

# **Milk**

A report on the supply in Great Britain of raw cows' milk



MONOPOLIES AND MERGERS COMMISSION

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raw cows' milk

**Presented to Parliament by the Secretary of State for  
Trade and Industry by Command of Her Majesty  
June 1999**

The report was submitted by the Monopolies and Mergers Commission (MMC) to the Secretary of State on 26 February 1999, before the MMC was dissolved, and its functions were transferred to the Competition Commission. The MMC was dissolved on 1 April as a result of the coming into force of section 45 of the Competition Act 1998.

## **Members of the Monopolies and Mergers Commission as at 26 February 1999**

Dr D J Morris (*Chairman*)  
Mr P G Corbett CBE (*Deputy Chairman*)  
Mrs D P B Kingsmill<sup>1</sup> (*Deputy Chairman*)  
Mr H G C Aldous  
Professor J Beatson QC  
Mr R D D Bertram  
Mrs S E Brown  
Professor M Cave  
Mr A T Clothier<sup>1</sup>  
Mr R H F Croft CB  
Mr C Darke<sup>1</sup>  
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Sir Archibald Forster  
Professor P A Geroski<sup>1</sup>  
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Mr J B K Rickford  
Dr A Robinson  
Dame Helena Shovelton DBE  
Mr G H Stacy CBE<sup>1</sup>  
Mr J D S Stark  
Professor A Steele

Miss P A Boys (*Secretary*)

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<sup>1</sup>These members formed the Group which was responsible for this report under the chairmanship of Mrs D P B Kingsmill.

## **Note by the Department of Trade and Industry**

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests.

**The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.**

# Contents

	<i>Page</i>
<b>Part I—Summary and Conclusions</b>	
<i>Chapter</i> 1	Summary ..... 3
2	Conclusions ..... 6
<b>Part II—Background and evidence</b>	
3	Origin of the reference and the regulatory framework ..... 101
4	Structure of the markets and participants ..... 113
5	The sale and distribution of raw milk ..... 176
6	Competition and prices ..... 221
7	Market practices ..... 246
8	Views of Milk Marque ..... 274
9	Views of other milk groups, producers and their representatives ..... 312
10	Views of dairy processors, manufacturers and their representatives ..... 359
11	Views of other interested parties ..... 442
	List of signatories ..... 457
<i>Appendices</i>	(The numbering of the appendices indicates the chapters to which they relate.)
1.1	Terms of reference and conduct of the inquiry ..... 458
2.1	Issues put to the principal parties and hypothetical recommendations more widely canvassed ..... 462
2.2	Feasibility of dividing Milk Marque to form several successor bodies ..... 470
3.1	Press release issued by the Office of Fair Trading on 27 January 1998 ..... 478
3.2	Press release issued by the European Commissioner for Competition on 6 October 1992 ..... 479
3.3	Press release issued by the Office of Fair Trading on 21 August 1996 ..... 481
3.4	Letter from the President of the DIF to the Director General of Fair Trading ..... 482
4.1	Milk Marque: statement of net operating assets ..... 483
4.2	The Milk Group: financial performance ..... 484
5.1	Changes to the Milk Marque selling system before January 1998 ..... 485
5.2	Details of Milk Marque contract types in its 1998 selling processes ..... 502
5.3	Changes to Milk Marque's contractual supply tolerances ..... 509
5.4	The United Dairy Farmers selling system ..... 517
5.5	Quality of milk ..... 524
6.1	Milk purchasers collecting milk in England and Wales by county, July 1998 ..... 529
6.2	Milk purchasers recruiting in England and Wales by county, July 1998 ..... 531
6.3	Regional differences in the number of raw milk purchasers ..... 533
6.4	Producer price league tables ..... 535
6.5	Econometric study by the DIF into pass-through from raw milk prices to retail prices, September 1998 ..... 537
7.1	Certain large processors' rationale for bids of milk from Milk Marque, 1994 to 1998 ..... 540

	<i>Page</i>
8.1 The DIF's account of the principal changes in contract types available in Milk Marque's selling processes, 1995 to January 1998, and Milk Marque's explanation of those changes .....	551
Glossary .....	564
Index .....	570

Part I

# **Summary and Conclusions**

# 1 Summary

1.1. On 27 January 1998 we were asked to investigate and report on the supply of raw cows' milk in Great Britain under the monopoly provisions of the Fair Trading Act 1973: see Appendix 1.1. By raw cows' milk ('milk') we mean milk as obtained from dairy cows and not yet subjected to treatment of any kind.

1.2. In 1997/98 about 12.6 billion litres of milk were produced on some 29,600 farms in Great Britain. Production varies throughout the year, with a 'spring flush' and a trough in the late summer. Milk is highly perishable and expensive to transport relative to its value, so competition from milk produced outside Great Britain is weak. Some milk is processed on farms, but nearly all is transported to dairies for processing. About half the milk produced in Great Britain is processed for consumption as fresh liquid milk. The remainder is manufactured into milk products, principally butter, cheese and milk powder, or used as an ingredient in other dairy products.

1.3. The distribution of milk for processing was deregulated in 1994. Just under half of all the milk produced in Great Britain is now collected from farms and delivered to dairies by Milk Marque Limited (Milk Marque), the successor to the Milk Marketing Board for England and Wales, and around a further 6 per cent by Scottish Milk Limited, successor to the Scottish Milk Marketing Board. The remaining milk is supplied to processors by other, much smaller, milk groups (of which there are around 50 in Great Britain) or by farmers directly. Dairy processing is unconcentrated compared to milk supply, with the seven largest processors purchasing two-thirds of the milk produced in Great Britain.

1.4. Milk production in the EC is subject to the dairy regime under the Common Agricultural Policy (CAP). This provides for EC intervention to support the prices of milk products and hence of milk. Milk prices in the UK are affected by exchange rates both through the CAP intervention prices (which until the end of 1998 were expressed in ecus) and through international trade in storable dairy products such as butter, cheese and milk powder. Each member state's milk production is limited by quota. Individual producers in the UK have shares of the national quota and they can trade this quota within the UK. The UK's quota allowance does not meet its demand for milk and milk products and the balance is met by imported milk products.

1.5. Milk prices in the UK have fallen sharply in the last two years. The central reason for this has been the appreciation of sterling against the ecu and European currencies. This has had the effect of reducing the sterling equivalent of CAP subsidies and the competitiveness of UK-based processors. UK farmers' incomes have declined accordingly but the range of profitability among dairy farmers remains wide.

1.6. Milk Marque sells most of its milk on six-month or longer contracts in selling processes held twice a year. Under its 'volume-bid' auction system, buyers bid for the volume of milk they require under one or more 'service contracts', which are offered at

specified prices that include delivery. The service contracts differ chiefly in the extent to which they permit Milk Marque or its buyers, respectively, to vary the volumes of milk that Milk Marque supplies daily, each month or over the entire contract period. Its 'market-led' contracts give buyers relatively even volumes of milk over these periods and are therefore more highly priced than the 'supply-led' contracts, under which the volumes of milk supplied may be far less stable and predictable. Milk Marque uses its supply-led contracts to manage daily and seasonal fluctuations in production and demand. Typically, fresh liquid milk processors, whose products cannot be stored, require even supplies of milk to meet a fairly predictable retail demand for their product. Processors of storable products such as cheese and milk powder can more readily handle fluctuating supplies.

1.7. Milk Marque's current processing operations consist of two modest cheesemaking plants. However, it plans to build a factory which, with its existing capacity, would enable it to process a total of 1 billion litres of milk a year in 2000.

1.8. We find that Milk Marque is a scale monopolist by virtue of its 49.6 per cent share of supply of milk in Great Britain in 1997/98. Milk Marque has been able to exploit its monopoly position by using its selling system to price discriminate and to control the supply of milk made available to the market.

1.9. Milk Marque has been able to price discriminate and raise the average price of milk above levels that would otherwise have been reached by engaging in the following practices. It has increased the required tolerances of its supply-led contracts to a degree greater than was necessary if its objective was to balance overall supply, and widened the price differentials between its different contract types more than was justified. It has forced its smaller processor customers to pay a higher average price for their milk than its larger customers to an unjustified extent. By imposing restrictions on the use of milk bought in its lowest-priced contracts in the summer 1998 selling process, it has obliged some processors to purchase milk at higher prices than they would otherwise have had to pay. It has entered into individually negotiated contracts with certain large processors on terms that were neither disclosed nor made available to the generality of customers. Finally, it has been able to exploit the particular aversion of some of its customers to the risk of obtaining inadequate supplies of milk or supplies obtained on adverse terms. It has been able to facilitate its price discrimination strategies by inhibiting the secondary trade in milk between processors.

1.10. As to control of supply, by arranging for milk to be contract processed outside the market in Great Britain, Milk Marque has been able to constrain the volumes of milk offered to its usual customers in the face of largely unchanged demand, thereby raising the marginal price of milk. Although we did not find that Milk Marque was exploiting the scale monopoly situation in respect of its current vertically integrated processing activities, we consider that the planned enlargement of its vertically integrated processing capacity will give Milk Marque the ability to exploit still further the scale monopoly situation in its favour and it may therefore be expected to operate against the public interest.

1.11. Milk Marque has also engaged in other practices which have had the effect of keeping prices higher than they otherwise would have been. Thus, by making frequent changes to its selling system it has been able to generate unnecessary uncertainty for its customers and so induce them to purchase milk at higher prices than would otherwise have been the case. It has paid insufficient regard to the legitimate demands of its customers, both large and small, in respect of the contract types it has offered them and other matters.

1.12. Milk Marque effectively sets the floor price of milk for producers in Great Britain, because of its membership policy and its high market share. Since purchasers of milk must offer producers a higher price than that offered by Milk Marque if they are to attract and retain those producers, milk prices throughout Great Britain are higher than they would otherwise have been.

1.13. Milk Marque's behaviour has resulted in greater uncertainty and higher costs for the dairy processing industry in Great Britain, resulting in lower levels of investment by them, than would otherwise have been the case. Consumers pay more for fresh liquid milk than they otherwise would. Milk Marque's exploitation of its monopoly position thus operates and may be expected to operate against the public interest.

1.14. Deregulation has not brought about a competitive market for milk. Milk Marque and the dairy processors have become increasingly confrontational and this has damaged the industry as a whole. The consumer has not been well served. We considered carefully several possible remedies to the public interest detriments mentioned in paragraph 1.13, including the reform of Milk Marque's selling system. However, we judge that many of the problems are attributable to the ability of Milk Marque to exercise in a number of ways its significant market power, which derives from the considerable discretion it has over the operation of its selling system and its 49.6 per cent share of the supply of milk in Great Britain. We consider that behavioural remedies would fail to address long term the adverse effects we have identified.

1.15. We therefore recommend that Milk Marque should be divided into a number of independent, quota-holding bodies having an approximately equal share of Milk Marque's supply of milk at the time the division takes place. We envisage that the division would be based on an allocation of Milk Marque's depots to the new bodies but would not necessarily involve a simple regional split. The precise configuration of the new structure should be a matter for the Secretary of State. We would expect the new bodies to have separate corporate identities, with independent directors and no common directorships. Early consideration should be given to repaying Milk Marque's cash to its farmer members, once the financing requirements of the successor bodies, which are likely to be modest, have been satisfied.

1.16. The purpose of our recommendation is to eliminate the market power of Milk Marque, to create a more competitive market for the supply of milk and to provide fresh opportunities for producers and processors to develop commercial relationships that serve their interests, as well as the interests of consumers. The new bodies should be allowed to engage in their own processing as, in the absence of market power, this should not prove a threat to competition. With competitive structures established, it should not be necessary to specify how the new bodies sell their milk. However, the possibility of collusion over milk supply among the newly-formed bodies, and attempts by them to form joint processing operations, cannot be ruled out. The Director General of Fair Trading should therefore monitor the new regime closely in the early years.

1.17. Although we think the advantages of structural reform of Milk Marque are overwhelming, we also recommend that a number of interim behavioural remedies should be put in place as a short-term measure to provide what we recognize is a very limited degree of protection to those affected by Milk Marque's behaviour during the period before our recommendations are implemented.