Part II

Background and evidence

3 Wiseman and the other Scottish milk processors

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Introduction

3.1. This chapter considers the groups primarily concerned in this inquiry: Wiseman, Claymore and Claymore's majority shareholder, Express. For each company, a brief history is followed by a description of its areas of operation and relevant financial information. Aside from Wiseman and Claymore, the only other dairies with market shares in excess of 1 per cent in Scotland are Graham's with 4 per cent, and SMD with 2 per cent. Therefore these two companies' backgrounds and financial information are also considered. Following the company analyses, there is a more detailed consideration of Wiseman's Scottish operations, including its volumes, revenues and costs. In Appendix 3.1 there is a chronology which sets out notable events and actions by parties involved in and surrounding the inquiry.

Robert Wiseman Dairies PLC

History of the group

3.2. The original Wiseman business was founded in the late 1940s when Mr Robert Wiseman started retailing milk from his dairy farm in East Kilbride, Lanarkshire. The business was relocated in the late 1950s when the East Kilbride Development Corporation required development of the farmland for housing and the dairy moved to a site nearer Glasgow.

3.3. Two of the sons of Mr Robert Wiseman, Mr Alan Wiseman, who is now Chairman, and Mr Robert Wiseman junior, who is now Managing Director, joined the business in 1967 and 1975 respectively and control passed to them in the late 1970s. The brothers took the view that growth and profitability could best be achieved in the wholesale rather than in the retail trade. In order to develop this market and to build up a base of wholesale customers, investment in equipment for non-returnable packaging was required. Throughout the 1980s and 1990s Wiseman acquired a series of milk rounds, depots and small dairies to develop a processing and distribution network across the Central Belt of Scotland (see paragraphs 3.5 to 3.10 for major acquisitions and developments throughout the 1990s). As a result of these acquisitions the business grew substantially. In particular, the company had invested to take advantage of the increased sales through larger supermarkets and single-outlet, corner-shop retailers, which accompanied the decline in popularity in Scotland of doorstep milk deliveries.

3.4. As the company expanded, Wiseman developed its business with larger supermarkets. These were by then achieving an increasing share of the liquid milk market as consumers continued to switch away from doorstep deliveries of milk. In 1989 Wiseman consolidated its processing and packaging facilities from four separate locations into a single modern dairy at Bellshill, east of Glasgow.

3.5. In 1991 Wiseman acquired a small dairy business in Manchester, Appleby Dairies, and established its first depot outside Scotland in order to serve two existing Scottish middle-ground customers, Farmfoods Ltd and Capital Foods Retail Limited, which were then establishing themselves in England. The acquisition gave Wiseman an opportunity to market its products in northern England and the Midlands. In 1992 a site was acquired at Trafford Park Industrial Estate, Manchester, for construction of a milk processing plant. The initial phase of the investment was completed in the autumn of 1995 and the final phase completed during 1997. Capacity of the Manchester dairy is 380 million litres a year and production throughput during 1999/2000 has reached 308 million litres. During 1997 Wiseman acquired a site adjacent to the dairy in Manchester and in 1998 built a new distribution depot there.

3.6. In May 1996 Wiseman purchased another site near Leeds for use as a distribution depot, which was to be supplied with processed milk from the Manchester dairy. This depot has been fully operational since November 1996. Another English depot, near Carlisle, was acquired in March 1997 following the receivership of Scottish Pride.

3.7. Developments in the milk market, notably the growth of the market share of multiple retailers and the deregulation of the milk production market in 1994, led to a number of dairies deciding to leave the processed milk market. Table 3.1 shows the acquisitions made by Wiseman up until the acquisition of Scottish Pride, whose main operating subsidiary, Scottish Pride Limited, went into receivership in March 1997.

TABLE 3.1 **Wiseman acquisitions, 1993 to 1996**

	Milk and dairy business acquired	*Consideration £*	*Principal location(s)*
April 1993	Claylands Dairies	1,044,000	Edinburgh
April 1994	Mackies Liquid Milk and Fresh Cream Business	3,049,000	Aberdeen
May 1994	Kennerty	8,100,000	Aberdeen/Central Belt
July 1995	CWS	6,088,000	Central Belt
Sept 1995	Hamilton	5,068,000	Central Belt

Source: Wiseman.

3.8. Following Wiseman's acquisition of Kennerty in December 1994, it has been alleged by Express/ Claymore that Wiseman entered into a market sharing agreement with NSMCSL. The allegations by Express/Claymore, Wiseman's response and other evidence are set out in Appendix 3.2. On the acquisition of Hamilton, Wiseman told us that it reviewed its operations. It decided to rationalize operations around the Stirling area. To achieve this end a business swap agreement was entered into with Graham's. This encompassed a two-year non-compete agreement in the area in which business had been swapped. It has been alleged that, at the cessation of this agreement, Wiseman and Graham's have continued to observe a market-sharing arrangement. Allegations, evidence and response from the parties is set out in Appendix 3.3.

3.9. Following the receivership of Scottish Pride in March 1997, Wiseman acquired certain tangible and intangible assets, including goodwill and the Fresh'N'Lo brand, from the receiver. The total cost of the acquisition was £5.5 million including £4.8 million for goodwill and other intangibles.

3.10. Since the investment by Express in Claymore in December 1998, Wiseman has undertaken two further acquisitions. These acquisitions were approved by the OFT as required by the undertakings given by Wiseman to the Secretary of State in consequence of the Scottish Pride acquisition. The first acquisition occurred in April 1999, when 80 per cent of the issued share capital of Gilmours was acquired with an option granted to acquire the remaining 20 per cent. The Gilmours business consisted of a dairy, in Newmilns, and a modern distribution depot at Kilmarnock. Total consideration comprised £3.53 million; including £2 million in respect of the 80 per cent of the ordinary share capital acquired, £0.5 million in respect of the remaining 20 per cent of the share capital, and £0.95 million in respect of no-competition guarantees. Subsequent to the acquisition, the dairy was closed and production was transferred to Bellshill. The option to acquire the remaining 20 per cent of the share capital was exercised in November 1999. Figures made available to us indicated that the acquired business contributed around £1 million of profit in the year to March 2000.

3.11. The second post-Scottish Pride acquisition occurred in May 1999 when the entire issued share capital of AMCo was acquired for £1.0 million. The principal activity of AMCo was the collection, and marketing of its members' raw milk. AMCo was the successor organization to the Aberdeen and District MMB (ADMMB) after deregulation in 1994. AMCo had a single subsidiary, Aberdeen Milk Services Limited, that provided transport services and operated a plant for the production of milk powder and butter. AMCo's shareholders consisted of a number of farmers in the Grampian region and the company existed as an outlet for their milk. Wiseman was the major customer of AMCo for raw milk. The milk and butter plant was old and suffered from capacity inefficiencies; therefore Wiseman closed the plant and disposed of it. The farmers then began supplying milk to Wiseman on a direct supply basis, with a three-month notice period if they wished to move to supply another processor.

3.12. Both the Gilmours and AMCo acquisitions have been subject to allegations of anti-competitive behaviour by Express/Claymore against Wiseman. As noted in paragraph 3.52, Express's entry strategy in Scotland included the acquisition of a Central Belt processing facility to complement the Claymore dairy in Nairn. It is alleged by Express/Claymore that the eventual purchase by Wiseman of Gilmours was designed to remove the opportunity for Express, or any other new entrant, to acquire this dairy, which was capable of servicing the middle-ground in the Central Belt. The acquisition of AMCo is alleged to have had three motives. The first was to prevent Express/Claymore from having easy access to additional raw milk supplies in northern Scotland should expansion of its operations occur. Secondly, the purchase was designed to force up the price of raw milk that Express/Claymore had to pay its farmers to retain their loyalty. An outcome of the Wiseman acquisition was that the former AMCo farmers received 1 ppl more than before the acquisition. Lastly, Express/Claymore considered that the acquisition cut off one of Express/ Claymore's means of balancing its raw milk supplies. Wiseman's reply to these allegations is set out in paragraphs 5.69 to 5.71.

3.13. Additional distribution facilities were required by Wiseman when the Scottish Pride business was acquired (see paragraph 3.9). A new distribution depot was constructed in Cambuslang, Glasgow, and became operational in July 1999, at a cost of £4.5 million. The construction of this permitted the closure of smaller depots in Glasgow and East Kilbride. The depot has a throughput of around 2.3 million litres a week and services primarily the western Central Belt, but its full area of operation stretches from Campbeltown to Oban.

3.14. In March 1994 Wiseman obtained a listing of its shares on the London Stock Exchange to provide capital for existing projects, such as the new processing plant in Manchester, and to fund future expansion. The placing on the Stock Exchange involved 16.1 million shares (25.2 per cent of the enlarged issued ordinary share capital) at a price of 100p a share. 15 million of the shares placed were new shares and £14.5 million, net of expenses, was raised for the company. The balance of 1.1 million shares was sold by existing shareholders. Since this initial placement, there have been two large additional share issues. On 2 June 1995 a placing was announced of 11,153,587 shares at £1.30 per share. Part of the proceeds was used to satisfy consideration for the CWS acquisition (see Table 3.1). The other significant placing was on 14 April 1997 when 7,887,979 shares were issued at £1.72 per share. Net proceeds of £12.98 million were raised of which £4.8 million was used to satisfy consideration for the Scottish Pride acquisition and fund further capital expenditure. As at 31 March 2000, Alan and Robert Wiseman had shareholdings totalling 50 per cent of the issued ordinary shares, and a third brother, Gavin, had 3 per cent.

Principal activities

3.15. Robert Wiseman and Sons Limited, a wholly-owned subsidiary, carries on all the trading activities of the group. The principal activity of the Wiseman group is the supply of liquid milk and cream to the multiple retail trade from three major processing dairies at Glasgow (Motherwell Food Park, Bellshill), Aberdeen (Tullos), and Manchester (Trafford Park). There are two smaller dairies in Rutherglen, Glasgow and East Kilbride. Map 1 shows the location of the dairies and distribution facilities throughout the UK.

3.16. In addition to its trade with larger supermarkets Wiseman also serves independent retailers, organizations such as schools and hospitals and both its own and independent doorstep delivery businesses. Wiseman's own doorstep delivery business is carried on primarily through milk rounds franchised to self-employed milkmen but also includes some roundsmen directly employed by Wiseman. Further details of the processed milk business, primarily in Scotland, together with the Wiseman share of it, is given in Chapter 4.

3.17. Wiseman produces fresh processed milk and sells it under a number of brands. In addition to own-label milk produced for larger supermarkets and large symbol groups, it produces a Wiseman brand with predominantly black and white packaging. Other fresh processed milk brands produced, but to a lesser scale include Fresh'N'Lo, a semi-skimmed milk, and a range of Ayrshire milk processed under licence for Ayrshires Milk Marketing.

3.18. An integral part of Wiseman's strategy is the use of depots for onward distribution of liquid milk from its dairies. In addition to the English distribution depots detailed in paragraphs 3.5 and 3.6. Wiseman has several throughout Scotland. Map 1 shows the location of each distribution facility. With one exception, the Scottish dairies service Scottish depots. The one exception is the Carlisle depot, which is serviced by Bellshill. Approximately one-third of the Carlisle depot's sales are in Dumfries, Galloway and the border areas. Wiseman determines the location of depots by the distances over which fresh milk can economically be transported between the dairy and the associated depot. The economics of milk transport are discussed in Chapter 4.

3.19. Wiseman's current strategy is to continue moving south into England, achieving further growth through supplying larger supermarkets. Planning permission was received during 1999 for a new dairy and depot facility at Droitwich, near Birmingham. Production is planned to commence during the spring of 2001. The project is planned in two phases: phase one, costing some £30 million, will create production capacity of 200 million litres a year. It is envisaged that the annual capacity after the completion of phase two will be 400 million litres. Phase two will cost between £10 million and £15 million and will be made when additional capacity is required. The company opened a £5 million depot, at Wolverhampton, supplied from the Manchester dairy, in September 1999 and is servicing supermarkets principally in the Midlands, but runs are made as far south as London. The Droitwich dairy will immediately supply the Wolverhampton depot releasing capacity at Manchester. Focus has turned to further development of the English distribution network with potential sites in and around the Bristol, Luton, Oxford and Swindon areas that could be supplied from the new dairy.

3.20. Wiseman's English aspirations were reflected in its March 2000 bid of £225 million for the liquid milk and cheese business of Unigate PLC (Unigate). In the year to March 1999 Unigate's turnover was £749 million on which it earned £51.5 million of operating profit. Unigate, at this time, was subject to an offer from Dairy Crest of £220 million. The Wiseman bid created a process of counter-bidding until May 2000 when Wiseman pulled out and Dairy Crest's offer of £250 million succeeded.

3.21. Table 3.2 shows the increasing importance of England and Wales to the profitability of Wiseman. The proportion of its total sales volumes supplied to England and Wales was 44.4 per cent in 1999/2000. This is expected to reach 50 per cent in 2000/01, and with production from the Droitwich dairy scheduled to begin in March 2001, English and Welsh sales volumes should surpass those of Wiseman's Scottish dairies in 2001/02.

TABLE 3.2 **Wiseman: Proportions of sales volumes and operating profits earned between Scotland and England and Wales**

per cent

	1996/97	*1997/98*	*1998/99*	*1999/2000*
Operating profit				
Scotland		*Figures omitted.*		
England and Wales		*See note on page iv.*		
*Sales volumes**				
Scotland	76.5	72.0	63.8	55.6
England and Wales	23.5	28.0	36.2	44.4

Source: Wiseman.

*Volumes relate to fresh processed milk only.

3.22. Wiseman told us that the disproportionate level of operating profit to sales volumes between Scotland and England and Wales shown in Table 3.2 reflected the differing mix of business in the two regions. Multiple retailer business made up a greater proportion of total business in England and Wales compared with the sales mix in Scotland. Operating profit percentage and sales volume percentage between the two areas has converged in the past two financial years as middle-ground profitability has eroded somewhat in Scotland.

Financial information

3.23. Wiseman prepares its accounts to the Saturday nearest 31 March each year. A summary of results and financial information for the five years from 1995/96 to 1999/2000 is set out in Table 3.3. Full profit and loss accounts and balance sheets are shown in Appendices 3.4 and 3.5 respectively.

TABLE 3.3 **Wiseman: summary of results and financial information**

£'000

	Years ended 31 March				
	1995/96	*1996/97*	*1997/98*	*1998/99*	*1999/2000*
Turnover	148,274	192,904	252,721	257,168	286,698
Operating profit	8,834	12,413	17,973	19,754	18,862
Net operating assets*	32,740	37,505	47,514	60,760	82,895
Average net operating assets	26,681	35,123	42,510	54,137	71,828
					per cent
Return on operating profit:					
On turnover	6.0	6.4	7.1	7.7	6.6
On average operating assets	33.1	35.3	42.3	36.5	26.3
Financial ratios:					
Gearing ratio (%)†	26.9	33.7	1.1	4.2	18.9
Interest cover (times)	41.1	22.2	61.3	63.5	19.3
Dividend cover (times)	2.5	2.8	3.7	3.8	3.4
Production information:					
Fresh processed milk sold ('000 litres)	305,000	409,854	584,300	631,433	752,344
Average revenue (ppl)‡	48.6	47.1	43.3	40.7	38.1
Average operating profit (ppl)‡	2.90	3.03	3.08	3.13	2.51

Source: Wiseman statutory accounts.

*Defined as net assets plus net debt.

†Defined as net debt divided by net debt plus equity.

‡The revenue per litre and operating profit per litre represent respectively the turnover and operating profit divided by the volume of output sold. Turnover and operating profit include the cream business.

3.24. Turnover has grown from £148.3 million in 1995/96 to £286.7 million in 1999/2000 as a result of organic growth and acquisitions. The significant increase in turnover in the year ending 1996/97 reflects the full-year effect of the CWS and Hamilton acquisitions in July 1995 and September 1995 respectively (see Table 3.1). The increase in 1997/98 shows the impact of the Scottish Pride acquisition and significant customer gains from Scottish Pride prior to its entry into receivership. The increase in the most recent period shows the effect of the Gilmours acquisition in April 1999 and volume gains throughout Great Britain, particularly with Tesco, Asda, Safeway and Morrisons. Wiseman told us that falling selling prices, due to falling raw milk prices, had been passed on to customers and increased competitive pressures in Scotland over the last 18 months had offset significant volume gains.

3.25. Operating profit has increased at a slightly faster rate than turnover, as volume increases have translated into production efficiencies. With the exception of the Hamilton acquisition, the Aberdeen dairy at Tullos, which formed part of the Kennerty acquisition and the Rutherglen dairy forming part of the Scottish Pride acquisition (see paragraphs 3.7 to 3.9), all processing facilities acquired have been shut down and production transferred to existing facilities. Operating profit has declined by 4.5 per cent in 1999/2000 from 1998/99. This reflects the deterioration of prices in the middle ground in Scotland coupled with lower returns from the sale of bulk cream and higher oil prices resulting in higher packaging and transport costs. The decrease has been offset by a reduction in vehicle depreciation charge of £2.0 million as the result of a revision in the estimated life of the vehicle fleet from four years to between five and ten years. Ongoing capital expenditure programmes at existing dairies, coupled with significant throughput increases due to acquisition and organic growth, has delivered significant efficiencies throughout the five-year period.

3.26. Net operating assets have grown substantially from £32.7 million in 1995/96 to £82.9 million in 1999/2000. This reflects growth attributable to acquisitions and an intensive capital expenditure programme. Capital additions were £14.4 million in 1995/96, £17.4 million in 1996/97, £26.8 million in 1997/98, £25.3 million in 1998/99 and £31.9 million in 1999/2000. The significant levels of capital expenditure reflect spend on infrastructure assets and commercial vehicles as Wiseman moves further south in England and has intensified since the Scottish Pride acquisition in 1997.

3.27. Increases in net operating assets have been largely financed through operating profits and company bank facilities. In April 1997 the company issued an additional 7,887,979 shares netting proceeds of £12.98 million. This was used to satisfy the consideration for Scottish Pride and to fund additional investment in tangible assets. Borrowings have increased considerably over the year to 31 March 2000 to fund continuing capital expenditure. Gearing levels during the period have remained low despite the increases in debt levels.

North of Scotland Milk Co-operative Society Limited and Claymore Dairies Limited

History

3.28. In December 1998 Express acquired a 51 per cent stake in Claymore for £2.2 million. The remaining 49 per cent remained within the ownership of the NMC, which until November 1998 had been known as the North of Scotland Milk Co-operative Society Limited and included a separate cheese and butter business in the Orkney Islands.

3.29. Claymore was the processing arm of the NSMCSL, which was the successor organization to the NSMMB. At this time Claymore consisted of a liquid milk processing business in Nairn and the cheese and butter business in the Orkney Islands.

3.30. In 1994, the NSMCSL acquired the assets of the NSMMB under the Reorganisation Scheme provided for in the Agriculture Act 1993. The Agriculture Act 1993 provided for the revocation of all statutory milk marketing schemes in Great Britain, while providing the opportunity for individual MMBs to promote a scheme for the marketing of milk within their respective areas. Under the Reorganisation Scheme put forward by the NSMMB, raw milk purchasing and selling operations and the processing operations were transferred to the NSMCSL. At the time of deregulation the newly-formed NSMCSL had 93 members.

3.31. The NSMMB historically operated within a statutory territory adjacent to the territory of the ADMMB (upon deregulation this became AMCo). MMBs did not trade in raw milk within each other's territories, although there was no similar restriction in relation to trade in processed products. The NSMMB developed a new processing dairy in Nairn in 1991. The Nairn site was strategically located between the largest population bases in northern Scotland, the Grampian region to its east and Inverness/ Fort William to the west. Claymore also supplied fresh processed milk to a number of isolated communities, including the Western Isles. The dairy operated primarily as an added value outlet for the members' milk.

3.32. In 1997, the business, goodwill and assets of Scottish Pride's depot in Oban were purchased by the NSMCSL from Scottish Pride's receiver. These activities were not integrated directly into the NSMCSL, but were held in a wholly-owned subsidiary, Claymore Argyll Limited. Also in 1997, the NSMCSL acquired a 50 per cent interest in Inverness Farm Dairies, a family wholesaler of fresh processed milk to the middle-ground market in Inverness. The 50 per cent interest was held through a wholly owned subsidiary, Claymore Inverness Limited. Membership of the NSMCSL in early 1998 stood at 78. In August 1998 the liquid milk processing business was split from the Orkney cheese interest, the effect of this split being that Claymore Dairies Limited contained only the assets pertaining to the production of fresh processed milk. Claymore Dairies Limited also acquired the 50 per cent interest in Inverness Farm Dairies via Claymore Investments Limited, and the Oban business.

3.33. In October 1999, the cheese and butter business in the Orkneys was separated from the NSMCSL, and in February 2000 the 42 Orkney members of the NSMCSL resigned, and ownership of the Orkney business was transferred to them. The NSMCSL had changed its name to North Milk Co-op in November 1998. The shareholders of the NMC, the only asset of which is now the 49 per cent of Claymore not owned by Express, consists today of the 36 farmers whose milk is processed by Claymore.

Principal activities

3.34. In addition to processing the milk produced by the members of the NMC, Claymore also distributes fresh milk through a network of depots. Depots are currently operating in Dingwall, Fort William, Oban, Tain and Wick. Between December 1994 and April 1999 Claymore made no sales in the Central Belt. Sales commenced in April 1999 when Express failed to acquire Gilmours and the CWS account was lost—material volumes began to be achieved in May 1999 (see paragraph 3.52). Distribution in the Central Belt was carried out through a depot in Coatbridge until August 2000, but this has now been closed and Central Belt distribution is performed via a depot in Airdrie owned by Blakes Chilled Distribution Limited (Blakes), a subsidiary of Express.

3.35. The capacity of the Claymore dairy, based on a double-shift, six-day week, is [✂] million litres a year. Currently the plant is operating on a single shift and the capacity is [✂] million litres a year. For the year ended 31 March 2000 production was [✂] million litres.

3.36. Claymore serves predominantly middle-ground customers. Claymore told us that it has the only processing facility in Scotland not owned by Wiseman to be accredited to supply the large supermarkets (see Chapter 4). When Express won the right to supply Sainsbury throughout Scotland, Claymore began supplying the Scottish Sainsbury stores. Following Express's acquisition of a stake in Claymore, a contract to supply [✂] stores was won and sales to [✂] Scottish garages also increased. The [✂] contract was an existing contract held by Express under which Express had supplied milk from England. Claymore has also lost customers to Wiseman following Express's acquisition of a shareholding in Claymore (see paragraphs 4.258, 4.260 to 4.262 and 4.265).

3.37. Fresh milk processed by Claymore in Scotland is sold under two brands owned by Express/ Claymore, as well as multiple retailers' own brands. In the Highlands and Islands and the Grampian region fresh milk is sold under the Highland Fresh label. Express/Claymore's expansion into the Central Belt has led to fresh milk being sold under the brand Scottish Pride. This brand is owned by Express and it was purchased following the receivership of Scottish Pride in March 1997.

Financial information: North of Scotland Milk Co-operative Society/North Milk Co-op

3.38. NSMCSL/NMC compiles accounts to 30 September of each year. Full profit and loss accounts and balance sheets for the three years to 30 September 1998 are shown in Appendices 3.6 and 3.7

respectively. A summary of results for the three years is set out in Table 3.4. Results are shown to 30 September 1998 as this was the last full year in which Claymore was wholly owned by the co-operative. The only activities of NMC are to sell its members' raw milk to Claymore, and to act as the holding company of its 49 per cent interest in Claymore.

TABLE 3.4 **NSMCSL: summary of results and financial information**

			£'000
	Years ended 30 September		
	1995/96	*1996/97*	*1997/98*
Turnover	22,725	20,332	18,659
Operating profit	293	558	448
Net operating assets*	7,588	7,888	8,093
Average net operating assets	7,552	7,738	7,991
			per cent
Return on operating profit:			
On turnover	1.3	2.7	2.4
On average operating assets	3.9	7.2	5.6
Financial ratios:			
Gearing ratio (%)	32.1	33.3	33.7
Interest cover (times)	1.4	2.5	1.8
Production information:			
Average producer returns (ppl)	23.2	24.5	21.1
Volumes—fresh processed milk (million litres)	25.1	24.7	25.2

Source: Express/Claymore.

*Defined as net assets plus net debt.

3.39. Turnover declined from £22.7 million in 1995/96 to £18.7 million in 1997/98. Throughout this period falling raw milk prices put considerable pressure on both the selling price of fresh processed milk and cheese. Turnover was further depressed over the period as surplus raw milk was being sold at low prices. Additionally, in 1997/98 the Kirkwall cheese factory was closed for November as major repairs were carried out. This further depressed raw milk sales.

3.40. Operating profit increased from £0.293 million in 1995/96 to £0.558 million in 1996/97 and then declined to £0.448 million in 1997/98. Appendix 3.6 shows that in 1995/96 NSMCSL incurred a loss after extraordinary items, interest and taxation. In that year NSMCSL incurred £0.379 million of extraordinary items. NSMCSL closed its processing and packaging facility for fresh processed milk in Wick and removed a crate packing line at Nairn. These actions led to a number of redundancies which contributed to the bulk of the extraordinary costs. The Wick dairy did not have the capability to produce skimmed or semi-skimmed milk. With the growth in popularity of these products a decision was made to transfer production to Nairn. Falling milk prices also impacted upon operating profit but significant savings in distribution costs were made. These included the effect of not sending raw milk to Wick for processing (supermarket processing being consolidated into one site at Nairn), some doorstep rounds being rationalized, and the partnership with Inverness Farmers Dairy producing synergies.

Financial information: Claymore

3.41. Claymore prepares accounts to 31 March of each year. This is in alignment with its majority shareholder, Express. Full profit and loss accounts and balance sheets for periods since Express's investment on 5 December 1998 are shown in Appendices 3.8 and 3.9 respectively. A summary of results and financial information over this period is shown in Table 3.5.

TABLE 3.5 **Claymore: summary of results and financial information**

		£'000
	*1998/99**	*1999/2000*
Turnover	3,688	13,714
Operating loss	(150)	(2,380)
Net operating assets†	3,061	5,165
Average net operating assets	N/A	4,113
		per cent
Return of operating loss:		
On turnover	(4.1)	(17.4)
On average operating assets	(4.9)‡	(57.9)
Financial ratios:		
Gearing ratio (%)	6.9	90.2
Interest cover (times)	(10)	(18.4)
Production information:		
Output sold (million litres)	§	
Average revenue per litre (ppl)¶	[✂]	[✂]
Average operating profit (ppl)¶		

Source: Express.

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*Represents results for the 18-week period ending 3 April 1999.
†Defined as net assets plus net debt.
‡Calculated on net operating assets.
§Represents annual production adjusted for the 18-week period.
¶The revenue per litre and operating profit per litre represent respectively the turnover and operating profit divided by the volume of output sold. Turnover and operating include the cream business.

3.42. Annualized turnover in 1998/99 would have been £10.6 million. The increase in 1999/2000 reflects the increased throughput at Nairn due to Sainsbury's production and sales into the Central Belt, which had not occurred in previous years. However, these have been offset by the loss of certain other accounts, especially CWS which, before Express's investment, constituted around one-third of Claymore's volumes. The impact of this increased throughput has been diminished by the intense competition faced by Claymore in retaining and gaining business and by falling raw milk prices.

3.43. Express told us that Claymore's operating losses were running at the rate of approximately £45,000 a week at 31 March 2000. Margins had fallen, as a result of pressure in prices and as additional raw milk had been required in Nairn to meet the increased throughput. This had been supplied by Scottish Milk. Distribution costs had increased as costs of distribution in the Central Belt were now being borne by Claymore. These costs were not intended to be incurred at Nairn. Express had expected to acquire Gilmours in Newmilns, which would have serviced customers in the Central Belt (see paragraph 3.52 for a discussion of Express's wider entry strategy into Scotland). Until October 1999 these had been met by Express. Distribution costs in 1998/99 did not include any costs of transportation into the Central Belt.

3.44. Claymore told us that, in order to attempt to mitigate some of the losses being incurred by Claymore, Express/Claymore had undertaken a number of actions, including:

— the conclusion of an agreement with SMD where SMD processed and packed milk, commencing in April 2000 (see paragraph 3.70), this enabled the Nairn dairy to operate on a single shift;

— the redundancies of process operators and supervisors facilitated by the reduction to a single shift;

— the closure of the Coatbridge depot, with operations relocated to the Blakes site at Airdrie;

— the closure of the Kingussie depot;

— the rationalization of depot staff as volumes were lost, including redundancies at the Wick and Tain depots;

— the rationalization of transport staff, including redundancies at the Nairn dairy; and

— the redundancies of three salesmen in northern Scotland.

3.45. Net operating assets have increased substantially in the last year. The most significant increase has been an additional £[✄] million spent on the plant at Nairn during the last year. This included expenditure on effluent plant to meet enhanced local water standards, alteration of the filling hall and installation of equipment from other Express facilities, and a change in the yard layout to allow room for the extra trailers needed to transport milk to the Central Belt. Also included in Claymore's net assets is an intercompany advance from Express. This balance stood at £[✄] million at 31 March 2000. The trading losses incurred by the company have been funded through this advance.

3.46. In the Claymore accounts for the year ending 1 April 2000 there is reference to the significant trading loss incurred. The accounts include a note that refers to Claymore's financial position and to this inquiry. The accounts state that Express would review its support in September 2000. Subsequently Express told us that it would reconsider its support in January 2001.

Express Dairies plc

History

3.47. Express was previously called Dale Farm Dairy Group Limited which was a major subsidiary of Northern Foods plc (Northern). On 6 March 1998 Dale Farm Dairy Group Limited changed its name to Express Limited. Express Limited and other companies were transferred into Express Dairies plc which was demerged from Northern on 30 March 1998. The demerger occurred as Northern's dairy and prepared foods businesses had developed separate strategies under different management teams. The Northern board decided that both businesses would benefit from operating as independent companies. Lord Haskins has chaired Express since the demerger and its Chief Executive since this time has been Neil Davidson.

3.48. Northern was founded as Northern Dairies Limited in 1937. The company expanded through acquisitions of doorstep businesses in northern England, the Midlands, North Wales and Northern Ireland and went public in 1956. It changed its name to Northern Foods plc in 1972. The original Express business was founded in London in 1864, deriving its name from its use of express trains to deliver milk into London. Northern acquired Express from Grand Metropolitan plc in 1992. The integration of these businesses established Express's current position as one of the major suppliers of liquid milk within the UK.

3.49. Express has continued to grow through acquisitions made within the UK. Major acquisitions in and around the time of the demerger were the acquisition of Scottish Pride's UHT operations at Kirkcudbright for £9.8 million in April 1997—included in the price was the purchase of the Scottish Pride brand for fresh processed milk. Woodgates Farm Dairy (Woodgate), a Sussex-based dairy company, was acquired in February 1998 for £17.6 million.

3.50. In the two years subsequent to the demerger the following acquisitions have been undertaken:

— a 51 per cent stake in Claymore (see paragraph 3.28) in December 1998 for £2.2 million;

— Star Dairies International Limited in February 1999, a wholesale supplier of milk, cream and other products to catering outlets around London, for £3.5 million; and

— Blakes in August 1999, a chilled food distribution business, for £3.0 million.

3.51. However, Express's largest acquisition occurred in June 1999 when it acquired the UK milk operations of Glanbia Plc (Glanbia) for £104.4 million, including £63.0 million of goodwill. The UK operations consisted of two companies, Avonmore Dairies Limited and Waterford Foods (UK) Limited, and their related assets. Glanbia's milk operations were the fifth largest in the UK with a market share of 9 per cent. Assets acquired included four fresh processed milk dairies, one UHT dairy, and 58 depots, none of which was in Scotland.

3.52. Express's investment in Claymore was part of a wider strategy for entry into the Scottish market. Express believed that with the collapse of Scottish Pride, and Wiseman's acquisition of its fresh processed milk business, this had made room for a major new competitor in Scotland. In addition to the investment in Claymore, Express's intention was to acquire Gilmours in Newmilns, outside Kilmarnock (eventually purchased by Wiseman in April 1999 (see paragraph 3.10)), and support it with a depot in Coatbridge. The Gilmours plant had local authority health approval but in the long term would have required substantial investment. When sufficient volumes had been achieved, the Gilmours dairy was to be closed down and conversion of the Coatbridge site into a processing facility was considered an option. Express's objective was to gain market share of 13 per cent in Scotland over two years from around a 9 per cent base (including Claymore and Gilmours). When Express failed to acquire Gilmours and lost the CWS account to Wiseman it was faced with three options:

- to liquidate the Claymore business;
- to continue trading in Claymore's traditional core area of activity with lower sales volumes; or
- expansion into Aberdeenshire and the Central Belt in order to sell milk that it was contractually bound to purchase.

Express decided on expansion into Aberdeenshire and the Central Belt. The factors that lay behind the decision are set out in paragraphs 6.16 to 6.18.

Principal activities

3.53. Express's business is focused on liquid milk and cream. It is one of the UK's largest suppliers of liquid milk by volume. This position was consolidated by the acquisition of Glanbia (see paragraph 3.51). Map 2 shows a map of the UK with the locations of the Express operations. The proliferation of distribution depots allows Express the benefit of widespread coverage. Operations in Scotland are those of Claymore with the exception of a distribution depot in Airdrie, part of the Blakes business, and a co-packaging agreement with SMD in the Central Belt for fresh processed milk. (See paragraph 3.71 for further details.)

3.54. Aside from the operations outlined in paragraphs 3.47 to 3.51, Express's two principal operations are:

(a) *Express Dairies Direct Service*, which processes and bottles milk and delivers milk to doorstep, small shops and catering customers through a network of franchisees and rounds staff and also to independent wholesalers. It has a wide network of depots in a number of major conurbations.

(b) *Express Dairies Major Retail*, which supplies fresh liquid milk to large supermarkets. It is also a substantial supplier of fresh cream to the larger supermarkets and the largest UK processor of UHT milk and cream.

Express's other business operations are:

(c) *Express Dairies Distribution*, which handles Express's distribution requirements including the daily collection of raw milk from farms and the delivery of processed product to large supermarkets and distribution depots.

(d) *Express Dairies Ingredients*, which purchases the entire Group's raw milk requirements and handles seasonal surpluses in excess of core market requirements. It produces a range of ingredients including bulk cream, condensed milk and chocolate crumb for food and confectionery manufacturers.

(e) *Express Dairies Ireland*, which is the leading supplier of liquid milk by volume in Northern Ireland, with a branded presence in fresh dairy products and until this year, when it was divested, ice cream interests. Express Dairies Ireland operates only in Northern Ireland.

Financial information

3.55. Express prepares its accounts to 31 March each year. A summary of results and financial information for the five years from 1995/96 to 31 March 2000 is set out in Table 3.6. Full consolidated profit and loss accounts and balance sheets are shown in Appendices 3.10 and 3.11 respectively.

TABLE 3.6 **Express: summary of results and financial information**

£ million

	Years ended 31 March				
	1995/96	*1996/97*	*1997/98*	*1998/99*	*1999/2000*
Turnover	923.4	809.1	752.8	794.0	928.5
Operating profit	60.8	44.8	62.5	65.7	59.4
Net operating assets*	150.4	146.3	141.9	151.1	246.9
Average net operating assets		148.4	144.1	146.5	199.0
					per cent
Return of operating profit:					
On turnover	6.6	5.5	8.3	8.3	6.4
On average operating assets		31.1	43.4	44.8	29.8
Financial ratios:					
Gearing ratio (%)†	58.1	48.7	59.3	52.4	81.3
Interest cover (times)	2.3	2.5	9.5	9.7	5.4
Dividend cover (times)	N/A	N/A	1.6	1.5	0.0
Production information:					
Output sold (million litres)					
Fresh processed milk		*Figures omitted.*			
UHT		*See note on page iv.*			

Source: Express.

*Defined as net assets plus net debt.
†Defined as net debt divided by net debt plus equity.

3.56. Turnover has moved from £923.4 million in 1995/96 to £928.5 million in 1999/2000. However, movements between years have been significant. Factors affecting the reduction in turnover between 1995/96 and 1996/97 were the shift in liquid milk distribution channels from doorstep to large supermarkets, disposals of doorstep milk operations and the withdrawal from unprofitable business with secondary multiple retailers. Over this period perhaps the greatest effect on turnover, and consequently on operating profit, was the adverse effect of a year-on-year swing of commodity prices in 1996/97. This was caused by a rapid currency-linked fall in commodity prices, not immediately reflected in a reduction of raw milk costs because of the operation of fixed price contracts under the Milk Marque Limited (Milk Marque) selling system. This had an adverse effect in the first half of 1997/98 also. Processors now have the option of moving to price-indexed contracts. Further factors affecting turnover in 1997/98 were falling selling prices following the reduction in raw milk prices, and a further decline in the doorstep business. Offsetting these declines were sales attributable to the Kirkcudbright UHT business and the Woodgate business, together contributing £35 million. Turnover increased in 1998/99 as a full year of Woodgate business was included and there was a 53rd week of trading. The 1999/2000 increase reflects the Glanbia and Blakes acquisitions and a full year of Claymore and Star Dairies trading. These increases have come during a time of falling raw milk prices that have softened selling prices further.

3.57. Operating profit has moved from £60.8 million to £59.4 million over the five years. Operating profit suffered significantly in 1996/97 due to commodity price movements and doorstep declines (see paragraph 3.56). Profits recovered in 1997/98 as all operating units improved performance; this was cited as the reflection of the clear strategic focus due to the demerger and the benefits of ongoing restructuring. Woodgate and the Kirkcudbright facility contributed £1.4 million to profit in this period. Profit increased by 5 per cent in 1998/99 due to a full year of the ex-Woodgate business and increases in contributions from major multiple business. Operating profit has declined by 10 per cent in the most recent period, attributable to rising oil costs affecting packaging and distribution costs and a ‘one-off’ pension valuation cost of £6.6 million. These cost increases have offset the increased profits attributable to the acquired Glanbia business.

3.58. Appendix 3.10 shows significant exceptional costs incurred in 1998/99 and 1999/2000. The £6.1 million loss in 1998/99 arose from the sale of Express’s ice-cream business in Ireland. The

£42.7 million loss arose from the rationalization of operations included in the acquisition of Glanbia. The major components of this charge relate to the closure of four processing plants and five distribution sites and the subsequent transfer of the associated trade into existing operations.

3.59. Net operating assets have increased substantially over the last two years primarily due to the acquisition of Glanbia. The nature of funding expansion has changed due to the demerger. Borrowing had been traditionally performed through an associated company but, since the demerger, this has been replaced by a revolving credit facility. The acquisition of Glanbia and the requirement to meet the ongoing funding requirements of the enlarged group necessitated the increase of the credit facility. To secure ongoing funding in March 2000, the company issued US$140 million notes due in 2010 in the USA. The proceeds of these notes have been swapped into sterling and stand at £87.5 million at 1 April 2000.

Grahams Dairies Limited

History and principal activities

3.60. Graham's had its origins in dairy farming and has operated a dairy business since 1939. The business is family owned and is based at the Bridge of Allan, Stirlingshire. The dairy business took milk from its own cows until 1969 when it ceased farming and began to take supplies from the Scottish MMB (now Scottish Milk). In 1988 Graham's resumed farming but on a reduced scale, with this representing approximately 4 per cent of the total Graham's raw milk intake. Until 1 April 2000 the business had traded as a partnership called Robert Graham and Son. At this date the business began trading as a limited company under the current name.

3.61. All processing and the majority of distribution are undertaken at the Bridge of Allan site. Graham's has two other small depots at Alexandria and Fife that are principally used as pickup points for milk roundsmen. The business is principally fresh processed milk, which represents 90 per cent of turnover. The dairy's sales are within the middle ground, as the dairy does not have large supermarket accreditation (see Chapter 4). However, the dairy is accredited to supply larger symbol groups with [✄] being Graham's largest customer.

3.62. Graham's area of operation is through the Central Belt, including Edinburgh, covering Falkirk, Stirling, Airdrie, and Glasgow. Graham's has customers in Largs and Alexandria to the west and as far north as Perth, but generally areas south of Glasgow are not covered.

Financial information

3.63. The business produces accounts to 31 March each year. As a partnership, accounts are not required to be filed with Companies House, so Graham's has provided us with the information in Table 3.7.

TABLE 3.7 **Graham's: summary of results and financial information**

£'000

	*Years to 31 March**				
	1995/96	*1996/97*	*1997/98*	*1998/99*	*1999/2000*
Turnover	*Figures omitted. See note on page iv.*				
Operating (loss)/profit					
					per cent
Return on operating profit:	*Figures omitted. See note on page iv.*				
On turnover					
Production information:					
Output sold ('000 litres)					

Source: Graham's.

*Unaudited.

3.64. Turnover has increased nearly tenfold in the past five years. Growth has been achieved organically, picking up business when Scottish Pride entered receivership in March 1997 and also picking up business from Gilmours when it sold out to Wiseman. Graham's told us that it had made a number of small acquisitions of dairies with small market shares, notably Strathhendrick Dairies in 1998, closing them down and moving production into its Bridge of Allan facility.

3.65. [

Details omitted. See note on page iv.

]

Scottish Milk Dairies Limited

History and principal activities

3.66. Until May 2000 SMD had been called Drakemire Dairy Foods Limited. In February 1998 Scottish Milk purchased a 36 per cent interest in Drakemire. By May 2000 this interest had increased to 80 per cent. Scottish Milk told us that it planned to acquire the remaining 20 per cent later this year.

3.67. Originally the Edmunds family owned the Drakemire business, which was based in Castlemilk, Glasgow. The business was operated as a partnership until March 1995 when the partnership became a limited company with the two Edmunds brothers and their brother-in-law taking shareholdings. The change in ownership structure coincided with the dairy moving to the present site in Hamilton.

3.68. Historically, the dairy produced fresh processed milk, cream and butter. The move to the larger site at Hamilton enabled the construction of a UHT plant, which has become an increasingly important part of the business. SMD's fresh processed milk dairy does not have large supermarket accreditation.

3.69. SMD's principal customers for fresh processed milk are independent retailers in the greater Glasgow region, although there are customers as far south as Ayr and as far north as Stirlingshire. SMD's UHT dairy is of such a standard that it can supply large supermarkets and larger symbol groups, with Morrisons and Lidl among its major customers. Due to the size of the Hamilton site and the concentrated customer base, all distribution is undertaken at Hamilton using SMD's own fleet of vehicles.

3.70. At the end of April 2000, SMD entered into an agreement with Claymore to process and pack milk for it using the Scottish Pride label. Distribution of this milk is not undertaken by SMD. Current throughput is approximately 85,000 litres per week.

Financial information

3.71. Turnover increased by 31.2 per cent over the period 1995/96 to 1997/98. The increase was attributable to growth in UHT business throughout this period. The UHT plant was commissioned in the year 1995/96. However, the fall in turnover from the peak in 1997/1998, and consequently operating profit, have been due to falling margins on UHT business and the loss of Kwik Save, a key customer, in 1998/99. Although fresh processed milk volumes have remained relatively stable since the entry of Express/Claymore into the Central Belt in the spring of 1999, profits have suffered as selling prices have fallen considerably in an attempt to retain business.

TABLE 3.8 **SMD: summary of results and financial information**

£'000

	Years ended 31 March				
	1995/96	*1996/97*	*1997/98*	*1998/99*	*1999/2000*
Turnover	10,160	12,842	13,326	10,880	11,294
Operating profit/(loss)	30	366	465	(104)	(303)
Net operating assets*	1,669	1,602	2,035	1,960	1,995
Average net operating assets		1,636	1,819	1,998	1,978
					per cent
Return of operating profit:					
On turnover	0.3	2.9	3.5	(1.0)	(2.7)
On average operating assets		22.4	25.6	(5.2)	(15.3)
					'000 litres/kg
Production information—output sold:					
Fresh processed milk				11,470	11,263
UHT				13,749	18,236
Butter				834	919
Other				489	698

Source: SMD.

*Defined as net assets plus net debt.

Analysis of Wiseman's profitability and costs

Comparison with other companies

3.72. We compared Wiseman's indicators of key performance for the year ending March 1999 against other food producers and processors and also against all other industries, excluding food producers and processors. The data for other industries are from the latest year end from 25 January 1999. We have used the year ended 31 March 1999 because it was the last year, except for the final quarter, when Wiseman did not face vigorous competition from Express/Claymore. Table 3.9 shows the results.

TABLE 3.9 **Wiseman: comparison with other food producers and processors and all industries of key performance indicators**

per cent

	Operating profit/sales	*Return on net operating assets**	*Return on equity†*
Food producers and processors excluding Wiseman	4.3	17.9	4.3
Wiseman	7.7	36.5	23.9
All industries			
Excluding food producers and processors	10.6	18.9	17.7
Wiseman	7.7	36.5	23.9

Source: Commission analysis.

*Where net operating assets are defined as net assets plus net debt.
†Defined as profit after tax before minority interests divided by equity.

3.73. Wiseman outperformed other food producers and processors significantly on all three indicators. The widest margin is on return on equity where Wiseman earned 23.9 per cent compared with 4.3 per cent for the industry. In comparing Wiseman against all other industries except for food producers and processors, Wiseman's operating profit as a percentage of sales was lower than other industries but earned a higher return on net operating assets and its equity. However, Wiseman's out-performance of other food producers and processors was greater than against all other industries. Wiseman's 1999/2000 results show a decline in profitability (see Table 3.3).

Analysis of Wiseman's Scottish operations

3.74. We asked Wiseman to provide us with a breakdown of its profitability between Scotland and the rest of the UK. Table 3.10 illustrates the performance of Wiseman's Scottish operations.

TABLE 3.10 **Wiseman's performance: Scottish operations**

				£'000
	1996/97	*1997/98*	*1998/99*	*1999/00*
Sales				
Cost of sales				
Gross margin				
Processing				
Packaging				
Trunking				
Distribution		*Figures omitted. See note on page iv.*		
Operating profit before central cost allocation				
Central cost allocation				
Operating profit				
Fresh processed milk sold ('000 litres)				
				per cent
Operating profit as percentage of sales				
Costs expressed as a proportion of sales:				
Cost of sales		*Figures omitted. See note on page iv.*		
Processing				
Packaging				
Trunking				
Distribution				
Central costs				
				*ppl**
Sales, costs and profits:				
Sales				
Cost of sales				
Gross margin				
Processing		*Figures omitted. See note on page iv.*		
Packaging				
Trunking				
Distribution				
Central costs				
Operating profit				

Source: Wiseman.

*The sales and costs per litre include the cream and other business. The levels of non-fresh milk sales is shown in Table 3.11.

3.75. The decrease in operating profit shows the effect of Express's entry into the Scottish market (see paragraphs 3.24 and 3.25 for a fuller discussion of Wiseman's overall profitability over this period). UHT and other product cost of sales were £[✂] million in 1999/2000. This is 0.3 ppl of cost that does not relate to fresh processed milk. This is not a material amount and therefore has not been adjusted for in subsequent analyses. Table 3.11 shows the composition of Wiseman's Scottish sales by product type.

TABLE 3.11 **Composition of Wiseman sales by product type: Scotland**

				£'000
	1996/97	*1997/98*	*1998/99*	*1999/2000*
Total milk				
Cream				
UHT milk				
Other products		*Figures omitted. See note on page iv.*		
Total sales				
Less cream				
Adjusted sales				

Source: Wiseman.

3.76. As expected, milk makes up the vast majority of revenue. Cream, which is sold in pots and in bulk, is the next largest item. It is a by-product of the skimming process that occurs in the production of semi-skimmed and skimmed milk. Wiseman offsets cream revenue for management reporting purposes against milk cost of sales. This appears to be industry practice. Claymore's submissions to us showed that milk costs were net of cream revenues. Wiseman buys in UHT and other products from third parties. Typically Wiseman's franchised roundsmen sell these items. Other products include such items as orange juice, yoghurt and cheese.

3.77. Table 3.12 shows Wiseman's Scottish depots and the volumes of fresh processed milk sales through them.

TABLE 3.12 **Wiseman's Scottish fresh processed milk sales: volumes by location**

				'000 litres
	1996/97	*1997/98*	*1998/99*	*1999/2000*
Aberdeen				
Carlisle				
East Kilbride*				
Cupar				
Dundee				
Edinburgh*				
Glasgow*†				
Keith		*Figures omitted. See note on page iv.*		
Kilmarnock				
Perth				
Peterhead				
Rutherglen*				
Stirling*				
Whitburn*				
Bellshill—dairy				
Aberdeen—dairy				
East Kilbride—dairy				
	313,738	420,335	402,678	418,300

Source: Wiseman.

*Denotes Central Belt depot.
†Includes Cambuslang in 1999/2000.

3.78. Table 3.12 shows that the majority of Wiseman's sales volumes are out of depots in the Central Belt. The largest depots for fresh milk sales are Glasgow (when the Cambuslang depot opened in 1999, the Glasgow and East Kilbride depots closed), so the Glasgow line contains Glasgow and Cambuslang volumes in 1999/2000, Whitburn, and Edinburgh. Wiseman's Aberdeen depot also distributes just over 10 per cent of Wiseman's total Scottish volumes. In the year 1999/2000 the largest movements in volume not attributable to the opening of Cambuslang have been Kilmarnock and Keith. Kilmarnock was acquired as part of the Gilmours acquisition (see paragraph 3.10) in April 1999; prior to this, deliveries into Ayrshire had been undertaken out of Glasgow. Keith volumes have increased as Wiseman has expanded into the Highlands; a significant part of this growth was the capture of CWS's Highland stores.

Analysis of processing and distribution costs

3.79. We now turn to a consideration of Wiseman’s costs, concentrating on its Scottish operations and on the distinction between fixed and variable costs.

3.80. Costs of sales include the cost of raw milk and its subsequent transportation to the dairy for processing. Raw milk is purchased either from farmers contracted directly to Wiseman or from Scottish Milk. The purchase of an additional litre of raw milk adds an additional cost to each litre of production of fresh milk. Therefore costs of sale are considered to be completely variable in nature.

3.81. Processing costs, however, contain an element of fixed and variable costs. Table 3.13 shows the processing costs by dairy.

TABLE 3.13 **Processing costs by dairy**

£’000

	1996/97	*1997/98*	*1998/99*	*1999/2000*
Aberdeen				
Bellshill				
Rutherglen				
East Kilbride				
Carlisle adjustment—English portion		*Figures omitted. See note on page iv.*		
Volume processed (’000 litres)				
Cost per litre processed (ppl)				

Source: Wiseman.

3.82. Just less than half Scottish processing costs are accounted for by Bellshill, Wiseman’s largest dairy in Scotland. Rutherglen’s costs were low in 1996/1997 as it was acquired late in the year as part of the Scottish Pride acquisition. Rutherglen’s is used only for the glass bottling of fresh milk. The adjustment to processing costs for Carlisle reflects the fact that approximately two-thirds of Carlisle’s sales are made into northern England, yet it is supplied from Bellshill. The adjustment was very small in 1996/97 as it was acquired as part of the Scottish Pride acquisition (see paragraph 3.9). Appendices 3.12 to 3.15 provide a breakdown of processing costs by dairy by year in more detail. Discussion of the splits between fixed and variable costs are undertaken in paragraphs 3.87 to 3.105.

3.83. Wiseman told us that it regarded packaging costs as being entirely variable in nature. The production of an additional litre of fresh processed milk would lead to additional packaging cost of some kind. Wiseman packs milk into tetra cartons, plastic containers and glass bottles. Costs of this packaging range from [✂] ppl for a 600-ml (1-pint) glass container (with an expected utilization of 5 times) to [✂] ppl for a 1-pint (600-ml) plastic container (used only once). Table 3.10 shows that the average packaging cost over the period 1996/97 to 1999/2000 has been between [✂] and [✂] ppl. Wiseman told us that customers take a range of package sizes so an average is used in price negotiations. However, if a customer were to take a high proportion of one type of container, then the price could be negotiated accordingly.

3.84. Trunking costs are associated with the transportation of processed milk from the dairy to the depot. Wiseman told us that it treated all these costs as fixed in nature. The sensitivity of adjusting the proportion of trunking costs that are considered fixed and variable are considered in paragraph 3.101.

3.85. As with processing costs, distribution costs also contain an element of fixed and variable cost. Table 3.14 shows the distribution costs incurred by depot. Appendices 3.16 to 3.19 provide a breakdown of the costs by depot by year in more detail.

TABLE 3.14 **Distribution costs by depot**

				£'000
	1996/97	*1997/98*	*1998/99*	*1999/2000*
Aberdeen				
Carlisle				
East Kilbride				
Cambuslang				
Cumbernauld				
Cupar				
Dundee				
Edinburgh				
Glasgow	*Figures omitted. See note on page iv.*			
Keith				
Kilmarnock				
Kintore				
Perth				
Peterhead				
Rutherglen				
Stirling				
Whitburn				
General*				

Source: Wiseman.

*The depot denoted 'general' refers to functions that are carried out with regard to distribution but are not attributable to any one depot, for example, Wiseman services all its own vehicles, which constitute the majority of this cost.

3.86. Distribution costs have increased year-on-year since 1996/97. Table 3.12 illustrates major movements in sales volumes through depots. Costs have moved in line with increases or decreases in volumes. Discussion of the split between fixed and variable costs is undertaken in paragraphs 3.95 to 3.100. However, Wiseman considers general distribution cost expenditure fixed.

Fixed and variable costs

3.87. Fixed and variable costs have been considered for the years 1998/99 and 1999/2000 as Express's entry into Scotland was toward the end of the third quarter of 1998/99, in December 1998, and these are the periods in which Express/Claymore has alleged predatory pricing.

Fixed and variable costs in processing

3.88. Wiseman told us that, averaged across all its Scottish dairies, 53 per cent of its processing costs were variable and the remaining 47 per cent were fixed in 1998/99 and 1999/2000. Table 3.15 shows the variable processing costs as a percentage of total costs for each of Wiseman's Scottish dairies for the two years.

TABLE 3.15 **Proportions of variable processing costs by dairy**

		per cent
	1998/99	*1999/2000*
Aberdeen	55	55
Bellshill	51	51
Rutherglen	49	49
East Kilbride	54	54
Weighted average	53	53

Source: Wiseman.

3.89. Wiseman told us what it considered to be fixed costs in its dairies. By far the largest proportion of fixed costs related to employee costs. Employee costs considered to be fixed were salaried employees (all of whom are employed in a managerial/supervisory capacity) and waged employees in administration, supervising, cleaning, laboratories, milk intake and security. Other costs considered fixed were service contracts for plant, depreciation, and rent and rates. Wiseman also estimated that 35 per cent of its fuel, power and water consumption were fixed.

3.90. Tables 3.16 and 3.17 give the fixed and variable costs per unit at the percentages outlined in Table 3.15 for 1998/99 and 1999/2000 respectively.

TABLE 3.16 **Fixed and variable costs of processing, 1998/99**

	Bellshill	*Aberdeen*	*East Kilbride*	*Rutherglen*	*Total*
					'000 litres
Production volumes	(	*Figures omitted. See note on page iv.*			)
					£'000
Total costs	(	*Figures omitted. See note on page iv.*			)
					per cent
Fixed	49	45	46	51	47
Variable	51	55	54	49	53
					£'000
Fixed costs Variable costs		*Figures omitted. See note on page iv.*			
					ppl
Total cost per litre Fixed cost per litre Variable cost per litre		*Figures omitted. See note on page iv.*			

Source: Wiseman.

3.91. In 1998/99 the average total processing cost (APC) was [✂] ppl, ranging from [✂] ppl at Bellshill to [✂] ppl at East Kilbride. The weighted average variable processing cost (AVPC) was [✂] ppl, ranging between [✂] ppl and [✂] ppl. Table 3.17 shows the equivalent data for 1999/2000.

TABLE 3.17 **Calculation of fixed and variable costs of processing, 1999/2000**

	Bellshill	*Aberdeen*	*East Kilbride*	*Rutherglen*	*Total*
					'000 litres
Production volumes	(	*Figures omitted. See note on page iv.*			)
					£'000
Total costs	(	*Figures omitted. See note on page iv.*			)
					per cent
Fixed	49	45	46	51	47
Variable	51	55	54	49	53
					£'000
Fixed costs Variable costs		*Figures omitted. See note on page iv.*			
					ppl
Total cost per litre Fixed cost per litre Variable cost per litre		*Figures omitted. See note on page iv.*			

Source: Wiseman.

3.92. In 1999/2000 the APC was [✂] ppl; however, the range was from [✂] ppl at Bellshill to [✂] ppl at East Kilbride. Of these totals, the AVPC was [✂] ppl, ranging between [✂] and [✂] ppl. The cost of processing at East Kilbride was much higher than that for the other dairies. This was because it produces specialist products, for example school and flavoured milk. In addition, East Kilbride packs all the potted cream for the group. The costs relating to this activity are included above but production volumes relate only to liquid milk.

3.93. We took the percentages in Table 3.15 and tested their sensitivity to changes in the assumptions in order to examine the effect on the variable costs per litre if these percentages were altered. Table 3.18 shows the effect on variable unit costs if the variable percentage were 65, 60 or 55 per cent rather than the 53 per cent calculated by Wiseman.

TABLE 3.18 **Sensitivity analysis: processing weighted average variable cost proportions**

	1998/99	*1999/2000*
		'000 litres
Production volumes	(✂	)
		£'000
Total costs	(✂	)
		ppl
Variable cost/litre @ 53%		
Variable cost/litre @ 55%		
Difference		
Variable cost/litre @ 53%	*Figures omitted. See note on page iv.*	
Variable cost/litre @ 60%		
Difference		
Variable cost/litre @ 53%		
Variable cost/litre @ 65%		
Difference		

Source: Commission based on Wiseman data.

3.94. If the proportion of variable costs increased to 55 per cent of total compared with 53 per cent calculated by Wiseman, then the AVPC would increase by [✂] ppl in 1998/99 and 1999/2000. If variable costs moved from 53 to 60 per cent of the total, then the increase would be [✂] ppl. If variable costs were 65 per cent of total costs, then the difference would be [✂] ppl if compared with 53 per cent. For every five percentage point increases in the proportion of total costs assumed to be variable, the estimated AVPC increases by [✂] ppl in each year.

Fixed and variable costs in distribution

3.95. Wiseman told us that, averaged across all its Scottish depots, 60 per cent of its distribution costs were variable and the remaining 40 per cent were fixed. This calculation excluded the depot denoted as 'general' where all costs were considered fixed. Table 3.19 shows the differences between depots and their respective proportions of variable costs.

TABLE 3.19 **Proportions of variable distribution costs by depot**

		per cent
	1998/99	*1999/2000*
Aberdeen	56	56
Carlisle	58	58
East Kilbride	57	57
Cupar	62	57
Dundee	61	62
Edinburgh	62	61
Glasgow	57	62
Keith	69	69
Kilmarnock	-	58
Perth	61	-
Whitburn	64	64
Weighted average	60	60

Source: Wiseman.

3.96. We asked Wiseman to tell us what it considered to be fixed costs at its depots. As with processing costs, the largest proportion of fixed costs related to employee costs. Employee costs considered to be fixed were salaried employees (all of whom are employed in managerial/supervisory capacity), and waged employee costs of people employed in administration and supervising and yard workers. Yard workers are those who load and unload vehicles coming into the depot. Wiseman considers these fixed, as only a certain number of trucks can be loaded and unloaded at any depot at any point in time. Other costs considered fixed were depreciation, service contracts, and 35 per cent of fuel, power and water consumption. Appendices 3.20 and 3.21 give the fixed and variable costs per litre at the percentages outlined in Table 3.19 for 1998/99 and 1999/2000 respectively. As noted in paragraph 3.86, general costs are treated as entirely fixed by Wiseman and so are omitted from the appendices.

3.97. In 1998/99 the weighted average distribution cost (ADC) was [✂] ppl; however, the range was from [✂] ppl at Dundee to [✂] ppl at Aberdeen (the ADC for Perth was higher than Aberdeen but this depot closed part way through the year). Of these totals, the weighted average variable distribution cost (AVDC) was [✂] ppl, ranging between [✂] ppl and [✂] ppl.

3.98. In 1999/2000 the ADC dropped slightly to [✂] ppl. Again the lowest ADC was [✂] ppl at Dundee and the highest was [✂] ppl at Aberdeen. Of these totals, the AVDC was [✂] ppl, ranging between [✂] ppl at Dundee and [✂] ppl in Edinburgh.

3.99. We took the percentages in Table 3.19 and tested their sensitivity to see the effect on variable costs per litre if these percentages were altered. Table 3.20 shows the effect on AVDC if the variable percentage were 65, 70 or 75 per cent, rather than the 60 per cent calculated by Wiseman.

TABLE 3.20 **Sensitivity analysis: distribution weighted AVC proportions**

	1998/99	*1999/2000*
		'000 litres
Sales volumes	(✂)	
		£'000
Total costs	(✂)	
		ppl
Variable cost/litre @ 60%	*Figures omitted. See note on page iv.*	
Variable cost/litre @ 65%		
Difference		
Variable cost/litre @ 60%		
Variable cost/litre @ 70%		
Difference		
Variable cost/litre @ 60%		
Variable cost/litre @ 75%		
Difference		

Source: Commission based on Wiseman data.

3.100. If variable costs were 65 per cent of the total compared with 60 per cent, then the difference in AVDC would be [✂] ppl in 1998/99 and [✂] ppl in 1999/2000. If variable costs increased to 70 per cent of the total then the difference would be [✂] ppl and [✂] ppl in 1998/99 and 1999/2000 respectively. If variable costs were to be increased further to 75 per cent of the total, then the difference would be [✂] ppl and [✂] ppl in 1998/99 and 1999/2000 respectively. For every five percentage point increases in the proportion of total costs assumed to be variable, the estimated AVDC increases by around [✂] ppl in each year.

Fixed and variable costs of trunking

3.101. As noted in paragraph 3.84, Wiseman considers all its trunking costs as fixed. However, there is room for discussion on this. For the purposes of building up an average total variable cost (ATVC), 50 per cent of these costs might be taken to be variable. Table 3.10 shows that in 1998/99 and 1999/2000 trunking costs per litre were [✂] ppl. If half this cost is considered variable, then the average variable trunking cost is [✂] ppl in both 1998/99 and 1999/2000. We have used this figure in arriving at ATVC.

Average total variable cost

3.102. In paragraphs 3.87 to 3.101 we have described the proportions of the fixed and variable costs of Wiseman's Scottish operations. In Table 3.21 all variable costs are brought together to arrive at an AVC.

TABLE 3.21 **AVC of Wiseman's Scottish operations**

	1998/99	*1999/2000*
		ppl
Cost of sale	*Figures omitted. See note on page iv.*	
Processing		
Packaging		
Trunking*		
Distribution		
ATVC		

Source: Wiseman and Commission estimates.

*Commission estimate.

3.103. The ATVC has dropped by [✂] ppl from 1998/99 to 1999/2000. The major contributor to the decrease has been the cost of sales which has fallen by [✂] ppl. This decrease reflects the falling raw milk price in the past year. Per litre packaging and distribution costs have also decreased but to a lesser degree and have been partly offset by a small rise in processing costs.

3.104. The result of changing the variable proportion of total processing to 65 per cent and the variable proportion of distribution costs to 75 per cent is shown in Table 3.22.

TABLE 3.22 **AVC: processing costs 65 per cent variable and distribution costs 75 per cent variable**

	1998/99	*1999/2000*
		ppl
Cost of sale	*Figures omitted. See note on page iv.*	
Processing		
Packaging		
Trunking*		
Distribution		
AVC		

Source: Commission based on Wiseman data.

3.105. If the percentages in Table 3.22 are applied, the AVC increases from [✂] to [✂] ppl in 1998/99. This represents an increase of [✂] ppl or [✂] per cent. In 1999/2000 the AVC would increase to [✂] ppl from [✂] ppl. This represents an increase of [✂] ppl or [✂] per cent.

Cost of capital

3.106. Included in ATC should be an allowance for Wiseman's cost of capital. In Table 3.23 we have made an estimate of Wiseman's weighted average cost of capital (WACC) for the year ending 31 March 2000. We have used data for this year to compare the cost of key contract prices against AVC and ATC in paragraphs 3.111 to 3.114.

TABLE 3.23 **Wiseman pre-tax nominal WACC, 1999/2000**

		per cent
Risk-free rate (real)	3.0	
Inflation	1.6	
Risk-free rate (nominal)		4.6
Equity risk premium	4.0	
Beta*	0.63	
Equity risk premium x beta*		2.5
Post-tax cost of equity		7.1
Post-tax cost of debt†		5.95
Average gearing 1998/99 and 1999/2000 (%)	11.2	
Pre-tax cost of equity‡	10.1	
Pre-tax weighted cost of equity§	9.0	
Pre-tax weighted cost of debt¶	0.7	
Pre-tax weighted average cost of capital	9.7	

Source: Commission analysis.

*As calculated by the London Business School Risk Measurement Service.
†Assume Wiseman borrows at LIBOR + 0.5 per cent.
‡Represents post-tax cost of equity divided by 70 per cent, assuming a 30 per cent corporate tax rate.
§Cost of equity multiplied by 88.8 per cent.
¶Cost of debt times multiplied by 11.2 per cent.

3.107. Table 3.23 shows Wiseman's pre-tax, nominal WACC to be 9.7 per cent. Wiseman's average net operating assets during the year ending March 2000 were £71.8 million. This represents Wiseman's entire operations including England and Wales. As Scottish production during the period represented 55.6 per cent of total production, this percentage was applied against the average net operating assets to give an estimate for Scottish net operating assets, giving £39.9 million. Applying the WACC to this average gives £3.9 million. Applying this amount across production volumes for the year of 418.3 million litres gives 0.92 ppl that should be included in arriving at ATC.

Average fixed and total costs

3.108. Table 3.24 sets out the components of per litre fixed costs. Added to them at the bottom of the table is the ATVC from Table 3.21 and, for 1999/2000 only, the WACC to come to ATC.

TABLE 3.24 **Average total fixed cost and ATC**

		ppl
	1998/99	*1999/2000*
Processing		
Trunking		
Distribution		
Distribution—general		
Central allocation	*Figures omitted.*	
Average total fixed cost	*See note on page iv.*	
ATVC		
ATC before WACC		
WACC		
ATC after WACC		

Source: Commission based on Wiseman data.

[✄]

3.109. Average total fixed cost has dropped by [✄] ppl from 1998/99 to 1999/2000. Increases in per litre fixed processing costs have been offset by decreases in per litre distribution costs.

3.110. Table 3.25 sets out the fixed cost components if variable costs were to represent 65 per cent of processing costs and 75 per cent of distribution costs. The ATVC is added from Table 3.22 to arrive at the ATC which is unchanged from that shown in Table 3.24 as it is only the split between the variable and fixed elements that has been altered.

TABLE 3.25 **Average total fixed cost and ATC with processing costs 65 per cent of total and distribution costs 75 per cent of total**

ppl

	1998/99	*1999/2000*
Processing		
Trunking		
Distribution		
Distribution—general		
Central allocation	*Figures omitted.*	
Average total fixed cost	*See note on page iv.*	
ATVC		
ATC before WACC		
WACC		
ATC after WACC		

Source: Commission based on Wiseman data.

[✂]

Comparison of average total variable cost and average total cost with key account prices

3.111. It has been alleged that Wiseman has been engaging in predatory pricing by Express/ Claymore. Express/Claymore has submitted to us a number of key accounts (ie CWS) in which Wiseman either gained volume from Express as part of securing Scotland-wide supply arrangements, or retained existing business using pricing that Express alleged was below Wiseman ATVC. Table 3.26 shows the key accounts contract price and compares against it Wiseman's ATVC and ATC in 1999/2000.

TABLE 3.26 **Comparison of Wiseman's 1999/2000 AVC and ATC against key account prices**

ppl

	CWS	*C J Lang (Spar)*	*Aberness (Mace)*
Average contract price		*Figures omitted.*	
AVC		*See note on page iv.*	
ATC			
Contract price less ATVC	6.22	7.90	6.53
Contract price less ATC	(0.53)	1.15	(0.22)

Source: Commission based on Wiseman data.

3.112. In all contracts, the contract price exceeds ATVC. The largest differential is C J Lang at 7.90 ppl over AVC, with the smallest differential being CWS at 6.22 ppl. Therefore all these contracts are making a contribution to fixed costs. However, with the exception of the C J Lang (Spar) contract price, Wiseman's total costs were not completely covered.

3.113. Table 3.27 shows equivalent data to that in Table 3.26, except the AVC calculated in Table 3.25 is used, treating 65 per cent of processing costs as variable and 75 per cent of distribution costs as variable. The difference between the contract price and total cost will not have changed from Table 3.26 as only the split between variable and fixed costs has been altered.

TABLE 3.27 **Comparison of Wiseman's 1999/2000 AVC (considering 65 per cent of processing costs as variable and 75 per cent of distribution costs as variable) and ATC against key account prices**

ppl

	CWS	*C J Lang (Spar)*	*Aberness (Mace)*
Average contract price	*Figures omitted. See note on page iv.*		
AVC			
ATC			
Contract price less AVC	5.03	6.71	5.34
Contract price less ATC	(0.54)	1.14	(0.23)

Source: Commission based on Wiseman data.

3.114. As in Table 3.26 the contract price in all cases exceeds AVC. None of the differentials in Table 3.26 between ATVC and the contract price was less than 1.20 ppl, so it was expected that this would be so.