

9 Views of other milk groups, producers and their representatives

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Successor bodies to the MMBs in Scotland

Aberdeen Milk Co Limited

9.1. AMCO, the successor to the ADMMB (see paragraph 4.141), said that it sold approximately 90 per cent of its milk into the liquid market. The other 10 per cent collected from farms was either processed by AMCO or sold on to the open market at the best return for the producer. This was normally at a lower price and led to a dilution of the average price for AMCO's members. It did not reflect in any way on the consumer price.

9.2. AMCO said that it sold milk through individually negotiated contracts. In all cases it carried the transport cost; it was unable to recover the cost of haulage through increased prices. It had sought quotations from private hauliers but its own transport costs had been lower. But AMCO had no powers to stop producers or buyers of milk making their own transport arrangements. This was already happening in the area AMCO serviced.

Prices

9.3. AMCO said that its prices were determined by those of Milk Marque. In AMCO's view the assurances Milk Marque had given to the OFT had put impossible demands on Milk Marque's selling arrangements. The 90 per cent threshold had been an unfair restriction and had distorted the milk market. Milk Marque had been forced to sell milk at less than competitive terms. This had had a direct effect on the incomes of AMCO's members.

9.4. AMCO told us that sales at the IMPE were reasonable for manufactured products but effectively removed the premium paid for liquid milk, which had the potential to give producers a better average milk price whilst not raising the price to consumers. The IMPE had been designed to put a floor on the market and protect the consumer, but, in AMCO's view, it had failed. The consumer was still paying more for milk than before deregulation. It seemed to AMCO that supermarkets and processors were profiting at the expense of the primary producers whose prices had fallen considerably over the last few years; in 1998 producer prices did not provide a sustainable income. AMCO thought further losses to the industry were inevitable.

9.5. AMCO said that the chief reason co-operatives were lower in the milk price league table than direct suppliers was that milk groups supplying the liquid milk market only could afford to pay higher prices to their producers through the premiums the groups received from processors. The processors then used the co-operatives to balance their fluctuating milk supply. AMCO believed producer prices would be fairer and more equally distributed if direct suppliers of milk destined for the liquid market were made to pay a levy. Proceeds from that levy would be paid to the co-operatives that were selling milk used for the manufacture of added-value and commodity products, which attracted lower prices. AMCO did not believe such a move, in itself, would have an effect on consumer prices.

Vertical integration

9.6. AMCO believed that if co-operatives were allowed entry into vertical integration to compete with processors it would change the whole balance of the milk market for the better. It said that in most EC countries, dairy co-operatives had grown into large businesses with a dominant share of farmers' milk. While still nationally based and owned, many were operating as international businesses.

The complex monopoly situation

9.7. In responding to the MMC's provisional finding that it was a member of a complex monopoly situation, AMCO said that, whilst it might fulfil the legal definition of a member of a complex monopoly situation, in practice the situation did not exist in its favour. In Scotland, AMCO's predominant buyer, Wiseman, dictated the manner in which AMCO sold its milk. AMCO had a common interest with Milk Marque in agricultural matters and AMCO's associate company, Aberdeen Milk Services, contract processed milk for Milk Marque. But there the relationship ceased. In AMCO's view, milk groups other than the four co-operatives, which were successors to the MMBs, could equally be deemed to be complex monopolists.

9.8. AMCO said that it had adopted good business practices which had been acceptable to the Scottish Office. AMCO did not engage in uncompetitive practices or exploitation either in the purchase or sale of milk to buyers. It existed to satisfy the needs of both the sellers and buyers of milk in north-east Scotland, an area where production costs were higher than the average in Great Britain.

Public interest issues

9.9. Commenting on the practices we had identified in the issues letter (see Appendix 2.1), AMCO said that the public interest concerns that the MMC might find could be resolved by the appointment of an independent milk regulator who might be able to suggest a fairer distribution of profit margins and create a better environment for all in the milk industry.

9.10. In AMCO's view, co-operatives acted as a safety net for their members, and did not distort competition between suppliers and purchasers. Competition was distorted, however, by the increasingly strong power of purchasers who bought milk for the liquid milk market for which they refused to pay the liquid premium which, in the past, had given all producers a fair price for their milk. AMCO believed it was unlikely that its selling arrangements enabled it to achieve higher prices for milk than would be the case in a more competitive market. It had only one major buyer of its milk.

9.11. With regard to AMCO's ownership of milk processing facilities, it said that processors could not guarantee to purchase all the milk available from co-operatives, as production varied. It was, therefore, necessary for co-operatives to have their own processing facilities to absorb any residual milk.

9.12. On the practice of universal coverage, AMCO said that immediately after deregulation all but one of the producers in the former area of the ADMMB had chosen to join AMCO. But there was no requirement for AMCO to accept new producers into membership unless it had a guaranteed sale for their milk. Also, AMCO operated to different rules from the other co-operatives, particularly in relation to shareholding. Members were admitted on the understanding that they would supply a high-quality product and a volume of milk for which AMCO could arrange advance contractual sales. Collectively, producers could respond to market needs in terms of quality, welfare issues and customer awareness more effectively than individually. But they were at liberty to join any other buying group.

9.13. On non-cost-reflective payments, AMCO said that the prices it paid its producers reflected volume, fat, protein and bacterial content, somatic cell counts and transport costs. AMCO operated everyday, or every-other-day, collections for the benefit of individual producers. It equalized the transport costs incurred in collecting the milk among its members to give them a better, more efficient and cheaper service. This equalization could be offset against the total volume, leading to a cost reduction in ppl. AMCO said that its members had taken a perfectly reasonable commercial decision to accept these terms.

9.14. On producer leaving terms, AMCO said that its membership rules were designed to ensure that it had adequate supplies for its advance sales to customers, which were mostly agreed on rolling six-monthly contracts. The rules dictated that a 12-month contractual obligation for producers was necessary. AMCO believed a stable market for milk would be almost impossible if individual producers could change their buyer at short notice.

9.15. Commenting on possible remedies in the issues letter in respect of itself, AMCO said that:

- (a) It believed that the transport charge to the individual producer did reflect the cost to AMCO of handling milk.
- (b) It had one predominant buyer of its milk and no other buyer of like volume was willing to accept a contract on an ex-farm basis. If there were such a buyer, this would call into question the need for AMCO's existence. AMCO existed because it was needed.
- (c) It did not bundle transport costs and therefore there was no cross-subsidization.
- (d) Its producer leaving terms were fair and reasonable. They applied only to producers leaving AMCO to enter into a contract with another buyer. AMCO imposed no penalty if a producer left farming, or against a producer's estate on death.

- (e) The suggestion of an auction system was irrelevant for a co-operative with only one major buyer.
- (f) Its processing associate, Aberdeen Milk Services, utilized only milk not required by local buyers. If AMCO had to transport this surplus milk to the more populated areas of Scotland, ultimately the consumer would bear the cost.

Hypothetical recommendations

Producer leaving terms

9.16. AMCO said that all co-operatives needed to be able to match sales and supply contracts to achieve a stable market. Leaving terms were an important part of any membership agreement and should not be changed.

Reform of Milk Marque's selling system

9.17. Commenting on whether Milk Marque's selling system should be reformed, AMCO said that it should be possible to adopt a type of falling clock auction system similar to that used in Northern Ireland. However, the system would still be open to abuse and manipulation by purchasers. A reformed Milk Marque selling system, subject to regular audit, would work only if the total marketing system was fully independently audited, ie suppliers and purchasers alike. AMCO believed that Milk Marque should be allowed to carry out its own auditing but the appointment of a neutral party (similar to the regulators in the utilities) would be a positive step forward.

9.18. AMCO believed that the formal objectives set for any reformed system should include the ability for Milk Marque to have the same trading rights as any other milk seller; and equitable sharing of costs in the supply chain for producers, processors and supermarkets. Stability would be essential and the system should not be influenced other than by the natural course of events in the markets, and world trade influences. In AMCO's view, full traceability and quality assurance were already achievable but these safeguards were at risk from foreign imports if some of the hypothetical recommendations were to be implemented.

9.19. In AMCO's view full market clearance in an auction system should be at a sustainable price for producers. Otherwise the industry would fall into decline, milk supplies would diminish and consumer prices increase. AMCO considered that a direct suppliers' levy based on ex-farm prices could possibly be applied to even out industry supply costs. Improved agreements on deliveries between sellers and buyers would facilitate diversions of milk and reduce unnecessary haulage charges.

9.20. AMCO said that in a reformed system the rules would need to be agreed by all parties. Prices would have to be determined through negotiation, using joint committees to establish prices (with the help of an industry regulator). However, AMCO believed it was doubtful whether any auction system could be devised that was fair to all parties.

Reform of Scottish Milk's selling system

9.21. With regard to the hypothetical recommendation concerning Scottish Milk, AMCO said that it believed Scottish Milk would need to adopt the same selling system as Milk Marque to remain competitive.

Structural reform

9.22. Commenting on the possible recommendation that Milk Marque should be divided into smaller bodies, AMCO said that such a remedy would increase supply chain costs. It would be contrary to the policies now being adopted by most organizations in the modern world, which were

increasing in size to achieve lower unit costs. There would also be a danger of smaller regional bodies devising their own selling systems, leading to an unstable and less transparent market place. This would cause confusion among all purchasers.

9.23. AMCO said that Milk Marque was small in European or world market terms and did not hold a dominant position in the wider market place. The current supply structure in England gave producers and processors sufficient choice. In Scotland the market was dominated by one buyer and therefore the issue of supplier choice was irrelevant. More important was an appreciation by the industry of farm production costs and poor returns currently being achieved by producers.

9.24. In AMCO's view no constraints should be placed on amalgamations among any newly-formed groups if it was to their commercial benefit to merge. And they should have the right to accept or reject producers based on commercial considerations.

9.25. AMCO believed Milk Marque should be allowed to retain and expand its processing capacity to assist it in improving its producer prices, and its position in the milk price league table.

Claymore Dairies Limited

9.26. Claymore, the successor body to the NSMMB (see paragraph 4.147), told us that there was little competition in the milk market in Scotland because of the small number of large buyers. The geographic location of the buyers dictated who supplied the milk. Claymore did not consider itself to be in competition with Scottish Milk.

9.27. Claymore did not believe that Milk Marque had abused a dominant position in the market, particularly when viewing the actions of processing companies. At the time of deregulation, large processors had offered direct-supply contracts to producers at prices which guaranteed premiums above the prices paid to producers by Milk Marque or Scottish Milk. Claymore believed that those processors had failed to reflect fully all the costs of their milk collection operations to justify those prices. Dairy farmers had been tempted by the premiums but it was notable that several processing companies were now reducing or removing them.

9.28. Claymore said that the processing industry would rationalize further. If the seller was not permitted to process its own milk it would be at the mercy of the large buyers who could bid for most of the milk at the IMPE. It was clear that certain processed products yielded a return which was in excess of the IMPE and it was critical that market returns reflected this. It was Claymore's view that the best way of achieving a good return was to allow the seller of the milk to bid for it on the same terms and conditions as other buyers, and to process that milk for the market.

9.29. The unregulated market had led to a position where one processing company had a vast proportion of the liquid milk market in Scotland. Consolidation meant that the industry throughout Great Britain was moving in that direction. Claymore believed this to be against the public interest. It said that there was a need to reassess the industry and put in place the necessary checks and balances which would be in the longer-term interests of dairy farmers, processors and the general public.

Selling systems and prices

9.30. Claymore said that other suppliers in Great Britain saw Milk Marque's prices as a benchmark. Claymore and its customers found it easy to negotiate because both parties were aware of Milk Marque's prices. Claymore believed there was a weakness in Milk Marque's selling system in that it took account of currency revaluations only at six-monthly intervals.

9.31. In Claymore's view the 90 per cent threshold had been unrealistic and had restricted Milk Marque. Ultimately it had meant lower prices for producers. Retention of the 90 per cent threshold, or a successor to it, would, in Claymore's view, be acceptable only in a market where Milk Marque was able to undertake processing, and had the facilities to allow it to compete on equal terms with other processing companies. Milk Marque's freedom to engage in vertical integration was essential for the

protection of the supply side of the dairy industry, particularly in the light of consolidation which had taken place within the processing sector. Claymore believed that processing restrictions on Scottish Milk had led to a reduction in capacity in the Scottish market in recent years. This was of concern to Claymore which, on occasion, had to transport milk almost 300 miles to find processing facilities.

9.32. Claymore said that Milk Marque's system of offering milk at different service levels had largely been responsible for creating a secondary market in milk. Secondary trading had reduced the purchase price of milk to virtually end-use price levels.

The complex monopoly situation

9.33. Claymore did not accept our provisional finding that it was a member of a complex monopoly situation, or that its business practices restricted competition. When reviewing prices, Claymore said that it was influenced by Milk Marque's published prices together with other factors such as price levels in the secondary market and local conditions.

9.34. Claymore said that it was impossible not to take cognizance of Milk Marque's prices and their importance to the raw, packaged and processed milk markets in the UK. More than 50 per cent of Claymore's packaged milk was sold to major supermarket chains. The relationship between the final selling prices of packaged milk to customers, particularly supermarkets, and Milk Marque's selling prices had to be taken into consideration by the seller.

Public interest issues

9.35. In commenting on the practices we had provisionally identified in the issues letter (see Appendix 2.1), Claymore said that it did not agree with the MMC's provisional findings. It contended that none of its practices operated against the public interest. It did not believe that the prices it received for milk were higher than those achieved elsewhere in Great Britain. Its customers received service levels similar to Milk Marque's Premier contracts at competitive prices which were negotiated directly with the customers. Prices Claymore achieved for surplus milk were probably lower than other sellers because of its location and distance from alternative purchasers. It also provided a choice of processed milk to consumers which it believed was clearly in the public interest. In the packaged milk market in Scotland one processing company had a market share in excess of 70 per cent which Claymore believed constituted a monopoly.

9.36. On universal coverage, Claymore said that it was not admitting new members as it had no commercial need for their milk. All producers in the area formerly covered by the NSMMB had been offered membership of Claymore at deregulation. Since then it had not sought or admitted new members.

9.37. On non-cost-reflective payments to producers, Claymore said that the payments it made to its members reflected fully the costs of handling the milk. Its haulage charges were comparable with many milk groups throughout Great Britain. Its transport policy stipulated that it could impose a higher transport charge on any producer whose farm was located more than 50 miles from the receiving dairy. (In practice, it had only one producer in that category.)

9.38. Regarding transport-inclusive prices, Claymore believed that its transport arrangements, which were negotiated directly with its customers, enabled it to offer service levels that were better than processors could otherwise obtain by organizing the haulage themselves. Deliveries were tailored to match customers' exact requirements and had the flexibility to change if circumstances required it.

9.39. On producer leaving terms, Claymore did not believe that the leaving terms for its members were restrictive. It said that there were few buyers of milk in Scotland and most of Claymore's members were located many miles away from processors. In practice, producers were only required to pay a penalty if they left with less than three months' notice. Claymore did not believe this was more onerous than the conditions set by other milk groups; its obligations to its customers required that it maintained a three-month notice period.

9.40. Claymore did not believe any remedial action was justified or necessary in respect of it. In particular:

- (a) It should not be required to offer milk only on an ex-farm basis as to do so would lead to a reduction in the service levels offered to customers.
- (b) Unbundling of transport would ultimately lead to higher costs for its customers.
- (c) The leaving terms which it operated were comparable to those operated by many milk groups throughout Great Britain.
- (d) It believed its selling arrangements were responsive to market conditions. There was no justification for requiring the divestment of its processing facilities. It provided a market for its producers' milk and offered an alternative supply to supermarkets and other customers in Scotland. Its business provided valuable employment for about 200 directly employed staff in an area where opportunities were very limited. In Claymore's view this was clearly in the public interest.
- (e) It did not believe it had an obligation to admit to membership any producer who fulfilled the criteria for becoming a member.

Hypothetical recommendations

Universal coverage

9.41. On whether the four co-operatives, or newly-created milk groups, should be required to accept all producers in an area into membership, Claymore said that such a remedy would be grossly unfair. In its case, where it operated as the only buyer of milk in the Highlands and Islands of northern Scotland, it was conceivable that, under this proposal, it could be faced with collecting milk involving journeys of, say, a round trip of some 400 miles. Claymore believed that all buyers should be free to reject producers on the grounds of location, level of efficiency, quality, or demand.

Reform of Milk Marque's selling system and divestment of its processing assets

9.42. Claymore said that it believed reform of Milk Marque's selling system would be an improvement and would achieve the aims of greater transparency, predictability and insurance against manipulation. Claymore saw no reason why Milk Marque should not be allowed to continue to operate a revised selling system and to bid for milk for its processing operations. The results of the auction should be made public as a means of creating awareness of the milk price to the market. On the separate proposal that Milk Marque should be required to divest Aeron Valley and any other processing facilities, Claymore said that it was opposed to such a remedy.

Structural reform

9.43. In Claymore's view a remedy to require the division of Milk Marque into smaller bodies was not justified. Claymore said it was fundamentally inequitable that the principal seller of milk should be forced to break up its operations whilst there were no limitations on the size of the major processing companies. But if the recommendation were to take effect, there should be no constraints on amalgamations of any of the newly-formed groups.

Scottish Milk Limited

9.44. Scottish Milk, the successor body to the SMMB (see paragraph 4.115), said that the fall in the number of large and medium-sized dairies operating in Scotland had left the market for liquid milk in Scotland largely in the hands of just one buyer, Wiseman. The closures, together with the loss of members to direct-purchasing customers, had markedly reduced demand for milk from Scottish Milk in Scotland. However, Scottish Milk sold substantial volumes of milk outside Scotland.

9.45. In Scottish Milk's view the processing industry in the UK would undergo further, major rationalization within the next year or two. Considerable overcapacity in the liquid sector, and the opportunity to achieve further economies of scale, pointed to fewer, larger processing companies. Scottish Milk believed there was insufficient competition within the processing sector. Further rationalization could only make this worse.

Scottish Milk's selling system

9.46. Scottish Milk believed its selling arrangements were closer to normal commercial trading arrangements found in other industries than the system currently offered by Milk Marque. Differences in Scottish Milk's negotiated contract prices were principally related to differences in service and, as far as practically possible, to estimated differences in costs. Scottish Milk needed to ensure that it did not become a marginal supplier, subject to large and unpredictable swings in the demand for its milk. As a small supplier in the British market, it believed it was essential that it should be able to retain the freedom to contract individually with its major customers, and to offer them a tailored service.

9.47. Scottish Milk told us that it discussed the supply requirements of all its customers and potential customers on a continuous basis. Generally, the only reason that a customer's requirements were not fulfilled was because of a failure to agree on price.

9.48. Scottish Milk said that initially it had sold its milk through a combination of option milk contracts (see paragraph 5.78), through a falling clock auction, and on the secondary market. But shortly after deregulation, market circumstances changed: milk production tended to increase beyond expectations and the market for commodities became relatively weaker. Prices in other parts of the UK were lower than in Scotland and, at one stage, spot market prices in England were lower than those for Scottish Milk's option milk. As a result, processors (which earlier had demanded the security of supply afforded by option milk) began to fail to take up some or all of their option entitlements.

9.49. In 1995 Scottish Milk reviewed its selling arrangements. It told us that, in addition to the problems it had encountered with the use of option milk, it found that in nearly one-half of all months some milk was left unsold at auction, particularly in the summer months. It became increasingly clear that few, if any, of the major processors viewed the auction process Scottish Milk had implemented at deregulation as a source of core supply. While several of the large processors regularly viewed, and occasionally purchased, milk in the auctions, their presence had tended to be more for information and general interest rather than as purchasers. For much of the year the auctions acted as source of marginal, or top-up, supplies for a few locally-based liquid milk processors. Scottish Milk decided, therefore, to change to its present system of largely individually negotiated contracts.

9.50. Scottish Milk rejected any implication by the SDA that genuine negotiations had not taken place before most of Scottish Milk's customers were asked to accept individual contracts (see paragraph 10.124). It said that one or two key buyers (which were members of the SDA) had approached Scottish Milk asking for a change in the selling arrangements at approximately the same time that Scottish Milk was itself considering a change. Scottish Milk discussed its proposals with all its main customers prior to introducing any changes; and many of the suggestions customers made were incorporated into the revised system. It also discussed its proposals with the SDA but the SDA said that its members were not of a single mind on the way forward. As a result of Scottish Milk's own consultations, it was not aware of any large-scale opposition from its customers.

9.51. Scottish Milk said that it generally set a reserve price at its auctions at the level of the lowest Milk Marque Residual contract because it did not make commercial sense to sell milk in the auction at a lower price than could be achieved elsewhere.

Competition between milk suppliers

9.52. Scottish Milk said that there was direct competition between Scottish Milk and other milk groups in Great Britain, most importantly Milk Marque. In Scottish Milk's view the border between England and Scotland was of no competitive significance; Scottish Milk supplied almost all the major processors in Great Britain. In the year to March 1998, for example, over one-third of its milk was sold for delivery to England and Ireland.

Prices and market power

9.53. Scottish Milk said that if milk prices were above the quota-constrained competitive level, it was inconceivable that this could result from any of its practices. It had no power to influence the price of milk as a traded commodity; it sought to differentiate itself from other milk groups through the level of service it was able to provide to its customers. Scottish Milk did not accept that it could adopt more competitive pricing vis-à-vis Milk Marque; the suggestion that Scottish Milk should sell its milk at any rate other than the market rate was completely uncommercial.

9.54. Scottish Milk said that there was ample evidence of the operation of market mechanisms within the milk supply industry which would act to correct any transitory imperfections. Dissatisfied producers and customers were able to contract directly with one another and bypass any suppliers which were unable to offer a satisfactory deal in terms of price and service quality. Any co-operative which sought to support small and poorly located farms, or which operated an inefficient delivery system, would either lose efficient members (who would be reluctant to subsidize less efficient members), or they would lose customers if they were asked to pay prices higher than the customers could obtain elsewhere.

9.55. Also, many processors used their directly contracted farms for their base requirements and used the co-operatives as sources of top-up volumes. If a mutually profitable opportunity were to present itself for customers to increase the volumes of milk which they obtained on direct contract, there was nothing to prevent them from doing so. Conversely, whilst co-operatives were able to meet the fluctuating demands of their customers efficiently and effectively, they would have a role to play in the market. In addition, the short-term markets Scottish Milk and Milk Marque offered enabled customers to balance supply and demand.

9.56. In Scottish Milk's view, a further example of the operation of the market was the switch to the lowest service level contracts offered by Milk Marque by its major customers which effectively meant that they received milk on an ex-farm profile. Scottish Milk believed processors were happy to accept contracts which did not match their individual demand profiles because they knew that there were numerous alternative sources of milk, and that deficits or surpluses could be remedied through the secondary market.

9.57. Scottish Milk did not accept our provisional analysis that the post-deregulation regime had been responsible for keeping prices higher than the system that existed before deregulation. It believed that to compare periods prior to and post-deregulation was not appropriate. It said that the pre-deregulation market within the MMB structure was highly artificial, involving the existence of end-use pricing and the Joint Committee structure for agreeing prices. In Scottish Milk's view it was inevitable that the abolition of these artificial elements would have an effect on milk pricing regardless of the selling systems introduced at deregulation. Scottish Milk believed the MMC's analysis ignored other factors that might have accounted for the narrowing of the gap between the target price and farm gate prices. For example, shortly after deregulation the fall of sterling had created additional demand from Continental Europe and substantial butter purchases from the EC had been made by Russia. This had increased EC and domestic prices and inevitably pushed up milk prices. Also, Scottish Milk believed there might well have been other demand-side variables which had not been taken into account in the

analysis, and which might offer an alternative explanation for the narrowing of the gap between the target price and farm gate prices.

9.58. Scottish Milk told us that, in recognition of its customers' ability to contract for milk from other sources, and particularly Milk Marque, all Scottish Milk's longer-term contracts contained clauses which explicitly linked changes in its negotiated prices with its customers to changes in the published prices of standard Milk Marque contracts. Any developments which affected Milk Marque, and in particular its selling arrangements, were of critical importance to Scottish Milk. The linkage with Milk Marque's prices benefited Scottish Milk's customers by ensuring that the existing relationship between the prices they paid Scottish Milk and the prices their competitors paid Milk Marque could not vary. The linkage also ensured that the competitive impact of Milk Marque, and the behaviour of its English and Welsh customers, was fully reflected in Scottish Milk's relations with its customers.

9.59. Scottish Milk said it noted that the decline in milk prices had not led to a similar reduction in retail prices: processors and retailers were in a position where they did not have to pass on to consumers the benefit of the reduction in milk prices. This was an indication of their market power.

Price discrimination

9.60. Scottish Milk believed the demise of end-use pricing had inevitably led to a convergence in the prices paid for milk by different classes of customer. It said that the kind of end-use pricing which existed prior to deregulation was a form of price discrimination. However, this was only possible when one firm enjoyed substantial market power by virtue of controlling the overwhelming majority of supplies, and customers were unable to trade among themselves. In Scottish Milk's view, neither of these conditions were met in the deregulated milk market in Great Britain. Any attempt systematically to charge one set of customers higher prices would lead them to look for alternative suppliers. Competition alone would act to eliminate any large, non-cost-related price differences between customers. Also, the existence of an active secondary market acted to erode price differences between customers. In Scottish Milk's view, sustained price discrimination of any magnitude was not possible.

9.61. Scottish Milk said that the trading down which had occurred in Milk Marque contracts since its early selling processes had proved that it was impossible to sustain different prices across different customer categories. Theoretically, a sufficiently large supplier could offer a variety of contracts to different customer groups based not on cost differences but on individual customers' willingness to pay. But even processors with a particular requirement could contract for their core needs in one way, and obtain their balancing supplies from other sources, including the secondary market. Scottish Milk had customers who intentionally specified a high service level from their Scottish Milk contracts to enable them to trade down in the hierarchy of Milk Marque contracts.

Vertical integration

9.62. Scottish Milk believed it was important for it to maintain processing capacity. It said that the EC quota regime was expected to undergo radical change leading to the end of production constraints. Initially production would boom and prices would fall, after which production and demand would come back into balance through the normal operation of market forces. During that transitional period Scottish Milk's members would still expect it to take all the milk they produced and find a good market for it. In such an uncertain and potentially unpredictable market environment, Scottish Milk believed it would be better placed to discharge that responsibility if it had direct involvement in processing.

9.63. Initially, Scottish Milk's strategy had been to wait and see how the reorganization of the quota system developed. However, two unsolicited opportunities—the purchase of the cheesemaking plants of Scottish Pride when it went into receivership (see paragraph 4.131), and part-ownership of Drakemire (see paragraph 4.137)—had presented themselves which enabled Scottish Milk to establish a presence in processing. The UHT business of Drakemire was of particular strategic interest to

Scottish Milk; it told us that the opportunity this acquisition represented was unlikely to be replicated in the foreseeable future.

9.64. Scottish Milk said that it intended to operate its milk supply business at arm's length from its processing businesses. It expected Scottish Milk Products and Drakemire to make a reasonable profit on sales and return on capital employed. Both subsidiaries contracted for milk to meet their own needs. The extent to which they might make use of any surplus milk would depend on their commercial judgment and was not directed by Scottish Milk. Neither Scottish Milk nor Scottish Milk's stake in Drakemire was acquired with the intent of influencing milk or processed product prices. Scottish Milk would judge the success of its acquisitions solely on the basis of their profitability, independently of the profitability of Scottish Milk. This policy could change, however, following the abolition or relaxation of the quota system.

9.65. Scottish Milk said that it was not actively seeking to make further acquisitions. Nonetheless, as and when opportunities arose it would review them and, if they appeared to fit with its longer-term strategy, consider expansion. However, it appreciated that its future success depended largely on maintaining good relations with its existing customers. For this reason it would not wish to be seen to be aggressively threatening its customers' markets.

9.66. Scottish Milk saw no rationale for the imposition of limits on its processing activities or that of any other milk group, including Milk Marque. In Scottish Milk's view the acquisition of processing capacity by milk suppliers should be subject to the same competition scrutiny as would be applied to a merger between stand-alone processors. Scottish Milk believed that even if it were possible to increase the throughput of the facilities of its two subsidiaries, it was difficult to see how, in the context of the market for milk in Great Britain, their behaviour could have any perceptible effect on market prices for milk or processed products. In total, the subsidiaries were responsible for less than 1 per cent of the UK's milk supply.

Secondary market

9.67. Scottish Milk said that the secondary market was expanding rapidly in England and Scotland. For many customers it offered the possibility of ironing out pricing discrepancies. Certain processors took the view that imbalances in the market would be remedied by trading directly with each other or through a secondary market. Scottish Milk questioned whether, in every transaction, the extra costs inherent in the shipment of significant volumes of milk by a multitude of processors (in circumstances where the co-operatives were undertaking no balancing role) was preferable to the system Scottish Milk operated. Its system had the flexibility to deal with different demand on different days. It had handled over 70 million litres as a facilitator of secondary trading in the period since deregulation. It actively encouraged processors to trade through its sales office, which it believed improved the efficiency of milk handling. The nature of the secondary market meant that it was not possible to estimate precisely how much milk was bought and sold on this market.

The monopoly situations

9.68. In response to our issues letter (see Appendix 2.1), Scottish Milk said it did not accept that it was a monopolist, nor that the practices identified in the MMC's provisional findings demonstrated the existence of a complex monopoly situation involving Scottish Milk, Milk Marque, AMCO and Claymore (the four co-operatives). Scottish Milk believed that some or all of these practices were also common to other milk groups. Accordingly, in Scottish Milk's view, if these practices were to be retained as indicators of a complex monopoly situation, the membership of the group would have to be widened considerably. Scottish Milk believed it would be more accurate to see the market as one in which there was a scale monopolist and a variety of other sellers of milk whose pricing was largely governed by Milk Marque's prices.

9.69. Scottish Milk said that it was only a player of modest size in a market which was characterized by intense competition for supplies of milk and by growing concentration among its customers, including some of the most powerful UK food companies. By virtue of the relatively small volumes of

milk which it handled, it had no option but to follow the prices dictated to it by the market. In practice, it was constrained to charge its customers a price which reflected the price at which they could obtain milk supplies elsewhere. This constraint would apply whether its customers' outside options were to buy from several alternative suppliers or from one. Scottish Milk did not believe its behaviour contributed to excessive prices.

9.70. Scottish Milk said that its activities were not in breach of EC competition law. This view had been supported by the European Commission in the past. In particular, Scottish Milk considered that Article 39 of the EC Treaty, concerning the need to ensure a fair standard of living for the agricultural community (partly through the means of the target price mechanism), should have a significant impact on any finding that the MMC might wish to make. There was authority for the proposition that the interests of agricultural workers were required to be given priority as against other interests identified in Article 39. Scottish Milk did not consider that any other provisions of the EC Treaty, or secondary legislation, conflicted with this principle. It believed that no action by national governments or authorities should be allowed to prevent milk producers doing what they considered necessary to secure prices at or near the target price. This, in turn, suggested that producers were free to group together and sell their milk in such a way as they chose and to engage in a measure of vertical integration if that was necessary to achieve the target price.

Public interest issues

Universal coverage

9.71. On the practice identified in our provisional findings of universal coverage (ie admitting as members any producers within a particular area on the basis that they met membership requirements), Scottish Milk said that it was not required to accept any producer into membership who wished to join it. During the run-up to deregulation the Scottish Office had indicated that the scheme presented by the SMMB for the reorganization of the arrangements in its area would not be acceptable unless membership of the new co-operative was open to all former SMMB members. Following a survey of producers, in which they expressed an overwhelming preference for universal coverage, Scottish Milk had offered to accept into membership all former SMMB members. But, since that time, new applications for membership had been admitted entirely at Scottish Milk's discretion. Its rules conferred on its directors 'an absolute discretion to accept or refuse admission to membership of the co-operative'.

9.72. Scottish Milk said that it welcomed new members, but only if to do so was in its best interests. Rather than being in a position where it had to formally reject membership applications, it had tended to dissuade those producers it considered unsuitable from applying. In practice few had been refused membership. It was aware that a policy of accepting all-comers would reduce its competitiveness, and its ability to offer a competitive price to all members.

Non-cost-reflective producer prices

9.73. Scottish Milk said that the MMC's possible remedy to make payments to producers which more fully reflected the cost to Scottish Milk of handling that member's milk was unworkable and not necessary. Generally it was not possible to attribute the currently pooled costs to a particular member. There were savings from operating as a network which, by their very nature, could not be attributed directly to specific farms.

9.74. Any distortion of competition caused by payments to its members of prices which did not reflect their individual milk-handling costs was, in Scottish Milk's view, of marginal importance. To the extent that this practice had any economic effect, it would be constrained by the operation of the market. Furthermore, producers might be willing to accept the slightly lower producer price which resulted from the element of cross-subsidy in return for the greater security which they believed was offered by Scottish Milk. Its collection charges were largely based on frequency of collection and volume, not on costs arising from farm location, which were minimal. Transport costs in total represented approximately less than 10 per cent of Scottish Milk's selling prices. If it were to select only the favourably located farms, the average savings that could be achieved would represent less than 3 per cent of the total cost to the processor of acquiring milk. The influence on producer prices

would be of a similar magnitude. Thus the fact that the costs of servicing particular locations were not charged to producers did not provide any material cross-subsidy to producers.

Supplying milk on an ex-farm profile

9.75. To the proposal in the issues letter that all milk should be sold on an ex-farm profile, Scottish Milk said that such a remedy would prove impractical. A small number of the very large multi-product processors could cope with an ex-farm supply profile relatively easily, but some of them, and many of the medium and smaller liquid dairies, could not. Some processors would become dependent on other processors to balance their requirements. There was no certainty that the desired level of co-operation would prevail. A possible consequence would be to force through a rapid structural adjustment within the industry in favour of the larger multi-product processors.

Delivered prices

9.76. Scottish Milk told us that the costs of handling milk were reduced by the system of delivered prices. The scheduling of daily collections and deliveries was complex; to minimize transport costs, milk from a particular farm was not necessarily delivered to the nearest processing facility. Furthermore, milk from a particular farm was not necessarily delivered to the same customer from one day to the next, further complicating allocation. Scottish Milk believed that in this type of business delivered prices were inherent.

9.77. Scottish Milk said that if it were forced to run an inefficient collection and delivery system, the resultant increase in costs would have to be recovered from its customers, and its members. In such circumstances both groups might bypass it. As its costs rose, opportunities for other milk groups and processors to create efficient distribution networks independently of Scottish Milk (by offering incentives to its members whose farms were most favourably located) would increase.

Producer leaving terms

9.78. Scottish Milk said that it did not accept our provisional finding that its membership conditions discouraged producers wishing to resign. It said that its leaving terms had not acted to prevent farmers from joining other milk groups and contracting directly with processors. Scottish Milk was unaware of any strength of feeling from its members on this matter. Its leaving terms reflected the costs it would incur if large numbers of producers resigned their membership at the same time. In particular, haulage costs would increase as either milk would need to be moved over longer distances, or Scottish Milk would be required to acquire milk from other sources. Most of Scottish Milk's contracts with its customers were for periods of 6 to 12 months or more. Reduced notice periods could be insufficient to deal with a substantial loss of members during the course of the contract. Scottish Milk did not accept that it could rely on *force majeure* clauses to reduce volumes of milk supplied in the event of the departure of a large number of members. It said that to do so would be highly undesirable in terms of customer relations.

Hypothetical recommendations

9.79. In commenting on our hypothetical recommendations (see Appendix 2.1), Scottish Milk said it did not accept that any adverse public interest issues arose on which remedies needed to be imposed. Remedies could be justified only if the market was found to be delivering milk at prices which were higher than would prevail in a competitive environment, either because inefficient operations had inflated the cost base or because suppliers were earning excessive margins. Scottish Milk had seen no such evidence—quite the contrary. Furthermore, in Scottish Milk's view, the imposition of remedies was not justified if there were proven market mechanisms which would remedy any adverse effects that might flow from the operation of the market.

9.80. In any event Scottish Milk believed that some of the remedies were directed at the wrong targets. It said that if any remedial action was considered necessary, it should be directed towards the scale monopolist in the market. If it were true that milk prices were higher than they would have been in a more competitive market, it could only be by virtue of the actions of the price leader. Once the leader's ability to set prices which were above a competitive level was removed, through appropriate structural or behavioural remedies, there was no action that could be taken by price followers, such as Scottish Milk, that could restore prices to supra-competitive levels.

Reform of Scottish Milk's selling system

9.81. Scottish Milk said that whatever selling system it adopted it would not be able to realize prices materially different from those of Milk Marque. Scottish Milk's customers were able to obtain the bulk of their requirements from direct supplies, or from Milk Marque. Scottish Milk's great concern was to avoid being a balancing supplier only. This problem would become acute if it were required to adopt a transparent selling system; the transparency would expose its vulnerability. Experience with its auction system had confirmed this fear; if Scottish Milk had not changed its system to one predominantly consisting of individually negotiated contracts, it would have been unable to continue trading.

9.82. Therefore, Scottish Milk told us, the suggestion that all four co-operatives might be required to sell their milk by auction would severely disadvantage Scottish Milk's members. Also, to require the four co-operatives to adopt such a selling system, when other milk groups in the country were free to adopt whatever selling system they considered appropriate, would discriminate against them. Scottish Milk said that the nature of the milk market in Great Britain was fundamentally different from the market in Northern Ireland and there was no reason to believe that the system used in Northern Ireland would work in Great Britain.

Reform of Milk Marque's selling system

9.83. Scottish Milk said that its experience of trying to operate an auction system had led it to have serious doubts as to whether the imposition of an auction system on Milk Marque would be equitable or sustainable. Milk Marque would instantly become a marginal supplier. The processors would ensure that their core demand was met by their own direct suppliers, or from other suppliers on long-term contracts. Scottish Milk believed that Milk Marque would be used solely as a source of augmenting supply. In periods of plentiful milk, processors would have little need to balance supply. Thus the volumes of milk at auction would be at their highest when auction demand was at its lowest. This would cause prices to collapse. Conversely, in periods of relative scarcity, prices would surge as top-up demand rose and auction volumes fell.

9.84. Also any exogenous changes in demand caused by an unexpected currency appreciation would, in Scottish Milk's view, impact solely on producers supplying Milk Marque. The dramatic swings in price caused by relative changes to supply and demand at auction would be most severe if the proportion of total milk volumes going through the auction was small. With only 40 to 50 per cent of total volumes at Milk Marque's disposal, it could be expected that there would be considerable volatility in the auction price which it would be able to achieve for its members. They would see greater volatility in their returns and this would make business planning far harder for Milk Marque's members than for producers supplying dairies direct.

9.85. Scottish Milk said that the small number of major buyers, who between them accounted for between 70 and 80 per cent of Milk Marque's potential market, already left Milk Marque vulnerable. This vulnerability would be increased in an auction system. The five major buyers would be able to bid strategically to secure prices which were lower than those which would be achieved in a genuinely competitive auction. These concerns were heightened since the buyers were also Milk Marque's (and the other three co-operatives') competitors for producers' milk. Processors, therefore, had an added incentive to see Milk Marque's members receive a low price to make it easier to tempt them away from Milk Marque and on to direct-supply agreements.

Scottish Milk's producer leaving terms

9.86. Scottish Milk said that its leaving terms for members were a means of securing more stability in its dealings with customers. Unlike processors, Scottish Milk had available to it only the milk supplied by its members; its commercial position would be undermined if it had to seek supplies of milk from third party organizations. There was no evidence to suggest that an alteration to the leaving terms was required to achieve a competitive market structure.

Structural reform

9.87. Scottish Milk said that if Milk Marque were to be divided into regional co-operatives, the newly-formed groups would be in danger of becoming marginal suppliers in their own areas, as would Scottish Milk. Moreover, any break-up proposal would constitute a serious infringement of individual producers' rights to form mutual organizations of their choice, a right enjoyed by producers elsewhere within the EC.

- *Constraints on amalgamation*

9.88. Scottish Milk said that if a structural remedy were to be adopted, it was not obvious why amalgamations between newly-formed co-operatives should be subject to more stringent limits than those imposed by the operation of UK merger control legislation. To impose additional constraints would severely limit the ability of the market to create an efficient structure. As a matter of principle, Scottish Milk believed that such intervention in normal competitive processes was undesirable.

Universal coverage

9.89. Scottish Milk did not accept that a remedy obliging it to accept members, even if it were appropriate to consider imposing such obligations on a co-operative in an unchallengeable dominant position, could appropriately be imposed on Scottish Milk. An obligation to take on all prospective members would cause Scottish Milk to be at a significant competitive disadvantage. An alternative might be for admissions to membership to be subject to some form of independent scrutiny to ensure that they met certain objective criteria, although to do so would impose a costly administrative burden which would discriminate against the four co-operatives.

Federation of Agricultural Co-operatives (UK) Ltd

9.90. The Federation of Agricultural Co-operatives (UK) Ltd (FAC) told us that it was the industry association representing farmer co-operatives throughout the UK. Its primary aim was to promote the success of competitive, well-structured, and commercially driven co-operatives in UK agriculture.

9.91. The FAC said that the development of farmer co-operatives in the UK had lagged behind other countries. In some other EC member states, and elsewhere in the world, co-operatives had developed steadily over the years in response to changing market circumstances. They were usually similar in size to processing companies and distributors.

9.92. Farming co-operatives in the UK were suffering from a severe financial downturn which stemmed largely from the strength of sterling. They were subject to competition from world markets greater than at any time since the 1930s. Very few of them had achieved a scale of business comparable to that of their processor and retailer customers. The FAC believed that well-structured and well-resourced co-operatives, managed on strong commercial lines so as to meet their customers' needs, would play an increasingly important part in the UK food chain.

9.93. The FAC said that quality specifications for milk were high. This required efficient management of milk distribution. Without strong co-operatives, farmers would be unable to meet consumers' quality and safety expectations.

9.94. The FAC believed there was a need for new investment in the dairy industry to modernize plant, establish higher quality standards and develop new products. Farmers should compete in downstream activities and secure a stake in the food chain. To do this, Milk Marque and other co-operatives should be engaged in processing. Their involvement was also of wider economic benefit to the UK and the well-being of rural communities. Any limitation in Milk Marque's activities, other than those agreed at the time of deregulation, would weaken the UK's competitiveness in the European market.

Other milk groups

A19, Eskdale and Tynedale Groups of Milk Producers

9.95. The A19, Eskdale and Tynedale Groups of Milk Producers (the groups) told us that together they had around 140 members and supplied approximately 70 million litres of milk exclusively to ACC.

9.96. The groups said that their members believed a strong Milk Marque, or a similar producer-owned organization, was vital for the future milk production industry. The farmer was not in a competitive position, but was dominated by the few large processors and retailers. It was not possible for producers, or a milk group, to dominate the market with a perishable commodity like milk.

9.97. In the view of the groups, no individual producer was able to provide a large processing company with the volume of milk or the service it required; neither was the producer able to negotiate fair terms for his or her product. This could be achieved only by producers grouping together to form a selling co-operative such as Milk Marque, or a vertically integrated co-operative (as in the EC and other parts of the world). Only in this way were a large number of small producers able to meet the requirements of the market, and redress the imbalance in their respective negotiating positions.

9.98. In the experience of the groups, the terms and conditions of direct-supply contracts were not negotiable but were dictated by processors. Prices were not agreed at the time contracts were signed, but when it suited the processors. The groups believed some processors had refused to enter into new contracts with producers other than Milk Marque leavers, and that these producers were paid additional payments to encourage them to leave Milk Marque. The groups believed processors behaved in this way to weaken Milk Marque so that processors could dictate the prices paid to all producers.

9.99. The groups said that much of processors' manufacturing plant was old and inefficient. Some plants had been closed since deregulation and there was insufficient capacity to clear the market. The groups believed this had resulted in a surplus in the market which undermined Milk Marque's selling system and forced milk prices down. In the groups' view, the conduct of the processing companies, by agreement or not, had created a complex monopoly situation. The balance of power had swung in favour of the processors: the groups did not believe it was not Milk Marque that was behaving in an unfair or monopolistic way.

9.100. The groups said that Milk Marque's prices were the benchmark for the rest of the industry. The 90 per cent threshold had allowed processors to manipulate prices, ensuring that the final round of bidding would be very close to the IMPE. This had resulted in British dairy farmers being among the lowest rewarded in Europe. The groups believed the IMPE calculation should be changed to take less account of the inefficiencies of dairy processors.

9.101. The groups told us that the fall in producer prices since 1997 had had a drastic effect on producers' profit margins but retail prices had not changed, and processors' profits had risen significantly. In the groups' view this was clear evidence that Milk Marque did not operate against the public interest; it was unable to manipulate an artificially high price level.

9.102. The groups believed further weakening of Milk Marque would damage the milk production industry considerably. It would not lead to a competitive and efficient industry but would restrict producers' ability to invest and develop. Ultimately such a weakening would impact adversely on related trades, the balance of payments, and the consumer.

Hypothetical recommendations

Reform of Milk Marque's selling system

9.103. With regard to the possible reform of Milk Marque's selling system, the groups said that they believed the existing system had two weaknesses. First, it was unsatisfactory for Milk Marque to invite bids at a price it proposed. It would be more acceptable for the buyer to bid at a price of its own choosing. Second, the time delay between bidding rounds was far too long, which in the groups' view enabled collusion and abuse among processors. The groups believed that both these faults could be corrected by replacing the system with another type of auction.

9.104. The groups fully endorsed a change to a falling clock auction system. They believed the advantage of such a system was that it had been tried and tested in Northern Ireland, apparently to the satisfaction of major buyers. It was also proof against abuse by either the seller or the purchaser. The groups believed Milk Marque should be allowed to operate a reformed selling system, subject to a regular independent audit (as happened in Northern Ireland). A selling system operated by a neutral party would, in the groups' view, only add to the expense and complication of the system and was not required.

9.105. The groups believed a reformed system should have complete transparency (subject to individual transactions remaining confidential). It was also essential for the system to be predictable and stable in operation and not subject to frequent changes. The market, including the spot market, should be fully cleared by the end of each auction. Milk should be auctioned on a delivered basis. Full traceability and quality assurance should be provided in respect of all the milk sold; and there should be no cap on floor prices imposed.

Structural reform

9.106. The groups strongly opposed Milk Marque being divided into smaller co-operatives. They told us that if a satisfactory and successful auction system were to be established, Milk Marque would find its own level in the market place alongside other quota-holding groups. Milk Marque's success would depend on the kind of service it gave, its efficiency, quality and other features valued by buyers.

Divestment of processing assets

9.107. The groups expressed complete opposition to Milk Marque being required to divest any of its processing or manufacturing subsidiaries. The groups said that the subsidiaries should be allowed to bid for milk supplies in the same way and on the same terms as all other buyers. MMD should be left as a wholly-owned subsidiary of Milk Marque in the same way as, in Northern Ireland, DQF was a wholly-owned subsidiary of United.

Producer leaving terms

9.108. The groups said that co-operatives selling milk on contracts lasting up to 12 months should have security of supply for the duration of those contracts. No milk producer was forced to join a particular milk group and the contract terms were a matter to be determined by the two parties.

Association of Dairy Farmer Groups

9.109. The Association of Dairy Farmer Groups (the Association) told us that it was a gathering of non-quota-holding milk groups covering producers selling to ACC, Lancashire Dairies, MD Foods, AWG and Wiseman.

9.110. The Association said that the rural community, including dairy farmers, was part of the public interest. Any imposed conditions which disadvantaged them might be to the long-term harm of the wider population. A large percentage of milk going into the manufacturing sector was, directly or indirectly, open to competition from abroad. This fact had been given in the near past as one of the main reasons for the decline in the milk price and therefore had to be considered as a major factor in determining prices. Producers were subject to legal and contractual conditions concerning the hygienic production of milk and the welfare of their stock which incurred considerable capital and ongoing costs. In the Association's view, these high standards were not always adopted by overseas competitors.

9.111. The Association believed that any system of bulk commodity selling was always likely to be open to abuse by the seller or the buyer. Modification of Milk Marque's present selling arrangements would not necessarily prevent abuse. Milk Marque, or any other seller, should be free to make selling arrangements with its customers as it saw fit. The Association thought that sufficient constraints within the market were already in place to prevent abuse by either party.

9.112. The Association believed strongly that MMD should be allowed to continue in its present form and without constraint on its activities. In the Association's view, any attempt by Milk Marque to manipulate internal milk prices by using MMD would be negated by the competition from abroad. Moreover, there were no constraints on other processors purchasing supplies far above their actual requirement and marketing the surplus milk to other processors. Secondary movement of milk between dairies was quite commonplace.

9.113. The Association believed that constraints on producers wishing to change their purchaser, such as financial penalties or restrictions on numbers leaving at a given point in time, should be removed. This would facilitate greater freedom of movement and remove what the Association thought was a justifiable claim that purchasers were artificially obstructed from increasing market share by restrictions beyond their control.

Express Milk Partnership

9.114. EMP (formerly Northern Milk Partnership) was formed at deregulation. The ownership of EMP is divided equally between Express Dairies and the partnership's producer members. EMP told us that its members' milk was sold to Express Dairies; EMP's membership comprised over 1,000 milk producers, supplying approximately 600 million litres a year; and its members' milk accounted for over one-half of Express Dairies' requirements. EMP said that it acted as a forum for discussions on all aspects of the relationship between Express Dairies and members of EMP, and issues such as quality standards were agreed by the EMP board. Express Dairies negotiated prices with producer representatives who were members of the EMP board.

9.115. EMP said that the main factor which would affect its business in the future would be the continued existence of Milk Marque as an unregulated dominant supplier of milk. EMP believed Milk Marque had continually abused its market power. Competition between EMP and Milk Marque was restricted and distorted, in EMP's view, by the leaving terms Milk Marque imposed on its members, which EMP believed were onerous. EMP told us that Milk Marque's practices prevented EMP providing independent competition to Milk Marque, restricted EMP's growth, and enabled Milk Marque to protect its high market share.

9.116. EMP believed that Milk Marque discriminated against smaller producers and this discrimination raised two substantive public interest issues. First, it enabled Milk Marque to pay higher prices to larger producers so as to deter them from switching to other milk groups, or engaging in direct supply. Second, it prevented smaller producers from competing with large producers, irrespective of their relative efficiency.

Hypothetical recommendations

Reform of Milk Marque's selling system

9.117. EMP said that its business aim was to achieve a fair and realistic milk price which was sustainable and in the interests of the future development of the dairy industry as a whole. It considered that a new selling system should be developed which delivered fair, transparent, and non-discriminatory prices. The details of such a system could be negotiated between Milk Marque and processors with the OFT approving the final system, which should not be open to manipulation by either Milk Marque or processors. As to whether the Northern Ireland selling system provided a good model for a fair market-clearing selling system, EMP believed there was an inherent conflict of interest if the main seller of milk was also a significant bidder into the auction system.

Structural reform

9.118. EMP commented on the suggestion that Milk Marque should be divided into a number of co-operatives, with the possibility that these co-operatives should have full discretion as to the design of their selling systems and the extent to which they engaged in dairy processing. EMP said that, owing to the existence of quotas, such a remedy would be ineffective if there were to be only a few co-operatives. In such circumstances, co-operatives' discretion as to the design of their selling systems, and the extent to which they were vertically integrated, was likely to raise appreciable competition concerns. In addition, such a remedy would not serve the interests of either producers or processors as the existence of a number of regional co-operatives would lead to the duplication of costs. Such additional costs would not raise the income of producers, but would raise the price of milk to processors, and ultimately to consumers. Accordingly, EMP did not favour the division of Milk Marque, but rather the introduction of more focused proportionate behavioural remedies which addressed directly the main adverse effects of Milk Marque's conduct.

Producer leaving terms

9.119. EMP believed that Milk Marque continued to protect its market share through the imposition of restrictive leaving terms on its producer members. EMP was in competition with Milk Marque for members and believed competition in this regard was restricted and distorted by the onerous leaving terms imposed on Milk Marque producers. EMP said that these terms should be relaxed.

Quality Milk Producers Ltd

9.120. QMP told us that it was a co-operative set up to market premium dairy products made from the milk of Jersey and Guernsey cows (Channel Island (CI) milk). QMP was financed by its members who sold their milk through Milk Marque and through royalties paid by processors for using QMP's registered trade marks, Breakfast Milk, Light Gold and Gold Top. QMP's main activities were research, advertising and promoting products made from CI milk, and managing its brands. At March 1998, 83 per cent of its members sold their milk through Milk Marque. QMP said that during the run-up to deregulation, it had pointed out to its members the advantages to them of trying to keep the pool of CI milk together so as to maximize availability and provide the opportunity for cost-effective marketing across the whole country.

9.121. Since deregulation, and in partnership with Milk Marque, sales of separately collected CI milk (on which processors paid a premium) had more than doubled. Because such a high proportion of

the available pool of CI milk was handled by Milk Marque, the product could be offered for sale to processors across the whole country. This enabled Milk Marque's customers to buy either Jersey or Guernsey milk on its own; and to experiment with, and develop, new products that added market value. High transport costs could be offset by using tankers for return loads of other products. Under the current selling system CI milk was available from Milk Marque under an Ex-farm Profile contract and on a fixed spot price. The process linked the price of CI milk to the market-clearing price achieved for all milk.

9.122. QMP said that CI milk was a specialist sector where smaller companies could start up in processing knowing that they could purchase milk. The current selling system lacked flexibility in negotiation. This hindered its ability, and that of Milk Marque, to supply customers cost-effectively with specified types of milk.

9.123. QMP told us that because milk was perishable, any surplus had to be processed quickly and effectively into storable products. It believed Milk Marque was good at collecting and transporting CI milk at the lowest cost and that this had only been achieved by keeping the majority of the CI milk pool within Milk Marque. QMP believed that Milk Marque's move into processing was necessary.

9.124. Commenting on our hypothetical recommendations, QMP said that a large number of its producers would be disadvantaged if Milk Marque was divided into a smaller number of bodies. CI milk was a specialist sector and its successful marketing depended on its being able to be collected and transported throughout England and Wales by one organization.

The English Guernsey Cattle Society

9.125. The English Guernsey Cattle Society (the Society), whose members, along with the Jersey members, constituted QMP, responded separately to our hypothetical recommendations. It said that any selling system should be straightforward and fair; neither side should be able to gain undue advantage. It would be against a neutral third party being involved as it believed the costs would inevitably be reflected in the milk price to producers (even if, in theory, both sides contributed).

9.126. In the Society's view it was essential for the efficient administration of the collection and delivery of CI milk that its members should be part of a nationwide handling organization, which was not only able to deliver the special milk to its customers but was also able to absorb any surplus into its general pool. Without this facility it would not be able to market CI milk separately on an economic basis. Therefore it considered that any attempt to break up Milk Marque would be near-disastrous. The Society was sure that MMD was a necessity if Milk Marque were not to be held to ransom by its large customers. On leaving terms for producers, the Society believed that for a co-operative to be successful it must have stability. If its members left the industry they should not pay financial penalties. But opportunist movements should be severely restricted.

Sorn Milk Ltd

9.127. Sorn Milk, a small quota-holding milk group in Scotland, told us that it had over 30 members producing approximately 16 million litres of milk a year. It imposed no size restrictions on its producers and recruited new members from within its milk field, in a 15-mile radius of its depot. Sorn Milk said that it could achieve a better price for milk for its members than Scottish Milk. Sorn Milk believed there was scope for more milk groups in Scotland; more groups trying to achieve the best possible prices would benefit producers and allow for healthy competition.

9.128. Sorn Milk did not think there was collusion between processors. It said that they did not bid against one another because they knew the price of milk would be lower the next day on the spot market if they delayed bidding. Sorn Milk believed Milk Marque should sell its milk by auction and be allowed to process any surplus. If it were to sell its milk by auction, the milk would go to the highest bidder in times of undersupply, and in times of surplus there would be a guaranteed sale of all the milk, thereby maximizing producers' returns and benefiting the consumer.

9.129. Sorn Milk said that it took into account the prices achieved by Milk Marque, Scottish Milk and direct suppliers when it negotiated with its customers. However, it was Milk Marque that set the benchmark. Sorn Milk tried to negotiate a premium by offering better-quality milk and service. Traceability of milk was important, and what the multiple retailers wanted. Sorn Milk was able to give assurances of full traceability—its customers knew which farm the milk came from every day.

9.130. Sorn Milk said that Scottish Milk's leaving terms for its members were onerous. They prevented more producers from leaving Scottish Milk and affected Sorn Milk's expansion plans. It believed that several of Scottish Milk's members wanted to join Sorn Milk but the leaving penalties stopped them from doing so. Any Sorn Milk member wishing to leave had to give only three months' notice with no penalty. It believed that producers should have complete freedom of choice to whom they sold their milk, based only on performance and price.

9.131. Sorn Milk believed that Milk Marque and Scottish Milk had vertically integrated to take milk out of the selling system. In this way processors would be forced into bidding and prices would be pushed up. But Sorn Milk was not critical of Milk Marque or Scottish Milk for doing this. It saw no reason why milk groups or producers should not be allowed entry into vertical integration if that was what they wanted. In a free market Sorn Milk believed they should have the choice of investing their money however they wished.

Southern Milk Producers

9.132. In its initial response to our invitation to comment on the inquiry, Southern Milk Producers told us that it was a group of Sussex dairy farmers that formed a division of Lewes Farmers Ltd. Express Dairies and Unigate were its only customers. In January 1999 Southern Milk Producers told us that it was in the process of forming a new quota-holding company, Southern Milk Ltd, which would become operational in April 1999. It had raised sufficient financial support from its members for the new venture. But its negotiations to find new sales of milk were proving arduous. Dairies with which it had been in contact had indicated that their preference would be for Southern Milk Ltd to enter into individual contracts with them, with the dairies holding the quota. Such an arrangement would involve the dairies paying a higher price than they would pay to Southern Milk Ltd as a wholesale supplier. One processing company had said that it was hesitant to trade with Southern Milk Ltd for fear of destabilizing a competitor. The similarity of the responses Southern Milk Producers had received from two of the dairies it had approached gave it cause to believe that the processors had spoken to each other about its plans.

9.133. Southern Milk Producers said that farmers had benefited temporarily from a rise in the price of milk when Milk Marque was set up. This was because processors were unsure about the availability of free market milk, and so outbid Milk Marque by competing for direct supplies. But in the latter half of 1998 producer prices and returns as a proportion of retail prices had fallen to lower levels than prices in the last days of the former MMBs. Members of Milk Marque were leaving to join smaller milk groups, or to sell directly to processors. Milk Marque was becoming an unsuccessful seller and weaker in the market place.

9.134. Southern Milk Producers had been dissatisfied with the 90 per cent threshold, because it said only one company needed to abstain from the bidding round for it to fail. Processors entered the bidding rounds in the knowledge that much of their milk requirement had already been satisfied through their contracts with other milk groups and direct suppliers. They had learned tactical methods of responding to Milk Marque's selling system, which meant that the volume taken up on the cheaper Residual contracts had increased from an initial figure of 5 per cent to nearly 70 per cent for the February 1998 bidding round. This residual price was now making the market for all producers.

9.135. Southern Milk Producers was concerned that mergers and rationalizations were greatly reducing the options open to farmers in the processing industry. In Southern Milk Producers' view, supermarkets had a strong influence on the choice of buyer for a processing company, particularly where the buyer was the major purchaser. Southern Milk Producers believed supermarkets were increasing their influence by moving their contracts with processors in consortium so that the

processor became dedicated to the one retailer; and that the proportion of the sale price being retained by processors and retail outlets was too high. Hence falls in milk purchasing costs were being withheld from the consumer.

Hypothetical recommendations

9.136. In response to our hypothetical recommendations, Southern Milk Producers said it was worried that solutions advanced late in 1998 might soon cease to be relevant because of the speed of change in the milk industry, both in Great Britain and internationally. It believed Agenda 2000, the reform of the CAP (see paragraph 3.58); the abolition of quotas; the World Trade Organisation (WTO); and the enlargement of the EC could all affect what happened.

9.137. Southern Milk Producers thought that to divide Milk Marque into regional co-operatives would deal with the problem of its dominance in the market. The co-operatives might be dominant in their own regions, but offsetting that there were processors and retailers that had unacceptably large local market shares. In addition, those members of Milk Marque who saw the need for a single equitable organization selling milk for farmers might lose faith in the fragmented business and leave it. On vertical integration, Southern Milk Producers said that, because milk was perishable and required immediate processing to extend its life and retain any value, a major vendor should be allowed to have some processing capacity as a safeguard against not finding buyers to clear the market of its milk.

9.138. Southern Milk Producers believed there was a need for equity in the milk industry. It told us that there was much to be said for the appointment of a regulator, in a market in which four or five processors were controlling the industry through a similar number of supermarkets. The need for a regulator would last for so long as there was imbalance, market forces were distorted and substantial public money was involved.

9.139. Southern Milk Producers believed that there were complex issues to be considered. Large amounts of public money were spent on the farming and dairy industry by both the UK Government and the EC. The transition from a regulated market to a free market coincided with rationalization of the processing and retailing of milk. The production of milk by dairy farmers was necessarily fragmented and there was public and EC concern that social, environmental and animal welfare considerations should conserve that fragmentation. Southern Milk Producers believed fragmentation could be synonymous with weakness in the market, whereas collective buying or selling, and the attendant umbrella organizations of buyers and sellers, could be monopolistic. It believed there was a need to explore new ways of establishing a free market selling system, with flexibility to accommodate change, as needed.

The Milk Group Ltd

9.140. The Milk Group, a large quota-holding milk group in Great Britain (see paragraph 4.154), told us that it had around 400 members supplying 300 million litres of milk in north-west England, the East Midlands and the Severn Vale. It held regional meetings with its producers at which information was exchanged and it was able to listen to their needs.

9.141. The Milk Group said that it believed a strong Milk Marque was needed and that it was good for the industry. If there was any further weakening of Milk Marque, there could be a further weakening of producer prices. The Milk Group believed that if the EWMMB had been split into regional milk groups at deregulation, and if these groups had then become strong, the current problems with the supply and sale of milk would not have occurred.

9.142. The Milk Group said that it believed it gave a fair return to its producer members. It, and Milk Marque, had greater market strength because they were quota-holders. Many other producer groups, even those bigger than The Milk Group, were tied by direct supply to one or more of the large processors. These groups were not in the same position to negotiate with their existing customers and might find it difficult to gain new ones.

9.143. The Milk Group believed that as the dominant seller in the market, Milk Marque had a strong influence on all UK milk prices. Its prices were important to all those trading in the milk market; Milk Marque set the 'tone'. The Milk Group regarded Milk Marque's prices as a reference point against which it and other references increased or reduced their prices depending on the service they provided, and the type and quality of milk they supplied.

9.144. The Milk Group said that it was disappointed that Milk Marque had not succeeded with its July 1998 selling process and that there had been an impasse between Milk Marque and the processors. The Milk Group had been unable to negotiate its prices for the autumn until Milk Marque's prices were agreed.

9.145. The Milk Group said that it negotiated contracts and prices individually with processors. Other than one customer which specifically asked to use Milk Marque's prices as a benchmark, there was no explicit reference to Milk Marque's prices in The Milk Group's contracts. Some processors paid for milk on a compositional basis, others on a flat rate basis; some would pay premiums for cell counts, others would pay a haulage bonus. The Milk Group said that of prime importance was the need to provide tailor-made contracts.

9.146. The Milk Group said that the major differences in its haulage arrangements compared with Milk Marque's were: that The Milk Group collected milk daily from farms; the farms were allocated to a specific processor for six months or more; haulage contracts ran for 6, 12 or more months; and some contracts were integrated with customers' own transport arrangements.

9.147. The Milk Group was pleased that Milk Marque had withdrawn its Residual contracts because they had been particularly damaging to The Milk Group's recently acquired subsidiary, Nene Valley (see paragraph 4.160). It had not had the capacity to take in 100,000 litres of milk per day and was therefore not eligible to purchase on Milk Marque's Residual contracts. At the same time, some of Nene Valley's larger competitors, which were in scope, had been able to buy milk at much lower prices.

9.148. The Milk Group said that the opportunity for regional vertically integrated co-operatives appeared to have been lost. Its impression in the past had been that the processing industry had not invested enough and that the UK needed more investment to make it a viable industry within Europe. The Milk Group intended to equip Nene Valley with the most modern machinery available. The greatest need for investment was in added-value products, although if quotas disappeared there would also be a need for additional bulk processing plant to cater for surplus milk.

Hypothetical recommendations

9.149. The Milk Group said that it was difficult to suggest an acceptable solution to the present problems of the milk market. Many factors would come into play in the future, the effects of which were at present unknown. They included the likelihood of quotas being abolished with the result that more milk would be released on to the market, the single European currency, and increased mobility of milk between EC member states. A break-up of Milk Marque into separate powerful regional selling groups was a potential solution.

United Milk Producers Ltd

9.150. UMP, a large non-quota-holding milk group, told us that it operated in central and southern England (see paragraph 4.165). It had about 440 members supplying over 500 million litres of milk. All its milk was supplied exclusively to Unigate and AWG.

9.151. In UMP's view, Milk Marque's prices would always be the benchmark for the industry, and would underpin the prices paid to direct suppliers. UMP's price negotiations with processors concentrated on variable elements of the contracts such as group bonus and haulage charges. UMP said that it competed with Milk Marque and other milk groups by adding value, for example through improving milk field density (ie maximizing the ratio between milk collected from farms and mileage travelled by tanker to pick it up), providing constituents which matched market requirements, encour-

aging the highest possible welfare standards by working with buyers on quality-assured milk schemes, and by being proactive in terms of contract development.

9.152. UMP said that it had a philosophy of encouraging its members to meet market requirements. Accordingly, it had worked with its buyers to develop contracts which made producers aware of what was required in terms of constituents and production profile. For example, in contracts it had exchanged with some major processors in 1998 it had incorporated payment structures that encouraged production of an ideal 'litre', or for providing level production.

9.153. UMP believed the 90 per cent threshold had been totally artificial and had interfered with the normal rules of supply and demand. In UMP's view such a threshold should not have been introduced into the bidding process. UMP believed, too, that the reality of the market, and not the IMPE, should have governed prices as most of the milk produced in Great Britain was for domestic consumption.

Hypothetical recommendations

9.154. In response to our hypothetical recommendations, UMP said that, provided Milk Marque's selling system was fair, transparent, stable and independently audited, it should be allowed to remain a single, vertically integrated producers' co-operative. UMP believed that Milk Marque's current selling system should be replaced by some other type of auction system such as a falling clock; and that Milk Marque should be allowed to continue to operate the system subject to regular independent audit to ensure impartiality.

9.155. UMP opposed the split of Milk Marque into smaller bodies. It believed Milk Marque should remain in its current unified form, so as to match the size and strength of producer co-operatives elsewhere in Europe. However, UMP favoured Milk Marque's leaving terms being amended to include the removal of financial penalties.

9.156. UMP said that Milk Marque should be allowed to continue its processing operations and expand its manufacturing interests, provided its selling system was reformed as UMP had described (in paragraph 9.154).

West Wales Milk Producers

9.157. West Wales Milk Producers (West Wales Group) told us that its membership consisted of around 100 producers supplying 50 million litres of milk chiefly to three large processing companies. It said that processors fixed the prices they paid to direct suppliers such as West Wales Group only after reference to Milk Marque prices. This was done in the belief that if processors could manipulate Milk Marque's prices, the whole pricing system would be under processors' control as it had been prior to deregulation. The market for liquid milk had fallen since deregulation and more milk was available to process. However, in West Wales Group's view, large processors did not want to buy at competitive prices because of their inefficient operations. Furthermore, West Wales Group noted that the drop in prices suffered by farmers had not been reflected in the retail price of dairy products. It believed that consideration should be given to appointing an industry regulator to control prices.

9.158. West Wales Group said that nearly every country in Europe, and many more elsewhere in the world, had vertically integrated producer co-operatives: neither milk prices nor the efficiency of processors suffered because of this. To impose restrictions on Milk Marque's processing or selling system, or on any other milk group, was not acceptable to West Wales Group and it believed any such measures should be resisted.

Small milk groups

9.159. We received 17 responses on matters relating to the inquiry from other smaller milk groups and farming co-operatives.

Market power

9.160. Only one of the other milk groups said that Milk Marque had a dominant position in the milk market. Seven groups believed Milk Marque's market share was weak and did not constitute a monopoly. Nine groups said that large processors held a dominant position, or that negotiating power in the market place was unfairly weighted in favour of them.

9.161. Some milk groups said that processors had used their market dominance to create a fall in milk prices. Also, processors appeared to have formed a cartel, or at the very least had collaborated, to abuse Milk Marque's selling system.

9.162. A view expressed by one milk group, and echoed by several others, was that individual dairy farmers were unable to operate on a sufficient scale to match the commercial demands of the big processors or retailers. The argument made was that well-structured and well-resourced marketing co-operatives were increasingly important in enabling producers to maintain commercial strength and meet customers' needs.

Prices

9.163. Thirteen milk groups said that the price of milk to producers was too low. Eight groups said that retail prices were too high; they believed this had been reflected in the high profit margins declared by the large processors and supermarkets.

9.164. A widespread concern among the groups was that, if sterling remained strong against other EC currencies and Milk Marque's position remained weak, milk prices would remain low. There was a fear that some producers would be forced to leave the industry. A commonly expressed view was that prices had fallen to such a level that members' livelihoods were in danger. Rural communities would also be adversely affected.

Milk Marque's selling system

9.165. Four milk groups were critical of Milk Marque's selling system; 13 groups believed processors had exploited it. There was general agreement that the assurances Milk Marque had given to the OFT, and in particular the 90 per cent threshold, had done nothing to improve the system and had not benefited producers. Two groups said that any further attempts to regulate Milk Marque's activities (its selling arrangements or its entry into vertical integration) would jeopardize the long-term future of the UK dairy industry.

9.166. Several milk groups said that although for the most part Milk Marque's prices were used as a benchmark, Milk Marque's influence on the rest of the industry was not against the public interest. One group said that it supplied a processor which had declared that its prices were not directly linked to those of Milk Marque. But the processor continued to use Milk Marque's prices as a benchmark for its own contracts despite its requirement for additional farm assurances on quality, which involved producers upgrading and improving their facilities at some cost to them.

Hypothetical recommendations

9.167. Nine of these smaller milk groups responded to our hypothetical recommendations.

Reform of Milk Marque's selling system

9.168. Eight milk groups commented on the recommendation that Milk Marque's selling system should be reformed. Only one group was not in favour of some kind of reform. One group said that it would be difficult to devise a selling system that would be free from the potential for abuse or

manipulation. It believed it would probably be best to let Milk Marque devise its own system without the involvement of processors. The group further commented that processors did not want a Milk Marque selling system and seemed intent on destroying the co-operative system. Another group said that Milk Marque and the dairy industry should try to agree a system between themselves without MMC or OFT interference. Three groups said that a reformed selling system should not be in the control of an independent neutral third party, but that Milk Marque should be allowed to operate it, subject to regular independent audits. One group said that there needed to be a change to a more open and fair system: a straightforward auction with no 90 per cent threshold or link to the IMPE would be appropriate.

9.169. Two milk groups believed that the opportunity should be taken to devise a new system which Milk Marque would not operate. The first group suggested an independently run milk exchange transacting spot and forward sales, using open outcry or a Dutch auction system. This would create a new index for Great Britain milk prices completely separate from Milk Marque, and would enable market forces to prevail and transparency to be restored. The second group said that the bureaucracy associated with audits and checks would make an 'in-house' system too expensive. In an open auction all milk would be made available for sale and there would be no floor price.

9.170. Three milk groups said that in a reformed selling system there should be full market clearance (and no cap or floor price controls). One group said that full market clearance would mean that it was essential for Milk Marque to have processing capacity. Another group commented on the reform of Milk Marque's delivery system. It believed transport charges, and any changes to the delivery system, were a matter of negotiation between Milk Marque and its customers. Another said that Milk Marque should remove restrictions on the diversion of milk.

Structural reform

9.171. Nine milk groups commented on whether Milk Marque should be divided into smaller bodies. There was universal opposition to the proposal. The nine groups said that dividing Milk Marque would weaken it and give more negotiating and market power to the large processors. They believed this imbalance would continue to disadvantage producers: interference in Milk Marque's structure was unnecessary unless similar action was to be taken against large processors and supermarket chains.

9.172. One milk group said that if structural reform was effected, the financial security of producers would be put at risk. If they did not get a realistic price for their milk they would be unable to invest in new equipment to meet the increasing demands of buyers. Also, the division of Milk Marque would add to the cost of administration, a cost producers would have to meet and which would be of no benefit to the consumer. Another group said that a structural remedy meant that many producers would leave. This would result in processors being oversupplied from direct sources and would create problems for other milk and producer groups.

9.173. A common view was that there were already too many small groups, contrary to what was happening in the rest of the EC. If fragmentation of the industry in Great Britain continued, the argument ran that it was inevitable that amalgamation would be necessary eventually. If new regional groups developed naturally it would be accepted by the milk industry, but a structural reform to Milk Marque was not required and should not be imposed.

Divestment of processing assets

9.174. All nine responding milk groups were against the proposal that Milk Marque should be required to divest Aeron Valley and any other processing assets. The consensus was that it was essential that Milk Marque should be allowed to retain and develop its processing capacity on the grounds that it was needed to absorb surpluses and fluctuations in supply. Most groups said that if Milk Marque could not find sufficient buyers to clear the market, it needed some processing capacity as a safety net. One group commented in particular that if MMD was an independent company with externally audited accounts, it should be allowed to compete for milk in the same way as other

processors. Another group said that Milk Marque should be allowed some processing facilities in preparation for the abolition of quotas.

Producer leaving terms

9.175. Four milk groups commented on the recommendation that the successor co-operatives to the MMBs should amend their producer leaving terms. All were in favour of such reform, stating that there should be free movement of producers without penalty: penalties, fines or lost bonuses should be abolished. One group said that a relaxation of Milk Marque's leaving terms would result in more producers being willing to join Milk Marque and increase competition. Another group said that the removal of restrictive producer leaving terms should also apply to direct-supply producers.

Producers' representatives

Farmers' Union of Wales

9.176. The Farmers' Union of Wales (FUW) said that it was founded in 1955 by a group of farmers who were dissatisfied with the existing producer organizations. Its aim was to provide the farmers of Wales with their own independent body to promote and safeguard their interests. In 1977 the FUW had been officially recognized by the Government and was now formally consulted on all issues relevant to the agricultural industry in Wales.

The milk industry in Wales

9.177. The FUW said that milk production was critically important to Welsh agriculture and underpinned much of the rural economy. It generated over 30 per cent of the agricultural gross domestic product of Wales. Because of its terrain, climate and farm structure Wales was predominantly a livestock-producing area; the scope for viable alternative farming was limited. The dairy sector was more important in Welsh farming than in most other farming areas of the UK.

9.178. It was important to Welsh milk producers that there was strong consumer demand for milk and dairy products and that the Welsh dairy industry could respond to that demand. The FUW said that dairy farmers would be able to meet the challenges of future markets only through adding value to the raw commodity. The FUW was concerned that financial pressures would lead to an exodus of Welsh milk producers from the industry. This would have major repercussions for an area reliant on milk production.

9.179. Deregulation had exposed the industry to competition and free market forces but, in the FUW's view, had offered no safeguards for producers who were remote from the market place, and whose costs were influenced by physical and climatic constraints. Deregulation, the reduction in cull cow/calf values brought about by the BSE crisis and the effect of green pound revaluations on the IMPE prices had particularly affected small-scale dairy farmers in Wales. They were dependent on the success of co-operative selling.

9.180. The FUW said that there was consensus within the industry that producers should emulate co-operatives in other EC member states to meet the challenges of the global dairy market. The FUW had believed from deregulation that a vertically integrated co-operative would be in the best interests of producers and consumers. The FUW had supported the formation of Milk Marque, which its members had believed would provide an assured purchaser as an alternative to processing companies which were interested only in suppliers close to their plants. Milk Marque was the only organization that would collect milk from all dairy farms irrespective of herd size or location.

Prices

9.181. The FUW said that the fall in milk prices in recent years represented a huge loss of producers' income and had occurred at a time when the profits of major processors had increased. There had not been a similar fall in retail milk prices in the same period. The viability of many dairy farmers in Wales was threatened. The FUW's members did not understand the accusations that Milk Marque was keeping prices too high.

9.182. The FUW was concerned about the DIF's adverse reaction to the changes Milk Marque had tried to introduce in the summer 1998 selling process. The FUW said that producers should be given the freedom, through their co-operatives, to set a fair market price for milk. Milk Marque's proposed changes would have helped to develop a sustainable position for producers.

Processors' capacity and alleged inefficiency

9.183. The FUW said that since deregulation the liquid milk market had declined and this required more milk to be processed into butter, powder and cheese. However, processing capacity had been reduced during the same period. For the UK industry to compete with the highly efficient farmer-owned European co-operatives and meet increased competition in world markets, investment in quality processing capacity was essential. The FUW believed that UK plants were less efficient than their Continental competitors and that producers were, in effect, subsidizing this inefficiency. Processors' investment represented little more than upgrading existing capacity, whilst producers in other EC member states, through their dairy co-operatives, were investing for the long term in efficient, high-quality manufacturing plant. Welsh dairy farmers, through Milk Marque, should be given the same opportunity to invest in processing in the interests of both producers and the wider rural economy.

Hypothetical recommendations

9.184. The FUW said that many of its members were profoundly disappointed at the apparent reluctance of the MMC to address issues other than Milk Marque, the only organization which was committed to the collection of milk from all producers, irrespective of herd size or location. The FUW believed that the MMC's public interest findings should concentrate primarily on the differences between the prices paid to producers and retail prices.

Reform of Milk Marque's selling system

9.185. On the reform of Milk Marque's selling system, the FUW said it fully accepted that the system needed to be fair to both the buyer and seller. Banks and other lending institutions were unlikely to fund manufacturing capacity unless there was some form of assurance that raw material supplies would not be subject to fluctuations in price and volume. The selling system should provide security for buyer and seller, and maintain the full confidence of both parties. As a perishable product, milk was much less suited to an auction selling system than other commodities where time was not such an imperative. The Dutch flower industry operated one of the few auction systems which operated for a product with a limited shelf-life. However, it had a fall-back reserve price. The FUW believed a similar floor price had to be established as a prerequisite of any auction system for milk.

9.186. The FUW was concerned that an auction system might not satisfy small customers, many of whom were totally dependent on Milk Marque for the low volumes of milk they purchased. It was questionable whether an auction system would benefit them given the added uncertainty and price volatility that would be associated with this type of selling system.

9.187. Over the past four years Milk Marque had developed a selling system which had ensured a market for all its members' milk. Whilst the FUW believed it was not perfect, it was not convinced that there was a procedure which would satisfy the demands of buyers and sellers better. During this period, producers had become increasingly aware of the greater efficiency which existed within the

European dairy co-operative structure and the higher processing margins which had been demanded by the dairy industry in Great Britain for the manufacture of milk into butter and SMP. Any selling system would need to recognize these deficiencies and allow the sale of milk to external markets in circumstances where the domestic industry proved uncompetitive. The system should also give producers and processors sufficient confidence to invest for the future, and allow buyers and sellers to work closely together.

Transport

9.188. The FUW said it had long been concerned that processors were seeking to operate their own collection systems from Milk Marque members. Such a step would severely undermine the efficiency of Milk Marque's collection system and was an attempt to undermine it by establishing a company presence on-farm. Decisions over the efficiency of transport operations should be left to Milk Marque members who, inevitably, would secure the most cost-effective and efficient means of milk collection.

Structural reform

9.189. The FUW viewed the proposal to divide Milk Marque into a number of smaller bodies as a backward step which would provide little benefit for producers, processors or consumers. It said that Milk Marque offered a highly efficient service to the FUW's members and played a vital role in supplying small, medium-scale and even large-scale milk buyers who had not established their own supply chain. Regional differences in milk production were evened out through the operation of a national co-operative thereby ensuring a stability in supply which would not be a feature of regional co-operatives.

9.190. The enforced break-up of Milk Marque into regional co-operatives could lead to regional pricing systems and would be particularly damaging to those producers who were furthest from the market place. The FUW believed that other producer groups should be encouraged, but that no restrictions should be placed on the operation of Milk Marque as a national co-operative. It should be afforded the same freedom as its Continental counterparts. Through Milk Marque, producers were able to negotiate fair prices with large, multinational processors.

9.191. In the FUW's view, structural reform as envisaged would result in a highly regulated market place since farmers would have to be prevented by law from re-forming themselves into a national co-operative. This would inevitably result in conflict and would do little to prepare the industry for the challenge of competing in Europe and further afield into the next millennium.

Divestment of processing assets

9.192. On whether Milk Marque should divest itself of Aeron Valley and of any other processing assets, the FUW said that farmers had to maintain the right to enter into profitable processing. They were investing in their long-term future when establishing high-quality manufacturing plants. Improvements in processing efficiency that were derived from investment of this nature would ultimately work in the public interest since such efficiencies would be reflected in the quality and price of the end-product. Dairy farmers in Wales, through their co-operative structures, should also be able to invest in future processing and develop the Welsh food strategy in the interests of both producers and the wider rural economy.

Producer leaving terms

9.193. The FUW said that Milk Marque's leaving terms were some of the most liberal in the EC. The FUW had no fundamental objection to a reassessment of leaving terms, but care should be taken to ensure that any proposals did not undermine continuity of supply.

Holstein Friesian Society of Great Britain and Ireland

9.194. The Holstein Friesian Society of Great Britain and Ireland (HFS) (which on 1 January 1999 merged with the British Holstein Society to form Holstein, UK & Ireland) told us that it had over 13,000 pedigree herd members in the UK and the Republic of Ireland and was the dominant dairy breed society in the British Isles. Its milk represented 96 per cent of total UK milk production. The HFS said that its size, absence of vested interests, and financial independence enabled it to advise its members, and many other agri-related organizations, on issues pertaining to the industry (and not solely on dairy breeding aspects).

9.195. The HFS said that dairy farmers were being forced out of business by the present level of milk prices. If the current losses continued unchecked over the next five to seven years, there would be a danger of insufficient milk when the EC's milk quota regime disappeared. This could even result in the importation of fresh milk into the UK from other EC member states.

9.196. The HFS subscribed to the view that, in reality, both sides of the milk procurement industry were interdependent. In late 1997 and early 1998, the HFS had organized individual 'confidential forums' with the major processors, three of the UK successor bodies to MMBs, and the DIF. The HFS was shocked by the open antagonism of the processors to Milk Marque. The HFS strongly believed that, rather than engaging in negative, time-consuming, internecine disputes, Milk Marque, producers and processors should be working together to address the issues which the dairy industry faced. The real need was to positively and proactively market and promote the image and sales of milk and dairy products, neutralize the excessive buying power of the five national multiple processing companies and leading supermarket chains, and add value to production by product modification, diversification and, especially, new product development.

Hypothetical recommendations

9.197. The HFS said that the deregulated, free market environment had not resulted in the expected improvements in milk selling arrangements, especially in England and Wales. However, Milk Marque's selling price set the floor price for milk, and hence had wider implications. Furthermore, despite public utterances and posturing to the contrary, producers were interested in security of payment as much as they were concerned about the milk price. Also, processors were committed to the security of their milk supply rather than the narrow perspective of the buying price (a fact reinforced by the consideration that buyers were paying a premium for directly purchased supplies).

9.198. Rather than imposing a selling system on Milk Marque involving either an independent audit or a neutral third party, the HFS believed it would be much better if Milk Marque and the processors could agree on a mutually satisfactory selling system, based on trust and goodwill which took into full account the requirements and reservations of both sides. If this were a non-starter, then there were existing auction system models working to the mutual satisfaction of sellers and buyers in Northern Ireland and Scotland which could be adopted in England and Wales.

9.199. The HFS was concerned that a remedy for structural change was still being discussed seriously as a realistic option for Milk Marque four years on from vesting day. As a major milk procurement and selling co-operative, Milk Marque required economies of scale to compete on equal terms

with both dominant processors and retailers and to provide a better service for its customers. The MMC referral had increased producer support for Milk Marque.

9.200. The HFS considered that in a completely deregulated free market, all sectors of the industry should be equally free to function commercially. If processors could attain efficiencies and economies of scale through mergers, the same opportunities should be given to milk producers, especially if they decided of their own choice to work together co-operatively and collaboratively, thereby minimizing the individual producer's weakness.

9.201. The HFS said that it could not support a remedy to divest Milk Marque's processing assets. Milk Marque acting on behalf of, and with the full support of, its members should be able to expand its manufacturing activities in a similar manner to processors and EC co-operatives. An even more pertinent justification already existed within the UK through DQF in Northern Ireland, which did not appear to attract adverse comment from the competition authorities, or processors. This could be because United operated a mutually acceptable falling clock auction system. This endorsed the HFS's call for both sides of the industry in England and Wales mutually to evolve an acceptable milk selling system.

9.202. The HFS strongly believed that leaving terms for Milk Marque's members were a commercial matter solely for Milk Marque and its members to determine.

National Farmers' Union of England and Wales

9.203. The NFU told us that it represented approximately 80 per cent of the milk producers in England and Wales, and was funded by voluntary subscriptions from farmer members.

9.204. The NFU said that farmers were facing great hardship and an uncertain future as the strength of sterling and weak market demand forced milk prices down to the EC support level. The NFU strongly supported vertically integrated producer co-operatives as a means of equalizing the market power of a highly concentrated milk processing sector.

Market power

9.205. The NFU said the fact that Milk Marque had sold milk at the IMPE was evidence that it did not exercise monopoly power. Since deregulation an increasing number of milk producers had left Milk Marque and sold directly to processors, or had joined other co-operatives. This showed that there was no anti-competitive behaviour by Milk Marque.

9.206. In contrast, the NFU believed milk processors in the UK constituted a complex monopoly situation which was damaging to the interests of producers and consumers. By exploiting the weaknesses in Milk Marque's selling system, particularly when the 90 per cent threshold was in operation, processors had prevented and distorted competition. The NFU did not believe they colluded but that their collective behaviour depressed producer prices to a level which was lower than it would be in a free competitive market. The NFU concluded that it was processors that engaged in uncompetitive practices, not Milk Marque.

Milk Marque's selling system

9.207. The NFU said that Milk Marque's selling system should be judged by two criteria: the ability to provide prices that were stable, and prices with a premium above the IMPE. The premium was justified by the fact that the UK was a deficit milk region of Europe, and restricted by quota to produce only 85 per cent of domestic demand. The current selling system had failed the first criterion and the NFU did not believe the premiums of previous years could be regained in the short or medium term. It believed the Milk Marque selling system should be critically reviewed.

9.208. The NFU supported the abolition of the 90 per cent threshold, which it said had been superficially attractive but fundamentally flawed. Because of the threshold, processors had bought milk

from Milk Marque on its cheaper Fluctuating or Residual contracts. This had exacerbated the downward pressures on producer prices with the end result that they were lower than they should have been.

9.209. The NFU believed it was vitally important for all those in the industry to have confidence in the mechanism for setting prices. This had not been the case for some years. Instability in prices was not in the industry's long-term interest. It needed a fair, transparent and market responsive price-setting system which would produce more stable prices.

9.210. There were various ways in which the NFU believed this could be achieved. For example, the selling system adopted by United in Northern Ireland contained interesting elements which could be considered; similarly, the new US system, with its use of futures markets. Whichever system was introduced it should adopt principles including:

- (a) a fair market-related price for milk;
- (b) security for producers and processors to confidently plan and invest for the future;
- (c) sufficient flexibility to allow prices to respond quickly and efficiently to market circumstances;
- (d) equal access and opportunity to purchase milk for all customers;
- (e) a fair allocation of milk for all customers;
- (f) everyday market clearance;
- (g) compliance with UK and EC competition legislation; and
- (h) provision for the IMPE to be accommodated within the system.

Prices

9.211. The NFU said that milk prices had been particularly volatile since deregulation, partly because of the increased strength of sterling, but more directly because of the effects of the CAP and the green pound. Another factor was the delay between the immediate effect of foreign exchange movements on the IMPE, and its effect on UK milk prices. Other causes included the changing demand for dairy products, the pricing behaviour of the MMBs in the run-up to deregulation, and the bidding behaviour of processors since then. In the first two years following deregulation producers had benefited from relatively high milk prices and increased demand from processors. By 1998 prices had fallen considerably, and by more than was justified.

9.212. In the NFU's view it was important to separate the effects of currency movements from the changes in UK milk prices. It was inappropriate for them to be driven downwards by the foreign exchange rate to the extent to which they had been, particularly as over one-half of milk produced in the UK was consumed as liquid milk.

9.213. The NFU told us that when producers' prices were compared with the target price it could be seen that UK farm gate milk prices fell short of the target price and the differential had fluctuated considerably since deregulation. The NFU believed the proportion of the target price that producers in the UK received was not acceptable.

The need for vertical integration

9.214. The NFU said that producers had made substantial investments in the efficient production of milk but were increasingly alarmed by the failure of processors to improve the competitiveness of their sector of the industry. The interests of consumers and producers would be best served by

increased investment in world-class plant and equipment. The dairy industry should be allowed to develop in the international market. It needed to compete in world export markets and defend the domestic market against imports.

9.215. The NFU welcomed the interest being shown by Milk Marque in processing and believed it should be allowed entry into vertical integration, completely independently from its role in selling milk. Vertical integration would improve price stability in the market and ensure the long-term security of producers.

Hypothetical recommendations

9.216. In responding to our hypothetical recommendations the NFU said that it would be difficult to argue that no reform of the milk market was required, given the parlous state of dairy farm incomes, and the continued tensions between Milk Marque and the main processors. The NFU believed a system was needed in which all parties had confidence. It was firmly of the view that fundamental reform remained critical to the long-term prosperity of all parties in the dairy supply chain.

9.217. The NFU believed that the MMC's recommendations should ensure that the milk market was able to develop to allow producer-owned co-operative processors to compete on a more equal basis with privately-owned processors. The interests of milk producers were dependent on the development of efficient, internationally competitive dairy processing capacity.

9.218. In the NFU's view, a large unified Milk Marque, actively engaged in processing, would be in the interests of consumers, other processors and producers, and would benefit the wider economy. Additional processing capacity owned and operated by Milk Marque would enhance competition among processors. It would also serve to help address the balance of payments deficit in dairy products, most notably in cheese.

Reform of Milk Marque's selling system

9.219. The NFU said that whilst it did not concede that Milk Marque's actions were anti-competitive, to ensure that Milk Marque could continue as a unified body able to process milk, producers would accept major changes to the selling system.

9.220. The two elements of milk selling were: the nature of any new system and who would operate it. The NFU did not advocate any preference. Rather it reaffirmed its belief that the best way forward was for the two sides of the industry jointly to develop a new selling system. As each of them was dissatisfied with the existing system, both had a clear incentive to reach a speedy solution. The NFU noted that all the complaints about Milk Marque had been about the selling system itself, not who operated it.

9.221. The NFU proposed that all interested parties should be invited to join a working group, perhaps under the chairmanship of a DTI or OFT official, to devise a new selling system that met the concerns and interests of all concerned. Such a system, to which all parties would have commitment, should provide the confidence processors needed to accept Milk Marque's involvement in processing.

9.222. The NFU did not underestimate or disregard the administrative, legal and commercial difficulties that would be avoided if Milk Marque continued to operate the selling system. Nor did the NFU wish to see new layers of bureaucracy and costs introduced. However, if the working group charged with developing a new selling system were to conclude that it should be operated by a neutral third party, the NFU would co-operate in considering how this might be achieved.

Structural reform

9.223. On the possible recommendation that Milk Marque should be divided into a number of smaller co-operatives, the NFU said that the outcome of any such move would be that smaller regional

groups would not be as well capitalized or efficient as a united co-operative; international competitiveness would be undermined. Also, smaller groups would have fewer resources available for product development.

9.224. The NFU said that most dairy co-operatives in Europe and throughout the world were larger than Milk Marque, and the international trend was for them to get bigger. The future of British dairy farmers was dependent on the availability of internationally competitive dairy processing capacity to utilize their milk but it was widely acknowledged that UK processing capacity was not among the most efficient in Europe. This concerned milk producers, who wished to ensure that adequate, efficient, internationally competitive processing capacity was in place should EC quotas be abolished. The break-up of Milk Marque into a number of small, poorly capitalized co-operatives would act against this aim.

9.225. Producers sold their product into two distinct yet closely linked markets: the bulk commodity market and the value-added product market. The NFU said that it was questionable whether smaller milk co-operatives could perform as well in those two markets as a large, unified Milk Marque could.

9.226. The NFU said that the UK might have sufficient capacity to supply the internal market but this capacity was not competitive with the new overseas plants that aimed to supply export markets. Commodity products competed almost entirely on price, and the large-scale, most efficient plants, normally delivered the lowest price. The NFU believed that the capital and throughput requirements of this scale of plant required a processor with a larger market share than 25 per cent. If quotas were abolished, or if additional quota were made available in the UK, it would be even more vital that world-scale processing capacity be in place. The NFU did not see how smaller co-operatives could be competitive.

9.227. The NFU did not believe that large-scale companies were slower moving and less in touch with their customers than smaller ones. It said that there was ample evidence, both within the dairy industry and elsewhere, that big companies could be just as market-responsive and innovative as small ones. The product development history of major EC producers and the New Zealand Dairy Board provided excellent examples. Large-scale dairy companies were essential for success in the commodity market and they could also perform well in the value-added market. Smaller companies might perform well in this market too, but there was no evidence that they could compete successfully in world commodity markets. The only way in which they could participate, in the NFU's view, would be to amalgamate their operations. But then they would attract the same concerns from the competition authorities as a larger company.

National Farmers' Union of Scotland

9.228. The National Farmers' Union of Scotland (NFUS) told us that it represented approximately 75 per cent of milk producers in Scotland. It said that the viability of many dairy farms in Scotland was very fragile and producers were currently under severe financial pressure.

9.229. The NFUS said that most producers had committed themselves to co-operative selling as the best means of achieving balance in the market. Grouping together gave them strength to overcome the disadvantages of the small scale of their businesses relative to the larger and stronger processing companies and the major retailers, which now dominated the liquid milk market.

9.230. The NFUS believed processors' increasing use of direct suppliers had resulted in milk prices being depressed, despite the premiums direct suppliers received. By creating their own regional milk pools, large processing companies had placed an increasing strain on the co-operatives' commitment to serve all producers equally. It had become increasingly difficult for some producers to seek customers further afield, and spread their additional transport costs over a larger volume of sales. This was particularly relevant to those in relatively isolated areas, such as the North and West of Scotland.

Selling systems and prices

9.231. The NFUS said that co-operatives had tried to find a system for selling milk which would give fair and sustainable prices. But they had failed. The result was the current financial crisis facing the dairy industry. Producer prices had been eroded at a time when retail prices for milk and milk products had remained firm, and the profitability of processors was increasing. Producers' confidence in the price-setting mechanism for their milk was at a low ebb.

9.232. The NFUS told us it was widely recognized that Milk Marque's selling prices were the benchmark used by producers and processors throughout Great Britain to set prices. The success or failure of Milk Marque's selling system and prices was the focus of attention for producers in Scotland.

9.233. The NFUS had been particularly concerned about the effect the 90 per cent threshold had had on prices. Adherence to the threshold had meant that control of the selling system was in the hands of a few purchasers. It had not provided for a fair, market-related price.

9.234. Before deregulation, the higher-priced milk destined for the liquid milk and other fresh products market had accounted for a greater proportion of Scotland's milk sales than it had in England and Wales. Consequently, producers in Scotland had received higher net prices compared with the rest of Great Britain. Since deregulation, prices in Scotland had converged with those in England and Wales, and in recent years had fallen. The biggest single influence on the fall in prices had been the value of sterling. Processors were now exposed to increased competition from overseas and this restricted the price they could offer for milk.

9.235. The NFUS believed that the increased dominant position of multiple retailers had allowed them to exploit producers' weakness in the market place, and had contributed to the downward pressure on prices. At the same time as supermarkets' share of the liquid milk market had increased, the processing industry had contracted into a smaller number of larger processors capable of meeting the supermarkets' stringent requirements. The prices offered by the multiple retailers were paramount. Their objective was to gain market share of the liquid milk market at the expense of local retailers and doorstep deliveries.

The need for vertical integration

9.236. The NFUS said that processing in some of the other member states of the EC had been rationalized and restructured through mergers and acquisitions. Companies, including farmer-owned businesses, had increased the scale of their operations and had developed a wider range of products for their domestic customers, as well as for export.

9.237. In the UK too, processing had been restructured but efficiency and product innovation had lagged behind. The industry needed to do more to compete directly with imports, develop exports, and expand existing markets. A better total return from each litre of milk produced was needed. To achieve this processors should engage in the manufacture of high-quality, high value-added products.

9.238. The NFUS said that there was an increasing need for producer groups to become actively involved in milk processing to stabilize falling milk prices. Producers needed outlets for their milk. Any which could not be sold at a reasonable price in the liquid milk market had to be processed into other dairy products needed by the consumer. The NFUS supported moves by the Scottish-based co-operatives to become involved in milk processing to secure a future for the industry.

Hypothetical recommendations

Reform of Scottish Milk's selling system

9.239. The NFUS did not believe it was necessary or desirable to change Scottish Milk's selling system. It had evolved through Scottish Milk meeting individual customers' requirements and the NFUS believed it operated successfully. The reintroduction of an auction system for a greater part of the milk sold by Scottish Milk could have serious repercussions for producer prices in Scotland, where there was one dominant buyer.

Reform of Milk Marque's selling system

9.240. On whether Milk Marque's selling system should be reformed, the NFUS said that consumers needed the security of a reliable and regular supply of milk. To achieve this objective a selling system should be devised which could not be manipulated by either purchaser or seller to the disadvantage of the other. A satisfactory agreement between processors and Milk Marque was critical to Scottish farmers. Milk Marque and its customers should be left to devise an equitable system which gave fair returns to producers, and also offered fair trading conditions to processors and consumers.

9.241. The NFUS did not believe that transferring Milk Marque's selling system to a neutral party would guarantee freedom from abuse; prices achieved through most auction systems could be influenced if buyers had the ability to collude. In the NFUS's view, the smaller the number of buyers, the greater the possibility of collusion: any alternative to Milk Marque's selling system should ensure that buyers were unable to act together to influence the milk price. The key to a successful system was the rules governing it. The introduction of a neutral party would impose an additional link in the chain between producer and consumer at an extra cost which would not be in anyone's interest. The NFUS said that it was difficult to envisage an unregulated auction with adequate safeguards to protect the seller. However, it believed if Milk Marque's selling system were to be reformed, it should include a floor price. A system without a floor price would contravene the CAP objective of ensuring a fair return for producers.

9.242. The NFUS believed that if full transparency were a formal objective of any reformed selling system, this should not only be applicable to co-operatives but to other producer groups, processors and retailers. If Milk Marque were forced to declare the prices it achieved from each of its customers, vital information would be available to any party wishing to avoid fair competition.

Structural reform

9.243. The NFUS was strongly opposed to any recommendation which would withdraw the right of producers to choose who they supplied, including a forced division of Milk Marque. The NFUS believed that the existence and further development of co-operative organizations such as Milk Marque were essential if the industry was to remain a credible force within the EC.

9.244. If Milk Marque were to be broken up, however, the NFUS believed there should be no constraints placed on amalgamations between milk groups. Restricting the size of co-operatives would lead to increased costs, reduced efficiency and inevitably lower producer prices. It would become increasingly difficult for smaller co-operatives to achieve a viable customer base and to spread transport costs in the way larger groups could. Processors would be given a distinct advantage in the market place; smaller co-operatives would have far weaker negotiating strength.

Universal coverage

9.245. The NFUS believed that Scottish Milk, AMCO and Claymore should have the freedom to decide whether or not applicants for membership were acceptable. Decisions should be reached on the grounds of objective criteria, for example location, level of efficiency or quality.

Divestment of processing assets

9.246. The NFUS believed that Milk Marque and the other co-operatives should be able to engage in processing as they saw fit to enable them to manage fluctuating supply and demand. The NFUS supported freedom for Scottish-based co-operatives to become more actively involved in processing. Their attempts to add value to their product should not be undermined. They posed no threat to the dairy trade since, in the producers' interest, co-operatives would have to equal or exceed the margins being achieved by other processors.

Producer leaving terms

9.247. The NFUS believed leaving terms were a matter for the co-operatives' members to agree. It said that they should be balloted before any membership rules were changed. There was a risk to the future commercial viability of the co-operatives if the leaving rules were to be relaxed to the extent whereby they were no longer able to develop long-term stable contracts with their customers.

Royal Association of British Dairy Farmers

9.248. The Royal Association of British Dairy Farmers (RABDF) told us that it had an educative role in the industry, organizing and running the annual European Dairy Farming event conferences and training courses. Its present membership was about 2,500.

9.249. The RABDF said that milk production in the UK had many strengths. It was better structured than most of its EC counterparts, and the quality of milk produced compared favourably with that produced anywhere else in the world. But producers were receiving one of the lowest milk price returns in the EC.

9.250. In the RABDF's view the individual farmer was in a weak position. There was no stable mechanism for selling milk and, in most cases, no link between the farmer and the end-product. In Continental Europe, and in other major milk-producing nations, dairy industries had been based around strong, often vertically integrated co-operatives.

9.251. The RABDF acknowledged that the UK dairy industry had evolved differently from other EC countries. In the post-deregulation years the acrimony between Milk Marque and the DIF had increased. There was no shared will to develop a competitive profitable and holistic dairy industry.

9.252. The RABDF believed there should be about five or six co-operatives. It said that the merger of the present 50 or so milk groups, including Milk Marque, should be a priority. All groups should be quota-holders and employ their own milk transport system. It was also vitally important for co-operatives to acquire their own processing facilities. Historically, producers had not enjoyed an equal share of the value of the end-product. Nonetheless a move towards regionally-based groups would require careful consideration if a free and competitive dairy industry was to be encouraged.

Hypothetical recommendations

9.253. The RABDF said that it had considerable concern about the hypothetical recommendations. It wanted producers to contribute to a dairy industry which would compete successfully within Europe and the world. It believed the hypothetical recommendations conflicted with that aim. It believed in the need for transparency in the milk selling system. It saw considerable merit in a falling clock auction, although it believed Milk Marque had made positive moves in the last year to make its system more transparent.

9.254. The RABDF strongly opposed Milk Marque being divided up into smaller bodies. It said that Milk Marque was a key player in the new UK dairy industry. To break it up would weaken the producing side of the industry and place even greater power in the hands of the big processing companies.

9.255. In the RABDF's view Milk Marque, or any other milk group, should be allowed to develop its manufacturing capacity in line with most other major milk-producing countries in the world. However, it would be necessary for Milk Marque to meet transparency and legal requirements if it did so.

9.256. Similarly, the RABDF believed it would be inappropriate to interfere in the commercial relationship which was developing among the smaller milk groups. Ultimately there would be mergers among them resulting in a smaller number of producer-owned groups or co-operatives. This development should be controlled by market and commercial forces, and subject to appropriate legislation, but not by any outside interference.

Scottish Dairy Farmers' Association

9.257. The Scottish Dairy Farmers' Association (SDFA) told us that its organization comprised farmer representatives from all over Scotland supplying all the main first-hand buyers in Scotland. It believed milk producers should be allowed to sell their milk to whatever organization they chose, including Milk Marque in its present form. Producers should be allowed to set up in groups of their choice and to invest in their own processing facilities in line with the large producer co-operatives which were the model in many European countries. The ability to process milk would become even more important in a market without milk quotas.

9.258. The SDFA believed that the recent reductions in milk prices dispelled any argument that producer organizations could keep prices higher than market forces would allow. Moreover, these reductions did not appear to have led to a decrease in retail prices. If Milk Marque were forced to adopt an auction system, producer prices would be further depressed because Milk Marque would become a marginal supplier and would be used for only balancing supplies. This would have a further deteriorating effect on all producer returns because the price paid by Milk Marque to its members set the base for UK milk prices.

9.259. The SDFA said that it was difficult to envisage an auction system in which adequate safeguards to protect the seller could be put in place. The agricultural community should be allowed to have a fair standard of living as set out in the EC Treaty.

South-West Milk Producer Group Forum

9.260. The South-West Milk Producer Group Forum (the Forum) said that it was set up after deregulation to represent milk producers in Cornwall, Devon, Dorset and Somerset. It represented 25 smaller groups and Milk Marque, accounting respectively for about 35 per cent and 65 per cent of the milk produced in the region. Its purpose was to exchange information and discuss matters of common interest, for example the pricing system, and to ensure that smaller groups had a political voice. But it did not attempt to fix its members' prices.

9.261. The Forum believed that the existing Milk Marque system resulted in milk prices below market values: purchasers had driven milk prices close to the IMPE level. If the purchasers, through their use of the spot market, created demand below supply then Milk Marque's prices in its principal selling processes would continue to move toward the IMPE price level. This would be reflected in milk prices nationally and would have a damaging effect on the prices other milk groups could obtain, since their prices were closely linked to those of Milk Marque.

9.262. The Forum said that currency fluctuations were affecting the IMPE price level and threatening many dairy farming businesses. A drift away from the more extreme seasonality payments for milk, coupled with a change in calving patterns, were likely to lead to still greater price volatility. In the USA a futures market was being actively sponsored by the US Government as a means of helping farmers hedge against price volatility. The Forum believed there would be a strong case for such a move in the UK. The Forum said that the removal of tariff barriers was forcing manufacturing companies to merge, leading to further rationalization. And milk quotas resulted in dairy companies being reluctant to invest in processing capacity.

9.263. The Forum told us that there was great pressure on farmers and processors, particularly from supermarkets, to invest in quality-assured milk. The Forum feared that, since there was little advertising of liquid milk, quality assurance would be used by the supermarkets to promote their own-label sales, rather than increase the size of the market. There was little branding of liquid milk and brand price premiums had been difficult to maintain for many manufactured dairy products. There was a danger that quality assurance without a comprehensive advertising campaign would give little benefit to farmers. Since one-half of milk production resulted in sales of liquid milk, there was a strong case for farmers and processors to promote its merits; the increase in demand could have a dramatic effect on prices.

Hypothetical recommendations

9.264. With regard to the possible reform of Milk Marque's selling system, the Forum said that the summer 1998 selling process had been resolved to the satisfaction of both sides of the dairy industry. It believed that Milk Marque should be allowed to negotiate in a similar manner in future selling processes; it was clear that the system was not biased in favour of Milk Marque.

9.265. A falling clock auction would be acceptable to the Forum but with so few major buyers there would still be a danger of collusion in bidding, so as to force prices down. That danger would be reduced if Milk Marque's processing subsidiary was allowed to bid. It would also make a floor price unnecessary. The Forum believed that Milk Marque's development of its processing operations on a national basis should be an essential pre-condition for the introduction of an auction.

9.266. The Forum was in favour of an auction-based selling system operated by an independent third party provided costs were kept to a minimum. Such an arrangement would be seen to be untainted (thus reducing the danger of further damaging conflict between Milk Marque and the processing companies). It would also allow the activities of the buyers to be scrutinized.

9.267. The Forum said that the division of Milk Marque into a number of smaller groups would be seen by its members as an emasculation of their co-operative. This would lead to an exodus of members and create instability throughout the producing side of the industry. The Forum believed smaller co-operatives would run the risk of processors playing each milk group off against another.

9.268. The Forum considered it vital for Milk Marque to continue with processing so that adequate capacity would be available in the post-quota era.

Producers

9.269. In paragraphs 9.270 to 9.336 we set out the views expressed by producers, beginning with three submissions from individual producers who gave us oral and written evidence, followed by a summary of the many letters we received from dairy farmers throughout Great Britain.

Mr J Keddie

9.270. Mr J Keddie, a dairy farmer in Clackmannanshire, said that as current milk prices were, in real terms, the lowest he had experienced, the processors' complaint that Milk Marque was using its position to influence the price of milk appeared unfounded. Mr Keddie accepted the reasons some co-operatives had not been allowed to integrate the MMBs' former processing operations at deregulation. However, direct supply had shifted the balance of power between processors and co-operatives in favour of processors. It was now the co-operatives that appeared to need protection.

9.271. Mr Keddie said that the 90 per cent threshold might have been relevant if Milk Marque had controlled all the market, but it now handled less than one-half of the milk supply in Great Britain, with large processors purchasing much of their requirements direct and augmenting their supply from Milk Marque. Mr Keddie believed it would be logical for Milk Marque to process surplus milk in-

house. He said that this would not be detrimental to the processors, or give Milk Marque an unfair advantage, as its products would be sold in a competitive market at a realistic price.

9.272. Mr Keddie believed it was unfair that dairy companies with high market shares could purchase milk direct and carry out processing. Their market strength, and the high volume of liquid milk now sold through supermarkets, enabled the processing and retailing sectors to influence consumer and producer prices. As it seemed to Mr Keddie that consumers had gained little or no benefit from the recent fall in milk prices, he thought it was reasonable to assume that processors were manipulating the market: this was surely against the public interest.

9.273. Mr Keddie believed that the producer co-operatives should be allowed to process and to market their products in the way which best benefited their members. This applied particularly in Scotland, where one processing company was dominant.

D & P Mead & Co

9.274. D & P Mead & Co (Mead) of north Somerset said that UK farmers were disadvantaged because milk production, processing and marketing were not integrated. Mead believed that dairies were maintaining their profit margins at dairy farmers' expense. Producers were now dealing with big multinational dairy companies, both in the EC and in the world market. Milk Marque's activities were much smaller than those of dairy co-operatives in Holland and Denmark. Mead believed that UK dairy farmers needed to form integrated co-operatives with their own processing facilities to secure their future, and stand up to the DIF.

9.275. In Mead's view the 90 per cent threshold and the IMPE formula had served only to increase profits for the large processors. The introduction of the ROF agreements (see paragraph 3.11) had led to processors' plant being improved at producers' expense.

9.276. Mead said that the DIF had no interest in generic advertising of liquid milk. This lack of initiative, and the longer shelf-life of supermarket milk, had reduced sales, resulting in more milk being processed into commodity products, thus reducing prices to producers. It appeared to Mead that the supermarkets were trying to eliminate doorstep competition. The large processors were paying producers less but demanding higher standards. Processors were chiefly concerned with retaining or increasing supermarket business.

9.277. Mead believed the emphasis in the MMC's hypothetical recommendations was wrong. Mead said that the milk industry was in the same predicament now as it was in 1933, owing to its total domination by the DIF. Mead did not believe that Milk Marque was the dominant player in the market. It did not abuse the selling system, as evidenced by the cheap milk and dairy products available to the general public. Mead said that it would not be in the public interest to see dairy farmers going out of business.

9.278. Mead said that producers were not given a chance to vote on the future structure of the dairy industry when Dairy Crest was floated. The divestment should not have happened. Farmers should have formed three or four vertically integrated co-operatives instead of Milk Marque. Mead thought it should be the ambition of all dairy farmers in the UK to form two or three vertically integrated co-operatives so that producers could compete with the DIF on equal terms.

9.279. Mead said that reform was needed as Milk Marque's selling system at present unfairly advantaged processors at the expense of farmers. It believed the lower producer prices for milk should be passed on to the consumer. This would increase demand and result in more milk being sold.

9.280. Mead believed that full transparency was needed (and would be in the public interest) and full traceability of milk would help to alleviate future food hygiene scares. A possible falling clock auction system had merits but not stability. Mead believed that Milk Marque should continue to operate the reformed selling system. Mead was not in favour of it being put into neutral hands. It said

that one possible solution would be to integrate the UK milk auction with others in Europe (for small volumes of milk). This would give greater flexibility to the UK dairy farmer.

9.281. Mead believed that if transport costs were unbundled from the selling price of raw milk it would give greater flexibility and more cost savings to the farmer.

9.282. Mead said that Milk Marque should be allowed to retain its own processing operations although it would conflict with Milk Marque's other activities if its processing capacity grew larger. Mead thought it would be better for Milk Marque to operate as a holding company and be divided up into a number of smaller, vertically integrated regional bodies. Both sides of industry would benefit from more regular negotiations on a smaller scale. Vertically integrated co-operatives would help the smaller, disadvantaged producers by giving them a bigger market share. Mead believed regionalized co-operatives should be obliged to take on farmers within their geographic location, but objective standards would be required over a specific period.

Mr J W Pitts

9.283. Mr J W Pitts, a dairy farmer in Northamptonshire since 1956, told us that he fully supported Milk Marque. He said that milk producers were small and lacked marketing ability when compared with their customers and Milk Marque offered them an efficient service which enabled them to sell their produce in a professional way. Mr Pitts did not believe that Milk Marque sought to monopolize the market. Its aim was to obtain a reasonable price for a highly perishable commodity which would be sustainable to the ultimate customer, the consumer. In Mr Pitts' view this was sound marketing policy.

9.284. Mr Pitts said that, although milk prices had dropped over the last five years, this had not been reflected in retail prices. Supermarkets and processors were benefiting at the farmers' expense. Mr Pitts said that prior to deregulation, under CATFI (see paragraph 3.8), the processors' profits had been guaranteed. Generally, they had not managed their businesses efficiently: now they had to operate in a normal supply and demand situation, and they found this uncomfortable. They were also being put under pressure by the powerful supermarkets, which often used liquid milk as a loss leader.

9.285. Mr Pitts said that, like other producers, he made considerable ongoing investment in his business but he believed there was no comparable current investment by the processors. Despite the demand from supermarkets for new products, there had been little innovation by the dairy industry.

9.286. Mr Pitts said that the dairy processing industry wished to weaken or destroy Milk Marque and that this had led to the MMC inquiry. If there was abuse in the market, Mr Pitts believed it was by the processors, whose actions in the 1998 selling processes had indicated that they were operating a cartel. In Mr Pitts' view, the 90 per cent threshold had been unrealistic and had led to a 30 per cent decrease in milk prices.

9.287. Commenting on our hypothetical recommendations, Mr Pitts said that he believed the milk selling system should be based on a free market, without what he regarded as monopolistic influences such as the DIF's behaviour in respect of the July round of the summer 1998 selling process. Regarding a structural remedy, Mr Pitts said that dividing Milk Marque would reduce the co-operatives' business base. Producers were dealing with large processing companies and this would further weaken their position in the free market.

9.288. Mr Pitts could see no reason why Milk Marque should be required to divest its processing facilities. He believed Milk Marque should be allowed to continue to represent the producers' best interests in this way. He questioned why dominant producer co-operatives should be acceptable in other EC member states but not in Great Britain. Mr Pitts believed that the recommendation regarding change to Milk Marque's members' leaving terms was irrelevant; all businesses made decisions and needed time to act on them.

Summary of other producers' views

9.289. Another 187 producers wrote to us during the course of our investigations in response to our initial invitation to comment on the inquiry (see Appendix 1.1). Thirteen of the respondents were also engaged in processing.

Market power

9.290. Ninety-nine respondents (53 per cent) said that market power lay with the processors; ten (5 per cent) believed Milk Marque was dominant. Many producers added that they were unfairly disadvantaged in negotiations with processors. Forty-five respondents (24 per cent) believed retailers used their superior market power unfairly.

9.291. Several producers expressed the view that they would be receiving considerably more for their milk if Milk Marque were truly in a monopolistic or dominant position in the market. There was widespread concern that there were no restrictions on large European co-operatives or processors expanding and investing in the UK whilst the profits the companies made did not benefit the UK.

9.292. A common theme in the responses was that it was imperative for producers to have a strong marketing organization such as Milk Marque if they were to achieve prices for milk to enable them to survive. Respondents believed that as individuals, producers were insignificant compared with dairy companies; only by co-operating in bodies such as Milk Marque and Scottish Milk could there be equality of power in the market place.

9.293. Some producers said that Milk Marque and the other co-operatives helped to balance the power of producers with that of the processors. Without the co-operatives, respondents believed producers whose farms were situated at a distance from processing plants would be severely disadvantaged: processors were more interested in selectively recruiting producers whose farms were near processing plants.

9.294. A view expressed by many respondents was that the DIF, and large processors, wanted to gain control of the milk market through the use of direct supplies. In the opinion of these respondents, the processors' intention was to eliminate Milk Marque and replace it with large farming companies owned by the processors or multiple retailers. The respondents believed it would be to the DIF's advantage if small producers selling to Milk Marque, or directly to consumers, ceased to farm and sold their quota to large producers directly supplying major processors. Some producers said that by manipulating the Milk Marque selling system and recruiting direct-supply producers, the processors had created a surplus of milk and forced prices down.

9.295. Twenty-eight respondents (15 per cent) criticized the DIF generally for its actions and behaviour towards Milk Marque and its members. One producer/processor said that processors appeared to be united and met regularly through the auspices of the DIF to protect themselves. The respondent contrasted this level of communication with the 40 or so milk groups and co-operatives which he said rarely met, and when they did were reluctant to discuss milk prices with each other. Some producers said that they believed the DIF and the large processors colluded to manipulate Milk Marque's selling system in order to dominate milk groups and their members. A few respondents said that they believed processors had formed a cartel to operate against Milk Marque and its members.

9.296. Some producers believed that processors had an unwritten rule not to recruit direct-supply producers from each other, but instead to recruit only Milk Marque members, paying them a premium to entice them away from Milk Marque. The argument followed that through direct supply, processors had now secured enough ex-farm milk to supply all the market for liquid milk. Thus Milk Marque had to sell most of its milk for use in the lower-priced manufacturing market (in which respondents said processors had failed to invest). Some producers told us that processors offered producers a premium above Milk Marque's price before they knew what the Milk Marque price would be.

9.297. Responses from 83 producers (44 per cent) specifically expressed satisfaction with Milk Marque. One producer/processor and five producers indicated that they were not in favour of Milk

Marque. A further 30 respondents (16 per cent) said that they fully supported the milk group or co-operative system.

9.298. A commonly expressed view was that Milk Marque was the only way forward for dairy farmers, particularly if small farmers in remote areas were to survive. One producer/processor said that his business could not exist without balancing his milk production volumes through Milk Marque. Selling surplus milk and buying it when short was vital for his continued survival.

9.299. One producer (a small farm) said that Milk Marque's attitude towards its smaller members had changed for the worse since deregulation through the introduction of volume-related pricing which favoured large producers. A few respondents complained about Milk Marque's producer leaving terms.

Prices and viability of farm businesses

9.300. Respondents expressed widespread concern about the fall in milk prices in 1997 and 1998: 161 producers (86 per cent) said that current prices were too low. Many commented about the unprofitability of their businesses. They argued that the cost to rural life and the countryside would be devastating if low milk prices were sustained. These respondents believed that not only would dairy farmers suffer, but also rural communities and the rural economy as a whole.

9.301. Many respondents said that unless a realistic price for milk was achieved, large numbers of producers would go out of business. This would lead to a shortage of milk and allow into Great Britain less hygienic and non-assured milk, with no traceability. This would not be in consumers' interests. Several producers said that they were at a critical point. There was no money for reinvestment or even maintenance on farms; many jobs would be lost, and many of them would not be replaced. A few respondents said that they were producing milk for the cost of production, sometimes taking on more land to produce more milk merely to 'stand still', but unable to make a profit.

9.302. Many respondents said that the way in which milk prices had fallen, and closely shadowed the IMPE in 1997 and 1998, was indicative of manipulation and profiteering by processors and multiple retailers. Some respondents said that Milk Marque's ability to compete in the market was constrained by other milk groups and processors using Milk Marque prices as the benchmark, thus constraining all prices.

9.303. Many producers questioned how some of the large processors could continue to pay a premium for direct-supply milk, and were prepared to pay more to direct suppliers than they were prepared to pay for milk purchased from Milk Marque. For example, several producers in the South-West of England said that one large processor had approached them in July 1998 with an offer to buy their milk direct whilst at the same time it had refused to bid for milk at the same or a lower price in the July bidding round of Milk Marque's summer 1998 selling process, claiming it to be too expensive.

9.304. We received fewer comments from direct-supply producers than from Milk Marque members. Some of the former told us that they had reluctantly relinquished membership of Milk Marque; they believed it was needed to counteract the power of processors but the respondents' own circumstances had led them to opt for the higher prices obtained by becoming direct suppliers. Most said that they, too, had been disadvantaged by the fall in prices. Some of these respondents said that they had upgraded their facilities at a processor's request. This had been very costly for the farmers, usually involving the need to take out a loan. But their profit margins were negligible.

9.305. Over 60 per cent of respondents (113) said that they believed the lower price of milk was not being passed on to the consumer. Producers saw their own profits declining but believed the profits of large processors and multiple retailers, particularly supermarkets, remained high. Some respondents said that the unwillingness to reduce retail prices meant that there had been no increase in the sales of liquid milk to consumers, which might have helped producers to sell more milk.

Milk Marque's selling system

9.306. One-half of respondents said that processors had exploited or abused Milk Marque's selling system with the intent of forcing milk prices down. Eighty producers (43 per cent) were critical of the assurances Milk Marque had given to the OFT (in particular the 90 per cent threshold) which respondents believed had been imposed on Milk Marque unfairly and had assisted processors to exploit the selling system.

9.307. Some respondents were critical of Milk Marque's system itself, but most believed its faults were caused by the constraints imposed on it by the OFT and what they saw as the manipulation of the system by processors. Few blamed Milk Marque. One producer commented that 'a ridiculous system had been imposed on Milk Marque' and this was typical of the many views expressed about the 90 per cent threshold. One respondent said that the selling system was clearly inadequate and did not respond to true market conditions. Its biggest failing was its inflexibility, made worse by the political stances of Milk Marque and the DIF, neither of which had the interests of the other side in mind at any time. This respondent said that the supplier/customer relationship was non-existent.

9.308. Several respondents said that a complete review or restructuring of Milk Marque's selling system was required. However, an almost equal number said that the selling system should be left alone and Milk Marque should be free to trade as it wished. Some producers said that Milk Marque had tried to meet customer demands by changing its selling system, whereas the proper and most practical solution would be for Milk Marque to vertically integrate and retain its processing operations.

9.309. One respondent said that severe fluctuations in milk prices since deregulation had been damaging to an orderly market. Others said that the selling system needed to be more market sensitive and much more responsive to market forces. One producer said that the system should be demand led rather than supply led. Possible solutions mentioned were to split Milk Marque into two regions and allow both to vertically integrate; to develop a joint selling arrangement with the processors; or to appoint an independent industry regulator.

9.310. Some small producer/processors feared that if Milk Marque's selling system were changed, it would preclude them from purchasing low volumes of milk. They feared that Milk Marque might deal only with large processors which these respondents feared would jeopardize the future of small dairies, and be anti-competitive.

Vertical integration

9.311. Eighty-one respondents (43 per cent) said that Milk Marque should be allowed to vertically integrate. No sole producers and only two producer/processors said that Milk Marque should not own processing assets. Many respondents believed that it was in the public interest to allow Milk Marque to process its own milk. They believed it would be able to process competitively-priced products made in modern, efficient facilities. Several respondents said that they saw no reason why Milk Marque should not be allowed to contract process.

9.312. One producer/processor believed that Milk Marque's acquisition of Aeron Valley would affect his own business. He was concerned that he would not be able to sustain the unfair competition caused, in part, by MMD's access to market information from its parent, Milk Marque.

Hypothetical recommendations

9.313. We received 227 responses from producers commenting on our hypothetical recommendations.

Reform of Milk Marque's selling system

9.314. Just over one-half of these respondents commented on the proposal that Milk Marque's selling system should be reformed. Of these, 45 per cent said that the selling system should be reformed; 55 per cent said that no reform was necessary.

9.315. Many of those advocating reform of the system said that the present system was open to manipulation by processors. They believed changes had to be made which were fair to all sides of the industry to bring about a selling system which could not be abused. A common view was that the reform had to be one that was better than the restraints they felt had been put on Milk Marque by the OFT. A few producers said that an auction system was acceptable only if a reserve price was attached to it.

9.316. Most of those who believed reform was necessary said that Milk Marque should be allowed to continue to operate the reformed selling system, subject to regular independent audit. Some added that an independent auditor would be expensive and believed that the costs would be passed on to producers. However, some producers favoured placing the operation of an auction in the hands of a neutral party. They believed this would allow Milk Marque to move into processing unhindered. A few producers said that they would like to see Milk Marque and its buyers agree a new system, one that could be allowed to evolve naturally and not one that was imposed.

9.317. Some respondents were concerned about full transparency in a reformed system. They believed the present system was too transparent, ie its openness led to a dilution of producer prices and put the processors in a weak position when dealing with powerful supermarket chains. A few added that a case could be made for making the selling system less transparent in order to prevent collusion among the large processors.

9.318. Some producers said that there was no need to reform Milk Marque's transport arrangements if its selling system were reformed. They believed Milk Marque should not be forced into relinquishing its delivered milk price.

9.319. Several producers said that Milk Marque should be allowed to reform its own selling system. They believed that outside interference would further distort the market. These respondents believed reform was a matter primarily for Milk Marque, in consultation with the processing companies, or their representatives; and that mediation or arbitration from outside would only be necessary if there was disagreement between Milk Marque and its buyers, and the system had completely broken down. Others said that although the system might not appear to be ideal it did work and Milk Marque could make any adjustments when necessary. A view was that processing companies had shown that they could act in a restrictive way by refusing to bid. But this meant that there was already an element of market forces at work in the system.

Reform of Scottish Milk's selling system

9.320. We received only two comments from producers on the hypothetical recommendation that Scottish Milk should reform its selling system. The first respondent said that the system needed to be reformed but that Scottish Milk should be allowed to operate a new system, subject to independent review or audit. The second respondent said that a restriction of 70 per cent should be applied to Scottish Milk's individually negotiated contracts; a minimum of 30 per cent should be sold through a Dutch auction system.

Structural reform

9.321. We received 181 comments on the hypothetical recommendation which would require Milk Marque to divide into a number of smaller bodies. Only seven producers supported this proposition. One hundred and seventy-five respondents (97 per cent) said that structural change was not necessary or wanted.

9.322. Many of the producers who were against structural reform believed that dividing Milk Marque into three or four bodies would weaken its market and negotiating powers further in relation to what respondents saw as increasingly dominant processing companies and retailers. Typical of comments were that processors in effect acted as one body, and to divide Milk Marque into smaller bodies would make producers even more weak and vulnerable. Respondents believed that producers should be able to rely on their own co-operative to balance the power of the DIF and the large processors.

9.323. Many respondents said that fragmentation of producers since deregulation had already left them weak: structural reform of Milk Marque would be particularly damaging to smaller, isolated producers. Several producers said that Milk Marque and other milk groups should amalgamate instead of Milk Marque being divided.

9.324. There was a commonly expressed view that dividing Milk Marque into smaller bodies would only add to the divisions in the milk industry, creating regional differences and inequalities (for example, different end-price structures based on location). These respondents believed that the divisions between producers in different areas would widen if quotas were changed or ceased. Many producers questioned why the UK should be different from other EC member states where farming co-operatives were much larger and more powerful than Milk Marque.

9.325. Several producers said that dividing Milk Marque would create even more administrative problems, and add to expenses. For example, there would be increased transport costs but no nationally-based transport plan. These respondents believed such action would be against the spirit of current Government policy: as one body, Milk Marque stood a better chance of being a streamlined and efficient organization. This view held that a cumbersome and complex network of regional co-operatives was not wanted.

9.326. A view from some producers was that milk was delivered countrywide and there was an imbalance of processing capabilities in different geographical areas. Collection of speciality milk (for example, organic milk) would be more difficult in a regional structure as those producers were spread more thinly. One producer said that although Milk Marque should not be split up into regions, 'regional pricing' within Milk Marque could be considered. This would reflect the actual contribution to the milk market of producers in a particular geographical region.

9.327. Three of the seven producers who supported structural reform said that the EWMMB had made a serious mistake when it opted for only one co-operative at deregulation. These respondents believed that dividing Milk Marque into two or three co-operatives would result in a fairer market place for milk, and prevent collusion among processors. Two respondents said that the structural remedy would overcome the problem of vertical integration: each newly-formed group could develop its own processing plant without interference from the competition authorities. One producer said that there should be no more than three separate bodies, one of which should be a dedicated group in Wales. Another respondent said that there should be as many separate bodies as was reasonably practicable, possibly as many as ten.

Divestment of processing assets

9.328. All but one of the 175 comments we received on the hypothetical recommendation that Milk Marque should divest itself of Aeron Valley and other processing assets opposed the remedy. The exception was a producer/processor.

9.329. The common theme expressed by respondents was that Milk Marque should have its own processing assets because it could not sell all its milk to processors and needed to utilize surplus milk (an example frequently cited was Milk Marque's July 1998 bidding round when the large processors had declined to bid). Other comments made by these respondents included: that Milk Marque needed vertical integration to counter what respondents saw as dominant and (according to some producers) colluding processing companies; that processors had lagged behind other EC member states in plant investment and innovation; that MMD should be free to bid in the open market for its milk in the same way as all other processors; and that Milk Marque's processing facilities would be needed even more if quotas were reduced, or ceased and more milk was produced.

9.330. Several producers said that care should be taken by Milk Marque to show that its processing operations were separate entities, and at arm's length from its selling activities. Others said that Milk Marque's processing facilities should be confined to small units only.

9.331. Some producers in the South-West of England said that allowing Milk Marque to process milk would help to cut down on long-distance haulage. This would in turn give a better return to producers and help the local rural community. For example, MMD's proposal to build a factory in Devon would reduce the need for long-distance milk haulage and create employment in the area.

9.332. The producer/processor who told us that Milk Marque should not be allowed to vertically integrate said that MMD was damaging to the dairy industry. He said that Milk Marque was not seen as buying its milk at arm's length, and it was in direct competition with its customers. This respondent believed that Aeron Valley was being expanded to make Cheddar cheese in an industry suffering from overcapacity. The respondent was concerned that MMD would undercut its competitors' prices, and might become a buyer of last resort, producing commodity products while allowing foreign competitors to supply the UK with added-value products.

9.333. Others views expressed by many producers included: that Milk Marque should be allowed to compete in the market as a processor of added-value products and thus return a more realistic price to its producers (one respondent added that this would be preferable to Milk Marque selling on the 'spot market' at unreasonable prices); that there was a need to create extra demand for milk and alternative options for end-uses if a true free market was to develop; and that allowing Milk Marque to process milk would also help to put a realistic floor price on ex-farm milk.

Producer leaving terms

9.334. We received 68 comments on the hypothetical recommendation that the four successor bodies to the MMBs should amend their leaving terms for producers. Of these, nine (13 per cent) agreed with the possible recommendation, while 59 (87 per cent) said that the leaving terms should remain as at present.

9.335. Arguments supporting the retention of the existing leaving conditions included: that producers knew the terms that prevailed when they joined the co-operative and there was no need to amend the terms other than through a democratic vote by the members of the co-operative; and that the leaving terms should reflect the length of the contracts the co-operatives had with their buyers. Two producers in favour of relaxation of leaving terms said that if Milk Marque increasingly sold milk on the short-term markets, a relaxation of the 12-month notice period, say to six months, would be appropriate.

The case for no regulatory intervention

9.336. Almost all the 31 respondents (14 per cent) who said that no remedial action was needed said that developments were already taking place in the dairy industry which were market driven. These respondents believed the industry was capable of managing itself without outside interference. Several producers said that the intervention by the OFT had been damaging to the milk industry and were concerned that further remedial action would be imposed by yet another outside authority. The argument was that Milk Marque and the processors should be left to resolve their problems through a process of negotiation and interaction in the market place.