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MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

LIQUID MILK PRICE CONTROLS

Note by the Minister of Agriculture, Fisheries and Food

This paper by officials has been agreed between the Departments concerned as a basis for Ministerial discussion at E Committee on 19 March when the Binder Hamlyn Report and future policy on liquid milk price controls will be considered.

Background

2. About half of the milk produced in the UK is used for manufacturing milk products and about half for consumption as liquid milk. However, the pricing arrangements for the two sectors are very different. In the manufacturing sector the Milk Marketing Boards negotiate prices for milk directly with processors and the prices agreed for milk used for each different milk product broadly reflect the prices which these products will realise when they are sold. Manufacturing milk prices are therefore determined essentially by the markets for the products concerned, but the markets are underpinned by the intervention prices set by the European Community for butter and skimmed milk powder. By contrast, in the liquid milk sector the Government sets maximum wholesale and retail prices to reflect the average costs of production. The retail price is determined after taking account of the average costs of processing and distribution as incurred by

Ministry of Agriculture, Fisheries and Food
11 March 1981

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Liquid Milk Prices

Note by Officials

I. Introduction

Purpose

1. At its 43rd Meeting in 1980, the Ministerial Committee on Economic Strategy:

"Invited the Minister of Agriculture, Fisheries and Food, in consultation with the relevant Ministers, to arrange for an interdepartmental review of the recommendations in the Binder Hamlyn report on the milk costing system, and of the Secretary of State for Northern Ireland's proposal in his letter of 3 December for ceasing to control wholesale prices, and to make recommendations to the Committee by the end of January 1981."

This paper by officials reviews these questions taking into account also the subsequent suggestions from the Secretaries of State for Scotland and Trade for complete decontrol of liquid milk prices, or, failing that, for confirming retail control to an ex-dairy price.

Background

2. About half of the milk produced in the UK is used for manufacturing milk products and about half for consumption as liquid milk. However, the pricing arrangements for the two sectors are very different. In the manufacturing sector the Milk Marketing Boards negotiate prices for milk directly with the purchasers and the prices agreed for milk used for each different milk product broadly reflect the prices which those products will realise when they are sold. Manufacturing milk prices are therefore determined essentially by the markets for the products concerned, but the markets are underpinned by the intervention prices set by the European Community for butter and skimmed milk powder. By contrast, in the liquid milk sector the Government sets maximum wholesale and retail prices to reflect our judgement of what the market will bear, what margin should be given to processors and distributors, and what level of returns milk producers should receive. The retail price is determined after taking account of the average costs in processing and distribution as measured by

independent accountants from a representative sample and making allowance for a reasonable level of profit. The Milk Marketing Boards allow all they realise from both sectors of the market and pay producers a common price, irrespective of the use to which their milk is put. At present the return to the Board in England and Wales from the liquid market is 16.86p per litre and the average return from the manufacturing markets is 12.3p per litre: the difference between them, referred to as the liquid milk premium, stands at 4.56p per litre (2.6p per pint).

3. The controls over the maximum price of milk derive from the wartime arrangements for regulating prices and distributive margins for essential foodstuffs. They have been retained by successive governments largely on the grounds that:

- (a) the Milk Marketing Boards are monopoly sellers;
- (b) there are only a few relatively large milk distributors; and
- (c) that, in the absence of imports of liquid milk, the government must therefore establish the maximum prices at which both parties can sell their product in order to protect the consumer from exploitation.

4. As a result of negotiations in 1978 with the EEC certain limitations were placed on the position of the MMB as a monopoly seller. In particular it was agreed that provision would be made for the setting of prices by Joint Committees on which the Boards and the Dairy Trade had equal representation and for the reference of any disagreement over prices to be referred to arbitration. It is perhaps noteworthy, as a reflection of the relative negotiating strengths of the two sides, that when in 1980 the dairy trade decided to establish a provisional wholesale price at a level significantly lower than the maximum price fixed by the Minister the England and Wales Board did not have resort to arbitration, and although there was resort to arbitration in Northern Ireland the result has favoured the trade.

5. The Office of Fair Trading (OFT) have recently considered the possibility of making a reference to the Monopolies and Mergers Commission (MMC) of the supply of milk for retail sale in England and Wales. They had in mind that the existence of zoning arrangements, the absence of milk imports and the concentration of doorstep deliveries in the hands of a few large companies might indicate a lack of effective competition resulting in among other things, too high a retail price for milk in shops. It should also be noted that this

consideration extended only of the retail sector: a reference extending to the activities of the Milk Marketing Board could be made only by the Secretary of State for Trade, the Minister of Agriculture and the Secretary of State for Wales acting jointly.

6. Strong representations against a reference were made by dairy companies who provided evidence on the current competitive situation in the dairy industry. In the light of these representations and the latest information suggesting that a more competitive situation had developed in the supply of milk to the supermarkets, the Director-General of the OFT concluded that "the basis does not exist at the present time for me to initiate either a Fair Trading Act reference to the Monopolies and Mergers Commission or, as an alternative, a Competition Act investigation on the terms of supply offered by leading dairy companies to supermarkets. It might still be possible to establish a complex monopoly in relation to zoning arrangements but, in the light of the likely results, I do not consider that a reference of this issue alone - with the substantial burden which an investigation would impose on the dairy companies - would be justified". The OFT will however be keeping the industry under particular review.

Milk Distribution in Scotland compared to the rest of the UK

7. Although there is a range of conditions throughout the UK there are special features about the Scottish market and Scottish experience which distinguish Scotland sharply from the rest of the UK. Half of Scottish liquid consumption is bought in shops, compared with about 10% in England and Wales and 15% in Northern Ireland, and there is widespread availability of milk in shops at prices below the maximum retail price. A delivery service is available to 96% of the urban population in Scotland but 40% choose not to have milk delivered whereas in England and Wales the corresponding figures are 100% and 11%. In the last ten years, a period in which Scottish doorstep deliveries have declined from 75% to 50% of consumption, Scottish milk consumption has not fallen relative to overall UK consumption movements: that it has in fact risen from 10% below the national average to 5% below is probably due mainly to the large consumer subsidy paid in 1974 and 1975. Since then it has tended to decline in parallel with the rest of the UK. Successive large-scale surveys of the milk market conducted in Scotland since 1969 suggest that the slow growth in the shop sector has not had any depressing effect on the total level of milk sales in Scotland, but this remains appreciably below the level elsewhere in the UK.

8. These differences in the Scottish situation do not derive from the price control system which has been applied in broadly the same way throughout the UK but from other factors. The delivery service in Scotland provides a less comprehensive service than in the rest of the UK: very few goods other than milk are sold; deliveries are usually made very early in the morning so that there is little contact between roundsman and consumer and little possibility of varying orders and only 13% of the rounds operate 7 days a week compared with 68% in England and Wales (although 94% of rounds operate on 6 or 7 days, substantially the same figure as in England and Wales). A survey carried out in June 1980 by NOP Market Research Ltd for the National Dairy Council in England and Wales showed that 86% of households were "very satisfied" and 11% "fairly satisfied" with the delivery service. Scottish surveys do not provide a direct basis of comparison because, given that 40% of consumers chose not to use the doorstep delivery service, their questions seek to probe the reasons for consumer dissatisfaction. However, it appears that of those Scottish households not receiving deliveries 45% considered that they could regulate their purchases more easily by buying in shops than on the doorstep. Because of these features Scottish consumers tend to use the doorstep delivery as a base-load service and top up for any variation of their needs with shop purchases.

9. There is little firm evidence available about any differences in the economics of milk distribution as between Scotland and the rest of the UK and, without the improvements which Binder Hamlyn have recommended, the present costings system does not permit the relative costs of doorstep deliveries and shop sales to be distinguished. However, it does seem probably that there are considerable differences in the economics of the system between the different areas. In Scotland wage costs are about 10% lower (wages represent 60% of distributors' costs overall in Scotland, but 70% in the rest of the UK) but the average number of trips which a bottle makes is significantly lower, 9 as compared with 24 elsewhere, and as might be expected delivery rounds tend to be more extended. Bottle costs represent only 5-10% of distributors' costs but, since a bottle costs about five times as much as the non-returnable carton the relative economics of shop and doorstep sales in Scotland and the rest of England and Wales are significantly affected by the differences in bottle trippage rates. Another difference is the fact that 50% of all sales in shops in Scotland are

below the maximum price while the price of delivered milk is in almost all cases the maximum retail price. There is no specific evidence but it is reasonable to assume that little of this price cutting can be attributed to loss-leading on the part of the retailers because these lower prices occur in both supermarkets and small shops, and it suggests that distributors are competing on price with discounts which reflect the lower average cost of selling milk through shop outlets.

10. In the rest of the UK selling through small shops has never assumed the same proportions as in Scotland and although there has been a slow increase in the proportion of milk sold through the shops (it has risen in England and Wales from 6.1% in 1967 to 7.9% in 1978) much of the recent growth has been through supermarkets. As regards shop prices the information for the rest of the UK is less comprehensive than for Scotland but such evidence as is available suggests that, although some sales below the maximum retail price have developed, in other cases supermarkets have not always passed on to the consumer increased discounts they have obtained from the distributors.

11. In the rest of the UK the dairy trade consider that in current circumstances the doorstep delivery service is more fragile and sensitive to loss of sales than in Scotland. Information from the costings, in which the predominant influence is the throughput delivered to the doorstep, shows that fixed costs represent about 80% of the total. Each dairy may have just two or three bottling lines so a significant saving in processing and bottling costs could only be achieved with a large fall in throughput by shutting down one complete line; furthermore a switch to shop sales would necessitate the use of a separate, expensive and relatively slow cartonning line. Furthermore, savings of costs on the delivery rounds are difficult to achieve because staff and floats cannot be cut to reflect a loss in sales without reorganising all of the rounds. For all of these reasons unit costs tend to increase rapidly as doorstep sales are lost, even if shop sales are simultaneously increasing. On the other hand it can be argued that most of these factors must have applied in Scotland during the last 10 years when there was a substantial decline in doorstep deliveries as a percentage of consumption and that a switch away from doorstep delivery in the rest of the UK would be disruptive only if it occurred very rapidly.

12. The conclusions to be drawn from this comparison are: that a substantial increase in the proportion of milk sold in shops can occur in certain circumstances without leading to the collapse of doorstep delivery and without causing a decline in total consumption; but that Scottish experience reflects a slow evolution over a period of years in rather different social and economic conditions and cannot necessarily be taken as a guide to what would happen in the rest of the UK if steps taken to remove the existing framework of control led to a sudden large scale change in consumption patterns.

II. The Binder Hamlyn Report

13. Because doubts had been expressed both about the way in which the distribution industry's costs were being measured, and also as to whether the system provided an adequate incentive towards greater efficiency, Ministers appointed in November 1979 a firm of accountants (Binder Hamlyn) to carry out a thorough review of the costings arrangements. Their first report was made available at the end of February 1980; and a second report, following up certain questions in greater depth, was published last October.

14. Binder Hamlyn were not asked and did not comment on the comparative incentives to efficiency provided by a controlled or an uncontrolled system. However, they did conclude that in the present system:

"the incentive to 'beat the average' provides an effective incentive to improve efficiency in the trade and no immediate steps should be taken to measure the trade's efficiency in relation to a 'norm'."

Apart from this, their recommendations are concerned primarily with improving the way in which costs are measured. (A summary of their recommendations and the action it is proposed should be taken on them is given in the attached Appendix.) Many of these are of a relatively minor nature, and for the most part can be accepted without undue difficulty. Binder Hamlyn have however suggested two major changes.

15. First, they have pointed out that the dairy trade's margin is at present calculated by reference to the costs incurred by integrated processor-retailers in heat-treating milk and delivering it to the doorstep. It therefore takes no account of the costs of distributing milk through smaller concerns (bottled milk buyers): and, although sales through shops are covered in England, Wales and Northern Ireland

this is not the case in Scotland (where they account for about half of liquid milk consumption). On the assumption that the sectors excluded from the costings tend to represent less costly ways of getting milk to the consumer, it follows that the margin received by the trade has been greater than that needed to cover their costs on all sales. Binder Hamlyn have therefore recommended that wholesale sales by the processor-retailers to these other outlets should be brought within the costings system, and that, in order to prevent excess profits being made by bottled milk buyers and shops, the level of discounts allowed to them should be monitored.

16. Binder Hamlyn's second main criticism was directed at the way in which the trade's target rate of profit is set. This is expressed in terms of pence per litre, and the present figure merely represents the level of profit obtaining when the sample was first drawn up, updated from time to time to take account of factors such as inflation. Binder Hamlyn recommend that the target rate should in future be related to a given return on the capital employed by the dairies, and moreover that this figure should be related to that obtaining in industry generally - though at a somewhat lesser level to reflect the lower degree of risk to which they are exposed.

17. In principle, both sets of recommendations are sensible means of improving the present system, and the first of them regarding the costing of wholesale sales could almost certainly be implemented without too much difficulty, at least in England, Wales and Northern Ireland. There may however be difficulties in Scotland (see paragraphs 19 and 20); and, in any event, it should be noted that a system which involved a monitoring of discounts to bottled milk buyers and shops would require an additional administrative input - the cost of this could amount to about £50,000 per year in fees to accountants and perhaps £2,000 per year in staff costs in the agricultural departments. The recommendation on the target rate of profit, though also acceptable in principle, would also result in additional costs of administration - this could amount on average to about £50,000 per year in accountants' fees and about £5,000 a year in staff costs in the agricultural departments. In addition, it may be harder to implement in practice as there could clearly be considerable problems involved in defining and measuring capital, not to mention deciding upon what would be an appropriate return for the dairy trade. Discussions with the dairy

trade on the practical implications of implementation are currently in progress. Overall, the extra cost of a costings system modified as recommended by Binder Hamlyn would be around £100,000 per year in accountants' fees and about £10,000 per year in staff time in the agricultural departments, as compared with the existing system.

18. Assuming changes along the lines recommended by Binder Hamlyn were to be introduced, it follows that what we would have in future would be a system broadly akin to that at present, but with changes designed to reflect all the different routes by which milk reaches the consumer and to reduce the current degree of arbitrariness in the basis on which the trade's average profit margin is set. This would meet the main technical criticisms of the present system. On the evidence of an unpublished trial run carried out by Binder Hamlyn the implementation of their recommendations would reduce the present figure for the distributive margin in England and Wales by about £25 million in a full year, although this figure needs confirmation. If more detailed calculations confirm this figure, this would be a useful saving: it compares with the total profit of £50-60 million per year allowed to the distributors at present, but it is small in relation to the total distribution margin (some £900 million) - a saving of £25 million is equivalent to 1p per pint off the retail price for 2½ months. This suggests that in England and Wales (and also Northern Ireland) the current system has provided a reasonably accurate basis for the measurement of distributive margins which, with the relatively small amendments now proposed, could adequately underpin the continued operation of the present system.

19. A parallel calculation cannot be made for Scotland because of lack of data but it is clear that there is a significant difference in the considerations as they apply there. With 50% of sales through the shops there is an overall saving in the cost of distribution (compared with universal doorstep delivery), although this is somewhat offset by a consequential higher unit cost of delivery on the remaining 50% of milk to the doorstep. Adding these two elements together would inevitably produce a lower "average cost" which would mask two quite different costs of delivering to these outlets. In the extended costings now proposed by Binder Hamlyn this overall saving would show up as an "excess profit" though in practice it is likely that some of it is passed on, through increased discounts on shop sales to the final consumer (no precise figures on this are available).

20. The average distribution cost produced by the introduction of wholesale sales into the Scottish costings would therefore be likely to point to a reduction in the distributive margin going beyond what would result in the UK. If the present structure of price controls were maintained this would justify either a lower maximum retail price in Scotland (which has hitherto been set at the same level throughout the UK) or an increase in the producers' return as compared with England and Wales. The Scottish Office fear that, quite apart from the presentational awkwardness of either of these courses, they might result in a worse situation for the consumer than now exists, given that in Scotland there is a greater spread of prices and an average consumer price below that in England and Wales. If the producer return was increased in an attempt to squeeze the distributive margin, distributors would have less room to give discounts on shop sales unless they made savings on delivery costs (the Scottish Office believe there is probably a significant degree of cross subsidisation at present). If the retail price was reduced in theory the effect on the consumer ought to be beneficial or at worst neutral but, if the distributors over-reacted to the squeeze on their margins, the consumer's loss on shop sales might offset the gain on delivered sales.

III. Future Policy on Milk Prices

21. The second part of the remit given to the Minister of Agriculture by the Ministerial Committee on Economic Strategy was to review the proposal by the Secretary of State for Northern Ireland for ceasing to control wholesale prices. Subsequently the Secretaries of State for Scotland and Trade have put forward other suggestions for changing the present pricing arrangements for milk. The following paragraphs review the key features and the likely developments in the UK liquid milk market and the arguments for and against abolishing, modifying or retaining the present system of price control. Although a good deal of information is available from the milk costings system there is, as pointed out in paragraph 9, a lack of comprehensive information about the economics of milk distribution in Scotland and the rest of the UK and there differences of view between officials about how far the level of shop sales and the viability of the doorstep delivery service depend upon the maintenance of price controls in their present form. The relationship between the present system of price control, the viability of the doorstep delivery service and the level of liquid

milk consumption involves three important and separate issues:

- (i) the effect of the doorstep delivery service on the total level of liquid milk consumption;
- (ii) the impact of cut-price shop sales on the doorstep delivery service;
- (iii) the influence of the present system of maximum price control on the degree of price competition between shops and doorstep delivery.

The doorstep delivery service

22. Probably the most noteworthy and important feature of the UK liquid milk market is the almost universal availability of the doorstep delivery service. It is generally accepted that the delivery system provides a service which is highly valued by a large majority of consumers, particularly in England, Wales and Northern Ireland, although in Scotland consumers have increasingly turned to shop sales and there is so far no evidence that this has harmed consumption. There is evidence to suggest however that the widespread availability of doorstep deliveries helps to sustain a high level of liquid milk consumption: in countries where doorstep delivery is available - notably the UK and the Irish Republic - liquid milk consumption is high in the Netherlands, where the proportion of milk sold by doorstep deliveries declined from 94% in 1965 to 49% in 1975, consumption of all milk per head fell over the same period by 21%, even though sales of skimmed and semi-skimmed milk rose dramatically and despite the increasing availability of cheap imported milk in the shops. To the extent that the doorstep delivery service sustains liquid milk consumption, it serves to support the returns of milk producers because of the liquid milk premium which currently exists; it also benefits the distributive industry by maintaining high levels of sales, throughput and employment (some 45,000 jobs are involved in doorstep delivery).

23. There are two possible developments which might have a major impact on the continued existence of the doorstep delivery service. The first of these is the possibility of imports of liquid milk, which are at present effectively excluded by our domestic health and hygiene legislation. This legislation has been challenged by the Commission of the European Community and it seems likely that they will shortly refer the case to the European Court. If this happens, a Court decision could be available as early as the beginning of 1982.

Thus, if the Court were to find decisively against the UK, there would be a possibility of imports of milk early in 1982. Agreement in the Community on the harmonisation of hygiene regulations would also pave the way for imports. Such imports would almost certainly be UHT milk which, because of the liquid premium system currently in force (see para 2 above), would probably be sold at cheaper prices in the supermarkets. How far this would effect the doorstep delivery system would depend on the degree to which there was a switch away from doorstep deliveries to shop sales or whether the availability of cheaper milk would lead to increased consumption.

24. The second possible development would be a significant increase in lower price shop sales of home produced milk, which might come about as a result of a change in the economics of milk distribution or perhaps as a result of changes in the Government's control framework. The development of lower price shop sales of milk could be seen as improving the consumer's choice. On the other hand, it is clear that the vast majority of consumers, particularly outside Scotland, are fully satisfied with the delivery service and the fragility of this service might mean that improved choice for the minority who might wish to take advantage of it could result in the loss of a valued service for the majority.

Arguments for and against maintaining price control

25. The following paragraphs set out under three broad headings the arguments for and against maintaining our present system of price control.

Implications for consumers

26. In favour of decontrol it can be argued that the arrangements established in wartime to protect the consumer from excessive price levels or increases are no longer appropriate nor consistent with the Government's philosophy. At the very least decontrol will not result in any significant loss of protection to the consumer, while at the same time producing appreciable savings in official staff time and accountancy costs (the present system costs about £80,000 a year in official time and £350,000 in accountants' fees and implementation of the Binder Hamlyn recommendations might increase these figures to £90,000 and £450,000 respectively). More positively, decontrol should introduce a greater degree of competition into the retail sector to the benefit of consumers, eg through lower prices or wider consumer

choice and remove the misallocation of resources which may arise in the present administered price system.

27. In favour of retaining the present system of control it can be argued that there has been no change in the basic considerations described in paragraph 3 above, which have long been held to justify the retention of maximum price controls for liquid milk, and that it would be difficult to justify to consumer interests any weakening of this protection against abuse of monopoly position, at least as long as there is no competition from liquid milk imports from the rest of the Community. Moreover, since controls provide for a maximum not a fixed price, abolishing them would not necessarily lead to greater possibilities of competition than already exist (as is suggested by the evidence from Scotland). On the contrary abolition of control might result in a minority of distributors making ill judged attempts to secure excessive prices which could have the effect of depressing consumption to an extent which undermine the doorstep delivery system.

28. Against this it can be argued that there is no particular reason why distributors would cut their own throats in this way; that (on the evidence of survey research) consumers would be prepared to pay a premium to maintain doorstep delivery and that Scottish experience has shown that shop sales can grow to 50% of liquid consumption without destroying doorstep delivery.

29. On the other hand, however, it is argued against this last point that conditions in Scotland are so different that Scottish experience is not a safe guide to the likely effects in the rest of the UK of taking steps which could encourage a faster development of shop sales than would otherwise take place; and that experience in Holland, where increased sales of cheap imported milk have been paralleled by a sharp decline in a once comprehensive doorstep delivery and a 20% fall in consumption, is a clear indication of the dangers of such a course. Moreover, it is argued that, given the pressures of declining consumption and rising fixed costs, the UK doorstep delivery service outside Scotland would be very vulnerable to any further rapid loss of consumption. Thus any gain in consumer choice by a minority of consumers could inflict on the majority the loss or impairment of a service they are known to value.

Implications for producers

30. In favour of decontrol it has been pointed out that the present system, and in particular the liquid milk premium, is unlikely to be sustainable in the long-term if imported liquid milk were to become freely available following the current European Court case against UK import restrictions or if agreement is reached on the harmonisation of Hygiene Regulations. Removal of the controls would therefore help to prepare farm producers for a situation which may arise very suddenly in any case and thus encourage the agricultural industry to develop a healthier and more sustainable product structure for the future. Moreover, it would be presentationally more satisfactory if decontrol were embarked on voluntarily rather than in response to pressures from the Community.

31. Against decontrol it is argued (cf para 27 above) that if excessive price increased undermined the doorstep delivery service this would be likely to depress total liquid milk consumption and thus milk producers' returns and that there is no reason to take this risk when the battle with the Commission on the exclusion of liquid milk imports has not yet been lost. In addition it can be argued that insofar as decontrol removed the Government approved structure of prices which provides the retail trade with an adequate average margin it might lead them to use the superior bargaining power, which their recent actions have shown them to possess, to depress the returns of milk producers to an undesirable extent.

Other considerations

32. Decontrol can also be argued to have the advantage of removing controversial decisions from Ministers at a time when a combination of high inflation and a strong pound makes it increasingly difficult for them to set prices acceptable to both sides of the industry or to consumers; and to reduce the amount of political attention which the milk price has traditionally received. Against this, however, it is argued that decontrol will not remove the price of milk from political controversy; indeed subsequent price increases, which are inevitable given the inflationary pressure of costs, could be blamed on the Government as resulting from the removal of price protection from the consumer. Finally, it has been argued that decontrol would remove the possibility in the annual negotiations on CAP prices that other Member States could argue that UK domestic pricing policy for liquid milk is at odds with our stated Community objectives of stimulating

consumption and reducing production by stringent restraint on common price increases in the dairy sector. Such an argument is likely to appear particularly attractive to our partners, although it has not been developed in the past and the liquid premium has existed as long as the Community surplus has.

Modification of price control

33. Apart from abolishing or retaining the present system of control, there is the possibility of partial decontrol involving either (i) decontrolling the retail price, whilst maintaining a maximum wholesale price or (ii) decontrolling the wholesale price, whilst maintaining a maximum retail price; or of lesser modifications.

Decontrol of the retail price only

34. This would imply maintaining only wholesale price control, whilst leaving the dairy trade free to determine the price at which it sells milk either direct to the consumer or indirectly through bottled milk buyers or shops. Like total decontrol, such a step would of course obviate the present need for a costings system; and it would to a substantial extent have the advantages of total decontrol listed above. However, even though it is arguable that producers have benefited from the present control over the wholesale price, it would be extremely difficult politically - particularly in the prevailing economic circumstances - to confine any statutory measures to the Boards, whilst at the same time leaving the dairy trade free to operate in an unrestricted fashion. Such a step would hardly be consistent with what now appears to be the relative bargaining strength of producers and the trade; and it ignores the fact that the dairy trade itself comprises a relatively small number of processors. Against that background, and in the absence of liquid milk imports, such a step would - like total decontrol - require careful justification to consumers.

Decontrol of the wholesale price only

35. Such a step would involve setting a retail price at some point or other, whilst leaving the Boards and the dairy trade free to negotiate the wholesale price, and would thus provide an envelope within which the industry as a whole would have to operate. As such it would have a number of advantages. To the extent that it retained a measure of control over the retail price, it could be justified to consumers; the preservation of an orderly retail market, coupled with

the free negotiation of wholesale prices between the MMBs and dairy companies, would clearly represent a lesser gamble in terms of the doorstep delivery service than would total decontrol; and, although it would imply a continuing need for Government to monitor the position of milk producers and distributors, they would not be tied to a particular system as at present and the monitoring process could in the latter instance be carried out by means of a less elaborate procedure than the existing costings system.

36. On the other hand, in continuing to set a retail price, Government would still be involved with that element of the present system which attracts greatest political attention; to the extent that such an arrangement preserved the stability of the present system, it would provide no greater (or less) degree of competition than the present system; and it seems likely to be opposed both by the dairy trade (who would regard the control as impinging only on them) and by milk producers (who consider that even the present system does not adequately protect their interests).

Alternative points of retail control

37. Irrespective of what is done on the wholesale price, if some control is to be exercised over the selling price of the dairies, consideration needs to be given to whether this should apply essentially to the delivered product as at present or to the price of milk sold in shops or as it leaves the dairy.

38. A maximum ex-dairy price would be logical in as much as it would merely involve controlling the heat-treatment and bottling activities of the processor-retailers, which is the last point through which all milk sold for liquid consumption has to pass; it would be simple to operate in terms of information we already receive through the costings; and the level of distributive costs and retail mark-ups would as a consequence be left to the market place, where arguably they belong. In Scotland where milk is widely available in shops at prices below the maximum, there may be enough competition amongst distributors to give confidence that a move to ex-dairy price control should not lead to a rise in consumer prices. The disadvantages of this approach in the rest of the UK are that the consequences of such a radical departure from the present one are much more difficult to predict, and for the reasons explained in paragraphs 11 and 27 above could risk destabilising the present doorstep delivery system to the

disadvantage of that majority of consumers who want to keep it. In the absence of competing imports, this course might be difficult to justify to consumer interests - though clearly it would in that connection have more to commend it than total decontrol.

39. The second option of setting a maximum shop retail price would of course bring the point of control one stage nearer to the final consumer. It would thus provide him with a greater measure of protection than an ex-dairy price, leaving merely the additional amount charged for delivery to be controlled by market forces. It is also a course favoured by some in the dairy trade on the grounds that, if imports have to be admitted and if delivery costs can be accounted for separately, it would enable them to charge a lower price for the milk as such, and so compete more effectively with imported milk.

40. On the other hand, it has to be said that, insofar as delivery costs could represent a considerable extra charge on the consumer, particularly those such as pensioners whose volume of purchases is small, there could well be pressure on Ministers to fix these as well. Whilst there might be certain presentational advantages to the dairies in separating the price of milk and its delivery costs, the public - at least in England and Wales - tends at present to equate the price of milk with the delivered product. If the Government were instead to set a maximum shop price, the public might tend to identify with that instead and become more conscious of the cost of delivery, thereby inducing a further shift away from doorstep purchases.

41. The main problem however with setting a maximum shop price is a practical one. Such an approach would, particularly if applied in conjunction with a maximum wholesale price, make it necessary to extend the costings system into the retail trade and to make value judgements of retail mark-ups. In their follow-up report, Binder Hamlyn have advised that this would not be a feasible undertaking. Even if it were, it would still be necessary to decide in relation to which type of undertaking the price should be set: clearly, a price appropriate to a large retail chain would be inadequate for the corner-shop, whereas one intended to allow a reasonable profit to a small retailer would risk providing supermarkets with an excessive margin.

42. Maintaining control at the present point, ie the delivered price, would of course have the advantage of familiarity: and, insofar as that price has tended to be regarded as the "norm", it has probably in presentational terms been the most advantageous system for the

doorstep service. On the other hand, apart from any of the more general arguments referred to earlier regarding its effect on competition within the dairy industry, it does present certain technical difficulties. Insofar as it has hitherto taken inadequate account of sales through outlets such as shops and bottled milk buyers which may be less costly, it has been open to the charge that it provides an excessive margin for the dairy trade as a whole, whereas a "diluted" margin as now envisaged might be inadequate to cover the cost of delivery to the doorstep. Such a price would thus give dairies an incentive to sell through shops rather than on the doorstep. This would of course be particularly the case in Scotland, where the degree of dilution would be correspondingly greater; in the rest of the UK this effect would be small because of the low proportion of milk sold through shops.

43. This problem would be less evident if Ministers no longer set a maximum wholesale price at which the dairies buy from the Boards. But the only way it could be avoided altogether would be through a "dual margin" involving a separate maximum price according to whether the product is sold through a shop or delivered. Whilst this would be technically possible if Ministers decided to decontrol the wholesale price, it would be very complex and difficult to administer - and probably impossible to audit - if it operated in conjunction with a maximum wholesale price. Moreover, a dual retail price would presentationally be the worst option of all for the doorstep delivery service.

Summary of Options

44. The options discussed in paragraphs 26-43 may be summarised as follows:

- (i) Retention of the existing system (with the modifications proposed by Binder Hamlyn);
- (ii) Total abolition of control;
- (iii) Decontrolling the retail price while maintaining wholesale price control;
- (iv) Decontrolling the wholesale price while maintaining retail price control;
- (v) Modifying the form of retail price control to cover:
 - (a) a maximum shop retail price; or
 - (b) a maximum ex-dairy price;
 irrespective of whether wholesale prices are controlled.

Summary of Recommendations by Binder Hamlyn and likely action

This appendix lists all of the main recommendations which were contained in the two reports prepared by Binder Hamlyn (BH) in 1980. For each recommendation, the appendix describes the action which officials believe, on the basis of discussions between the Ministry of Agriculture and the Department of Agriculture and the Dairy Trade Federations, could be negotiated with the dairy trades in England, Wales and Northern Ireland, if Ministers agree.

RecommendationLikely ActionInclusion of Wholesale Sales

- | | |
|---|-----------------------|
| 1. Wholesale sales should be included in the costings, with separate target rates of profit for milk sold retail and wholesale. | 1. Implement in full. |
|---|-----------------------|

Discount Monitoring

- | | |
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| 2. Discounts given by dairies on sales to bottled milk buyers and shops should be monitored. | 2. Implement in full. |
|--|-----------------------|

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|--|-----------------------|
| 3. A small sample of bottled milk buyers should be costed to provide data about their costs and profits; similar data about shops should be obtained from published figures. | 3. Implement in full. |
|--|-----------------------|

- | | |
|--|-----------------------|
| 4. If bottled milk buyers or shops appear to be making excessive profits on milk, the discounts given to them by dairies shall be limited in the costings. | 4. Implement in full. |
|--|-----------------------|

Target Rate of Profit

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|---|--|
| 5. The target rate of profit should be based on a return on capital employed; ideally this would be on a current cost accounting basis but, for practical reasons, historic cost accounting should be used initially. | 5. Accept in principle; BH to carry out pilot study to establish feasibility of method on CCA basis, with possibility of HCA in reserve. |
|---|--|

Sample and Averaging Method

- | | |
|---|--|
| 6. Consideration should be given to combining the costings samples for all parts of the UK. | 6. Agree combined sample for all of England Wales (Provinces) (Scottish sample would remain separate and the position of London still under consideration. |
|---|--|

7. Ideal samples would be 6 in London, 40 in rest of England and Wales and 15 in Northern Ireland.

8. The sample should contain a higher proportion of small dairies than at present to reflect the proportion of such dairies in the country as a whole.

9. Participation in the sample should be compulsory for dairies selected to take part.

10. (MAFF Proposal)

The position of costees which persistently make a loss should be reviewed and they should be excluded if no satisfactory explanation was available or if no improvement took place.

11. The median or the simple average should be used to average the costings results.

Efficiency Factors

12. Further incentives to efficiency could be built into the system by basing the distributive margin on the simple average of the costings results minus, say 5%; or by omitting to make retrospective adjustments to the margin if they were smaller than a certain percentage.

Cost Conventions

13. Detailed recommendations on treatment of: cost of other goods; roundsmen's commission; rounds shortages; proprietors' remuneration; and head office and group charges.

Penny Schedule

14. BH have now revised their recommendations; the need for a penny schedule adjustment and the form it will take will depend on the details of the costings system finally agreed.

7. Agreement likely. Combined sample of 40-50.

8. Discussions are continuing with the DTFs on a sample based on size of dairy, geographical location and type of ownership. Despite pressure from officials the DTF are having difficulty agreeing to a substantially increased proportion of small dairies in the sample.

9. Compulsion has been agreed to be undesirable, but officials are seeking a satisfactory assurance of co-operation from the DTF.

10. Accepted by the DTF, if part of a satisfactory overall package.

11. Simple average will continue to be used.

12. Agreed to be capable of resolution only at a political level.

13. Agreed subject to minor amendment.

Further discussion necessary with DTF once final system becomes clearer.

Use of Cost Indices

15. Pilot costings should be replaced by use of cost indices in making projections of future distributive margin requirements.

London and Belfast Allowances

16. Further study should be given to arrangements for London allowances.

17. Further study should be given to Belfast allowance.

15. Agreement that pilot costings satisfactory; cost indices would be marginally cheaper to operate but could be less accurate.

16. Proposal still under study whereby London sample of dairies will be combined with overall sample for E, W and NI.

17. No decision reached: the NI DTF are unable to express a firm view.