Title: Implementation of the EU Dairy Package **IA No:** Defra1088 **Lead department or agency:** Defra **Other departments or agencies:** OFT, BIS, RPA, WAG (FMDD), SG (RPID), NIE (DARD),	Impact Assessment (A)
	Date: 22/10/2012
	Stage: Consultation
	Source of intervention: EU
	Type of measure: Primary legislation
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Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£0.5m	£1.1m	-£0.2m	No	NA

What is the problem under consideration? Why is government intervention necessary?

An EU review found that the dairy industry suffers from an imbalance in bargaining power between farmers and first purchasers (processors) which can lead to unfair commercial practices, in particular farmers having no control over the price they will receive for milk and not knowing the price when delivering the milk. These problems have been addressed in EU Regulation No 261/2012 which is directly applicable in all Member States. The Regulation has two mandatory elements which we must implement now because current UK practices and administrative controls are not fully compliant with the EU Regulation. There are three discretionary elements which we have the option of implementing if appropriate.

What are the policy objectives and the intended effects?

The Regulation aims to improve stability in the EU dairy sector by promoting better contractual relationships and addressing the imbalance of bargaining power between farmers and first purchasers (processors / manufacturers of dairy products) as well as improving transparency along the supply chain. We aim for domestic implementation that provides minimum burden and cost whilst enabling benefits to be realised from farmers establishing Producer Organisations that can negotiate contracts, including price, on their behalf, whilst industry has delivered its own non-legislative solution to improve contractual terms and conditions.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

OPTION 1: Do nothing. This is considered to be the baseline against which all other options are assessed. Doing nothing would breach our obligation to implement this EU Regulation domestically and would lead to significant risk of infraction proceedings. **OPTION 2:** implementation of only the mandatory elements of the EU Regulation (i.e. recognition of dairy Producer Organisations which can jointly negotiate contract terms, including price, as long as they do not exceed more than 3.5% of EU production or 33% of national production by volume, and the collection of information from processors on raw milk deliveries on a monthly basis). **OPTION 3:** as option two but additionally the implementation of the discretionary element making it compulsory for first purchasers (processors) to provide written contracts and/or offers of contracts to their supplying dairy farmers. **Option 2 is the preferred option,** as we believe it is the best for all operators in the dairy industry and the benefits outweigh the costs.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 06/2014

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** No
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**		**Non-traded:**

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Date: 21th Nov 2012.

Summary: Analysis & Evidence

Policy Option 1

Description: Do nothing.

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2012	Time Period Years 7	Net Benefit (Present Value (PV)) (£m)		
			Low: 0	**High:** 0	**Best Estimate:** 0

COSTS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low				
High				
Best Estimate				

Description and scale of key monetised costs by 'main affected groups'

Please see key assumptions entry below.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low				
High				
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

As the status quo would be maintained, there would no resulting changes to costs or benefits. However, doing nothing would breach our obligation to implement this EU Regulation domestically and would lead to significant risk of infraction proceedings because current UK practices and administrative controls are not fully compliant with the EU Regulation. Doing nothing is therefore considered only as the baseline against which the other options are assessed

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs:	**Benefits:**	**Net:**	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Implement mandatory elements of the EU Regulation

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	**PV Base Year 2012**	**Time Period Years** 7	**Net Benefit (Present Value (PV)) (£m)**		
			Low: £0.5m	**High:** £0.5m	**Best Estimate:** £0.5

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low			£1.0m	**£7.0m**
High			£72.8m	**£442.9m**
Best Estimate	£1.8m		£36.7m	**£223.4m**

Description and scale of key monetised costs by 'main affected groups'

Producers: PV costs setting up POs (agreeing terms& conditions; applying for recognition) of £0.01m; PV running costs (membership fees & internal discussions) of £3.0m; PV reporting costs of £3,800.
Processors: PV negotiating costs of £10,300; PV increased cost of milk of £219.5m.
Authorities: PV cost of setting application process £100,000; PV cost of monitoring and reporting £0.5m.

Other key non-monetised costs by 'main affected groups'

Whilst there are no direct costs to retailers or consumers, it is likely that any increase in costs to processors will be passed down the supply chain in the form of higher prices

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		£1.2m	**£7.5m**
High	0		£72.9m	**£443.4m**
Best Estimate	0		£36.8m	**£223.8m**

Description and scale of key monetised benefits by 'main affected groups'

Producers: increased price received for milk due to increased bargaining power £219.5m; time saving from reduced negotiation time of £2.1m
Processors: time saving from reduced negotiation time of £2.2m

Other key non-monetised benefits by 'main affected groups'

Producers: improved efficiency due to sharing of best practice; improved contractual conditions through increased bargaining power.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

We assume that Scenario 1 (whereby current co-operatives and producer groups form POs) is the most likely, and so all above costs and benefits are based on this scenario. The magnitude of the cost and benefit estimates are highly reliant on the assumption that POs use increased bargaining power to secure an increase in price. The bargaining power estimates are highly sensitive to the number of producers that form POs and the extent to which these producers secure a higher milk price.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: £1.0-69.9m	**Benefits: £1.2-70.0m**	**Net: £0.2m**	No	NA

Summary: Analysis & Evidence

Policy Option 3

Description: Implementing compulsory contracts.

****** <u>Costs and benefits estimations here are incremental to those of the mandatory elements identified in Option 2</u> ******

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2012	Time Period Years 7	Net Benefit (Present Value (PV)) (£m)		
			Low: -£7.6m	High: -£7.6m	Best Estimate: -£7.6m

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low				
High				
Best Estimate	£1.8m		£0.95m	**£7.6m**

Description and scale of key monetised costs by 'main affected groups'

Processors: PV costs of familiarising of £0.01m; PV costs of re-issuing all contracts in the first year of £1.17m; and PV cost of revising contracts more frequently of £2.9m.
Producers: PV costs of familiarising of £0.29m; PV costs of re-issuing all contracts in the first year of £0.29m; and PV cost of revising contracts more frequently of £2.9m.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low				
High				
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

Contracts will provide more clarity to producers on the terms of their agreement, and the price they will be paid. They are also anticipated to provide more certainty for producers which will enable them to make longer term decisions and investments based on clearer future outcomes

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

We have assumed that the requirement to have a fixed or formulaic price specified in contracts will result in an increase in the frequency of contract revisions for producers that are currently on long term contracts.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £1.2m	**Benefits: £0m**	**Net: -£1.2m**	Yes	IN

1. Problem under consideration

1. In 2008-9 there was a sustained period of low dairy prices resulting from decreased demand for dairy on global markets and increased dairy production in third countries following exceptionally high prices in 2007. Statistics published by the EU Commission show that average EU farmgate milk prices fell by 30% between 2007 and 2009. In October 2009, the Commission created a High Level Experts Group (HLG) on milk to develop a regulatory framework to assist in stabilising the market and producers' income and enhance transparency for the medium and long term.

2. The HLG process identified a number of problems in the dairy industry in particular that with a low concentration of supply (at farm level) there is an imbalance in bargaining power between farmers and first purchasers (processors). The HLG concluded this can lead to unfair commercial practices, in particular farmers having no control over the price they will receive for milk and not knowing the price when delivering the milk. These problems have been addressed in EU Regulation No 261/2012 (the EU Regulation[1]), which is directly applicable in all Member States. The new rules are intended to boost the position of the dairy producer in the dairy supply chain by balancing the bargaining power of milk producers relative to major processors / first purchasers whilst safeguarding competition and preparing the sector for a more market orientated and sustainable future.

3. The EU Regulation:

a) permits producers to set up dairy producer organisations (POs) that can jointly negotiate contract terms, including price, for the delivery of raw milk to first purchasers as long as they do not exceed more than 3.5% of EU production or 33% of national production by volume; this is a liberalisation that partly relaxes competition law in favour of dairy farmers, but which could potentially hinder the free movement of market forces.

b) provides a simplified approach to the monthly reporting by first purchasers (processors / first purchasers) of the volume of raw milk that they collect; and,

c) includes certain provisions that allow Member States to decide whether to:-

   i. make it compulsory for dairy processors / first purchasers (purchasers) to have written contracts with (and/or provide written offers to) dairy producers covering certain key elements, including a price or price formula, the delivery volume, the duration of the contract, and the timing of collections;

   ii. permit the establishment of interbranch organisations bringing together operators from along the supply chain to improve transparency and promote best practice; and,

   iii. set down binding rules to regulate the supply of cheeses with protected designations of origin (PDO) and protected geographical indications (PGI) if this is requested by the group of operators who applied for registration of the PDO/PGI or a recognised PO or interbranch organisation.

4. The new measures will initially apply only until 30 June 2020. They are subject to review and there will be two intermediate reports by the Commission to the European Parliament and the Council by 30 June 2014 and 31 December 2018 regarding the operation of these new measures and the development of the market situation in the milk and milk products sector. Provided that these reports conclude that the introduction of this Regulation has been successful, then the EU Commission would most probably seek for them to continue. Whilst it is impossible to be definite at this point in time, the general perception is that the underlying framework is unlikely to be radically transformed[2].

5. The UK now needs to consider options for the implementation of the EU Regulation and seek opinions through consultation. The UK must ensure that the mandatory elements of the EU Regulation are implemented so as to avoid infraction. It must also decide whether or not to adopt any of the optional national measures permitted by the EU Regulation.

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1 - Regulation (EU) No 261/2012 of the European Parliament and of the Council

2 - Even within a 7 year period some producers might envisage a positive return on their initial investment in setting them up.

6. For more detailed background information see Annex F the overview of the dairy industry.

2. Rationale for intervention

7. The EU Regulation aims primarily to address market failures in relation to:

a) "information" by promoting greater transparency throughout the dairy supply chain; and

b) "market power" as there is currently an imbalance in bargaining power in the supply chain between farmers and downstream sectors – i.e. processors / first purchasers and retailers.

8. Current UK practices and administrative controls are not fully compliant with the new EU Regulation. Therefore, the UK Government must ensure that we meet our legal obligations to give effect to the mandatory requirements of the EU Regulation. This requires recognition of POs and collection of raw milk delivery data.

9. The UK also needs to decide whether or not to adopt any of the optional national measures permitted by the EU Regulation.

2.1. Policy objective

10. The Government's aim is to support and develop UK farming and encourage sustainable food production. Effective and proportionate implementation of the EU Regulation could help to improve the state of the UK dairy sector which is still emerging from a lengthy period of market management by the Milk Marketing Boards across the UK (where processors / first purchasers often paid artificially high farmgate prices to farmers) and the impacts of EU production quotas (which have served to restrict production to around 80% of UK market demand). To some extent, this has reduced investment and growth in the UK processing sector.

11. In line with the Government's priority of encouraging growth, the aim is to adopt the least burdensome and most beneficial approach for UK businesses when implementing the EU Regulation.

2.2. Assessing the Costs and Benefits

12. The impact of the main mandatory element of the EU Regulation (recognition of POs) is dependent on voluntary uptake by producers. Hence, we cannot say with any certainty how many UK dairy farmers will use this facility, at what size and scale such POs might operate, and what impact this might have on the supply chain between farmers and dairy processors / first purchasers. Co-operation among dairy farmers has always been possible under EU and national law. However current competition law only permits the joint negotiation of milk prices by farmer associations if this is deemed absolutely necessary for the agreement to work; generates substantial efficiencies; and the association does not command more than 15% or 20% of the relevant market share for a joint commercialisation and a joint production agreement respectively. No formally recognised dairy POs currently exist in the UK. Through the consultation process we hope to improve our understanding of the possible consequences of dairy-specific POs.

13. The cost and benefits have been assessed over the seven year period, as these EU Regulations expire in 2020 (although subject to the outcome of the two reviews). The 7 year period has been taken as the most appropriate time horizon for determining Net Present Values and Equivalised Annual Costs, because the regulatory framework after 2020 is entirely unpredictable at this point.

3. Policy Options

3.1. Background

14. The EU Regulation is directly applicable in all Member States. However, as above, some elements of the Regulation are discretionary. The two mandatory elements of the EU Regulation are:-

a) the recognition of POs and permitting such organisations to carry out contractual negotiations for the delivery of raw milk to processors / first purchasers; and,
b) the reporting of information from dairy processors / first purchasers on raw milk deliveries to the EU Commission.

15. In addition, there are three discretionary elements which Member States can choose whether or not to apply:-

a) introduction of compulsory written contracts;
b) recognition of interbranch organisations;
c) introduction of binding rules on the supply management of cheeses with protected designation of origin (PDO) or protected geographical indication (PGI) status.

16. Whilst there has been considerable interest in (a) the possibility of compulsory contracts, having liaised with industry there is no known interest in either (b) the recognition of Interbranch Organisations or (c) binding rules on the management of the supply of PDO/PGI cheeses. Whilst we examine (a) in more detail (b) and (c) are dealt with for information only in Annex G.

3.2. Options considered

17. **Option 1**: the no change option. This provides the baseline for the calculation of any additional costs and savings arising from other options. In view of the UK's Treaty obligations, Option 1 is not a viable option for the implementation of the EU Regulation as current UK administration and legislation does not fully deliver its requirements.

18. **Option 2:** the UK government will implement the mandatory requirements of the EU Regulation fully, but will not go beyond this to implement the discretionary elements of the Regulation. We will enable Producer Organisations to seek recognition and will conduct reporting procedures but do not seek to introduce further legislation at this time.

19. **Option 3:** the UK government will make it compulsory for purchasers to have written contracts with producers (one of the three discretionary elements) in addition to the mandatory elements of the EU Regulation.

20. The preferred option at this stage is **Option 2**, because we conclude that the benefits outweigh the costs to business, it ensures compliance with EU Regulations and it is not Government policy to go beyond the minimum requirements of the EU Regulation, unless there are exceptional circumstances.

21. Section 4 describes the impact of the mandatory requirements of the EU Regulation, and also consider the Government's proposed approach to implementation in areas where discretion is available.

3.3. One-In-One-Out consideration

22. Our preferred option is out of scope of OIOO because it does not involve legislation and does not go beyond the minimum EU requirements. We will be enabling the formation of producer organisations which is the main focus of this Impact Assessment without the need for domestic legislation. We will deal with the other mandatory requirement, the reporting requirements for milk volumes, nearer to 2015 when it enters force, by which time there should be greater certainty of the European Commission's reporting requirements. We do not intend to implement any of the discretionary options because the industry has introduced its own non-legislative solution on contracts (the industry code of practice) and there is no known industry interest in the other options (recognition of Interbranch organisations and controlling the supply of cheeses of specific origin).

4. Options Appraisal

4.1. Option 1: do nothing

23. Option 1 is the considered as the baseline against which each option is assessed. As the status quo would be maintained, there would be no resulting changes to costs or benefits. Doing nothing would breach our obligation to implement this EU Regulation domestically and

would lead to significant risk of infraction proceedings. This could lead to the UK being fined and a loss of UK's credibility in transcribing EU law into UK law. Doing nothing is therefore not considered as a genuine option.

4.2. Option 2: implement mandatory elements of the EU Regulation

24. There are two mandatory elements to the EU Regulation (a) the recognition of Producer Organisations (POs) and (b) arrangements to continue the reporting of raw milk production volumes from 1 April 2015, after the Milk Quota regime ends. We will start by providing a brief explanation of the two mandatory elements, then we outline the costs and benefits associated with these elements and we finish with a summary.

4.1.1. Description of mandatory elements

a) Recognition of POs

25. Dairy POs are associations of farmers with a specific aim. Under the EU Regulation Member States are required to formally recognise as producer organisations in the milk and milk products sector all legal entities or clearly defined parts of legal entities that apply for such recognition, provided that they meet the requirements laid down in the EU Regulation. The EU Regulation also sets out time limits and obligations for Member States.

26. The EU High Level Group on Milk found that the concentration of raw milk supply is low with a resulting imbalance in the supply chain between farmers and dairies. The processing sector in the UK is highly consolidated – 87% of milk output comes from just 23 processing companies. Whilst 23% of raw milk production in Northern Ireland is exported to Ireland for processing, there is no appreciable export of raw milk from GB as liquid milk is a bulky and perishable product.

27. Producer Organisations provide dairy farmers with the opportunity to improve their bargaining power within the supply chain. Groups of dairy farmers must apply to be formally recognised as a PO to be allowed to jointly negotiate contract terms, including price, for some or all of their members' production. Applications must demonstrate that the PO:-

- has been formed at the initiative of the producers;
- will pursue a specific aim;
- has a minimum number of members and/or covers a minimum volume of marketable production;
- is able to provide sufficient evidence that it can carry out its activities properly over time; and,
- has a statute that is consistent with the above points.

28. Under the EU regulation, the minimum number of members and/or minimum volume of marketable production that a group of farmers must cover in order to be formally recognised as a PO must be laid down by individual Member States. At this stage, we propose that a minimum of 10 producers would be required to meet the threshold for recognition in the UK. This proposal seeks to strike a reasonable balance between ensuring flexibility for producers and avoiding potentially high administration costs if there are large numbers of applications from very small groups of farmers. Views and evidence from the industry would be welcome as part of the consultation process, as this may help in finalising this decision. In any event, it is proposed that the threshold criteria should be set out in guidance and be reviewed in 2014 in the light of experience (when it may also be necessary to address the EU Commission's proposals for CAP reform which would extend the PO model to all agricultural sectors).

29. Member States must decide whether to grant recognition to a PO within 4 months of the lodging of an application accompanied by all the relevant supporting evidence.

30. The Government will appoint a national competent authority with responsibility for recognising POs in response to any application. The competent authority will carry out periodic checks to ensure that recognised POs are complying with the requirements of the EU

Regulation and report annually to the EU Commission every decision to grant, refuse or if necessary withdraw recognition. We propose there will be no charge made on industry for the activity of this competent authority.

31. Under the EU Regulation, POs may negotiate contracts for the delivery of raw milk to processors / first purchasers on behalf of their members. In order to maintain effective competition in the dairy market, the Regulation sets limits on the size of the negotiations. Accordingly, the volume of raw milk covered by such negotiations by a PO (or association) cannot exceed 3.5% of total EU production and 33% of the total national production of the Member State(s) in which the milk is produced or delivered.

32. However, even where these thresholds are respected the EU Regulation includes additional safeguards to ensure that competition is not excluded. Before each negotiation starts, POs must notify the competent authority of the Member State(s) in which they operate of the volume of raw milk to be covered by the negotiations. The competent authority may intervene to prevent a negotiation or to order it to be reopened if it believes that this is necessary in order to prevent competition from being excluded or to avoid seriously damaging SME processors / first purchasers of raw milk.

33. The Office of Fair Trading (OFT) will carry out this role for negotiations conducted entirely in the United Kingdom. At present, the OFT regularly exercises its powers to consider mergers, some of which it refers to the Competition Commission (CC) for more in-depth assessment. Both the OFT and the CC will also investigate any commercial conduct or agreements which they believe might have an adverse impact on competition in the UK milk market. Most notable recent examples of these investigations has been the division by the CC of the excessively large producer cooperative ‘Milk Marque’ into three separate cooperatives in 1999 and the more recent investigation by the OFT of price fixing of milk and cheese between competing processors and retailers from 2002-3 which continued until conclusion in 2011. These activities will be taken over by a new authority resulting from a merger of the OFT and the CC – the Competition and Markets Authority (the CMA) in 2014. Although the full extent of the CMA’s activities is still being finalised, the assessment of mergers and investigation of anti-competitive conduct and agreements (as well as of abuse of dominance cases) will continue under the new Authority. For transnational negotiations the European Commission would be the competent authority. We propose there will be no charge made on industry for the activity of this competent (competition) authority.

b) Continuing the reporting of raw milk production volumes

34. The EU Regulation obliges “first purchasers” from 1 April 2015 to make monthly declarations to the competent national authority of the quantity of raw milk that has been delivered to them each month. National authorities would then notify this information to the Commission. The purpose of this requirement is to enable the EU Commission to monitor the volume of raw milk collected and developments on the market after the milk quota regime expires. It will supersede some of the current requirements for reporting under EU milk quota legislation but does not affect any of the statistical reporting requirements for Eurostat. The term “first purchaser” means an undertaking, group or processor which buys milk directly from producers (whether or not under contract) in order to: (a) subject it to collecting, storing or processing; or (b) sell it to one or more undertakings for processing into drinking milk or other milk products.

35. The EU Regulation provides that the Commission may adopt further implementing Regulations laying down rules on the content, format and timing of such notifications in due course. These would help to clarify the scope of the requirement. However, subject to what the implementing rules provide when the Commission introduces them nearer to 2015, the content of such notifications may change from current requirements which require additional detail such as butterfat content. The UK is also far advanced in terms of market information through the wealth of data published by DairyCo, which includes data on weekly raw milk deliveries to processors / first purchasers. Therefore this element of the EU Regulation is assumed to have a very low impact for industry, although the competent authority will need to continue some data

gathering and reporting work that would otherwise have ceased in 2015 when the quota regime ends.

4.1.2. Summary of Costs and Benefits

36. The mandatory element that has the greatest potential impact on the main affected groups is the recognition of POs. Scenario 1 is considered to be more likely, therefore we have used the costs and benefits associated with Scenario 1 only in the cover sheets of costs and benefits.

37. Two scenarios have been used to illustrate the possible costs and benefits of recognising POs because we do not know the exact number or scale of POs that will form. Scenario 1 is that all three existing supply groups form POs. Scenario 2 is that three POs form, each representing the legal maximum of 33% of the UK market. We consider Scenario 2 to be a theoretical extreme. Scenario 1 is considered to be more likely, therefore we have used the costs and benefits associated with Scenario 1 only in the summary of costs and benefits. For further details of the scenarios, please see Section 4.1.4a.

38. By far the most significant impact will be if POs are able to negotiate a higher milk price for their members for the raw milk they supply by their control of a larger share of the total supply of milk. Under Scenario 1 we have modelled this as a range of outcomes. At the minimum, the increased price is just enough to enable producers to cover the costs of running and being members of the PO, and at the theoretical extreme they could negotiate a price equal to the price of liquid milk received by retailer aligned producers.

39. We have assumed a best estimate of the mid-point of the difference between the UK average price and the more favourable average price among retailer aligned producers. We assume the mid-point because retailer aligned producers are paid for their compliance with additional production criteria by the retailers.

40. A summary of the costs and benefits to the affected groups is given in Tables 1 and 2.

41. Table 1 shows the annual costs and benefits for Scenario 1, all represented in £millions. Presenting the results in this way gives an impression of the relative magnitudes of the costs and benefits. The improved bargaining power of producers has the biggest impact, both as a cost to processors / first purchasers and as a benefit to producers. The Net Present Value refers to the present value of benefits less the present value of costs. The Net Present Value for this option is £0.5million. This means that under scenario 1, the recognition of POs is estimated to result in a benefit worth £0.5 million over the course of 7 years.

42. The increase in price attained for the milk would represent a benefit to producers, but would be borne as a cost to processors / first purchasers (or to those further down the supply chain if the costs are passed on), when looking at the Net Present Value (NPV) over the period these will, in being a transfer of cost from one party to another, cancel each other out.

43. It can be helpful to consider the NPV figure against the total annual value of the UK dairy industry (£3.7 billion at the farm level and £8.8billion the ex-factory level). The best estimate of the average annual NPV represents only 0.002% of the annual farm-level value and 0.001% of the annual ex-factory value of the UK dairy industry.

44. Similarly, Table 2 shows the annual costs and benefits for Scenario 2 in £millions. Scenario 2 is included to illustrate the theoretical maximum impact of introducing POs, hence all costs and benefits to producers and processors are substantially higher than in scenario 1. This stems from the greater number of PO members in scenario 2, as well as the assumption that all POs form immediately rather than gradually over time, as in scenario 1.

45. The Net Present Value for this option under scenario 2 is -£16.0million. This suggests that if three POs were to set up and represent 99% of the raw milk market, this would result in a cost of £16million over a 7 year period. Once again, the largest impact is a transfer in bargaining power from processors to producers, which would be estimated to result in a transfer worth £707million. The net cost primarily stems from the costs of running POs, such as membership fees and discussion groups.

Table 1: Option 2 summary of costs and benefits for Scenario 1 (£millions).

Year				1	2	3	4	5	6	7	PV
Costs:	Producers	One-Off		0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
		Ongoing		0.3	0.5	0.5	0.5	0.5	0.5	0.5	3.0
		Reporting		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.00
	Processors	Negotiating		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.01
		Bargaining Power	Min	0.4	0.6	0.5	0.5	0.5	0.5	0.5	3.2
			Max	50.5	75.8	75.8	75.8	75.8	75.8	75.8	439.1
			B.E.	25.3	37.9	37.9	37.9	37.9	37.9	37.9	219.5
	Authorities	One-Off		0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
		Reporting		0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5
	Total		**Min**	**1.1**	**1.2**	**1.1**	**1.1**	**1.1**	**1.1**	**1.1**	**7.0**
			Max	**51.2**	**76.5**	**76.4**	**76.4**	**76.4**	**76.4**	**76.4**	**442.9**
			B.E.	**25.9**	**38.6**	**38.5**	**38.5**	**38.5**	**38.5**	**38.5**	**223.4**
Benefits:	Producers	Bargaining Power	Min	0.4	0.6	0.5	0.5	0.5	0.5	0.5	3.2
			Max	50.5	75.8	75.8	75.8	75.8	75.8	75.8	439.1
			B.E.	25.3	37.9	37.9	37.9	37.9	37.9	37.9	219.5
		Time Savings		0.2	0.4	0.4	0.4	0.4	0.4	0.4	2.1
	Processors	Time Savings		0.2	0.4	0.4	0.4	0.4	0.4	0.4	2.2
	Total		**Min**	**0.9**	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**	**7.5**
			Max	**51.0**	**76.5**	**76.5**	**76.5**	**76.5**	**76.5**	**76.5**	**443.4**
			B.E.	**25.8**	**38.6**	**38.6**	**38.6**	**38.6**	**38.6**	**38.6**	**223.8**
Net Present Value			**B.E.**	**-0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.5**

Table 2: Option 2 summary of costs and benefits for Scenario 2 (£millions).

Year				1	2	3	4	5	6	7	PV
Costs:	Producers	One-Off		0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.6
		Ongoing		5.3	5.3	5.3	5.3	5.3	5.3	5.3	32.6
		Reporting		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Processors	Bargaining Power	Min	5.9	5.3	5.3	5.3	5.3	5.3	5.3	33.2
			Max	220.2	220.2	220.2	220.2	220.2	220.2	220.2	1346.3
			B.E.	110.1	110.1	110.1	110.1	110.1	110.1	110.1	673.1
	Authorities	One-Off		0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
		Reporting		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Total		**Min**	**12.0**	**10.8**	**10.8**	**10.8**	**10.8**	**10.8**	**10.8**	**67.0**
			Max	**226.3**	**225.6**	**225.6**	**225.6**	**225.6**	**225.6**	**225.6**	**1380.1**
			B.E.	**116.2**	**115.5**	**115.5**	**115.5**	**115.5**	**115.5**	**115.5**	**707.0**
Benefits:	Producers	Bargaining Power	Min	5.9	5.3	5.3	5.3	5.3	5.3	5.3	33.2
			Max	220.2	220.2	220.2	220.2	220.2	220.2	220.2	1346.3
			B.E.	110.1	110.1	110.1	110.1	110.1	110.1	110.1	673.1
		Time Savings		1.4	1.4	1.4	1.4	1.4	1.4	1.4	8.9
	Processors	Time Savings		1.5	1.5	1.5	1.5	1.5	1.5	1.5	8.9
	Total		**Min**	**8.8**	**8.2**	**8.2**	**8.2**	**8.2**	**8.2**	**8.2**	**51.0**
			Max	**223.1**	**223.1**	**223.1**	**223.1**	**223.1**	**223.1**	**223.1**	**1364.1**
			B.E.	**113.0**	**113.0**	**113.0**	**113.0**	**113.0**	**113.0**	**113.0**	**690.9**
Net Present Value			**B.E.**	**-3.2**	**-2.5**	**-2.5**	**-2.5**	**-2.5**	**-2.5**	**-2.5**	**-16.0**

4.1.4. Analysis of Costs and Benefits

46. A detailed view on our best estimate of the size of each cost and benefit over the 7 year appraisal period is at Tables 1 and 2. Costs and benefits are assessed in 2011 prices. We assume that the 'real' price of milk (excluding inflation effects)[3] at the retail level will remain constant over the seven year appraisal period. Since milk and milk products are not subject to Value Added Tax, there is no direct return to the exchequer for this option. Annex A explains the method and assumptions underpinning the estimates for each cost and benefit. All present values (PVs) of costs and benefits are discounted at the 3.5% rate. All assumptions are based on best available evidence including industry knowledge and some anecdotal evidence to enable rough estimates for illustrative purposes. Input and evidence to further strengthen the validity of the assumptions will be gathered as part of the consultation process.

4.1.4a. Summary of Scenarios

47. We do not know the exact form, in terms of size and membership that any future PO might take. We have therefore modelled two possible scenarios to give an indication of the range of possible costs and benefits.

48. Scenario 1: All existing producer 'supply groups' form as POs with the same number of members as at present, whilst co-operatives do not. Supply groups are existing organisations established to represent the interests of farmers supplying an individual processor. We assume that the three known producer groups in the UK (Arla, Dairy Crest Direct and Robert Wiseman Dairies) choose to form POs. We assume that uptake is gradual, with two POs forming in the first year, and one in the second year. Based on the DairyCo 'Company Strategy and Performance Report' in 2011, these three producer groups together purchased a total of 4.3billion litres of milk in 2011 and represented 32% of the total milk produced in the UK.

49. Scenario 2: Uses the absolute maximum scale that POs could reach within the UK market place alone, where three POs form each producing 33% of the volume of raw milk processed in the UK. We assume that the total volume processed in the UK remains at the same level as in 2011, which we estimate to have been 12.5 billion litres[4]. We use scenario 2 solely as an indication of the maximum possible impact to industry and do not suggest that it is likely the industry would develop in this manner, given in particular existing cooperative structures that already cover one third of UK production. This scenario may be seen as the theoretical maximum, because it is possible that the National Competition Authorities would make use of the right to intervene if actions of POs under this scenario were deemed to be anti-competitive.

50. More details of scenarios and the assumptions underpinning them are included in Annex A.

3 - This essentially considers the price of milk relative to a general measure of the prices of all other goods Given the considerable uncertainties around the retail milk price level, it is not possible to predict their movements over the next 7 years. Whereas for purely analytical purposes the hypothetical assumption was made that as a result of operations of POs the milk price at the intermediate processing stage might rise somewhat, it is not possible to say with any confidence how that will ultimately affect downstream retail or manufacturing milk prices.

4 - Because we do not have figures for the volume processed in 2011, we estimated this volume by taking the volume processed in 2009 (outlined in table E2 in Annex E) as a proportion of the total volume produced in that year. We then multiplied the volume produced in 2011 (13.3 billion litres) by this proportion.

4.1.4b.Costs

a) Producer Organisations

<u>One-off Costs</u>

51. Producers that choose to set up POs will need to agree on the conditions of membership including internal arrangements and how contracts would be arranged between them with any purchaser/processor(s) they supply.

i) <u>Agreeing Terms and Conditions</u>

52. The initial cost of agreeing terms and conditions by each new PO will be:

- *Total Number of PO Members* × *Hours Spent Agreeing Terms and Conditions* × *Hourly Wage of Farm Manager*[5]

ii) <u>Applying for Recognition</u>

53. The initial cost of each new PO applying for recognition will be:

- Hours Spent Applying for Recognition × Hourly Wage of Farm Manager

54. In scenario 1, the PV of one-off costs over the 7 year appraisal period would be £142,000. In scenario 2, the PV of one-off costs over the 7 year appraisal period would be £561,000.

<u>Ongoing Costs</u>

55. After a PO has been set up, it is likely that producers would need to pay an annual membership payment to cover expenses associated with its operation and negotiations.

i) <u>Membership Fees</u>

56. The annual cost of membership fees will be:

- *Number of PO Members* × *Membership Fees*

ii) <u>Internal Discussions</u>

57. The annual cost of ongoing internal discussions will be:

- *Number of PO Members* × *Hours in Internal Discussions* × *Hourly Wage of Farm Manager*

58. In scenario 1, the PV of ongoing costs over the 7 year appraisal period would be £3.0 million. In scenario 2, the PV of running costs would be £32.6million.

i) <u>Reporting</u>

59. The EU Regulation stipulates that each PO must notify the competent authorities of each negotiation and then annually of their total activities. The annual cost to processors / first purchasers of reporting would be:

- *Number of POs in each Year* × *Hours Spent on Annual Report* × *Hourly Wage of Manager*

5 - The hourly rate of an agricultural manager is from the Annual Survey of Hours and Earnings (2011). The survey is available on the ONS website at: http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-256648.

60. In scenario 1, the present value of the cost of reporting would be £3,800 over the 7 year appraisal period. In scenario 2, the PV of the cost of reporting over the 7 year appraisal period would be £4000.

b) Costs for Processors / first purchasers

Ongoing Costs

i) Negotiating costs for processors / first purchasers

61. Processors / first purchasers would need to conduct detailed negotiations with the POs and where necessary arrange the introduction of a contract between the processor and the PO rather than with individual producers. The annual cost of increased negotiation time will be:

- *Number of Negotiations with POs per Year × Additional Hours Spent Negotiating× Hourly Wage of Manager in Processing Firm*

62. In both scenarios, the PV of the total cost of negotiations over the next 7 years will be around £10,300.

ii) Increased cost of milk for processors / first purchasers

63. POs could enable producers to negotiate a higher price for their milk through increased bargaining power and control over a greater supply of milk. This is explained in detail in the benefits section for producers under the heading 'Bargaining Power', and includes details of the estimates for the possible scale of the increase in price for each scenario. The impact of this would be higher costs to processors / first purchasers, estimated as below:

(a) In scenario 1, the PV of the direct cost to processors / first purchasers of an increase in the bargaining power of producers over the next 7 years would be in the range £3.2m to £439.1m. The best estimate for this scenario is a cost to processors / first purchasers of £219.5m .

(b) In scenario 2, the PV of the cost to the rest of the supply chain of an increase in the bargaining power of producers over the next 7 years would be in the range £33.2m to £1,346.3m. The best estimate for this scenario is a cost to processors / first purchasers of £673.1m.

64. If POs do manage to obtain an increase in price, processors / first purchasers could try to pass some or all of this cost on to retailers in the form of a higher price. We cannot estimate the proportion of the cost that processors / first purchasers would pass along the supply chain nor the period over which they might be able to do this. In the event of significant increases to prices paid for raw milk by processors, this would lead to an initial reduction in their operating margins. If the price increase was sustained over time, the reduction in their operating margins could in turn reduce profitability.

65. Some firms could attempt to deal with this pressure through innovation, however the squeeze on their resources may hinder their ability to do so. Although all processing firms could potentially be affected by increases in milk price, we would expect the cost pressures to fall most heavily on smaller firms due to the importance of economies of scale in the sector. Defra compiles a regular milk utilisation survey[6] which shows there has been a considerable consolidation of companies engaged in the processing of the majority of raw milk in the UK since 1995 (135 companies) to 2011 (64 companies). There is recent evidence that financial pressures can cause processors to struggle in business and to close operations (Dairy Farmers of Britain,

6 - Survey information available at: http://www.defra.gov.uk/statistics/foodfarm/food/milk/milk-utilisation/

2009). The merger between Arla and Milk Link this year supports the view that the processing sector is becoming more consolidated over time. The heightened pressures on processors' profitability arising from the current measures could over time lead to further consolidation of the processing sector. Acceleration in the reduction of the number of processors could have wider impacts. For example, there could potentially be losses in innovation, product development, product differentiation and ultimately on the extent of competition between firms, leading in the longer term to a loss of consumer choice. This set of developments would also have the potential to reduce employment in the sector. Under circumstances where there is potential that competition has been excluded or there is potential for serious damage to SME processors the EU Regulation includes specific powers for competition authorities (the OFT) to intervene in negotiations by POs. Preventing the exclusion of competition in particular should ultimately protect consumer interests.

66. If processors / first purchasers choose to pay extra for their milk but do not increase the price at which they sell milk, they will see a reduction in their profits. Given the importance of economies of scale in the sector, this could lead to further consolidation of the processing sector.

c) Retailers and Food Service / Manufacturing

67. While there are no direct costs to the retailers and food service/ manufacturing firms, it is likely that if POs were to secure a higher price from processors / first purchasers, some or all of this cost will be passed down the supply chain to the retailers in the form of a higher price. However, we do not know the proportion of the cost that would be transferred, or the extent to which retailers would absorb the cost as opposed to passing the higher price on to consumers.

d) Consumers

68. Again, while there are no direct costs to consumers, it is possible that if POs were to secure a higher price from processors /first purchasers, some or all of this cost would be passed down the supply chain from the retailers to the consumers in the form of a higher price. However, we do not know the proportion of the cost that would be transferred, or the extent to which retailers would absorb the cost as opposed to passing the higher price on to consumers. It is possible that the impact of a higher milk price in shops would be a fall in the demand for milk and shrinkage of the industry. The responsiveness of consumer demand to a change in price is measured by the price elasticity of demand.

69. Estimates in research literature suggest that the price elasticity of demand for milk is inelastic. This means that if the price of milk increases, consumers will not dramatically change the amount of milk they buy because milk is seen as a staple product that is not easily substitutable. Research commissioned by Defra and completed by the University of Reading in 2011, estimates that over the period 2001-2009, the price elasticity of demand for milk has been in the range of -0.6 to -0.8[7]. Similarly, research by the University of Oxford in 2008 estimated the price elasticity of milk to be -0.75[8]. The closer the elasticity is to zero, the lower the likelihood that consumers will alter the amount of milk that they purchase if the price increases. The inelastic nature of the demand for milk suggests that, in the event of a price increase, consumers would not dramatically change the amount of milk that they

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7 - The own price elasticity of demand for milk was - 0.83. The report is entitled 'Estimating Food and Drink Elasticities', was published in 2012 and is available at: http://www.defra.gov.uk/statistics/files/defra-stats-foodfarm-food-price-elasticities-120208.pdf

8 - From 'The Milk Supply Chain Project' (2008) by Howard Smith and John Thanassoulis, Department of Economics, Oxford. The research was commissioned by Defra and estimated an overall own-price elasticity of demand for milk of -0.7

purchase. If this is the case, consumers would be likely to spend a higher proportion of their income on milk as a result of Producer Organisations gaining a higher price from processors /first purchasers. All other things being equal, this will mean the consumer has marginally less money to spend on other goods and services.

70. This relatively low price elasticity of demand for milk could also increase the likelihood that retailers would pass at least some of any milk price increase onto consumers. Retailers would be less likely to pass on a price increase if demand was very sensitive to price because in this situation consumers would buy a lot less milk when the price increases.

e) Competent Authorities (CA)

71. The CA will need to set-up an application process to enable POs to seek recognition and respond to such requests. Then they will need to conduct any monitoring, compliance and reporting processes required including establishing penalties and an appeals process. We propose there will be no charge made on industry for the activity of the competent authorities.

One off costs

72. It is estimated that the start up costs for the CA will fall within the range of £100,000 to £150,000. In 2010, the Rural Payments Agency (RPA) spent £96,000 on setting up and running the EU Dairy Fund. Based on this experience, it is assumed that start up costs will be at the lower end of this range, and that the start up costs to the authorities will be £100,000. One-off costs should be the same for both scenarios.

Ongoing Costs

73. Based on its experience of monitoring and reporting on POs in the fruit and vegetable sector, the RPA estimates that 2.5 people would need to be employed in order to meet the monitoring and reporting requirements set out by the Commission. The RPA estimates that costs to the authorities would be in the range £75,000 to £100,000 per year. In our estimates we assume that monitoring and reporting will cost £87,000 per annum (i.e. the mid-point of this range). Running costs are estimated to be £0.5m over the 7 year appraisal period. The running costs should be the same for both scenarios.

4.1.4c.Benefits

a) Producers

Ongoing Benefits

i) Bargaining Power

74. The recognition of POs should provide members with a better negotiating position with processors / first purchasers by virtue of scale of milk volume. Groups of producers have more power in a bargaining situation with processors / first purchasers than individual producers because as the size of the volume supplied increases it becomes more difficult for the processor to source from alternative suppliers. Due to their improved bargaining position, members of POs may be able to secure improved contracts and contractual conditions and perhaps marginally improve the price received by members. Currently producer organisations cannot negotiate on price unless it is indispensible to them being able to secure efficiency gains.

75. In order to place a value on the total benefit to farmers, we have made some assumptions. The assumptions are based on economic logic applied to the current raw milk market and we aim to establish whether they are reasonable via the process of consultation. The benefits of this Option will be felt almost entirely by micro or small businesses given that the vast majority of businesses affected will be dairy farms which are micro or small businesses.

Assumptions

76. A producer would only join a PO if the benefits of being a member of the PO are at least of equal value to the cost of membership. The cost to producers of setting up POs is therefore the minimum benefit that producers gain from membership of a PO.

77. The maximum amount that a PO could increase the price of milk to is the average price received by retailer aligned producers.

- Where:
  - We assume that, on average, the producers that form POs sell milk at the average UK milk price. All POs that form receive the same price.
  - The average UK milk price in 2011 was 27.4ppl.[9]
  - The average farmgate milk price received by producers that supply Marks and Spencer, Waitrose, Sainsbury, Tesco and Asda in June 2012 was 29.2 ppl (in 2011 prices).[10] This price is at the very top end of the distribution of farm gate milk prices in the UK, and so represents the highest price that POs could negotiate.

78. The best estimate of the amount a PO could increase the price of milk by is half the difference between the price of milk that retailer aligned farmers currently receive, and the average milk price. This is an increase in price of just under 1ppl. We do not expect POs to receive the full retailer aligned price, because retailer aligned producers receive a price premium for meeting a farm practice criteria that goes above and beyond the activities of the average farm. We do not know the extent of the premium, and so the midpoint between the retailer aligned milk price and average milk price forms the basis of our best estimate[11].

79. In scenario 1, the PV of the benefit to producers over the 7 year appraisal period will be in the range £3.2m to £439.1m. The best estimate for this scenario is a benefit of £219.5m. In scenario 2, the total benefit to producers will be in the range £33.2m to £1346.3m. The best estimate is a benefit of £673 m. At the two extremes, the minimum benefit possible would be if no producers join POs and the maximum would be under scenario 2 if all producers joined POs and they all gained the maximum possible price for their milk. For more details, please see the summary section of this option.

80. In reality neither of these extremes are probable, since it is likely that at least some POs will form (there has already been strong interest within the industry to forming POs), but highly unlikely that all producers will form into 3 large POs equivalent to the entire milk market. We therefore assume for the purposes of this IA that scenario 1, in which existing producer supply groups but not co-operatives apply

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9 - From Chapter 5, 'Agriculture in the UK', Defra in 2011. Available at: http://www.defra.gov.uk/statistics/foodfarm/cross-cutting/auk/

10 - From DairyCo league table at: http://www.dairyco.org.uk/resources-library/market-information/market-information/league-table-new-profile/

11 - This is the average for Marks and Spencer, Waitrose, Tesco, Sainsbury and Asda aligned farms as listed in the June 2012 DairyCo milk price league table. The price has been deflated to the 2011 level. The league table is available at: http://www.dairyco.org.uk/market-information/milk-prices-and-contracts/milk-calculator-and-contracts/league-tables/

for formal recognition as POs, is the most likely outcome. Based on this assumption, the range of benefits will be £3.2m to £439.1m. Attaining the very highest prices for milk (i.e. equivalent to the price received by retailer aligned producers) is also unlikely since retailer aligned producers receive a price premium for complying with additional standards and farm practices specified by the retailers. The most probable outcome is assumed to be that POs attain a price of milk equal to half the price received by retailer aligned producers who are typically seen to obtain a more favourable price for their milk than average.

81. It is worth noting that an increase in the bargaining power of farmers through a PO would in effect create an oligopolistic market structure at this stage of the dairy supply chain (this structure already exists between retailers and processors / first purchasers). It is well-established in economic theory that oligopolistic markets can produce a wide range of possible outcomes – from a low, perfectly competitive price to a high monopoly price.

ii) Time Savings

82. Producers that join POs will no longer be required to individually negotiate contracts directly with processors / first purchasers. This will represent a time saving equal to the amount of time the producer spent negotiating contracts individually with processors / first purchasers prior to joining the PO. The annual benefit to producers of time savings will be as follows:

- *Number of POs × Number of Members per PO × Hours Saved by not Negotiating Directly with Processors / first purchasers× Hourly Value of Time to a Producer*

83. In scenario 1, the PV of the benefit to producers of time savings over the 7 year period would be £2.1million. In scenario 2, the PV of benefit to producers of the time savings would be £8.9million.

b) Processors / first purchasers

Ongoing Benefits

Time Savings

84. If POs form, processors / first purchasers would no longer need to conduct individual negotiations with each producer that is a member of a PO. This will represent a time saving equal to the amount of time the processing firm manager spent negotiating contracts with individual producers prior to the PO forming. The annual benefit to processors / first purchasers of time savings will be as follows:

- *Number of POs × Number of Members per PO × Hours Saved by not Negotiating Directly with Individual Producers × Hourly Value of Time to a Producer*

85. In scenario 1, the PV of the benefit to processors / first purchasers of time savings over the 7 year period would be £2.2million. In scenario 2, the PV of the benefit to processors / first purchasers of the time savings over the 7 year period would be £8.9million.

Non- Monetised Benefits

86. POs have the potential to:

(a) provide efficiency improvements at individual farm level (through knowledge and best practice exchange) in particular if the PO manages or influences members' production in a manner that increases the output efficiency of the least efficient member's farms - an increase from current lowest farm efficiencies to current average would increase outputs by 7% (DairyCo);

(b) provide efficiency improvements in the onward supply chain as a result of joint production and commercialisation agreements; and,

(c) improve professionalism of supply chain relationships between producers and processors / first purchasers to increase market orientation and efficiency of all parties.

4.2. Option 3: Implementing areas of national discretion

87. This section looks at the possibilities for implementing the discretionary elements of the EU Regulation. All of the costs and benefits under this option are incremental to those identified for the mandatory elements covered in Option 2. The following section provides a more detailed analysis of the one discretionary element that is of interest to the UK industry, which is the possible requirement for written contracts and offers for contracts between first purchasers (processors / first purchasers) and farmers.

88. There are two other discretionary elements to this EU Regulation but having liaised with industry there is no known interest nor clear benefit to industry in either the recognition of Interbranch Organisations (IBOs) or allowing binding rules on the management of the supply of cheeses with Protected Designation of Origin and Protected Geographical Indication (PDO/PGI) status. These are dealt with for information only in Annex G.

89. In considering the way forward, our default assumption – in line with Government policy – has been that we should not go beyond the minimum requirements of the EU Regulation and we believe the benefits to business of going beyond the minimum would not outweigh the costs of doing so.

4.2.1. Requirement for written contracts

4.2.1a. Description of Discretionary Elements

90. The vast majority of UK dairy farmers already have a written contract with the processing company that buys their milk. However, approximately 65% of contracts do not include a guaranteed, transparent price for the producer and some 75% of contracts require producers to give from 6 to 12 months notice if they wish to terminate their contract without incurring a penalty[12]. Many current contracts do not specify milk volumes (which reduces the predictability of supply for processors / first purchasers) and/or do not provide for price adjustments based on milk content or quality or for issues such as milk sampling arrangements and force majeure.

91. Under the EU Regulation, Member States may introduce in their territory: (a) an obligation for formal written contracts for the supply of milk, and/or (b) an obligation for the first purchaser of milk to present a written contract offer to the producer, who would be able to accept or reject that offer. Such a contract and/or such an offer for a contract would need to be made in advance of the delivery and fulfil the following elements:-

- the price payable for the delivery, specified either as a static price, and/or calculated by combining various factors set out in the contract, which may include market indicators reflecting changes in market conditions, the volume delivered and the quality or composition of the raw milk delivered;

12 - From 'Analysis of Milk Selling Arrangements on Dairy Farms in England' by RBR May 2010.

- the volume of raw milk which may and/or must be delivered and the timing of such deliveries;
- the duration of the contract, which may include either a definite or an indefinite duration with termination clauses;
- details regarding payment periods and procedures;
- arrangements for collecting or delivering raw milk; and,
- rules applicable in the event of force majeure.

92. Where a Member State decides to make written contracts for the delivery of raw milk compulsory, it may also establish a minimum duration, applicable only to written contracts between the first purchaser of the raw milk and the farmer. Such a minimum duration must be at least six months and shall not impair the proper functioning of the internal market. Farmers would have the right to refuse any minimum duration specified by Member States provided that they did so in writing. In all cases, the parties would be free to negotiate all elements of the contract.

93. Although compulsory contracts under the EU Regulation would be required to cover each of the elements listed above, the precise details of prices and volumes etc. would need to be freely negotiated between the contracting parties in all cases.

94. In this case, the Government believes that a viable alternative to regulation exists, following the recent agreement by the UK dairy industry of a code of contractual best practice. The Code will provide greater flexibility and cover more elements than the optional provisions for written contracts that are set out in the EU Regulation. Contracts between dairy processors / first purchasers (milk purchasers) and farmers drawn-up in accordance with the industry code of practice can be freely negotiated and should be fairer and more transparent than current contracts. The Code adds additional value and goes beyond the provisions of the EU Regulation by:

- allowing alternative, more flexible pricing mechanisms;
- giving farmers more notice of price changes where prices are set at the purchaser’s discretion;
- allowing farmers to resign from their contracts more quickly if they do not wish to accept a price change;
- allowing farmers to decide to supply other purchasers with additional milk if they have expanded their production and if their current purchaser does not wish to purchase their additional milk under the same terms and conditions;
- encouraging contracts to cover a wider range of issues such as price adjustments (e.g. based on milk content or quality) and sampling of milk, along with other legal rights, risks or obligations.

95. The effectiveness of the Code will be subject to review by industry within its first year of operation. The Government will revisit the case for introducing compulsory written contracts as permitted by the EU Regulation if voluntary action is deemed not to have been effective.

96. The benefits of this Option will be felt almost entirely by micro or small businesses given that the vast majority of businesses affected will be dairy farms which are micro or small businesses.

4.2.1b. Summary of Costs and Benefits

97. For a detailed view on our best estimate of the size of each cost and benefit over the 7 year appraisal period, please see the summary table (Table 3).

98. The summary table shows the annual costs and benefits associated with the option to enforce compulsory contracts, all represented in £millions. Presenting the results in this way gives an impression of the relative magnitudes of the costs and benefits. The table shows that enforcing compulsory contracts has a net cost of approximately £7.55million. The average annual cost is £1.20 million (which excludes one-off costs) which is equivalent to 0.03% of the annual farm-level value and 0.01% of the annual ex-factory value of the UK dairy industry.

99. The largest costs would be to processors / first purchasers in the first year, when they would need to issue new contracts to all of the producers that they intend to purchase milk from. The cost of revising contracts to producers and processors / first purchasers also contributes a sizable proportion to the total cost, however it is worth noting that we do not know with certainty the extent to which contracts will be revised more frequently. We will seek to clarify this via the process of consultation.

100. Please see Annex A for an explanation of the method and assumptions underpinning the estimates for each cost and benefit. All present values (PVs) of costs and benefits are discounted at the 3.5% rate. All assumptions are based on best available evidence and in some cases this required using industry knowledge or anecdotal evidence to enable rough estimates for illustrative purposes. Input and evidence to further strengthen the validity of the assumptions will be gathered as part of the consultation.

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Table 3 – Summary Table for Option 3 – compulsory contracts

Costs and benefits estimations here are incremental to those of the mandatory elements identified in Option 2

Year		1	2	3	4	5	6	7	PV
Processors	Familiarisation	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.01
	Re-Issuing of Contracts	1.17	0.00	0.00	0.00	0.00	0.00	0.00	1.17
	Revision of Contracts	0.47	0.47	0.47	0.47	0.47	0.47	0.47	2.90
Producers	Familiarisation	0.29	0.00	0.00	0.00	0.00	0.00	0.00	0.29
	Re-Issuing of Contracts	0.29	0.00	0.00	0.00	0.00	0.00	0.00	0.29
	Revision of Contracts	0.47	0.47	0.47	0.47	0.47	0.47	0.47	2.88
	Total	-2.71	-0.95	-0.95	-0.95	-0.95	-0.95	-0.95	-7.55
	Net Present Value	-2.71	-0.95	-0.95	-0.95	-0.95	-0.95	-0.95	-7.55

4.2.1.c. Analysis of Costs and Benefits

4.2.1.c.i.Costs

a) Processors / first purchasers

One-off costs

i. Familiarisation:

101. Processors / first purchasers would need to familiarise with the new legislation to ensure that they are aware of the information that the contracts that they offer must contain.

102. We assume that processors / first purchasers will only need to familiarise with the legislation in the first year. The total cost of familiarisation will be:

- *Number of Processors / first purchasers* × *Hours Spent Familiarising* × *Average Hourly Wage of Processing Firm Manager*

103. We assume that the (approximately 456) small processing firms that process fewer than 300 million litres of milk per year will dedicate 1 manager to spend 1 hour familiarising with the new rules. We assume that the 9 processing firms that process more that 300 million litres of milk per year (67% of the total volume) will need to disseminate the new rules throughout the firm, and so will dedicate 3 hours of firm managers' time to familiarisation.

104. We estimate that PV of familiarisation costs is £0.01 million or £21 per processor.

ii) Re-Issuing of Contracts:

105. Processors / first purchasers would need to re-issue contracts that are compliant with the new legislation. We do not know the number of existing contracts that would not be compliant with the rules set out by the Commission. However, RBR carried out telephone interviews with 252 milk producers in England in 2010 regarding their contractual arrangements[13]. Results suggested that while all farms interviewed had the duration of their contract and collection times set out in their contract, 65% of farms did not have a guaranteed price for their milk. The survey did not collect data on the number of farmers' contracts that required a specific volume to be produced or collected, however anecdotally we know that few, if any, contracts specify volume (generally all production is collected by the sole purchaser). We therefore assume that all contracts will need to be revised. The total cost of re-issuing contracts will be:

- *Number of Producers* × *Hours Spent Re-Issuing Contracts* × *Average Hourly Wage of Processing Firm Manager*

106. We assume that all producers have only 1 contract and that processing firms dedicate 4 hours of managers' time to re-issuing contracts. We estimate that the PV of costs of re-issuing contracts is £1.17million or £20 per producer.

Ongoing costs

i) Revision of Contracts

107. Under the EU Regulation contracts would have to provide the price either as a static rate or a formula and would therefore need to be renegotiated each time the static price or formula is changed. Given the ongoing volatility of markets it is inevitable that contract prices under the EU Regulation would have to be revised and thus contracts will need to be renegotiated far more regularly than at present. Although the industry is doing some work on formulaic milk pricing it is not clear that any given formula would work perfectly over time, so even formulaic price contracts would need renegotiation from time to time. The total cost to processors / first purchasers of increased frequency of revising contracts would be:

13 - Results were published in the RBR report 'Analysis of Milk Selling Arrangements on Dairy Farms in England' in 2010.

- *Additional Number of Contracts to be Issued per Year* × *Hours Spent per Contract* × *Average Hourly Wage of Processing Firm Manager*

108. The majority of current contracts are of an "evergreen" nature (i.e. without any fixed end date) and have prices set at the purchaser's discretion. On average[14] UK farmgate prices are changed every 5 months, but under current contractual arrangements this normally occurs without any renegotiation of the contract. This means the current rate of change of contracts is relatively low, with just 5% of dairy farmers establishing different contracts within the last year[15]. Assuming there is one contract per producer, this translates to around 700 new contracts per year in the current situation. However, this EU regulation would require a static price or a formula to be stated in all contracts and would also require the renegotiation of the contract every time that price or that formula was changed. We assume under the EU Regulation that two-thirds of contracts are static prices and based on current trends these would need renegotiation every 6 months, whilst one-third are formulaic and would need renegotiation every 12 months (to keep the formula accurate to market trends). Based on this potential new legal requirement and these assumptions, there would be approximately 20,000 revisions of fixed price contracts per year, and 5,000 revisions of formulaic contracts per year. We would therefore estimate that there would be approximately 24,000 more contract revisions per year if contracts were made compulsory.

109. We assume that the processors / first purchasers spend 1 hour revising contracts. We assume that the time spent on revising contracts is shorter than the time spent on the initial re-issuing of contracts following the change in legislation because the contract will need to be amended but not completely redrafted.

110. We therefore estimate that the PV of costs of re-issuing contracts is £2.9million.

b) Producers

One-off costs

i) <u>Familiarisation:</u>

111. Producers would need to familiarise with the new legislation to ensure that they are aware of their entitlements over what the contracts that they are offered must contain.

112. We assume that producers will only need to familiarise with the legislation in the first year. The total cost of familiarisation will be:

- *Hours Spent Familiarising* × *Average Hourly Wage of a Farm Manager*

113. We assume that all dairy producers will dedicate 1 manager to spend 1 hour familiarising with the new rules.

114. We estimate that PV of familiarisation costs is £0.29million.

ii) <u>Re-Issuing of Contracts:</u>

115. In the first year, all producers would receive a new contract that they would need to check, review and sign. We assume that the total cost to producers of checking and signing the re-issued contracts will be:

- *Number of Producers* × *Hours Spent Checking Re-Issued Contracts* × *Average Hourly Wage of Farm Manager*

116. We assume that all producers have only one contract and dedicate 1 hour of managers' time to checking the re-issued contracts. We estimate that the PV of costs of re-issuing contracts is £2.9million.

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14 - from DairyCo market information on farmgate milk prices

15 - according to DairyCo's most recent Farmers' Intentions Survey (2012).

iii) <u>Revision of Contracts</u>

117. As with processors / first purchasers, the possible increase in the frequency of the revision of contracts would result in a time cost to producers, who will need to check through and sign the revised contracts. The total cost to producers would be as follows:

- *Additional Number of Contracts to be Issued per Year × Hours Spent Re-Issuing Contracts × Average Hourly Wage of a Farm Manager*

118. As for processors / first purchasers, we assume that there would be approximately 24,000 more contract revisions per year if contracts were made compulsory. We assume that producers spend 1 hour revising each contract, and they are required to revise the contracts once more per year than at present.

119. We therefore estimate that the PV of costs if re-issuing contracts is £2.9million.

c) MoJ – Enforcement

120. In the case of a serious dispute between contracting parties, resolution would be pursued by the parties, ultimately through the courts. We do not know the number of legal disputes, if any, that would take place if contracts were to be made compulsory, and so a full cost has not been estimated. It is difficult to anticipate the nature of any enforcement action by competent authorities, other than the possible need to remind first purchasers of their legal obligation to provide contracts in this scenario.

4.2.1.c.ii. Benefits

a) Producers

<u>i) Price Clarity</u>

121. Introducing compulsory contracts would resolve the critical issue of the clarity of price paid to producers. Contracts will provide more clarity to producers on the terms of their agreement, and the price they will be paid. They are also anticipated to provide more certainty for producers which will enable them to make longer term decisions and investments based on clearer future outcomes. Whilst these are likely to be positive changes for producers, we are not able to estimate what financial impact these might have on their turnover, or what the value of clarity and certainty may be. We would hope to gather greater information over the course of the consultation on the proposed benefits of compulsory contracts to producers and processors / first purchasers, and will use this to provide a more detailed picture of benefits in the final stage IA.

4.2.1.c.iii. Non-monetised benefits.

122. Contracts under either the industry code of practice or the EU Regulation are likely to bring certain non-monetised costs or benefits to the dairy industry, as envisaged by recommendations of the EU Commission's High Level Group on Milk. In particular they should resolve asymmetry of price transmission back up the supply chain and share risks more evenly between the parties.

123. The Government intends to revisit the case for a compulsory approach to written contracts if the outcome of the industry Code of best practice is deemed not to have been effective by the review process.

4.2.1.d. Conclusion on costs & benefits

124. Total net costs for compulsory contracts are valued at £7.3m over seven years. The main benefits are likely to be to producers from having greater clarity over their terms in the contract, and greater certainty over the price they will receive. We have not been able to monetise these benefits. However, given the current lack of clarity and spread of risk in current

contract arrangements, it would be hoped that the benefits of clearer contracts would outweigh the costs of introducing the proposal.

125. Under the industry Code of Practice, contracts with prices set at purchasers' discretion would need to be 'renegotiated' if producers were not content with contract price changes proposed by purchasers. As explained in paragraph 108, this means contracts would have to be 'renegotiated' more regularly than at present although not as frequently as contracts under the EU Regulation. We make the assumption that contracts under the industry Code of Practice would be 'renegotiated' no more regularly than every 12 months on average.

5. Overall Conclusion

5.1. Summary of options

126. Option 1 is the baseline position which in view of the UK's EU Treaty obligations is not a viable option for the implementation of EU Regulation.

127. Option 2 addresses some of the issues around the balance of market power within the supply chain by enabling dairy farmers to form Producer Organisations. It is not clear to what extent UK dairy farmers will wish to take advantage of this opportunity, but we conclude that it is likely that some POs will form and we have assessed scenario 1 to be the most plausible for this impact assessment (where all existing producer groups apply for formal recognition as POs, reflecting the current scale of collaboration at farming level other than that by co-operatives).

128. We assess that any increase in price attained by POs for their milk would be an equally but opposite cost to first purchasers (or to those further down the supply chain if the costs are passed on) so that when looking at the Net Present Value over the period this is a transfer of cost from one party to another, so cancel each other out so that overall the best estimate NPV is £1.1m of benefit, largely felt by dairy farmers who are micro or small businesses.

129. Conversely there are total net costs for implementing compulsory contracts which are valued at £7.55m over seven years. Whilst we find that producers would be the main beneficiaries from having greater clarity and certainty over the contract and price, we find that the industry code of practice offers less cost and the potential for wider benefits. This is because the rate of change of contracts under the industry code of practice is likely to be significantly lower than the rate of change under the EU Regulation.

130. In both cases contracts will be revised more regularly than they are currently but it is clear that producers want the outcome of greater clarity of contractual terms, conditions and price as well as the ability to seek alternative contracts more easily than is possible today. We assess that the largest costs would be to first purchasers in the first year (of either the code or compulsory contracts), when they would need to issue new contracts to all of the producers from whom they purchase milk. The largest benefit would in either case be to the dairy farmers.

131. Following the agreement on Friday 31 August of the industry code of best practice on contractual negotiations, we find no justification at this stage to warrant pursuing the implementation of compulsory contracts or the other discretionary elements of the EU Regulation in option 3, i.e. Interbranch organisations and the control of supply of PDO/PGI cheeses.

132. On balance we therefore find Option 2 to be most beneficial to the supply chain as a whole. Compulsory contracts under option 3 are not being dismissed but are being deferred to give the necessary time for the industry code to take effect on contractual relationships. If the code fails to deliver the desired outcomes in particular after review, then implementation of compulsory contracts under option 3 could be re-examined at any time.

5.2. Risks

Option 1: Do nothing.

133. Doing nothing would not ensure compliance with the EU Regulation and would fail to address the current imbalance of bargaining power of milk producers relative to major processors / first purchasers in the dairy supply chain.

Option 2: Implement the minimum requirements of EU Regulation No 261/2012

134. The main Option 2 risk is that the adoption of the minimum requirements of the EU Regulation will result in increased costs for some businesses if the creation of POs results in a disproportionately different balance of bargaining power in the supply chain between farmers and dairies.

Option 3: Implement additional areas of national discretion

135. The main Option 3 risk would be if the UK adopted a framework that was inconsistent with current Government policy and good practice which could result in increased costs for businesses and the competent authority.

5.3. Enforcement

136. The UK has an obligation to ensure that effective, dissuasive and proportionate penalties are in place. In relation to the recognition of producer organisations, it is considered that the withdrawal of recognition provides the most appropriate penalty in the event of non compliance. We envisage that existing competition law penalties will apply to POs in the event of a failure to comply with the provisions on the negotiation of contracts. Penalties for failure to report quantities of raw milk purchased will need to be introduced at a later stage. As regards compulsory contracts, no enforcement by competent authorities is anticipated. In the case of a dispute, resolution would be for contracting parties to pursue, ultimately through normal legal processes for contractual disputes.

5.4. Implementation

137. The EU Regulation is directly applicable in UK law. However, in order to implement the compulsory elements of the Regulation it will be necessary to set up new administrative processes in order to provide for the recognition of POs and to ensure compliance with the provisions allowing POs to negotiate contracts. It is not envisaged that we would introduce any supplementary UK legislation at this stage. In terms of administration, we plan to prepare for full implementation in the first half of 2013. Preliminary preparations for implementation have already started.

138. The existing reporting requirements for milk delivered will need to be amended in advance of the new regime applying from 1 April 2015. This will be informed by Commission regulations to be adopted setting out further details of the requirements.

5.5. Monitoring and Evaluation

139. The operation of the new regime will be monitored through regular liaison with key industry stakeholder bodies and competent authorities, and in the light of results from the dairy industry's own review of the effectiveness of its new code of contractual best practice in approximately 12 months' time.

140. In addition, the EU Commission has committed to producing two reports on the development of the EU dairy market and how the measures set out in the new EU Regulation have operated and whether they should continue to apply. These will be submitted by 30 June 2014 and by 31 December 2018.

6. Feedback

141. Feedback will be obtained from those affected by the new EU regulation through regular liaison meetings and periodic reviews.

7. Specific impact tests

142. Initial screening of these Regulations determined that there would be no appreciable impact caused by them on the Environment, Greenhouse Gases, Human Health, Human Rights, Justice and Equalities, so no specific impacts tests have been conducted in respect of these issues. However we have considered in more detail the impact on small firms, competition, rural proofing and sustainable development given their relevance in this instance.

7.1. Small Firms Impact Test – Annex B

143. All dairy farmers (producers) fall within the definition of a small or micro business. All the costs and benefits identified in the IA will apply to small firms as they do to any firms. We find that most of the benefits will be felt by farmers. The introduction by the EU of specific rules for POs in the dairy sector is intended to enable farmers to achieve improved negotiating capability and thereby contractual terms and conditions, including potentially improved income. Many processors that may face the opposite impacts of POs negotiating milk delivery contracts will also be small businesses. However, the EU regulations mitigate that risk by enabling the competent competition authorities to protect SME processors from serious damage and any processor from exclusion of competition if that is caused by any negotiation by a PO.

7.2. Competition Assessment – Annex C

144. The EU regulation specifically amends competition law in the dairy sector to enable large-scale POs to form and negotiate contracts including prices for raw milk deliveries to processors (first purchasers). Whilst we have assessed the impact on competition of this change in EU law within the IA and find that there are potentially significant risks, we are unable to affect the outcome of the Regulation as a result of our assessment. This is because the EU Regulation is directly applicable and provides no latitude for any further domestic regulation. However, competent authorities are able to protect competition within the constraints of the new rules for the dairy sector introduced by this EU Regulation.

7.3. Rural proofing – Annex D

145. The proposed Regulations have been scrutinised with the rural proofing checklist in mind and no instance of the proposed Regulations negatively impacting upon rural communities or areas has been identified. The regulations should result in stronger business relationships, for processors and particularly farmers, in rural areas so that it may in fact provide an element of rural proofing that may not otherwise have been available to those areas.

7.4. Sustainable development – Annex E

146. The proposed Regulations have been scrutinised with the sustainable development checklist in mind. No instance of the proposed Regulations impacting upon rural communities or areas has been identified. The regulations should result in stronger business relationships, for processors and particularly farmers, so that it should in fact provide for more sustainable businesses than the current situation may have supported.

8. Annex A: Method and Assumptions for Calculating Costs and Benefits of Option 2: POs

147. The following is an outline of how the costs and benefits of Option 2 have been calculated. These were all calculated on an annual basis over a ten year period. We then found the present value of these costs and benefits by discounting future costs and benefits at the 3.5% rate and summing.

148. In Scenario 1, we assume that:

- All producers who join POs are already members of 'supply groups'. We know of 3 major supply groups that operate in the UK, which are aligned to three major processors. On average, these supply groups represent 1,250 members who produce 1,422 million litres of milk annually[16].
- Supply groups form POs so that they can have discussions or negotiations of prices with the purchaser to which they are aligned.
- Not all POs form immediately but do so during the first two years as producers organise themselves into properly constituted groups and industry sees the benefits arising from other groups formed. Therefore, we assume 2 POs form in the first year, followed by one more in the second year. We assume that after this no more POs will form, as those groups that wish to form POs will have already had the opportunity to do so.
- Existing major co-operatives do not form as POs for the following reasons:
  - (a) Although within existing competition rules there is some scope for larger scale cooperation, each has remained close to 11% of UK raw milk market share;
  - (b) Whilst cooperatives, can increase their representation of raw milk to 33% of the UK market under this EU Regulation, their ability to increase the scale of their processing operations is likely to be far more limited by competition law covering those activities (which is not affected by the EU Regulation). This is likely to limit their expansion of farmer membership supplying milk.
  - (c) According to DairyCo's league table statistics, membership of a co-operative that brokers raw milk to other processors / first purchasers demonstrates no significant effect on farmgate prices compared to the prevailing market. In order for co-operatives to have any real impact on the price of brokered raw milk they would need an alternative market (demand) for their milk.
  - (d) No co-operative has indicated any interest in seeking recognition as a PO under the EU Regulation.

149. In Scenario 2, we assume that:

- Three very large POs form, which together represent 99% of the milk volume in the UK. The POs are assumed to be UK-only, of equal size, and each representing 33% of the total UK volume produced.
- Each PO has 4909 members and controls 4129 million litres of milk, which is 33% of the total number of dairy farms (Figure 2) and estimated volume of milk processed in the UK in 2011 respectively.

  All of the POs form immediately because this would represent the maximum change from the current situation.

16 - This is the total volume each group is shown to represent in the same DairyCo report.

8.1 Costs

8.1.1 Producers

One-off costs

i) <u>Agreeing Terms and Conditions</u>

150. The annual cost of agreeing terms and conditions will be:

- *Number of New POs ×Number of PO Members × Hours Spent Agreeing Terms and Conditions × Hourly Wage of Farm Manager*[17]

151. Where:

- In scenario 1 there are two new POs in year 1 and one in year 2. In scenario 2 all three POs form in year 1.
- In scenario 1 there are 1250 members per PO, and in scenario 2 there are 4909 members per PO.
- We assume that members of existing co-operatives and producers groups spend 2 hours agreeing the terms and conditions of membership to a PO. This is a very rough estimate which we aim to clarify via the process of consultation.
- We assume that producers that are not previously affiliated to a co-operative of producers group spend 4 hours agreeing the terms and conditions of membership.
- The hourly wage of farm managers is £15.13, which is the average wage recorded for an agricultural manager in the Annual Survey of Hours and Earnings, 2011. We multiply this by 0.3 and add this to the wage in order to include non wage costs such as technology used by workers and premises. The hourly wage (including non wage costs) that we use is therefore £19.67.

152. Therefore the PV of costs of agreeing terms and conditions are:

- Scenario 1: £141,000
- Scenario 2: £560,000

ii) <u>Applying for Recognition</u>

153. The annual cost of applying for recognition as a PO will be:

- *Number of New POs × Hours Spent Applying for Recognition × Hourly Wage of Farm Manager*

154. Where:

- In scenario 1 there are two new POs in year 1 and one in year 2. In scenario 2 all three POs form in year 1.
- We assume that each PO spends 16 hours applying for recognition. This is a very rough estimate which we aim to clarify via the process of consultation.
- We assume that the hourly wage of farm managers is £19.67, as explained above.

155. Therefore the PV of costs of applying for recognition are:

- Scenario 1: £902
- Scenario 2: £912

17 - The hourly rate of an agricultural manager is from the Annual Survey of Hours and Earnings (2011). The survey is available on the ONS website at: http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-256648.

156. Therefore Total PV of Ongoing Costs are:

- Scenario 1: £142,000
- Scenario 2: £561,000

Ongoing costs

i) <u>Membership Fees</u>

157. The annual cost of membership fees will be:

- Number of PO Members each Year × Membership Fees

158. Where:

- In scenario 1 there are 2,500 PO members in year 1 and 3,750 members in year 2 onwards. In scenario 2 there are 14,727 PO members from year 1 onwards..
- We assume that annual membership fees increase by £10 per month for existing producer groups (at total increase of £120 per year). We assume that the annual membership fees are £400 for producers that are not currently aligned to a producer group. We assume the cost for new members is higher, because producers that are already in a producer group will already be paying fees. This is a very rough estimate based on expert judgement which we aim to clarify via the process of consultation.

159. Therefore the PV of costs of membership fees are:

- Scenario 1: £2.6m
- Scenario 2: £29.6m

ii) <u>Internal Discussions</u>

160. The annual cost of ongoing internal discussions will be:

- *Number of POs each Year* × *Number of PO Members* × *Hours in Internal Discussions* × *Hourly Wage of Farm Manager*

161. Where:

- As outlined above, the number of POs and the number of PO members will vary according to the scenario at hand.
- We assume that each producer that joins a PO that was already a member of a co-operative or producer group dedicates 1 extra hour per year of a farm manager's time to internal discussions within the PO. This is a very rough estimate which we aim to clarify via the process of consultation.
- We assume that each producer that joins a PO that was not a member of a co-operative or producer group dedicates 4 hours per year of a farm manager's time to internal discussions within the PO. This is a very rough estimate which we aim to clarify via the process of consultation.
- We assume that the hourly wage of farm managers is £19.67, as explained above.

162. Therefore the PV of costs of internal discussions are:

- Scenario 1: £427,000
- Scenario 2: £3.0m

163. Therefore the PV of running costs are:

- Scenario 1: £3.3m
- Scenario 2: £32.6m

iii) Reporting Costs

164. The annual cost to producers of reporting would be:

- (Number of POs in each Year × Hours Spent on Annual Report × Hourly Wage of Manager) + (Annual Number of Negotiations × Hours Spent Reporting Negotiations).

165. Where:

- We assume that each PO will conduct negotiations with 3 processors. The number of negotiations depends on the number of POs, which will vary according to the scenario as outlined above.
- We assume that each PO spends 1 hour reporting per negotiation, and 8 hours on annual reporting. This is a very rough estimate which we aim to clarify via the process of consultation.
- The hourly wage of a farm manager is £19.67, as explained earlier.

166. The PV of costs of reporting annually are:

- Scenario 1: £1,000
- Scenario 2: £1,100

167. The PV of costs of reporting negotiations are:

- Scenario 1: £2,700
- Scenario 2: £2,900

168. Therefore the total PV costs of reporting are:

- Scenario 1: £3,800
- Scenario 2: £4000

8.1.2. Processors

Ongoing costs

i) Negotiating costs

169. The annual cost of increased negotiation time will be:

- *Number of Negotiations with POs per Year × Additional Hours Spent Negotiating× Hourly Wage of Manager in Processing Firm*

170. Where:

- We assume that each PO will conduct negotiations with 6 processors. The average number of buyers that producers had to choose from in a 2010 telephone survey completed by RBR[18] was 3. Since the POs will consist of large groups of producers and would control a larger proportion of milk, it is reasonable to assume that the choice of processors will be higher for POs than for individual producers. We have therefore assumed that via membership of a PO, the producers' choice of buyers doubles. This is a very rough estimate which we aim to clarify via the process of consultation. The

18 - 'Analysis of Milk Selling Arrangements on Dairy Farms in England' by P.Wilson and R. Darling. Published in 2010 Available at: http://www.fbspartnership.co.uk/documents/Analysis%20of%20Milk%20Selling%20Arrangements%20on%20Dairy%20Farms%20in%20England%202010.pdf

number of negotiations depends on the number of POs, which will vary according to the scenario.

- We assume that each processor spends 5 additional hours in negotiations with a PO than they would with other producers or producer groups. This is a very rough estimate which we aim to clarify via the process of consultation.
- The hourly wage of a processing firm manager is £15.27, which is the average wage recorded for an agricultural related services manager as recorded in the Annual Survey of Hours and Earnings, 2011. As explained earlier, we multiply this by 0.3 and add this to the wage in order to include non wage costs such as technology used by workers and premises. The hourly wage that we use is £19.85.

171. Therefore the PV of negotiation costs are:

- Scenario 1: £10,300
- Scenario 2: assumed to be zero

ii) <u>Bargaining Power</u>

172. If POs were to succeed in increasing the price that processors pay their members for milk, this would be a direct annual cost to processors equal to:

- *Volume of Milk Purchased from POs per Year× Change in Price (£)*

173. Where:

- The volume of milk purchased from POs varies according to the scenario at hand.
- The change in price obtained is based on the assumptions set out in part 1a) of the benefits section.

174. Therefore the PV of costs of reduced bargaining power are:

- Scenario 1:
  - **Min:** £3.2m
  - **Max:** £439.1m
  - **B.E.:** £219.5m
- Scenario 2:
  - **Min:** £33.2m
  - **Max:** £1,346.3m
  - **B.E.:** £673.1m

8.1.3. Retailers

175. Costs to retailers are explained qualitatively only.

8.1.4. Consumers

176. Costs to consumers are explained qualitatively only.

8.1.5. Competent Authorities

177. Estimates of costs to the authorities are based on figures supplied by the Rural Payments Agency. These estimates are based on the costs to RPA of setting up, monitoring and reporting on POs in the fruit and vegetable sector.

a) One off costs

178. PV of costs of setting up are:

- Scenario 1: £100,000
- Scenario 2: £100,000

b) Monitoring and Reporting

179. PV of costs of annual reporting are:

- Scenario 1: £0.5m
- Scenario 2: £0.5m

8.2. Benefits

8.2.1. Producers

Ongoing Benefits

i) <u>Bargaining Power</u>

180. The method and assumptions underpinning the estimated benefits to producers of improved bargaining power are explained in text. In summary, if POs were to succeed in increasing the price that processors pay their members for milk, this would be a direct annual benefit to producers equal to:

- *Volume of Milk Purchased from POs per Year* × *Change in Price (£)*

181. Where:

- The volume of milk purchased from POs varies according to the scenario at hand.
- The change in price obtained is based on the assumptions set out in part 1a) of the benefits section in the main body of text.

182. Therefore the PV of benefits of increased bargaining power are:

- Scenario 1:
  - **Min:** £3.2m
  - **Max:** £439.1m
  - **B.E.:** £219.5m
- Scenario 2:
  - **Min:** £33.2m
  - **Max:** £1,346.3m
  - **B.E.:** £673.1m

ii) <u>Time Savings</u>

183. The annual benefit to producers of time savings will be as follows:

- *Number of POs each Year* × *Number of Members per PO* × *Hours Saved by not Negotiating Directly with Processors*× *Hourly Value of Time to a Producer*

184. Where:

- The number of PO members will vary according to the scenario at hand, as outlined above.

- We assume that producers save 5 hours of direct negotiation time per year by being a member of a PO. This is a very rough estimate which we aim to clarify via the process of consultation.
- The hourly value of time to a producer is equal to the average hourly wage rate of farm managers in 2011, which was £19.67. If a farm manager decides to spend an hour saved from not negotiating on the farm business, the benefit will be equal to the additional income that the manager generates for the business in that hour. We assume that this is equal to the manager's wage. If the manager chooses to spend the time saved on leisure, the owner of the farm business will not have to pay him for that hour, and so will have a direct hourly saving of £19.67.

185. Therefore PV of benefits of time savings are:

- Scenario 1: £2.1m
- Scenario 2: £8.9m

8.2.2. Processors

Ongoing Benefits

i) <u>Time Savings</u>

186. The annual benefit to processors of time savings will be as follows:

- *Number of POs each Year* × *Number of Members per PO* × *Hours Saved by not Negotiating Directly with Individual Producers* × *Hourly Value of Time to a Producer*

187. Where:

- The number of PO members will vary according to the scenario at hand (see above section on ongoing costs to POs).
- We assume that processing managers save 5 hours of direct negotiation time per year by no longer negotiating with individual producers. This is a very rough estimate which we aim to clarify via the process of consultation.
- The hourly value of time to a processing firm is equal to the average hourly wage rate of firm managers in 2011, which was £19.85. If a firm manager decides to spend an hour saved from not negotiating contacts individually on other work for the processing firm, the benefit will be equal to the additional income that the manager generates for the business in that hour. We assume that is equal to the manager's wage. If the manager chooses to spend the time saved on leisure, the firm will not have to pay him for that hour, and so will have a direct hourly saving of £19.85.

188. Therefore PV of benefits of time savings are:

- Scenario 1: £2.2m
- Scenario 2: £8.9m

9. Annex B: Small Firms Impact Test

A. At an early stage in the Impact Assessment preparation make a preliminary assessment of businesses likely to be affected:

A1. Does the regulation apply to small businesses or affect the business environment in which they operate? If "yes" then the initial presumption should be that costs will fall disproportionately on small businesses and the process should move to step B.

189. YES

A2. What are the characteristics of small businesses likely to be affected? – For example, number of businesses, size, ownership type (sole proprietor, partnership, limited company, etc), geographic distribution?

190. 99% of dairy farms (usually family/partnerships) can be classified as small or micro-businesses. There are just under 15,000 dairy farms in the UK covered by this EU Regulation.

191. There are 465 processors of which majority (456) process the minority of milk (33% of UK production) and some of those will be small businesses. The minority (9) processors handle the majority of raw milk (67%). Processors vary from family-run to major PLCs and CoOperatives.

192. Geography of UK dairying is diverse although most is concentrated away from the East of England.

B. Consider alternative approaches for regulating smaller firms:

B1. Consider whether alternative approaches (including, but not limited to, exemptions, simplified inspections, less frequent reporting) might be appropriate for firms with fewer than 20 employees.

B2. Consider whether a complete or partial exemption would be appropriate for micro and small businesses (those with fewer than 50 employees).

193. No exemption possible under EU law, however:

(a) The opportunity to form Producer Organisations (POs) is open to producers of any size; and

(b) With respect to processors the competent competition authority can protect SME processors from serious damage caused by negotiations of POs.

C. Scope issues with a representative sample of small businesses:

C1. Contact a reasonable number (e.g. 10) of representative businesses.

194. This has been done through liaison with industry representative bodies throughout the supply chain including farming unions, processor association and producer supply groups

C2. Obtain feedback about the likely effects of the proposal:

C3. How serious is the problem the proposal seeks to address in relation to smaller firms?

195. The problem is relevant to all scales of dairy farms and is particularly serious for any farms which struggle financially in the current circumstances. The introduction of POs offers benefits to any dairy farms that join them. The introduction by industry of the code of practice on contracts should also offer benefits to any dairy farms that negotiate contracts in compliance with it.

C4. What changes will smaller firms have to make to the way their business operates?

196. For farmers formation of POs and any consequent contractual changes are the key changes, but these would ultimately bring benefits to them.

197. For (small) processors, there is a potential impact from POs negotiating with them for the supply of raw milk that might cause a change and an impact, but this is why the competent competition authority can step-in to halt negotiations if they are seriously damaging SME processors.

C5. Is there likely to be a greater impact on the operations and performance of smaller business than others?

198. For farms there should be no real operational change, they will still produce and supply milk as they do now, but potentially under more suitable contractual arrangements. The impact should be the same for all dairy farms resulting from any better contracts including those negotiated by POs, for example in terms of pence per litre or efficiency gains they might make.

199. Farms and particularly processors, at any scale, may benefit from fewer negotiations of contracts than they experience today, making operations more efficient.

C6. What are the likely approximate costs and benefits of the proposal for small business?

200. These are the same for all businesses at any scale, as laid-out in the main IA, although any one-off costs may be proportionately higher on smaller firms.

C7. Will exempting (either fully or partially) smaller firms from the policy materially affect the potential benefits from the policy?

C8. Are there alternative approaches for smaller firms, which would not materially affect the potential benefits from the policy?

201. This cannot be done because the rules are set by the directly applicable EU Regulation.

202. It would probably not help deliver material benefits anyway.

D. Determine if there is likely to be a greater impact on the operations and performance of small business than others:

203. We assess that the benefits of enabling POs to form (Option 2 in IA) in the dairy sector will be felt almost entirely by micro or small businesses given that the vast majority of businesses affected will be dairy farms which are micro or small businesses. The same is true for Option 3 where contracts are arranged in accordance with the industry code of practice on contractual relationships (so that contracts are not made mandatory under this EU Regulation). Processors might also benefit from improved contractual relationships and clarity.

204. With respect to economic gains, we assess that any increase in price attained by POs would most likely be a transfer of cost from one party to another rather than a significant gain, leading to the best estimate NPV of £1.1m of benefit, largely felt by dairy farmers who are micro or small businesses.

205. If however large POs form and obtain increased prices, whilst farmers (small business) would gain initially there are risks that processors, in particular SME processors might be harmed. This is where it might be necessary for the OFT to intervene in negotiations by POs in order to prevent competition from being excluded or to prevent serious damage to SME processors, using the specific powers given to competition authorities under the EU Regulation to critical effect.

D1. If yes, proceed with the next stage of the small businesses analysis, based on the information received from the sample of businesses and other research, where appropriate. (Note it is normal for the impact of measures to bear more heavily on small businesses because they do not enjoy the economies of scale of larger firms).

D2. If no, prepare the draft impact assessment for public consultation, including details of preliminary soundings. Note that you will still need to consider:

D3. Whether alternative approaches (including, but not limited to, exemptions, simplified inspections, less frequent reporting) are appropriate for firms with fewer than 20 employees; and

D4. Whether exemptions are appropriate for small firms (those with up to 50 employees).

206. Exceptions cannot be made for any businesses and would probably not help deliver material benefits anyway. Any monitoring and inspections required under this Regulation will be done in a light-touch risk-based manner.

<u>E. Gather detailed data about likely impacts on small businesses as part of the wider consultation including costings:</u>

- **Contact a wider sample of representative businesses.**
- **Obtain feedback about likely effects of the proposals, including estimates of costs and benefits that can withstand external scrutiny.**
- **Consider again if the proposal will have a greater effect on small business.**
- **Consider alternative approaches for smaller firms.**

207. Appropriate businesses will be well represented during the public consultation.

<u>F. Ensure that the IA covers the impact on small businesses</u>

F1. The Small Firms Impact Test (SFIT) should be viewed as an integral part of the IA process and will help policy leads assess the costs for self employed, micro, small, medium and large firms that can be fed back into the IA template. Policy leads should summarise details of feedback obtained from SFIT analysis in the Impact Assessment. Points to cover are:

- **Industry structure (e.g. number of businesses; business size)**
- **Consultation to date**
- **Estimates of costs and benefits of each option**
- **Implementation issues**

208. All these are in the consultation stage IA.

F2. The SFIT will also help policy leads comply with the Government's new commitment to regulating small firms, which involves assessing whether alternative approaches (e.g. additional flexibilities or exemptions) are appropriate for firms with fewer than 20 employees. The analysis underpinning this decision should be included in the evidence base section of the IA – if an alternative approach appears possible this should be included as a separate option. A summary of the evidence on which the final decision on how to regulate smaller firms is based will also need to be included in the Explanatory Memorandum (EM).

F3. Provide feedback to participants on:

- **How policy was influenced or, if no changes were made, why not**
- **How they can have further input into the regulatory process.**

209. This will be done during and/or after the public consultation.

10. Annex C: Competition Assessment

A. Summary:

210. The competition assessment was completed for option 2. The proposal to recognise Producer Organisations that may represent up to 33% of the volume of milk produced in the UK was found to have an impact on competition primarily through the likely effect of reducing the incentives of suppliers to compete as vigorously as they would absent the proposal. The proposal will allow organisations to form that under existing UK competition law might be classed as holding strong market power (in other words, a dominant position, although that would only be a competition concern if there was an abuse of that position). However, the UK is obliged to implement the proposal as it is an EU law, which has supremacy over UK law.

B. Would Option 2, the introduction of mandatory elements of the EU Dairy Package:

B1. Directly limit the number or range of suppliers?

211. The proposal would not directly limit the number or range of suppliers.

B2. Indirectly limit the number or range of suppliers?

212. The proposal could indirectly limit the number or range of suppliers through the recognition of Producer Organisations. The proposal will allow producers to form organisations that are able to negotiate their price and act as one entity. This will mean that those purchasing milk from the producers could see a reduction in the number of suppliers that they are able to purchase milk from.

213. However, the proposal is not likely to significantly raise the costs of entering the dairy farming sector or of milk production.

B3. Limit the ability of suppliers to compete?

214. The proposal to recognise POs could limit the ability of suppliers to compete. The proposal seeks to improve the bargaining position of dairy farms by allowing them to form large organisations that can negotiate prices. A consequence of these large organisations forming is that they could increase the price that the farmers can charge milk purchasers. Over time, this may lead to increased membership of the organisations, which are each allowed to represent up to 33% of the volume of milk produced in the UK, thus resulting in increased concentration/consolidation in the market. The dairy farming sector is currently characterised by just under 15,000 producers. Some co-operatives also exist. It is possible that the recognition of POs each representing up to 33% of the market could lead to a smaller number of raw milk suppliers in the UK. The reduction in the number of competitors in the market may in turn lead to a reduction in the scope for innovation.

B4. Reduce suppliers' incentives to compete vigorously?

215. The proposal will reduce suppliers' incentives to compete vigorously because it will – for negotiations that do not cover more than 33% of national milk production in the UK or 1.5% of EU milk production – exempt suppliers from the prohibition under general competition law on engaging in anti-competitive price-fixing, albeit the OFT will have a power to intervene to block negotiations that would exclude competition or cause serious damage to SME processors even where these fall within that exemption. The recognition of POs representing up to 33% of the volume of milk supplied in the UK will allow dairy farmers to form groups that would be considered by UK competition law to hold strong market power (i.e. a dominant position). The proposal allows POs to negotiate prices on behalf its members. The proposal does not allow suppliers to agree to restrict supply, however it does allow them to agree on prices, thus in principle making it easier for them to raise prices above what they might otherwise have been. This could in turn result in a consolidation of the milk processing sector, which is characterised by economies of scale. It is also possible that the higher milk prices could be passed on to retailers and consumers.

Annex D: Rural Proofing

Step One: The policy development process

What are the objectives of the proposed policy?

216. Domestic implementation of new EU Regulations. See sections 1 and 2.1 of Impact Assessment for detail.

217. We aim to implement mandatory elements that allow dairy farmers to form Producer Organisations to a significant scale that can negotiate contracts including prices (changing competition law) and introduce certain reporting requirements. We do not intend to implement any discretionary elements such as that which allows Member States to make contracts compulsory between processors and farmers.

What are its intended impacts or outcomes?

218. Overall impacts are most likely to be moderately positive with better contractual terms and conditions between processors (first purchasers) and dairy farmers (producers) which might include some increase in income for producers, particularly members of POs.

219. There is a known risk that very large POs could form and could exert excessive bargaining power that ultimately could threaten a sustainable dairy industry in the UK and thus threaten the rural economy and community. However the competent competition authority can step-in to protect: at least SME processors from serious damage; and any operators from the exclusion of competition. The risk posed by excessively large POs is relatively remote at present.

Which areas, groups or organisations are supposed to benefit?

220. Most benefit will be felt by dairy farmers (producers) but there may also be overall benefits for processors (first purchasers).

What is the current situation and why is it not delivering the outcomes required?

221. Contractual terms and conditions in the dairy sector have left dairy farmers (producers) with little bargaining power and most risks in the supply chain, ultimately threatening their sustainability and therefore their rural economy and community.

How will you move from the current situation to where you want to be? What's the rationale for intervention? How will you deliver what is needed? Are all realistic options being appraised?

222. The dairy industry has an agreed a code of practice to improve contractual terms and conditions in the dairy sector, so we will not be implementing compulsory contracts in the first instance (so long as the code has the desired impact in good time).

223. We are obliged under EU law to enable Producer Organisations to form, seek recognition and if successful negotiate contracts including price, and aim to do this from spring 2013.

224. All possible options under the EU Regulation have been considered in developing this policy, including industry's own non-legislative solutions.

Where answers reveal a potentially different impact for rural areas/people, or uncertainty, investigate further. Evidence-based decisions are key to good policy-making. Use Step Two (below) to help to rural proof your policy and consider what evidence you may need.

225. The entire focus of this EU Regulation is to benefit dairy farmers (who are within the rural community) and therefore there is no ‘different’ impact on rural areas / people. Section 2 has not been completed.

Where the impact in rural areas will be significantly different, explore how to adjust policy options to produce the desired outcomes in rural areas or avoid/mitigate any undesirable impacts. This exercise may also highlight opportunities to maximise positive impacts in rural areas.

226. As above.

Seek advice, as necessary, including from the Commission for Rural Communities and other rural stakeholders and experts.

227. Not applicable.

On implementation, monitor change - evaluate the impact the policy is having, using appropriate data collection, and assess what is, or isn’t being achieved.

228. Defra plans to conduct an evidential review of the outcomes of this policy.

11. Annex E: Sustainable Development

Stage 1

1. Environmental Standards

1a. Are there are any significant environmental impacts of your policy proposal (see Wider Environment Specific Impact Test)?
No
If the answer is 'yes' make a brief note of the impacts below:
Not applicable

1b. If you answered 'yes' to 1a., are the significant environmental impacts relevant to any of the legal and regulatory standards identified?
Not applicable
If the answer is 'yes' make a brief note of the relevant standards below:
Not applicable

If you answered 'yes' to 1b, have you:
1c. Notified the Government Department which has legal responsibility for the threshold and confirmed with them how to include the impacts appropriately in the analysis of costs and benefits?
Not applicable
1d. Informed ministers where necessary?
Not applicable
1e. Agreed mitigating or compensatory actions where appropriate?
Not applicable

2. Intergenerational impacts

2a. Have you assessed the distribution over time of the key monetised and non-monetised costs and benefits of your proposal? This assessment can be included in your Evidence Base or put in an annex.
Yes
For the known duration of the EU Regulation (7 years to 2020 from date of domestic implementation)

2b. Have you identified any significant impacts which may disproportionately fall on future generations? If so, describe them briefly.
No
Most changes will occur within the first few years. There is more likelihood of overall impacts being beneficial to sustainable development of dairy farming. There is a known risk that very large POs could form and could exert excessive bargaining power that ultimately could threaten sustainable dairy industry in the UK. However the competent competition authority can step-in to protect: at least SME processors from serious damage; and any operators from the exclusion of competition.

If you answered 'yes' to 2b. , have you:
2c. Informed ministers where necessary? If so, provide details.
Not applicable
2d. Agreed mitigating or compensatory actions where appropriate? Provide details.
Not applicable

Stage 2

3. The purpose of the second stage is to bring together the results from the impact assessment with those from the first stage of the SD test. The following questions are intended to reflect the uncertainties in the cost benefit analysis and help you consider how to proceed in the light of further evidence from the first stage of the SD test.

3a. Indicate in the appropriate box whether the balance of monetised costs and benefits is:				
Strongly positive	Moderately positive	Roughly neutral / finely balanced	Moderately negative	Strongly negative
	YES			

3b. Indicate in the appropriate box whether the balance of non-monetised costs and benefits is likely to be:				
Strongly positive	Moderately positive	Roughly neutral / finely balanced	Moderately negative	Strongly negative
	YES			

3c. Indicate in the appropriate box whether the results of the SD questions 1-3 are, on balance, likely to be:				
Strongly positive	Moderately positive	Roughly neutral / finely balanced	Moderately negative	Strongly negative
	YES			

3d. Indicate in the appropriate box whether, overall, the balance of the monetised and non-monetised costs and benefits and the sustainability issues is considered to be:				
Strongly positive	Moderately positive	Roughly neutral / finely balanced	Moderately negative	Strongly negative
	YES			

3e. Provide an explanation of the final result from 3d, explaining, for example, how you have compared monetised and non-monetised costs and benefits and how you have resolved any conflicts between the cost-benefit results and the SD results.
Overall impacts are most likely to be moderately positive with better contractual terms and conditions between processors (first purchasers) and dairy farmers (producers) which might include some increase in income for producers, particularly members of POs. The risk posed by excessively large POs is relatively remote at present.

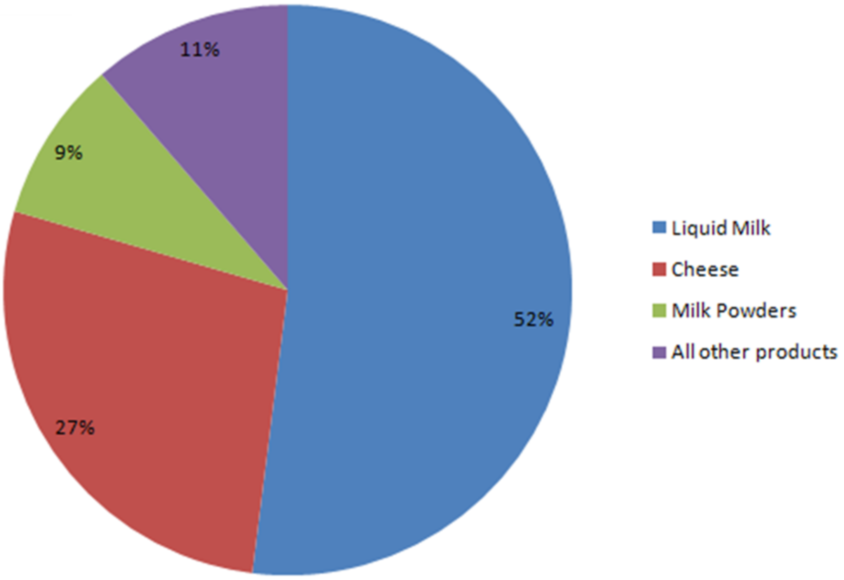
Annex F Overview of the Dairy Industry

1. Dairy is the UK's largest single sector of agriculture with a total value at farm level estimated at £3.7 billion[19] or 18% of total income from agriculture in 2011. Dairy UK estimates the annual value of the UK dairy market to be worth approximately £9 billion. The industry is still emerging from a legacy of market management by the Milk Marketing Boards and is in the process of adjusting to a de-regulated market where prices are now set by commercial negotiations between farmers and milk buyers in a competitive market. Dairy industry is important to the UK because milk and milk products are staple foods for the vast majority of the population and it generates a significant level of agricultural employment and income.

2. The majority of raw milk in the UK is processed into liquid milk and cheese (Chart F1).

Chart F1: Usage of raw milk in the UK (2009) *DairyCo / Defra statistics;*

(percentage use of raw milk produced).



1.2. Affected groups:

- **Producers**

3. In the UK in 2011 there were just under 15,000 dairy farmers producing a total of just over 13 billion litres of raw milk annually, detailed at Table F1. Dairy Farms vary greatly in size, method and costs of production, and output volume but the majority are small or micro businesses (up to 99% can be formally classified as SMEs according to the latest Defra 'Farm Business Survey').

Table F1: Producer numbers across the UK in 2011

	Total volume produced (Billion Litres)	Total Commercial Herds
UK	13.34	14,878
England	8.62	8,970
Scotland	1.27	1,189
Wales	1.53	1,926
Northern Ireland	1.92	2,793

(Sources: Defra, RPA; AHVLA-DHI, DairyCo, DARD(NI), Scottish Govt.).

19 - This is the provisional value for the year 2011, published in chapter 5 in Agriculture in the UK, 2012. Available at: http://www.defra.gov.uk/statistics/foodfarm/cross-cutting/auk/

- **First purchasers / Processors / first purchasers**

4. Raw milk is sold by farmers to ‘first purchasers’ – organisations that will either process the milk themselves or sell it on to another company for processing (i.e. pasteurising raw milk for bottling and drinking or manufacturing products such as cheese and yoghurt). Organisations that process milk can be co-operatives, private dairy companies or major PLCs. Around one third of UK dairy farmers are members of co-operatives (up to 80% in Northern Ireland).

5. There are 465 processors / first purchasers in the UK. However, the industry is led by 9 major organisations which purchase nearly 67% of all UK raw milk (Table F2). The processing sector is characterised by economies of scale with the largest scale organisations able to process milk at lower costs. For example, processing plants with a capacity of 100 million litres have processing costs of around 5ppl whilst plants with a processing capacity of 300 million litres have processing costs of 2ppl[20].

Table F2: Distribution of Processors / first purchasers of Milk in the UK

2009	**Size Distribution of Dairy Companies by Milk Intake**			
	Companies Processing Milk		Volume of annual intake	
Size Band (litres)	Number	% of Total	Million Litres	% of Total
5 million and under	395	84.9	173.1	1.4
Over 5 - 20 million	19	4.1	219.1	1.8
Over 20 - 50 million	17	3.7	533.6	4.3
Over 50 - 100 million	11	2.4	717.5	5.8
Over 100 - 300 million	14	3.0	2,428.3	19.7
Over 300 million	9	1.9	8,242.5	66.9
Total	**465**	**100.0**	**12,314.1**	**100.0**

(Sources: Defra and DairyCo)

- **Retailers**

6. Processors / first purchasers sell liquid milk and other dairy products to retailers, distributors and the food and catering industry.

7. Just over half of raw milk produced in the UK is sold as liquid milk[21], of which the vast majority is sold through the retailers. In the UK, 76% of groceries are sold by the top four retailers. Defra’s family food survey shows that nearly **90%** of household purchases of fresh milk are from the major multiple retailers. Only 4% of all liquid milk retail sales are doorstep deliveries (December 2010).

Table F3: UK grocery retail market shares for year 2009

Retailer	Tesco	Asda	Sainsbury’s	Morrisons	Somerfield	Waitrose	Aldi	Lidl	Others
Market Share (appx)	31%	17%	16%	12%	4%	4%	2.5%	2.5%	11%

Source: Kantar World Panel / DairyUK White Paper 2009

- **Food service and manufacturing sectors**

8. Just under half of raw milk produced in the UK is sold into the food services and manufacturing sectors[22]. The sectors cover a wide range of products, including cheese, milk

20 - KPMG ‘Price and Profitability in the British Dairy Chain’ (2002).

21 - From ‘Agriculture in the UK’, published by Defra in 2011

22 - From ‘Agriculture in the UK’, published by Defra in 2011

powders, yoghurt and fromage frais. The individual products sectors have varying degrees of market consolidation. The Mintel Market Intelligence report in 2006 suggested that the cheese sector is characterised by a large number of small, 'own label' firms, with over 60% the value of production going to 'own label' products[23]. By contrast, the report in 2004 suggested that 75% of the value of production in the butter sector was generated by just three firms[24].

- **Consumers and trade**

9. Dairy industry is important from a consumption point of view in the UK because milk and milk products are staple foods for the vast majority of the population. As Table F4 shows the average person in the UK will consume just over 1.5 litres of milk per week, spending £2.72 per week on all dairy products.

Table F4: Domestic consumption of dairy products – 2010 per week

	Volume Consumed	Value of Consumption
Liquid Milk	1508ml	101p
Cream	24ml	8p
Butter	40ml	16p
Cheese	118g	79p
Yoghurt / Fromage Frais	204ml	50p
Ice Cream & others	65ml	18p

Source: DEFRA family and food survey - *(average purchasing per person per week)*

10. The UK processing industry has tended to focus on liquid milk for domestic consumption and there is a substantial trade gap in dairy. As Table F5 shows, the UK is a net importer of products such as cheese, butter, buttermilk, ice cream and yoghurt, generating a trade deficit of around £1.25 billion per year. However, the predicted increase in global demand for dairy provides a positive opportunity for the UK industry.

Table F5: summary of key import and export statistics.

Type	Unit	Imports	Exports	% of total trade (value)	Crude Trade Gap (millions)
Liquid Milk	Volume (million tonnes)	158.3t	575.6t		417.2t
	Value (£ millions)	£60.9	£176.5	7%	£115.6
Cheeses	Volume (million tonnes)	414.1t	124.1t		-289.9t
	Value (£ millions)	£1,267.9	£404.3	46%	-£863.6
Powders	Volume (million tonnes)	64.5t	78.9t		14.4t
	Value (£ millions)	£108.2	£161.4	7%	£53.2
Other products	Volume (million tonnes)	653.2t	270.1t		-383.1t
	Value (£ millions)	£1,011.5	£455.2	40%	-£556.3
Total	Volume (million tonnes)	1,290.2t	1,048.7t		-241.4t
	Value (£ millions)	£2,448.5	£1,197.4	(100%)	-£1,251.2

Source: H M Revenue and Customs & DEFRA - Crown Copyright.

23 - Mintel Market Intelligence Report, 2006

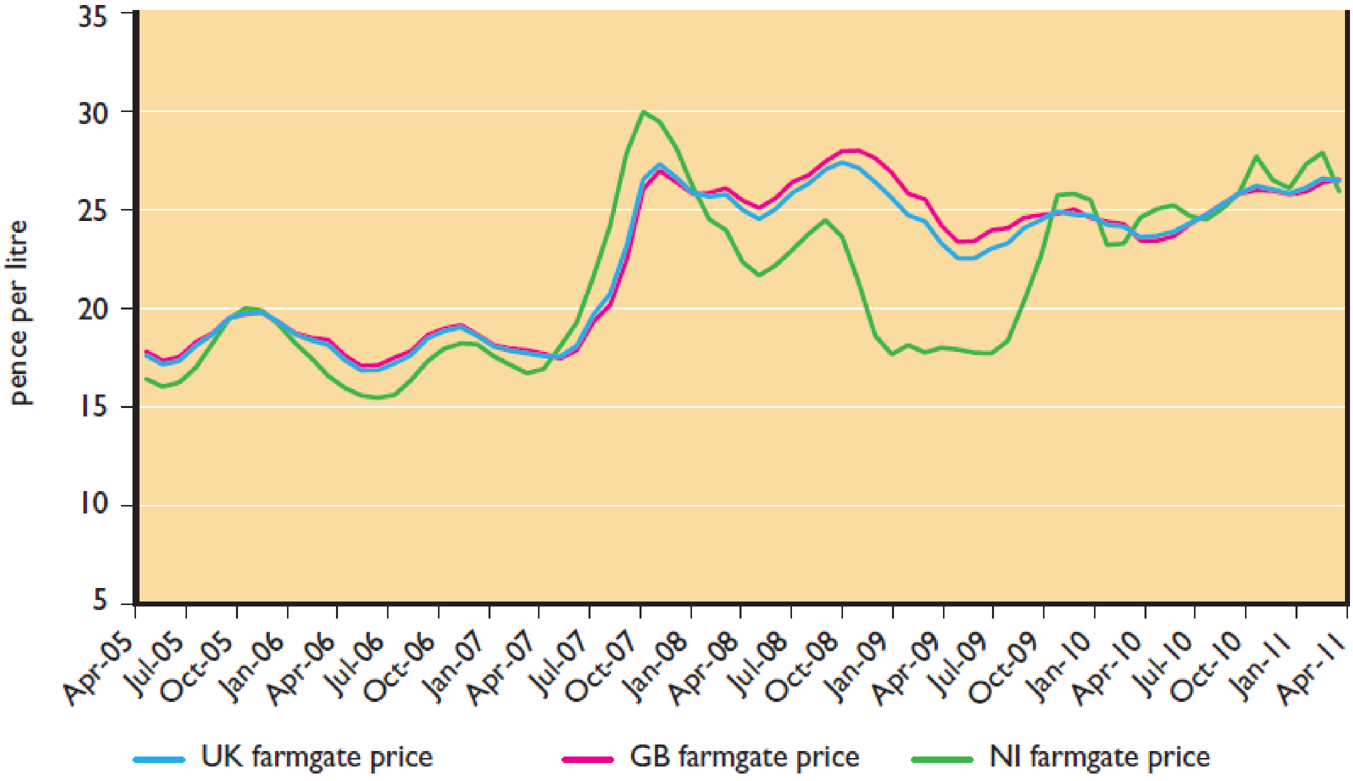
24 - Mintel Market Intelligence Report, 2004

1.3. Factors affecting farmgate price

11. The vast majority of UK dairy farmers have a written contract with the processing company that buys their milk. However, around 65% of contracts do not include a guaranteed or transparent price for the producer, with prices set at the purchasers' discretion. In addition, some 75% of contracts require producers to give at least 6 and frequently 12 months notice to terminate their contract to avoid incurring a penalty[25]. Many current contracts do not specifically cover other terms and conditions such as price adjustments based on milk content or quality and other terms such as sampling, force majeure, and other legal rights, risks or obligations.

12. The average farmgate price from 2005 to 2011 is shown in Chart F2 although there is a substantial variation in the prices paid to individual farmers (DairyCo estimates that the spread between the highest and lowest farmer prices can be as much as 7ppl). Members of cooperatives have tended to receive farmgate prices which are below the average, whilst those who are members of dedicated supply chains producing liquid milk for the major supermarkets often receive the highest prices (up to 6ppl above the average farmgate price).

Chart F2: Average UK farmgate price 2005-2011 (Source DairyCo / Defra / DARD)

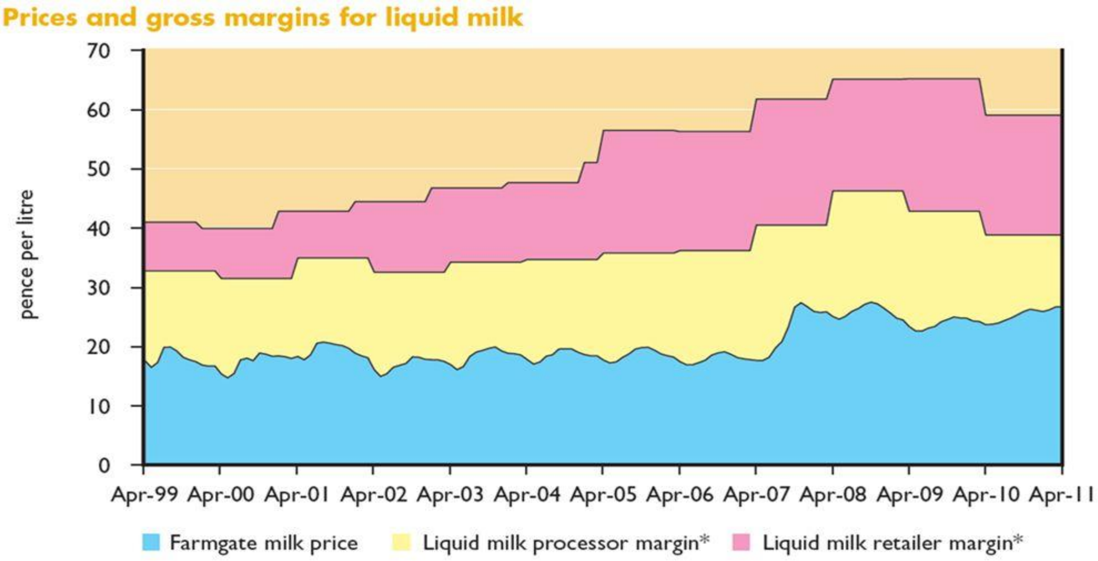


1.4. Distribution of margins along the supply chain.

13. There is limited data on margins made in the supply chain but DairyCo has produced a graph in their Supply Chain Margins Report 2011 (at Chart F3) that sets-out the progression of average farmgate prices against gross margins (average difference between buying and selling prices) at processor and retailer level for liquid milk.

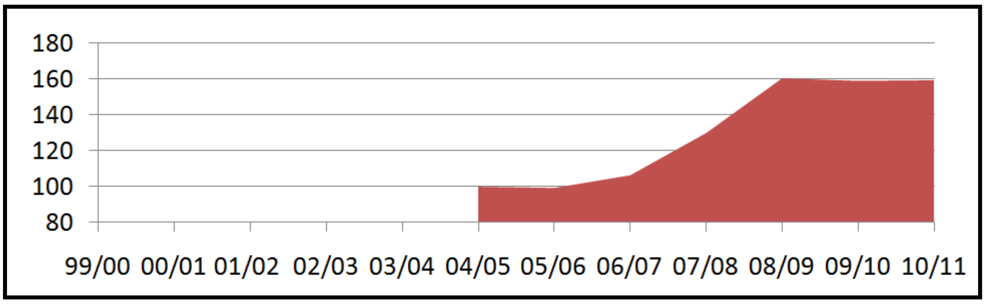
25 - From 'Analysis of Milk Selling Arrangements on Dairy Farms in England' by RBR May 2010.

Chart F3: Prices and gross margins for liquid milk (Source: DairyCo)



14. In order to provide an indication of the progression over time of milk production costs for dairy farms, we have taken data from Defra's Farm Business Survey for England from 2004 to 2011 (Chart F4). The data is indexed with 2004-05 being '100'. This indicates that the variable costs of milk production have risen over the last 6 years. Charts F3 and F4 indicate there are price pressures at both ends of the supply chain, with dairy farmers facing rising costs of production and declining processor margins.

Chart F4: Progression of milk production variable costs (Source: Defra FBS)



Annex G – Other discretionary elements of the EU Regulation that are not relevant.

G.1 Interbranch organisations (IBOs)

1. Individual Member States have the option to recognise interbranch organisations which:-

- have formally requested recognition and are made up of representatives of economic activities linked to the production of raw milk and linked to at least one of the following stages of the supply chain: processing of or trade in, including distribution of, products of the milk and milk products sector and account for a significant share of such activities;
- are formed on the initiative of all or some of the representatives;
- carry out, in one or more regions of the EU, taking into account the interests of the members of those interbranch organisations and of consumers, one or more of the activities specified in the EU Regulation, including improving the knowledge and the transparency of production and the market, and promoting consumption of milk and milk products in both internal and external markets;
- carry out their activities in one or more regions in the territory concerned; and,
- do not themselves engage in the production of, processing of, or trade in products in the milk and milk products sector.

2. We have identified below some of the potential costs and benefits of recognising IBOs in the UK, however we have not at this stage attempted to quantify them.

G.1.a.Costs

a) Inter-Branch Organisations

One-off costs

3. Any IBOs that decided to set up would incur one-off costs of agreeing terms and conditions and applying for recognition.

4. The cost of agreeing terms and conditions would be:

- *Number of IBOs* × *Hours Spent Agreeing T&Cs* × *Average Hourly Wage of Member Representatives*

5. The cost of applying for recognition would be:

- *Number of IBOs* × *Hours Spent Applying for Recognition*× *Average Hourly Wage of Staff Applying for Recognition*

Ongoing costs

6. Any IBOs that decided to set up would incur ongoing costs in the form of membership fees and internal discussions and activities. The cost of membership fees would be:

- *Number of IBO Members* × *Membership Fee*

7. The cost of internal discussions would be:

- *Number of IBOs* × *Hours Spent in Internal Discussions* × *Average Hourly Wage of Member Representatives*

8. We have not attempted to quantify the size of these one-off and ongoing costs because we do not know the number of IBOs that would form, or what parts of the supply chain they would represent. However we can estimate the *set-up* costs for recognition, monitoring and reporting processes that competent authorities might incur.

b) Authorities

One-off costs

9. In order for IBOs to be formally recognised, the authorities would need to establish a formal application process. This would incur a similar cost to the cost of setting up the

application process for POs; estimated at £100,000 although it might be able to benefit from the same basic processes and systems to reduce costs.

Ongoing costs

10. As with POs, the authorities would need to monitor any IBOs that are recognised. This would incur a similar cost to the cost of setting up the monitoring and reporting process for POs; estimated at £87,000 per annum. Running costs are estimated to be £0.5m over the 7 year appraisal period.

G.1.b. Benefits

11. Given the existence in the UK of well-established trade associations and representative bodies for both farmers and milk first purchasers, and the role of the industry levy body DairyCo which provides high quality market information and advice, it is not clear what additional benefits the IBO model could contribute to the dairy sector. Establishing and formally recognising these bodies would, however, entail costs for businesses and the competent authority.

12. There has been no significant interest to-date in establishing any formally recognised IBOs in the UK and given the absence of clear benefits compared with the current situation, there is no reason for Government to pursue the implementation of the specific provisions for IBOs in the UK. However, further views and information on the potential costs and benefits of IBOs will be invited through the public consultation.

G.2 Management of PDO/PGI cheeses

13. Member States may, under specific conditions, lay down binding rules on the management of the supply of cheeses with Protected Designation of Origin and Protected Geographical Indication (PDO/PGI) status in order to adapt the production of PDO/PGI cheeses to the actual demand. The rules should cover the entire production of the cheese concerned and should be requested by an inter-branch organisation, a producer organisation or a group of operators who applied for registration of the PDO/PGI in accordance with Council Regulation (EC) No 510/2006 on the protection of geographical indications and designations of origin for agricultural products and foodstuffs.

14. Such a request would need to be supported by a large majority of milk producers representing at least two thirds of the volume of milk used for that cheese and, in the case of interbranch organisations and groups, by two thirds of cheese producers representing two thirds of the production of that cheese. Moreover, these rules would be subject to a number of strict conditions set out in the EU Regulation; in particular, to avoid damage to the trade in products in other markets and protect minority rights. Member States would be required to immediately notify to the Commission any adopted rules, ensure regular checks to ensure that conditions are being met, and repeal the rules in cases of non-compliance.

15. The UK Government is opposed to any group of producers having the power to manage the supply of PDO/PGI cheeses onto the market and this was the formal UK position during the negotiation of the EU Regulation. Allowing such controls carries a high risk of distorting the market and creating barriers to new entrants.

16. There has been no significant interest from industry to-date in establishing such formal controls. This process would entail new administrative costs for businesses and the competent authority, although we have not at this stage attempted to estimate these. As such, we find no justification at this stage to warrant pursuing the implementation of rules for the management and supply of PDO/PGI cheeses. However, further views and information on the potential costs and benefits of these controls will be invited in the public consultation.