Part II

Background and evidence

3 Origin of the reference and the regulatory framework

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Introduction

3.1. In this chapter we first give a brief account of how the reference came to be made. We then describe how the marketing of raw milk in Great Britain has evolved from the highly regulated system that, until 1994, operated under the MMBs. Finally, we describe the framework of the CAP in relation to milk and milk products and the CAP's impact on the policies and practices of producers, milk groups and processors with regard to the supply of raw milk in Great Britain. The conduct of the inquiry is described in Appendix 1.1.

Origin of the reference

3.2. On 27 January 1998 the DGFT, in exercise of his powers under the FTA, made a reference to us relating to the supply of raw cows' milk[1] in Great Britain. The DGFT's chief concern was the selling system operated by Milk Marque, the successor body to the EWMMB. The DGFT told us that

[1]Not defined in our terms of reference but defined in EC Council Directive 2597/97 as milk which has not been heated above 40°C or subjected to treatment having equivalent effect.

Milk Marque's system lacked transparency, and that frequent changes to its terms and structure had led to uncertainty for its customers. In the DGFT's view this had led to prices being higher than they might otherwise have been. The DGFT said that the price set by Milk Marque was effectively adopted in Great Britain as the base price for milk sold by other producer groups, including Scottish Milk (the successor body to the SMMB), and for direct sales from farms. The DGFT was concerned, too, with the possible scope for price discrimination as a result of Milk Marque's move towards vertical integration through its acquisition of Aeron Valley, a Welsh cheesemaker (see paragraph 4.92).

3.3. The DGFT, however, told us he had no evidence that Milk Marque's prices or behaviour had had any impact on the market in Northern Ireland where a different type of selling system is operated. Our inquiry was therefore limited to Great Britain. We were asked to report by 26 October 1998. The reporting period was subsequently extended twice, to 26 January 1999, and then to 26 February 1999.

3.4. Our terms of reference are in Appendix 1.1. The DGFT's Press Notice announcing the referral is at Appendix 3.1.

The marketing and sale of raw milk in Great Britain

Pre-deregulation—the Milk Marketing Boards

3.5. From the early 1930s until deregulation in 1994, the marketing and sale of raw milk produced in Great Britain was undertaken through statutory Milk Marketing Schemes operated by four MMBs: the EWMMB; the SMMB; the ADMMB; and the NSMMB. (The NIMMB carried out a similar function in Northern Ireland.) The MMBs were established through the provisions of the Agricultural Marketing Acts of 1931 and 1933.[1] The Acts were intended to deal with dairy farmers' low incomes and unequal bargaining power at a time of consolidation and expansion of dairy processing companies. The MMBs became the sole purchasers of almost all the raw milk from farmers and sole sellers of milk to the dairy processors, mostly within each MMB's specified territory.

3.6. Government control of milk prices, which started in 1940, continued until 1981 in Scotland and until December 1984 in England and Wales (and in Northern Ireland). In 1978, after a five-year transition period following the UK's entry into the EEC in 1973, the MMBs were incorporated in the common organization of the market in milk and milk products.[2] New EEC legislation was enacted under which the MMBs' prices were to be established on the basis of negotiations between the MMBs and processors. Both groups were to be represented on an equal footing.[3] From that time, until 1994, prices in each MMB area were negotiated in Joint Committees comprising representatives of the MMB and milk purchasers in that area. In England and Wales the DTF represented the interests of milk purchasers; in Scotland the Scottish Dairy Trade Federation sat in Joint Committee with the SMMB and more informal arrangements existed in respect of the ADMMB and the NSMMB. Each side had a single block vote. Provision was made for independent arbitration in the event of failure to agree.

Common approach to financial information

3.7. Milk production increased by more than 20 per cent between 1978 and 1983. Investment in manufacturing capacity was required to handle the extra milk. Milk Marque told us that dairy farmers needed a secure outlet for their production and dairy companies wanted assurance that there would be a reasonable rate of return on such investment.

3.8. In 1978 a cost-plus formula was agreed between the EWMMB and the DTF in Joint Committee to determine the price for milk manufactured into butter and SMP. Known as the Common Approach to Financial Information (CATFI), the formula used the cost of manufacturing butter and SMP, the wholesale prices of these products, and an agreed return on capital invested. (Wholesale

[1]Described more fully in *Scottish Milk Marketing Board and Co-operative Wholesale Society Limited* (see footnote to paragraph 2.320).
[2]EC Regulations 1421/78 and 1422/78 and EC Regulation 1565/79.
[3]Article 9(4) of Regulation 1422/78.

prices were gathered from returns by dairy companies to an industry-wide panel.) Through the CATFI formula, the value of milk in a tonne of butter and SMP was derived. This was divided by the volume of milk needed to produce a tonne of butter and SMP to give a ppl value to the milk. CATFI guaranteed processors a standard rate of return on their capital employed in the manufacture of butter and SMP. Differences in profit levels occurred to the extent that a dairy company's selling prices, operating costs and throughput differed from the values used in the CATFI formula. AWG told us that the CATFI system had given protected margins, reducing the risk of acquisitions (see paragraph 4.205).

3.9. A hierarchy of milk prices was negotiated between the MMBs and the purchasers' representatives according to the end-use of the milk. Milk for the liquid and other fresh products markets was the highest priced; its processors received priority of supply; processors engaged in cheese, butter or SMP manufacture were accorded the lowest priority use. Once prices were agreed in Joint Committee, they remained in force until either party requested a change, although latterly most prices were agreed for fixed time periods. Buyers were allocated specific farms from which their supplies were obtained; they were required initially to accept all the milk produced by those farms. However, if any of this milk was surplus to a liquid milk processor's requirements, the MMB would normally arrange for it to be diverted to other manufacturers with no direct handling charge. If a liquid milk processor experienced a deficit in supply, the MMB would recall supplies from manufacturers of commodity products and transfer them to the liquid milk processor. Milk Marque told us that there was extensive recall of milk from manufacturers' silos to satisfy the liquid milk processors and that this led to a deterioration in milk quality. Manufacturers with excess supplies would be asked to relinquish farms or to pay the cost of moving supplies to other locations.

Rationalization of processing capacity

3.10. In 1984 the EC milk quota regime was introduced (see paragraph 3.48). The UK milk industry, that had been expanding, now began to contract. The CATFI pricing formula (see paragraph 3.8) became wholly inappropriate for farmers. Producers' milk prices fell as processors ran factories below capacity, requiring higher margins per litre to cover fixed costs, the average of which were guaranteed through the CATFI system.

3.11. In England and Wales, the EWMMB implemented measures, agreed jointly between both sides of the industry, to cope with the surplus processing capacity. These measures were known as the Rationalisation of Facilities (ROF) programmes. ROF was financed by dairy farmers, through the MMB, in the belief that a reduction in processing capacity would bring better returns to producers through the CATFI system and the elimination of the fixed costs associated with excess manufacturing. Three ROF programmes were introduced: the first, introduced in 1987 for butter and SMP, reduced capacity by 25 per cent; in 1989 a second ROF programme removed a further 20 per cent of butter and SMP capacity; and in 1992 the scheme was extended to include hard-pressed cheese. In total, the ROF programmes cost the EWMMB over £134 million and reduced manufacturing capacity by nearly 12 mlpd. Processors which accepted the funds (which were outside the CATFI formula) undertook not to replace the capacity for five years. ROF programmes were not introduced in Scotland.

The decision to deregulate the market

3.12. We were told by MAFF that, during the late 1980s and early 1990s, the operations of the MMBs led to increasing tension between the supply and processing sides of the milk industry. A consultant's study commissioned by the EWMMB concluded that the existing arrangements were unsatisfactory and, in particular, that end-use pricing discouraged innovation and investment in new products, so that the industry, shielded from the disciplines of a competitive market, stagnated. The MMB, and notably its Chairman, concluded, therefore, that change was necessary. MAFF told us that it found the consultant's analysis persuasive. During that period UK producer prices fell below those of other EC member states when (since the UK was a net importer) they might have been expected to be much higher.

3.13. Milk Marque told us that although the ROF programmes had reduced the pressures, there were still enormous problems. It said that at times of shortage, the 'grandfathering rights' effectively in place through the allocation of farms to processors created difficulties for manufacturers of priority-priced milk as well as for potential new entrants. These pressures led to the formulation in 1991/92 of a new system for the marketing and sale of raw milk for manufactured products which was called 'New Ways of Buying Milk' (New Ways). The system involved manufacturers of all processed products bidding for volumes of milk priced according to service levels. Milk Marque told us that the EWMMB and the DTF implemented the new arrangements but the market-clearing mechanism (which would determine the price) did not operate as had been intended: the collapse of New Ways signalled an end to the Milk Marketing Scheme.

3.14. Milk pricing arrangements were changed in 1992. CATFI was abolished and in its place manufacturing prices were determined on the basis of an agreed margin and yield for butter and SMP.

3.15. In 1991 the Government announced that it was to end the MMBs' statutory monopoly. The Agriculture Bill, which was granted Royal Assent on 27 July 1993, provided for the four Milk Marketing Schemes in Great Britain to be revoked. The Agriculture Act 1993 (Agriculture Act) provided for the MMBs to apply to Ministers for approval of a scheme for the reorganization of the arrangements relating to the marketing of milk in their areas. The Agriculture Act also provided that the task of preparing such a scheme would form part of the MMBs' statutory duties and that Ministers, in deciding whether to approve the scheme, should consult producers, purchasers and consumers of milk. The Agriculture Act further provided for the creation of residuary bodies to wind up the remaining assets and liabilities of the MMBs, including the disposal of Dairy Crest.

Proposals for successor bodies to the Milk Marketing Boards

England and Wales

3.16. In April 1992 the EWMMB introduced proposals for deregulation within which a voluntary producers' co-operative (later named Milk Marque) would be responsible for selling all the milk produced by its members. Under the proposals each eligible producer would be given shares in Dairy Crest, the EWMMB's processing subsidiary (according to the value of milk sold by that producer in 1992/93). It was envisaged that some 30 per cent of shares would be available to the public.

3.17. Several earlier proposals had been put forward by the EWMMB which included the creation of a single vertically integrated co-operative. However, the replacement of the EWMMB with a national milk marketing organization, which was also the largest single processor of milk, was not acceptable to the European Commission, notably DGIV, its Competition Directorate. Nor was it acceptable to MAFF.

3.18. The EWMMB then proposed that two separate organizations should be created: Milk Marque and an independent Dairy Crest. On this basis, and with the provision of more liberal membership terms on which individual producers could leave Milk Marque, DGIV did not object to the proposals. The then Competition Commissioner, Sir Leon Brittan, commented that his personal preference would have been for the EWMMB to be replaced by several bodies rather than one co-operative. He added that it was, at that early stage, uncertain what the exact competitive position of the new body would be on the UK milk market. Against that background, and on the basis of the information made available to him, he believed that there were no grounds for action under Articles 85 and 86 of the EC Treaty with regard to the proposed new co-operative for an initial period of two years. He therefore asked DGIV to monitor carefully the market position of the new co-operative during this initial period. The Press Release issued by Sir Leon Brittan is at Appendix 3.2.

3.19. In October 1993 the EWMMB submitted its formal Scheme of Reorganisation to MAFF, which published a consultation document later that month. In a Press Release issued in December 1993 MAFF expressed concern about certain aspects of the proposals which it said gave 'rise to hesitations'.

3.20. Following the issue of the Press Release the EWMMB held three meetings with the DTF (chaired by MAFF). On 9 March 1994 MAFF issued a further consultation document. The Minister of

Agriculture, Fisheries and Food and the Secretary of State for Wales gave their approval to revised proposals in June 1994. Vesting Day was set for 1 November 1994.

3.21. The key principles of the EWMMB's proposals were that:

(a) a free market in milk should be created with prices determined by the interplay of supply and demand, but within the framework of the CAP common organization of the market in milk and milk products;[1]

(b) farmers should be able to sell their milk to whomsoever they wished, and dairy companies should have the same freedom in buying their milk;

(c) all the obligations of farmers to sell all their milk to the EWMMB should be cancelled, and farmers should be free to form co-operatives if they wished;

(d) Dairy Crest would become an independent public limited company in which eligible dairy producers would be allocated shares; and

(e) Milk Marque, a producer-owned organization, would have a sound financial base for its operations, inheriting certain assets from the EWMMB and issuing Certificates of Entitlement (see paragraph 4.48) to all eligible producers, whether or not they became members.

3.22. Milk Marque told us that throughout the consultation process on reorganization, the DTF had declined MAFF's invitation to put forward any proposals for an alternative system: the DTF had been hostile to Milk Marque from the outset. But when devising an appropriate selling system, neither Milk Marque nor the DTF had wanted an auction that would have radically changed the way milk was sold. Milk Marque was concerned about the potential for abuse by buyers of their market power in an auction. Milk Marque said that, as the DTF had declined to participate in the discussions, Milk Marque chose to use forms of contract based on New Ways (see paragraph 3.13).

3.23. The DIF told us that only the MMBs were permitted, under the terms of the Agriculture Act, to put forward proposals on the way in which milk was traded after deregulation. The DTF had vigorously objected to its exclusion from the decision-making process and had lobbied Parliament and the Minister unsuccessfully on the subject. However, the DIF said that the DTF had played as full a part as it was permitted in the consultation process. It put forward alternative suggestions on aspects of the proposed new system following both consultation exercises. Changes to the selling system introduced by the EWMMB following discussions with the DTF, after MAFF had expressed hesitations, did not meet the DTF's concerns. Nor was the Scheme of Reorganisation in its entirety acceptable to the DTF. It had feared that the outcome of the reorganization would be the replacement of one monopoly seller by another, but without effective regulatory constraints.

3.24. By July 1994 over 19,000 producers (over two-thirds of the total), accounting for 50 per cent of production in England and Wales, had contracted to sell their milk to Milk Marque. It then invited formal bids from purchasers of milk under the new arrangements (having invited expressions of interest prior to approval of the Scheme of Reorganisation). Prices were established after three rounds of bidding. The DTF continued to object to Milk Marque's proposed selling system, the price structure and the effect on the industry, and asked MAFF to ask the DGFT and the Secretary of State for Trade and Industry to refer the matter to the MMC.

3.25. MAFF rejected this request on the grounds that:

(a) before approving the EWMMB's reorganization scheme MAFF had concluded that Milk Marque's trading practices took account of the interests of milk purchasers;

(b) the new milk marketing arrangements had yet to come fully into effect;

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[1]EC Regulation 804/68.

(c) many purchasers of milk had themselves been offering to pay dairy farmers prices in excess of those achieved by Milk Marque; and

(d) a substantial restructuring of milk prices was inevitable once the MMBs' end-use pricing systems ceased.

3.26. The OFT told us that it had commented in detail during the preparations for the establishment of the new bodies to replace the MMBs. It had expressed some concern about the anti-competitive potential of the Schemes of Reorganisation by the EWMMB and the SMMB. However, the DGFT was anxious not to pre-judge issues he might be called on to consider if the supply of milk was. brought within his reference-making powers. Accordingly, he stood back from the final stages of the deregulation process.

3.27. In September 1994 the DTF sought an application for leave to apply for judicial review of the decision by the Minister of Agriculture, Fisheries and Food to approve the EWMMB's Scheme of Reorganisation. The Court refused the application principally because it had not been made promptly and there was no good reason for extending time.

Scotland (and Northern Ireland)

3.28. The scheme originally proposed by the SMMB provided for a transfer of all its assets to a new co-operative including the processing of raw milk carried on by the SMMB's subsidiary company, Scottish Pride Ltd (Scottish Pride). However, the Scottish Office (which was the 'appropriate authority' for the purposes of the Agriculture Act) did not accept the proposed inclusion of the processing businesses of Scottish Pride Ltd within the new co-operative. The proposals were therefore amended to allow for the creation of two successor bodies to the SMMB, namely Scottish Milk and Scottish Pride Holdings plc which was to become the holding company for the Scottish Pride processing business.

3.29. In October 1993 the SMMB submitted its revised Scheme of Reorganisation to the Scottish Office and, following some further amendments, the Scheme was approved by the Secretary of State for Scotland in July 1994. The Scheme proposed that all farmers who had been members of the SMMB at any time in the seven years prior to the vesting date would receive a share in its assets, including in its processing operations carried on by Scottish Pride (see paragraph 4.116). Scottish Milk, together with AMCO, the successor to the ADMMB, and the North of Scotland Milk Company (later Claymore—see paragraph 4.147), successor to the North of NSMMB, became operational on 1 November 1994. (Deregulation in Northern Ireland came into effect on 1 March 1995 when United (see paragraph 5.90) succeeded the NIMMB.)

Post-deregulation

3.30. Within one month of Vesting Day, the DIF, successor to the DTF (see paragraph 4.273), complained to the OFT and the European Commission about Milk Marque's trading practices. Following the complaint, Milk Marque notified its selling system to DGIV of the European Commission. DGIV told us that in view of the decision by the OFT to examine the practices of Milk Marque, DGIV decided to suspend its own investigation and await the outcome of inquiries initiated by the UK competition authorities.

3.31. The OFT's scrutiny of these representations led to the DGFT telling Milk Marque on 26 February 1996 that he was minded to refer the wholesale supply of milk to the MMC, under the monopoly provisions of the FTA. The DGFT said that he was concerned at the lack of transparency in the selling system, the fixing of prices by Milk Marque without reference to demand and movements in prices not reflecting the true state of supply and demand within the market. In particular, he was concerned that Milk Marque was using its market power to price discriminate and to sustain the price above the competitive level.

3.32. However, in August 1996, following negotiations with Milk Marque, the DGFT agreed, in lieu of a reference to the MMC, to accept non-statutory assurances from it about certain aspects of its operations. The OFT's press release of 21 August 1996 (see Appendix 3.3) said that the lack of symmetry in Milk Marque's selling system had 'allowed prices to rise when there was an excess demand for milk, but did not provide for a corresponding fall in prices when there was a shortfall in demand'. The assurances are set out in paragraph 5.15.

3.33. In the same period the House of Commons Agriculture Committee[1] had been examining the milk industry. In July 1996 it concluded that:

(a) there was no convincing evidence of any anti-competitive abuse by Milk Marque which led to milk prices being higher than was justifiable;

(b) it would not support any move to force Milk Marque to relinquish control over the delivery of the milk which it sold;

(c) the length of Milk Marque's producer contracts, and their terms, were no more than sound and responsible business practice; and

(d) there was still a need for dairy farmers to have a strong stake in the marketing of their milk.

The Select Committee opposed a reference to the MMC.

3.34. The DIF told us that when Milk Marque published the terms of its July 1996 selling process the DIF, and many of its members, objected to the prices quoted by Milk Marque on the grounds that they bore no relationship to current market conditions. The DIF requested Milk Marque to lower its prices but was refused. Some large processors discussed whether to reach an agreement among themselves not to bid in the selling process. The DIF, through its Ways and Means Committee, considered recommending to its members that they should not participate in the process, as well as telling them about the action contemplated by the large processors.

3.35. Before reaching a conclusion the DIF consulted the OFT, and took separate legal advice, on whether the measures under consideration would be unlawful. The OFT advised that the action contemplated would appear to breach the Restrictive Trade Practices Act. It said that it would be difficult for the OFT 'not to see such actions [ie boycotts] as being significant' and that the DGFT would have serious concerns were the DIF or its members to proceed in the way proposed. The DIF then told the DGFT that it had 'reluctantly ... therefore decided not to go down this route'. (The DIF's letter to the DGFT of 17 July 1996 is at Appendix 3.4.)

3.36. Three further main selling processes were conducted under the provisions of the assurances and the OFT continued to monitor their operation. It sought further evidence from processors. Criticisms of Milk Marque and its selling system persisted, and in January 1998 the DGFT referred the supply of raw milk in Great Britain to the MMC. A summary of the DGFT's concerns is in paragraphs 5.17 to 5.21. The DGFT's press release announcing the referral is at Appendix 3.1.

3.37. In May 1998 Milk Marque met the OFT to discuss the status of the assurances. The OFT told us that it had confirmed on this occasion that once a reference had been made to the MMC, the consideration in respect of which Milk Marque had given the assurances would disappear.

The dairy regime in the EC

3.38. All raw milk production in the EC is subject to the common organization for milk and milk products[2] established in 1968 under the CAP formed pursuant to Article 3(e) of the EC Treaty. The objectives of the CAP[3] are:

[1]See footnote to paragraph 2.302.
[2]EC Regulation 804/68.
[3]Article 39 of the EC Treaty.

(a) to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilization of the factors of production, in particular labour;

(b) thus to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;

(c) to stabilize markets;

(d) to assure the availability of supplies; and

(e) to ensure that supplies reach consumers at reasonable prices.

3.39. The main elements of the regime, designed to support the farm gate price of raw milk, are institutional or 'common' prices, intervention buying, import tariffs and export subsidies, aid for private storage and disposal, and milk quotas (which were introduced in 1984). We describe the institutional or common prices (more particularly the target price for milk and intervention prices set by the Council of Ministers), and the agri-monetary regime which preceded the introduction of the euro, in paragraphs 3.41 to 3.44. The remaining elements, other than milk quotas, are briefly covered in paragraphs 3.45 to 3.47. The milk quota system is described in paragraphs 3.48 to 3.57. An outline of the Agenda 2000 proposals, the European Commission's proposed reform of the CAP in respect of milk and milk products, is set out in paragraphs 3.58 to 3.60.

3.40. In contrast to the arrangement for CAP support in the UK (see paragraphs 6.67 and 6.68), the vertically integrated structure of the milk industry in most other EC member states is such that CAP support goes directly to producer-owned organizations. For example, in Denmark, Ireland and the Netherlands a high percentage of the production and supply of milk and milk products is controlled by vertically integrated producer-owned co-operatives. (In Denmark over 90 per cent of milk deliveries from farms are made to co-operatives; in Ireland the larger processors are for the most part either co-operatives or companies controlled by co-operatives; and in the Netherlands three large co-operatives dominate the dairy sector.) In France, private dairies account for most sales of dairy products, offering a wide range of branded value-added products, whilst the processing activities of farmers' co-operatives concentrate on bulk products.

Institutional or common prices

3.41. The system of institutional or common prices within the CAP consists of:

(a) a target price for raw milk set annually by the Council of Ministers described as 'The target price shall be that price which it is aimed to obtain for the aggregate of producers' milk sales, on the Community market and on external markets, during the milk year';[1] and

(b) intervention prices which are fixed annually for butter and SMP, relating to sales in the intervention system.

3.42. Exchange rates affect UK milk prices, both through the CAP intervention prices and through their indirect effect on international trade in products such as butter, cheese and SMP. The level of support prices is specified in euros. In the UK, these prices must be translated into sterling terms using the daily market exchange rate published in the *Official Journal*. The relationship between exchange rate movements and raw milk prices is discussed in Chapter 6.

3.43. Until the introduction of the euro on 1 January 1999, the European Commission used agricultural conversion rates between the ecu and the local currency in the operation of the CAP to overcome the continuous fluctuation of market exchange rates. Agricultural conversion rates,[2] commonly known as green rates, converted centrally fixed amounts expressed in ecus into the national currency

[1]EC Regulation 804/68.
[2]Defined in EC Council Regulation (EEC) No 3813/92 (as amended).

of a member state. They were realigned from time to time with actual market rates. Green rates differed from normal commercial rates of exchange in two key respects:

(a) they were fixed over time and did not vary from day to day; and

(b) they were subject to predetermined rules which governed the timing and amount of any changes to them.

Green rates were designed to enable suppliers, processors and traders to know with greater certainty the intervention price for a certain product, and for trade to take place between EC member states without disadvantaging particular groups within any particular member state. Changes in the rate for sterling against the ecu have been considerable since 1991 and have been reflected in both devaluations and revaluations of the green pound.

3.44. The DIF told us that in its view the operation of the agri-monetary system had given rise to considerable delays in aligning the rate to reflect the actual market and that this had detracted from any benefit of the system. The introduction of the euro brought about the end of the agri-monetary regime and the use of green rates.

Intervention buying

3.45. The intervention system supports market prices in the EC by providing for the purchase and storage of certain dairy products by national intervention authorities (in the UK, the Intervention Board, a Government executive agency). Intervention stocks are released for sale by the EC when appropriate. Intervention buying is available for butter and SMP only. For butter it becomes available only if market prices in a member state fall below 92 per cent of the intervention price for two consecutive weeks. It is offered into intervention in fortnightly tenders. Legislation stipulates that the price at which the butter is bought cannot be less than 90 per cent of the intervention price. The European Commission fixes a maximum buying-in price for each tender which can be anything from 90 to 100 per cent of the intervention price, although in practice (and certainly at present) it has been fixed at 90 per cent. Any offers pitched at levels higher than the maximum buying-in price for a particular tender are rejected. Acceptance of bids is also subject to a minimum quantity tendered of 10 tonnes. Intervention for SMP is available for only six months of the year: from 1 March to 31 August. It is a fixed price purchase although there is the provision for the suspension of intervention buying at a fixed price should intervention purchases in a given year rise above a certain threshold. If this happens, tendering may be introduced. In such circumstances, private storage aid must also be made available.

Imports and exports

3.46. The supported prices for dairy products produced within the EC are usually above prices of milk products produced outside the EC. Therefore EC tariffs are imposed on most dairy products imported from outside the EC. In addition exports of certain dairy products from the EC receive subsidies. The 1994 GATT Uruguay Round Agreement (GATT Agreement) committed the EC to reducing tariffs, increasing market access and reducing export subsidies, particularly on cheese and on the ‘other dairy products’ category, which includes WMP, progressively over a six-year period commencing in July 1995. An indirect effect of the GATT Agreement has been the diversion of processed dairy products to the UK from other member states, which would otherwise have been exported to countries outside the EC.

Private storage and disposal

3.47. Aid for private storage of butter is available in the UK under the CAP during certain times of the year. It may also be introduced for SMP and cream. Subsidies are available for the provision of milk in schools to encourage the consumption of dairy products. In order to help dispose of surplus milk production, subsidies are also available for the use of butter in the manufacture of confectionery, pastry products and ice cream; for the incorporation of SMP into calf-feed; and for the manufacture of casein from skimmed milk.

The EC milk quota system

3.48. Over time, the support measures described in paragraphs 3.45 to 3.47 led to much greater production of milk in the EC throughout the 1970s and early 1980s. But the EC Council of Ministers became increasingly concerned about the proportion of the CAP budget absorbed by support measures and in April 1984 they introduced a quota system limiting the amount of milk which could be marketed without incurring the liability of a levy (see paragraph 3.53). The quota system was brought in for five years but was extended for three years in 1988, one year in 1992 and a further seven years in 1993. In March 1998 the European Commission published proposals to extend milk quotas for a further six years as part of its Agenda 2000 CAP reform package (see paragraph 3.58).

3.49. A milk quota is linked to a land holding, and the producer who occupies the holding is registered by the Intervention Board. There are two types: a wholesale quota, which covers the delivery of milk or milk products to an approved milk purchaser (see paragraph 3.54); and a direct sales quota which covers the marketing of milk or milk products direct to the public. Levy-free production levels are fixed for each member state and set out in an EC Regulation.[1] Wholesale and direct sales quotas are allocated separately.

3.50. At the outset the wholesale quota allocated to UK producers was 15.5 billion litres, their 1983 level of production minus 9 per cent. (Direct sales quota was based on 1981 production.) This was less than the Government wanted. But the UK has not been self-sufficient in milk during the post-war period; before it joined the EEC, successive UK governments encouraged imports of cheese, butter and other storable dairy products from the Commonwealth. After joining the EEC in 1973, incentives provided by the CAP and by UK Government policy resulted in UK milk production increasing steadily but not enough to achieve self-sufficiency. When quotas were introduced in 1984, the UK was producing more than 16.5 billion litres of milk a year. The introduction of quotas in 1984 therefore effectively obliged the UK to cut production suddenly.

3.51. Following the initial allocation, the UK's national wholesale quota was reduced by almost 1 billion litres in the 1987/88 quota year to 14.4 billion litres, after which there was little change. Since 1994/95 allocation has remained constant, at 14.2 billion litres. Table 3.1 shows the total milk quota for the whole of the UK for each year since the introduction of the quota system, together with actual wholesale production in excess of wholesale quota. Output per cow has risen annually by 1.2 per cent and there has been a compensating reduction in the number of milking cows.

TABLE 3.1 **Summary statistics for milk quota in the UK**

million litres

Years ended 31 March	*Quota*	*Net wholesale production in excess of quota*	*Quota transferred Leased*	*Quota transferred Permanent*
1985	15,489	0*	0	0
1986	15,335	8	0	0
1987	15,321	96	218	464
1988	14,432	56	289	421
1989	14,055	78	378	450
1990	14,350	0	511	417
1991	14,324	39	647	400
1992	14,083	15	744	350
1993	14,079	0*	749	370
1994	14,091	74	886	273
1995	14,167	138	1,038	562
1996	14,167	140	1,143	600
1997	14,167	50	1,175	680
1998	14,167	115	1,277	767

Source: Intervention Board.

*Production under quota.

[1]EC Regulation 3950/92 (as amended).

At first sight the table seems to indicate that quota leasing has exceeded permanent transfers in recent years, but this is not the case. A leasing transaction (see paragraph 3.55) results in a movement in the location of production for one year only, while permanent transfers will result in a movement for that year and all future years. The cumulative total of permanent transfers to March 1998 was 5,754 million litres, about 40per cent of total quota (although some quota may have been transferred more than once).

3.52. Quotas act as a barrier for those wishing to enter dairy farming or to expand their dairy operations. This aspect of the quota system is dealt with in paragraphs 6.57 to 6.61.

Management of quota

3.53. The quota system is administered in the UK by the Intervention Board, which holds records of all quota-holders and the amount and type of quota they hold. The quota year runs from 1 April to 31 March. If at the end of the year a member state's total milk production of one type exceeds its national quota of the same type it must pay a levy to the European Commission on all excess production. This supplementary levy (commonly referred to as super-levy) is currently set by European Commission legislation[1] at 115 per cent of the target price of milk.

3.54. A producer's wholesale quota allocation is registered with the purchaser who first buys milk from the producer to process it, or to sell on wholesale to another person or firm to process. Initially, the MMBs were the only purchasers approved by the Intervention Board. But there are currently over 100 such purchasers (see paragraph 4.43). Liability for the payment of wholesale levy is assessed initially at the level of the first purchaser who then recovers the money from the producer. The Manchester Report[2] stated that 14 per cent of the herds it surveyed were liable for super-levy on their 1996/97 milk sales; the average levy paid by these herds was £23 per cow. The average cost of the levy to all herds in the sample was £236, or £3 per cow.

Leasing and permanent quota transfer

3.55. Quota cannot be traded between member states but within each one the arrangements for leasing and permanent transfer of quota varies. In most other member states, national provisions allow for the transfer of quota, but in general the rules are more restrictive than those in the UK. In the UK there are no restrictions on the transfer of quota between regions or purchaser groups other than in Shetland and Orkney, part of the Kintyre peninsula, and some of the smaller Scottish islands. Elsewhere, an individual producer can change the amount of quota he holds by either leasing it to or from another producer or permanently transferring it between himself and another producer. Thousands of such commercial transactions take place each year.

3.56. There are a large number (around 5,000 in 1997/98) of non-producing or non-active quota-holders, including retired farmers, who have ceased milk production but have retained quota and receive income from it by leasing it out thus providing a substantial pool of quota for the leasing market. The proportion of quota for the UK leased out by non-active quota-holders in 1997/98 represented 5.3 per cent of the total. The procedure for leasing wholesale quota is relatively straightforward requiring notification to both the purchaser of the producer's milk and the Intervention Board, and the payment to the Intervention Board of a small administrative fee. (However, many quota-holders have to pay much larger sums by way of commission to quota agents or brokers to secure purchase, sale or lease of quota.) By contrast, the permanent transfer of quota can be complex.

3.57. Used and unused quota can be transferred at any time during the quota year. If used quota is transferred it is registered to the new holder but the used quota is temporarily returned to the seller and its purchaser for the rest of the quota year for the purposes of levy calculation. The producer taking over the used quota cannot produce against it until the beginning of the next quota year.

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[1]Council Regulation (EEC) No 3950/92 as amended; EEC Regulation No 536.93 as amended; and the UK Dairy Produce Quotas Regulations 1997.

[2]See footnote to paragraph 2.52.

Agenda 2000—reform of the CAP

3.58. As part of its Agenda 2000 proposals on reform of the CAP, the European Commission has proposed that the regulation of dairy products should be revised and consolidated, and in particular that the milk quota system be amended. Support prices for butter and SMP sold into intervention would be cut by 15 per cent in four stages, commencing on 1 July 2000. Producers would receive annual payments or 'dairy cow premium' of 100 ecus per 'premium unit'.[1] In addition, payments would be made to EC member states to be used at their discretion. The total premium would be the equivalent of about 60 per cent of the total cuts in support prices. Milk quotas would be extended for a further six years until 2006. They would be increased by up to 2 per cent in four equal instalments, to accompany the cuts in subsidy. Of this 2 per cent, one-half would be an across-the-board increase to EC member states' national quotas, to be allocated to young farmers. The remaining 1 per cent, for which UK producers would not qualify, would be allocated to dairy farmers in mountainous areas.

3.59. The UK, Denmark, Italy and Sweden have opposed the proposals and put forward alternatives. In a Press Release issued on 22 September 1998, the Minister of Agriculture, Fisheries and Food said 'In the context of Agenda 2000, the [European] Commission has proposed cuts in dairy support prices of 15 per cent over four years. Whilst this proposal would be a step in the right direction, it does not go far enough because the quota regime would be left intact.'

3.60. The proposed cut in support prices is much smaller than the reduction of about 30 per cent which MAFF estimates would be needed to close the gap between EC and world prices. (The difference is a complex calculation because world trade takes place in storable products such as butter, cheese and SMP rather than in milk itself.) Other proposals put forward by this group include: a 4 per cent increase in quota to be introduced in parallel with the support price cuts; removal of quotas in 2006; an extension of direct payments; and the replacement of existing intervention with a safety net, for example by increased use of private storage. Most other EC member states oppose the proposals from this group of four. Some member states would prefer to retain the status quo, leaving support prices and quota levels unchanged. Others can support some reduction in support prices. The debate continues.

[1]5.8 tonnes of milk quota will be the premium unit or 'virtual' dairy cow.