

# 4 Structure of the markets and participants

## Contents

	<i>Page</i>
Introduction .....	114
Production of milk .....	115
Dairy farming.....	117
Trends in dairy farming.....	120
Farm profitability .....	120
Trends in profitability .....	123
On-farm processing.....	124
Milk groups .....	124
Purchasers of raw milk.....	127
Successors to the Milk Marketing Boards.....	127
Milk Marque .....	128
Structure and sources of finance .....	128
Management.....	130
Facilities and staffing.....	131
Membership .....	131
Joining and leaving terms.....	132
Allocation of costs to members .....	133
Financial performance.....	133
Vertical integration.....	137
Aeron Valley Holdings Ltd.....	139
North Bradon Farms Ltd.....	140
Proposed factory at Cullompton .....	141
Contract processing.....	143
Scottish Milk .....	145
Origins of Scottish Milk.....	145
Membership of Scottish Milk .....	147
Financial performance.....	147
Vertical integration.....	149
Scottish Milk Products Ltd .....	149
Drakemire Dairy Foods Ltd.....	149
Aberdeen Milk Co Ltd .....	150
Claymore Dairies Limited (North Milk Co-operative).....	151
Other quota-holding milk groups .....	151
The Milk Group Ltd .....	152
Non-quota-holding milk groups.....	153
Express Milk Partnership .....	153
United Milk Producers Ltd .....	153
Southern Milk Producers.....	154
Quality Milk Producers Ltd .....	154
Utilization of milk.....	155
Trends in production and consumption of milk products .....	156
Processors of raw milk.....	157
Shares of raw milk purchases in Great Britain .....	158

The major processors.....	159
Express Dairies plc .....	159
Avonmore Waterford Group plc (Glanbia plc).....	161
Unigate PLC .....	162
Dairy Crest.....	164
Dairy Crest before deregulation .....	164
Closure of the Whitland creamery.....	165
Flotation of Dairy Crest.....	165
Dairy Crest since flotation.....	166
MD Foods.....	168
Associated Co-operative Creameries.....	169
Robert Wiseman Dairies PLC.....	169
Other processors.....	170
Nestlé UK Ltd .....	170
Bodfari Ltd.....	171
Cadbury Ltd.....	171
Profitability of the major processors .....	171
Aggregate profitability .....	171
Profitability by product.....	173
Processors' trade associations.....	174
The Dairy Industry Federation Limited .....	174
Scottish Dairy Association.....	175

## Introduction

4.1. In this chapter we look first at milk production and recent trends in dairy farming and its profitability; we then describe the milk groups, which for our purposes include not only those that have emerged since plans for deregulation were first put forward, but also the successors to the four MMBs; we describe recent trends in consumption of milk products; we explain how raw milk is utilized by processors and then describe the major processors themselves. Finally we report on our analysis of the profitability of the major processors.

4.2. We obtained information on the production of raw milk and on the consumption of milk products from several sources. MAFF compiles statistics for the dairy industry in England and Wales, and the Scottish Office Agriculture, Environment and Fisheries Department (SOAEFD) for Scotland, but some of the information published by MAFF on production and consumption is for all of the UK including Northern Ireland, which is outside the scope of our inquiry. Other sources were *Dairy Facts and Figures*, published by the National Dairy Council, and the *UK Milk Report*.<sup>1</sup> For information on dairy farming in England and Wales, we drew on the Manchester Report (see paragraph 3.54). Some of the published information used in this chapter is for the UK or for England and Wales, rather than for Great Britain.

4.3. The quota year (see paragraph 3.53) runs from 1 April to 31 March and much of the published statistical information is for quota years. The financial years of most of the major processors end on 31 March. In this chapter 1997/98, for example, is the year ended 31 March 1998 (except where otherwise stated).

4.4. Raw milk accounts for about one-fifth of the value of all the UK's agricultural output. The UK is the third largest producer of milk in the EC after Germany and France, and its output represents a little over 12 per cent of the EC total.

---

<sup>1</sup>*Dairy Industry Newsletter's UK Milk Report—97/98* by Barry Wilson, Michael Bessey & Stephen Bradley.

4.5. Figure 4.1 shows the flows of milk in the UK in 1997.

4.6. The principal flow is that from the dairy herd to dairies, and it is this flow (excluding the Northern Ireland portion) which is the subject of our inquiry.

4.7. In recent years production of milk in the UK has been close to the EC quota level (see Table 3.1). Table 4.1 shows the distribution of this quota between Great Britain and Northern Ireland for the last three quota years.

TABLE 4.1 Wholesale and direct sales quota, three years to 1997/98

	<i>million litres</i>		
	<i>1995/96</i>	<i>1996/97</i>	<i>1997/98</i>
UK:			
Wholesale quota	13,885.1	13,913.9	13,928.7
Direct sales quota	<u>272.5</u>	<u>244.1</u>	<u>228.4</u>
Total quota	14,157.6	14,158.0	14,157.1
Northern Ireland:			
Wholesale quota	1,387.4	1,440.1	1,502.2
Direct sales quota	<u>10.4</u>	<u>8.4</u>	<u>8.5</u>
Total quota	1,397.8	1,448.5	1,510.7
Great Britain:			
Wholesale quota	12,497.7	12,473.8	12,426.5
Direct sales quota	<u>262.1</u>	<u>235.7</u>	<u>219.9</u>
Total quota	12,759.8	12,709.5	12,646.4
			<i>per cent</i>
Proportion of Northern Ireland to UK:			
Wholesale quota	10.0	10.4	10.8
Direct sales quota	3.8	3.4	3.7
Total quota	9.9	10.2	10.7

Source: *Dairy Facts and Figures* (from the Intervention Board).

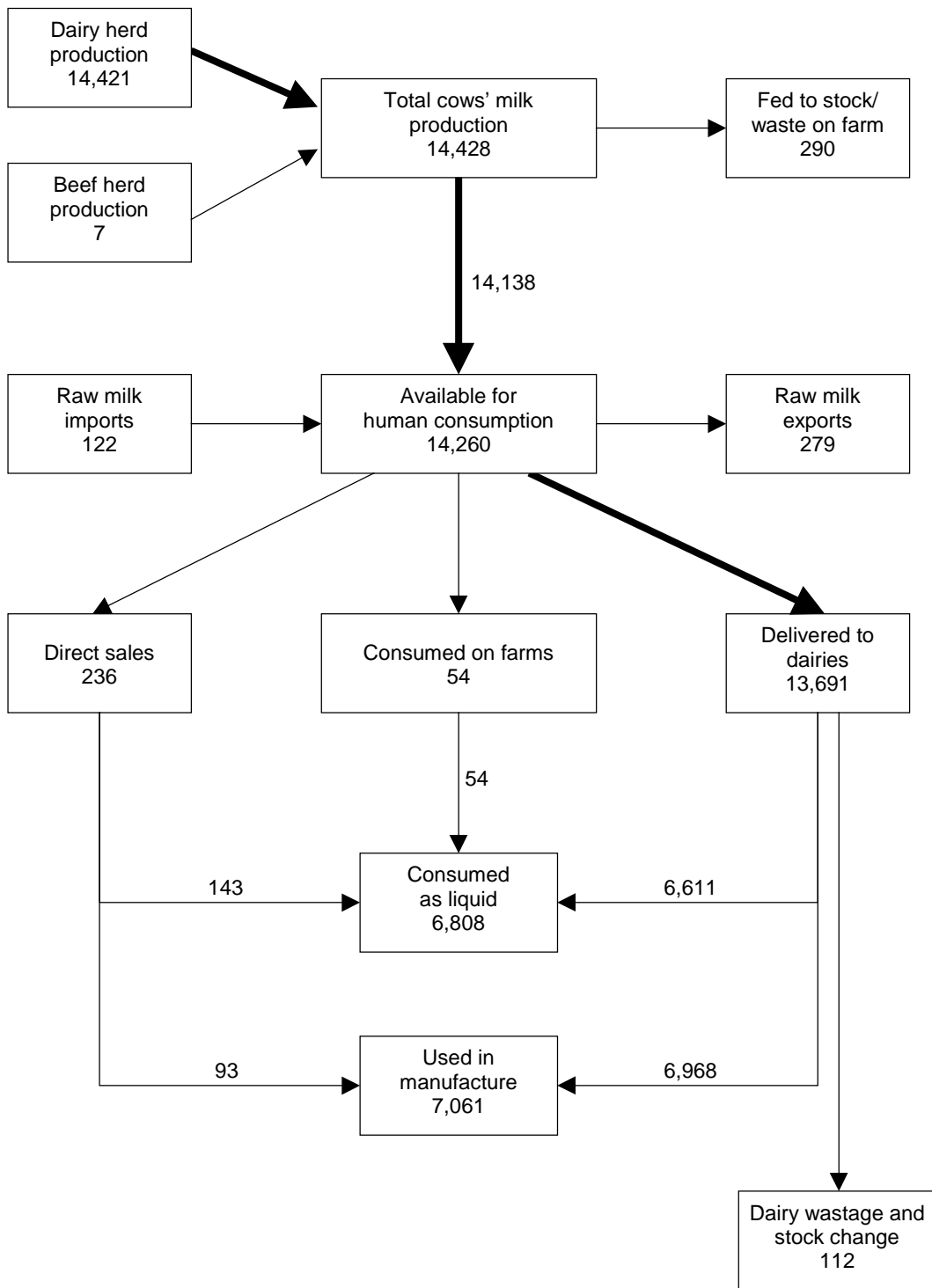
We were told that because of the cost, only small volumes of milk were shipped between Great Britain and Northern Ireland, until Milk Marque began to send milk there for contract processing (see paragraph 4.107). The volume of milk delivered to dairies in Great Britain has therefore been close to the wholesale quota of around 12.5 billion litres.

## Production of milk

4.8. In 1997 there were about 27,200 dairy farm holdings in England and Wales, and 2,400 in Scotland. The chief milk-producing areas, which are referred to in the industry as milk fields, are West Wales and the western lowlands of England and Scotland, where the relatively warm and wet climate is favourable for grassland and animal husbandry. Consumption of fresh liquid milk and milk products is concentrated on the most heavily populated areas, which tend to lie to the east of the main milk fields. The processing of raw milk into fresh liquid milk mostly takes place in dairies close to the main population centres, while processing into other milk products mostly takes place in creameries located near the milk fields. A sizeable proportion has to be transported over long distances to deal with the imbalance between demand for fresh liquid milk and local production, as described in Chapter 5.

FIGURE 4.1

**UK milk flow diagram, 1997 (million litres)**



Source: Dairy Facts and Figures (from MAFF).

Note: Figures are provisional.

4.9. This geographical imbalance between regions of production and consumption is shown in Figures 4.2 and 4.3. Figure 4.2 shows the population density of Great Britain by county<sup>1</sup> and the locations of the major dairies,<sup>2</sup> most of which are clustered around London and other major conurbations. Figure 4.3 shows the density of milk production (in terms of wholesale and direct sales quota per hectare for each county<sup>1</sup>) and the location of the larger creameries,<sup>2</sup> almost all of them in the western part of Great Britain.

4.10. There is a marked seasonality to milk production, with increased output during the so-called 'spring flush' and a trough in production during the late summer and early autumn. These seasonal fluctuations can be controlled to some extent by a variety of means, including calving patterns, feed patterns and content, and changing herd sizes. Milk processors supplying fresh liquid milk have a fairly constant demand from their retail purchasers and doorstep customers. But they cannot store their product. They therefore need as even a supply of raw milk as possible. Such processors can encourage a more even production throughout the year by making incentive payments to compensate for the additional production costs during the trough months.

## Dairy farming

4.11. Our inquiry took place at a time when the price of raw milk had fallen to levels well below those prevailing in recent years, and it was clear that many dairy farmers were in financial difficulties. Trends in net farm income in the UK for seven types of farm are set out in Table 4.2, covering the nine years to 1997/98. (The years in the table are accounting years ending on average in February.)

TABLE 4.2 Index of UK net farm income in real terms by type of farm\*

	Dairy	Cattle and sheep (LFA)†	Cattle and sheep (lowland)	Cereals	General cropping	Pigs and poultry	Mixed
1989/90	100	100	100	100	100	100	100
1990/91	70	74	59	120	78	79	94
1991/92	73	88	99	119	65	47	84
1992/93	93	112	139	164	68	54	115
1993/94	99	128	163	155	85	16	106
1994/95	82	92	122	205	146	33	123
1995/96	97	128	125	313	165	67	175
1996/97	76	124	100	272	83	59	130
1997/98‡	48	70	34	153	60	33	60

Source: *Farm Incomes in the United Kingdom 1996/97* (rebased by MMC).

\*Average net farm income per farm. 1989/90 = 100.

†Less Favoured Area.

‡Figures for 1997/98 are provisional.

Table 4.2 shows that in 1997/98 farm incomes for all types of farm except cereal farms were estimated to be well below the level attained in 1989/90. The net farm income of dairy farms had been reduced by one-half in two years, although some other types of farm had experienced even larger reductions. We therefore sought information, not only on the number of dairy farmers and the size of their herds, but also on the factors affecting the profitability of dairy farms. (Trends in the price of milk are dealt with in Chapter 6.)

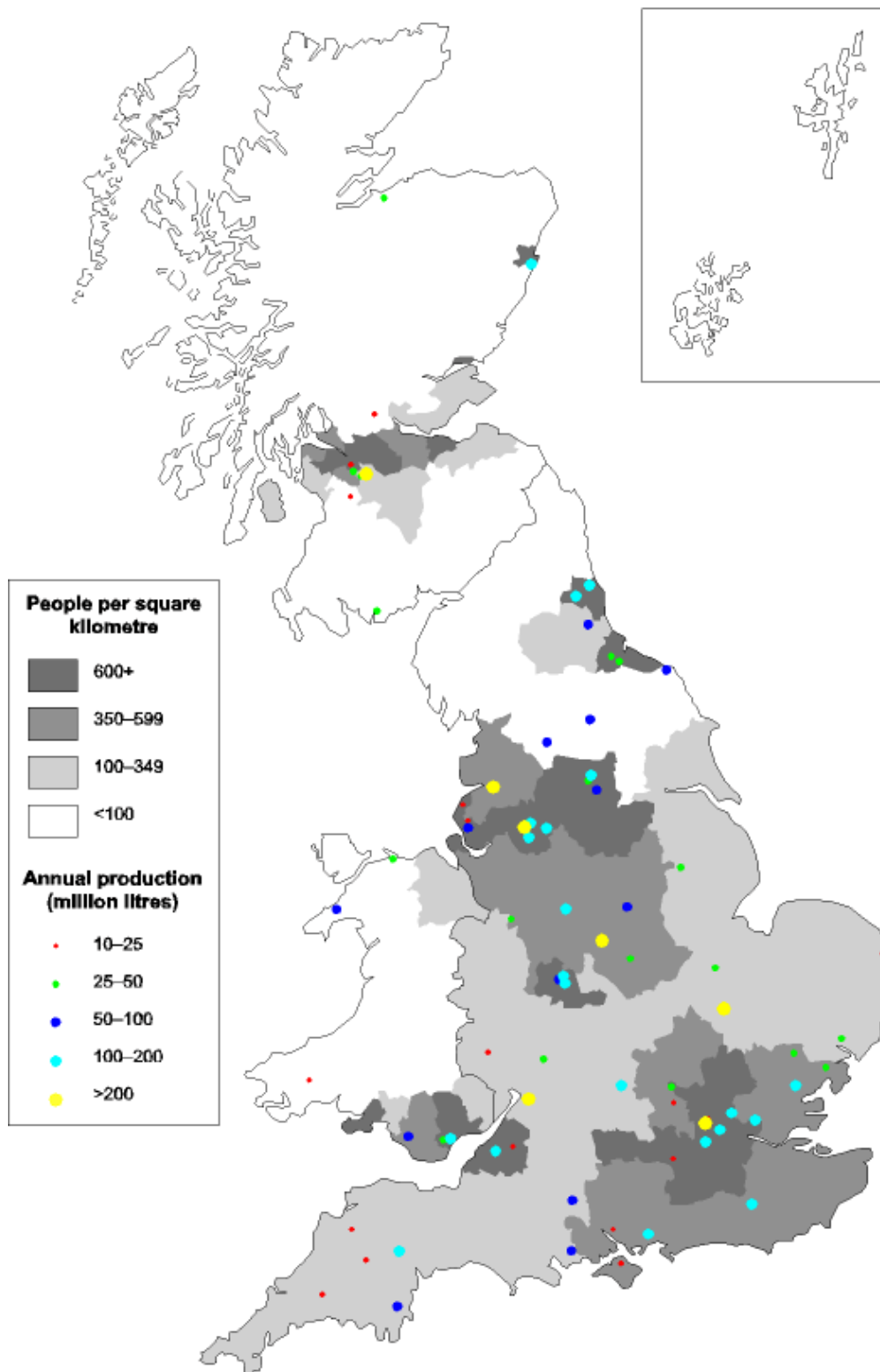
4.12. One of our sources of information on dairy farming, the Manchester Report (see paragraph 3.54) was based on a detailed survey of 377 farms in England and Wales (but not Scotland). In addition, we commissioned a report from ADAS, an agricultural consultancy, on the profitability of the dairy farmers in its client database.

<sup>1</sup>*Regional Trends 32*, 1997 edition, ONS.

<sup>2</sup>*The Dairy Industry in the United Kingdom*, Agri-Food Market Analysis, September 1998.

FIGURE 4.2

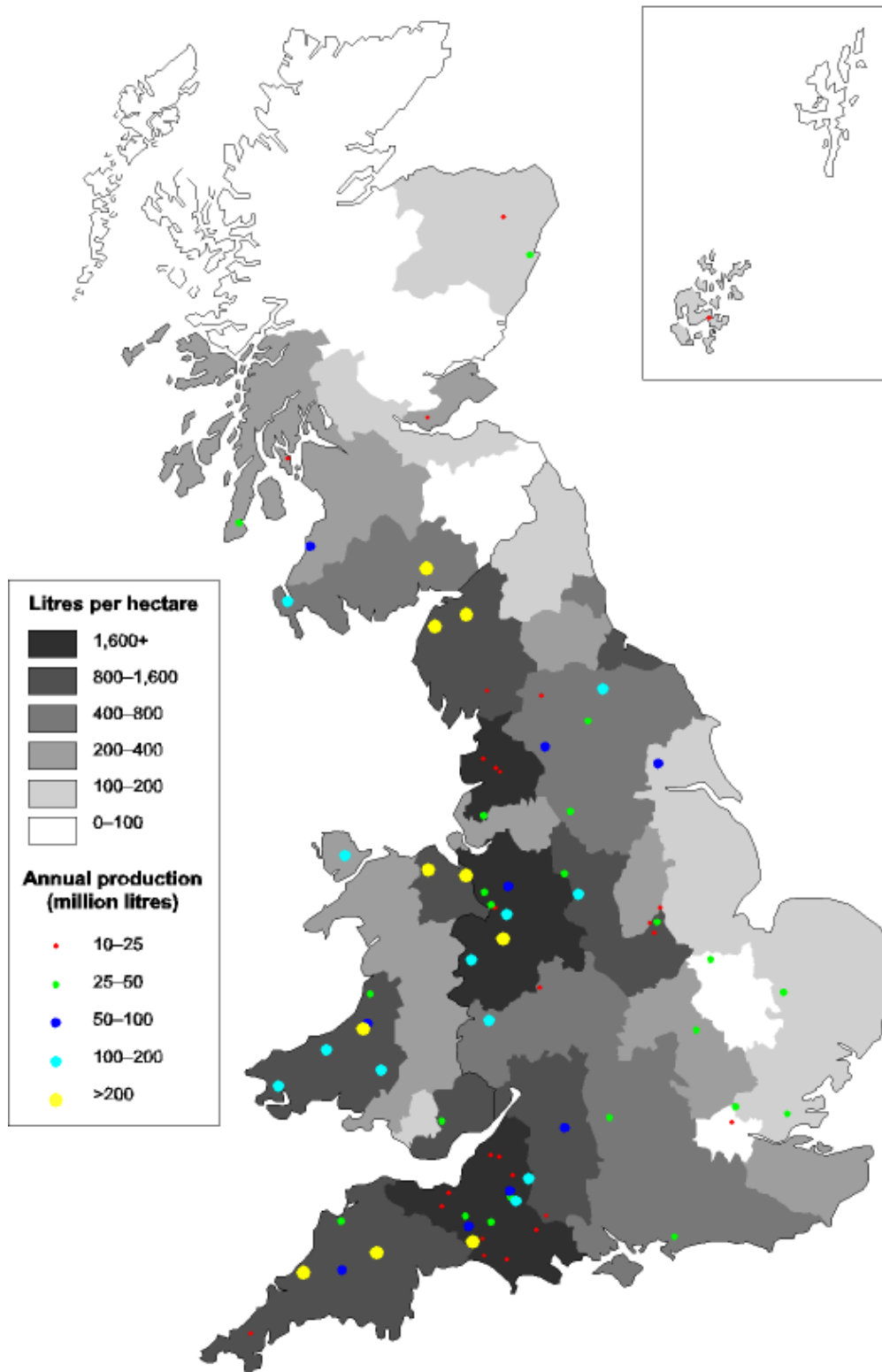
**Distribution of liquid milk dairies and population in Great Britain**



Sources: MMC from ONS and Agri-Food Market Analysis (see paragraph 4.9).

FIGURE 4.3

**Distribution of creameries and milk quota in Great Britain**



Sources: MMC from ONS and Agri-Food Market Analysis (see paragraph 4.9).

## Trends in dairy farming

4.13. In the last 15 years or so, better dairy management, investment and improved genetic stock have led to higher milk yields although total milk production, which has fallen by 8.5 per cent in the period 1984 to 1997, has been governed by milk quota, introduced under the EC CAP in 1984 (see paragraphs 3.48 to 3.57). During this period the trend has been towards fewer, larger dairy herds. The average herd size in England and Wales in 1997 was 75 cows, and in Scotland 95.

4.14. The Manchester Report stated that the value of all milk sold by producers in the UK in 1995/96 was about £3.5 billion, which represented an average for each registered milk producer of about £125,000. In 1996/97 it fell by some 11 per cent to £3.1 billion because of falls in milk prices. (Farm gate prices continued to fall, as shown in Figure 6.4.)

4.15. Dairy farming in Great Britain is fragmented and consists predominantly of sole traders or family businesses. The authors of the Manchester Report found that some 60 per cent of all farm labour in England and Wales was provided by farmers and their families or was otherwise unpaid, and so they made adjustments to their data to compensate for the effect of non-milk activities and to include the value (at agricultural wage rates) of unpaid labour by the farmer, spouse and others.

4.16. The number of producers, reflected in the number of herds, has been falling since at least 1984, as shown in Table 4.3. The decline has been greatest among those with smaller herds, with herds of 100 or more cows increasing in number between 1991 and 1996.

TABLE 4.3 Number of dairy herds and changes in herd size in England and Wales

Herd size	Number of herds			Decline % 1984 to 1996
	1984	1991	1996	
1-9	4,110	2,373	1,715	58
10-29	7,971	5,370	4,064	49
30-39	5,497	3,773	2,898	47
40-49	4,503	3,770	3,039	33
50-69	7,621	6,218	5,146	32
70-99	7,346	6,161	5,563	24
100-199	6,194	5,610	5,700	8
200+	997	829	843	15
Total	44,239	34,104	28,968	35

Source: The Manchester Report.

By 1997 the number of herds had fallen to 27,153.

## Farm profitability

4.17. Precise measurement of milk production costs is rarely possible, partly because they often cannot be separated from the costs of other activities on any one farm. Furthermore, in making comparisons between the most and least profitable operators, there are costs of capital and costs of access to assets such as land and milk quota, which vary considerably and have a significant impact. (These costs are described as 'financial overheads' by ADAS.) In comparing the performance of farms we looked at operating profit per hectare, before these financial overheads.

4.18. Table 4.4, based on data from the Manchester Report, shows milk output, turnover and profitability by herd size for the 27,154 herds with ten or more cows in England and Wales in 1996/97. Out of a total milk volume for these herds of 12,496 million litres, almost one-half came from approximately 6,500 herds, each with 100 or more cows. The table also demonstrates the cost savings associated with increasing herd size, in terms of their effect on operating profit per litre and operating profit per hectare. Larger farms tend also to achieve better milk prices. The table does not

show the contribution from herds with fewer than ten cows, but as the number of such herds is only about 1,700 (see Table 4.3), their output is not material.

TABLE 4.4 Financial performance by herd size in England and Wales, 1996/97\*

	Number of cows				
	10–39	40–69	70–99	100–149	150+
Total number of herds	6,862	8,184	5,567	4,212	2,329
Average cows per herd	29.4	55.0	85.0	118.1	211.4
Average milk produced (litres per cow)	5,241	5,467	5,924	6,162	6,316
Total milk volume (million litres)	1,057	2,461	2,803	3,065	3,110
Milk volume as percentage of total	8.5	19.7	22.4	24.5	24.9
Achieved price (ppl)	24.1	24.8	24.7	25.4	25.4
Average turnover (£'000)	37.2	74.6	124.4	184.8	339.1
Operating profit (ppl)	2.6	6.3	8.6	10.1	11.0
Operating profit/(loss) per hectare (1996/97) (£)	199	549	852	1,147	1,300
Updated to 1997/98	(277)	(310)	(358)	(394)	(415)
Operating profit/(loss) per hectare (1997/98) (£)	(78)	239	494	753	885

Source: MMC from data in the Manchester Report.

\*Excluding herds with fewer than ten cows.

Note: The data in this table were derived by extrapolating sample data and therefore may be subject to sampling errors.

4.19. The 1997/98 figures for operating profit per hectare in Table 4.4 were derived from the 1996/97 figures by applying indices from the Manchester Report to each of the revenue and cost components. The authors of the Manchester Report pointed out that this assumed that farmers continued to produce the same level of milk, made no alterations to their dairy management strategy, and did not adjust the physical quantities of inputs used in response to changes in relative prices. It was therefore an updating exercise rather than a forecast of profitability in 1997/98.

4.20. ADAS provided us with data on a sample of dairy farms, drawn from its client database for 1997/98. ADAS told us that there was virtually no farm which was exclusively milk producing. The EC's definition of a dairy farm is one where milk production comprises at least two-thirds of total farm activity. ADAS thought that this might be too low for the purposes of our inquiry, and we agreed a milk activity level of 80 per cent for the sample farms, as measured by standard gross margin, so that data on dairy farming would not be significantly affected by the results of non-dairy activities. ADAS then used its judgment to eliminate unrepresentative farms, such as those that processed and retailed milk rather than sold it in its raw state, and farms with unusually high profits per hectare caused by other activities.

4.21. We asked ADAS to rank the farms in its sample by net profit per hectare and to present the data in quintiles in ppl. With 80 dairy farms in the sample, Quintile 1 in Table 4.5 contains the 16 farms with lowest net profit per hectare, and Quintile 5 the 16 farms with the highest.

TABLE 4.5 Profitability of 80 dairy farms, year ended 31 March 1998

	Quintile (16 farms per quintile)					ppl
	1	2	3	4	5	
Total output*	25.6	27.5	26.2	28.5	27.2	
Variable costs†	10.1	9.4	8.8	9.3	7.8	
Gross margin	15.5	18.1	17.4	19.2	19.4	
Production overheads:						
Paid labour‡	1.5	1.4	2.0	2.2	1.7	
Power and machinery	5.4	5.6	4.9	4.7	4.5	
Property costs (excluding rent)	1.2	1.8	1.3	1.2	1.3	
Sundries	1.1	1.3	1.2	1.4	1.5	
	9.2	10.1	9.4	9.5	9.0	
Operating profit	6.3	8.0	8.0	9.7	10.4	
Financial overheads:§						
Rent	1.0	1.3	0.5	0.7	0.1	
Finance	3.4	2.5	2.1	1.7	2.2	
Quota leasing	2.0	1.9	1.2	1.3	0.5	
	6.4	5.7	3.8	3.7	2.8	
Net profit/(loss)	(0.1)	2.3	4.2	6.0	7.6	
Other data:						
Farm area (hectares)¶	112	117	107	95	99	
Number of cows	138	127	144	122	135	
Milk yield (litres per cow)	6,138	6,155	6,644	6,802	6,721	
Milk price (ppl)	20.9	21.7	22.1	21.7	21.8	
Operating profit (£ per hectare)	473	543	699	872	942	
Net profit (£ per hectare)	(18)	153	350	518	671	

Source: ADAS.

\*Including that of non-milk activities, divided by the number of litres of milk produced. Output from a milking herd includes calves and cull cows so that herd output will always be slightly higher than that from milk sales alone.

†Includes purchased feed, bedding, seeds, fertilizer and veterinary fees.

‡No allowance is made here for unpaid labour from the farmer or his family and friends, nor for the farmer's own management and administration time.

§As recorded for each farm: there is no imputed rent for owner-occupied farms, nor is there any charge for amortization of purchased quota.

¶Represents the farm size including arable areas. (1 hectare = 2.471 acres.)

4.22. There is little variation in size of farm across the five quintiles, whether measured in hectares or in number of cows. The average herd size for all 80 farms in the ADAS sample is 133 cows which, as Table 4.4 shows, is above the average for England and Wales. This suggests that ADAS's clients are somewhat larger in their scale of operation than the average, possibly because they are likely to be medium to large-scale farmers more able to justify expenditure on consultancy fees.

4.23. Table 4.4 showed the lack of profitability among smaller dairy herds. Table 4.5 shows that even among larger herds, there are some that are barely profitable. A particularly striking feature is that the 16 farms in the lowest 20 per cent of ADAS's sample (Quintile 1 in the table) have the lowest operating profit per litre but have the highest financial overheads. ADAS told us that these businesses had little alternative but to incur these costs. Its experience showed that many businesses in this category had a long-established history of poor profits and of low levels of cover for drawings, tax and investment. They had to finance business and sometimes personal expenditure from bank lending, which they then had difficulty in repaying on account of the lower business performance. Many found it hard to break out of this cycle.

4.24. ADAS noted that the two lower quintiles had lower labour costs than the other farms and, as there was no business reason for different labour requirements, it looked at this in more detail. It found that this lower 40 per cent might be using more family labour but, if so, this was not reflected in higher drawings. It seemed that these businesses were achieving a below-average performance and had some higher costs, such as rent and quota leasing, and they had lower labour costs due to necessity.

4.25. The highest quintile (Quintile 5) pays little for rent or for quota leasing, suggesting that these are freeholders who are longer established and who, when quota was introduced in 1984, received an allocation at no cost. But ADAS said that it would be inaccurate to attribute their relatively strong position to being owner-occupiers in receipt of free quota. Those in the top 20 per cent would have achieved high levels of efficiency, and would have been generating cash for reinvestment in land purchase, new buildings and equipment, and the purchase of milk quota. Others would have been in this upper quintile as a result of capital introductions from external sources.

4.26. We compared the ADAS data for operating profit per hectare with data in the Manchester Report. In Table 4.5 there is an average herd size of 133 cows for the 80 ADAS farms with little variation in herd size between the five quintiles. These farms had an average operating profit per hectare in 1997/98 of £706 (varying from £473 for Quintile 1 to £942 for Quintile 5). In Table 4.4 the operating profit per hectare for farms with herds of 100 to 149 cows (when updated to 1997/98 in the way described in paragraph 4.19) was a little higher at £753. Taking into account the differences in approach and samples in each study, we found them to be broadly comparable.

4.27. Commenting on these differing results, ADAS said that there were key differences between the two data sets. ADAS had examined the distribution of farms with different profitability, while the Manchester data were reported by herd size. ADAS would expect to find considerable variation within each size group, particularly the larger ones.

## Trends in profitability

4.28. ADAS provided us with data on dairy farm profitability for the five years to 1997/98 from the database of its clients. The farms were selected using the same criterion as used for the detailed analysis of the 1997/98 dairy farm profitability, with qualifying farms having at least 80 per cent of the standard gross margin from dairying. ADAS found that farm profitability in terms of operating profit expressed in ppl was moving upwards until 1996/97, after which it fell by 20 per cent, largely as a result of the strengthening of sterling against the ecu with a consequent fall in milk prices. Table 4.6 shows summary data for five years.

TABLE 4.6 Trends in dairy farming profitability

	<i>ppl</i>				
	<i>Years ended 31 March</i>				
	1994	1995	1996	1997	1998
Total output*	24.9	27.8	29.5	31.1	27.0
Variable costs	<u>8.2</u>	<u>9.5</u>	<u>10.1</u>	<u>10.5</u>	<u>9.1</u>
Gross margin	16.8	18.3	19.4	20.6	17.9
Operating overheads	<u>8.8</u>	<u>9.3</u>	<u>9.4</u>	<u>10.0</u>	<u>9.5</u>
Operating profit	7.9	9.0	10.0	10.6	8.5
Financial overheads	<u>2.3</u>	<u>3.5</u>	<u>3.7</u>	<u>3.8</u>	<u>4.5</u>
Net profit	5.6	5.5	6.3	6.8	4.0

Source: ADAS.

---

\*Includes sales of calves and cull cows and revenues from non-dairy activities.

Note: Figures may not sum because of rounding.

4.29. Farm gate milk prices continued to decline after March 1998 (see Figure 6.4) with some increase towards the end of the year. The short-term effect of this decline will have been to reduce the profitability of dairy farmers further, although in the longer term there will have been some scope for reducing costs, particularly rent and quota leasing. (Table 6.6 shows that the price for purchased quota in 1997/98 fell by 31 per cent from 1995/96; the price for one-year leased quota fell by 21 per cent.)

4.30. The Manchester Report related only to England and Wales. The SOAEFD told us that it did not have empirical data covering Scotland but had made some estimates based on a survey of 1996/97 farm accounts. The figures used were net margins, which include an imputed value at agricultural wage rates for the labour of farmers and their families. The SOAEFD estimated that at a milk price of

25 ppl only 55 per cent of farms recorded a positive net margin, at 20 ppl only 15 per cent did so and at a milk price of 15 ppl no farms showed a positive net margin.

4.31. With the continuing fall in milk prices (see Figure 6.4), some of the less profitable producers can be expected to leave the industry. The herds with more than 100 cows illustrated in Table 4.4, and the two or three more profitable quintiles in Table 4.5, would include many of the dairy farmers best able to survive. ADAS emphasized to us that herd size was not the dominant issue in determining farm profitability. While many farmers with smaller herds will find it difficult to survive, there are some with large herds that are vulnerable for a variety of reasons, as the performance of the lowest quintile shows (see paragraphs 4.23 and 4.24). ADAS said that success in dairy farming was determined by optimizing output, principally through obtaining higher milk yields, without increasing unit production costs, and at the same time limiting exposure to rent, finance costs and quota leasing. Herds of any size had broadly the same potential to achieve these requirements for success. The principal disadvantage of smaller herds was their lower absolute profit than larger herds.

4.32. The number of herds has contracted at all size levels during the last two decades (see Table 4.3) and continuation of this trend seems likely, although there is no immediate prospect of production levels falling below the UK's annual quota.

### **On-farm processing**

4.33. A few farmers process their own milk into liquid milk or milk products for sale direct to the public. These farmers hold direct sales quota, while farmers selling their milk to milk groups or processors hold wholesale quota (see paragraph 3.49). In 1997/98 there were only 1,731 holders of direct sales quota in Great Britain. More than three-quarters of them held less than 100,000 litres of quota and, as Table 4.1 shows, the total of all direct sales quota was only 219.9 million litres out of total quota for Great Britain of about 12.7 billion litres.

### **Milk groups**

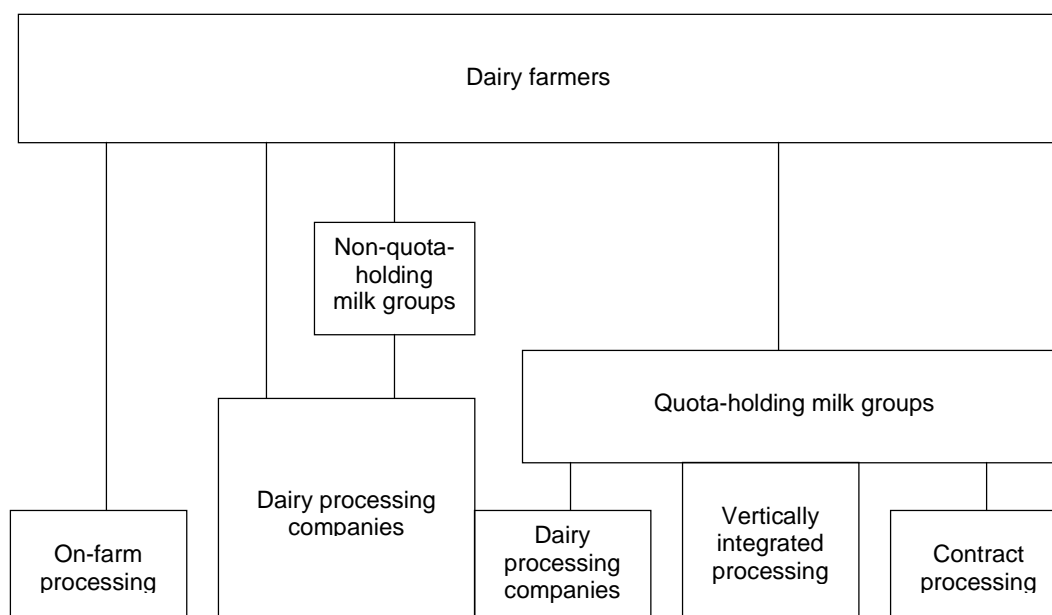
4.34. For dairy farmers, other than those engaged exclusively in on-farm processing, milk has to be collected from the farm and transported to a dairy for processing. Samples of milk must be taken and tested for compositional content and compliance with quality requirements. Before deregulation, these services were provided by the MMBs, each of which paid the same base price to all its producers. Since deregulation several different types of organization have provided these services, and farmers may need to negotiate the sale of their milk to purchasers, either individually or collectively.

4.35. During the summer of 1993 the dairy companies, anticipating deregulation in 1994, were already engaged in seeking to persuade producers to sign contracts for the direct supply of milk after deregulation, while the MMBs promoted the benefits of their designated successor bodies. Most farmers did join the successor bodies, but many formed milk groups to negotiate the sale of their milk to one or more processors. Others negotiated the sale of their milk directly with a processor, often joining a milk group affiliated to that processor.

4.36. Figure 4.4 shows the structure of the milk distribution system that has emerged since deregulation. (Quota-holding groups are described in paragraph 4.39 and non-quota-holding groups in paragraph 4.40.)

FIGURE 4.4

**The milk distribution system**



Source: MMC.

4.37. Milk groups for our purposes include the four successors to the MMBs (although Milk Marque objected to being described as a milk group—see paragraph 8.1). They vary greatly in their size and structure. Some of them are organized as partnerships or limited companies or unincorporated associations, but many are co-operatives. *The UK Milk Report* listed about 45 milk groups that were active in Great Britain during the summer of 1997, and we sent them questionnaires. Some had disbanded or merged with other groups, but we received replies from 25 of them, including all the larger ones listed. Table 4.7 shows the 16 milk groups, which supplied more than 50 million litres of milk in 1997/98.

TABLE 4.7 Principal milk groups in Great Britain at 31 March 1998\*

	Members	Milk pool m litres	'000 litres per member	Quota- holder?	Selling to
Milk Marque	15,475	6,376	412	Y	Various
Scottish Milk	1,502	722	481	Y	Various
EMP	1,066	592	555	N	Express Dairies
United	436	528	1,211	N	Unigate; AWG
The Milk Group	383	305	796	Y	Various
Premier Milk Producers	276	175	634	N	MD Foods
Waterford Farmers Association	245	147	600	N	AWG
Somerset Milk Producers	200	128	640	N	Unigate
Wessex Milk	139	100	719	N	Unigate
North Devon	146	92	630	N	AWG
AMCO	124	91	734	N	Wiseman
A19 Group	141	80	567	N	ACC
Southern Milk Producers	74	72	973	N	Express Dairies; Unigate
Fylde Dairy Association	68	58	853	N	Lancashire Dairies
Ford Milk	103	64	621	N	Dairy Crest
Claymore	84	53	630	Y	Claymore

Source: MMC from milk groups' data.

\*Milk groups with a milk pool of more than 50 million litres.

4.38. The table shows that at the end of March 1998 Milk Marque and Scottish Milk were the two largest milk groups, but the average volume of milk per member was smaller for them than for any of the other large milk groups.

4.39. We identified seven milk groups, which have become registered purchasers with the Intervention Board (see paragraph 3.54), although there may be more. These quota-holding milk groups are Milk Marque, Scottish Milk, The Milk Group, Claymore, Sorn Milk, Peninsula and Torridge Vale. As quota-holding groups, they sell or process milk on behalf of their farmers. They arrange the collection, testing, and transport of their milk, and they run their own systems for invoicing processors, making payments to members for their milk and managing their members' quota. The complexity of operating such systems may have deterred other groups from becoming quota-holders.

4.40. Most milk groups are non-quota-holding milk groups. They do not register as purchasers with the Intervention Board. They tend to be less complex organizations as they do not take ownership of their members' milk, nor do they usually engage in any distribution or administrative activities, which they leave to the processors who buy their members' milk. We found only two non-quota-holding milk groups that supplied more than one processor, United (see paragraphs 4.165 to 4.168) and Southern Milk Producers (see paragraphs 4.169 to 4.172). While most of these groups were established by farmers to negotiate the sale of their milk, some exist as much for the convenience of the processor as for the members, and the processor may contribute to their running costs. Some farmers who have approached a processor to sell their milk have been required to join an associated milk group.

4.41. When processors negotiate contract terms with a non-quota-holding milk group, they usually enter into formal contracts with each of the farmer members rather than with the group itself. When purchasing from a quota-holding group, the contract is usually between the processor and the group.

4.42. Many milk groups, including the four successors to the MMBs, are organized as co-operatives. A co-operative may be registered as a company under the Companies Acts or as a society under the Industrial and Provident Societies Act 1965. There is no legal definition of a co-operative, but for a society to be registered the Chief Registrar of Friendly Societies must be satisfied that it is a bona fide co-operative. The features which distinguish a co-operative are:

- (a) It aims to provide services and inputs and to optimize the returns to members for their produce, rather than to make a return on investment to shareholders.
- (b) A society issues shares to its members, repayment of which is in accordance with its rules.
- (c) The benefits of membership derive from participation rather than investment.
- (d) Interest payable on share and loan capital is not to exceed a rate necessary to obtain and retain the capital required to carry out its objects.
- (e) Voting should normally be equal, or approximately so, for all members and unrelated to the varying amount of investment that each of them provides.

By incorporating the features listed above in its constitution, a co-operative ensures that it is run for the benefit of its members and discourages persons who have no cause to use its services from becoming members and investing in it for financial gain. This limits sources of permanent capital for co-operatives. There is no limit to the number of shares that a society can issue, but there is a statutory limit to the amount that any one member can hold (currently £20,000). In the event of a dissolution of a co-operative, any residue is generally distributed to members not in proportion to shares held but in proportion to use of the co-operative over a number of years.

## Purchasers of raw milk

4.43. Producers who wish to deliver milk or milk products on a wholesale basis must use a purchaser approved by the Intervention Board, with whom they must register their wholesale quota. Purchasers are required to inform the Intervention Board of the amount of quota registered with them. They must notify the Board when producers transfer or lease quota or change purchaser, and send it weekly or monthly declarations of deliveries. The Intervention Board told us that during 1997/98 there were 112 active registered purchasers of raw milk in Great Britain. Some of these purchasers may be different subsidiaries or branches of one company, not necessarily buying milk at the same price or on the same terms as other parts of the same company.

4.44. We asked all quota-holding milk groups and the larger processors for the amounts of wholesale quota registered with them by producers for each of the three years to 1997/98. Table 4.8 shows the shares of these purchasers of raw milk, calculated as a percentage of the total wholesale quota for Great Britain (as shown in Table 4.1). These shares differ slightly from the shares in other tables in this chapter (Tables 4.9 and 4.25), which have been calculated as a percentage of the actual volume of milk delivered. Table 4.8 does not include those processors who, rather than buying directly from producers or through a non-quota-holding milk group, acquire all their milk from other purchasers, nor does it include purchasers with registered quota in 1997/98 of less than 50 million litres.

TABLE 4.8 Registered purchasers' shares of wholesale quota

	<i>per cent</i>		
	<i>1995/96</i>	<i>1996/97</i>	<i>1997/98</i>
Milk Marque	60.2	56.0	52.3
Unigate	5.4	6.7	7.1
Scottish Milk	6.6	6.0	5.8
AWG	4.3	4.7	5.2
Express Dairies	4.8	4.9	4.7
Nestlé	2.8	3.2	3.4
MD Foods	1.4	2.1	2.5
The Milk Group	2.0	2.2	2.4
ACC	2.2	2.3	2.4
Wiseman	0.8	1.3	1.9
Dairy Crest	0.1	0.6	1.4
Midlands Co-op	0.6	0.8	1.1
Bodfari	1.0	1.1	1.1
Lancashire Dairies	0.8	0.9	1.0
Müller	0.5	0.6	0.6
Wessex Dairies	0.2	0.4	0.6
Claymore	0.4	0.4	0.4
Other purchasers	<u>5.9</u>	<u>5.8</u>	<u>6.0</u>
	100.0	100.0	100.0

Source: MMC from company data.

Note: Figures may not sum because of rounding.

4.45. When acting as purchasers of milk from farmers, quota-holding milk groups and processors are competitors. But when these milk groups are selling their milk, the same processors are often their customers. If processors are successful in recruiting more farmers as direct suppliers or as members of affiliated milk groups, they diminish the membership and milk volumes of quota-holding milk groups, since total output is fixed by the quota system. At the same time they become less dependent on these milk groups for part of their supplies of milk. Table 4.8 shows that the two largest milk groups, Milk Marque and Scottish Milk, have lost some market share, in terms of purchasers' quota, mostly to the larger processors, while all but one of the processors, including the smaller ones, have increased their share.

## Successors to the Milk Marketing Boards

4.46. Four of the milk groups in Great Britain (one in England and Wales, three in Scotland) are successors to the MMBs. Table 4.9 shows their shares of milk supplies for the three years to 1997/98.

TABLE 4.9 Shares of milk supplied in Great Britain by MMB successors, three years to 1997/98

	<i>million litres</i>		
	1995/96	1996/97	1997/98
Milk Marque	7,404	6,818	6,246
Scottish Milk	822	735	722
AMCO	98	85	86
Claymore	55	53	53
Other producers and suppliers	<u>4,313</u>	<u>4,907</u>	<u>5,486</u>
	12,692	12,598	12,593
	<i>per cent</i>		
Milk Marque	58.3	54.1	49.6
Scottish Milk	6.5	5.8	5.7
AMCO	0.8	0.7	0.7
Claymore	0.4	0.4	0.4
Other producers and suppliers	<u>34.0</u>	<u>39.0</u>	<u>43.6</u>
	100.0	100.0	100.0

Source: MMC from company data.

The volume of milk supplied by Milk Marque in 1997/98 differs by a small amount from the volume collected from its members, shown in Table 4.9, because of deliveries made outside Great Britain.

4.47. We calculated that in 1997/98 the HHI for the four successors to the MMBs listed in Table 4.9 together with the other large milk groups listed in Table 4.7 was a little over 2,500. It would have been higher in the two previous years when Milk Marque had a larger market share. Milk Marque has attributed its declining market share to the fall in its membership, which it expects will continue (see paragraphs 4.65 and 8.163).

## **Milk Marque**

### ***Structure and sources of finance***

4.48. Milk Marque is a members' voluntary co-operative society which was established on 22 December 1992 under the Industrial and Provident Societies Act 1965. The EWMMB, which intended Milk Marque to be its successor, bore the initial costs of formation, promotion and signing members. Milk Marque told us that these costs accounted for some £1.5 million out of the total cost of about £30 million for the process of deregulation and winding up the EWMMB, and so were paid for by all dairy farmers, including those who did not join Milk Marque. All the assets of the EWMMB belonged to its farmer members but, on 1 November 1994 under the Scheme of Reorganisation described in paragraphs 3.19 to 3.21, certain assets and liabilities, with a net value of £39,617,392, were transferred to Milk Marque. In consideration for the transfer of these net assets, which included cash of £31.4 million, Milk Marque issued Certificates of Entitlement to eligible EWMMB producers in accordance with the formula determined under the Scheme. The Certificates bear interest at 7.5 per cent a year.

4.49. Some of the farmers who sold their milk through the EWMMB did not join Milk Marque, and they were entitled to repayment of their Certificates of Entitlement on 1 April 1997. Those who later resigned from Milk Marque were entitled to repayment 29 months after their official leaving date.

4.50. Table 1 of Appendix 4.1 is a statement of the net operating assets of Milk Marque's milk trading business. The table shows negative net operating assets, because Milk Marque's external creditors are sufficient to finance all the operating assets of its milk trading business. Table 4.10 shows how this business, and Milk Marque's investment in its processing subsidiary, MMD, were financed.

TABLE 4.10 Milk Marque: capital employed, four years to 1997/98

	At 31 March			£'000
	1995	1996	1997	1998
<i>Net operating assets/(liabilities)</i>				
Milk Marque excluding MMD (see Table 1, Appendix 4.1)	(8,846)	(14,410)	(8,565)	(8,959)
Investment in and advances to MMD:	-	-	-	-
Investment in MMD	-	-	-	4,600
Loan to MMD	-	-	-	800
MMD current account	-	-	-	751
Net operating assets/(liabilities)	<u>(8,846)</u>	<u>(14,410)</u>	<u>(8,565)</u>	<u>(2,808)</u>
<i>Financed by</i>				
<i>Members' funds:</i>				
Ordinary shares	113	113	114	114
Class A preference shares	-	-	-	16,608
Preference share issue reserve*	-	-	-	15,000
Retained profit	109	471	524	1,195
Certificates of Entitlement redemption reserve	2,389	8,358	15,109	1,846
Less: Sinking Fund trust account	<u>(1,525)</u>	<u>(7,425)</u>	<u>(13,980)</u>	-
Total members' funds	1,086	1,517	1,767	34,763
Provisions and deferred taxation	1,590	872	-	-
<i>Debt less cash:</i>				
<i>Certificates of Entitlement:</i>				
Due within 1 year	-	-	14,466	4,183
Due within 2 to 5 years	14,196	15,473	3,339	2,041
Due after 5 years	25,421	24,144	21,812	4,056
Class A loan stock	-	-	-	292
Other long-term loans	-	-	4	36
Finance leases	<u>416</u>	<u>135</u>	<u>2</u>	-
Total debt	40,033	39,752	39,623	10,608
Cash balances†	<u>(51,555)</u>	<u>(56,551)</u>	<u>(49,955)</u>	<u>(48,179)</u>
Net debt/(cash)	<u>(11,522)</u>	<u>(16,799)</u>	<u>(10,332)</u>	<u>(37,571)</u>
Capital employed	<u>(8,846)</u>	<u>(14,410)</u>	<u>(8,565)</u>	<u>(2,808)</u>

Source: Milk Marque.

\*Converted into preference shares in October 1998.

†Excluding Sinking Fund trust account.

4.51. Milk Marque received £31.4 million in cash at Vesting Day. In view of the continuing large cash balances shown in Table 4.10, we suggested to Milk Marque that this amount had proved to be far more than was required for its core milk trading business. Milk Marque told us that it required substantial overdraft facilities to ensure satisfaction of its trading obligations to members and other creditors, which could only be supported by a strong asset base. By March 1997 more than £14 million was required to repay Certificates of Entitlement within the coming year. At about this time Milk Marque had decided to invest in its own facilities to enable it to undertake processing of milk on its own account. In May 1997 it wrote to its members, proposing that they should exchange their Certificates of Entitlement for preference shares. Holders of more than 80 per cent accepted this offer. (See paragraph 4.85 for Milk Marque's own assessment of the capital requirements of its milk supply business at December 1997.)

4.52. On 1 October 1997 Milk Marque issued 16,608,000 Class A preference shares of £1 each in exchange for outstanding Certificates of Entitlement with the same nominal value. These preference shares carry a dividend of 2 per cent above the base rate published each 1 October and 1 April. (Milk Marque told us that at 1 October 1998 the base rate was 7.5 per cent.) They are redeemable at the option of the company at five-yearly intervals at face value. On account of the statutory shareholding limits described in paragraph 4.42, members exchanging Certificates with a value in excess of £19,995 were required to accept loan stock for the excess. This loan stock is redeemable in 2027 and bears interest at the same rate as the preference shares. Because of other statutory requirements, only members of Milk Marque may hold preference shares; those who cease to be members have their shares exchanged for loan stock with the same nominal value. Preference shares can be sold to other members and loan stock can be freely transferred. Milk Marque has arranged a sales facility with

Lloyds Bank Registrars, which charges buyer and seller 1 per cent (subject to a minimum charge of £20). The price of preference shares and loan stock at 1 October 1998 was £1.08 per £1 of nominal value.

4.53. Milk Marque told us that this exchange of Certificates of Entitlement for preference shares was carried out in order to strengthen its balance sheet. With more than 80 per cent of the Certificates exchanged, the board was able to consider and eventually approve the capitalization of part of the certificate redemption reserve by means of a further bonus issue of £15 million of Class A preference shares to members. As this was derived from a capital reserve account it was not permitted to pay it in cash. These shares were issued on 1 October 1998 and were attributed to members on the basis of their trading with Milk Marque in the year ended 31 March 1998. They thus represented an addition to the price of their milk in that year and so permitted Milk Marque to deduct the amount concerned for corporation tax purposes. This created a tax loss for 1997/98 that could be carried back to previous periods and used to recover tax due or paid of £6.3 million.

4.54. In May 1998 Milk Marque considered several proposals under which the regular profits distribution or 13<sup>th</sup> month payment (which is the means by which it pays out its final surplus to members once the audited accounts have been approved) could be used by members to invest in its processing subsidiary, MMD. It found that it was not feasible to invite equity subscriptions to either Milk Marque or MMD due to the uncertainty caused at that time by the MMC inquiry. Milk Marque therefore decided to declare the maximum possible distribution from its profits and to pay it in two instalments. The first instalment of £9.9 million, deriving from trading in the year 1997/98, was paid in July 1998 in the usual way. The second instalment, deriving from the tax recovery, was to be paid after the tax was fully repaid by the Inland Revenue. The board noted at the time that, should this payment coincide with an eventual issue of shares by MMD, members could be offered the opportunity to use the amount due to buy any such shares that they then wanted. (Milk Marque's management accounts for the nine months to December 1998 show that a further £5 million was subscribed to MMD as a long-term investment and £2.6 million was advanced as an intercompany loan.)

## ***Management***

4.55. Most of the senior managers of Milk Marque joined from the EWMMB. However, those who became Chief Executive, Operations Director and Finance Director were recruited by the EWMMB with a view to deregulation. Other managers who transferred to Milk Marque included the Secretary, the Director of Sales, the Director of Distribution, the Head of Planning and the Head of Communications. Four of the six non-executive directors of Milk Marque at the time of our inquiry had at one time or another served on the 18-member board of the EWMMB. As a result, those who had taken leading roles in establishing Milk Marque and devising its selling system became responsible for its day-to-day management.

4.56. Milk Marque told us that it was presented to producers as an entirely new organization, commercially orientated and with new contracts for members, customers and haulage contractors. It stated that its main appeal to producers was its professional management and knowledge of the market place to enable it to succeed in the new, unregulated market place. It said that Andrew Dare as Chief Executive, David Yeomans as Operations Director and Christopher Melchers as Finance Director of Milk Marque were all seen as non-MMB people. It added that the term 'Successor to the MMB' tended to be a derisory term used by competitors, implying bureaucracy and slowness to react.

4.57. Until 31 December 1998 the board of Milk Marque consisted of three executive directors (the Managing Director, Finance Director and the Chairman of MMD) and six non-executive directors. As a result of its co-operative status, the board of Milk Marque has a majority of non-executive directors who are elected by the members, one director for each of five geographical areas, and from September 1995 a further independent non-executive director. On 31 December 1998 the Chairman of MMD resigned from the board and in February 1999 had not been replaced.

4.58. Each of the five areas has an Area Council, comprising up to 20 district representatives elected by the members in that district, together with the Area Director and the Area Manager. Milk Marque told us that the role of the district representatives was primarily to be Milk Marque's eyes and ears in the field, helping to sustain existing membership and encouraging new members to join. They formed a vital link in the effective communication of Milk Marque policy to all members and potential members, and in reflecting views back to the Area Council and to the board. The Area Councils had no executive function, but assisted in the communication of policy and in providing a sounding board for policy proposals.

4.59. The executive group, consisting of the Managing Director, Finance Director and six senior managers, is responsible for the day-to-day management of Milk Marque. It meets three times a month and is chaired by the Managing Director and attended by the Chairman of the board.

### ***Facilities and staffing***

4.60. Milk Marque did not take over the EWMMB's offices in Thames Ditton, Surrey, but moved to a smaller headquarters located in a former EWMMB area office in Worcester. It took over two former regional offices in Newcastle under Lyme and Plymouth, and has smaller offices in Crudginton (Shropshire), Reaseheath (Cheshire) and Walton-on-Thames (Surrey). At 31 March 1998 it had 309 full-time and 20 part-time employees, little changed from two years previously. However, by September 1998 staff numbers had fallen to 276 full-time and 21 part-time employees, a reduction of 13 per cent on March 1996.

4.61. At deregulation Milk Marque changed the way in which haulage was undertaken. Under the EWMMB around 45 per cent of haulage was undertaken by its wholly-owned subsidiary, Dairy Crest Transport, but Milk Marque put all its transport operations out to contract. On Vesting Day Milk Marque took over 22 depots, which the EWMMB had owned or on which it held the head lease, and these sites were leased to the contractors undertaking the haulage operations. The remainder of the haulage operation was undertaken from 36 depots provided by the contractors. The number of depots decreased, especially in the last six months of 1998 when seven were closed as Milk Marque sought to reduce its operating costs. At the end of 1998 there were 45 depots, 13 fewer than on Vesting Day. Milk Marque's transport operations are described in paragraphs 5.101 to 5.160.

### ***Membership***

4.62. Milk Marque was required by MAFF to offer membership to all milk producers in England and Wales and still accepts new members from anywhere in England and Wales. It told us that it had also sought members in southern Scotland. As a result of retirements, withdrawals from dairy farming, expulsions and resignations, Milk Marque, with relatively few new members joining, has suffered a net decline in membership. This is shown in Table 4.11.

TABLE 4.11 Membership of Milk Marque, 1 November 1994 to 31 March 1998

	<i>Five months to 31 March</i>	<i>Years ended 31 March</i>		
	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
Numbers at beginning of year	20,940	20,346	19,253	17,404
Joined	9	60	90	103
Resigned	(15)	(527)	(1,029)	(618)
Ceased supply*	(588)	(626)	(910)	(1,414)
Numbers at end of year	20,346	19,253	17,404	15,475

Source: Milk Marque.

\*Includes retirements, expulsions and administrative terminations.

4.63. Milk Marque gave us a detailed account of how the changes in its membership shown in Table 4.11 had affected its supplies of milk:

- (a) During the first trading period from November 1994 to March 1995 15 members resigned from Milk Marque to join other purchasers, 9 new members joined and 588 ceased to supply milk, the vast majority because they retired from dairy farming. The average size of a producer consigning milk to Milk Marque in this period was 960 litres a day. By contrast, those members resigning to join other buyers had an average size of 1,360 litres a day whilst those members retiring from milk production had an average size of 470 litres a day.
- (b) In 1995/96 the number of resignations from Milk Marque was 527 with an average size of 1,630 litres a day as members began to become aware of the premiums on offer from competitors. Sixty new members joined Milk Marque. The average size of supply of retiring members was 550 litres a day compared with the average size of a supplier consigning to Milk Marque, which had increased to 1,030 litres a day.
- (c) In 1996/97 the number of resignations from Milk Marque to join other buyers increased to 1,029, as members became more aware of the increased premiums on offer. The average size of supply of a member leaving to join other buyers was 1,320 litres a day, still above the Milk Marque average, which stood at 1,040 litres a day. This confirmed the tendency for Milk Marque to lose larger members to competing purchasers, to whom these members were often more attractive because of their size.
- (d) By 1 April 1998 Milk Marque's membership had dropped to 15,475. Throughout the entire post-Vesting Day period, Milk Marque has lost members consistently to competing buyers offering higher prices for their milk. As a consequence, the total volume of milk handled by Milk Marque has fallen steadily from 7,475 million litres in 1995/96 to 6,834 million litres in 1996/97 and 6,376 million litres in 1997/98. A further fall in 1998/99 is inevitable, reflecting the membership lost to competitors mentioned above; at the end of 1998 this was estimated to result in supplies of 5,875 million litres in 1998/99.

4.64. Milk Marque provided us with membership details updated to the end of September 1998. In the six months since 31 March it had lost a further 1,141 members, 471 to join other organizations or to supply processors direct, and 670 who had retired or ceased to supply milk. Twenty-six new members joined Milk Marque, so that it had 14,360 members at 30 September. At 30 November 1998 there were 440 members with resignations pending.

4.65. Milk Marque told us that its falling membership was the cause of its declining market share. Table 4.9 shows that its share of milk supplied in Great Britain fell from 58.3 per cent in 1995/96 to 49.6 per cent in 1997/98. In January 1999 it estimated that its volume of deliveries for 1998/99 would be 5,875 million litres, which would give it a share of 46.6 per cent. Taking account of the known number of resignations pending for March 1999 and beyond, it forecast that its share of the market in Great Britain in 1999/2000 would be 41.6 per cent.

4.66. Although most of Milk Marque's membership losses are attributable to resignations and retirements, some members have been expelled for failing to meet Milk Marque's minimum quality standards. They can be readmitted to membership once they have demonstrated to Milk Marque that they are meeting its standards.

### ***Joining and leaving terms***

4.67. Milk Marque requires new members who do not hold Certificates of Entitlement to make a loan to Milk Marque equal to 0.125 ppl of their expected production during the first three years of membership. The new members may pay this sum on joining or have it deducted from the payments made to them for their milk during that three-year period. The loan from the member is treated on the same terms as applied to the original members' Certificates of Entitlement. These terms include interest at 7.5 per cent and a full repayment 29 months after leaving Milk Marque. When fully subscribed, a Member's Loan Note is issued. There is no obligation on the member to buy preference shares or loan stock although, at the end of three years, the member may request the issue of an equivalent sum in preference shares.

4.68. Milk Marque told us that members wishing to sell their milk elsewhere, such as to another milk group or milk processor, could terminate their contracts and leave Milk Marque. Its rules stated that they must give one year's notice of termination to expire on 31 March, 30 September or 31 December in any year. If they gave less than one year's notice, they were required to pay compensation unless the circumstances were totally outside their control, such as incapacity through illness. Compensation was determined as a percentage of the member's milk income during the preceding 12 months depending on the length of notice given, as follows:

<i>Length of notice</i>	<i>Relevant percentage</i>
Less than 6 months	2.0
At least 6 but less than 9 months	1.5
At least 9 but less than 12 months	1.0

Milk Marque told us that these leaving terms had been approved by the competition authorities of the European Commission, as notified in the Press Release issued by Sir Leon Brittan on 6 October 1992 (see paragraph 3.18 and Appendix 3.2).

4.69. Milk Marque stated that, other than ensuring that provision was made for any outstanding debts, for example outstanding quota levy liability, there were no other restrictions or limitations imposed on members who had given valid notice to leave Milk Marque. Members who leave have any preference shares that they hold converted into loan stock, which they can sell (see paragraph 4.52). If they rejoin, they are treated as new members and are required to make a Member's Loan to Milk Marque. If they already hold loan stock, it is not counted against their loan requirements, but Milk Marque told us that they could sell it to finance their loan.

### ***Allocation of costs to members***

4.70. Milk Marque told us that it undertook a detailed study of costs at the end of its first complete financial year (1995/96), which showed that the majority of its overhead costs were incurred on a cost per member basis, rather than by cost per litre. This included most of the costs of its ex-farm collection, sampling and testing, and administration. As a result, a new system of allocating costs to members, validated by Milk Marque's auditors, was implemented in January 1997—after wide consultation with the Area Councils—to give a more cost-reflective basis for charging the costs of running the whole organization to individual members. The new cost allocation, which Milk Marque called a 'standard adjustment', of £13.50 a day was introduced. Because more of the overhead costs would be charged directly to members through this standard adjustment, a simultaneous increase of 0.5 ppl in the standard litre price was made. At the same time an incentive of £5.50 a day was introduced for members on every other day collection (EODC) (see paragraph 5.103). The effect of having a flat rate for both the standard adjustment and EODC bonus was that they had a greater impact in terms of ppl for smaller members. Hence the new system was known as Volume Related Pricing. The standard adjustment is deducted from the monthly payment to the member, and therefore operates in a similar way to the collection charges imposed by some other purchasers.

4.71. According to data from ADAS, this flat rate deduction means that for small producers with volumes of 400 litres a day or less, Milk Marque imposes one of the highest collection charges of any major purchaser. Milk Marque commented that its flat-rate standard adjustment was comparable with charges made by other purchasers, stating that it was aware that one major processor charged £14 a day. At a volume of 400 litres a day, its own charge amounted to about 3.4 ppl but, with the vast majority of its members (over 80 per cent) on EODC, the rate was effectively reduced to 2.0 ppl.

### ***Financial performance***

4.72. The financial performance of Milk Marque for the four years after it commenced trading is summarized in Table 4.12. Milk Marque does not try to maximize its profits but, as a co-operative, tries to maximize payments to its members for their milk. These payments are therefore shown as the bottom line of the profit and loss account.

TABLE 4.12 Financial performance of Milk Marque, 1 November 1994 to 31 March 1998

	<i>£ million</i>			
	<i>5 months to 31 March 1995</i>	<i>Years ended 31 March</i>		
	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
<b>Sales:</b>				
External sales of members' milk	776.1	1,957.3	1,785.1	1,391.4
Sales of members' milk to MMD	-	-	-	3.4
Contribution from contract processing	-	-	-	37.4
	<u>776.1</u>	<u>1,957.3</u>	<u>1,785.1</u>	<u>1,432.2</u>
<b>Less:</b>				
Ex-farm haulage costs	<div style="display: flex; align-items: center; justify-content: center;"> <div style="font-size: 4em; margin-right: 10px;">[</div> <div style="text-align: center;"> <i>Figures omitted. See note on page iv.</i> </div> <div style="font-size: 4em; margin-left: 10px;">]</div> </div>			
Transshipment haulage costs				
Other direct distribution costs				
Distribution income				
Quality control				
Indirect costs				
Interest expense/(income)	0.2	(3.0)	(1.9)	(2.4)
Preference share dividend	-	-	-	0.7
	[	⌘	]	]
<b>Add:</b>				
Increase in contract processing stocks	-	-	-	5.9
<b>Available for members</b>	[	⌘	]	]
Corporation tax	(2.2)	(3.0)	(4.2)	5.8
Retained profits	(2.4)	(6.3)	(6.8)	12.6
Bonus share distribution	-	-	-	(15.0)
<b>Net members' payments</b>	[	⌘	]	]
				<i>million litres</i>
Volume collected	2,980	7,475	6,834	6,376
Volume in contract processing stocks	-	-	-	32
<b>Volume sold</b>	<u>2,980</u>	<u>7,475</u>	<u>6,834</u>	<u>6,344</u>
				<i>ppl</i>
Sales	26.044	26.185	26.121	22.462
<b>Costs:</b>				
Ex-farm haulage costs	<div style="display: flex; align-items: center; justify-content: center;"> <div style="font-size: 4em; margin-right: 10px;">[</div> <div style="text-align: center;"> <i>Figures omitted. See note on page iv.</i> </div> <div style="font-size: 4em; margin-left: 10px;">]</div> </div>			
Transshipment haulage costs				
Indirect costs				
Other costs				
<b>Available for members</b>	24.390	24.660	24.421	20.712
Retentions and tax	(0.154)	(0.125)	(0.161)	0.053
<b>Average payment</b>	<u>24.235</u>	<u>24.535</u>	<u>24.260</u>	<u>20.765</u>

Source: Milk Marque.

Note: Figures may not sum because of rounding.

4.73. The net members' payments represent the surplus arising after all operating expenses, including 12 monthly payments on account to members for milk. This surplus, less any retention required by Milk Marque, is paid out after the end of Milk Marque's financial year in the form of a '13<sup>th</sup> month' payment. As explained in paragraph 4.53, Milk Marque increased its payments to members for 1997/98 by a distribution of preference shares, which led to a refund of corporation tax.

4.74. Although Milk Marque's volume had declined, it was not able to reduce its operating costs in 1997/98 except for some lessening in ex-farm haulage costs, but it took action towards the end of that year to reduce them in 1998/99 by approximately £3 million. It reduced staff numbers in several departments (see paragraph 4.60), renegotiated the service agreement with its provider of information technology and contracts for other professional services, and closed seven depots (see paragraph

4.61). In December 1998 Milk Marque forecast that, as a result of these actions, indirect costs per litre would fall to their 1996/97 level. However, with an increasing proportion of its milk being transshipped with no compensating revenue from customers, its operating costs were forecast to increase to [ 38 ] ppl.

4.75. The sales of Milk Marque for the same period are analysed in Table 4.13. The information is taken from schedules in Milk Marque's management accounts, in which sales from Ex-farm Profile contracts are combined with those of market-led contracts. (Milk Marque's volume-bid selling system and its contract types are described in Chapter 5.)

4.76. Table 4.13 shows that the mix of sales under Milk Marque's various contracts has greatly changed over the period. In 1994/95 market-led contracts, which allow customers to vary their demand, accounted for 62.4 per cent of Milk Marque's sales volume. Supply-led contracts, those where the customer accepts wide fluctuations in deliveries from day to day, accounted for 33.5 per cent of volume. Taking both types of contract together, with specialist milks, the volume-bid selling system covered 97.1 per cent of Milk Marque's sales volume. By 1997/98 market-led contracts accounted for only 15.6 per cent of sales volume. With 67.5 per cent of volume being sold through supply-led contracts, the volume-bid system was used for 83.4 per cent of a diminished total volume. Within this percentage, tailored contracts accounted for 18.2 per cent of volume, more than double their initial level, with most of the growth coming from those derived from supply-led contracts. The fall in the proportion of milk passing through the volume-bid system was entirely offset by growth in short-term market sales from 2.6 to 13.0 per cent of sales volume. Milk Marque told us that this was in response to customer requests. In 1997/98 milk was contract-processed for the first time, as a result of which 3.0 per cent of Milk Marque's milk volume was sold outside its sales system and its short-term markets.

4.77. Table 4.13 shows that prices for milk in short-term market sales were higher than those for market-led contracts in 1995/96, but by 1997/98 these sales achieved prices below those of any of Milk Marque's contracts, except its supply-led tailored contracts. Milk Marque told us that in 1995/96 short-term market prices rose dramatically in response to the drought of the summer of 1995 and buoyant markets for butter and SMP. Short-term market prices averaged 27.0 ppl, which was higher than the average price for market-led contracts. In 1996/97 these short-term market prices fell below the average price not only of the market-led contracts, but also of the lower-priced supply-led contracts. Milk Marque attributed this decline to falling commodity markets and the rising value of the pound. In 1997/98 this trend continued with short-term market prices again falling below the average of supply-led contract types.

4.78. The same table shows that tailored contracts based on market-led contracts enjoyed a premium over standard contracts, varying from almost 0.2 ppl to 0.6 ppl. Until 1996/97 tailored contracts based on supply-led contracts enjoyed a premium of about 1.1 ppl. However, in 1997/98 they sold at a discount of 1.8 ppl. Milk Marque said that there were several reasons for these trends:

- (a) There were different contract types within the supply-led category, and it was likely that in the earlier years the higher-priced types were the ones that were tailored. The average price for tailored supply-led contracts would therefore have been higher than the average price for standard contracts.
- (b) The year to March 1998 included the July 1997 selling process, in which great interest was shown by purchasers of the Residual contracts in tailored (indexed) contracts. The average price for standard contracts would have been lifted by the exclusion of the tailored Residual contracts.
- (c) For each year the difference in realized prices between standard and tailored contracts was sensitive to which contracts were tailored and which were not, and to which tailored options were chosen by customers. The difference over a period of years of 2.9 ppl was simply a function of the preceding point, exaggerated by the change in contract types that had been tailored.

TABLE 4.13 Milk Marque: analysis of sales, four years to 31 March 1998

	Five months to 31 March 1995			1995/96			Years ending 31 March 1996/97			1997/98		
	Revenue £m	Volume m litres	Price ppl	Revenue £m	Volume m litres	Price ppl	Revenue £m	Volume m litres	Price ppl	Revenue £m	Volume m litres	Price ppl
Gross sales:												
Market-led—standard	459.6	1,732.2	26.533	1,003.9	3,767.0	26.650	457.0	1,689.6	27.048	150.2	623.1	24.105
Market-led—tailored	34.0	126.2	26.941	71.3	265.7	26.835	48.9	176.7	27.674	90.9	369.0	24.634
Supply-led—standard	227.1	888.6	25.557	662.3	2,584.9	25.622	976.0	3,791.5	25.742	799.8	3,511.4	22.777
Supply-led—tailored	29.0	108.7	26.679	121.3	453.0	26.777	165.1	615.1	26.841	165.8	793.7	20.890
Specialist milk	9.6	35.2	27.273	18.7	64.0	29.219	17.0	54.9	30.965	5.2	18.4	28.261
Short-term markets	19.3	77.2	25.000	88.8	328.5	27.032	125.3	496.4	25.242	182.7	827.6	22.076
Total gross sales	778.6	2,968.1	26.232	1,966.3	7,463.1	26.347	1,789.3	6,824.2	26.220	1,394.6	6,143.2	22.702
Contribution from contract processing	-	-	-	-	-	-	-	-	-	37.4	193.8	19.298
Sales and haulage costs	(4.1)	2,968.1	(0.138)	(10.7)	7,463.1	(0.143)	(5.3)	6,824.2	(0.078)	(0.1)	6,143.2	(0.002)
Total contract sales	774.5	2,968.1	26.094	1,955.6	7,463.1	26.204	1,784.0	6,824.2	26.142	1,431.9	6,337.0	22.596
Salvage	1.6	8.5	18.824	1.7	10.2	16.667	1.0	7.1	14.085	0.5	5.6	8.929
Adjustments	-	-	-	-	2.1	-	0.2	3.1	-	(0.2)	33.1	-
Total milk sales per management accounts	776.1	2,976.6	26.073	1,957.3	7,475.4	26.183	1,785.2	6,834.4	26.121	1,432.2	6,375.7	22.463
Statutory accounts adjustments:												
Reduction in bad debt provision										0.6		
Additional contract processing costs										(0.2)		
Cost of sales netted off sales	4.1			10.7			5.1			7.4		
Milk Marque turnover	780.2			1,968.0			1,790.3			1,440.0		
MMD transactions:												
Sales to MMD										(3.4)		
MMD external sales										6.4		
Group turnover										1,443.0		
<i>Volumes by contract type (%)</i>												
Market-led—standard			58.2		50.4			24.7			9.8	
Market-led—tailored			4.2		3.5			2.6			5.8	
Supply-led—standard			29.8		34.6			55.5			55.1	
Supply-led—tailored			3.7		6.0			9.0			12.4	
Specialist milk			1.2		0.9			0.8			0.3	
Short-term markets			2.6		4.4			7.3			13.0	
Contract processed			0.0		0.0			0.0			3.0	
Salvage and other			0.3		0.2			0.1			0.6	
			100.0		100.0			100.0			100.0	

Source: Milk Marque.

Note: In this table, market-led contracts include Ex-farm Profile contracts.

4.79. Milk Marque gave us the same information as in Table 4.13 for the nine-month period ended 31 December 1998, which is set out in Table 4.14.

TABLE 4.14 Milk Marque: analysis of sales, nine months to 31 December 1998

	<i>Revenue £m</i>	<i>Volume m litres</i>	<i>Price ppl</i>
Gross sales:			
Market-led—standard	⊞	318.3	⊞
Market-led—tailored		245.3	
Supply-led—standard		2,397.0	
Supply-led—tailored		609.7	
Specialist milk		32.4	
Short-term markets		<u>645.3</u>	
Total gross sales	864.7	4,248.0	20.355
Contribution from contract processing	29.6	159.8	18.523
Sales and haulage costs	<u>(0.4)</u>	<u>-</u>	<u>-</u>
Total contract sales	893.9	4,407.8	20.280
Salvage	0.4	4.0	10.000
Adjustments	<u>(0.3)</u>	<u>(0.7)</u>	
Total milk sales per management accounts	894.0	4,411.1	20.267
Statutory accounts adjustments:			
Cost of sales netted off sales in			
Management accounts	<u>5.6</u>		
Milk Marque turnover	899.6		
MMD transactions:			
Sales to MMD	(9.2)		
MMD external sales	<u>17.9</u>		
Group turnover	908.3		
<i>Volumes by contract type (%)</i>			
Market-led—standard		7.2	
Market-led—tailored		5.6	
Supply-led—standard		54.4	
Supply-led—tailored		13.8	
Specialist milk		0.7	
Short-term markets		14.6	
Contract processed		3.6	
Salvage and other		<u>0.1</u>	
		100.0	

Source: Milk Marque.

Note: In this table, market-led contracts include Ex-farm Profile contracts.

4.80. Table 4.14 shows that supply-led contracts accounted for about two-thirds of Milk Marque's sales volume in the nine-month period. Tailored versions of these contracts were at a premium over the first six months (as few Residual contracts were tailored), but at a discount from October 1998 since all Capacity contracts (see paragraph 5.46) were tailored, giving an overall premium. The December 1998 management accounts show that in that month Milk Marque's short-term market sales were 51.4 million litres at an average price of about 25.1 ppl.

4.81. The information in Tables 4.13 and 4.14 is based on financial years. Table 5.1, where the information is based on contract periods, shows similar trends to those in these tables.

### ***Vertical integration***

4.82. Before deregulation, early proposals for its successor by the EWMMB had included the creation of a single, vertically-integrated co-operative. But this was not acceptable to DGIV or MAFF. The revised proposals of the EWMMB included the flotation of Dairy Crest as a separate entity (see paragraphs 3.16 to 3.18). Milk Marque told us that at deregulation it had no intention of going into processing, although it had drawn up its Articles of Association to allow it to do so if it wished. In a hearing before the House of Commons Agriculture Committee in February 1994<sup>1</sup> the Chief Executive of the EWMMB said:

<sup>1</sup>Milk marketing/House of Commons Agriculture Committee First Report (HC 209, Session 1993-94).

... You could imagine, therefore, there are certain circumstances where it would be in the public interest for some small asset, manufacturing asset, to go to Milk Marque. That is why it is drawn like that. I think any thoughts that Milk Marque could go in on a mass scale back into manufacturing is unrealistic, I think all the necessary regulatory authorities are there to make sure that the public interest is guarded.

Explaining its later change of policy, Milk Marque told us that this answer had been given in the context of a perceived shortage of milk in the UK. In all the selling processes until July 1996 all its milk was bid for, and up to then it had no ambitions to go into processing, and did not do so. It was only after underbidding in successive selling processes, even at the IMPE price levels, that it became clear to Milk Marque that it would have to adjust its strategy. It said that this change of strategy had been signalled in advance to both the OFT and MAFF.

4.83. Milk Marque said that there were other reasons for its decision to enter processing. When reviewing its strategy in June 1997, it found that the demand for milk in domestic markets was generally static, with the liquid milk market in decline. Following the 1994 GATT Agreement, it seemed likely that imports of butter and cheese from Australasia, the USA and other countries would increase, reducing the market opportunities for British manufacturers, and hence the demand for milk. In the longer term it seemed that quotas would be relaxed, in one way or another, so increasing the supply of raw milk. Most dairy trade investment had been in the liquid milk business. In manufacturing there had been some investment in mozzarella cheese and premium yogurt but, in Milk Marque's view, this had been more than offset by creamery closures, most notably: Unigate, St Erth; Dairy Crest, Whitland; and The Cheese Company, Appleby. As a result the remaining plants were operating close to capacity, placing a limit on demand for Milk Marque's milk. Its review concluded that if Milk Marque did nothing, there would at best be long-term downward pressure on price but, more ominously, it could be left with unsold supplies of milk.

4.84. In July 1997 Milk Marque Services Ltd, a dormant subsidiary of Milk Marque, changed its name to Milk Marque Developments Limited. In September 1997 Mr Andrew Dare, who had resigned as Chief Executive of Milk Marque in June 1996, became Chairman of MMD. In an interview with *Farming News* in September 1997, his successor as Chief Executive of Milk Marque stated that by the end of 2000 Milk Marque would be processing 3 million litres of milk a day or 15 per cent of its daily throughput. He saw no reason why, in ten years' time, Milk Marque should not be processing 50 per cent of its throughput either in partnership or, if needs be, alone. Milk Marque told us that this was no longer its policy. Its current plan was to process 1 billion litres of milk in 2000. The revised policy had been adopted because, in addition to the factors identified in its June 1997 strategy review, it had, since July 1996, been consistently underbid for its milk by about 1 billion litres a year.

4.85. In October 1997 Milk Marque agreed to subscribe £4.6 million for shares in MMD to cover the cost of its first acquisition, Aeron Valley, and subsequent additional investment in land and buildings (see paragraphs 4.92 to 4.97). However, MMD needed further funding if it was to meet its aim of processing 1 billion litres a year by late 2000. In December 1997 Milk Marque had about £37 million of permanent capital, of which £10 million was required for the core milk-trading business. If the remaining £27 million were allocated to MMD, it could support a total gross investment of up to £60 million. The balance of £33 million would be provided by a combination of bank loans, plant leasing and dedicated stock financing for maturing cheese. It believed that investment of £60 million should be adequate, depending on the final mix of assets acquired and assuming that they were 100 per cent owned, to process 500 to 600 million litres a year—about 10 per cent of its members' current production.

4.86. In reviewing its strategy in January 1998, Milk Marque stated that one aspect of the law relating to co-operatives was the difficulty of raising additional equity in Milk Marque either through retentions from income (which incurred tax at 46 per cent) or by direct issue of its shares, when the governing principles required that trading, not capital, was the basis of profits distribution (see

paragraph 4.42). Its board therefore examined the possibility that equity capital above the initial £27 million should be sought directly from Milk Marque members by MMD, so as to avoid any dilution of the concept that Milk Marque was a common ownership co-operative.

4.87. Milk Marque told us that, being aware of regulatory sensitivities, it had decided to set up MMD as a separate company with its own management, which could bid for milk on the same terms as any other customer. It said that MMD operated at arm's length whilst continuing to report in summary to the Milk Marque board. Both Milk Marque and MMD said that they had been keen to establish proper mechanisms to protect commercial confidentiality between the two operations, which were located in adjoining buildings, and to that end a 'Chinese wall' existed between the two. This was achieved by MMD having a self-contained suite of offices with its own entrance; separate accounting systems and facilities; and its own board of directors, management group and financial controller.

4.88. In addition to its Chairman (who resigned from the board of Milk Marque in December 1998), the board of MMD comprises two of the non-executive farmer directors of Milk Marque. The MMD board reserves to itself the following functions: the search for processing opportunities; negotiations with outside parties; the appraisal of specific projects; target setting; and monitoring overall performance against target. To finance acquisitions, MMD is required to borrow money from banks, or from Milk Marque at commercial rates, or to issue equity. Its operating subsidiaries are required to fund their own capital requirements by borrowing directly from commercial banks without any guarantees from Milk Marque.

4.89. MMD brings projects to the Milk Marque board for approval. The board of Milk Marque assesses the projects against the strategy of increasing demand in the geographical areas where milk is produced. Although the board of Milk Marque will take account of transport economies—or additional transport costs—when considering a project, these are not taken into account by MMD. Milk Marque said that its board expected all MMD's investment projects to make a return on funds invested commensurate with the risks involved.

4.90. Milk Marque told us that the directors of MMD were bound to keep confidential any information about MMD and its subsidiaries. Furthermore, the MMD board did not discuss details of milk procurement, as they were a matter for its operating subsidiaries.

4.91. Milk Marque told us that, where staff of Milk Marque had acted on behalf of MMD, they had been required to respect the confidentiality of any information received. Until his appointment as Managing Director on 9 April 1998, Milk Marque's Secretary was the Company Secretary of MMD, while providing secretarial services to the parent company's board. Milk Marque's Finance Director had appraised MMD's investment projects from a purely financial perspective so that he could give the board the necessary advice. As part of their group responsibilities, Milk Marque's treasurer, information technology manager and internal auditor provided services to MMD and its subsidiaries and were required to respect any confidential information received.

### *Aeron Valley Holdings Ltd*

4.92. On 9 October 1997 MMD acquired all the issued share capital of Aeron Valley for £4.0 million with acquisition costs of about £200,000. Net assets acquired were about £1.1 million after fair value adjustments, so that goodwill on acquisition was £3.1 million. The sale agreement provided for an earn-out payment of £4.8 million to the previous owners, if profit before tax exceeded £4.4 million in the two years from 1 July 1998. Aeron Valley had been in arrears with its payments to Milk Marque, and in June 1997 Milk Marque had considered taking a charge on its assets.

4.93. Aeron Valley has two wholly-owned subsidiaries, Aeron Valley Cheese Ltd, which manufactures cheese at Felinfach, near Lampeter, and Aeron Valley Farms Ltd, a company engaged in the purchase and resale of milk from farmers directly contracted to it. The consolidated results of Aeron Valley from the management accounts for the six months to 31 March 1998 show sales of £6.4 million, an operating profit of £840,000 and a profit before tax of £235,000. The consolidated balance sheet showed gross assets of £13.5 million, financed by shareholders' funds of £1.7 million, long-term group debt of £0.8 million, and external debt of £11.0 million.

4.94. MMD told us that, like many other cheese businesses, Aeron Valley did not manufacture all the cheese and butter that it sold. The accounts for the six months to 31 March 1998 include purchases of cheese and butter of £3.2 million out of a total cost of sales of £4.8 million, of which about £0.7 million was held in stock at the period end. MMD told us that these were purchases of Cheddar and other cheeses that it used to provide a full range of products to its customers.

4.95. MMD also told us that, as a cheesemaker, Aeron Valley was able to accept large fluctuations in milk supply. It had considerable milk storage, which meant that it could accommodate daily and weekly fluctuations in milk availability. Making a product that matured over a period of up to 15 months, it could also accommodate monthly variations. MMD stated that Aeron Valley had therefore consistently bid for a Residual B contract in recent selling processes. In the July bidding round of the summer 1998 selling process it had bid for and acquired milk on a Varying Supply contract. In addition, Aeron Valley bought milk on Milk Marque's short-term markets and from other processors.

4.96. The due diligence report prepared by MMD's accountants stated that Aeron Valley would provide an outlet for some of the excess milk in mid-Wales, which was estimated at 700,000 litres a day. Proposed capital expenditure to increase production levels, and to install modern equipment, would increase Aeron Valley's milk requirements and would greatly reduce Milk Marque's transport costs. A paper prepared by MMD in mid-1997, when it was contemplating a joint venture rather than an acquisition, had estimated that at full capacity after investment there would be annual savings of £2.3 million to £3.7 million to Milk Marque on secondary haulage. The same paper set out plans for the first phase of the expansion of the factory's capacity by installing block formers (completed in 1998 at a cost of £0.5 million), and for building an additional cheese store, for which planning permission has been sought. MMD said that the latter project had, in principle, been awarded a 30 per cent processing and marketing grant from the Welsh Office. The capacity of Aeron Valley has been increased from 250,000 to 346,000 litres a day. The cheese store project will not increase capacity.

4.97. Aeron Valley was profitable for the six months to March 1998 (see paragraph 4.93), but from January 1998 onwards there was a severe downturn in market conditions. Furthermore, some longstanding customers, themselves major cheesemakers, were lost and cheese had to be sold early from stock as mild Cheddar to maintain cash flow. [

*Details omitted. See note on page iv.*

]

#### *North Bradon Farms Ltd*

4.98. In November 1997 the board of Milk Marque gave its approval to negotiating heads of agreement for the purchase of North Bradon from its main shareholders, Murray Vernon Holdings Ltd (Murray Vernon), which held 80 per cent of the issued shares, and the Chairman of North Bradon and his family who together held the remaining 20 per cent. Murray Vernon is a dairy trading company which, MMD told us, occasionally purchases modest quantities of cheese from North Bradon. [

*Details omitted. See note on page iv.*

]

4.99. North Bradon is a producer of mature and farmhouse Cheddar cheese, operating from a single site near Taunton, Somerset. In December 1997 a fire destroyed the dairy and the acquisition was delayed until October 1998.

4.100. In their due diligence report MMD's accountants considered the acquisition only from the point of view of MMD, as had MMD itself in its own financial evaluation, and they took no account of a projected saving of £300,000 in Milk Marque's annual transport costs.

4.101. The report stated that North Bradon's own cheese accounted for about one-half of turnover, with the other one-half coming from traded cheese (in earlier years the proportion of traded cheese had been higher still). Of the 38.6 million litres of milk utilized in production by North Bradon in 1996/97, 63 per cent had been purchased from Milk Marque.

4.102. The final acquisition cost of North Bradon was £[ ] million, consisting of £[ ] million net assets and £[ ] million of goodwill, subject to the agreement of completion accounts. Bank borrowings of £[ ] million guaranteed by Murray Vernon were rolled over into a new facility guaranteed by MMD. MMD compared the acquisition of North Bradon with that of Aeron Valley, as shown in Table 4.15.

TABLE 4.15 Comparison of North Bradon and Aeron Valley acquisitions

	<i>£ million</i>	
	<i>North Bradon</i>	<i>Aeron Valley</i>
Performance in 1996/97:		
Cheese production (tonnes)	3,904	3,967
Estimated capacity (tonnes)	4,500	8,000
Turnover	16.7	17.4
Adjusted operating profit	1.2	0.6
Cash consideration*	( )	4.0
Borrowings assumed		8.7
Debt-free price		12.7
Goodwill	⊗	3.1
Ratio of debt-free price to historical PBIT†		21.2
Ratio of cash consideration to historical PBIT		6.7

Source: MMD.

\*The possible earn-out payment of £4.8 million for Aeron Valley has been excluded from cash consideration. It has also been excluded in calculating goodwill and the ratios of debt-free price and cash consideration to historical PBIT.

†PBIT is adjusted operating profit before interest and tax.

The reporting accountants pointed out that the North Bradon acquisition was substantially cheaper, in terms of both the value of goodwill and the PBIT multiple, than that of Aeron Valley. The lower PBIT multiple reflected the fact that North Bradon was operating much closer to its capacity than was Aeron Valley and was currently more profitable, but had less scope to increase production quickly. In contrast, the Aeron Valley acquisition had given MMD the opportunity to achieve a step change in production without significant capital expenditure.

### *Proposed factory at Cullompton*

4.103. In April 1998 the Chairman of MMD reported to the board of Milk Marque that MMD planned to handle 200 million litres of milk a year at Aeron Valley and North Bradon. A further 80 million litres would be absorbed by other small projects. The current objective was to process 1 billion litres a year by 2001/02, and the balance of 720 million litres was to be processed at a new butter and milk powder factory in Cullompton, Devon, where MMD had an option until January 1999 on a 15-acre site.

4.104. MMD had identified several areas of England and Wales with what it described as ‘surplus milk’:

*'000 litres a day*

South and West Wales	900
Devon and Somerset	900
Cornwall	500
Cheshire	230
Lancashire	230

While the surplus milk arising in Devon and parts of Cornwall and Somerset was well located for processing at the Cullompton site, the rest was produced in distant areas, and it would be expensive to transport it there. To enable it to be handled near to where it was produced, MMD considered the feasibility of building separation and concentration facilities at one or more of three possible sites in the North-West, Cornwall and Wales. The cream and skim concentrate would be sold or sent to Cullompton for churning and drying respectively. The additional processing costs would be more than offset by savings in transport costs. But the processing costs would be met by MMD, while the savings on transport would arise in Milk Marque. MMD therefore proposed that it should build and operate the factory on whole milk. It would construct any of the possible satellite concentration facilities, and operate them on a contract-processing basis for Milk Marque. Milk Marque could then evaluate the cost of contract processing against the savings in its transport costs. MMD told us that this proposal had not been progressed.

4.105. In a detailed appraisal, MMD stated that the projected capital cost of the Cullompton factory was about £46 million. Operating costs per litre would depend on the cost of capital and on capacity utilization. With a 6 per cent return, processing costs would be 3.0 ppl at 70 per cent utilization and 2.7 ppl at 90 per cent utilization. With a 12 per cent return, processing costs would be 3.5 ppl at 70 per cent utilization and 3.0 ppl at 90 per cent utilization. MMD found that these costs were high compared with those quoted by Coberco, the largest co-operative in the Netherlands. According to the Netherlands dairy statistics office, the Dutch average was around 2.6 ppl. The reasons for the differences, set out in its appraisal, were:

- (a) A lower cost of capital in the Netherlands. (Milk Marque told us that interest rates were lower than in the UK; also Dutch co-operatives accepted a lower rate of return than UK public companies because they did not have City investors to satisfy and valued the security they could offer their members.)
- (b) The fixed capital cost of a new factory represented some 1.6 ppl in terms of interest and depreciation. MMD’s policy was to depreciate plant over ten years even though dryers and evaporators operated over a much longer period. Consequently, MMD’s depreciation costs could well drop significantly after ten years, bringing its unit costs into line with the Dutch. (Coberco’s fixed cost was quoted at [  $\approx$  ] ppl and was based on an older plant.)
- (c) Having consolidated its capacity into just a few plants serving the whole of the Netherlands, their utilization was much better than 70 per cent, which again reduced final costs per litre. (MMD told us that it could not confirm this nationally, but that it was the case at Coberco’s factory in Lochem.)

4.106. MMD pointed to the volatility of butter and milk powder prices; preliminary discussions had been held with Milk Marque Sales, but these needed to be firmed up into a specific offer of a Forward Long Term Contract. (The board of Milk Marque stated that MMD would have to acquire milk from Milk Marque on the same terms as any other processor.) MMD said that it was not considered prudent to commit fully to the project until the outcome of the MMC inquiry was known. MMD recommended that work should be undertaken to obtain planning consent. Since it would be in

the public domain, MMD made a public announcement on 23 September 1998, when it submitted its planning application.

### ***Contract processing***

4.107. Milk Marque told us that it began to offer milk for contract processing after its January 1997 selling process and after two advance sales of short-term milk failed to clear the market. The four major processing companies with butter and SMP capacity in Great Britain capable of manufacturing products to intervention standards did not take up the offer to contract process milk on Milk Marque's behalf. However, Coberco (see paragraph 4.105) tendered at a processing fee of [  $\infty$  ] ppl, and Milk Marque accepted this tender. The first processing took place in July 1997. In August 1997 manufacturers were again invited to bid for contract processing into intervention products, but again the four major companies did not tender. Five smaller companies in Great Britain offered to manufacture non-intervention products, and their offers were taken up. In addition, tenders from manufacturers in Northern Ireland and the Republic of Ireland were accepted.

4.108. Table 4.16 sets out the volumes of milk that Milk Marque had contract processed from July 1997 to March 1998. Milk Marque told us that it aimed to achieve a contribution from contract processing higher than if it had sold the milk at the IMPE, and the surpluses and deficits in the table had been calculated against this target. The cost of milk in the table is shown at the 'estimated gross milk price equivalent' (EMPE). Milk Marque told us that it calculated the EMPE by taking the returns for the products manufactured and sold in the market place and converting them into a ppl equivalent price using yield factors relating to each processing contract.

4.109. Milk Marque told us that the amount of £425,684 (equivalent to 0.187 ppl) shown at the foot of the table represented the surplus over the revenue that would have been achieved if milk had been sold at the IMPE.

4.110. As shown by Table 4.16, the results from contract processing until the end of March 1998 were uneven. Deficits on a few contracts in relation to the IMPE were more than offset by surpluses on the majority. There was a large deficit on the first contract with Coberco in July to September 1997. Coberco offered a low price for processing, which Milk Marque cited to us as evidence that British processors were relatively inefficient. Even with the low processing charges, once transport costs were taken into account, Milk Marque achieved a contribution £519,420 lower than if it had sold the milk at the IMPE. On the other hand, the arrangements with processors in Northern Ireland and the Republic of Ireland gave a contribution above the IMPE.

4.111. From Table 4.16 we calculated that the weighted average of the IMPE for the 227.6 million litres processed was 19.076 ppl while that for the 193.8 million litres sold was 19.088 ppl. (The difference between these two volumes was unsold stocks of processed products at 31 March.) Table 4.13 shows that the contribution from contract processing for 1997/98 was 19.298 ppl, about 1.1 per cent above our calculation of the weighted average IMPE.

4.112. In the six months to September 1998 Milk Marque reduced its contract processing to less than one-half of the volumes contract processed in the six months to March 1998. The results are set out in Table 4.17.

TABLE 4.16 Results of Milk Marque's contract processing, year ended 31 March 1998

Contractor	1997/98 month	Volume m litre	EMPE ppl	Transport costs* ppl	Other Milk Marque costs† ppl	Net selling price ppl	IMPE ppl	Surplus/ (deficit) ppl	Surplus/ (deficit) £
IRL1	7	3.1	22.69	1.21	0.654	20.826	19.01	1.816	56,296
	8	5.1	22.69	1.21	0.654	20.826	19.01	1.816	92,616
	9	2.4	22.69	1.21	0.654	20.826	19.01	1.816	43,584
	10	3.8	21.70	1.21	0.654	19.836	19.01	0.826	31,388
	11	3.6	21.70	1.21	0.654	19.836	19.01	0.826	29,736
	12	<u>1.9</u>	21.70	1.21	0.654	19.836	19.01	0.826	<u>15,694</u>
		<u>19.9</u>							<u>269,314</u>
GB1	12	<u>6.2</u>	22.69	1.10	2.970	18.620	19.01	(0.390)	<u>(24,180)</u>
GB2	7	3.1	23.26		3.250	20.010	19.01	1.000	31,000
	8	3.0	23.26		3.250	20.010	19.01	1.000	30,000
	9	2.0	23.26		3.250	20.010	19.01	1.000	20,000
	10	0.1	22.14		3.230	18.910	19.01	(0.100)	(100)
	11	2.2	22.10		3.230	18.870	19.01	(0.140)	(3,080)
	12	<u>4.5</u>	21.97		3.230	18.740	19.01	(0.270)	<u>(12,150)</u>
		<u>14.9</u>							<u>65,670</u>
NL1	4	11.1	24.32	3.78	2.530	18.010	19.80	(1.790)	(198,690)
	5	12.3	24.32	3.78	2.530	18.010	19.52	(1.510)	(185,730)
	6	<u>13.5</u>	24.32	3.78	2.530	18.010	19.01	(1.000)	<u>(135,000)</u>
		<u>36.9</u>							<u>(519,420)</u>
GB3	7	4.1	22.05		2.580	19.470	19.01	0.460	18,860
	8	4.0	22.05		2.580	19.470	19.01	0.460	18,400
	9	2.1	22.05		2.580	19.470	19.01	0.460	9,660
	10	4.1	21.19		2.570	18.620	19.01	(0.390)	(15,990)
	11	3.7	20.51		2.560	17.950	19.01	(1.060)	(39,220)
	12	<u>7.5</u>	19.47		2.540	16.930	19.01	(2.080)	<u>(156,000)</u>
		<u>25.5</u>							<u>(164,290)</u>
IRL2	12	<u>7.8</u>	22.40	2.00	2.000	18.400	19.01	(0.610)	<u>(47,580)</u>
IRL3	7	6.5	24.93	1.21	3.370	20.350	19.01	1.340	87,100
	8	0.5	24.93	1.21	3.370	20.350	19.01	1.340	6,700
	9	<u>5.2</u>	24.93	1.21	3.370	20.350	19.01	1.340	<u>69,680</u>
		<u>12.2</u>							<u>163,480</u>
GB4	7	3.1	21.75		1.880	19.870	19.01	0.860	26,660
	8	3.0	21.75		1.880	19.870	19.01	0.860	25,800
	9	2.1	21.75		1.880	19.870	19.01	0.860	18,060
	10	1.7	20.42		1.850	18.570	19.01	(0.440)	(7,480)
	11	2.8	19.60		1.840	17.760	19.01	(1.250)	(35,000)
	12	<u>1.7</u>	18.60		1.830	16.770	19.01	(2.240)	<u>(38,080)</u>
		<u>14.4</u>							<u>(10,040)</u>
IRL4	7	8.8	24.40	1.60	1.500	21.300	19.01	2.290	201,520
	8	9.9	24.40	1.60	1.500	21.300	19.01	2.290	226,710
	9	8.1	24.40	1.60	1.500	21.300	19.01	2.290	185,490
	10	6.2	22.83	1.60	1.440	19.790	19.01	0.780	48,360
	11	8.4	23.37	1.60	2.130	19.640	19.01	0.630	52,920
	12	<u>12.4</u>	22.66	1.60	1.920	19.140	19.01	0.130	<u>16,120</u>
		<u>53.8</u>							<u>731,120</u>
GB5	7	9.3	21.65		2.420	19.230	19.01	0.220	20,460
	8	7.2	21.65		2.420	19.230	19.01	0.220	15,840
	9	8.9	21.65		2.420	19.230	19.01	0.220	19,580
	10	3.5	21.02		1.820	19.200	19.01	0.190	6,650
	11	2.8	19.97		1.800	18.170	19.01	(0.840)	(23,520)
	12	<u>4.3</u>	18.99		1.780	17.210	19.01	(1.800)	<u>(77,400)</u>
		<u>36.0</u>							<u>(38,390)</u>
Total		227.6							425,684
Processed in:									
Great Britain		97.0							(171,230)
Ireland‡		93.7							1,116,334
Netherlands		<u>36.9</u>							<u>(519,420)</u>
		227.6							425,684

Source: Milk Marque.

\*Cost shown is cost of transporting milk beyond Milk Marque's delivered pricing area.

†Mostly processing costs.

‡Northern Ireland and Republic of Ireland.

TABLE 4.17 Results of Milk Marque's contract processing, six months to 30 September 1998

Contractor	1998/99 month	Volume m litres	EMPE ppl	Transport costs* ppl	Other Milk Marque costs† ppl	Net selling price ppl	IMPE ppl	Surplus/ (deficit) ppl	Surplus/ (deficit) £
GB6	1	5.1	22.94	1.10	2.94	18.90	19.01	(0.11)	(5,100)
	2	3.5	22.62	1.10	2.93	18.59	18.48	0.11	3,850
	3	5.8	22.62	1.10	2.93	18.59	18.44	0.15	8,700
	4	5.9	23.32	0.95	2.94	19.43	18.44	0.99	58,410
	5	5.9	23.32	0.95	2.94	19.43	18.44	0.99	58,410
	6	<u>2.7</u>	22.68	0.95	2.80	18.93	18.44	0.49	<u>13,230</u>
		<u>28.9</u>							<u>137,500</u>
IRL5	1	5.9	23.26	1.55	1.85	19.86	19.01	0.85	50,150
	4	3.8	22.71	1.55	1.86	19.30	18.44	0.86	32,680
	5	7.7	22.71	1.55	1.82	19.34	18.44	0.90	69,300
	6	<u>8.9</u>	22.71	1.55	1.47	19.69	18.44	1.25	<u>111,250</u>
		<u>26.3</u>							<u>263,380</u>
Total		55.2							400,880

Source: Milk Marque.

\*Cost shown is cost of transporting milk beyond Milk Marque's delivered pricing area.

†Mostly processing costs.

After Milk Marque's summer 1998 selling process, contract processing was further expanded, reaching a maximum of about 5 per cent of the milk offered in the selling process. In October 1998, the first month of the new contract period, the volume of milk sent for contract processing was 42.4 million litres, almost as high as in March; in November it was 42.3 million litres; and in December 31.4 million litres.

4.113. Milk Marque reported in its management accounts for the nine months to December 1998 that products from almost 160 million litres of contract-processed milk had been sold during this period for £35.0 million (see Table 4.14). After deducting the manufacturing service fees paid to contractors of £3.2 million and the costs of transporting milk from the borders of England and Wales to processors in Scotland and Ireland of £2.2 million, the contribution from contract processing was £29.6 million, or 18.534 ppl. The IMPE equivalent was 18.72 ppl. Milk Marque told us that the information contained in its management accounts could not be used as a basis on which to draw conclusions about the outcome of its contract processing. When realizations were taken fully into account (as was done in Table 4.17) Milk Marque had shown a substantial surplus over the IMPE.

4.114. The sale of products arising from Milk Marque's contract processing is managed by MMD. MMD holds discussions with various agents, and obtains quotations from them. Subsequently, it maintains close contact with them to decide on selling policy and tactics, and to maximize the revenue from the products. [ *Details omitted. See note*

*on*

*page iv.*

] MMD told us that discussions between Milk Marque and [ *⊗* ] to form a new company for selling the products from its contract processing had taken place, but had so far come to nothing. Milk Marque pays MMD and the agents a commission of [ *⊗* ] per cent for selling the products from its contract processing. MMD told us that neither Aeron Valley nor North Bradon had undertaken contract processing for Milk Marque.

## Scottish Milk

### *Origins of Scottish Milk*

4.115. The Scheme of Reorganisation, put forward by the SMMB and approved by the Secretary of State for Scotland, was broadly similar to that for England and Wales. The SMMB had originally

proposed that it should be succeeded by a single co-operative, which would retain ownership of the processing operations, but this was not acceptable to the Government for competition policy reasons (see paragraph 3.28). Under the approved Scheme of Reorganisation the milk purchasing and selling operation was transferred to an independent milk marketing co-operative, Scottish Milk. The processing assets, which had been held within three subsidiaries of the SMMB, were acquired on 1 November 1994 by a newly-formed company, Scottish Pride Holdings plc, which reorganized them into a single business under a subsidiary operating company, Scottish Pride Ltd (Scottish Pride), in March 1995.

4.116. The overriding principle of the Scheme of Reorganisation was that all those farmers who had been members of the SMMB at any time in the previous seven years were to receive a stake in its assets, including the processing operations carried on by Scottish Pride. This stake was to be proportionate to the volume of milk each farmer had supplied to the SMMB during that seven-year period, and shares in Scottish Pride Holdings plc were issued to the relevant members and former members accordingly. To ensure that these shares represented the value of all assets owned by the SMMB and not just the value of the processing businesses within Scottish Pride, an independent valuation of the assets of the SMMB was carried out. The value of the assets transferred to Scottish Milk was reflected in a debt owed to the SMMB residuary body. The residuary body was obliged to pass payments received from Scottish Milk to Scottish Pride Holdings plc, after settling any liabilities. These arrangements ensured that the Scottish Pride Holdings plc shares represented the value of all parts of the old SMMB business. Following approval of these proposals, Scottish Milk became operational on 1 November 1994.

4.117. All existing SMMB members were automatically eligible for membership of Scottish Milk, which also extended offers of membership to producers in Cumbria and in the area of the ADMMB. Scottish Milk told us that the abolition of the MMBs had destroyed the geographical demarcations of its predecessor to the extent that, in the year to 31 March 1998, Scottish Milk sold about one-third of all its milk for delivery outside Scotland. It had members from Brechin in the North of Scotland to Ulverston in Cumbria, and its regular customers were located as far north as Nairn and as far south as Oxford.

4.118. Producers who wished to join Scottish Milk, whether or not they were current members of the SMMB, were required to complete an application form and to pay £10 for a single share. As producers were offered a free choice as to whether or not to join Scottish Milk, there was no question of penalties if they chose not to join. The allocation of shares in Scottish Pride Holdings plc was not affected by the producers' choice of selling arrangement. On 1 November 1994, the business of Scottish Milk comprised three main activities:

- (a) milk collection and delivery;
- (b) the sale of members' milk; and
- (c) milk sampling and quality management.

4.119. Although Scottish Milk operated successfully after deregulation, Scottish Pride experienced falling sales and in 1995/96 made an operating loss of £3 million on turnover of £138 million. An approach from Wiseman (see paragraph 4.248) led to an inquiry by the MMC, which reported to the Secretary of State on 29 November 1996 (see paragraph 4.251). In February 1997 Scottish Pride went into receivership.

4.120. Scottish Milk had to provide for a large loss when Scottish Pride went into receivership by reducing the price paid to members for their milk in January and February 1997, being the months affected by non-payment of milk sold to Scottish Pride. Recognizing that this might place a strain on members' cash flow, Scottish Milk advanced to them an equivalent sum of money on condition that all or part of that advance would have to be repaid once the outcome of the receivership was known.

## ***Membership of Scottish Milk***

4.121. On becoming a member of Scottish Milk, each member purchases one membership certificate, which represents a share in the co-operative. The certificate has a nominal value of £10 and is not capable of being withdrawn or transferred except on termination of membership when the membership certificate is cancelled and any sum paid up is retained by the co-operative.

4.122. On 1 November 1994 Scottish Milk had 1,898 members compared with the 2,098 producers who were registered with the SMMB on 31 October 1994. One hundred and sixty-seven of these initial members were producers who had previously supplied their milk to other MMBs. Three hundred and sixty-seven producers who were registered with the SMMB, 17.5 per cent of the total, did not join Scottish Milk.

4.123. The membership of Scottish Milk on 31 March 1998 was 1,502. The changes each year since deregulation are shown in Table 4.18. The table shows that Scottish Milk's membership fell by almost 21 per cent from Vesting Day to 31 March 1998.

TABLE 4.18 **Membership of Scottish Milk, 1 November 1994 to 31 March 1998**

	<i>Five months to 31 March 1995</i>	<i>Years ended 31 March</i>		
		1996	1997	1998
Numbers at beginning of year	1,898	1,871	1,703	1,543
Joined	2	14	5	38
Resigned	0	(107)	(88)	(6)
Ceased production	<u>(29)</u>	<u>(75)</u>	<u>(77)</u>	<u>(73)</u>
Numbers at end of year	1,871	1,703	1,543	1,502

Source: Scottish Milk.

4.124. Scottish Milk told us that a member might resign from the co-operative in one of two alternative ways. Members may either give 12 months' notice or, on payment of a fee, three months' notice. The fee, which amounts to 2 per cent of the total value paid by the co-operative for the member's milk in the preceding 12 months, is intended to compensate Scottish Milk for the disruption to business caused by the short notice. Scottish Milk said that its supply contracts were generally for periods of 12 months or more and any substantial number of resignations would cause major difficulties for it in procuring milk from elsewhere to fulfil such contracts. Resigning members must repay any loans or other sums due to the co-operative.

4.125. Scottish Milk told us that payment to its members for their milk was normally made by 12 monthly payments on account and any surplus was distributed after the end of the milk year by a 13<sup>th</sup> payment. At the July 1996 General Meeting the rules of Scottish Milk were amended to give the directors the right, when considering to which members the 13<sup>th</sup> payment in any year should be made, to take account of whether a particular member had either resigned or intimated resignation. Scottish Milk stated that, to date, this discretion had been exercised on one occasion, for the year ended 31 March 1997. The payment to which this decision applied was 0.05 ppl amounting to a payment of approximately £200 for the average member. (However, the same decision was later applied to the corresponding payment for 1997/98, which was at the much higher rate of 0.45 ppl.) Scottish Milk told us that the rules were changed because the members wished to emphasize that membership of the co-operative was a long-term commitment and only those prepared to make such a commitment should be entitled to this discretionary payment.

## ***Financial performance***

4.126. Scottish Milk, like Milk Marque and other producer co-operatives, seeks to maximize payments to its members for their milk rather than maximize its profits.

4.127. The financial performance of Scottish Milk is summarized in Table 4.19, which is presented in the form of a profit and loss account with members' payments as the bottom line.

TABLE 4.19 Financial performance of Scottish Milk, 1 November 1994 to 31 March 1998

	£ million		
	17 months to 31 March 1996*	Years ended 31 March	
	1997	1998	
<i>Sales</i>			
Members' milk:			
To Scottish Milk Products*			
To Drakemire*			
To other customers			
Bought-in milk			
Other sales			
	298.9	194.0	173.8
<i>Less:</i>			
Cost of bought-in milk			
Milk collection			
Delivery costs†			
Quality control			
Haulage reorganization			
Other direct costs			
Indirect costs			
Bad debt provision	-	3.4	-
Interest			
Available for members			
Retained profit	0.9	0.2	1.2
Net members' payments			
<i>million litres</i>			
Volume collected			
Volume bought in			
Volume sold			
<i>ppl</i>			
Sales			
Costs and retained profit			
Average payment			

Source: Scottish Milk.

\*Post-acquisition sales to Scottish Milk Products and Drakemire.

†Delivery costs are shown separately from milk collection costs for 1997/98 only.

4.128. Scottish Milk told us that its cost base tended to be largely fixed and payments to members mainly varied in line with changes in sales returns from the market. The increase in costs in 1996/97 could be explained in the main by the Scottish Pride bad debt provision, amounting to 0.46 ppl. The principal change in 1997/98 was the increase in handling third party milk, both to income and costs.

4.129. The initial funding of Scottish Milk was principally the debt due to the SMMB Residuary Body, repayable over five years. Repayments of this debt have been made from the gradual accumulation of revenue reserves. Any other funding required by Scottish Milk has been from cash flow or bank borrowing. Scottish Milk told us that there was a careful balance to be struck between the need to maintain payments to members at the highest possible level, the need to build funds, and the requirement to repay the initial debt. Payments to members for the 17 months to 31 March 1996 totalled £[ 300 ]; £536,000 was transferred to reserves, which was equivalent to £[ 300 ] for an average member producing [ 300 ] litres. For the 12 months to 31 March 1997 £[ 300 ] was paid to members and £412,000 transferred to reserves. The latter transfer was equivalent to £[ 300 ] for an average producer.

## ***Vertical integration***

4.130. Scottish Milk told us that its initial strategy on vertical integration had been to wait and see how the reorganization of the quota system developed. It had initially predicted that direct involvement in processing would not be necessary until after the year 2000. However, two unsolicited opportunities unexpectedly presented themselves to Scottish Milk to establish an initial presence in processing and to give the Scottish Milk board of directors a platform from which to gain experience in commercial processing. These were the sale of Scottish Pride's cheese business by the receiver and an approach by the owners of Drakemire Dairy Foods Ltd (Drakemire).

### ***Scottish Milk Products Ltd***

4.131. In February 1997 Scottish Pride went into receivership (see paragraph 4.119). Scottish Milk wanted to acquire Scottish Pride's UHT milk and cream business, but was outbid by Northern Foods (see paragraph 4.196 and 4.197), while Wiseman acquired most of Scottish Pride's fresh liquid milk business (see paragraph 4.251). Scottish Milk was, however, successful in its bid of £13.5 million for the cheese business, which it made through Scottish Milk Products Ltd (Scottish Milk Products), incorporated as a wholly-owned subsidiary in October 1996. The bid was made in partnership with a Glasgow-based cheese broker, A McLelland & Son Ltd (McLelland), which contributed 20 per cent of Scottish Milk Products' share capital.

4.132. As a result of its successful bid Scottish Milk Products acquired three cheese plants on the Isle of Arran (200 tonnes a year), the Isle of Bute (1,800 tonnes a year) and the Mull of Kintyre (3,200 tonnes a year), together with a prepacking plant at Mauchline, Ayrshire. In total approximately 52 million litres of milk a year is converted into cheese at these three plants. The necessary expertise to produce top-quality cheese was already available at the acquired cheese plants, but Scottish Milk did not have the necessary skills available to market the cheese. Marketing expertise has been made available to Scottish Milk Products through McLelland, the minority shareholder. Scottish Milk Products started trading on 8 May 1997.

4.133. The purchase price of £13.5 million was assessed as being equal to the fair value of the assets acquired, £2.3 million for tangible fixed assets and £11.2 million for stocks of cheese. In addition to the share capital of £4 million, a loan of £1.5 million and a working capital facility of £11.0 million were made available by the company's bankers, with Scottish Milk providing guarantees for £3.5 million of these facilities. A further short-term loan of £1.5 million was advanced by Scottish Milk.

4.134. The financial statements of Scottish Milk Products for the 11 months to March 1998 show sales of £12.4 million, nearly all to McLelland, an operating profit of £889,000 and interest payable of £868,000, leaving a net profit of £21,000. But these results were distorted by a major accident at Mauchline, where large blocks of cheese are processed into consumer packs (prepacks), supported by a large cheese store. The directors' report states that in a unique accident the electronically guided fork lift truck collided with the racking and caused its total collapse and substantial damage to the building. Approximately 1,500 tonnes of cheese had to be condemned and prepacking operations were suspended. The losses were largely covered by insurance.

4.135. The board of directors of Scottish Milk Products is made up of six directors. Four of them are directors of Scottish Milk, and there are two McLelland appointees, both directors of McLelland.

### ***Drakemire Dairy Foods Ltd***

4.136. Drakemire is located in Hamilton. It grew rapidly as a result of the introduction of UHT products, which account for approximately two-thirds of its turnover. It processes approximately 30 million litres of raw milk a year into UHT, fresh milks, butter, cream and yogurt.

4.137. The shareholders of Drakemire approached Scottish Milk, explaining that they had been approached by other interested parties based outwith Scotland, which had raised their interest in realizing some of the capital they had tied up in the business. They stated that they would prefer an arrangement that ensured both their continued involvement in the business and the Scottish orientation of the enterprise. The UHT business of Drakemire was of particular strategic interest to Scottish Milk. The opportunity that Drakemire represented appeared to Scottish Milk to be unique and certainly unlikely to be replicated in the foreseeable future. In February 1998 Scottish Milk acquired 36 per cent of Drakemire with an option to acquire the outstanding 64 per cent of the business in three years' time.

4.138. Drakemire is not a subsidiary of Scottish Milk and has its own independent management and administration. In addition to the three Scottish Milk directors on the Drakemire board, the individual shareholders of Drakemire act as its executive directors. The financial statements of Drakemire for the year ended 31 March 1998 show that it made an operating profit of £400,000 on turnover of £13.3 million.

4.139. Scottish Milk Products and Drakemire together process approximately 80 million litres of milk in meeting existing demand for their products. Scottish Milk's annual sales of raw milk for the coming year are expected to be between 700 and 750 million litres. Scottish Milk told us that Scottish Milk Products and Drakemire were likely to be processing about 11 per cent of Scottish Milk's total raw milk supplies, or less than 1 per cent of total UK milk supplies.

4.140. Scottish Milk told us that both Scottish Milk Products and Drakemire were regarded as fully commercial enterprises, expected to make a reasonable profit on sales and return on capital employed. They were not acquired with the intent of influencing raw milk or processed product prices and this would not be possible given their insignificant market share.

## **Aberdeen Milk Co Ltd**

4.141. AMCO is the successor to the ADMMB. It is a company incorporated under the Companies Act 1985 and recognized as a co-operative by the Secretary of State for Scotland. At deregulation in 1994 it was allowed to retain the ADMMB's processing facilities, which are operated by its wholly-owned subsidiary, Aberdeen Milk Services Ltd (AMS). It took over the Twin Spires creamery at Bucksburn, Aberdeen, where there is a small butter and milk powder manufacturing facility. It operates its own fleet of milk tankers.

4.142. AMCO's milk field extends from Montrose in the South to Buchan in the North. In March 1995 AMCO had 165 members but three years later membership had fallen by 25 per cent to 124, leading to a 9 per cent reduction in its milk pool. Almost all its membership losses have been caused by retirements. AMCO told us that its neighbouring co-operatives had not sought to recruit its members, nor had Wiseman, its largest customer.

4.143. Members must give at least three months' notice that they wish to resign from AMCO. They may terminate their membership either by giving 12 months' notice or by giving a shorter period of notice and paying a penalty of 2 per cent of their production receipts over the previous year. No penalty is payable in the event of the death or retirement of a member.

4.144. AMCO sells most of its milk to Wiseman. It has no facilities for liquid milk processing and it retains only a small quantity of its milk for cheesemaking by AMS. Its drying facilities are mostly used for contract processing for Milk Marque.

4.145. AMCO acts as an agent in selling its members' milk on a delivered price basis. It collects and delivers all the milk produced by its members using its own fleet of tankers. It told us that it had not analysed the efficiency of its transport operation or benchmarked its costs against other milk groups or similar haulage operations, but that quotes from private hauliers had been higher than its own transport costs. It said that it used the price paid to its members for their milk as a measure of its performance.

4.146. AMCO deducts a two-part transport charge from the price paid to members for their milk. This consists of a 'stop' charge of £5 per collection and a charge of 0.7p per litre collected. AMCO told us that about one-quarter of its members had opted for EODC.

### **Claymore Dairies Limited (North Milk Co-operative)**

4.147. The North of Scotland Milk Co-operative Society Ltd was formed as the successor to the NSMMB. It is a co-operative incorporated under the Industrial & Provident Societies Acts. In November 1994 it took over the NSMMB's processing facilities, principally a dairy in Nairn, 15 miles east of Inverness, and began trading under the Claymore name, changing its name to Claymore Dairies Limited in July 1997. Its wholly-owned subsidiary Claymore Inverness Ltd became a 50 per cent partner in Inverness Farmers Dairy, an unincorporated partnership. Through another subsidiary it acquired a liquid milk business in Oban from the receiver of Scottish Pride in 1997. For its financial year ended 30 September 1997 Claymore reported an operating profit of £557,000 on turnover of £20.3 million.

4.148. In March 1995 Claymore had 97 members, but by March 1998 membership had fallen to 84, mostly because of retirements. No producers left to join another milk group. Claymore told us that it was not seeking new members because it had surplus milk. Most members are located along the ribbon of coastline from Inverness to Buckie. A few members are located in Caithness, about 100 miles north of the Nairn dairy. A third group of members farm on the Orkney Islands.

4.149. Claymore's Members' Agreement states that in all cases members must give at least three months' notice that they wish to resign. They may terminate their membership either by giving 12 months' notice or by giving a shorter period of notice and paying a penalty of 2 per cent of their production receipts over the previous 12 months. Claymore told us that the penalty was only applied to members giving less than three months' notice.

4.150. Claymore collects all its members' milk, using its own fleet of tankers. A two-part transport charge is deducted from the price paid to members for their milk. This consists of a £5 charge per collection and a charge of 0.77p per litre collected.

4.151. Claymore sells some milk to a small number of local dairies operating in the Highlands, but retains the bulk of its supplies for processing in its own facilities. Cheese and butter are manufactured in Orkney, using milk from Orkney and Caithness, and liquid milk and fresh cream are produced at the Nairn dairy. Milk that has been collected from producers and is not required for its liquid milk customers on the mainland is usually sold through Scottish Milk. Claymore told us that this surplus milk had tended to be sold at around Milk Marque's Residual B contract price or lower, after substantial transport costs had been incurred.

4.152. In December 1998 Claymore entered into an agreement to sell 51 per cent of its liquid milk processing business to Express Dairies. All of this business, including its interest in the Inverness Farmers Dairy partnership, was transferred to a new company that took over the name of Claymore Dairies Ltd. The parent society, which retains a 49 per cent interest, changed its name to North Milk Co-operative. The information elsewhere in this report pre-dates these changes, and describes the position of Claymore before December 1998.

### **Other quota-holding milk groups**

4.153. We identified seven quota-holding milk groups (see paragraph 4.39). Three of them are successors to the MMBs and are described in the preceding section (AMCO is a non-quota-holding group). Of the remaining four quota-holders the largest, and for us the most interesting, is The Milk Group.

## The Milk Group Ltd

4.154. The Milk Group is a company incorporated under the Companies Acts. It told us that quota-holding could bring advantages of independence, flexibility and a greater degree of security and self-determination when coupled with a wide range of customers. It was able to control its own sales volumes and prices, its transport, milk testing and payments for milk to its members.

4.155. The Milk Group told us that it collected most of its milk from three distinct areas: the North-West of England, the Severn Vale (Gloucester, Hereford) and the East Midlands (mostly Derbyshire, Leicestershire and Nottingham). In 1998 it began recruiting members in Norfolk. Its membership is shown in Table 4.20.

TABLE 4.20 Membership of The Milk Group, 1 April 1995 to 30 September 1998

	Years ended 31 March			6 months to
	1996	1997	1998	30 September 1998*
Numbers at beginning of year	275	286	342	383
Joiners— <i>from Milk Marque</i>	14	15	43	29
— <i>other</i>	9	55	12	9
Leavers*	(12)	(14)	(14)	(13)
Numbers at end of year	286	342	383	408

Source: The Milk Group.

\*Leavers include members retiring or ceasing milk production.

4.156. The Milk Group told us that a further 72 members joined it in October 1998 and it expected its membership to exceed 500 by March 1999. It said that it was essential to maintain a balance between potential sales and potential membership growth. It did not take on new members unless it was confident that it could sell the additional milk at satisfactory prices and margins.

4.157. The financial performance of The Milk Group, as set out in its audited financial statements, is summarized in Table 4.21.

TABLE 4.21 The Milk Group: financial performance, three years to March 1998

	Years ended 31 March		
	1996	1997	1998
	£'000		
<i>Profit and loss account</i>			
Turnover of milk supply business	63,874	72,540	70,375
<i>Balance sheet</i>			
Tangible fixed assets	39	23	40
Stock	-	-	6
Debtors	3,317	4,793	4,386
Creditors	(5,810)	(7,350)	(7,940)
Net operating assets	(2,454)	(2,534)	(3,508)
Unamortized formation costs	185	133	82
Investment in and advances to subsidiary	-	-	2,563
Net assets	(2,269)	(2,401)	(863)
Shareholders' funds	289	565	872
Proposed dividends			36
Net debt/(cash)	(2,558)	(2,966)	(1,771)
Capital employed	(2,269)	(2,401)	(863)

Source: The Milk Group.

4.158. The milk supply business of The Milk Group has grown each year since 1993/94. This business, like Milk Marque's, is financed by its creditors although it, too, has cash balances, suggesting that broking co-operatives may have modest requirements for capital.

4.159. More detailed profit and loss accounts for the same three years are set out in Table 1 of Appendix 4.2. During this period The Milk Group's members have received higher prices for their milk than those of Milk Marque.

4.160. In June 1997 The Milk Group set up a wholly-owned subsidiary, Milk Group Products Ltd, which acquired 80 per cent of Nene Valley Foods Ltd, Peterborough (Nene Valley), for £830,000. In the nine months after its acquisition, Nene Valley made an operating profit of £92,000 on sales of £10.6 million. Its dairy is being relocated to new premises on a greenfield site in Peterborough.

## **Non-quota-holding milk groups**

4.161. Table 4.7 lists the milk groups with a milk pool of more than 50 million litres in 1997/98. We identified 16 of them, four of which are quota-holding groups. The other 12 have chosen not to be quota-holders, and the members of ten of them deal with only one processor. There were about 30 milk groups in 1997/98 with a milk pool of less than 50 million litres. The two largest non-quota-holding milk groups were the Express Milk Partnership and United Milk Producers.

### **Express Milk Partnership**

4.162. Express Milk Partnership (EMP), which is the trading name of The Northern Milk Partnership Ltd (a company limited by guarantee), is owned on a 50:50 basis between the producer members of the partnership and Express Dairies. Producer representation is built up through district and regional groupings. EMP is the largest non-quota-holding milk group in Great Britain, with 1,066 members at 31 March 1998 (see Table 4.7). It is organized into 40 districts throughout England and Wales with eight districts making up each of the five regions. Each district can send two elected representatives to a Regional Board, which in turn elects two of its 16 members to the main EMP board.

4.163. The Chairman of EMP told us that before deregulation he had founded what was then the Northern Milk Partnership in collaboration with Northern Foods plc, at that time the owner of Express Dairies (see paragraph 4.196), because he did not believe that the proposals for Milk Marque were in the best interests of milk producers. Its formation had been strongly opposed by the EWMMB and by some dairy farmers. Northern Milk Partnership was a marketing partnership, and the costs of setting it up were borne 50:50 by Northern Foods plc and the members. Northern Foods plc had provided all the original finance, and the members were repaying their share in instalments.

4.164. EMP said that it sought members only in those areas where it wanted milk, in relation to Express Dairies' processing facilities.

### **United Milk Producers Ltd**

4.165. United Milk Producers Ltd (UMP) is the second largest non-quota-holding milk group after EMP. It is a company limited by guarantee, and therefore does not have share capital. Voting rights are based on volume of production at one vote per 500,000 litres or part thereof. UMP is non-profit-making. It told us that its main function was to act as a negotiating body with the objective of maximizing its members' profits from milk production.

4.166. UMP told us that in early 1994 several larger producers in central and southern England decided that following deregulation they would become direct suppliers and agreed that their negotiating position would be strengthened if they set up as an independent group. Unigate had prompted one large dairy farmer to canvass other large producers, offering the group an incentive based on volume supplied at deregulation and at 1 April 1996. This funding recognized the part that UMP played in developing the Unigate Business Deal (see paragraph 5.100) and was seen as start-up finance for the group. The group was eligible for grant aid for three years to 1998 under the MAFF Marketing Development Scheme, receiving £33,000 in 1997.

4.167. UMP told us that it aimed to recruit members in the premium milk fields of central, mid-west and southern England. Its members supplied the markets for liquid milk or added-value dairy products. It was seeking to expand membership to handle at least 1 billion litres a year. In order to secure the best possible terms, it sought producers who were close to buyers' premises.

4.168. All UMP's milk is sold to Unigate and AWG. Its members have a single contract direct with these processors, varied only by an addendum letter. In 1997/98 UMP supplied 528 million litres of milk, and at 31 March 1998 had 436 members. Table 4.7 shows that it had 1,211,000 litres of milk per member in 1997/98, more than any other large milk group, and almost three times as much milk per member as Milk Marque.

## **Southern Milk Producers**

4.169. Southern Milk Producers is a non-quota-holding milk group. It was established as a division of Lewes Farmers Ltd, an agricultural co-operative with interests in other agricultural products. It told us that it had two customers, Unigate and The Woodgate Farms Dairy Ltd (Woodgate), formerly a privately-owned dairy in Uckfield, East Sussex. In February 1998 Express Dairies had acquired Woodgate (see paragraph 4.198) and wanted the farmers who supplied it to join EMP in due course.

4.170. Southern Milk Producers told us that its members were reluctant to merge with EMP, which, for a typical farm, had a placing in milk price league tables only a little above that of Milk Marque. Southern Milk Producers had therefore decided to investigate the possibility of converting itself into a quota-holding milk group, and had set up a separate limited company for this purpose. It told us that the new company would be at liberty to sell to additional purchasers and to welcome any new producers who wanted to join. Those members of Southern Milk Producers who had been supplying Unigate would be able to join UMP if they did not join the new quota-holding company, and it was possible that they would obtain a slightly higher group premium from UMP than from Southern Milk Producers. We were told by Southern Milk Producers that, at 1 January 1999, its remaining members had an annual milk supply of about 65 million litres. It believed that its milk was worth a premium price, as it could bring a volume of quality-assured milk from large, efficient farms in the South of England, which were not far from the area of greatest consumption. It could give traceability to every production unit.

4.171. Southern Milk Producers said that in its negotiations with dairy companies, it had found that they would prefer its members to enter into individual supply contracts, where the dairies would hold the quota (see paragraph 9.132). These dairies had invariably maintained that they would pay a better price under a direct-supply arrangement than they would to a quota-holding group. The offer of a longer contract period did not change their position. Southern Milk Producers believed that the dairy companies saw a new quota-holding group as a threat. It said that it had not initially found it easy to arrange transport for its milk by locally-based and suitably accredited contractors. It added that processors owned many specialist milk haulage businesses, which meant that there was little competition between hauliers.

4.172. Southern Milk Producers told us that some of its milk had already been contracted under arrangements where it would administer the quota. If it failed to sell all its milk in this way, it would show that as a small group it did not match the dairy companies with equal might.

## **Quality Milk Producers Ltd**

4.173. Quality Milk Producers Ltd (QMP) differs from other milk groups in that it is a marketing co-operative and does not arrange the sale of its members' milk to one or more processors. It was set up in 1954 to market milk and milk products manufactured from the milk of Jersey and Guernsey cows. At deregulation QMP advised its members to join Milk Marque, as it believed that this was the most effective method of collecting and supplying Channel Island milk. Since then QMP, in partnership with Milk Marque, has more than doubled sales of Channel Island milk and the premium paid to

producers has increased from 0.3 ppl to 0.6 ppl over Milk Marque's compositional and hygienic quality-adjusted price. Great Britain is the only country in the EC where Channel Island milk is collected separately, and it is transported over relatively long distances.

4.174. QMP has 544 members, whose production in 1997/98 was 160 million litres. Four hundred and ninety members sell their milk through Milk Marque. Milk Marque has a separate selling category for Channel Island milk, for which processors pay a premium (3.8 ppl in the July 1998 selling process). The premium income obtained in the market place is placed by Milk Marque in a Channel Island income fund. After deduction of the cost of secondary transport, this fund is distributed to QMP's members as a producer premium. QMP told us that its members had agreed to forgo part of this premium in order to fund some of QMP's operating costs. Milk Marque deducts an agreed amount each year from the fund and pays it to QMP. QMP receives grants from MAFF, voluntary contributions from its members, and royalties from the licensing of brands such as Breakfast Milk and Gold Top. Its main activities centre on research, generic advertising and marketing of Channel Island milk products, and on managing its brands.

## Utilization of milk

4.175. Raw milk is not sold to consumers (except in small quantities by a few producers). The demand is therefore derived almost entirely from the demand for processed liquid milk and dairy products. This demand has been affected by continuing changes in consumption.

4.176. Table 4.22 shows how milk has been utilized by dairies in the UK in the four calendar years to 1997.

TABLE 4.22 Utilization of milk in the UK, 1994 to 1997

	<i>million litres</i>			
	1994	1995	1996	1997
Consumed as liquid milk	6,976	6,972	6,885	6,801
Used for manufacture of:				
Butter	N/A	272	266	284
Cheese	N/A	3,182	3,348	3,372
Cream	N/A	279	276	263
Condensed milk	N/A	661	719	692
WMP	N/A	623	558	655
SMP	N/A	1,422	1,322	1,313
Other	N/A	<u>480</u>	<u>445</u>	<u>482</u>
	7,134	6,919	6,934	7,061
Total utilization	14,110	13,891	13,819	13,862

Source: *Dairy Facts and Figures* (from MAFF).

The table includes utilization of the milk produced in Northern Ireland, around 1.5 billion litres (see Table 4.1), of which about 15 per cent is used for liquid milk with the remainder used for the manufacture of milk products.

4.177. The table shows that almost one-half of all milk produced in the UK is processed for consumption as fresh liquid milk. In Great Britain the proportion is about 53 per cent. This is a much larger proportion than in the EC as a whole. (In 1997 EC member states excluding the UK used only 21.8 per cent of the milk delivered to dairies for liquid milk.) Around 24 per cent of milk goes into cheesemaking, while some 11 per cent is used for butter and SMP. The remainder is sold as fresh cream; or manufactured into WMP, yogurt and condensed milk; or is used as an ingredient either in dairy products such as desserts or milk shakes, or in foods such as biscuits and chocolate.

## Trends in production and consumption of milk products

4.178. The Family Expenditure Survey<sup>1</sup> found that in 1997/98 the average household in the UK spent about £276 a year on fresh milk and dairy products, £119 of which was spent on fresh milk, £68 on cheese, £73 on fresh milk products (cream, yogurt, etc), and £16 on butter. For the average household, total spending on fresh milk and dairy products constituted about 1.6 per cent of total household expenditure. For households on the lowest incomes, however, these products accounted for about 2.8 per cent of all expenditure.

4.179. Consumption of fresh liquid milk has fallen in recent years. According to the 1997 National Food Survey,<sup>2</sup> the average person in Great Britain consumed 1.8 litres of liquid milk each week in 1997, as compared with 2.1 litres in 1987. However, whereas in 1987 only 22 per cent of liquid milk drunk was skimmed or semi-skimmed, in 1997 these lower fat milks accounted for over 60 per cent of liquid milk consumption.

4.180. Table 4.23 shows the decline in total liquid milk purchases since 1989 and the somewhat greater decline in household purchases. The other main change in the liquid milk sector has been a movement away from doorstep delivery towards purchasing in supermarkets. In 1989 about 72 per cent of household milk was delivered to the doorstep, but in 1997 this proportion had fallen by almost one-half.<sup>3</sup>

TABLE 4.23 Segmentation of fresh liquid milk purchases in England and Wales, 1989 to 1997

Calendar year	Total liquid purchases	million litres				
		Household purchases			Per cent share	
		Total	Doorstep	Retail	Doorstep	Retail
1989	5,827	5,020	3,603	1,417	71.8	28.2
1990	5,794	4,970	3,397	1,573	68.3	31.7
1991	5,752	4,927	3,242	1,685	65.8	34.2
1992	5,739	4,873	2,994	1,879	61.4	38.6
1993	5,719	4,812	2,739	2,073	56.9	43.1
1994	5,680	4,740	2,420	2,320	51.1	48.9
1995	5,568	4,633	2,063	2,570	44.5	55.5
1996	5,532	4,588	1,828	2,760	39.8	60.2
1997*	5,500	4,552	1,678	2,874	36.9	63.1

Source: *Dairy Facts and Figures* (from Measurement for Management Decision Ltd).

\*1997 data are provisional.

It can be seen from the table that the decline in household purchases of liquid milk has been partially offset by an increase in non-household purchases from about 800 million litres in 1989 to almost 950 million litres in 1997.

4.181. The move to supermarket purchases has led to the rationalization of doorstep deliveries, with some dairies being closed, and some dairy companies swapping delivery rounds and dairies. According to data from the National Dairymen's Association, quoted in *Dairy Facts and Figures*, the number of doorstep delivery rounds in England and Wales fell from about 19,800 in 1994 to about 13,500 in 1998. Over the same period the average daily volume of milk per round fell from 359 litres to 274 litres.

4.182. The increase in the proportion of liquid milk sold through supermarkets has been accompanied by a growing differential between doorstep and retail prices of milk as shown in Table 4.24.

<sup>1</sup>Family Spending 1996-97, Office for National Statistics 1997.

<sup>2</sup>The National Food Survey 1996, MAFF 1997.

<sup>3</sup>'Milk', March 1998, Mintel Market Intelligence.

TABLE 4.24 Average fresh liquid milk prices by source of purchase, England and Wales, 1991 to 1997

*pence per pint*

<i>Calendar year</i>	<i>Doorstep (a)</i>	<i>Retail (b)</i>	<i>Difference (a)-(b)</i>
1991	33.2	29.7	3.5
1992	34.9	27.3	7.6
1993	36.1	25.2	10.9
1994	36.8	23.5	13.3
1995	37.9	23.9	14.0
1996	38.2	25.0	13.2
1997	38.7	23.9	14.8

*Source: Dairy Facts and Figures (from NDC).*

Most of the increase in the differential took place between 1991 and 1994, with the average doorstep price for milk in 1994 being about 11 per cent above that in 1991, while the average retail price fell by about 21 per cent over the same period.

4.183. A further consequence of the decline in doorstep sales of liquid milk has been that supermarkets account for an increasing proportion of the sales of all the major processors. However, we found that doorstep sales continue to make a large contribution to the operating profits of most of the major processors (see paragraph 4.267).

4.184. Butter consumption has also fallen markedly in recent years. In 1987 the average person consumed 61 grams of butter each week, but in 1997 this had fallen to 38 grams.<sup>1</sup> The declining trend in butter consumption (as well as that of margarine) has been associated with a movement towards low fat and reduced fat spreads.

4.185. Purchases of cheese for consumption at home have also fallen, from about 116 grams a week in 1987 to 109 grams in 1997.<sup>1</sup> However, estimates of consumption of cheese in the UK as measured by 'disappearance' (UK production adjusted for stock movements, imports and exports) in *Dairy Facts and Figures* show an increase of almost 30 per cent in the eight years to 1997. We were told that demand for cheese has grown in the industrial and catering sectors, led by mozzarella, which is now second only to Cheddar in UK cheese production.

4.186. The EC CAP support system, described in paragraphs 3.38 to 3.47, provides a further source of demand for milk products, with butter and SMP benefiting from intervention buying, and a wider range of milk products, such as cheese and WMP, from other support measures.

4.187. The UK has for many years been a net importer of dairy products, but not to any significant extent of raw or processed liquid milk. The NDC reported that in the ten years to 1997 the UK was generally self-sufficient in cream, SMP and condensed milk. It estimated that in 1997 home production supplied 78 per cent of the UK's consumption of butter and 67 per cent of its consumption of cheese.

## Processors of raw milk

4.188. In the last ten years the processing industry in Great Britain has undergone a major programme of rationalization. In the 1990s several mergers and acquisitions took place, including Wiseman's purchase of four Scottish dairies between 1994 and 1995, and its acquisition of the fresh liquid milk business of Scottish Pride; Waterford Foods' purchase of The Cheese Company in 1995 and its subsequent merger with Avonmore Foods in 1997; and Express Dairies' demerger from Northern Foods in 1998. A more detailed account of the major processors, and the products they manufacture, is set out in paragraphs 4.195 to 4.254.

<sup>1</sup>National Food Survey 1997.

4.189. The 1998 edition of *Dairy Facts and Figures*, published towards the end of our inquiry, contained information compiled by MAFF for 1997 on the number and size of enterprises producing dairy products in the UK. Some of the larger processors may include more than one enterprise, and a few enterprises were involved in mergers during 1998. The information includes enterprises in Northern Ireland.

4.190. In 1997 there were 880 enterprises in the UK that supplied drinking milk (mostly fresh liquid milk). These enterprises included agricultural holdings engaged in on-farm processing (see paragraph 4.33). The 796 smallest enterprises, each producing 1,000 tonnes (equivalent to 971,160 litres) or less, accounted for only 0.2 per cent of drinking milk. The 11 largest enterprises, each producing more than 100,000 tonnes, accounted for almost 88 per cent of UK drinking milk output in 1997. We were told that in Great Britain the seven largest processors (see Table 4.25), led by Express Dairies and Unigate, accounted for more than two-thirds of doorstep sales. The same large processors accounted for possibly as much as 90 per cent of sales to supermarkets.

4.191. In 1997 142 enterprises were engaged in the production of cheese in the UK. Of these, 102 produced less than 1,000 tonnes each and accounted for less than 4 per cent of UK output. The six largest enterprises, each producing more than 10,000 tonnes, accounted for about 65 per cent of production, with a further ten enterprises that produced more than 5,000 tonnes accounting for a further 18 per cent. Other sources suggest that in Great Britain two companies, The Cheese Company (see paragraph 4.205) and Dairy Crest (see paragraph 4.231), account for nearly one-third of total production. There are fewer enterprises engaged in the manufacture of other dairy products. Six enterprises, out of a total of 35 which manufactured butter in the UK in 1997, accounted for over 90 per cent of production. In powdered dairy products, six enterprises accounted for 83 per cent of UK output. In Great Britain, Unigate and Dairy Crest are the two largest manufacturers of butter and SMP.

### **Shares of raw milk purchases in Great Britain**

4.192. With UK production of raw milk limited by the EC quota system, supplies of milk available for processing in Great Britain change little from year to year. Although it is in theory possible to import milk from other EC member states, processors can normally increase their intake of milk only if other processors reduce their purchases.

4.193. We asked the larger processors to provide us with details of the volume of milk purchased in each of the three years to 1997/98. From their responses, and from information on the totals of milk production in Great Britain, we calculated the shares of raw milk purchases for each processor.

TABLE 4.25 Shares of raw milk purchases by processors in Great Britain

	<i>per cent</i>		
	<i>Years ended 31 March</i>		
	1996	1997	1998
Express Dairies	15.0	13.8	13.6
AWG	12.3	12.0	13.1
Unigate	13.3	12.4	12.5
Dairy Crest	<u>11.7</u>	<u>11.9</u>	<u>12.5</u>
	<u>52.3</u>	<u>50.1</u>	<u>51.7</u>
MD Foods	4.9	5.8	6.1
ACC	5.4	5.5	5.8
Wiseman	<u>2.7</u>	<u>3.6</u>	<u>5.1</u>
	<u>13.0</u>	<u>14.9</u>	<u>17.0</u>
Nestlé	3.9	3.6	3.5
Bodfari	1.1	1.5	2.0
Cadbury	1.4	1.5	1.4
Midlands Co-op	1.5	1.4	1.3
Lancashire Dairies	1.0	1.1	1.2
Wessex Dairies	0.2	0.6	1.1
Southern Co-operative Dairies	0.9	1.0	1.0
Caledonian Cheese Co	1.1	1.2	0.9
Müller	0.9	0.9	0.9
Dansco	<u>0.9</u>	<u>0.9</u>	<u>0.8</u>
	<u>12.9</u>	<u>13.7</u>	<u>14.1</u>
	<u>78.2</u>	<u>78.7</u>	<u>82.8</u>
Small processors*	<u>21.8</u>	<u>21.3</u>	<u>17.2</u>
Great Britain	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
HHI	776	736	795

Source: MMC from processor data.

\*Processors purchasing less than 100 million litres in 1997/98.

4.194. Table 4.25 shows that in 1997/98 four processors together accounted for 51.7 per cent of purchases, each purchasing more than 1.5 billion litres of milk. Three processors, who each purchased more than 500 million litres, accounted for a further 17.0 per cent, so that the seven largest companies in the table purchased two-thirds of the raw milk in Great Britain. Adding in the volumes for the ten processors who purchased between 100 million and 500 million litres shows that the 17 largest processors accounted for four-fifths of the raw milk purchased in Great Britain in 1997/98. The HHI for these processors has remained between 700 and 800, much less than for the milk groups that supply them (see paragraph 4.47).

## The major processors

4.195. Table 4.25 shows that in 1997/98 the seven largest processors purchased two-thirds of the raw milk available in Great Britain. An account of these companies is set out in this section.

### Express Dairies plc

4.196. The original Express Dairy business was founded in London in 1864, deriving its name from its use of express trains to deliver fresh milk to the capital. Northern Foods plc was founded as Northern Dairies in 1937, and by the early 1990s had become the largest dairy company in the North and Midlands of England. In 1992 it acquired Express Dairies and Eden Vale from Grand Metropolitan plc, thereby strengthening its position in the South of England and establishing itself as the largest supplier of liquid milk by volume in Great Britain.

4.197. Northern Foods' Dairy and Prepared Foods businesses developed separate strategies under distinct management teams. Northern Foods concluded that the two businesses, given their different characteristics, should operate as independent companies, and in March 1998 it demerged its Dairy business. The fresh dairy products operation of Prepared Foods (including yogurt, fromage frais, dairy desserts and cottage cheese) remained with Northern Foods. The Dairy business was floated on the London Stock Exchange as Express Dairies plc.

4.198. Express Dairies' business is concentrated on liquid milk and cream. Its two principal operations are:

- (a) *Express Dairies Direct Service*, which processes and bottles milk and delivers milk, cream and other products to doorstep customers, small shops, catering customers, garage forecourts and institutional outlets. Since 1994 it has reduced the number of bottling dairies from twelve to four, in Wakefield, Liverpool, Nottingham and London, and has a network of 88 distribution depots. It said that it had improved this business through exchanges of depots and rounds with other operators.
- (b) *Express Dairies Major Retail*, which is the largest supplier in Great Britain of fresh liquid milk to major retailers, with dairies in London, Leicestershire, Manchester and Middlesbrough. In February 1998 it acquired for £17.6 million The Woodgate Farms Dairy Ltd, a dairy in Uckfield, East Sussex. Express Dairies Major Retail is the largest supplier in Great Britain of UHT milk and cream, with production facilities at Crediton in Devon and Kirkcudbright in Scotland (acquired from the receiver of Scottish Pride in April 1997 for £9.8 million).

4.199. Express Dairies has three other businesses:

- (a) *Express Dairies Distribution*, which principally handles the group's distribution requirements including the collection of milk from farms and the deliveries of processed milk to supermarkets and distribution depots. It undertakes external contracts, including the operation of some milk collection depots for Milk Marque;
- (b) *Express Dairies Ingredients*, which purchases all Express Dairies' raw milk and handles seasonal surpluses at butter and milk powder facilities in north Yorkshire and Somerset. At a creamery near York it produces a range of ingredients including bulk cream, condensed milk and chocolate crumb; and
- (c) *Express Dairies Ireland*, which is the largest supplier of liquid milk, fresh dairy products and ice cream in Northern Ireland, through its Dale Farm brand.

4.200. Express Dairies obtains about one-half of its milk requirements direct from dairy producers through EMP (see paragraph 4.162), with nearly all of the balance being acquired from Milk Marque. It also purchases small volumes of milk from Scottish Milk. Express Dairies told us that it derived significant advantages from its arrangements with EMP. EMP offered stable supplies of milk which were used to meet a large part of Express Dairies' core requirements; it provided full product traceability and quality assurance; it enabled Express Dairies to reduce its dependence on Milk Marque's higher-priced contracts; and it enabled Express Dairies to reduce its overall cost of milk procurement by targeting local farms close to its processing plants and minimizing distribution costs. A key benefit of EMP was that it enabled Express Dairies to work directly with producers to ensure that it met the changing requirements of its major customers.

4.201. The financial performance of Express Dairies (which includes the results of Express Dairies Ireland) is summarized in Table 4.26.

TABLE 4.26 Express Dairies: financial performance, four years to 31 March 1998

	<i>£ million</i>			
	<i>Years ended 31 March</i>			
	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
Sales	991.8	923.4	809.1	752.8
Operating profit*	58.9	59.9	43.9	61.4
Year-end net operating assets	176.9	168.6	157.4	161.0
Average net operating assets†	176.9	172.8	163.0	159.2
	<i>per cent</i>			
Return of operating profit on:				
Sales	5.9	6.5	5.4	8.2
Average net operating assets	33.3	34.7	26.9	38.6

Source: Express Dairies.

\*In 1994/95 operating profit before restructuring costs of £43.3 million.

†In 1994/95 year-end net operating assets.

4.202. Commenting on its 1997/98 results, Express Dairies attributed its decline in sales to lower selling prices, particularly in its Major Retail and Ingredients businesses, following the reduction in raw milk prices. The decline in doorstep volumes moderated, and the volume of its Direct Service business was 7.0 per cent lower than in the previous year.

4.203. In December 1998 Express Dairies announced that it had acquired 51 per cent of the dairy business of Claymore (see paragraph 4.152), and had leased a distribution depot in Coatbridge, Glasgow. It told us that it saw a commercial opportunity in the fresh liquid milk business in Scotland, a market with 5 million people.

### **Avonmore Waterford Group plc (Glanbia plc)**

4.204. In January 1999 AWG announced that it was shortly to change its name to Glanbia plc. A resolution for this change was to be put to its shareholders at an Extraordinary General Meeting on 15 February 1999, and it would begin to use the new name from March 1999. AWG is an Irish company, quoted on the Dublin and London stock exchanges, which was formed on 4 September 1997 from the merger of Avonmore Foods plc (Avonmore) and Waterford Foods plc (Waterford). The merging companies were each majority-owned by Irish co-operatives, Avonmore Creameries Ltd and Waterford Co-operative Society Ltd. These co-operatives themselves amalgamated to form Avonmore Waterford Co-operative Society Ltd (to be renamed Glanbia Co-operative Society Ltd), which reduced its holding in the company to 55 per cent by distributing some of its shares to members. AWG told us that at the time of the merger between Avonmore and Waterford in 1997 it was the fourth largest dairy company in Europe and the seventh largest in the world.

4.205. Before the 1997 merger both Avonmore and Waterford had acquired dairies and creameries in Great Britain. AWG told us that both companies had been attracted to what they saw as a large developed market, which was easy to enter because of its fragmented nature. It also offered scope for rationalization. The CATFI system operated by the EWMMB (see paragraph 3.8) had given protected margins, reducing the risk of acquisitions. Following the 1997 merger AWG restructured its UK operations into three processing divisions and a milk procurement division:

- (a) *Avonmore Waterford Dairies* which became the fourth largest supplier in the British liquid milk market, with dairies in Durham, Manchester, Birmingham and Salisbury;
- (b) *The Cheese Company* (acquired by Waterford in 1995) is principally involved in the production and marketing of cheese and butter. It is the largest supplier of Cheddar and territorial cheeses to the British retail sector with a market share at the time of the merger of 27 per cent.

It has four manufacturing plants at Lockerbie, North Tawton, Malpas and Melton Mowbray, and operates one of the largest cheese-packing facilities in Great Britain at Oswestry;

- (c) *Golden Foods Products*, combining the pizza cheese businesses, manufactures and distributes mozzarella cheeses from factories in Whitchurch (Shropshire), Anglesey and Northern Ireland; and
- (d) *Avonmore Waterford Foods* handling the entire milk purchasing and balancing operations in Great Britain for the three processing divisions.

4.206. This reorganization into four businesses did not lead to the creation of a UK holding company. It is therefore not possible to show the consolidated financial performance of AWG's businesses in Great Britain, but they are all contained within its Consumer Foods group, of which they form the greater part. They also form the greater part of AWG's European interests outside the Irish Republic. The 1997 annual report of the recently merged parent group gives a breakdown of its trading results, both by line of business and by geographical area, extracts from which are shown in Table 4.27.

TABLE 4.27 **AWG: sales and operating profit, 1996 and 1997**

	<i>Irish £</i>	
	1996	1997
<i>Total group</i>		
Sales	2,363.0	2,369.6
Operating profit	85.0	92.8
Operating margin (%)	3.6	3.9
<i>Consumer foods</i>		
Sales	1,061.5	1,071.7
Operating profit	38.7	39.7
Operating margin (%)	3.6	3.7
<i>UK and rest of Europe</i>		
Sales	982.3	1,036.1
Operating profit	28.4	35.4
Operating margin (%)	2.9	3.4

Source: AWG.

## Unigate PLC

4.207. Unigate was created in 1959 with the merger of Cow & Gate Ltd and United Dairies Ltd to form what was then the largest processor of milk in Great Britain. United Dairies Ltd came into being during the First World War with the merger of several dairies, aimed at releasing men and horses for the war effort.

4.208. In 1979, in a major change of strategy, Unigate sold 19 butter and cheese creameries to the EWMMB, which greatly increased the size of the latter's Dairy Crest operation (see paragraph 4.216), and in 1981 it sold the baby foods business of Cow & Gate to NV Nutricia in exchange for a 29 per cent shareholding in Nutricia (sold for about £330 million in 1995). In 1989 Unigate decided to concentrate on liquid milk activities in the South of England and to seek a greater density of doorstep customers within this area. It therefore sold seven liquid milk dairies situated north of a line between central London and South Wales to Dairy Crest for £152 million, at the same time buying back the butter and milk powder plant at Chard in Somerset for £25 million.

4.209. Since 1989 Unigate has purchased several small and medium-sized dairy businesses in the South and West of England to increase the density of its operations, including Clifford Foods PLC in

1993. Unigate told us that it had incurred substantial capital expenditure on major new or enlarged facilities, and had closed several older and smaller dairies. Following deregulation, the increase in the cost of milk, together with the decline in doorstep sales, led Unigate to rationalize further its dairy-related businesses, for which it provided £55.1 million in 1995.

4.210. Unigate is now involved in food processing and distribution, mainly in Great Britain, but also in Ireland, France and Italy. Its subsidiary, Unigate (UK) Ltd, is the holding company for its UK food businesses. Unigate Dairies Ltd is primarily involved in the sale of fresh liquid milk. St Ivel Chilled Products Ltd produces yellow fat spreads, yogurt, fromage frais, cottage cheese, cream and dairy desserts. St Ivel Provisions Ltd manufactures butter, SMP and hard cheese. Unigate Dairy Group Ltd acquires milk for use by other group companies. A separate subsidiary of Unigate PLC, Wincanton Logistics Ltd, is the second largest logistics business in Great Britain. One of Wincanton's activities is the provision of milk distribution services, collecting from farms and distributing to processing dairies for the Unigate businesses, for third party processors and, to a small extent, for Milk Marque. Unigate told us that it had made no major acquisitions or disposals in the dairy sector in the last three years.

4.211. Unigate's dairies and creameries are located in southern England and South Wales. It has dairies in London, Kidlington (Oxfordshire), Cardiff, the Isle of Wight, Totnes (Devon), Hanworth (West London) and Bournemouth. There are St Ivel factories in Haverfordwest (Dyfed), Chichester, Shepton Mallet, Paignton, Liverpool and Wootton Bassett, and a large butter and milk powder factory in Chard. In the four years to 1997/98 Unigate's capital expenditure was concentrated on expanding its dairies and the St Ivel chilled product facilities.

4.212. Until October 1997 Unigate's manufacturing capacity of butter, milk powder and hard pressed cheese was restricted under the last round of the ROF programmes (see paragraph 3.11). In April 1998 the board of Unigate approved, in principle, the expenditure of £[

*Details omitted. See note on page iv.*

]. In February 1999 it told us that no expenditure had yet been committed to this project which had not been started because of continuing uncertainties surrounding the Milk Marque selling arrangements.

4.213. The financial performance of Unigate as reported in its annual report and accounts is summarized in Table 4.28.

TABLE 4.28 Unigate: summary of financial performance

	Years ended 31 March					£ million
	1994	1995	1996	1997	1998	
<i>Unigate PLC</i>						
Sales	1,980.0	1,892.7	2,133.7	2,413.9	2,309.3	
Operating profit	126.5	129.1	132.9	127.2	138.9	
Exceptional items	(11.1)	(58.3)	173.7	(13.4)	1.5	
Profit before interest	115.4	70.8	306.6	113.8	140.4	
Net operating assets	541.3	506.5	475.0	419.2	451.6	
Average net operating assets*	541.3	523.9	490.8	447.1	435.4	
						<i>per cent</i>
Return of operating profit on:						
Sales	6.4	6.8	6.2	5.3	6.0	
Average net operating assets*	23.4	24.6	27.1	28.5	31.9	
						<i>£ million</i>
<i>Dairy</i>						
Sales			672.9	636.7	581.2	
Operating profit			44.6	34.5	40.5	
						<i>per cent</i>
Return of operating profit on						
Sales			6.6	5.4	7.0	

Source: MMC from Unigate data.

\*1993/94 year-end net operating assets.

4.214. Table 4.28 shows that in 1997/98 £581.2 million of Unigate's sales arose in its Dairy business, which includes all of Unigate's liquid milk interests and, since 1996/97, its butter and milk powder activities. St Ivel UK, which includes its cheese, yogurt, desserts, spreads and orange juice lines, increased its sales to £519 million in 1997/98.

## **Dairy Crest**

4.215. Dairy Crest Limited was formed in 1987 as a subsidiary of the EWMMB to take over the processing activities which it had been carrying on under the Dairy Crest name. Dairy Crest Group plc was formed in 1996 to acquire Dairy Crest Limited from the Residuary Milk Marketing Board. We refer to all these entities as Dairy Crest.

### ***Dairy Crest before deregulation***

4.216. Before 1979, the EWMMB had acquired a few small processors that were in financial difficulties, but in that year it became a major processor with the acquisition of 19 cheese and butter creameries from Unigate (see paragraph 4.208). The EWMMB, with a statutory obligation to dispose of all the raw milk produced in England and Wales, developed its processing capacity to ensure that it could handle seasonal peaks in the milk supply and daily fluctuations in demand. Some of its plant was only required in periods of peak supply, and was consequently often surplus to milk processing requirements. Surplus milk was generally processed into longer-life dairy products such as Cheddar cheese, butter and SMP.

4.217. In 1981 Dairy Crest was established as a separate division within the EWMMB. (In 1986 Dairy Crest Limited became a subsidiary of the EWMMB.) By 1983 it was processing around 4.7 billion litres of milk a year and operating 37 creameries and dairies.

4.218. The introduction of milk quotas in 1984 led to a cut in production. The resulting reduction in the volume of milk that it had to process forced Dairy Crest to change its strategy. There was substantial overcapacity in the industry, but mainly at Dairy Crest, the leading butter and milk powder processor. It took advantage of the three ROF programmes (see paragraph 3.11) between 1987 and 1992 to close nine butter and milk powder factories, two cheese creameries and several associated transport depots, and sought to expand into the more profitable liquid milk sector. In 1989 it acquired seven dairies from Unigate (see paragraph 4.208). In the early 1990s a new management team was recruited to improve the performance of Dairy Crest.

4.219. As a result of the closures, Dairy Crest's turnover fell by 13.7 per cent in 1993/94 from £1,156 million to £998 million (excluding its share of the turnover of joint ventures). In the same year its net operating assets fell from £252 million to £190 million, so that its net debt of £70 million in March 1993 had been replaced by net cash of £23 million a year later.

4.220. By the beginning of 1992, the EWMMB was engaged in discussions with MAFF and DGIV of the European Commission concerning the Agriculture Bill and the EWMMB's proposed Scheme of Reorganisation. These revealed that neither MAFF nor DGIV had any sympathy for the creation of a single vertically integrated co-operative in England and Wales, which would also be the major seller of milk to other companies (see paragraph 3.17). MAFF made it clear that funding of the Scheme of Reorganisation could not be at the public expense. In these circumstances the EWMMB decided to propose that Dairy Crest be floated on the London Stock Exchange, but with the majority of shares held by dairy farmers. The decision to divest Dairy Crest was therefore one taken only reluctantly by the EWMMB, in order to progress the Scheme of Reorganisation.

## ***Closure of the Whitland creamery***

4.221. On 1 November 1994, after Milk Marque's first selling process in which Dairy Crest's bids were scaled back, it announced the closure of its cheese plant at Longridge, Lancashire, and the mothballing of its butter and milk powder factory at Whitland, Dyfed. The Whitland plant, with a capacity of 1.8 mlpd, was one of the most modern in Great Britain, but Dairy Crest was left with butter and milk powder plants at Crudgington in Shropshire and Severnside in Gloucestershire.

4.222. Dairy Crest told us that just prior to Milk Marque's first selling process in 1994 the EWMMB approved Dairy Crest's planning assumptions (an average milk price of 23.9 ppl and milk volume of 1,769 million litres) as being an appropriate base upon which its advisers, Schrodgers, could develop the plan for the flotation of Dairy Crest. (The flotation proceeds were required to settle the EWMMB's liabilities and to pay the estimated £30 million cost of establishing Milk Marque.) As the EWMMB was at that time requiring Dairy Crest to buy all its milk from Milk Marque, the company went in to the first selling process wholly dependent on Milk Marque. However, the prices in the initial round were materially higher than Dairy Crest had expected. It reassessed its bidding strategy and bid for cheaper supply-led contracts, which were the ones subject to the greatest degree of scale-back. Dairy Crest told us that the outcome of the selling process was that it faced a milk cost of 26.0 ppl for some 1,117 million litres. This represented an increase of £23.5 million that had to be recovered from the market place on only 63 per cent of the milk necessary to meet its operating plans.

4.223. Dairy Crest told us that on 8 August 1994 the EWMMB gave approval for it to buy milk direct from producers. By late August, having secured some direct supplies from milk groups and from Scottish Milk, Dairy Crest's average milk cost was 26.2 ppl and the milk supply was 452 million litres short of its normal operating volume. The volume shortfall was to be closed by eliminating the capacity that yielded the lowest, most volatile return and was the cheapest capacity to close in terms of ppl. Dairy Crest stated that Whitland, which was forecast to lose £3.2 million and was concentrated on the commodity markets, met both of these criteria. Longridge represented the next most appropriate capacity reduction. Dairy Crest gave us copies of contemporaneous board minutes and internal correspondence, to support its account of the events leading up to the closure of Whitland.

4.224. The closure of the Whitland factory caused much adverse comment, and a Whitland Creamery Steering Group was set up by the local authority and other interested parties to campaign for its reopening. At a hearing before the Agriculture and Welsh Affairs Committees of the House of Commons on 14 February 1996, one of the witnesses stated that it was in Dairy Crest's interest to have the plant in its present condition.<sup>1</sup> The witness said that as long as it remained there, it would stop anyone else from trying to set up in the area because it would hang like a Sword of Damocles over the area.

4.225. Dairy Crest told us that it had received a few approaches about the site but no firm offers. In December 1996 Milk Marque verbally raised the possibility of acquiring the Whitland site in a conversation with Dairy Crest. In response Dairy Crest had verbally confirmed its position that the site had only been closed as a result of the substantial increase in milk costs imposed at deregulation. Dairy Crest believed that the deregulated market had not settled down and it was continuing to keep its options open by retaining the site in case milk prices fell sufficiently for it to become commercially viable again.

## ***Flotation of Dairy Crest***

4.226. Under the regulations for the ending of the Milk Marketing Scheme, the Residuary Milk Marketing Board (RMMB) retained the assets and liabilities of the EWMMB. Its most valuable asset was its investment in Dairy Crest. Its largest liability was its Rolling Fund debt, a debt of £66.57 million owed to Rolling Fund Producers. (A Rolling Fund Producer was a wholesale producer,

---

<sup>1</sup>First report: *the UK dairy industry and the CAP dairy regime*: Volume II, House of Commons Agriculture Committee (HC 40-II, Session 1995-96), HMSO, 1996.

producer/retailer or producer/processor who produced milk for sale in the year to 31 March 1994, or one of a small number of producers who made non-scheme sales.)

4.227. Dairy Crest Group plc was incorporated in February 1996. In August 1996 Dairy Crest was floated on the London Stock Exchange. The flotation involved four offers:

- (a) a distribution of shares to Eligible Producers with a cash alternative;
- (b) an offer of shares to Rolling Fund Producers;
- (c) a placing of shares; and
- (d) a free offer of shares to eligible employees.

Details of the offers are set out in Table 4.29.

TABLE 4.29 Dairy Crest share offers

Offer	Number of shares '000	Percentage of total	Price per share p	Proceeds £'000
Producer Distribution	69,900	63.5	0	0
Rolling Fund Offer	6,893	6.3	155	10,684
Placing	33,000	30.0	155	51,150
Free offer	207	0.2	0	0
	<u>110,000</u>	<u>100.0</u>		<u>61,834</u>

Source: Dairy Crest.

Note: The table does not include shares issued to the trustee of the Dairy Crest Long Term Incentive Share Plan.

4.228. None of the proceeds of the flotation went to Dairy Crest. They were used to pay off the Rolling Fund debt and other liabilities of the RMMB, including its loan from Dairy Crest.

4.229. As a result of the flotation Dairy Crest has many dairy farmers as its shareholders. On 15 May 1998, 21,962 individuals and other holders held 49.7 per cent of the shares, while 658 financial institutions held the remaining 50.3 per cent. Dairy Crest told us that as an independent, commercial company, floated on the Stock Exchange, its primary objective was to return an increase in shareholder value to all classes of shareholders. It therefore aimed to run the company as efficiently and profitably as possible.

### ***Dairy Crest since flotation***

4.230. At deregulation, Dairy Crest was relieved of its role as buyer of last resort for raw milk and was able, for the first time, to purchase only the milk necessary for its own business requirements. Having finally obtained the consent of the EWMMB to seek direct supplies of milk in August 1994 (see paragraph 4.223), it has been able to recruit producers. But with competitors having begun this process more than a year before Dairy Crest, it obtains a smaller proportion of its milk in this way.

4.231. Dairy Crest is now a broadly-based dairy food company, servicing multiple retail, household and industrial customers. It told us that it had significant positions in each of the main sectors of the dairy market:

- (a) cheese is manufactured at Davidstow (Cornwall), Aspatria (Cumbria), Hartington (Derbyshire) and Sturminster Newton (Dorset), while cheese prepacking is carried out at Maelor (Clwyd) and Frome (Somerset);
- (b) dairy spreads and packet butter are produced at its site in Crudgington (Shropshire);

- (c) liquid milk products (supplying both multiple retailers and Dairy Crest's household delivery service) and a fresh milk drink are produced at three liquid milk processing plants in Fenstanton (Cambridgeshire), Chadwell Heath (Essex) and Severnside (Gloucestershire); and
- (d) ingredients by-product processing takes place at most of Dairy Crest's main processing sites: butter and SMP at Severnside and Crudgington; whey powder at Davidstow and Aspatria; and whey syrups at Maelor.

4.232. In November 1995 Dairy Crest acquired the remaining 55 per cent of Mendip Dairy Products that it did not already own, for £25 million. Dairy Crest told us that Mendip Dairy Products had particular skills in purchasing a range of mature Cheddar from farmhouse and overseas suppliers. In August 1997 Dairy Crest acquired Anglia Dairies from the Anglia Regional Co-operative Society for £4.6 million, and production was integrated into the Fenstanton glass bottling operation.

4.233. In 1991 Yoplait SA and Dairy Crest agreed to co-operate in the marketing and sale of Yoplait SA's branded and own-label fresh dairy products (including yogurts, fromage frais, desserts and fermented cream) by establishing a joint venture company, Yoplait Dai

ry Crest Ltd (YDC). In February 1998 YDC acquired Raines Dairy Foods Ltd, which manufactures and distributes fresh dairy products, for £66.25 million.

4.235. The financial performance of Dairy Crest for the five years to 1997/98 is summarized in Table 4.30.

TABLE 4.30 Dairy Crest: financial performance

	Years ended 31 March					£ million
	1994	1995	1996	1997	1998	
Turnover:						
Continuing operations*	805.4	747.6	739.6	787.3	787.4	
Discontinued operations	<u>192.3</u>	<u>73.8</u>	<u>11.0</u>	<u>-</u>	<u>-</u>	
	997.7	821.4	750.6	787.3	787.4	
Operating profit:						
Continuing operations*	29.7	28.2	34.1	39.6	43.3	
Discontinued operations	<u>10.1</u>	<u>3.8</u>	<u>1.3</u>	<u>-</u>	<u>-</u>	
	39.8	32.0	35.4	39.6	43.3	
Exceptional items	<u>(35.5)</u>	<u>(11.2)</u>	<u>-</u>	<u>(0.9)</u>	<u>-</u>	
Profit before interest and tax	4.3	20.8	35.4	38.7	43.3	
Net operating assets	190.0	166.7	180.7	186.3	182.8	
Average net operating assets	220.9	178.4	173.7	183.5	184.6	
						per cent
Ratio to turnover:						
Operating profit	4.0	3.9	4.7	5.0	5.5	
Profit before interest and tax	0.4	2.5	4.7	4.9	5.5	
Ratio to average net operating assets:						
Operating profit	18.0	17.9	20.4	21.6	23.5	
Profit before interest and tax	1.9	11.7	20.4	21.1	23.5	

Source: Dairy Crest.

\*Including turnover of £35.7 million and operating profit of £0.5 million from acquired operations in 1995/96.

4.236. Table 4.30 shows that between November 1994 and Dairy Crest's flotation in August 1996 the trends described in paragraph 4.219 persisted as its management continued to rationalize its business. Turnover continued to fall and exceptional costs were incurred as a result of closures. Net operating assets also fell, and in 1994/95 Dairy Crest was able to advance £27.0 million to the RMMB as a short-term loan, repaid after flotation. In the last four years margins have improved, and returns

on net operating assets have increased, as a result of cost reductions and investment in added-value products.

## MD Foods

4.237. MD Foods AMBA is a Danish farmer-controlled co-operative formed in 1970. It has about 8,200 members and accounts for approximately 70 per cent of Danish milk production. Danish production greatly exceeds domestic requirements and therefore MD Foods AMBA is a large exporter of dairy products. The UK is its largest market, where for many years it has sold lactic butter under the Lurpak brand name and Danish Blue cheese.

4.238. In 1989 MD Foods AMBA decided to expand into processing outside Denmark and established a subsidiary, MD Foods International A/S (MDI), in which it controlled 51 per cent of the shares with the other 49 per cent held by several Danish banks and financial institutions. Most of MDI's investments were acquisitions of existing processing operations in Great Britain through its subsidiary, MD Foods Holdings Plc, and its principal operating sub-subsidiary, MD Foods Plc (we refer to these two companies as MD Foods).

4.239. In December 1990 MD Foods acquired Associated Fresh Foods Ltd, which operated a dairy in Leeds, for £92.4 million. In 1992 it acquired the milk business of Co-operative Retail Services, and in 1993 the Dairy Crest dairy at Bamber Bridge in north Lancashire, for £16 million. In September 1996 it acquired Lord Rayleigh's Dairies from the receiver for a net cost of £11.9 million, after selling part of the business. There were some closures and disposals as businesses were rationalized, and some swaps of doorstep depots with Northern Foods, Dairy Crest and Unigate.

4.240. These acquisitions left MD Foods as the third largest liquid milk processor in Great Britain, with dairies in Newcastle, Leeds, Bamber Bridge, Oakthorpe and Hatfield Peverel (Essex). It has a butter and milk powder plant in Settle where it also produces UHT milk.

4.241. MD Foods Holdings Plc transferred all its investments in subsidiaries to MD Foods Plc, which became the only trading company in the group. MD Foods Plc also handles the importation of Danish products from MD Foods AMBA, the main product areas being butter, blue cheeses, fromage frais and yogurt. Fromage frais, yogurt and some cheeses are included in the turnover of MD Foods Plc, while sales of the other products generate a commission income. The financial performance of MD Foods Plc is shown in Table 4.31.

TABLE 4.31 MD Foods Plc: financial performance for five years to September 1997

	Years ended 30 September					£ million
	1993	1994	1995	1996	1997	
Sales	350.7	327.5	315.6	329.7	364.9	
Operating profit	14.1	2.8	0.3	(14.5)	(9.8)	
Profit on disposal of fixed assets	3.0	0.4	-	-	-	
Loss on sale of business*	(1.8)	-	(0.6)	-	-	
Exceptional write-offs:						
Goodwill	-	(10.0)	(9.0)	-	(13.0)	
Tangible fixed assets	-	-	-	-	(24.6)	
Investments in subsidiaries	-	-	-	-	(49.0)	
Profit before interest and tax	15.3	(6.8)	(9.2)	(14.5)	(96.4)	

Source: MD Foods.

\*A provision of £3.1 million set up in 1993/94 and released in the next year has been excluded.

Note: Figures may not sum because of rounding.

4.242. As a result of its losses, MD Foods did not pay dividends to MDI, which was unable to service its loans. In a refinancing exercise in June 1998 MDI became dormant and its subsidiaries were transferred to a new holding company, MD Foods International Group A/S, which is wholly

owned by MD Foods AMBA. As part of this transaction, MD Foods Holdings Plc sold MD Foods Plc and its dormant subsidiaries to MD Foods International Group A/S.

4.243. MD Foods told us that in the year to 30 September 1998 its results had improved and that it would report an operating profit. It attributed this improvement to the earlier rationalization of its dairy business.

### **Associated Co-operative Creameries**

4.244. ACC is an operating division of the Co-operative Wholesale Society Ltd (CWS). The CWS is the biggest consumer co-operative in Europe with a turnover of more than £3 billion in 1997/98. Its milk business had a turnover of £300 million.

4.245. ACC processes approximately 700 million litres of milk a year, 400 million litres into liquid milk and short-life products and 300 million litres into long-life products. Its major areas of milk distribution are north-east England, Cumbria, Yorkshire, West Midlands, North London, east Kent and South Wales. Liquid milk processing is carried out at its plants at Blaydon (Newcastle upon Tyne), Stockton on Tees, Leeds and Fole (Uttoxeter). UHT milk and short-life products are manufactured at Whitby. Cheese is manufactured in Llandyrnog in North Wales; butter and milk powder, canned products and UHT products are manufactured at Llangadog in South Wales.

4.246. Since 1994 there has been considerable rationalization within the ACC Group. This has been a reaction to the changing milk market, including the impact of higher prices. Partially as a result of the impending deregulation of the EWMMB, the CWS merged its two milk interests, ACC and CWS Milk Group. This was a major exercise, begun in August 1993 and completed in early 1995. The final Group at that time consisted of nine dairies and 51 milk distribution depots. ACC told us that, given the emerging situation of high milk prices, its milk interests in Scotland were sold to Wiseman in June 1995. (An earlier attempt in 1991 by CWS to sell these interests to the SMMB had been prohibited by the Secretary of State following a report by the MMC.<sup>1</sup>) Bottling dairies at Alnwick and Carlisle were closed as surplus to requirements.

4.247. A major rationalization was carried out in conjunction with Northern Dairies (now Express Dairies) in November 1995. ACC swapped its milk interests in the East Midlands for similar-sized interests of Northern Dairies in the north-east of England and Yorkshire. Consequently, ACC closed a major processing plant in Nottingham.

4.248. In June 1994 ACC reached agreement with Sheffield Co-operative Society to carry out its milk processing. As a result, Sheffield Co-operative Society closed its dairy. ACC subsequently purchased the whole of this liquid milk business in November 1997.

### **Robert Wiseman Dairies PLC**

4.249. Wiseman was founded in the late 1940s when Mr Robert Wiseman senior started retailing from his dairy farm in East Kilbride, Lanarkshire. Three of his sons joined the business including Mr Alan Wiseman, who is now Chairman of the company, and Mr Robert Wiseman junior, who is now Managing Director. In the late 1970s Wiseman took the view that growth could best be achieved in the wholesale rather than the retail trade, and invested in equipment for non-returnable containers. In addition, it acquired several milk rounds, depots and small dairies in central Scotland. In 1989 it consolidated its processing and packaging facilities into a single modern dairy at Bellshill, east of Glasgow.

---

<sup>1</sup>*Scottish Milk Marketing Board and Co-operative Wholesale Society Limited: a report on the proposed acquisition by the Scottish Milk Marketing Board of the Scottish milk business of Co-operative Wholesale Society Limited*, HMSO, Cm 2120, December 1992.

4.250. In 1991 Wiseman purchased a small dairy business in Manchester, and in 1992 it acquired a site at Trafford Park Industrial Estate for construction of a processing plant that came into operation in 1995. Wiseman continued to acquire dairies in Scotland, including Kennerty Farm Dairies Ltd in May 1994, CWS's milk business in Scotland (see paragraph 4.245) in July 1995, and Hamilton's Dairies Ltd in September 1995. These were the three largest producers of fresh processed milk in Scotland apart from Scottish Pride and Wiseman itself.

4.251. In March 1994 Wiseman placed 25.2 per cent of its shares on the London Stock Exchange, raising £14.5 million. A similar amount was raised by a rights issue in 1995, and a further £13 million in 1997. At 31 March 1998 the Wiseman family held 54 per cent of the ordinary share capital.

4.252. In May 1996 Wiseman made a formal approach to Scottish Pride, which was in financial difficulties, for information on the company, and in June approached its board over a possible offer. The proposed acquisition was referred to the MMC, which reported to the Secretary of State in November 1996 that the proposed merger would be against the public interest,<sup>1</sup> and recommended that Wiseman should give behavioural undertakings to the DGFT. But Scottish Pride's customers were already switching much of their purchases to Wiseman, and in February 1997 Scottish Pride went into receivership. Wiseman purchased its remaining liquid milk business from the receiver for £4.7 million.

4.253. After extensive rationalization of the facilities that it has acquired, Wiseman packages milk into plastic and paper containers at Bellshill, East Kilbride, Manchester and Aberdeen. In addition, it has bottling facilities in Aberdeen and Glasgow, and packages cream in East Kilbride.

4.254. The financial performance of Wiseman is summarized in Table 4.32.

TABLE 4.32 Wiseman: summary of financial performance

	<i>£ million</i>				
	<i>Saturdays nearest to 31 March</i>				
	1994	1995	1996	1997	1998
Sales	59.7	107.9	148.3	192.9	252.7
Operating profit	5.1	7.2	8.8	12.4	18.0
Net operating assets	11.2	22.9	36.2	42.4	53.9
Average net operating assets	9.3	17.1	29.6	39.3	48.2
	<i>per cent</i>				
Return of operating profit on:					
Sales	8.5	6.7	5.9	6.4	7.1
Average net operating assets	54.8	42.1	29.7	31.6	37.3

Source: Wiseman.

4.255. Wiseman enjoyed by far the fastest rate of growth in sales of any of the major processors in the five years to 1997/98, and in terms of return on net operating assets it is one of the most profitable.

## Other processors

### Nestlé UK Ltd

4.256. Nestlé is a subsidiary of the world's largest food manufacturing group. Its milk processing business in Great Britain operates from three factories. Its factory in Girvan, Ayrshire, produces milk

<sup>1</sup>Robert Wiseman Dairies plc and Scottish Pride Holdings plc: a report on the proposed merger, HMSO, Cm 3504, December 1996.

chocolate crumb, a co-dried mixture of milk, sugar and cocoa liquor, which is the base material for the manufacture of chocolate by its Nestlé Rowntree division. Its factory at Dalston, Cumbria, produces WMP, sweetened condensed milks and sterilized cream, and its factory at Ashbourne, Derbyshire, produces evaporated milk, as well as canned rice pudding, dessert topping and a range of flavoured UHT drinks. Nestlé told us that it exported 45 per cent of its output.

4.257. Nestlé told us that it sought to ensure a secure long-term supply of milk at an acceptable price. Before deregulation it recognized that this would best be achieved by having a large proportion of its milk supplied direct by contracted farmers. Its own recruitment efforts had been successful, and after deregulation most of its recruitment had been the result of being approached by producers. It had sufficient milk contracted directly to meet its requirements, and it had not bought from Milk Marque in any of its selling processes since the autumn of 1996. It routinely traded milk, mostly with other processors, with volumes traded increasing every year since deregulation.

### **Bodfari Ltd**

4.258. Bodfari Ltd is a processor that includes among its shareholders many of the producers who supply it with milk, but it is not a milk group and we did not include it in Table 4.7. Bodfari Producers Ltd is the leading British manufacturer of anhydrous milk fat, but it also derives about 30 per cent of its turnover from sales of fresh liquid milk. After deregulation it offered ordinary shares to those producers who had become its direct suppliers. In 1995 Bodfari Producers Ltd and Meadow Foods Ltd agreed to merge. Bodfari Ltd was incorporated in May 1995 to acquire the two companies, whose shareholders received shares in the new company in exchange for their existing holdings. Bodfari Ltd told us that after this transaction about 100 producer suppliers held about 15 per cent of its shares. The merged company, which is not a co-operative, reported an operating profit of £3 million on sales of £129 million for the year ended 31 March 1998.

### **Cadbury Ltd**

4.259. Cadbury Ltd operates a dairy crumb factory in Herefordshire. It remains a major customer of Milk Marque. Cadbury told us that it had not sought supplies direct. It was a major company in the confectionery business, not the milk industry. Milk was an ingredient for Cadbury, as were sugar, cocoa, nuts and fruit. In recognizing that it was not in the milk industry itself, it wished to obtain this important commodity in the same way in which it acquired every other ingredient, in the most commercially beneficial way.

## **Profitability of the major processors**

4.260. Earlier in this chapter we described the seven largest processors (in terms of annual volume of milk processed) and set out in tables an account of their financial performance, in so far as this was available from their published accounts. However, we obtained more detailed information on the profitability of the dairy processing operations of these companies and of the various products that they manufactured. Table 4.25 shows that these seven processors accounted for almost 68 per cent of processing of raw milk.

### **Aggregate profitability**

4.261. We received profit and loss accounts and balance sheets in the form requested from six of the seven processors. One of them told us that because of closures, reorganizations and the acquisition of subsidiaries with different accounting methods it could not give us consistent data for five years.

Another company could only give us data for the four most recent years. A third company gave us information that excluded a large subsidiary that it had recently acquired. Table 4.33 therefore covers the four years to 1997/98 for most of the activities of six of the largest processors. For companies whose financial year did not end on 31 March, the year ending in 1997 has been included in 1997/98, with earlier years treated similarly.

TABLE 4.33 Aggregated financial performance of six major processors, four years to 1997/98

	<i>£ million</i>			
	1994/95	1995/96	1996/97	1997/98
Sales	3,463.6	3,415.7	3,358.4	3,348.4
Cost of sales:				
Raw milk	[ <del>∞</del> ]†	1,785.6	1,798.0	1,674.0
Other	[ <del>∞</del> ]†			
Gross profit	709.7	669.9	602.6	669.3
Operating costs	534.3	499.0	470.9	481.8
Operating profit	175.4	170.9	131.7	187.5
Associates	1.2	2.0	1.9	2.8
Exceptional items	(33.6)	(15.1)	(4.0)	(0.1)
Profit before interest and tax	143.0	157.8	129.6	190.2
Operating assets:				
Fixed assets	672.8	642.6	664.4	678.3
Stocks	188.3	230.1	250.8	249.8
Debtors	330.7	336.0	329.0	320.0
Creditors	(445.9)	(458.6)	(462.7)	(450.0)
	745.9	750.1	781.5	798.1
Average operating assets*	755.3	748.0	765.8	789.8
				<i>per cent</i>
Ratio to sales:				
Cost of raw milk	50.4	52.3	53.5	50.0
Other cost of sales	29.1	28.1	28.5	30.0
Operating costs	15.4	14.6	14.0	14.4
Operating profit	5.1	5.0	3.9	5.6
Associates	0.0	0.1	0.1	0.1
Exceptional items	(1.0)	(0.4)	(0.1)	0.0
Profit before interest and tax	4.1	4.6	3.9	5.7
Ratio to average operating assets of:				
Operating profit	23.2	22.8	17.2	23.7
Profit before interest and tax	18.9	21.1	16.9	24.1

Source: MMC from company information.

\*For one company based on year-end operating assets.

Note: Figures may not sum due to rounding.

4.262. The table shows that although individual companies may have increased the size of their businesses in terms of sales and net assets, collectively they were little changed, even though in the last two years they increased their share of the total volume of milk processed by 2.5 per cent. Their sales revenues in 1997/98 were about 3 per cent lower than three years previously. Net fixed assets were almost unchanged, and the growth in stocks was mostly attributable to one company. Most of the improvement in profit before interest and tax arose from the diminution of exceptional charges from £33.6 million in 1994/95 (and for five of these companies an even higher aggregate amount in the previous year), as the companies completed their rationalization programmes. Excluding these exceptional items, their return on average net operating assets fell from about 23 per cent in 1994/95 to 17 per cent two years later, before returning to 24 per cent in 1997/98, a level almost certainly in excess of their cost of capital.

†Incorrect figures have been excised in accordance with section 83(3) of the Fair Trading Act 1973. The correct figures are: Raw Milk: 1994/95 '1,746.1'; Other: 1994/95 '1,007.8'; 1995/96 '960.2'; 1996/97 '957.8'; 1997/98 '1,005.1'.

4.263. We compared this return on assets with that of seven other food manufacturers selected from the FT/Extel company database. The selection criteria included a turnover in the range £200 million to £1,200 million so as to encompass the sizes of our selected processors. The food manufacturers' aggregate return on net operating assets for their latest reported years was 22.8 per cent, compared with the 23.7 per cent achieved by the six companies in the table for 1997/98.

### Profitability by product

4.264. We asked the same seven major processors to provide us with information on the profitability of product groups (that we had defined) in terms of return on sales and return on operating assets for 1997/98 only. Our request for this information in a standard form caused difficulties for several companies. Some processors told us that they could not differentiate assets between one product and another because their plant was used for several activities. Others were unable to allocate or apportion certain expense items or assets to individual products. We allocated these items to products ourselves, mostly in proportion to the cost of raw milk or to sales revenues.

4.265. A further complication was the differences in accounting practices between processors. One processor told us that it did not allocate part of the cost of raw milk to the cost of its cream, because it had already allocated all of the cost of the raw milk to the skimmed and semi-skimmed milk, from which this cream had been removed. Its cream sales therefore showed high margins. Another explained that there was no recognized convention for apportioning raw milk costs between skimmed milk, semi-skimmed milk and cream, nor between butter and SMP, all of which came from the same litre of raw milk. This processor derived the cost of the cream fraction of raw milk from the price for intervention butter into which the cream could be made. Although it showed losses on cream sales, it was nevertheless obliged to supply its major customers with cream.

4.266. Out of the seven major processors, five provided us with information that we were able to use. The company that could not provide us with information for Table 4.33 did provide information for this exercise, but one company supplied information which was not broken down to the level we required, and another was unable to give us any information at all. We did not require the information that was submitted to us to be reconciled to statutory accounts.

4.267. We aggregated the information provided by five of the major processing companies to calculate the return on sales and net operating assets for major product groups in 1997/98, as set out in Table 4.34. Looking at the returns provided by the individual companies, there were wide variations between the profitability of products.

TABLE 4.34 Profitability by product of five major processors, 1997/98

	Sales £m	Operating profit/ (loss) £m	Net operating assets £m	Return of operating profit on	
				Sales %	Net operating assets %
Doorstep milk	491.3	86.9	145.6	17.7	59.7
Other liquid milk	705.8	13.3	111.9	1.9	11.9
Cream	110.0	18.5	15.9	16.8	116.4
Butter	219.1	7.5	33.2	3.4	22.6
Powders	135.0	(0.9)	42.1	(0.7)	(2.1)
Cheese	721.3	(5.3)	302.1	(0.7)	(1.8)
Yogurt	75.5	3.8	19.6	5.0	19.4
Other products	<u>438.7</u>	<u>23.6</u>	<u>98.3</u>	5.4	24.0
Total	2,896.7	147.4	768.7	5.1	19.2

Source: MMC from company information.

4.268. Our analysis of the profitability by product of the five processors has to be seen in the light of the limitations set out above. The table indicates that liquid milk contributed more than two-thirds of the operating profit of these processors, with most of this attributable to the declining doorstep sector. If doorstep milk is excluded from the table, the total return on sales is only 2.5 per cent, and the return on assets is 9.7 per cent.

4.269. Commenting on our method of calculating operating assets for doorstep milk, one processor explained that it had had to make infill acquisitions of milk rounds in order to survive in a declining market. Such acquisitions invariably attracted a premium over asset value in the form of purchased goodwill, which it regarded as a material part of capital employed. Our exclusion of goodwill from operating assets would therefore not reflect capital invested in the business. In that particular instance, goodwill represented 179 per cent of tangible operating assets, so the return on the company's investment would have been less than half of the return on net operating assets.

4.270. The margins on butter and milk powders are much lower than those on liquid milk but, as they are joint products, the apparent losses on powders may arise from the way in which costs have been allocated between them. Taken together, butter and milk powders showed a return on sales of 1.9 per cent and a return on assets of 8.8 per cent.

4.271. Cheese not only had negative margins, but also accounted for almost 40 per cent of the net operating assets of these companies, mostly attributable to the large stocks of maturing cheese. Cheddar cheese accounts for most British production and this cheese, particularly mild Cheddar, is subject to competition from imports of Cheddar from Ireland, Australia, Canada and other countries. If cheese is excluded from Table 4.34, return on sales increases to 7.0 per cent, and return on net operating assets to 32.7 per cent.

4.272. The 'other products' category includes products bought in for resale as well as some items such as desserts, spreads and cottage cheese, which contributed above-average returns.

4.273. Taken together, the returns in Table 4.34 are lower than those in Table 4.33. However, given the sales mix of the two processors that were not included in Table 4.34, which was more heavily weighted towards liquid milk than the mix of the five that were included, the returns are broadly similar.

## **Processors' trade associations**

### **The Dairy Industry Federation Limited**

4.274. The DIF is a particularly active trade association on account of the role of its predecessor, the DTF (see paragraph 3.6). The DTF was founded in 1973. It was originally an unincorporated association, but became registered as a company limited by guarantee in December 1985. On deregulation on 1 November 1994 the DTF changed its Memorandum and Articles of Association and assumed its present name. The DIF's Memorandum requires it to promote and protect the interests of its member organizations based in England and Wales and which process liquid drinking milk or manufacture dairy products.

4.275. Membership of the DIF is open to:

- (a) organizations based in England and Wales which process liquid milk or manufacture dairy products;
- (b) sectoral trade associations which represent a distinct and substantial sector of dairy processing, distribution or manufacture; and
- (c) organizations or trade associations that are of a nature which would benefit the DIF if it were to be a member. (There are currently no members in this category.)

Milk Marque told us that MMD had applied for membership of the DIF, but that MMD was not yet a member. The DIF advised us that MMD had not applied for membership and, as a non-processing entity, it would not automatically qualify. However, Aeron Valley and North Bradon were members at the time of their acquisition by MMD, and remained in membership of the Federation.

4.276. The directors of the DIF are the members of its Council. Membership of the Council is open to any member which processes more than 100 million litres of milk a year (about 19 members would qualify), and there are arrangements for up to six smaller companies to be represented on the Council, and more at its discretion. The Council meets monthly. The DIF's Ways and Means Committee, consisting of what the DIF told us were its 'major contributors', meets as required before Council meetings to make policy proposals. (These major contributors are the six largest companies in Table 4.25 other than Wiseman, which has its head office in Scotland.)

4.277. We reviewed the minutes of meetings of the DIF Council and of the Ways and Means Committee from June 1996 to December 1998. Milk Marque had suggested to us that there had been collusion between the major processors in its selling processes since the introduction of the 90 per cent threshold (see paragraphs 8.72 to 8.75), and that we should review the minutes of the Ways and Means Committee. We found nothing in the minutes, either of the Council or of the Ways and Means Committee, to support Milk Marque's allegations.

4.278. The DIF played an active role in our inquiry, attending three hearings and sending us several written submissions. Its views are set out in paragraphs 10.2 to 10.96.

## **Scottish Dairy Association**

4.279. The SDA told us that it was the principal representative body for the milk processing, manufacturing and distribution industry in Scotland. It has its roots in the representative bodies which were formed as early as 1933 to give the milk processing sector a collective voice following the formation of three MMBs in Scotland. In an earlier role, as the Scottish Dairy Trade Federation, it represented purchasers of milk within the SMMB Area Joint Committee (see paragraph 3.6). In 1994 it was decided to reconstitute the Scottish Dairy Trade Federation as the SDA to reflect its changed role.

4.280. The SDA told us that it had 44 members, which included four of the largest Scottish processors, Wiseman, The Cheese Company (owned by AWG), Nestlé and Express Dairies. Some dairy companies were outwith the membership. Traditionally, these had been dairy companies either owned by the SMMB or by its successor, Scottish Milk. The SDA told us that it had an extensive regional branch network, which was open to members and non-members alike, through which the SDA kept in touch with a wider constituency of dairy businesses.

4.281. The SDA told us that the number of processing sites in Scotland had been fallen from 143 in 1990 to 90 in 1998 as a result of a process of rationalization, usually through acquisitions but in some cases through company failure. Before deregulation there had been a net flow of milk for processing into Scotland from England and Wales. The SDA estimated that in 1997 the volume of milk sold by producers, 1,181 million litres, was almost the same as the volume processed, 1,186 million litres. However, this position of net balance concealed substantial movements of milk in both directions, with 230 million litres of exports, mostly to England, and 235 million litres of imports. The SDA's views are set out in paragraphs 10.116 to 10.148.