



P.0619

PRIME MINISTERLiquid Milk Prices

## BACKGROUND

A  
B  
C

The papers before your meeting at 10.30am on Monday 21 December are the Minister of Agriculture's minute of 14 December and his letter of 16 December, and the Chief Secretary, Treasury's minute of 16 December. The issues are the amount by which the maximum retail price of milk should be increased in January and the method of calculating target rates of profit for the dairy trade in the light of the recommendations in Binder Hamlyn's report of November, 1981.

2. The Minister of Agriculture wishes to announce, in a Written Answer before the Recess, the Government's decision on the January price increase and its response to the Binder Hamlyn report. Before doing so he has to talk further with representatives of the trade about some of the details.

3. The system is complicated but, as background to the discussion, the main features are:

i. The distributive costings system, which will be amended to take account of Binder Hamlyn's recommendations, is designed to establish average costs by reference to a wide sample of dairies which excludes persistent loss makers.

ii. A target rate of profit is established in terms of x pence per litre; this target takes account of the separate target rates for milk processing, for wholesale sales and for retailing which are each calculated by reference to selected groups of food manufacturing and food retailing companies.

iii. Increases in maximum retail prices are announced periodically by the Government; the distributors' share of the yield is determined by the average costs and the target rate of profit, and the rest goes to the milk producers.



## AGREED POINTS

4. At the meeting of the Ministerial Committee on Economic Strategy on 10 December (E(81)38th Meeting), it was agreed that the increase in the price of liquid milk should take effect after the school holidays but in time to be taken into account in the Retail Price Index for January, as had the corresponding increase in 1981. To meet this requirement the increase has to be no later than 12 January and, since it is the practice to increase milk prices with effect from a Sunday, the Minister of Agriculture proposes that the increase should be on 10 January.

5. The Committee were unable to take a decision on the amount of the increase, or on whether the Binder Hamlyn recommendations should be implemented as proposed. The Minister of Agriculture was asked to discuss these questions further with the Chief Secretary with the aim of ensuring that increases in milk prices were as low as possible but not such as to risk the break-up of the present system of controls.

6. The only point on which the two Ministers were able to agree was that there should be a full re-assessment of the target rate of profit annually rather than every three years with indexation in the intermediate years.

## POINTS AT ISSUE

7. In their November 1981 report, Binder Hamlyn calculated their proposals for the target rate of profit on the alternative bases of historic cost and Current Cost Accounting (CCA) depreciation. While they commend CCA in principle, they warn of the practical difficulties of implementing it at this stage for the dairy trade; they do not make a recommendation as to which is the preferred course.

8. The Minister of Agriculture recommends that the system should incorporate CCA depreciation and that the increase in the maximum retail price from 10 January should be of  $1\frac{1}{2}p$  giving a total of 20p for a pint of milk. Of this, 1.1p would go to the milk producers and 0.4p to the distributors.

9. The Chief Secretary recommends that, until such time as adequate CCA data are available for the dairy trade, the system should be based on historic depreciation and that the January increase should be no more than 1p with the yield going to the



producers and not to the distributors. (NB 1p on a pint of milk leads to an increase in the RPI of 0.1 percentage points.)

10. Whichever method of depreciation is chosen, the trade's distributive margin will be substantially reduced by comparison with the present system. As the table at Annex 1 of the Minister of Agriculture's minute of 14 December shows, the reduction in the margin will be 0.42p per litre if CCA is used and a further reduction of 0.12p per litre if historic costs are used. Binder Hamlyn discuss this in paragraphs 6-9 and 45-53 of their report. They explain that the difficulty is that the dairy trade are not yet ready to adopt CCA in their accounts; they could do so only by a large amount of additional work which they have not the resources to undertake. They therefore recommend that if CCA is to be used it will be necessary to make an approximation by calculating the historic cost depreciation charge of each dairy and then scaling it up by reference to the ratio between historic and CCA depreciation charges of those companies in the chosen reference groups which have published CCA accounts (paragraphs 51 and 52). They warn that "it must be acknowledged, however, that the incorporation in this way of an estimate of CCA depreciation would introduce an additional element of approximation into the costing system which may not be regarded as acceptable".

11. The Minister of Agriculture defends his proposal on two broad grounds:

i. The use of CCA is right in principle, and Binder Hamlyn have produced a method for calculating it for the dairy trade.

ii. Whatever the technicalities, his proposals represent a package deal which is the best that can be negotiated with the dairy trade without risking the break-up of the present system of controls and withdrawal from door-step delivery. (He summarises in paragraph 5 of his minute of 14 December why the trade regards the package as severe enough already.)

12. The Chief Secretary argues that, until such time as satisfactory CCA accounts can be produced by the dairy trade, the system should be based on historic cost depreciation. His main arguments are:

i. CCA approximations would give the trade "an unwarranted bonus" of £17 million in 1981-82 and an unquantifiable though certain gain thereafter (see paragraph 6 of the Chief Secretary's minute.)



ii. Once Binder Hamlyn's report is made public, it can be used to expose the deficiencies of a system based on CCA approximations.

iii. Although historic costs will reduce the distributive margin yet further - to the benefit of the consumer - the fact is that the present system has allowed for unjustifiably generous margins.

#### OPTIONS

13. The system, and the arguments, are complicated and technical and without a detailed examination it is difficult to advise, or for Ministers to decide, on which is the right course. With that in mind, I think that your meeting is faced with a choice between three broad approaches.

14. First, you could agree to accept the Minister of Agriculture's proposals for both the system and for an immediate price increase of 1½p. This decision could be justified on the grounds that, while the system was open to criticism in some respects, it represented a defensible package deal overall. It would be tougher on the trade than the old system, and so the consumer would be better off. It could be defended by reference to the detailed recommendations from Binder Hamlyn. The disadvantage of this course is that while it represents a better system than the present one, it could still be argued, on the evidence of Binder Hamlyn's own report, that it is a technically suspect system which is over-protective to the trade at the expense of the consumer. This is the point which the Chief Secretary makes.

15. Secondly, you could accept the Chief Secretary's recommendation of a 1p increase now - which he regards as a concession to the transitional difficulties of moving from the old to the new system - and a system incorporating historic cost depreciation until such time as CCA accounts are available in the industry. This could be represented as a yet better deal for the consumer and defended by reference to Binder Hamlyn's report. On the other hand, the Minister of Agriculture will argue that it is a high risk course which could lead to the break-up of the present system of controls and the end of door-step delivery. The discussion at E Committee on 10 December suggests that there is considerable support for this view.



16. The third possibility is to decide now what should be the price increase in January but to defer, pending further advice, a decision on the basis for the new system in the longer term. This would recognise both the importance of settling on a new system which Ministers were fully satisfied they could defend and also the difficulty of taking an immediate decision on the basis of the complicated and conflicting advice in the papers now before you. Logically a decision on the price increase should be deferred until any such further work had been completed. But Agriculture Ministers would undoubtedly bitterly resist this partly because of their concern over the effect on farmers' income of delays in the price increase. So the immediate increase might be allowed to go ahead on the understanding that it was without prejudice to the shape of the new long term system.

17. On this approach you would decide on Monday whether the increase on 10 January should be 1p or 1½p. You would have to do so as a matter of broad judgement on what was the best balance between the needs of the trade and the producers on the one hand and of consumers on the other. The Minister of Agriculture could then announce this decision before Christmas and indicate that he would make a further statement on the implementation of Binder Hamlyn proposals as soon as possible in the New Year.

18. You could then ask the Minister of Agriculture and the Chief Secretary to arrange for further discussion by their officials and Binder Hamlyn of the arguments put forward on either side. The aim would be to establish, among other things:

i. whether CAA approximations as discussed in the Binder Hamlyn report could be publicly defended.

ii. whether it is possible to form a judgement on what difference in practice there might be between CCA calculations on the proposed approximate basis and proper CCA calculations made by the dairy trade themselves;

iii. whether, as a compromise, the dairy trade might be told that for, say, one year the calculations could be on an approximate CCA basis but that thereafter they would be either on the basis of proper CCA calculations made by the dairy trade or, pending such calculations, on the basis of historic costs; - the aim here would be to give the trade an incentive to put their accounts as quickly as possible on a CCA basis.



It would not be practical to complete such work in time to inform a decision on a price increase on 10 January, but I should think it ought to be possible to do so in time for decisions on the new system to be announced by, say, February.

19. If the meeting does agree that further work on these lines should be commissioned, you might like to consider whether you want some independent assessment of the further conclusions reached by Treasury and Ministry of Agriculture officials. One possibility would be to invite Mr K J Sharp, the Head of the Government Accountancy Service, to participate either as a member of the group or, perhaps, in the lead. Whatever his formal role in the group, I suggest that his advice should be made available to Ministers.

#### HANDLING

20. After the Minister of Agriculture has made his case and the Chief Secretary has replied you will wish to hear the views of the other Agriculture Ministers and also the Secretary of State for Trade who is concerned with the implications for consumers and for competition policy.

21. You might then consider the three broad options summarised in paragraphs 14-19 above.

#### CONCLUSIONS

22. You will wish to reach conclusions on which of the three courses should be followed. If you do decide on the third course - announcement before the Recess of a 10 January price increase and further work on the system - you will wish to ask the Minister of Agriculture:

- i. to clear the text of his Answer with the Chief Secretary and the other Agriculture Ministers;
- ii. to agree with the Chief Secretary on the details of how the further work should be carried forward and, if the meeting so wishes, to arrange for Mr K J Sharp to be involved.



✓ 23. The paper before E on 10 December, E(81)128, also recommended that the present premiums on Channel Islands and sterilised milk should be increased by  $\frac{1}{2}$ p per pint at the same time. E did not discuss this and the point has not been picked up in the present papers. I suggest that the Minister of Agriculture and the Chief Secretary can be left to settle this detail.

*Plg*

P L GREGSON

18 December 1981

CONQUEROR  
III  
LONDON