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From the Minister

CONFIDENTIAL

PRIME MINISTER

13 January 1984

MILK MARKETING ARRANGEMENTS AND THREATENED FEOGA DISALLOWANCE

You will wish to know that we are now confronted with some very difficult issues related to our domestic milk marketing system. I am minuting you immediately because the sums of money involved are very large and would be directly relevant to the negotiation on the budget problem; and because of the substantial domestic political repercussions in relation to our regime for marketing milk through the statutory Milk Marketing Boards (MMBs).

The background in brief is that the Commission and other Member States have always harboured suspicious of the MMBs, and in particular as incompatible with a common organisation of the market under the CAP. In 1978 and 1979, we negotiated regulations which authorised the continued operation of the MMBs subject to certain constraints on their freedom in pricing milk in negotiation with the dairy trade in the United Kingdom. It is these milk pricing arrangements which have continued to cause the trouble.

The Commission have argued that certain of the practices under which the MMBs and the dairy trade have agreed to differentiate the selling prices for milk for different end uses are contrary to the provisions of the relevant regulation. On butter, they have objected to separate selling prices for milk for bulk (mainly intervention) butter and packet butter. On skim, they have objected to the three price structure under which there is a lower price for manufacture into skimmed milk powder, and two higher prices for liquid skim for stockfeed and for high value products like yoghurt. In addition, they have taken issue with arrangements under which preferential prices are charged for milk for certain products for export to third countries which they argue is tantamount to an additional export subsidy.

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There have been detailed discussions with the Commission over the last five years to try to establish a clear understanding about what types of prices differentiation are permissible under Community law. But it has not been possible to reach any clear conclusions about what sort of price differentiation the Commission would find acceptable. At the same time, we have had detailed discussions with our industry during which we have pressed them to give up multiple pricing. But they have argued strongly that their present practices are essential to maintain their competitive position in the UK and export markets and that they are doing nothing different in principle to what the continental co-ops in France and the Netherlands do in differentiating their product selling prices according to competitive needs in different markets. They recently agreed to drop dual pricing of butter, though the implementation of this decision awaits the outcome of arbitration on how it should be done. But the industry have been unwilling to move on skim or exports without a Court ruling against us. The legal advice has always been that the Government has no powers to force the industry to change their pricing arrangements unless and until there is a clear Community obligation to do so as a result of an adverse Court finding.

Encouraged by the Irish who are out to weaken our marketing arrangements so that they can compete more effectively for a bigger share of our markets, the Commission decided last year to initiate infraction proceedings against us on butter and skim milk, and they have more recently taken the first steps also on export pricing. The legal process will lead to a European Court hearing probably towards the end of this year unless the progress of the cases is in some way aborted. The Law Officers have advised that our case on butter is weak; but that we may be on stronger grounds in defending infraction proceedings on skim and export pricing. The Irish Dairy Board have initiated legal proceedings in the High Court against the MMB seeking compensation for trading losses which they claim to have suffered on account of dual pricing of butter.

Quite separately from these infraction proceedings, a new and more urgent issue has now arisen. There is a risk that the Commission could decide to disallow expenditure on milk in the UK when they come to clear the FEOGA accounts for the years in question. We were first warned of this possibility last year, though the Commission did not give any indication of the expenditure which they would regard as relevant or the nature of the case they would argue. This issue could arise on the 1978 and 1979 accounts which are due to come to the Commission for clearance within the next few weeks. We were told last August that DG VI would not propose disallowance for these years because the regulations governing the MMBs activities within the Community were not implemented until the middle of 1979. But at a meeting in the middle of December, it emerged that DG XX (the Financial Controller) was recommending disallowance of all milk expenditure in the UK for these two years. If the Commission were to adopt this recommendation, the sums in question, on our figures, could amount to £463 million.

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Although a disallowance on this scale would seem virtually unthinkable, it would clearly cause us great political difficulty if the Commission were to decide on any substantial disallowance for 1978 and 1979 in the next few weeks whatever the ultimate outcome might be. Since the Commission could begin to clawback immediately the monies involved by reducing the allocations to IBAP pending the Court's decision, there would clearly be substantial implications for our budget negotiations, which outside commentators would be quick to see.

Although there is disagreement between DG VI and DG XX on the appropriate course of action in relation to 1978 and 1979, we understand that all parts of the Commission agree that the relevant expenditure should be disallowed in 1980 and later years. Again there remains uncertainty about the extent of the disallowance which the Commission might decide. The sums involved in 1980 to 1983 inclusive could be very substantial, and since the industry is still operating the practices complained of, we shall continue to build up additional risks in 1984 unless the present practices are stopped.

I should make it clear that it would be quite unprecedented for the Commission to disallow the whole of the expenditure in a particular commodity sector, and on the scale being recommended by DG XX. The Law Officers take the view on disallowance that the European Court would support the Commission in going beyond the existing precedents, but not in claiming that all expenditure should be disallowed. They consider that it would be necessary to show, not only that the practice complained of was illegal, but also that there had been an increase in FEOGA expenditure as a result. It is clear, however, that we are faced now with very substantial financial risks that could not previously have been foreseen; and that we must now take urgent steps not only to seek to minimise the risks of disallowance over the years since 1978; but also to remove the possibility of building up further risks in future.

Following full discussion of these issues at official level between the Departments concerned, I am proceeding immediately as follows:-

a) I have spoken myself this week to Messrs Tugendhat and Dalsager on the disallowance issue, particularly in relation to the clearance of the accounts for 1978 and 1979. Officials have also had discussions with DG XX.

As I have said, these two accounts are due to come to the Commission soon and we must keep up the pressure to avoid a decision by the Commission to disallow in this context. It is clearly very important to try to avoid an issue over disallowance emerging at this stage.

b) I shall be having urgent discussions with the milk industry to seek to persuade them to discontinue the pricing arrangement complained of. Given the importance which the industry attach

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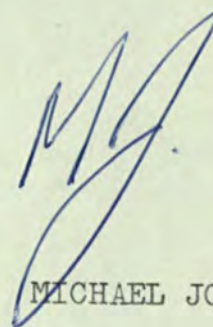
to multiple pricing in maintaining their competitive position particularly on exports, we have a politically difficult problem on our hands in getting them to change their practices voluntarily. If necessary, I shall have to be ready to indicate that the Government would be prepared to legislate urgently if the industry are unwilling to make the changes voluntarily. Whatever form such legislation took, it would be bound to be highly controversial.

c) On the basis of (b), I should seek to do a deal with the Commission to avoid both the infraction proceedings and the disallowances being pursued. We should put it to the Commission that, since the pricing practices complained of were to be ended, the infraction proceedings were not necessary. It is impossible to judge how far the Commission would be prepared to commit themselves in a deal of this sort. We should need, therefore, to maintain our view that no breach of Community law has been committed so that we do not weaken our position if it should still become necessary either to defend infraction cases or to oppose disallowances.

d) Work is already in hand on the amendments that might be made to our present milk marketing arrangements in order to avoid in future continuing scope for challenge by the Commission and other Member States. This means taking a fundamental look at the present organisation of the Milk Marketing Boards and the powers they exercise. You will understand that this is highly sensitive territory because of the fundamental role of the MMBs to our whole milk sector, and the current concerns about damage to the doorstep delivery system from cheap imports. We shall need to feel our way forward with the powerful interests concerned and not least our supporters in Parliament. But I am clear that we must find ways of avoiding in the future continuing problems with the Community over our milk set-up. I shall put my proposals to colleagues on all of this just as soon as possible.

I should add that we must avoid if possible public discussion of the threat of disallowance on the 1978 and 1979 accounts. It is clear that, if there is any suggestion that we are putting political pressure on the Commission not to disallow, this could be highly counter productive when the issue comes before the Commission.

I am sending copies of this minute to the Foreign and Commonwealth Secretary, the Chancellor, the Secretaries of State for Northern Ireland, Scotland and Wales, the Attorney General and the Secretary to the Cabinet.



MICHAEL JOPLING