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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

LIQUID MILK PRICES

Memorandum by the Minister of Agriculture, Fisheries and Food

Introduction

1. Following our discussion on liquid milk price controls in the spring - E(81)11th Meeting - I announced on 16 April that we had decided to continue the present system of controls in England, Wales and Northern Ireland, subject to the introduction of certain changes in the distributive costings system recommended by an independent firm of accountants, Binder Hamlyn. I also indicated that further study would be needed about the detailed application of those changes, and in particular on Binder Hamlyn's recommendation that the dairy trade's target rate of profit should be determined by some objective criterion, such as the return on capital employed.
2. As I indicated in my letter of 2 December to the Chancellor of the Exchequer (Annex A), we now have the results of that further study, and the industry are looking to us to announce our conclusions both on the Binder Hamlyn recommendations and on the level of liquid milk prices to apply this winter.

Binder Hamlyn

3. As the paper (Annex B) enclosed with my letter to the Chancellor indicates, I am proposing to implement virtually all Binder Hamlyn's detailed recommendations, and I have managed - with extreme difficulty - to persuade the Dairy Trade Federation to accept these. There is no doubt however that this represents a tough package for the distributive trade. In particular -

- (a) I have insisted that the changes should apply from 1 October 1980, and that some £40 million that would have been due to the trade under the old system should be written off;
- (b) their present target rate of profit of 0.9p per litre - which was itself set as long ago as October 1978 - will be reduced to a base figure of 0.66p per litre.

I am convinced that any attempt to go beyond this (and the Binder Hamlyn recommendations) would cause the trade to opt out of the system, with the consequences described in the second paragraph of my letter to the Chancellor. In particular, I would be greatly concerned at both the social and employment consequences of any cut-back in the doorstep delivery of milk.

Producer incomes

4. The immediate effect of these changes will of course be of some benefit to producers. Nevertheless, this would not on its own be sufficient to prevent yet a further sharp fall in their returns this year on top of the steady decline they have suffered since we came into office. Thus, if there was no further injection of funds, the net margin for 1981/82 would be as low as £58 per cow.

5. The inadequacy of this figure can be seen clearly from the following table showing the net margin per cow in real and money terms since the first year of the last Conservative Government:

Year	£	Index (1970/71 = 100)
1970/71	29.9	100
1971/72	54.6	167
1972/73	61.0	174

1973/74	37.2	96
1974/75	27.4	60
1975/76	78.3	138
1976/77	52.2	80
1977/78	101.7	136
1978/79	95.1	118
1979/80	73.4	78
1980/81	78.8	73
1981/82	58.4	49

Retail price

6. Since there is no scope for putting any further squeeze on the distributors, it is clear that an early increase in the maximum retail price is essential. As I have already indicated, I believe that it should be raised by 1 $\frac{1}{2}$ p per pint to 20p per pint with effect from 3 January 1982. This would be exactly one year after the last increase; it would represent an increase of only 8%, which is significantly below the forecast rate of increase in the RPI in the same period; and it is the very least that I could sell to the producers. Indeed, such an increase - which would have the effect of increasing the wholesale price in England, Wales and Northern Ireland to 18.130p per litre as from 1 January - would still only raise their net margin this year to about £73. In other words, it would in money terms be no higher than two years ago, and in real terms, it would be no better than 1974/75 (which was itself by far the worst year in the last decade).

7. In suggesting that the increase should take place on 3 January, I have considered very carefully the Prime Minister's thought that we should not make any change before the schools return. In practice, however, the evidence is that the school holidays make no discernible difference to household milk consumption, any minor variations in the children's nourishment pattern (which of course affects only mid-morning and lunch-time) being met in directions other than whole milk consumption. The impact on the average family budget of this particular point would therefore be negligible, which I think is borne out by the lack of any relevant adverse comment when changes were made on the corresponding Sunday in 1977, 1978 and last year. Conversely, to delay the increase by a week would lose the industry over £3 million in additional revenue, and would mean that we would have to re-open the very complex negotiations I had recently with the producers and distributors over the split now proposed between them.

Premiums on Channel Islands and Sterilised Milk

8. There have for many years been premiums on Channel Islands and Sterilised milk, and these currently stand at 2p and 1p per pint respectively. A fuller note has been circulated to officials, but I believe each of these premiums should be increased by ½p per pint concurrently with the proposed change in the retail price for ordinary milk. The Channel Islands premium was last increased in 1977, since when its value in real terms has been substantially eroded, and, although the sterilised milk premium was raised more recently, it also needs to be increased if the consumer demand for this specialised product is to be met.

Scotland

9. A further consequence of the wider decisions we took in the spring is that control of the milk price in Scotland was moved from the retail to the ex-dairy point with effect from 1 October. Milk price controls in Scotland do not therefore directly affect the consumer, and in practice most distributors have already raised their retail prices, although milk is still widely available at below 20p per pint. I understand, however, that the Secretary of State for Scotland intends to adjust the Scottish Milk Boards' maximum first-hand selling price after taking account of the adjustment which I am proposing for England, Wales and Northern Ireland.

Recommendation

- 10. I invite my colleagues to agree -
 - (a) that the Binder Hamlyn changes listed in Annex B should be implemented with effect from 1 October 1980;
 - (b) that the maximum retail price of milk should be increased in England, Wales and Northern Ireland to 20p per pint as from 3 January 1982 (and the maximum wholesale price to 18.150p per litre as from 1 January);
 - (c) that the present premiums on Channel Islands and Sterilised milk should be increased by ½p per pint, also from 3 January 1982.
 - (d) that I should make an early announcement of these changes, as in the draft statement at Annex C.

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH



From the Minister

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
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2 December 1981

Geoffrey Howe

BINDER HAMLYN: LIQUID MILK PRICES

As you know, following the two reports we had from Binder Hamlyn in February and October last year, I commissioned a further study from them on the feasibility of devising a more objective way of determining the target rate of profit on the lines they had suggested in their second report. I have received their report on this further study and enclose a copy of it.

As you will see, its recommendations have come as a great shock to the milk distributors, since they involve a very large cut in the target rate of profit available to them. It has been touch and go whether they could be prevailed upon to continue to co-operate in the price control system on this basis, but I am glad to say that they are now with great reluctance prepared to do so. Had they not been, it would have been very difficult to carry on with retail price control, and the retail price of milk could have soared in a way which would not only have added greatly to the Food Price Index but would have put at risk the continuation of doorstep delivery of milk.

We now need to take all the decisions necessary to implement a revised milk costings system. We also need to decide on future maximum retail and wholesale prices, following our autumn review. The wholesale price paid to the Milk Marketing Boards should have

been increased on 1 October (it was actually reduced on 1 April for the summer season), and I have been under heavy pressure to declare our intentions at a time when dairy farmers are themselves in considerable economic difficulty. I am sure it was right to defer this until we could sort out the future system for distributive costings, but any further delay would be impossible to defend, and we must clearly take our decisions and announce them as quickly as possible.

I enclose a draft statement which sets out the changes I propose to make to the costings system in implementation of the Binder Hamlyn recommendations and the decisions I propose on prices.

As regards the review of the costings system, I am proposing to accept virtually all of the detailed recommendations of Binder Hamlyn with only a few insignificant exceptions. On the central question of the target rate of profit I propose to accept the method proposed by Binder Hamlyn for establishing the basic target rate and to drop the existing depreciation convention as they suggest.

Of the two alternatives they offer, I propose to adopt the CCA depreciation proposal which gives the greatest reduction in the target rate of profit (the margin saving from change in depreciation convention being a much less stable and predictable figure). I propose also, despite very strong contrary representations from the Dairy Trades Federation, to follow Binder Hamlyn's strong preference for the use of preselected reference groups and of a straight average. When I sought their comments on the latest Binder Hamlyn report, the DTF argued strongly that, for the retail part of their industry, the reference group proposed by Binder Hamlyn was seriously unrepresentative of retail activity and that it ought to be further refined to eliminate this source of distortion or the average should be struck on a weighted basis, which would raise the rate of profit on turnover in the reference group from 2.0% to 2.7%.

Although I considered there was some justice in their arguments, I shared the view of Binder Hamlyn that it would be difficult to find a satisfactory and objective way of further adjusting the retail reference group and, having taken account also of the Binder Hamlyn arguments about the lower degree of risk in the dairying industry, I have concluded that we should base the basic target rate of profit on the bottom of the bracket (2.0-2.7%) established by Binder Hamlyn. This conclusion has been accepted only with very great reluctance by the DTF.

The effect of this will be to reduce the basic target rate of profit to 0.60 ppl compared with the existing figure (established two years

ago and not uprated while the full operation of the costing system has been suspended) of 0.90 ppl. In accordance with the recommendations of Binder Hamlyn I propose that this new basic rate should be updated annually in line with the movement of the milk price and reviewed every three years or so in a fresh comparison exercise.

I propose to introduce the revised costing arrangements at the earlier possible moment, ie with effect from 1 October 1980. This means that they will be fed into the usual autumn costings exercise that is now getting under way. I am also proposing, and again this has been accepted exceedingly reluctantly by the Dairy Trade, that the outstanding shortfalls in margin arising under the old costing conventions before that date should be written off: these amount to £40 million.

As regards milk prices, I propose that the retail price should be increased on 3 January 1982 by 1½p/pint to 20p/pint. This will be a full year after the previous increase and represents an increase of 8%. This is significantly below the forecast rate of increase in the RPI in that period and should not cause a significant depression in the trend of liquid milk consumption. I hope it will be possible to avoid any further increase in the retail price for at least the greater part of 1982. Taking account of this increase in the retail price and of the effects of implementing the Binder Hamlyn recommendations I propose to increase the wholesale price in England, Wales and Northern Ireland with effect from 1 January 1982 to 18.130p/litre.

The effect of this will be to provide some increase in the returns of milk producers but not to a level which would stem the continual erosion in the real value of their net margins which has now continued unabated since 1977/78. They have been pressing me for several months to take early action to restore the real value of their net margin at least to last year's level. Now that we have completed the review of the costings system I have no grounds for deferring a retail price increase any longer and for the reasons I have explained I think this cannot be less than 1½p/pint.

I have asked my officials to get in touch with yours and their opposite numbers in the other Departments concerned so that we can provide any further information necessary about the technical details involved in all this. I hope that on this basis my colleagues will be able to give their early agreement that I should make a written statement on the lines I propose.

I am sending copies of this letter to John Biffen, Humphrey Atkins, George Younger, Jim Prior, Nicholas Edwards and Sir Robert Armstrong.

PETER WALKER

Summary of Binder Hamlyn Recommendations and Decisions Taken on Them

This annex lists all of the recommendations which were contained in the three reports by Binder Hamlyn, dated February and October 1980 and November 1981. For each recommendation, the annex lists the action which the Minister of Agriculture, Fisheries and Food intends to take, following his discussions with the Dairy Trade Federations, Milk Marketing Boards and Farmers' Unions in England, Wales and Northern Ireland.

Recommendation

Intended Action

I. SCOPE OF THE COSTINGS SYSTEM

- | | |
|---|--|
| 1. All milk sales (including wholesale sales) by costed dairies should be fully included in the costings system, with discounts given on wholesale and semi-retail sales also being included in the costings. | 1. Agreed. |
| 2. Discounts given to bottled milk buyers (ie wholesale sales) and to shops should be monitored and, if excessive, limited in the costings. | 2. Agreed. |
| 3. Monitoring and limitation of discounts given to bottled milk buyers should be by reference to a triennial costing of a small sample of bottled milk buyers. | 3. Agreed in principle. A further study is needed to establish how best to cost bottled milk buyers. |
| 4. Monitoring and limitation of discounts given to shops should be by reference to published data about gross margins earned by general food retailers. | 4. Agreed. |

II THE COSTINGS SAMPLE

5. Although difficult to achieve at present, there could be advantage in there being one UK sample.

6. The sample should be structured so as to include costees which in terms of throughput are representative of the trade overall; the representation of smaller dairies should be increased.

7. New costees should continue to be selected by agreement between MAFF and the DTFs, but participation by selected costees in the sample should be made compulsory.

5. Different arrangements now apply in Scotland, but a single sample for E, W and NI is to be established.

6. Agreed. The proposed new sample takes account not only of throughput, but also of geographical location and type of ownership. The representation of smaller dairies will be increased.

7. The DTFs will use their best endeavours to persuade selected costees to participate. The Minister reserves the right to introduce compulsion, if necessary.

III GEOGRAPHICAL ALLOWANCES

8. On the evidence available at the time, Binder Hamlyn were unable to take a firm view on the need for a Special London Allowance in the long-term.

9. The London Distributive Allowance should be restricted to a fixed proportion of the Special London Allowance.

8. It is now apparent that costs are higher in London than in the provinces. An allowance will be paid but calculated using a simplified and objective method.

9. The London Distributive Allowance will be set at 40% of the Special London Allowance.

10. If there continues to be a difference in costs between Belfast and other areas then, subject to Government policy the Belfast Allowance should be continued.

10. For decision by the Secretary of State for Northern Ireland.

IV COST CONVENTIONS

11. Continue to calculate deduction for cost of "other" goods sold on rounds but review formula and figures.

11. New formula and provisional figures agreed.

12. Continue proprietors' remuneration formula with minor modifications.

12. Agree to continue, but reserve judgement on need for modification.

13. Allow costs of rounds shortages to be included subject to maximum level

13. Agreed.

14. Roundsmen's commission on milk sales should continue to be allowed in full, but that for other goods excluded.

14. Agreed.

15. Continue to exclude interest payable and receivable from the costings.

15. Agreed.

V TARGET RATE OF PROFIT AND DEPRECIATION

16. The basis of the depreciation charge in the costings must be consistent with the basis of the target rate of profit.

16. Agreed.

17. The present system of using tax allowances and net rateable values to represent the cost of depreciation in the costings should be replaced by the use of an actual charge on either a historic or CCA basis.

17. Agreed. A depreciation charge on a CCA basis will be used.

18. The target rate of profit for milk processing and wholesale sales should be calculated as a rate of return on capital employed by reference to a selected group of food manufacturing companies.

19. The target rate of profit for milk retailing should be calculated as a rate of profit on sales by reference to a selected group of food retailing companies.

20. The simple average should be used to calculate the appropriate reference rates of return on capital or turnover from the reference groups.

21. The lower degree of risk in the dairy industry should be taken into account in fixing the target rate of profit.

22. The target rate of profit for 1980 should be 0.81 ppl with historic cost depreciation, or 0.66 ppl with CCA depreciation.

23. There should be a full review of the target rate of profit every three years but, in the meantime, the TRP should be updated by reference either to the RPI or to increases in milk prices.

18. Agreed.

19. Agreed.

20. Agreed.

21. No specific adjustment made, but target rate agreed upon in lowest of possible range recommended by Binder Hamlyn.

22. Agreed to use 0.66 ppl with CCA depreciation.

23. Agreed. Updatings will be by reference to increases in the milk price.

VI THE AVERAGING METHOD

24. The median or the simple average should be used.

24. Agreed to use simple average.

VII COST COLLECTION SYSTEM

25. Simplify forms and instructions.

25. Agreed. This work is in progress.

26. Clarify and define role of investigating accountants.

26. Agreed. Discussions in progress.

27. Reorganise staff in London and Belfast.

27. Still to be considered in light of final decisions on future system.

28. Consider use of computers and self-assessment.

28. Cost-benefit study of use of computers in hand.

VIII MARGIN CALCULATION

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

29. Decided that pilot costings satisfactory; cost indices would be marginally cheaper to operate but would be less accurate and more complex.

30. Retrospective adjustments should be made only if they exceed a certain percentage of the TRP.

30. Agreed. Adjustments to be made only if greater than 5% of TRP.

31. BH changed their original recommendation and concluded that the penny schedule to be adopted would depend upon the details of the costings system finally agreed.

31. A formula for penny schedule factor has been agreed, with the approval of BH.

IX EFFICIENCY

32. Use of the simple average will ensure that the distributive margin is based on the results of the "reasonably" efficient dairy.

32. Agreed.

33. A further incentive to efficiency could be provided by basing the average on the very efficient dairy.

33. Not reflected in the averaging method chosen, but loss-making costees will be eliminated from the sample.

ConfidentialDraft statement by the Minister of AgricultureLiquid milk prices: review of the milk costings system

On 16 April 1981 I made an interim statement about the review which has been undertaken by an independent firm of accountants, Binder Hamlyn, of the way in which the dairy trade's costs are measured and taken into account under the system of control of maximum prices for liquid milk. I indicated that the Government accepted the need for certain detailed changes in the costings arrangements and in particular that we accepted Binder Hamlyn's two major recommendations: - that wholesale sales should be included within the costings system; and that it would be right in principle to determine the dairy trade's target rate of profit by reference to an objective and realistic comparison with rate of return in other industries.

In their second report of October 1980 Binder Hamlyn outlined a possible method of doing this based on return on capital but concluded that only a further detailed study would show whether this method was feasible in practice. I therefore commissioned them to carry out such a study and I have now received their report on this.

This report recommends that a basic target rate of profit for the dairy trade should be established on the basis of comparisons with two similar groups of industries. For the processing part of the dairying industry it recommends a comparison with the rate of return on capital in a specified reference group of food manufacturers: for the retail part the comparison would be with the rate of profit on turnover in a specified group of food retailers. Binder Hamlyn recommended that the current convention on depreciation (which allows writing off in one year on the basis of tax allowances) should be changed and replaced by one on a basis consistent with the calculation of the reference rates of profit. They proposed that this should be done on the basis either of a historic costs depreciation charge or alternatively an estimate of current cost accounting (CCA) depreciation charge could be made by scaling up the historic cost charge and

a corresponding reduction would then be made to the calculated target rate of return. Binder Hamlyn recommended that the basic target rate of profit thus established should be updated annually either on the basis of the Retail Price Index or by reference to changes in milk prices with a full review of the target rate of profit at less frequent, preferably 3 yearly, intervals.

The Government has decided to accept these recommendations and virtually all the other detailed recommendations of Binder Hamlyn (which are listed in Annex B to this Memorandum. The target rate of profit will be determined on the basis of a CCA depreciation charge and updated by reference to changes in milk prices. The new costings conventions will be effective from 1 October 1980 and will therefore be taken into account in the current autumn costing review which is now getting under way.

In making these changes to the milk costings system it has been my objective to encourage the provision of a full and efficient service to consumers, especially through the maintenance of a viable doorstep delivery system, and the continued health and competitiveness of the dairying industry and of the milk production industry which depends to so large an extent on returns from the liquid milk market. I have paid particular attention to shaping the costings system in such a way as to maximise the spur to efficiency it provides, both through the incentive to beat the average which Binder Hamlyn recognised it to contain, and by such measures as the removal of persistent loss makers from the sample and the use of simple averages. I am confident that the revised system, incorporating as it does, virtually all the specific recommendations of Binder Hamlyn, is well adapted to this end.

I recognise that the need to carry out this fundamental and thorough review of the costings system has inevitably created a period of uncertainty and some delay in initiating the usual autumn review of costings and prices; and that both these important industries can reasonably now look for a period of greater stability and regularity in the operation of the system so that they have a

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firmer basis for planning their commercial operations over the year as a whole. It will be my intention in operating the revised price control and costing system to seek to provide that firmer basis and to contribute to the fullest possible extent to the achievement of the objective I have stated above.

Having assessed the effect which the implementation of the changes to the costings system recommended by Binder Hamlyn will have upon the measured level of costs and profits in the dairy industry, the Government has also given consideration to the levels of the maximum prices for milk to apply this winter. It has decided to increase the maximum retail price for ordinary pasteurised milk by 1½p per pint, to 20p per pint, on 3 January 1982. At the same time, the maximum retail prices for Channel Islands milk and sterilised milk will be increased by 2p per pint, to 22½p per pint and 21½p per pint respectively. The maximum retail price for farm-bottled milk will be increased by just ½p per pint to bring it into line with the price for ordinary pasteurised milk, in accordance with the decision announced on 1 December 1980.

In order to reflect the increases in the maximum retail prices, taking account of the changes in the measured levels of dairies costs and profits arising from the implementation of Binder Hamlyn's recommendations, the maximum wholesale prices of milk in England, Wales and Northern Ireland will be increased as follows with effect from 1 January 1982:

	Present Price (p per litre)	Increase (p per litre)	Price from 1/1/82 (p per litre)
England & Wales (except London)	16.200	1.930	18.130
London	14.563	1.800	16.363
Northern Ireland (except Belfast)	18.840	1.930	20.770
Belfast	18.749	2.017	20.767

Orders giving effect to these changes will be laid before Parliament as soon as possible.

7 December 1981