Bd

C(79) 41

COPY NO 81

2 October 1979

CABINET

LIQUID MILK PRICES

Memorandum by the Minister of Agriculture, Fisheries and Food

INTRODUCTION

1. The returns of our milk producers - which are central to our agricultural policy - depend upon the prices they receive from the liquid and milk products markets. The latter depend essentially upon decisions taken in Brussels on EEC support prices, but the Government is itself responsible for determining maximum prices for liquid milk at both wholesale and retail levels. In this paper I make proposals on those prices for the 6 months from October to March.

BACKGROUND

2. In May we increased the maximum retail price of milk by 1½p per pint. The previous Government's deliberate postponement of a price decision meant that virtually the whole of this 1½p had to go to the distributors, to meet sharp increases in their costs and make good the 2 months' delay. We hoped then that the wholesale price could be increased in October sufficiently to give dairy farmers a reasonable return for the autumn without a further retail price increase until the New Year.

3. This is no longer possible. The measured costs of the distributors prove to have increased more than was then thought, and the rate of cost inflation in October-March will be higher than we then expected. As a result the increase in the wholesale price on 1 October can be only about half what we expected.

MILK PRODUCERS' NET MARGINS

4. Because of this, and because their own costs have increased, dairy farmers' margins in the April-March year, if there were no increase in the retail price, would be only about £75 a cow. That would be the lowest margin for 5 years, apart from the drought year of 1976-77, and in particular it would compare with £96 in 1978-79 and the £108 that would be needed to give producers this year the same return in real terms.

5. In Opposition we condemned that level as inadequate, and our Manifesto criticised the previous Government for seriously undermining the profitability of agriculture. It also pledged us to ensure that our industry had the means of keeping abreast of those in other countries. We therefore need, at the very least, to maintain the level of net margins which dairy farmers obtained in the last year of the Labour Government (1978-79). As the recent 1.1 per cent green pound devaluation will have only minimal effect on margins in 1979-80 and as the effect of any further green pound devaluation would not now show through until next year, the only way we can do this is by an early and adequate increase in liquid milk prices. This means raising the retail price by 1½p per pint on 18 November in England, Wales and Northern Ireland, and on 21 October in Scotland (where there is a greater backlog of distribution costs to meet), if all of my recommendations are agreed. Details of these changes, together with public expenditure and other implications, are given in the appended note by my officials based on figures agreed with officials of the Treasury and Department of Trade.

6. Because returns from the milk products market have been so depressed, this would still leave the average producer price in this country well below the EEC target price, and lower than in any other Member State; and, in so far as it helped maintain our own output, it would be entirely consistent with our wider objective in Brussels of securing a cut-back in production from inefficient farmers on the Continent and concentrating it in those areas, such as the United Kingdom, which are best suited to dairying.

SCOTLAND AND NORTHERN IRELAND

7. The figures quoted above and in the annex relate to England and Wales. The position in Scotland and Northern Ireland is however comparable - though two areas of difficulty do arise. The delay in implementing the last two retail price increases in Scotland now turns out, against expectations, to have resulted in an under-recoupment of distributors' costs. This means we have to make up the balance in distribution costs there. Part of this can be achieved by bringing the change in the retail price forward by 4 weeks on this occasion, with the remainder falling due next spring. Secondly, an increase in the retail price will widen the gap between the returns of producers in Northern Ireland and those in the rest of the United Kingdom. This means that we will need this year to pay the special milk aid at the maximum level of 1.3p per litre permitted under the special EEC authorisation. However, even this will leave net margins in Northern Ireland £18 per cow below those in England and Wales.

DISTRIBUTORS' PROFIT

8. We also have to decide on the distributors' target profit per gallon for the year from 1 October. We have appointed independent accountants to review the whole method of measuring distribution costs and determining profits. Pending their report we do not propose to increase the target profit, even though this means a sharp reduction in real terms (the last

Government's practice was to maintain its real value). This distributors will strongly resent, but the alternative is to increase the retail price further or sooner, and we do not think this justified. To maintain the value in real terms would require an extra 0.1072p per litre, equivalent to £1.50 per cow off producers' margins, or bringing the $1\frac{1}{2}$p per pint retail price increase forward by 8 days.

STERILISED MILK

9. We also have to decide on the premium allowed on sterilised milk (7 per cent of liquid milk sales). This has stood at $\frac{1}{2}$p per pint for 8 years. Its inadequacy is proved by the decline in the numbers of distributors now producing this milk. In order to maintain freedom of choice for the consumer and allow an adequate margin for the trade, I propose to increase the premium to 1p from 18 November. Leaving the premium at $\frac{1}{2}$p per pint is equivalent to £1.00 per cow off producers' margins, or bringing the $1\frac{1}{2}$p per pint retail price increase forward by 6 days.

RECOMMENDATIONS

10. I invite my colleagues to agree:-

i. that the maximum retail price of milk should be increased by $1\frac{1}{2}$p per pint (ie from 15p to $16\frac{1}{2}$p for pasteurised milk) from 18 November in England, Wales and Northern Ireland and from 21 October in Scotland;

ii. that the present target rate of profit for distributors should remain unchanged;

iii. that the $\frac{1}{2}$p per pint premium for sterilised milk should be increased to 1p from 18 November;

iv. that accordingly the maximum wholesale price in England and Wales should be increased by 3.465p per litre on 1 November, with corresponding increases in Scotland and Northern Ireland.

P W

Ministry of Agriculture, Fisheries and Food

2 October 1979

LIQUID MILK PRICES

INTRODUCTION

1. The returns to milk producers are derived from both the liquid and milk products markets. The latter is under-pinned by the EEC support arrangements for butter and skimmed milk powder, and is thus determined essentially by decisions taken in Brussels under the Common Agricultural Policy. The prices for liquid milk are however determined quite separately by UK Ministers. Under the present system, this involves fixing maximum wholesale and retail prices on 1 April and 1 October each year for the succeeding six-monthly summer and winter periods. The difference between the wholesale and retail prices constitutes the distributive margin, which covers the costs of processing and distributing liquid milk, plus a target rate of profit for the dairy trade (which is also determined by the Government).

2. Last May, Ministers decided that the maximum wholesale price for liquid milk in England and Wales should be set at 12.943p per litre as from 1 June, and that the maximum retail price should be increased by 1½p to 15p per pint. Similar increases were implemented in the other parts of the UK, although the retail price increase in Scotland was not applied until 24 June. A decision is now required on the winter prices to apply from 1 October, and on the dairy trade's target rate of profit for the 12 months commencing on that same date.

DISTRIBUTIVE MARGIN

3. Because the spring price changes had to be delayed this year until 1 June, the increase in the distributive margin needed to cover the dairy trade's costs for the summer months was larger than would otherwise have been the case. It was therefore forecast at the time

that we would on 1 October be able to reduce their margin for the winter months by about 1.3p per litre, and that this would be done by a corresponding increase in the wholesale price. As this is the price received by the Milk Marketing Boards from the dairy trade, this would have benefited producers. However, the information now available to us shows that the dairy trade's costs are increasing faster than we anticipated and that we shall need a larger distributive margin during the winter than we thought. As a result, the wholesale price can be increased by only 0.635p per litre from 1 October - which means that only half the amount we expected will be available for producers. Since the 1 October date has passed we will need to make the change on 1 November, when the necessary increase will be 0.763p per litre. The Treasury have suggested that a lower forecast rate of inflation should be used for the October 79 - March 80 period, but it has been agreed that this is more than offset by the increase in unit costs resulting from the fall in throughput caused by the proposed retail price increase.

TARGET RATE OF PROFIT

4. The target rate of profit is fixed by Government each year for the 12 months costings period commencing on 1 October, and is currently 0.8579p per litre (3.9p per gallon). In their submission to us, the Dairy Trade Federation have not proposed any specific figure for 1979/80, and have merely asked for an increase which takes into account the fall in the value of money over the last year, plus an adjustment towards a higher depreciation allowance. As the basis for setting the target rate of profit is one of the questions which is being considered in the current review of the

costings system, this would clearly not be the right time to make any radical changes. The main question, therefore, is whether any simple adjustment should be made to the target rate, for example to preserve its real value. Such an approach could increase the present figure by 0.1072p per litre to 0.9651p per litre: but of course, all other things remaining unchanged, this would increase the distributive margin and thus reduce still further the amount available to producers through the maximum wholesale price. 0.1072p per litre on the margin from October 79 to March 1980 is equivalent to £1.50 per cow off producers' net margins, or the return from a retail price increase of 1½p per pint for 8 days.

PRODUCER RETURNS

5. At the time of the spring review, the net margins per cow for producers in 1978/79 and 1979/80 were estimated to be £99 and £103 respectively. Now that the full impact of last winter's severe conditions has been more fully assessed, the figure for 1978/79 has been revised down to £95. However, these factors - together with further increases in producers' costs on such items as feed - have also affected the projected net margin for 1979/80. If there was to be no further change in the retail price before next April, and the target rate of profit for distributors was merely maintained in real terms at its present level, the latest indications are that this figure would be as little as £75 per cow. This is somewhat lower than it might have been, as the equivalent of about £6 per cow is being deducted from producer prices by the MMB towards the financing of their recent takeover of 16 Unigate creameries. But even an adjusted figure of £81 would be some £27 below the £108 needed to give producers the same return in real terms as in 1978/79.

6. Such a figure takes no account of the increased amount and cost of tenant-type borrowing. It also has to be seen against a background where, despite a slight increase in the national herd (following the relatively good year enjoyed by milk producers in 1977/78), milk yields are down, and production in the first 5 months of the current milk year only marginally (0.2%) more than that in the corresponding period for 1978/79. Moreover, the main indicators all point to a down-turn in cow numbers. Slaughterings are 14% higher than last year; dairy inseminations from April-August 1979 are 5.3% down on 1978; and there is evidence of an increasing interest among milk producers in the EEC's non-marketing scheme.

7. As a net margin for 1979/80 of £81 per cow would be almost identical in real terms to that for 1976/77, it seems certain that this would lead to a contraction in the size of the national herd, with an ultimate loss of perhaps 100,000 cows. This would incre our import requirement by about £40 million a year. It will therefore be necessary to increase producer returns in order to avoid this: and, as the continuing relative strength of sterling h reduced the scope for increasing manufacturing returns through devaluing the green pound, the only alternative is to increase returns from the liquid market.

8. This means increasing the maximum wholesale price. And, in order to allow for the distributive margin, that means increasing the maximum retail price as well. The effect on the net margin of various changes on the first Sunday of each of the coming months w be as follows (with the corresponding figures if there was to be n change in the target rate of profit being shown in brackets):

	Actual (£)	Real (1976/77 = 100)
1978/79	95.50	149
1979/80*		
+ 1p		
7 October	97.70 (99.20)	134 (136)
4 November	94.20 (95.70)	129 (131)
2 December	91.00 (92.50)	125 (127)
6 January	87.80 (89.30)	120 (122)
+ 1½p		
7 October	113.75 (115.25)	156 (158)
4 November	108.50 (110.00)	149 (151)
2 December	103.25 (104.75)	141 (143)
6 January	98.00 (99.50)	134 (136)
+ 2p		
2 December	109.00 (110.50)	149 (151)
6 January	102.00 (103.50)	140 (142)
+ 2½p		
6 January	107.50 (109.00)	147 (149)

8. The 1.1% green pound devaluation will add £0.50 to the actual returns above and + 1 to the real index. Thus, to maintain producer income for 1979/80 in money terms would require an increase around the end of October to 1p per pint, whilst to maintain it in real terms would require an increase of 1½p per pint at about the same time. The first of these would add 0.14% to the RPI; 0.17% to the TPI and 0.60% to the Food Index: the corresponding figures for the larger increase would be 0.21%, 0.25% and 0.91%.

9. The effect of these changes on the wholesale price of milk will also help to raise the average producer price in the UK in relation to the milk equivalent of the intervention price (MEIP). At present, this is 11.77p per litre. Because the over-supplied market has depressed manufacturing returns, the average producer price for the

---

* Converted to real terms on the basis of the change in the TPI between 1978/79 and 1979/80.

winter months would, in the absence of any change in the retail pri[illegible] be 11.69p per litre - ie below the intervention equivalent, and very considerably below the EEC target rate price of 12.81p per litre. Even an increase of 1½p per pint in the retail price would only raise the average producer price to 12.224p per litre.

SCOTLAND

10. Now that the Scottish costings exercise for 1977/78 has been completed it is clear that distributors' costs have been increasing at about the same rate as in England and Wales. This means that, against all expectations, the delay in implementing the last 2 retail price increases in Scotland was not justified and this, coupled with estimated higher costs in Scotland in the period to March 1980, notably the pay award due from February 1, 1980 (April 1 in England and Wales) points to the need in Scotland, for about 1p per pint more on the retail price for about 12 weeks more than in England and Wales. The proposed retail price increase should take effect in Scotland 4 weeks earlier than in England and Wales: the balance due to distributors in Scotland will have to be made up by a further temporary adjustment early in the New Year.

NORTHERN IRELAND

11. Any further increase in the retail price will, because of the much lower proportion of liquid sales to total production in Northern Ireland than in England and Wales, increase producers' returns in Northern Ireland to a lesser extent than elsewhere. In the event of a 1½p per pint increase late in October or early in November returns in Northern Ireland for 1979/80 would be about 1.75p per litre below England and Wales. As part of the CAP price-fixing in June, the EEC

Council of Ministers (Agriculture) extended the authority for the payment of the Northern Ireland special milk aid, which is intended to bridge this gap. However, the authority limited the aid to 1.3p per litre with the result that Northern Ireland producers will be about 0.45p per litre worse off than their counterparts in England and Wales over the year as a whole. This is equivalent to a reduction in their net margin of about £18 per cow in 1979/80.

STERILISED MILK

12. At present the maximum retail price for sterilised milk, which accounts for about 7% of total liquid milk sales, is set at a premium of ½p per pint over the level for pasteurised milk in order to reflect the higher costs of sterilising. The dairy companies who process sterilised milk have made an application through the DTF for an increase in the retail premium to meet increased processing costs. The premium has remained constant since 1969, despite the steady increase in sterilising costs, and despite the fact that a number of sterilising dairies have ceased production because of the inadequacy of the sterilising margin. There are therefore strong grounds for increasing the retail premium for sterilised milk to 1p per pint from the date of the next retail price increase. This move would have the effect of redistributing the existing distributive margin in favour of the sterilisers and, in a full year, of generating an additional £4 million income for the industry as a whole. This would increase producers' net margins in 1979/80 by about £1 per cow, equivalent to the return from our increase in the price of pasteurised milk of 1½p per pint for 6 days.

FINANCIAL IMPLICATIONS

13. A retail price increase of 1½p per pint at the beginning of November is expected to result in a fall in liquid milk consumption up to the end of March 1980 of 48 million litres; the fall resulting from a 1p per pint increase would be 32 million litres. On the assumption that all of this milk went to butter manufacture and that all of the extra butter was sold to intervention the direct extra cost to the Exchequer in 1979/80 would be £3.6 million for a 1½p per pint increase and £2.4 million for a 1p per pint increase. This direct cost does not take account of extra storage and finance costs. However, it should be noted that the full cost is reimbursed to the UK from FEOGA when the produce is sold. Inasmuch as the UK contribution to FEOGA is 16% the cost to the UK would be £0.6 million for 1½p per pint or £0.4 million for 1p per pint. If, however, the butter were sold on the open market, which is equally possible, the import savings on the balance of payments would be about £3.6 million (1½p increase) or £2.4 million (1p increase); and there would be no Exchequer costs.

1 October 1979