Written evidence submitted by Dairy UK (FFS0017)

January 2025

DAIRY UK SUBMISSION TO THE EFRA COMMITTEE INQUIRY INTO FAIRNESS IN THE FOOD SUPPLY CHAIN

Executive Summary

1. Dairy UK is the trade association representing dairy processors in the United Kingdom. Our members account for nearly 80% of the milk produced by dairy farms in the UK.

2. Dairy processing is a highly invested, dynamic and innovative industry, that makes a major contribution to the UK economy, and provides the route by which dairy farmers achieve value for their milk.

3. To be economically sustainable dairy processors require a stable, predictable regulatory environment that ensures the market for raw milk functions effectively to provide raw milk with a consistency of supply and prices that are comparable to their peers and international competitors.

4. There is no requirement for further regulation of the market between dairy farmers and processors. The raw milk market is functioning effectively and competitively.

5. The market is now subject to the recently introduced 'Fair Dealing Obligations (Milk) Regulations 2024' which were developed over a prolonged period, and which have yet to be fully implemented. The purpose of the regulation is to provide greater certainty to both dairy farmers and processors, by ensuring that clear terms and conditions are established in contracts. It will not change market fundamentals.

6. The regulation also creates the Agricultural Supply Chain Adjudicator. To provide regulatory certainty it is important that the ASCA remains within the remit of the regulation and that farmers are educated into realistic expectations of the role of the ASCA.

7. The Grocery Code Adjudicator and the Grocery Supply Code of Practice have had a positive effect on relations between suppliers and retailers. The remit of the GCA should be extended to a larger population of smaller retailers.

8. There would be no justification for extending the remit of the GCA down the supply chain to cover relations between dairy farmers and dairy processors. This would duplicate the scope of the FDOM regulation and create further regulatory uncertainty.

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STRUCTURE OF THE UK RAW MILK MARKET

Processor Ownership

1. There are approximately 10,000 dairy farmers in the United Kingdom currently producing around 15 billion litres of milk per annum.

2. Over 98% of UK dairy farmers supply their milk to a milk purchaser. The remaining 2% process and sell milk and dairy products direct to consumers.

Co-ops

3. Around 40% of UK milk supply is purchased by dairy co-operatives. Dairy co-operatives are under the ownership and control of dairy farmers. For co-ops the content of contracts or their equivalent are determined within the governance structure operated by the co-op.

Private Dairy Companies

4. The remaining 60% of raw milk volume is supplied to milk purchasers that are privately owned. Raw milk supplied to private dairy companies is covered by written contracts.

5. For private dairy companies the process by which contracts are developed and amended can be through:

    Negotiation with Producer Organisations.

    A Producer Organisation is a legal entity representing the dairy farmers supplying a private milk purchaser. Under EU law a PO has the right to represent its associated dairy farmers in negotiations with purchasers over the terms and conditions on which milk is supplied. Currently there are two registered POs, DCDirect for farmers supplying Saputo and MMG Dairy Farmers for farmers supplying Muller. As currently constituted POs in the UK do not take ownership of the milk. Instead they act as negotiating agents on behalf of their members.

Consultation through other frameworks

Some milk purchasers consult their supplying farmers through either a formal representative framework set up for the purpose or through dialogue at ad-hoc meetings.

6. Overall, taking into account co-ops, POs and other representative structures into account, a major portion of UK milk supply is operated under arrangements that provide a mechanism to consult the views of dairy farmers in the development of contracts.

Contractual Arrangements

7. Supply chain arrangements in the dairy industry are based around the necessity to maintain a secure continuous flow of raw milk from dairy farms to milk purchasers. Raw milk is a perishable product. Farmers do not have the storage capacity to keep more than a few days of production on the farm. Milk purchasers require a continuous flow of product to maximise utilisation of processing plant and service markets, especially fresh product markets. Milk purchasers need to obtain raw milk as much as farmers have to sell raw milk. Security of outlet and input is paramount to the successful operation of the dairy industry supply chain.

8. To ensure security of milk supply, contracts between private dairy companies and dairy farmers, and the written agreements between co-ops and dairy farmers, are normally evergreen. Arrangements remain in place until either party gives notice. Notice periods are generally long, from a minimum of three months to up to 12 months required from the farmer to the purchaser, with sometimes longer notice periods required from the purchaser to the farmer. The length of notice periods is designed to give purchasers time to secure alternative sources of supply to meet contractual obligations with customers.

9. Contracts, or their equivalent, generally cover:

    a. The mechanism for setting prices
    b. Valuation of the milk by constituent content (butterfat, protein etc)
    c. Quality requirements
    d. Pricing adjustments for milk quality, volume collection, transport etc
    e. Farm management practices
    f. Notice periods

Aligned Supply Arrangements

10. A unique characteristic of the UK dairy supply chain is the existence of aligned supply contracts with retailers. Under these arrangements the raw milk from defined groups of dairy farmers is processed exclusively for sale as liquid drinking milk for a specific retailer. In these arrangements the retailer specifies the price to be received by the dairy farmer and any additional contractual requirements or obligations dairy farmers have to meet to be a member of the aligned supply group.

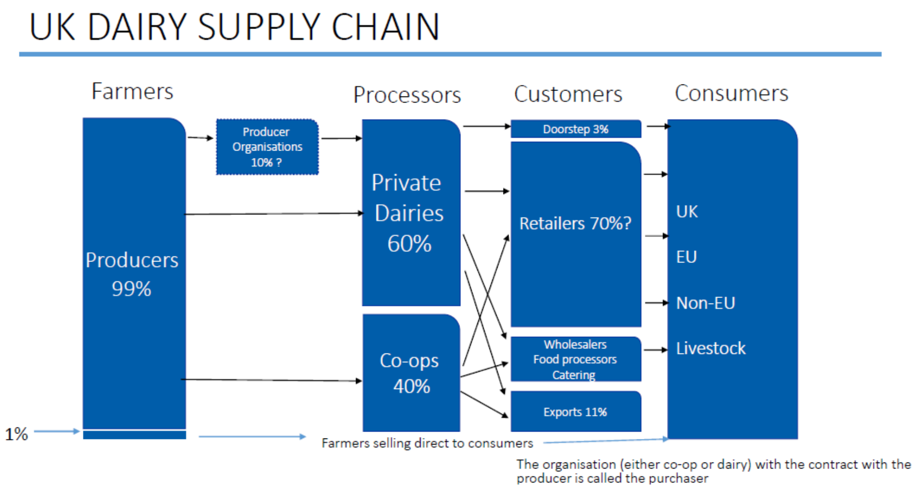
11. Prices paid to dairy farmers under these aligned arrangements are generally much higher than the prices paid by the rest of the industry in order to give the retailer security of supply. In several instances the prices are determined on the basis of average farm production costs. For instance, for Tesco information is collected by an independent firm of farm consultants on the operating costs for all the dairy farmers in the aligned milk pool and the price is then calculated as an average of those costs. This method of determining milk price is distinct from the rest of the raw milk market where prices are determined by the interaction of supply and demand (see below).

Retailer aligned contracts

Retailer	Pricing System
Marks & Spencer	Formula taking account of costs and market returns
Waitrose	Negotiation taking account of capital investment requirements
Asda	Premium over processor standard price
Sainsbury's	Quarterly review of key farm input costs
Co-op	Premium over processor standard price
Tesco	Formula taking account of costs and market return
Morrisons	Premium over processor standard price

12. However it is estimated that these aligned arrangements only cover around 20% of UK milk supply/dairy farmers.

13. Schematically the UK dairy supply chain can be represented as:



Operation of the Raw Milk Market

14. The safeguard against milk purchasers exercising excessive market power over their supplying farmers is the competitive operation of the raw milk market. In most regions of the UK the market for raw milk is competitive without any one purchaser being able to exercise market dominance.

15. Milk production is now highly concentrated into relatively tightly defined geographic areas. The main milk production regions are:

    - South west England (Cornwall, Devon, Somerset, Wiltshire, Gloucestershire)
    - West Wales (Pembrokeshire, Carmarthenshire, Ceredigion)
    - Cheshire, Shropshire and Staffordshire
    - Lancashire
    - Cumbria
    - South West Scotland (Dumfries and Galloway, East and South Ayrshire)
    - Northern Ireland

16. In each of these regions there are a number of milk purchasers competing for milk supply. This can be either;

    - purchasers with plant located in the milk region. These are normally purchasers with plant manufacturing dairy products such as cheese and milk powders. As the manufacture of dairy product reduces the moisture content of raw milk then logistical considerations make the location of manufacturing plant in the milk region the most cost-effective solution.

    - purchasers with processing plant located outside the region. These are normally processors of liquid milk. As the production of liquid drinking milk does not reduce the volume of raw milk then logistical considerations mean that is more appropriate to locate these plants next to population centres.

This results in a west to east shipment of raw milk, sometimes in excess of 100 miles for plants in London sourcing milk from Wales.

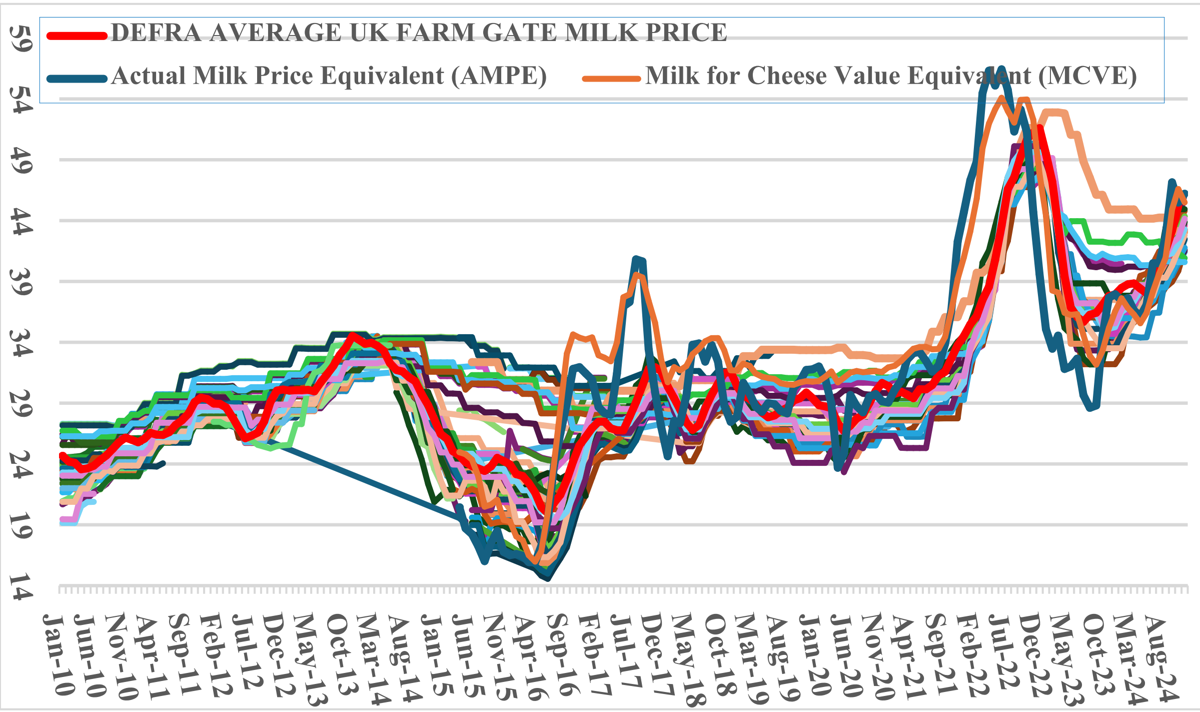
17. The result is that the overwhelming majority of dairy farmers have a choice to supply a range of milk purchasers. Dairy farmers can and do switch between purchasers. Over time the numbers involved are significant.

18. There is no indication that the notice period required by the purchaser from the farmer significantly influences the choice of dairy farmers or that is has impeded the movement of dairy farmers.

19. There are some regions where there is an absence of competition amongst milk purchasers. These are the Aberdeenshire region and certain Scottish Islands. However the number of dairy farmers in these areas is very small.

20. Overall, the competition in milk fields and the ability of dairy farmers to move means that purchasers are acutely mindful of their reputation with dairy farmers in case it jeopardises their existing milk supply or their ability to expand in the future by recruiting new farmers. As a result there are no instances of milk purchasers being able to set prices that are in opposition to the prevailing market trend. This is demonstrated by the graph below which plots the milk prices paid by milk purchasers since the beginning of 2000 for dairy farmers that are not in retailer aligned supply pools. The information is taken from the Market Intelligence website of the AHDB which is the statutory levy funded industry development body for the agricultural sector.

Graph 1: Average Price Paid: Pence per Litre



Source: AHDB

21. The graph demonstrates that the operation of the raw milk market works to effectively safeguard the interests of dairy farmers. Milk purchasers rapidly adjust milk prices when the market is recovering. When the market is falling the speed of price adjustment by individual purchasers depends largely on their exposure to the commodity markets which determine trends in the raw milk market.

Assertions of Market Failure

22. A number of assertions have been made by various stakeholders to support the contention that the UK raw milk market is not functioning correctly. These arguments include:

    - Price volatility: that dairy farmers suffer an undue burden of price risk

    - Lack of price transparency: that arrangements for raw milk pricing are opaque

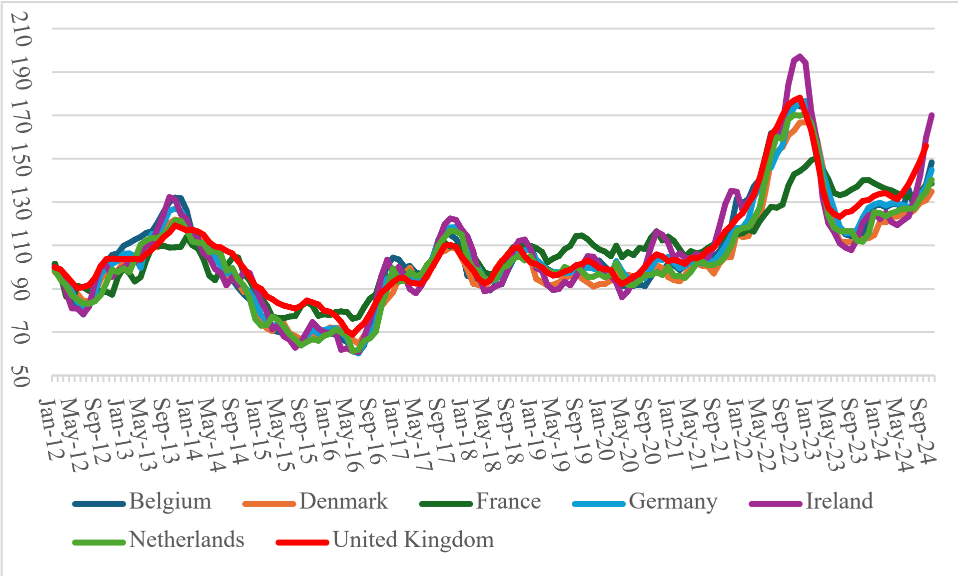
Price Volatility

23. Price volatility is an inherent feature of deregulated agricultural commodity markets. Whilst dairy farmers carry of the primary burden of price volatility in the dairy supply chain milk purchasers are not exempt. Manufacturers of mature cheese can be particularly badly affected by the differences in raw milk costs and market valuation of finished product.

24. Price trends in the raw milk market are set by trends in markets for commodity dairy products such as bulk butter and skimmed milk powder. There are a multiplicity of mechanisms by which trends in dairy commodity markets immediately affect returns from other dairy markets such as fresh products, but in terms of economic theory this means that: ‘as a homogenous undifferentiated product with multiple competitive end-uses, the trend in the price of raw milk is determined by the marginal use to which it is put’, which for dairy is generally bulk butter, skimmed milk powder and generic cheeses.

25. Globally the degree of price volatility experienced in the UK is entirely consistent with the UK’s main EU competitors. This is demonstrated by the graph below. The information is taken from the AHDB website. This graph shows that the variability in UK prices is entirely consistent with the experience of other major milk producing countries.

<u>Graph 2: UK and EU milk price volatility: Index 2014 = 100</u>



Source: AHDB, Dairy UK

26. Judged against these market dynamics UK dairy markets are operating efficiently. They are not dysfunctional, distorted or operating outside European norms.

Volatility and the Role of Processors

27. In the market in which the dairy sector operates, milk purchasers, whether co-operatives or private, do not have the resources to protect their supplying farmers from price fluctuations. Efforts by milk purchasers to shield dairy farmers from price fluctuations would expose purchasers to the risk of bankruptcy. Each 1 pence per litre change in raw milk prices equates to £150m.

28. Purchasers, whether co-operatives or private, can generally only offer price stability with the support of their customers. Such arrangements exist with the aligned supply chains operated by major retailers for the supply of liquid milk (see above). However, as noted above, these arrangements only cover a small minority of UK milk production and, given the retail price discounting for liquid milk, probably represent a major cost burden for retailers.

Price Transparency

29. Another criticism of the raw milk market is the absence of price transparency both in respect of:

    a. Reliable market indicators.
    b. The way in which individual milk purchasers decide on raw milk prices.

30. The UK dairy industry is actually well served with information on commodity market trends. Information is available from:

a. The GDT auction run on behalf of Fonterra. This provides an early indication of world market trends.
b. EU and UK commodity price indicators compiled by the AHDB website.
c. Information circulated by financial service companies such as FCStone.
d. The European Commission's Milk Market Observatory.

31. If there is a deficiency it is in the absence of a commodity price series that meets the requirements of the financial sector to settle futures contracts against. However this is a technical issue. Overall the abundance of market data means that the industry at all levels has a high degree of understanding of short term market trends.

32. In respect of the limited transparency exercised by milk purchasers over price setting, this is an inevitable result of the need to protect commercially sensitive information. Each purchaser has its own unique portfolio of contracts with customers of varying duration and price. Purchasers are inevitably reluctant to share this information. In addition each purchaser has to respond to the raw milk prices offered by their competitors, not only in so far as it might affect raw material costs and the competitive position on the final product market, but also the ability to attract and retain farmers. Consequently purchasers inevitably need flexibility to respond to a dynamic and fluctuating market place. In the end purchasers have to exercise commercial judgement to be competitive.

33. The alternative is to lock arrangements into pricing formula, but this could leave the purchaser open to manipulation and unforeseen market developments. In addition price changes generated by formulas do not alter the price uncertainty or risk that dairy farmers are subjected to.

FAIR DEALING OBLIGATIONS (MILK) REGULATION (FDOM)

34. Contractual relations in the United Kingdom between processors and dairy farmers are now covered by the 'The Fair Dealing Obligations (Milk) Regulations 2024' made on the 16th April 2024. The regulation has come into force in the UK on 9 July 2024 for all new contracts made for the purchase of milk from dairy farmers. There is a transition period of 12 months for existing agreements, after which all such contracts will need to be compliant with the FDOM by 9 July 2025.

35. In developing the regulation Defra conducted a prolonged and exhaustive review of contractual practice in the dairy sector.

36. It is important to understand that the objective of the regulation is to achieve greater transparency. It is not to alter the level of prices achieved by the industry, or the degree of price volatility experienced by farmers.

37. Defra committed to introduce regulation following the 'Contractual practice in the UK dairy sector consultation' in June 2020 which: '…aimed to understand whether contract reform could provide greater certainty to both dairy producers and processors, by

ensuring that clear terms and conditions are established in contracts' (summary of responses document).

38. Dairy UK supported the principle of regulation to provide a level playing field between processors but argued for the necessity of retaining a degree of flexibility in pricing arrangements.

39. This is acknowledged in the regulation which will not require processors to offer either a fixed price or a mathematical formula but will instead require processors to set out in non-fixed price contracts those factors which they will have regard to in setting prices. Under variable prices in regulation 8, paragraph 2 states:

> A "variable price" is a price per unit of milk or milk constituent that is not fixed at the point that the milk purchase contract is made but is determined— (a) in accordance with; or (b) by the business purchaser with reference to, factors set out in the milk purchase contract.

40. This should give the industry the flexibility it requires to operate in a volatile market.

41. The regulation also created the office of the Agricultural Supply Chain Adjudicator to enforce the regulation and any subsequent regulation for other sectors. Richard Thompson has been appointed this position in May 2024. To date Dairy UK is not aware that the Adjudicator has received any complaints.

42. The ASCA has engaged in an extensive programme of stakeholder engagement since being appointed. However, there may still be unrealistic expectations amongst dairy farmers as to the implications of regulation. The FDOM will not change the fundamental operation of the raw milk market, either in the level of prices achieved or the degree of price volatility. To provide regulatory certainty it is important that the ASCA remains within the remit of the regulation and that farmers are educated into realistic expectations of the role of the ASCA.

43. It has been recognised by Defra that the Regulation has created uncertainty over the use of seasonality payment systems by processors. These are used to incentivise farmers to changes their profile of production over the year. They play a very important role in volume management and reconciling supply to efficient use of processing capacity.

44. Defra is developing an amendment that hopefully should be in place by the time the regulation comes into force for existing contracts on 9th July this year. Dairy UK understands that this will permit the use of seasonality payment systems for all milk purchasers so long as the price paid in any period covers all the milk supplied in that period, i.e.; different prices are not paid for different volumes. If this is the case then the concerns of the industry will largely be met.

PROCESSOR - RETAILER RELATIONS

45. The market between processors and retailers is intensively competitive.

Liquid Milk

46. Almost all the fresh pasteurised milk sourced by retailers is obtained from UK dairy processors. There is no significant source of foreign supply because of logistic constraints. Whilst there has been rationalisation amongst liquid milk processors there is still sufficient diversity of supply to ensure that the market remains intensely competitive. The result is the industry operates on thin margins. This was recognised by a recent CMA inquiry into the impact of inflation on selected supply chains.

47. In November 2023 the CMA published a report on: 'Price inflation and competition in food and grocery manufacturing and supply' which amongst nine other grocery sectors included an analysis of the liquid milk market. Appendix A of that report concluded that: 'Milk is a low margin category, consistent with it being a commodity product with limited product differentiation, dominated by own-label manufacturers'.

Manufactured Dairy Product

48. The wholesale market between dairy processors and retailers for manufactured dairy products (butter, cheese, yogurt etc) is extremely competitive.

49. The UK is not self-sufficient in raw milk production. It is reliant on imports to meet domestic demand. The result is a high degree of import penetration for dairy products. Imports account for 34% of domestic consumption, of which over 90% comes from the EU. The extent of foreign competition and the number of dairy processors operating in the UK means that retailers have a wide range of suppliers to choose from.

50. At the same time, UK exporters are heavily exposed to exports. Just over 20% of UK raw milk is exported abroad in the form of manufactured dairy products such as cheese and butter. UK processors therefore have to be internationally competitive to maintain their position in these markets.

51. This competitive environment ensures that the UK processing industry operates on thin margins. A report commissioned by Dairy UK from Ernst and Young on Contractual Relations in the UK Dairy Industry in 2020 concluded that:

    'Our financial analysis of the UK dairy market over the last 5 years show that processors generated an average net margin of 0.7p per litre, highlighting the low margin nature of the sector for processors'.

52. Although processor – retailer relations are generally good, the effective implementation of the GSCOP plays an important role in protecting processors from unfair commercial practices by the more unscrupulous operators in the retail sector. The GCA should be subject to continued review to ensure that it is operating effectively to implement the GSCOP.

<u>COMMITTEE QUESTIONS</u>

- the potential merits and demerits of expanding the scope of the Groceries Supply Code of Practice;

Commercial Practices

53. The GSCOP covers a specific list of potential contractual abuses between retailers and their suppliers. At present we believe that list to be comprehensive and not in need of addition.

54. In respect of expanding the scope of the GSCOP to cover relations between suppliers and farmers we do not believe this would be justified on the grounds:

    - There is no evidence of market failure in the relations between dairy farmers and processors. The competitiveness of the dairy sector supply chain and the balance in structural relationships means that the raw milk market is operating competitively and fairly.

    - The UK raw milk market has only recently been subject to regulation by the FDOM which has not been given a reasonable opportunity to bed in and operate to allow a fair and informed view of its efficacy.

Scope

55. The remit of the Grocery Code Adjudicator should not be extended further down the dairy supply chain to include relations between farmers and processors. Any further regulation of the dairy sector at this stage would be unwarranted and harmful to the long terms prospects of the sector.

56. Investment in dairy processing is expensive, not only in capital expenditure to build and maintain plant, but also in the development and marketing of new products. Raw milk is the biggest single component of operating costs, ranging from around 50% of the overall costs for liquid milk processors to over 80% for mild cheddar and bulk butter and skimmed milk powder. Investors need confidence that can source milk from a market that allows them to compete against strong domestic and international competition. This regulatory framework governing this market therefore needs to be consistent and stable if the dairy processing sector is to prosper.

57. It should also be noted that the commercial practices covered by the GSCOP have little or no relevance to the commercial practices in the raw milk market.

- other potential reforms to the Groceries Supply Code of Practice, including the potential benefits and risks of lowering the turnover threshold for which retailers are covered;

58. Currently the remit of the GCA is limited to 14 retailers and home delivery providers. There does not exist a compelling reason why the remit of the GCA should not be extended to smaller retailers and the food service sector.

59. Under the current arrangement smaller retailers are not under any restraint from exploiting the unfair trading practices banned under the GSCOP. Smaller retailers are just as able to exercise market power as larger retailers when their suppliers are comparatively small and the retailer consequently represents a significant portion of the sales of that supplier. The supplier can therefore be just as vulnerable as companies selling to larger retailers. There is therefore a need for these suppliers to be protected from arbitrary changes in commercial demands and unfair apportionment of risk that the GSCOP is designed to provide.

60. Food service companies are companies that deliver foods to outlets selling food for consumption outside the home such as restaurants, pubs, school and hospitals. Food service is a growing sector reflecting the change in consumption habits as consumers elect to eat more prepared food out of home.

61. Food service companies can constitute sizeable operations that hold the same commercial significance to the dairy sector as larger retailers. As the commercial relationship between food service companies and the dairy sector is broadly similar to that between dairy companies and retailers, then suppliers to food service companies are exposed to the same risk of unfair trading practices. Given the scale of food service operations then there is no reason for their exclusion from the remit of the GCA.

- adequacy of reviews into contractual practices in agricultural sectors and effectiveness of introduction of fair dealing powers under the Agriculture Act;

62. The FDOM regulations were developed following protracted and exhaustive consultation with the dairy sector.

63. The then Government announced its intention to regulate contracts in the dairy sector in 2018. A major consultation was undertaken in 2020. This was then followed by consultation on a policy paper in 2021 which rolled into late 2022 which was then followed by consultation on the draft regulation in 2023. There has been a further consultation on the draft amendment in 2024.

64. The time taken to finalise the regulation has caused considerable commercial uncertainty in the industry. The dairy sector would now welcome a period of stability.

- the benefits and risks of a sector specific approach to the introduction of fair dealing powers; and

65. Given a sector specific approach has been taken to dairy then the risk to the sector is if the Government decides to proceed with a generic approach. This would probably pose a considerable risk to the sector. Contracts in the dairy sector have their own specific

characteristics, particularly in respect of open ended exclusive contracts that do not specify fixed prices. A generic approach could be incompatible with the operation of the sector.

- scope for collaboration between the Agricultural Supply Chain Adjudicator and Groceries Code Adjudicator.

66. Given that the remit of neither body overlaps then there would not appear to be scope for collaboration.

January 2025