself to the NVZs Action Programme, but we regret that it did not at least approach the Commission to see how it would regard a further extension to the slurry storage requirements, given the difficult financial situation in which a substantial number of UK dairy farmers found themselves after the collapse of DFB. (Paragraph 101)

41. Defra does not believe the Commission would have looked favourably on a request to extend the deadline for compliance with the slurry storage requirements for a further year for dairy farmers as this would, in effect, have removed the requirement from the current NVZ Action Programme for this sector.

42. The UK's case for derogation from the Livestock Manure Nitrogen Farm Limit was based on evidence showing that, on the assumption that dairy farmers complied with all Action Programme requirements, the derogation would not have a detrimental environmental impact.

43. It is likely that the Commission would have seen any attempt to extend the deadline further beyond the three year adjustment period previously negotiated as insufficient to meet our obligations under the Nitrates Directive and, if so, that would risk jeopardising our ability to successfully negotiate an extension to the derogation from 2013.

44. The derogation is estimated to reduce the costs to the dairy sector of complying with the Nitrates Directive by up to 50% and has so far benefited 453 farmers who successfully applied in 2010.

Welsh Assembly Government and single farm payments

27. We commend the Welsh Assembly Government for making early single payments to former DFB members in Wales. The Rural Payments Agency failed former DFB members in England by being unable to make the same commitment. We continue to take a strong interest in the Rural Payments Agency and it is likely that our successor Committee will want to return to this subject. (Paragraph 108)

45. In order to provide the best possible service to both former DFB members and the wider 2009 Single Payment Scheme (SPS) claimant population, RPA focussed on making full payments at the earliest possible date. As a result, RPA was able to pay 80% of 2009 SPS claimants a total of £1.31 billion within two days of the payment window opening on 1 December and met its formal payment targets five weeks ahead of schedule. Mindful of the specific pressures felt by former DFB members, their claims were prioritised where possible

and 84% were paid in the first payment run. However, there is still work to do with the RPA and, in order to grip this issue and provide the necessary political leadership, the Minister of State for Agriculture and Food will in future chair the RPA Board.

In conclusion

46. The Government recognises the importance of the UK dairy sector. It is the single largest agricultural sector in the UK, and accounts for 18% of agricultural productivity. Defra is keen to promote the development of a profitable, innovative and competitive dairy industry.

47. Defra believes that co-operatives have an important role to play in improving productivity and competitiveness of farming, and is committed to participating actively in current discussions involving other Government departments which will enable them to perform that role effectively.

48. It is not for Government to determine what business model farmers and others should follow, but it is the Government's objective to ensure that the legislative and administrative framework in which they operate is fit for purpose.

49. Across Government many pieces of work relating to the regulatory, legislative and practical operation of co-operatives are underway. Defra, along with other lead departments, will be taking careful note of the lessons learned from the collapse of DFB, and will be putting these lessons into effect as part of its efforts to achieve an enhanced and more sustainable co-operatives sector.

Department for Environment, Food and Rural Affairs

July 2010