



Environment and Rural Development Committee

4th Meeting, 2006

Wednesday 1 February 2006

The Committee will meet at 10.00 am in Committee Room 2

1. Food Supply Chain Inquiry: The Committee will take evidence from—

Kevin Bellamy, Chief Executive, Milk Development Council;

John Cummings, Scottish Representative, Farmers for Action;

Alistair Donaldson, Executive Manager, Scottish Association of Meat Wholesalers;

Martyn Evans, Director, Scottish Consumer Council;

Wilma Finlay, Managing Director, Cream o' Galloway Dairy Company Ltd;

James Graham, Chief Executive, Scottish Agricultural Organisation Society;

Kevin Hawkins, Director General, British Retail Consortium;

Sarah Mackie, Senior Buying Manager – Scotland, Tesco;

Peter Nicholson, Milk Procurement Director, Robert Wiseman Dairies; and

James Withers, Deputy Chief Executive, NFU Scotland.

2. Animal Health and Welfare (Scotland) Bill (in private): The Committee will consider a further draft Stage 1 report.

Mark Brough
Clerk to the Committee
Direct Tel: 0131-348-5240

The following papers are attached:

<u>Agenda Item 1</u>	
SPICe briefing paper: Food Supply Chain	ERD/S2/06/4/1a
Submission from Milk Development Council	ERD/S2/06/4/1b
Submission from Farmers for Action [TO FOLLOW]	ERD/S2/06/4/1c
Submission from the Scottish Agricultural Organisation Society	ERD/S2/06/4/1d
Submission from the British Retail Consortium	ERD/S2/06/4/1e
Submission from Tesco	ERD/S2/06/4/1f
Submission from Robert Wiseman Dairies	ERD/S2/06/4/1g
Submission from NFU Scotland	ERD/S2/06/4/1h
Briefing from the Minister for Environment and Rural Development and the Deputy Minister for Enterprise and Lifelong Learning	ERD/S2/06/4/1i
<u>Agenda Item 2</u>	
Draft Report (<i>for members only</i>)	ERD/S2/06/4/2

THE FOOD SUPPLY CHAIN

GRAEME COOK, ALASDAIR REID & TOM EDWARDS

This briefing has been prepared for Members of the Environment and Rural Development Committee in advance of their inquiry into the food supply chain. It contains information on:

- Production by Scottish farmers
- The food supply chain for red meat and milk, and the retail sector
- Regulation of competition in the food supply chain
- Relevant parliamentary inquiries held at Westminster
- The effects of changes in the food supply chain on Scottish farming
- Relevant parts of Scottish Executive agriculture policy

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CONTENTS

KEY POINTS OF THIS BRIEFING	3
WHAT DO SCOTTISH FARMERS PRODUCE?	4
FOOD CHAIN	4
MILK	5
RED MEAT	6
RETAIL MARKET SHARE	6
EFFECTS OF CHANGES IN FOOD CHAIN	8
REGULATION OF COMPETITION	8
INVESTIGATIONS	9
COOPERATIVES	11
PARLIAMENTARY INQUIRIES	12
SCOTTISH EXECUTIVE POLICY	13
SOURCES	14

KEY POINTS OF THIS BRIEFING

- The four most important products of Scottish agriculture are beef, milk, lamb and barley
- Evidence suggests that the prices farmers receive for selling beef, milk and lamb are below the cost of production
- Supermarkets are responsible for over 70% of all grocery sales in the UK
- Tesco is the UK's largest food retailer, and the third largest food retailer in the world
- There has been a long term decline in the price farmers receive for their produce (in real terms). There has also been a long-term decline in the number of farms in Scotland, and the number of people employed in farming
- Regulation of competition is a reserved matter. Enforcement of competition law is the responsibility of the Office of Fair Trading and the Competition Commission
- Concerns about the relationship between supermarkets and their suppliers promoted investigations by the competition authorities. The Competition Commission reported in 2000 and recommended that a supermarket code should be drawn up.
- The supermarket code was agreed by the OFT and the major retailers in 2001. The OFT has subsequently investigated its effectiveness. It has not identified any concerns about the operation of the code, but farmers have suggested that this is because there is a reluctance to complain for fear of losing business
- The Scottish Executive has made representations to the OFT about the code
- Farm cooperatives are less common than on the continent. This is partly due to the way they have been regulated by the competition authorities. The OFT has published guidance on how farm co-ops can work within competition law
- Food supply chain issues have been debated in the Scottish Parliament, and at Westminster, and have also been covered in inquiries by House of Commons Select Committees
- The Scottish Executive has set out its long-term objectives for agricultural policy in a strategy produced in 2001. This strategy is currently being reviewed
- Several sources of financial assistance are available to help Scottish farmers become more competitive, to restructure and diversify their businesses, and to process and market their produce
- With the decline in job opportunities in farming, the Scottish Executive's rural policies are also important. These have been the subject of a recent inquiry by the Scottish Parliament Environment and Rural Development Committee

WHAT DO SCOTTISH FARMERS PRODUCE?

According to the [Economic Report on Scottish Agriculture 2005 Edition](#) (Scottish Executive 2005a) the total agricultural area in Scotland was 6,116,200 hectares in 2004 of which about 64% was rough and common grazing. Scotland's land area is 7,877,200 hectares ([Visit Scotland](#) 2006) so around 78% of Scotland's land area is classified as agricultural.

The Scottish Executive's (2005b) [Agriculture Facts and Figures 2005](#) contains some facts on cropping and stocking on Scottish farms. The table below shows the relative importance of selected commodities north and south of the border:

Table 1 – Gross output of selected commodities as a percentage of total gross output from agriculture in Scotland and England based on 10 year average 1995-2004

	England	Scotland
Wheat	12.6	4.3
Barley	4.6	10.5
Oilseed Rape	2.6	1.9
Vegetables	12.2	2.3
Fruit	1.8	1.1
Potatoes	3.7	6.3
Cattle	8.0	24.1
Pigs	5.8	3.4
Sheep	3.5	10.5
Poultry	8.2	4.7
Milk and milk products	15.8	11.8
Eggs	2.5	1.3

Note: Scotland 2003 and 2004 figures are provisional

Source: Scottish Agriculture – Output, Input, and Income Statistics (Scottish Executive 2005c) and DEFRA (2005a, pers comm)

The figures in Table 1 show that:

- Wheat, vegetables, poultry and milk are more important to English output than they are to Scottish output
- Beef cattle, barley and sheep are more important in Scotland

These differences can be accounted for, in some cases, by differing climatic and soil conditions.

FOOD CHAIN

Farming is the first link in a complex international chain. It extends not only to consumers through retail food outlets, but also through a wide range of catering businesses.

As products leave the farm they begin the journey to the consumer involving transport, processing and distribution via wholesalers, supermarkets and a range of catering establishments. It is in these areas that most of the value created in the food chain is added. Most food is now processed and much of it is presented in forms which demand little work in the home. (Lloyds TSB December 2001)

DEFRA (2005b) has produced a diagram which shows the relationships in the UK food [supply chain](#).

The National Farmers Union for Scotland (2005a) (NFUS), in a recent *Fight for Fair Trade* campaign reports the following differences between supermarket price, and farmgate price.

Table 2 Farmgate and supermarket prices for selected commodities

Commodity	Farmgate price	Supermarket price	Farmgate as a % of supermarket price
Milk	18p per litre	54p per litre	33
Potatoes	£95 per tonne	£550 per tonne	17
Porridge Oats	£70 per tonne	£570 per tonne	12
Beef	£1.90 per kilo	£4.25 per kilo	45
Strawberries	£1.30 per pound	£3.00 per pound	43
Carrots	£80 per tonne	£700 per tonne	11

MILK

The House of Commons Environment and Rural Affairs Committee (2004) published a report into [Milk Pricing in the United Kingdom](#) in May 2004. This found that dairy farmers have been experiencing low incomes since the deregulation of the dairy market in 1994; and on average, farmgate prices are not high enough to cover costs i.e. it costs between 18p and 23p to produce a litre of milk; yet, since 2000, average prices have varied between 16p and 20p. The Committee noted that:

The thrust of our findings is that the dairy market is not operating properly. The structure of the dairy sector is complex and there is a lack of transparency in the dairy supply chain. ...despite our best efforts in this inquiry to determine who takes what share of the retail price of a litre of liquid milk, we were unable to account for some 18 pence. ...Some of the answers we received in the course of taking evidence were at best opaque, if not disingenuous, making this a difficult inquiry to undertake and to conclude.

Scottish Executive (2005c) and [Milk Development Council](#) (MDC 2005) figures show the following average realised price for milk since 1995 as follows, the farmgate price falling from 57% of the retail price in 1995 to 37% in 2004:

Table 3 – Farmgate and retail prices of milk 1995-2004

Year	Pence per litre (farmgate)	Pence per litre ¹ (retail) UK
1995	24.09	42.1
1996	25.08	44.0
1997	21.91	42.1
1998	19.37	41.7
1999	18.67	40.8
2000	19.61	39.7
2001	19.75	43.5
2002	17.27	44.9
2003	18.33	47.5
2004	18.22	48.6

¹ Prices from MDC supplied in pence per pint. Converted to litres at a multiple of 1.76.

RED MEAT

Scottish processors sold 167,000 tonnes of beef and 29,500 tonnes of sheep meat during 2004. Nearly 70% of this production was exported to England and Wales and the European Union. Around 70% of Scottish processors' output is sold to supermarkets (Quality Meat Scotland 2005a). Work by Quality Meat Scotland (2005b) found that in 2004 costs of production were 134p/kg liveweight for rearing and finishing beef cattle and 123p/kg liveweight for upland lamb production. This compares to average liveweight prices of 115p/kg for both finished cattle and lambs².

The Meat and Livestock Commission (2004) and Scottish Executive (2005c) show the following average prices for beef and lamb since 1995:

Table 4 – Farmgate and retail prices of beef and lamb 1995-2004

Year	Farmgate cattle p/kg deadweight (farmgate)	Fillet steak p/kg	Steak Mince p/kg	Farmgate sheep p/kg deadweight	Lamb p/kg	Lamb cutlets p/kg	Diced lamb p/kg
1995	204	1745	506	226	827	548	
1996	175	1832	504	262	940	613	
1997	162	1798	515	243	954	894	
1998	150	1793	510	175	913	664	
1999	157	1850	524	168	932	646	
2000	152	1860	607	187	909	770	
2001	180	1900	627	182	875	768	
2002	179	1915	528	219	929	700	
2003	182	1887	481	245	1019	706	
Change 1995-2003 (%)	-11	+8	-5	+8	+23	+29	

RETAIL MARKET SHARE

There are 102,537 grocery stores in the UK, with sales worth a total of £119.8bn in 2005 (IGD Research 2005a). Split into 3 main sectors, the following table shows how they are defined, details the number of stores, and their market share:

Table 5 – Breakdown of UK grocery stores 2005

Sector	Number of stores	Value in £'s & % of market
Convenience stores	52,085 stores	£23.9bn 20%
Traditional retail (newsagents, grocers, off-licences etc)	43,874 stores	£7.7bn 6.4%
Supermarkets & superstores.	6,578 stores	£88.1bn 73.5%

Source: (IGD Research 2005a)

Groceries account for 13.1% of all household spending (the third largest area of expenditure³) (IGD Research 2005a). In the future, IGD Research (2005a) suggests that growth in the UK

² based on the estimated prices for 2004 quoted in Scottish Executive (2005) and an average killing out percentage of 47 for lambs and 60 for cattle.

³ First is housing, second is transport

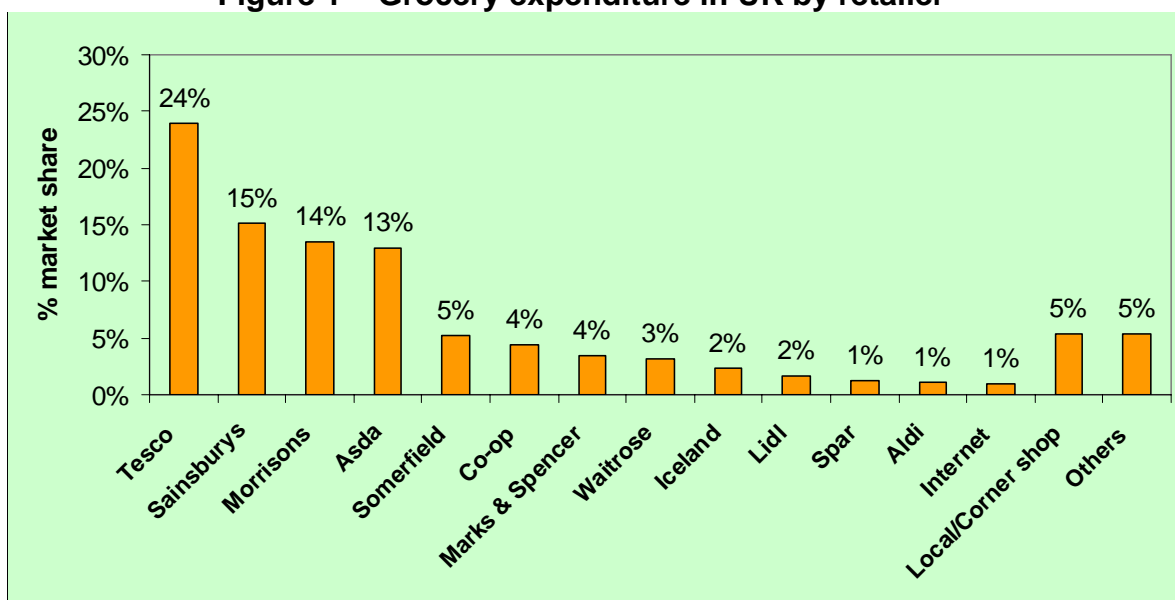
grocery retail market will occur at opposite ends of the market; i.e. convenience stores and hypermarkets.

With around 640 hypermarkets in the UK... this segment will increase by almost a third in the next five years, while the grocery convenience sector is also expected to continue growing strongly and is forecast to reach £32.3billion by 2010. (IGD Research 2005a)

Market share in the grocery retail sector is dominated by Tesco, Asda, Sainsbury, and Morrisons. Known as “The Big Four”, these companies traditionally sell produce through supermarkets and superstores; however they are increasingly expanding into the convenience and online grocery sector. Their interest in the convenience sector is reported to be due to finding it increasingly difficult to maintain growth because of tightened planning restrictions on out of town developments (Corporatewatch 2005). The BBC (2005) [reported](#) that Spar held 5.6% of the UK convenience store market, followed closely by Tesco with 5.4%. It was predicted that these positions would soon be reversed; due mainly to Tesco’s purchase of the T&S, Cullens and Europa chains (BBC News 2005).

The most recent data for overall grocery market shares excluding non-food sales is as follows (DEFRA 2005c):

Figure 1 – Grocery expenditure in UK by retailer



Source: DEFRA Expenditure and Food Survey 2004. Percentages have been rounded. Morrisons market share has been combined with Safeway’s following its acquisition of Safeway.

Tesco is the UK’s largest food retailer and the third largest in the world. It had 1,252 stores in the UK in February 2005, and employed over 250,000 staff; this also makes it the UK’s largest private employer. Consumers bought £27,146 million of goods from Tesco during its financial year 2004/05, where purchases of non-food items grew twice as fast as food items. This amounts to £1 in every £8 spent in shops. Tesco’s stock market value is worth more than Marks & Spencer, Sainsbury’s, Morrison’s, Next and Dixons combined (Economic and Social Research Council 2005, Guardian 2005).

Joanna Blythman, food critic and author charts the changes in retail choice (Guardian 2003):

At the end of the Second World War, our grocery needs were serviced by independent shops where customers were served by an assistant. In the 50s, there were just a few

hundred self-service supermarkets, by the mid-60s there were some 2,000 and today there are around 4,500, typically stocking upwards of 30,000 different lines...

In 1985, there were over 23,000 high street butchers for example. By 2000, there were 9,721 left. Last year, small newsagents were closing at the rate of one a day. Nowadays, only 15% of consumers make use of specialist shops such as butchers, fishmongers and greengrocers.

EFFECTS OF CHANGES IN FOOD CHAIN

The prices farmers receive for their produce have an important effect on the viability of their businesses. The returns that farmers make from the market will become more important in the future since the amount of support they receive from the CAP is set to reduce. Farmers also provide other services e.g. maintaining landscape, providing wildlife habitats which are not paid for by the market. These activities are supported under rural development schemes, and the government is committed to continuing to support these activities.

It is difficult to isolate the effects of changing relationships in the food chain from other factors affecting the economics of farming in Scotland. Such factors include:

- Reductions in trade protection for farm produce
- Reforms of the Common Agricultural Policy which have cut support linked to production
- The effects of the BSE crisis and the 2001 outbreak of Foot and Mouth Disease
- Exchange rate movements which affect the competitiveness of imports and exports

There has been a long-term decline in the price of farm goods in real terms. Changes in farm technology have increased yields and have greatly reduced the need for labour. There has also been a steady increase in farm size as some farmers have left the industry, and their land has been taken over by their neighbours. These changes have allowed farmers to absorb these price reductions. Other farmers have been able to survive by diversifying their businesses, while others have been able to support their farm businesses with income earned off-farm.

These changes have wider effects on the rural economy. Fewer jobs in farming mean more jobs have to be created in other areas to sustain rural populations, especially since jobs in rural areas are being taken by farmers who need a second income.

Farmers have also sought opportunities to shorten the length of the food chain so they can take a larger share of retail prices – in some instances, as with farm shops and farmers' markets - farmers have become retailers, though at the moment this remains a small share of the total food sales market. Others have marketed their produce so it commands a premium price e.g. by supplying local businesses or by joining other farmers to create a local label.

REGULATION OF COMPETITION

Regulation of competition is a reserved matter under the Scotland Act 1998, and lead responsibility for enforcing competition law rests with the Office of Fair Trading and the Competition Commission.

The [Office of Fair Trading](#) (OFT) and the [Competition Commission](#) (CC) are responsible for enforcing and implementing competition law.

The OFT aims to make markets work well for consumers by encouraging vigorous competition and fair dealing in business. OFT's activities in pursuit of this goal involve:

providing research and information services to the Scottish Parliament

- enforcement of competition and consumer protection rules
- market studies into how markets are working
- communication to explain and improve awareness and understanding

The CC is an independent public body which conducts in-depth inquiries into mergers, markets and the regulation of the major regulated industries. Every inquiry is undertaken in response to a reference made to it by another authority: usually by the OFT but in certain circumstances the Secretary of State. The Commission has no power to conduct inquiries on its own initiative.

The competition authorities have extensive powers to end anti-competitive practices where they find as a result of their investigations that a market is affected by practices such as price fixing, or abuse of monopoly power.

INVESTIGATIONS

In 1998/99 the OFT conducted an investigation into the supply of groceries from supermarkets in the United Kingdom. This identified several areas of concern including barriers to entry limiting competition, the level of supermarket operators' profitability, the price of land impacting adversely on the costs of stores, concerns about the intensity of price competition between the supermarket operators and about the relationship between the supermarket operators and their suppliers.

Subsequently, the Director General of Fair Trading (DGFT) referred the conduct of supermarkets in their grocery business to the Competition Commission. The CC's [report](#) (Competition Commission 2000) expressed some concerns about supermarkets' relationship with suppliers. In its report, the Commission found that supermarkets with more than 8% share of grocery purchases for resale from their stores "*are, for the most part, able to control their relationships with suppliers to their own advantage, whilst the smaller multiples are not able to do so to anywhere near the same extent.*"

The Commission recommended the establishment of a code of practice to put relations between supermarkets and their suppliers on a clearer and more predictable basis. The Government accepted this recommendation (Department for Trade and Industry 2000) and the [Code of practice on supermarkets' dealings with suppliers](#) was agreed in October 2001 (OFT 2001). Asda, Morrisons, Sainsbury and Tesco have given statutory undertakings to adhere to the code.

The Code applies only to the supply of groceries to these supermarkets by their direct suppliers and to supply contracts entered into on or after 1 November 2001. It permits supermarkets to seek certain payments, and contributions to promotions from suppliers⁴, provided their requests are reasonable.

The OFT (2005a) is required to prepare an [annual report](#) on the effectiveness of the code, particularly in relation to dispute resolution. This most recent 'compliance audit' (OFT 2005a) concluded that supermarkets were, by and large, complying with the Code, although it was not being used to settle disputes between them and their suppliers. The [press release](#) for this report notes (OFT 2005a):

The compliance audit of supermarkets ... found relatively little evidence of breaches of the Code. However there was evidence of some breaches consisting of supermarket requests that suppliers make lump sum payments in relation to loyalty and continued

⁴ where the supplier will make a contribution to promotions such as "buy two get third free"
providing research and information services to the Scottish Parliament

supply (Clause 9 of the Code). Without the use of mediation to resolve disputes as envisaged by the Code, it has been difficult to assess the Code's effectiveness. The Code's success depends on it being used. The OFT believes that suppliers should overcome the fear of complaining and use the Code's dispute resolution procedure when they have concerns about their dealings with supermarkets.

... It is not fair or legitimate for supermarkets to negotiate contracts with suppliers and then change or cancel them without reasonable notice or compensation. What is reasonable depends on the facts and can, if necessary, be established through mediation under the disputes resolution procedure. However, supermarkets and suppliers should ensure that their terms of business are in writing to help avoid misunderstandings and to ensure that bargains struck are kept.

The OFT believes that varying the Code would be unlikely to tackle its perceived ineffectiveness and would have legal and practical difficulties. No code can be successful in dealing with allegations of breaches unless there is evidence of those alleged breaches.

In August 2005, the OFT (2005c) completed a [review of the Code](#) and concluded that it should remain unchanged but be used more effectively. It stated that:

Without clear evidence that the Code is not working, or that competition in the market is being restricted or distorted, the OFT does not have grounds to refer the market to the Competition Commission or to launch a new market study.

The OFT undertook to continue to encourage the use of the Code and work with supermarkets and suppliers to improve its practical usefulness. This includes:

- working with supermarkets to ensure written records of supermarket-supplier dealings are kept, allowing for greater transparency in the terms of business
- regularly monitoring supermarkets' Code compliance procedures
- confirming that trade associations can take group actions on behalf of their members under the Code with sufficient evidence.

The NFUS (2005b) [expressed concern](#) that the OFT would not be taking further steps to regulate the relationship between supermarkets and suppliers, and called for an independent regulator to oversee the code. It stated that:

...the OFT...will never receive on-the-record complaints from suppliers of unfair supermarket trading practices if it does not offer any protection to those who complain. The fear of losing supermarket contracts as a result of complaining is so widespread that the Supermarkets Code of Practice is never used.

The Scottish Executive was asked about this in a written question (Scottish Parliament 2005a):

S2W-18064 - Rosemary Byrne (South of Scotland) (SSP) (Date Lodged 25 July 2005) :

To ask the Scottish Executive whether it will make any representations to the Department for Trade and Industry on appointing an independent regulator of the supermarket code of practice to ensure fair trade between supermarkets and suppliers.

Answered by Ross Finnie (17 August 2005): The Office of Fair Trading (OFT) recently published its report on supermarkets' compliance with the code of practice. We shall be

discussing with OFT the report's conclusions and the way forward. We shall continue to emphasise to supermarkets how seriously the Executive views the importance of maintaining a sustainable food chain with good trading relationships between suppliers and retailers.

The Press and Journal (2005) reported discussion at a conference in November 2005 where Ross Finnie was asked by one of the delegates if the Scottish Executive was happy with the clean bill of health the OFT had given the big retailers after its investigation of the supermarket code of conduct, while at the same time the watchdog opened new investigations into joint ventures between farming organisations and prevented them selling parts of their operations to larger companies:

Mr Finnie accepted there were concerns in the way the marketplace was operating, saying that while supermarkets and processors worked with each other they did not involve primary producers and final consumers in their negotiations.

He said: "I am at a loss to understand how we are going to achieve a better vertically integrated milk industry if the OFT continues with its views that a market can be established in a small part of Scotland when the rest of us are trying to compete with the whole of Europe. I have sought meetings with ministers down south to see if we can establish a mutual position and see if we can try to open up a dialogue with the Department for Trade and Industry and OFT. I personally fail to understand how we are going to achieve a better vertically integrated industry if the OFT can describe narrow sections of the UK market as a self-contained market if these same people have to compete with the whole of Europe."

But Mr Finnie said that far from castigating supermarkets, primary producers had to work with them as they were the largest outlet for the food they produced. He added: "We hear a great deal about the conflict with the supermarkets and we hear a great deal about the abuse or exercise of powers. There are clearly occasions when there might be some evidence of that, but I do think we have to look very carefully indeed about what and whom the supermarkets represent."

COOPERATIVES

Many forms of agricultural cooperation, such as sharing equipment, are good for productivity and raise no competition issues. However cooperation over common selling prices are anti-competitive, and against the Competition Act 1998⁵. The OFT (2004) recognises that "some farmers are unwilling to co-operate for fear of breaking competition law", and has published [Frequently asked questions: how does co-operation between farm businesses fit in with competition law?](#) to help clarify the scope for agricultural cooperation.

Generally, the OFT is only likely to become concerned if collaboration occurs to fix prices, share markets, or limit production. There are exemptions to this; for example, agreements between competitors that cover less than a 10% market share are allowed.

⁵ The Competition Act 1998 prohibits agreements, practices and conduct that have a damaging effect on competition in the UK. Chapter I of the Competition Act 1998 prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which may affect trade within the UK and have as their object or effect the prevention, restriction or distortion of competition within the UK.

Some forms of agricultural collaboration are excluded from the Competition Act. Exclusions include agreements between farmers or farmers' associations which concern:

- the production or sale of agricultural products (including livestock, dairy, meat and fish products as well as fruit and vegetables and other crops)
- the use of joint facilities for the storage, treatment and processing of agricultural products, as long as the agreements are only between farmers or associations of farmers. An agreement between a group of dairy farmers and milk processors would not come within the exclusion, nor would an agreement between livestock farmers and slaughterhouses

This exclusion might apply to marketing or sales agreements; however a decision on whether arrangements are anti-competitive depends on the specific details. The OFT states (2004):

...marketing might be generic advertising or producers selling under a common brand. Alternatively, joint marketing may be needed to have the scale and professional management to meet the specifications of large customers. None of these is likely to raise competition concerns.

Basically, parties to a joint selling agreement must be free to set their own prices, even though they sell through a cooperative. The co-operative should not seek to constrain competition by limiting quantities sold or imposing a choice of customer; this might be perceived as market sharing. Also, joint selling arrangements should guard against providing an opportunity for exchanges of sensitive commercial information, particularly on market strategy and prices. If the OFT believes that a joint selling agreement has led to a substantial and unjustifiable restriction of competition, consideration would be given to withdrawal of the agricultural exclusion.

PARLIAMENTARY INQUIRIES

There have been no specific inquiries carried out in the Scottish Parliament into the food chain, or specific commodities though food and supermarkets were [debated](#) in November 2004 and the Scottish Food Fortnight was [debated](#) in November 2005 (Scottish Parliament 2004 & 2005b).

The House of Commons Environment, Food and Rural Affairs Committee (2003 & 2004) has reported the results of its inquiries into [poultry farming](#) and the [milk market](#). The House of Commons All-Party Parliamentary Small Shops Group has been carrying out an inquiry, the High Street Britain 2015. Reports ([Guardian](#) 2006a) suggest that the inquiry concludes that *"food wholesalers and independent newsagents are "not expected to survive" more than 10 years because supermarkets will squeeze them out."* However the Scotsman (2006) suggests that *"MPs are to give giant supermarket chains the green light to trade as normal despite widespread fears that their dominance is threatening the survival of Britain's corner shops"*.

Tesco responded, saying that ([Guardian](#) 2006b)

the company did not accept MPs' conclusions, citing research by the Institute of Grocery Distribution showing that independent stores are surviving by joining franchises such as Lonsis or Spar, or are converting to specialist retailers such as off-licences or greengrocers. "There are certainly things in the report that we would not accept. It paints a bleak picture ... No business can afford to stand still and not innovate and that's what is needed," he said.

SCOTTISH EXECUTIVE POLICY

Through its agriculture, rural and enterprise policies there are a number of ways in which the Scottish Executive can help farmers become more competitive in the food market. This section describes some of the most relevant policy initiatives.

The Scottish Food and Drink Strategy was launched in 1999 (Scottish Executive 1999). It provides the overarching strategic direction for the development of the food and drink industry, and is being taken forward by an Industry Strategy Group (ISG) of senior figures in the industry. The Strategy identified six main areas for action:

- to develop leading processors
- to exploit premium markets in the UK and internationally
- to increase competitive advantage by innovation and exploiting technology
- to develop an effective and efficient supply chain
- to develop the capabilities of our people
- to effectively communicate the benefits of collaboration.

The Scottish Executive (2001) has set out its agricultural policy in a Forward Strategy for Scottish Agriculture. The Executive recently began a review of this strategy. The strategy contains several actions intended to help Scottish agriculture to become more competitive including:

- Advice for farmers, including on benchmarking their costs
- Encouraging farmers to understand their customers and their needs
- Encouraging businesses within the food supply chain to work together
- Shortening the supply chain
- Targeting support for marketing and processing at projects which involve collaborative action
- Offering support to farmers who want to restructure and diversify their businesses

The main source of financial support to Scottish farming comes through the CAP. Until recently, this EU policy has been very centralised, and has offered very little discretion to national administrations. The recent CAP reform of 2003/4 offered an unprecedented amount of choice to Member States in deciding how to implement it. The main part of the reforms was cutting the link between production and receipt of subsidy – decoupling. The Scottish Executive has chosen to fully decouple support in all sectors. This gives Scottish farmers an opportunity to restructure their businesses without affecting the amount of support they will receive. It also means that farmers must be more responsive to market demand – for example, if a farmer was growing a certain crop in order to receive support, and it wasn't possible to make money from the crop alone, after decoupling, they are no longer under an obligation to grow the crop in order to receive the support, and so might now choose not to.

The Scottish Executive also funds several schemes from national funds and from rural development funding from the CAP which can help improve the competitiveness of Scottish farming (Scottish Executive 2005e).

Two schemes, the Agriculture Processing and Marketing Grants Scheme, and the Marketing Development Scheme, support farmers with the costs of processing and marketing their produce, including capital investment.

Two similar schemes offer support for farmers who want to diversify their businesses – the Agricultural Business Development Scheme covers the Highlands and Islands, and the Farm Business Development Scheme covers the rest of Scotland.

The Whole Farm Review Scheme will contribute up to 80% of the costs of a review of a farm business by an agricultural advisor.

The Scottish Executive also part funds the development and advisory services offered by the Scottish Agricultural Organisation Society (SAOS). SAOS is owned and governed by 80 member cooperatives. Together these businesses had a turnover of £1.6 billion in 2004. SAOS's aim is to strengthen the profitability and competitiveness of farming and food businesses by encouraging more cooperation and joint activity. It offers advice on all stages of establishing a cooperative, and also offers support services to its cooperative members. Further information about SAOS (2005) is available in its [annual report](#). The report explains that the guidelines on cooperatives published by the OFT have not alleviated the concerns of its members and that SAOS is working to achieve better understanding of the tension that exists between agriculture policy (encouraging farmers to co-operate) and competition policy.

The Scottish Executive's wider rural policies are also important as they aim to create new jobs in rural areas and support rural communities. These policies have been considered in a recent inquiry by the Scottish Parliament Environment and Rural Development Committee (2005), and are described in a recent SPICe briefing (Edwards 2005).

The Scottish Executive also provides support to farmers and food businesses through its enterprise policies and the enterprise networks. With the Enterprise Networks the Executive has provided £2 million a year is available for the Farm Business Advice and Skills Service. Scottish Enterprise has identified food and drink as one of six national priority industries. It also provides financial support and business advice on strategy, marketing, innovation and workforce development. It has also funded research into supply chains and supported work to encourage more direct retailing. In the current year about £1.25 million of enterprise funding has been awarded in the Highlands and Island Enterprise (HIE) area to support projects in the food and drink industry, aquaculture, fisheries, shellfish and agriculture (Scottish Executive 2006). The enterprise companies provide a range of information through the [Scottish food and drink](#) website.

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MDC Submission to the Environment and Rural Development Committee

Introduction

1. The following comments are within the context of the dairy supply chain and should not necessarily be taken to apply to other supply chains.
2. The Milk Development Council is a non departmental public body with the role of informing policy. The MDC is not a trade association or lobby body and cannot therefore seek to influence the outcomes of debate.

Issues within the Dairy Supply Chain

Trade liberalisation

3. Recent reforms of the Common Agricultural Policy and agreements reached within the WTO for the removal of Export Subsidies by 2013 will mean that dairy commodities are in future likely to be sold at world prices, which are likely to be lower than current prices received for milk. While Scotland, or indeed the UK (since milk is easily transferable across borders), is producing such commodity products (Milk Powder, Butter, most Cheddar) these markets will influence the price achieved by raw milk supplies in all markets.
4. Recent work carried out for MDC by the University of Portsmouth, and published within the Dairy Supply Chain Margins report 2004/5 has shown that the major influence on the price achieved by primary producers has been prices within commodity markets.

Supply Chain Relationships and Contracts

5. Reduced support levels, exposure to lower world commodity prices and on occasion the impact of negative currency fluctuations have, together with a lack of understanding of supply chain economics, caused by the previous marketing arrangements through the Milk Marketing Boards, lead to the development of antagonistic supply chain relationships. Particularly between primary producers and other parts of the supply chain.
6. Supply chain relationship problems are further compounded by the nature of contractual relationships between farmers and processors where contracts have not yet developed in line with market fundamentals and hence lead to inefficiencies within both farm and processor businesses.
7. The period surrounding de-regulation of milk marketing arrangements also saw a massive consumer change from doorstep delivery of milk to the dominance of 'multiple retailers' in sales of liquid milk. Faced with this change the major processors initially focused on supplying large volumes of undifferentiated milk to retailers at the lowest possible cost. This has led to increased competition and pressure in the supply chain. That pressure has

often been focused at the bottom of the chain on farmers with movements in the commodity markets impacting on the price farmers receive very quickly due to this intense competition.

8. However, this focus on low cost, high volume dairy products is beginning to be complemented by the development of added value products and relationships. Example of these include: Arla's "Cravendale", Wisemans "The One", and Dairy Crests "St Ivel Advance". In addition to products, some retailers have formed good relationships with dedicated groups of farmers. These farmer meet higher standards and traceability requirements and earn significant premiums for doing so. Waitrose and Marks and Spencer both do this through Dairy Crest. This growth in added value products can only be good news for the industry in the medium to long term.
9. With the current policy changes of CAP Reform and WTO the future profitability of the dairy industry relies on three things:
 - a. Ensuring milk production and processing are as efficient as our competitors
 - b. Innovation and branding at farm and processing level to maximise the value of dairy products
 - c. Ensuring relationships and contracts are as good as possible to facilitate a and b.
10. However, it still seems that sometimes there is an attitude in the industry that you can push milk prices down and all you do is push out less efficient farmers, who are replaced by expanding efficient farmers. This attitude originated because previous high support for farmers through CAP meant there was some truth to this. However, support is now being cut and if this attitude continues, at a certain level of milk prices those leaving are not replaced. This is the point at which supply and demand begins to work and the recognition that there is mutual need between processors and farmers begins to work.
11. There is the danger that if pressure is maintained on farmers in order to push the less efficient out of the industry and it lasts too long then permanent damage will be done to the industry. This is because the negative signals sent out to farmers will mean that efficient farmers that may have expanded if they had been given clearer and more positive signals by milk buyers, may not, or may even leave. This could lead to much lower milk production in the short term, and processing site closures. Once those sites have closed, they are unlikely to be reopened or replaced even if farmers could produce more milk profitably. Therefore it is important to ensure that there is good communication between the different parts of the supply chain to avoid unnecessary restructuring and damage to the industry.
12. There is a general feeling in the industry of a current lack of confidence among farmers, partly supported by the fact that despite relatively good economics to produce marginal milk profitably, milk production is not very strong. This suggests that many farmers do not have the willingness to push their businesses forward. This may be because any expansion that would require investment requires confidence that there will be a return on that investment, and most farmers do not have that at the present.

Developing Relationships

13. It is of crucial importance to the future of the industry that there is the best possible relationship between milk buyers and farmers and possibly the end customer. There needs to be good communication between buyers and farmers, and a greater understanding on both sides. This is so they can work together to maximise the value of what they producing.
14. These relationships can be supported in four ways:
 - a. Support activity and communication within the supply chain – e.g. farmer/milk buyer groups to discuss issues and improve farm performance – The aim of MDC's current extension activities
 - b. Support farmer discussion groups and demonstrate their value to farmers – These groups appear to be the most effective way of helping farmers to move their business forward. This is another aim of MDC activities.
 - c. Support tours where farmers and others in the supply chain visit all parts of the supply chain. These can help create understanding of each others difficulties and problems, and can help to spot opportunities to reduce costs or increase value.
 - d. Help farmers to understand that retail prices and farmgate prices are not directly linked. At present farmgate prices are driven by commodity prices. If this is not the case in the future because the amount of milk going to commodities falls, then demand and supply would set farmgate prices. This means that farmers will be in competition with each other and the most efficient will prosper. It is important that farmers realise that a free market is a competitive one, and they will need to work with each other and customers to maximise profits for both parties.

**SUBMISSION FROM SCOTTISH AGRICULTURAL ORGANISATION
SOCIETY**

Environment and Rural Development Committee

**Inquiry into the Food Supply Chain – Submission from SAOS
January 2006**

Developing More Collaborative Supply Chains

1. SAOS is a development organisation owned by 80 agricultural and rural co-ops. Their collective turnover was £1.6 billion in 2004. Several have members, and trade extensively, in England as well as Scotland.
2. Through their co-ops, farmers organise for efficient production (making best use of machinery, labour and land), co-operate to purchase farm inputs, and collectively store, prepare for market, and in some cases, process, their produce for market. The degree of horizontal co-operation (amongst farmers), and the extent of vertical integration (to food manufacturing and retail ready products) varies significantly between sectors. In general, producers in sectors that were unsubsidised are more organised in co-ops, and are more closely integrated in food supply chains.
3. SAOS promotes co-operation amongst farmers and collaboration along supply chains. SAOS's development and consultancy work involves working with farmers' co-ops and their members and customers to research, innovate and implement supply chain strategies that satisfy customer demands, while providing security of market and growth opportunities for their farmer suppliers. We have some excellent examples of success. In addition, SAOS provides a range of services specially designed to support co-op directors, who are mostly farmer non-executives. SEERAD supports SAOS's work and provides some funding annually.
4. In 2005, SAOS carried out research commissioned by Scottish Enterprise into action that would bring about a step-change in the performance of the Scottish food and drink industry. We investigated collaborative supply chain developments in the food industry and contrasted these with collaborative chains in other industries. We found that commercially motivated, effective, all-chain collaboration was a key contributory factor to competitiveness. After initial development in the auto industry, collaborative supply chain development has transferred to many other industries, including food and drink.
5. Traditional, non-collaborative, supply chains (see page 3) compete within themselves wasting valuable resources and foregoing opportunities. Collaborative chains compete against other chains and are much more robust and efficient. The traditional approach is more prominent in parts of the food and drink industries, particularly where primary production has, in the past, been directly supported by subsidies.
6. In summary, the research found that:
 - a. collaborative chains respond more quickly to market opportunities,

- b. collaborative chains are more likely to be competitive and sustainable for all chain participants,
 - c. transformation from 'traditional' to 'collaborative' chains delivers a step change in competitiveness and performance.
7. Continuing review of academic papers carried out by SAOS has found that:
- a. Attempts to introduce collaborative chains in the UK food and drink industry have been only partially successful and could be described as being at a relatively early stage of development. To date, collaboration has been concerned more with cost reduction, than value creation. A range of reasons is cited for the limited degree of collaboration that has been achieved, including "retailer sentiments of dominance", and the benefits of collaboration not being shared throughout the chain, giving rise to mistrust.
 - b. Increased importance is being attached to developing supply chain collaboration at all levels. Cost saving through collaboration has further potential to improve competitiveness. And, for multiple retailers in the UK, although opportunities for growth in food and drink sales through expansion are limited, opportunities are unlimited for growth in margins from premium products that closely meet sophisticated consumer motivations for health, convenience and indulgence foods.
 - c. Consumer knowledge, product and marketing innovation, and 'speed to market' are much more critical to future competitiveness, and require effective collaboration throughout the supply chain. Professor David Hughes of Imperial College, London shared this perspective at the SAC Outlook Conference in November 2005. (Auto industry example; the time from design stage to new car launch has reduced by several years as a result of the entire supply chain collaborating.)
 - d. A method of evaluating the degree of collaboration amongst companies in food supply chains has been tested in New Zealand. It evaluates collaboration across a range of practices in three dimensions; "information sharing", "decision synchronisation", and "incentive alignment". SAOS tested this methodology with a highly successful, vertically integrated co-op that supplies multiple retailers, asking the co-op to score its experience of collaboration in each of the practices and categories. It scored "information sharing" 8 out of 10, "decision synchronisation" 5 out of 10, and "incentive alignment" 2 out of 10, reflecting that much of the potential of supply chain collaboration has not yet been realised.
8. SAOS believes that Scottish food and drink's competitiveness and sustainability (including agriculture) would benefit through increased development and implementation of effective supply chain collaboration. We have proposed that a higher degree of priority and resources be directed to this objective in the Forward Strategy for Scottish Agriculture and the Scottish Food and Drink Strategy, and we are developing plans to pro-actively accelerate collaborative supply chain development.
9. Next page: table comparing traditional supply chains and collaborative supply chains.

Traditional Chain	Collaborative Chain
Assumes many customers and suppliers	Recognises limited choices of customers and suppliers
Price is only differentiating factor	Price is one of many factors in Total Cost calculation
Focus is on individual transaction	Focus is on repeating and reliable transaction history
World view limited to firm boundaries	World view is of interdependent firms with aligned interests
Cannot justify investment in any customers	Need to invest to support key customers and suppliers
Short term maximising	Medium to long-term acceptable returns
No commitment – opportunistic behaviour	Commitment and mutual support
Buyer beware	No unpleasant surprises
Improve enough to win order	Continuous improvement to improve whole chain competitive performance
Hide failure to avoid loss of sales opportunity	See failure as opportunity to improve and remove possibility of future failure
High levels of individual risk	Shared Risk – lower levels of individual concern
Source SAOS 2005	

Developing Scotland’s Local Food Economy

1. The supply of, and market for, local foods have been growing rapidly in Scotland in recent years. Evidence is provided by the development of farmers’ markets (60 markets with 400 producer participants), farm retail outlets, organic box schemes, community food co-ops, and sales to local shops, restaurants and multiple retailers. Market research findings indicate that ‘local’ is an increasingly important buying criteria for consumers. This trend is universally considered to be positive, due to the range of social, economic, cultural, health and environmental benefits it offers.
2. Many opportunities to further extend and embed the benefits of local foods in local ‘economies’ have been identified and are consistent with a drive towards achieving sustainable procurement; school meals, hospitals, and tourism linkages comprise just some of many examples. In addition, local foods have fantastic potential to replace ‘imported’ foods in the food service sector. As awareness of local foods in the market is increasing (and the related benefits), so too is the scale of the potential market. It is self-evident that there will be a progressive and continuing increase in the scale of the market opportunity.

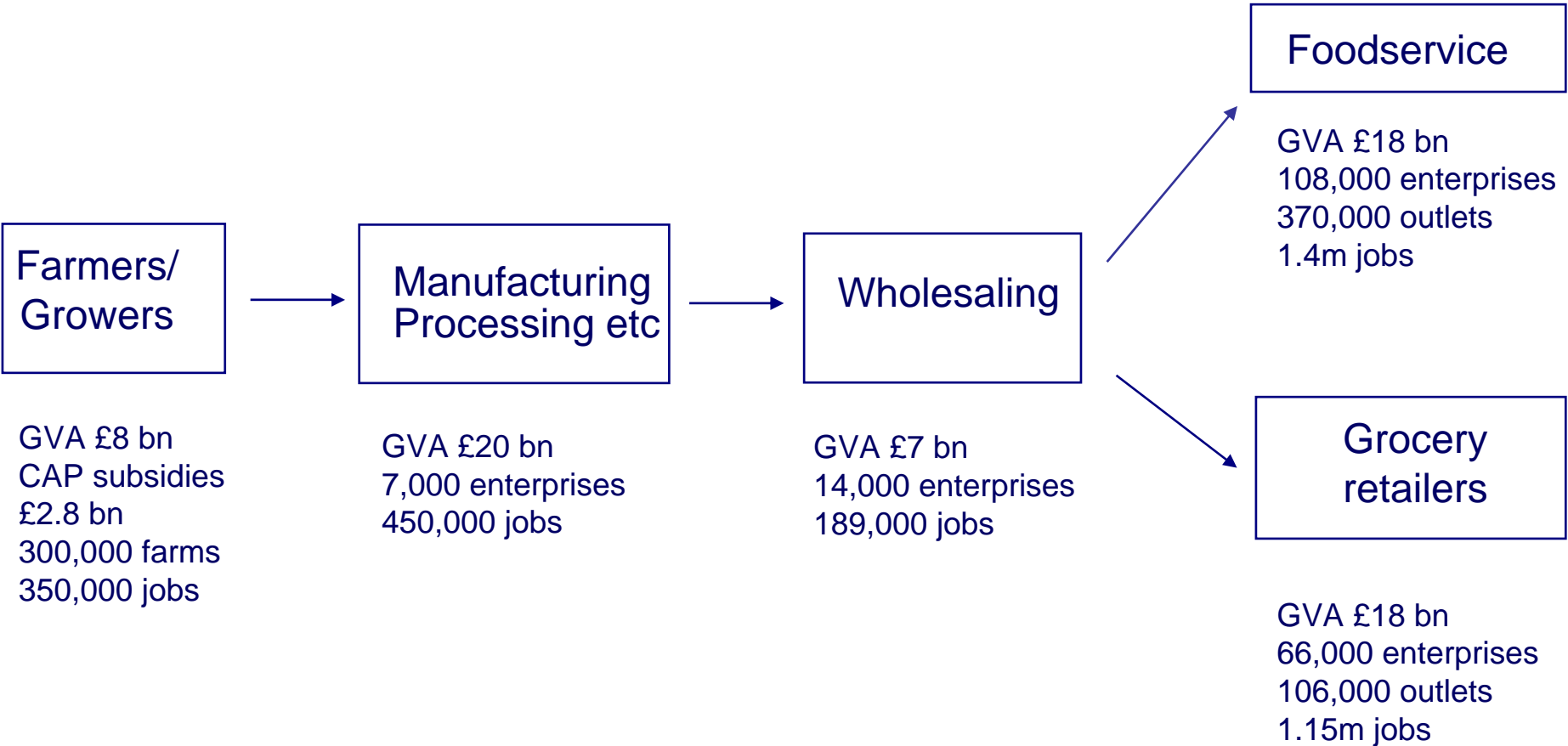
3. However, the development of local food manufacturers, the organisation of marketing channels, and stimulation of the market, are all taking place in a highly fragmented and individual pattern. And, as the development of local foods cross-cuts the objectives of several Scottish Executive departments and agencies, fragmentation in the business environment is repeated in the policy and support environment.
4. SAOS, SFQC and Food From Britain's representative in Scotland all agree that it would be advantageous to establish a coherent, overarching, policy and strategy framework which brings together the interests and ambitions of the various stakeholder groups and which provides direction and resources to achieve common objectives.
5. The first necessary steps to address the current fragmentation are to research and evaluate the market (the local food economy), envision the future scale and organisation of the local food economy supply chain, identify development opportunities and needs, and recommend over-arching policy and strategy objectives. This would provide all stakeholders, including the Scottish Executive, with robust and validated research upon which debate of shared objectives and collaborative action could be based.

Ends



BRITISH RETAIL CONSORTIUM

THE FOOD SUPPLY CHAIN



Source: "Agriculture in the UK 2003", Defra

SCOTTISH PARLIAMENT
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE
THE FOOD SUPPLY CHAIN

Written Evidence submitted by the BRC

This paper addresses three questions :

- How is the food supply chain organised?
- How is it changing and why?
- What are the implications for producers, processors and retailers?

1. **How is it organised?**

- 1.1 There are three distinct stages in the supply chain between the farmer and the final consumer – manufacturers/processors, wholesalers and retailers/food service operators. At each stage, economic value is added (GVA) to the primary product once it has gone through the farmgate. A simplified structure, including key statistics, is represented in Fig I (attached).
- 1.2 This structure broadly explains two features of supply chain relations which are frequently the subject of complaint by farmers:
 - The widening gap between farmgate and retail prices (the subject of a study by London Economics for Defra in Aug 04)
 - The declining share of UK farmers in the value (at retail prices) of a basket of food products, from 50% in 1988 to 35% in 2003.
- 1.3 It is immediately obvious from Figure I that the vast majority of farmers sell directly to manufacturers/processors/packers, not supermarkets. It is also the case that the price the farmer gets for his produce/livestock is determined not by the retailer but by the manufacturers/processor, although the pressure of competition in the retail market is to some extent transmitted back up the supply chain. The crude paradigm of farmers and small suppliers being crushed by “retail bullies” is not, however, applicable. The LE study for Defra concluded that farmgate/retail price spreads in the UK were no wider than in the rest of the EU-15 and that there was no evidence to link widening spreads with

concentration at the retail end of the supply chain and the emergence of the big supermarkets.

- 1.4 Farmers' share of retail value is trending downwards as a result of the changing end-use of primary products. Consumption of some traditional commodity products, e.g. milk, raw potatoes, most green vegetables, red meat joints, has been declining for over 30 years, while processed, added value foods, e.g. ready meals, have increased their market share. These trends reflect changes in consumer lifestyles, particularly the demand for food which is convenient, healthy and high quality, e.g. healthy eating sub-brands and premium brands.

2. **How is it changing and why?**

- 2.1 The UK grocery market is now mature and future sales growth will depend on inflation – which has been low since the late 1980s. Since 1989, the average price of food has fallen by c.12% in real terms. Downward pressure on prices is likely to remain significant due to the level of competition between food retailers.
- 2.2 As with any mature market, the level of concentration is high. The big four retailers between them have 75% of the grocery market (depending on how you define the market), a degree of concentration which is not out of line with the EU-15 average. Two separate enquiries by the Competition Commission (2000 and 2003) have concluded that it delivers substantial benefits to consumers in the form of lower prices, wider product choice and innovation. Concentration has also increased in both the manufacturing/processing and farming sectors. In farming, for example, 25% of farms account for 80% of agricultural output. If CAP reform lowers farmgate prices, as economists predict, the shift of output to larger units will accelerate.
- 2.3 The basic reason is that **scale economies drive profitability** throughout the supply chain. In commodity markets, maximising volume throughput is critical. But scale alone does not guarantee success in the market place. All operators need strategic clarity, a close understanding of their customers' needs and the management skill to deliver their offer. All long-term trading relationships – and most **are** long-term – have to be based on mutual trust and confidence that agreed performance levels will be consistently achieved.
- 2.4 Public understanding of how value is added and where profits are made is poor. There seems to be a widespread belief that supermarkets make massive profits. In reality, the scale economies achieved by leading retailers over the past 15 years have been passed on to consumers in lower prices and other benefits. Additionally, they have invested heavily in building and extending stores and developing new products and services. As a result, the top five retailers' average **net profit margin** as a percentage of sales has declined from 7.5% in 1990 to barely 3% now. Even Tesco's net margin, at 6%, has not changed since 1996, despite the big increase in their sales and market share.

Leading food manufacturers, by contrast, report net margins in the 8-15% range.

3. **What are the implications for producers, processors and retailers?**

3.1 In a mature, intensely competitive market, there will be continuous pressure on retailers and their suppliers to:

- **Cut costs and improve efficiency.** This also applies to farmers, especially as productivity growth in UK agriculture since the mid 1980s has been much slower than in several other EU members. The current work of the Defra-funded Food Chain Centre in applying Value Chain Analysis (VCA) to processors and, to a less extent, farmers has revealed considerable scope for eliminating waste and improving productivity (by 10-25%) in the red meat, cereals, horticulture and dairy supply chains. Some processors are seizing these margin-gaining opportunities; others are resisting.

The main barrier here is cultural – an ingrained resistance to sharing competitive information with outsiders. Experience suggests that this can be overcome as the message spreads through the network and the profit opportunities become apparent – but the process is slow.

- **Drive for scale economies** through mergers and acquisitions. The main barrier here is the attitude of the competition authorities. We need a strategic re-assessment by Government and its agencies of the trade-off between scale benefits and consumer choice relative to the future needs of UK plc.
- **Accelerate the pace of product and service innovation.** Consumer demand for differentiated products e.g. premium, healthy, organic and local foods, is likely to continue growing well above the market average. Retailers' demands on their suppliers in terms of quality and consistency will consequently become even more stringent as consumers have high expectations of these products. But the margin opportunities for all parties are attractive.

3.2 A market as competitive as this one may not appear to be fertile ground for collective initiatives and long-term thinking. There are, however, several current developments which suggest otherwise. For example, the work of the Food Chain Centre in encouraging the application of Value Chain Analysis in the red meat, cereals and dairy supply chains, the formation of Dairy UK as a catalyst for change in that sector and the continuing roll-out of the Curry Commission's food and farming strategy all point to the possibility of a more collaborative approach in the future. A parallel development is the closer integration of groups of farmers with the processors they supply and their final retail customers through long-term supply contracts. At a Scottish level, the Scottish Retail

Consortium (part of the BRC) is a founding member of the Scottish Food Dialogue Group, which is exploring key issues facing the food industry along with NFUS, SFDF Seafish and the BHA. Activities over coming months will focus on the links between food and health, the promotion of Scottish produce and identifying areas for waste minimisation between the key players in the supply chain. Some of these initiatives have been funded by government and, where successful outcomes are being achieved, it is critically important that this investment is maintained until the momentum becomes self-sustaining.

KHH
26/01/06

**ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE: INQUIRY
INTO THE FOOD SUPPLY CHAIN**

TESCO SUBMISSION, 26 JANUARY 2006

Thank you for the invitation to submit evidence to your Inquiry into the Food Supply Chain. This paper seeks to provide an overview of Tesco’s experience of and perspective on the food supply chain in Scotland and our role in helping to support and develop it.

Tesco in Scotland

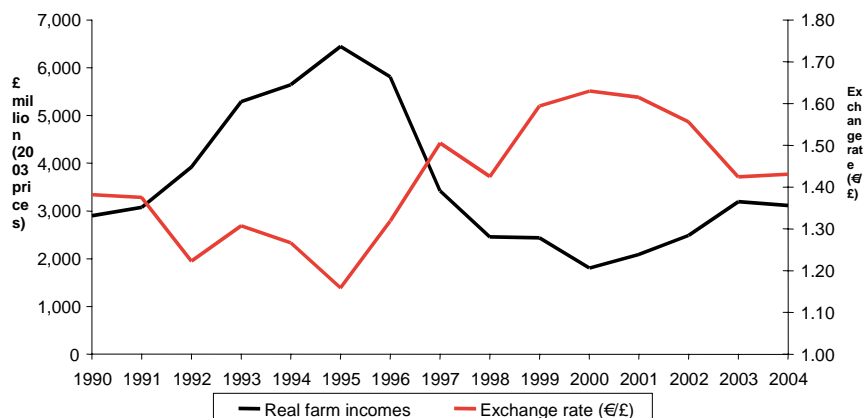
Tesco is currently the largest retailer in Scotland, with 84 stores and over 22,000 staff. In addition, our two world-class Distribution Centres – in Livingston and Dundee, our Tesco Personal Finance joint-venture, and our service centre in Dundee collectively provide another 1,500 Scottish jobs. All of our full and part-time staff receive an excellent benefits package, including a defined benefits pension scheme, childcare vouchers, and family-friendly flexible working conditions.

Without the support of our direct suppliers in Scotland, and the farmers and growers that work with them, we would not have been able to build our Scottish business in the way that we have. Many suppliers have grown with us over the years, and have benefited from a secure and growing market for their products. Tesco is now one of the Scottish food industry’s biggest customers, with over 175 direct suppliers providing over £700m of Scottish products last year.

Challenges in the food supply chain

It is difficult time for many Scottish farmers. Incomes are under pressure, with recent increases in the price of energy having knock-on effects on a range of costs, including fertiliser, feed, transportation, and packaging. Changes to the Common Agricultural Policy, coupled with the strength of Sterling against the Euro in recent years, have also posed significant challenges.

Relationship between exchange rate and real farm income



So the health of much of the sector, and the livelihoods of farmers, is hugely reliant on factors that are beyond their control (e.g. exchange rates impacting on subsidy levels). Moreover, for several decades farmers have understandably focused on maximising their returns from subsidies rather than on seeking out what the consumer wants.

Changing lifestyles, and changing customer demand

Our customers are living very different lives now compared to twenty years ago. At Tesco we need to understand these trends if we are to successfully deliver the products that customers want, but many of these issues are crucial for the food supply chain as a whole to consider.

A smaller share of income is spent on food today than twenty years ago. Customers are now spending more of their income on leisure goods and services.

There are an increasing number of smaller households (especially single households) and the population is ageing. Also, consumers concerns are changing, more want organics and healthy food compared to ten years ago.

Customers eat meals, not food, and convenience is increasingly driving food choice. Consumers attach an increasing value to 'time'. Time pressures are leading to more staggered meals, snacking and shorter food preparation times. Consumers are asking for more convenience foods, such as chilled ready meals and pre-packed salads.

These changing lifestyles directly and indirectly shape the type of products that our Scottish customers choose to buy.

Facing the challenges

Together, farmers, retailers, food manufacturers, processors, and the Scottish Executive need to move to a future where Scottish farming is self-sustaining, independent and profitable. By working together we can ensure the sector maximises its competitive advantages (e.g. proximity to large and wealthy consumer markets, skilled workers, access to capital, ability to deliver traceable high quality products, and consumer demand for those products), and follows customer demand. Farmers will need to adapt and respond to market signals, look at smarter ways to produce and deliver their products, identify where they can most add value, and ultimately, focus on delivering the higher value products that customers want. They will need the help of responsible retailers, and others, to do so.

Working together – a dedicated office for our Scottish suppliers

To support our operations in Scotland we now have a dedicated Scottish Office, whose role it is to ensure that we have the right range in store for our Scottish customers. They also have a crucial function to ensure that we have

a positive and constructive relationship with our Scottish suppliers. Our Scottish office has dedicated specialists in buying, marketing, technical standards and merchandising. They also have a clear remit to help build long-term supply relationships in Scotland, improve existing products, develop new products, share knowledge with suppliers, and give us feedback on what we are doing well and where we could do better. This investment in a dedicated Scottish resource is already paying dividends.

Listening to our Scottish customers – launching new Scottish products

Central to Tesco's business is listening to, and serving our customers. Many of our Scottish customers tell us that they want to buy quality Scottish products. They also want to know more about what they are buying and where it has come from.

Over the last year our Scottish team has worked with our Scottish suppliers to launch a huge number of new lines sourced from Scotland. These include McIntosh Pies, Rannoch smoked venison, Arbroath smokies, and new lines of Scottish roast pork, beef and ham. Other successes include our range of Scottish traditional bakery goods. Supplied by Mortons Cakes, they include Snowballs, Empire Biscuits and Ginger Squares and their weekly sales have almost doubled in the last 12 months.

Launching new products is incredibly risky, for suppliers and for Tesco. In fact, the majority of product launches fail. To help our new Scottish products succeed we put in place 165 Scottish specific merchandising plans. These ensure that we give enough shelf space to the goods that our Scottish customers want, and that the new products are given the marketing support they need to succeed.

Promoting Scottish products in store

We know that our customers want to buy quality Scottish products, but these need to be actively promoted in store to succeed. Our new "Enjoy the Taste of Scotland" point of sale information campaign highlighted and promoted Scottish food, and led to increases in sales for the lines featured.

We also recently organised a Scottish supplier sampling tour which enabled customers to try a range of local produce such as Stockan & Garden's oatcakes, Galloway cheese and Castle Maclellan pates.

Promoting Scottish products through events and the media

We also know that our customers are keen to understand more about where their food has come from and what they can do with it. This is why we have launched new labelling on meat and poultry featuring background on some of our farmers and growers. Last year we also worked closely with Scotland on Sunday to produce a 32-page colour guide highlighting the best of Scottish produce and providing exciting recipes for people to try. Marking traditional Scottish events is also important for our customers and we support events

such as Burns' Night and Hogmanay with extensive marketing and promotional activity – again leading to exciting sales growth for our Scottish suppliers.

We are also committed to an active role at Royal Highland Show, enabling us to strengthening our relationship with farmers and growers, and better understand the upcoming issues facing our direct suppliers suppliers.

Long term partnerships with suppliers

Angus Soft Fruits, a grower from Tayside, provide all of our Finest Raspberries. These are a special variety they developed, are picked and packed on the stalk for quality and freshness and then supplied to 650 Tesco stores. Such product innovation has helped Angus Soft Fruits to expand and to grow Tesco into the largest buyer of Scottish soft-fruit. We are now net exporters of strawberries and raspberries from Scotland to England – with all produce Saltire labelled.

Benchmarking and improving performance

McIntosh Donald has been supplying Tesco since 1995. They now supply all of the Scottish beef and lamb sold in Tesco stores in Scotland. They employ almost 400 people directly and process in excess of 80,000 cattle every year. With financial support from Tesco, McIntosh Donald has become the first red meat plant in the UK to adopt a new computer programme enabling their 1,200 beef producers to benchmark the performance of their cattle against the factory average and identify areas where improvements can be made.

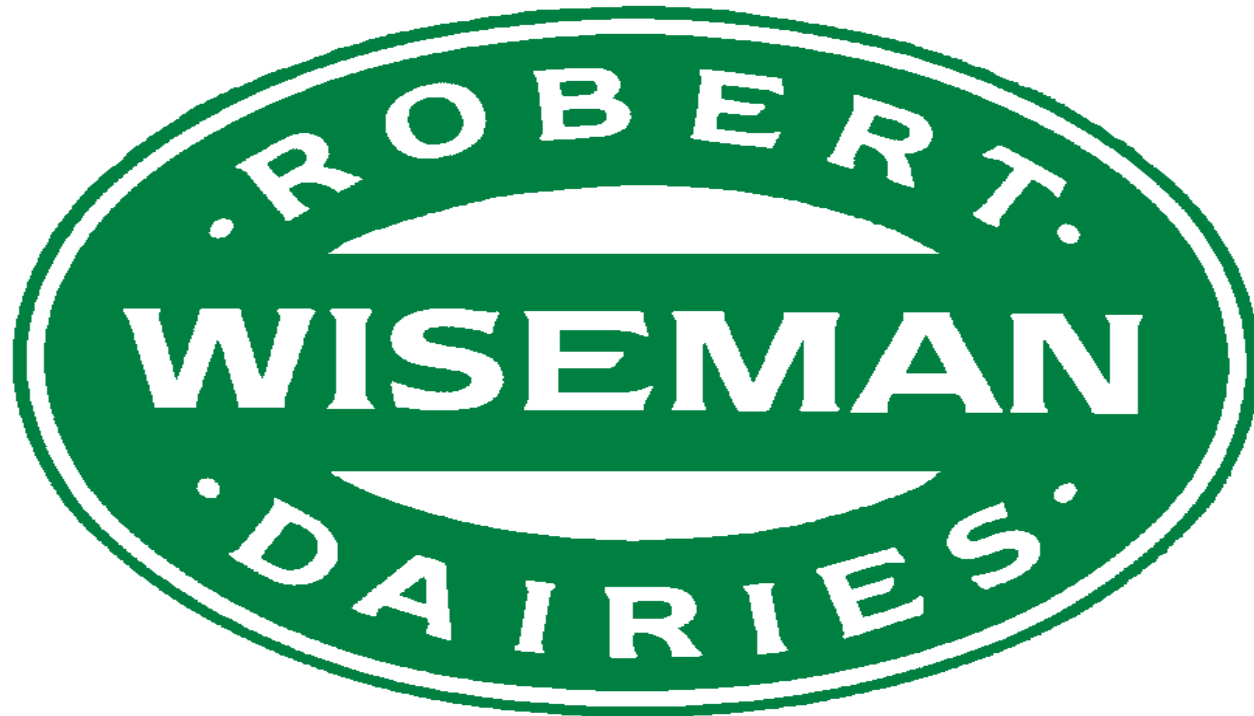
Inspiring children about food and farming

We also work closely with the Royal Highland Education Trust on their "Taking the classroom into the Countryside" project. This supports school trips to local farms to help children better understand more about farming and food production, and where what we eat comes from. Last year over 60 schools from across Scotland participated.

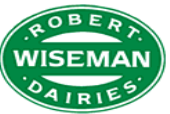
Conclusion

There are a series of challenges facing the food supply chain in Scotland, from exchange rates and subsidy reform, to an increasing cost base. But we believe, as do our customers, that much of what Scottish agriculture – and the food industry - produces is world-class.

By learning from each other, learning from customers, working together in partnership, and being prepared to change and adapt, the food supply chain can grow together. It is through working closely and effectively with our suppliers to deliver what our customers want that we feel Tesco hope to make a real contribution to a sustainable Scottish food supply chain



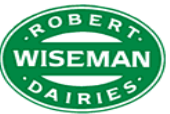
01 February 2006
Briefing Document



GB Liquid Milk Market

	Total (m litres)	% Market
1. Arla	1,970	34.6
2. Robert Wiseman	1,250	21.9
3. Dairy Crest	1,200	21.1
4. Dairy Farmers of Britain	600	10.5
Others	680	11.9
TOTAL	5,700	100.0

Source: Dairy Industry Newsletter and Wiseman estimates (Wiseman estimated October sales annualised)



Market Shares By Sector

	Doorstep	Middle-Ground	Super-markets	Total
Arla	380	470	1,120	1,970
Wiseman	50	340	860	1,250
Dairy Crest	380	250	570	1,200
Others	170	1,110	-	1,280
Total	980	2,170	2,550	5,700

Source: Dairy Industry Newsletter and Wiseman estimates for post October 2005

Supermarkets include Tesco, Sainsbury, Asda, Safeway, Somerfield, Morrison, Waitrose and M&S



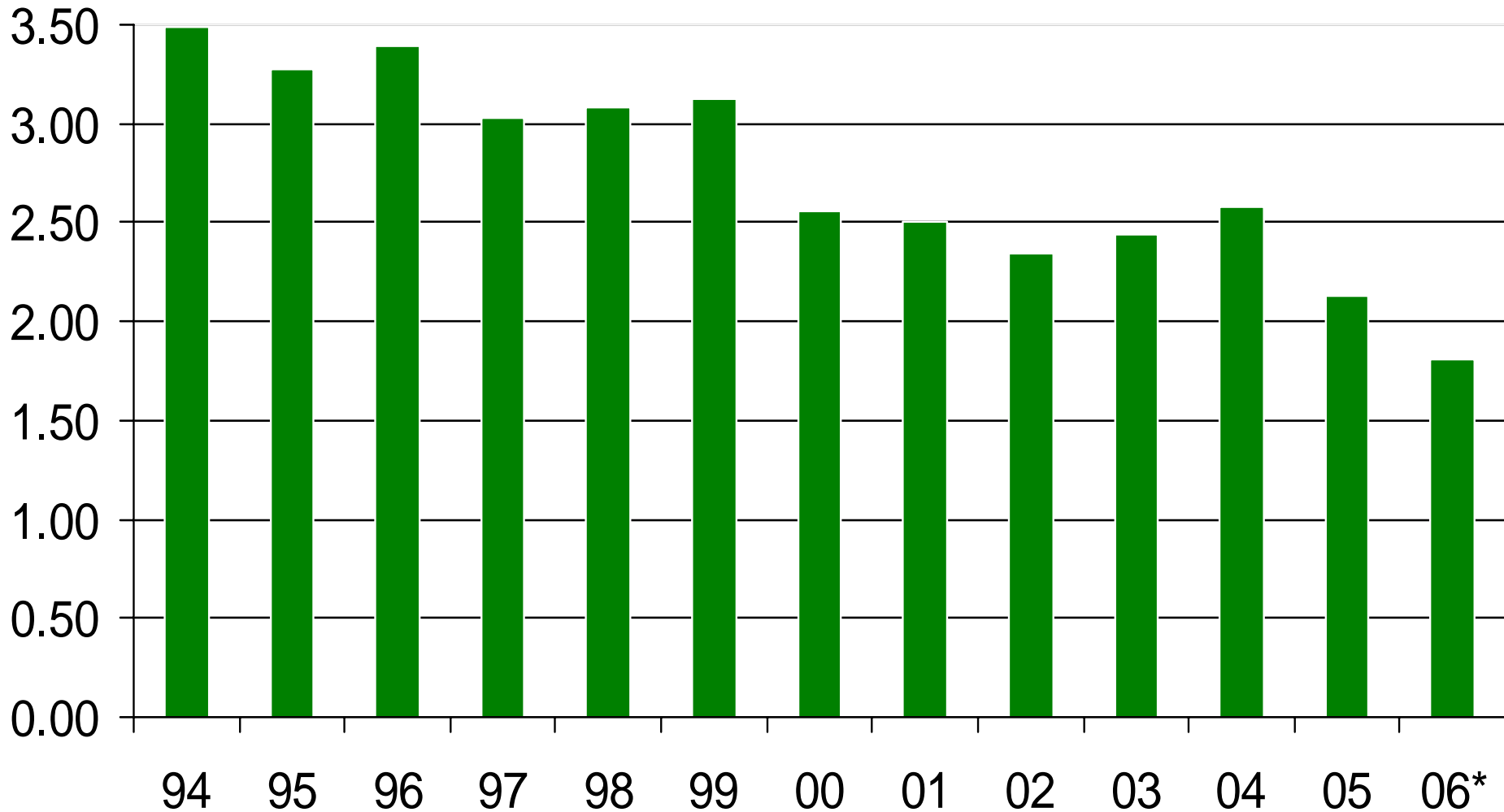
Market Shares

	Tesco %	Sainsbury %	S'field %	Morrison %	Asda %
Wiseman	60	50	35	-	-
Arla	40	-	60	50	100
Dairy Crest	-	50	5	50	-
	100	100	100	100	100

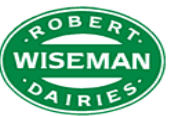
Source: Dairy Industry Newsletter and Wiseman estimates for post October 2005



Profit per Litre



* - First half, all others full years



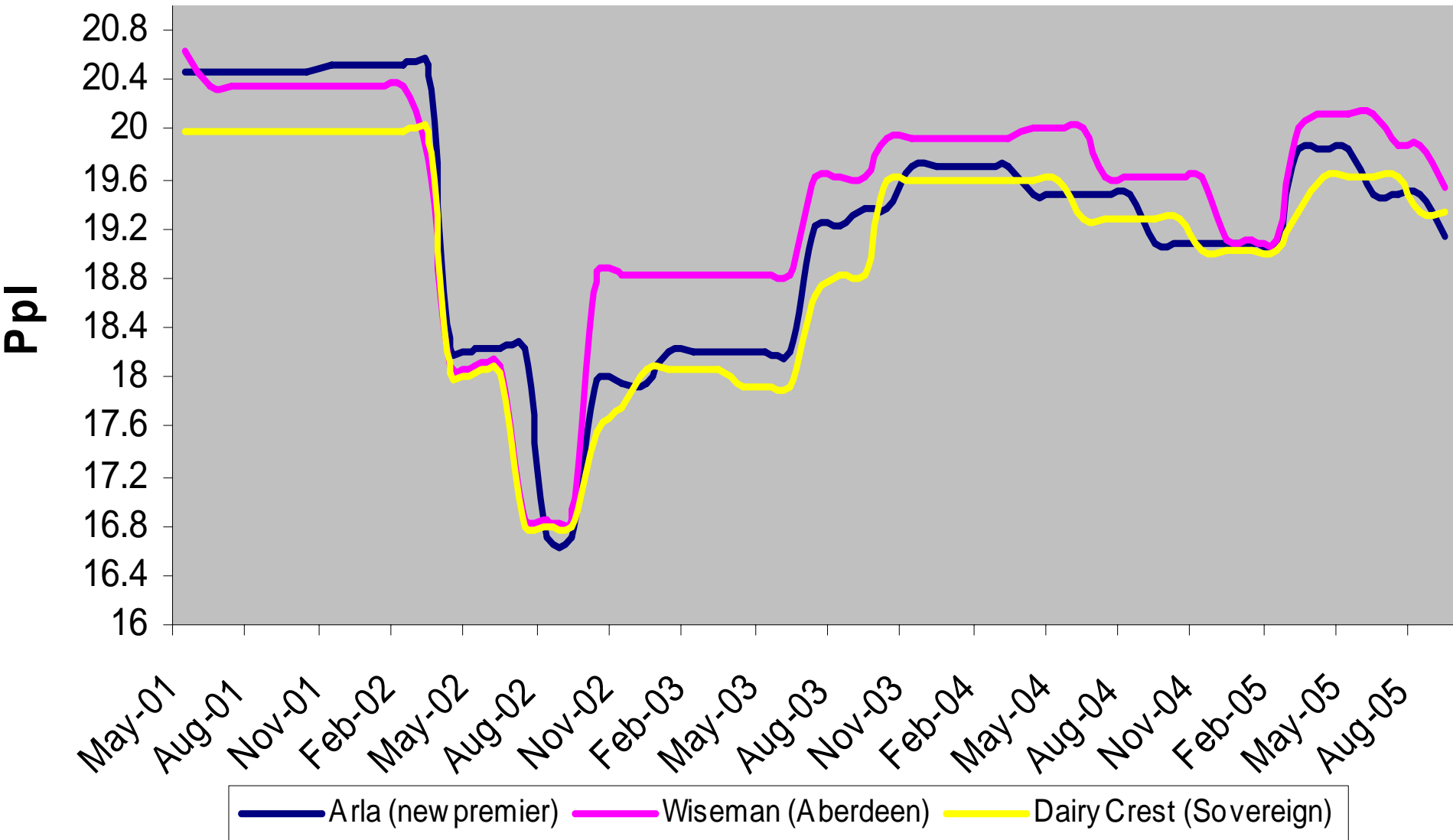
Milk Prices - Per Litre

	MDC*	MP.com Liquid*	MP.com Flagship*
Wiseman (WMP, England)	19.71	19.76	19.90
Arla (AMP)	19.13 (0.58)	19.13 (0.63)	19.35 (0.55)
Dairy Crest (Sovereign)	19.04 (0.67)	19.31 (0.45)	19.57 (0.33)



* - Relates to standard litre prices produced by Milk Development Council and Milkprices.com

Liquid Contracts



Please note: 1) These prices are based according to the MDC Standard Litre and are therefore indicative prices only. Prices before February 2004 are based off confirmed price changes from processors. The actual average price paid will depend on the average profile for the individual buyer. 2) We have removed the effect of the seasonality system introduced by Wiseman from April 2005. 3) Part of the price increase in October 2003 for Dairy Crest is due to contract changes.

Balance of Business

(Post transfer of Morrisons business – Nov 2005)

	RWD		Arla		DC	
	M of lits	%	Mil of lits	%	Mil of lits	%
S`mrkt.	900	69	1,150	60	600	46
D`step	50	4	350	18	350	27
M.Grđ	350	27	430	22	350	27
Total	1,300	100	1,930	100	1,300	100

SUBMISSION FROM ROBERT WISEMAN DAIRIES

**THE SCOTTISH PARLIAMENT
ENVIRONMENT & RURAL DEVELOPMENT COMMITTEE**

THE FOOD SUPPLY CHAIN INQUIRY

1. Robert Wiseman Dairies PLC (“Wiseman”)

Wiseman is the second largest liquid player in Great Britain, having expanded its operations by a combination of organic growth and acquisition since its flotation in 1994. It processes around 1.3 billion litres a year, representing around 22% of the liquid market. From its original roots in Scotland, the Company now has dairies in Manchester and Birmingham and has announced plans to build a new dairy in the South-West of England. The Group focus on the supply of fresh milk in non-returnable containers to supermarkets.

2. Recent Past and Current Trading Position

Wiseman has been impacted over the last couple of years by the massive shake-up in supermarket supply chain for fresh milk that followed ASDA’s decision to radically restructure how it purchased milk and went from 3 suppliers (Wiseman, Dairy Crest and Arla) to 1 supplier (Arla).

Since then, all the other major supermarkets have carried out reviews on how they source their milk, with Sainsbury’s going from 3 suppliers to 2 suppliers (Dairy Crest and Wiseman being successful), Tesco going from 3 suppliers to 2 suppliers (Arla and Wiseman being successful) and finally, in late October, Morrisons going from 3 suppliers to 2 suppliers (Dairy Crest and Arla being successful).

The attached Appendices 1, 2 and 3 show how the industry is shaped following these moves and who supplies who between the processors and the major supermarkets.

As a result of these contract changes, there has been for Wiseman (and others) a repositioning of where business is served from. For Wiseman, it has meant losing business in its

heartland of Scotland and the North of England, with both ASDA and Morrisons, and gaining business in the South-East and South-West of England with Tesco and Sainsbury's. This has inevitably resulted in job losses in Scotland and the North of England, and significant new investment and new jobs in the South of England (including a £7.5M new depot at Northampton that opened in mid-November 2005 and a £30M new dairy in the South West planned for the Summer of 2007).

Wiseman, and the industry generally, have in addition to the massive contract changes had to suffer exceptional inflation in energy (plus 50%), diesel (plus 20%) and plastic costs (plus 30%), which have added around £10M to our annual costs, as well as the cost of complying with EU Working Time Directives that has added a further £2M to our annual wage bill. Wiseman has been seeking an increase in its selling prices over the last month, with a view to recovering these exceptional costs.

Wiseman's recent Interim Results tell the story – with profits down at the interim stage by 22% to £12M and operating profit per litre at a record low of 1.8 ppl and, in operating profit percentage terms, to 4.4%. See attached Appendix 4 showing the trend in our margins over the last 13 years.

3. Milk Prices and Industry Structure

Since the Milk Marketing Boards were abolished in 1994 and the market deregulated, milk prices have been based on a "free market". Therefore supply and demand has established what prices retailers, processors and farmers receive for the end product.

There has always been a floor price for milk, as the UK being part of the EU has enjoyed the benefits of CAP support. The "intervention price" supports the bottom end of the market, namely powders and butter. As deregulation swept away end use pricing, the market was left to establish a hierarchy of premiums over intervention price with cheese prices and liquid prices carrying premiums above intervention milk price equivalent (IMPE). The level of premiums were initially established by the deregulated Co-ops (Milk Marque and Scottish Milk) and have evolved since that date.

Lots of consolidation at all levels of the industry (namely farms, Co-ops, processors and retailers) has taken place, but a similar hierarchy of prices continues with premiums for liquid and cheese over commodities such as powder and butter. These premiums reflect the fact that milk for liquid has to be

processed daily and milk for cheese has to be a regular supply, whereas butter and powders can be produced on a seasonal basis when milk supply is at its peak.

Attempts to isolate parts of the milk market and create artificial premiums has not proved sustainable. Retail price initiatives on cheese and liquid milk have given temporary fixes, but have not provided a lasting solution.

Given we are in the process of a fundamental CAP reform, with cuts in direct subsidies and the introduction of the decoupled single farm payment, it is not unexpected to see milk prices falling. Likewise, although great sympathy can be expressed for the plight of the farmers, in a free economy market forces inevitably must be allowed to operate.

Wiseman is committed to ensuring a long-term viable milk supply base. This means very high quality standards and a sustainable price. We have discussed this commitment at length with our major supermarket customers, who concur with this view. More generally, pressure on milk prices to suppliers arises from falling butterfat returns (cream) rather than any squeeze from supermarkets, who generally comply with the terms of any contracts with them.

Wiseman has always paid a premium over other suppliers (both Co-ops and other processors). The roots of this go back to paying farmers a premium price specific to the needs of the fresh liquid market, as opposed to the lower pooled price paid by the Co-ops. This allowed Wiseman to develop a milkfield of farmers supplying us direct. The level of these premiums has, in recent months, widened as a result of competitors reducing prices. The increase has been disproportionate within the liquid sector, to the point where Wiseman is potentially un-competitive and risks losing out on current/future contracts. This will be addressed in forthcoming months in a sympathetic manner, but differentials will have to be reduced. See attached Appendices 5 & 6 showing current differentials. Given Wiseman purchase over 1.3 billion litres per annum, this premium is costing the Company over £6.5M per annum.

Much has also been made by competitors that Wiseman's mix of business should somehow allow it to pay a premium. See Appendix 7 for an analysis of the three main players, which demonstrates this argument is fundamentally flawed.

Future prices will depend upon supply versus demand. However, in the event of substantial cuts in UK milk production taking place, which would eliminate our requirement for

intervention products, then most industry commentators expect milk prices to drift down in line with CAP cuts.

Wiseman sells for export over 50M litres of cream annually in bulk form, which is the Company's exposure to the commodity markets. Cream prices this year are already down around 8% compared to last year, yet milk prices paid by Wiseman are actually up on last year.

3. Competition Matters

Frustrations came about recently with the Company's proposed acquisition of a 10M litre dairy in Hamilton (Scottish Milk Dairies) being referred to the Competition Commission, despite this only representing 2% of the Scottish milk market and 0.2% of the UK market. This ultimately led to the deal collapsing and Scottish Milk Dairies being sold to another major competitor for middle ground, Grahams Dairies.

The OFT's involvement in the milk market is proving to be an obstacle to the much needed consolidation, with radical efficiencies required in order that the processing side of the supply chain can remain efficient and profitable.

Turning to the question of vertical integration, Wiseman and First Milk cemented their relationship recently with First Milk acquiring a 15% stake in Wiseman. Although no further steps are currently contemplated, the decision on Scottish Milk Dairies would surely mean no further progress would be allowed without serious examination by the Competition Authorities/ Competition Commission.

To summarise, Wiseman believes further consolidation of the supply chain must be allowed to take place. However, unlike other parts of Europe, there seems to be a much stricter interpretation of EU competition law in the UK.

4. Executives Agricultural Strategy

The Executive's review of the Agriculture Strategy must help facilitate primary producers become as competitive as possible and help focus them on producing what the market wants. Changes in the CAP are undoubtedly putting pressure on prices in the dairy sector, but the changes equally afford the industry the opportunity to concentrate on real market requirements.

Scotland has many very efficient dairy producers and Wiseman sources direct from around 300 of them. Regular visits from our farm liaison team allow us to communicate market signals back to these producers. This is vital in enabling them to react to these signals and continue to produce a high quality, fresh, local product to satisfy market requirements. This fits with the Strategy's original and ongoing aim of right time, right specification and right price.

The review of the Strategy should put the transfer of knowledge from the market place back to individual agriculture businesses at the heart of its aims. Government has a role in tandem with food businesses in the supply chain, as well as retailers, to ensure that these market messages reach primary producers in a clear and unambiguous way. Wiseman is happy to co-operate in this regard and continue to supply quality products produced to the highest standards from Scottish farms.

5. The Future

Wiseman, through its track record of premium payments to producers and success in building its market share within the UK dairy industry, has clearly demonstrated that it is a key player in the UK liquid milk market and treats its milk suppliers in an equitable manner. The Company is committed to Scotland and maintaining a viable supply base. The Group employs over 1,000 people in Scotland and 3,500 throughout Great Britain.

As a Company, we participate in the Dairy Supply Chain Forum chaired by DEFRA and are active within Dairy UK, who are the recognised trade organisation for the industry. Within and through both bodies, we are discussing the way in which the industry can move forward with better relationships and closer integration throughout the supply chain. We support the objective that the vision for the industry should be more long-term and share some of the principles relating to stable pricing and contract segregation. However, irrespective of concerns expressed, we believe the market cannot be interfered with and as there are undoubtedly further pressures ahead with CAP reforms, there will inevitably be downward pressure on prices in all sectors. The Company will continue to analyse the current and future implications of these changes on the industry. Wiseman is, however, absolutely committed to ensuring that it has a long-term stable and viable supply base.

INQUIRY INTO FOOD SUPPLY CHAIN

Summary

1. NFU Scotland welcomes the Committee's initiative in conducting this inquiry. NFUS recognises that many of the issues central to this inquiry relate to competition matters reserved to Westminster. However, we would stress that these issues have a direct impact on Scottish Executive policy areas and, as such, representation by Scottish Ministers at UK level is essential.
2. The Scottish Executive's Forward Strategy for Scottish Agriculture recognised the multi-functional role of Scottish farming as the provider of quality, healthy food, as the environmental steward of the countryside and as the foundation for around one in ten Scottish jobs. The Strategy recognised that farm business sustainability is the key to securing these public benefits. As a result of subsidy reform and the concentration of power in the food retail sector, the relationship between the major supermarkets and the rest of the food supply chain is now the most significant determinant of farm business sustainability.
3. As supermarkets have strengthened their dominant position in the supply chain, farmers have become increasingly weak sellers. The farming industry requires a structure within which it can develop and adapt to this changing operating environment. However, farmers' attempts to co-operate on a significant scale to strengthen their competitive position have been thwarted by the UK Government's over-zealous interpretation of competition law. **Farmers groups in Scotland and the UK must be able to co-operate to same degree as their counterparts in other countries.**
4. In general, supermarkets deal directly with food and drink processors, not with farmers. However, the relationship between supermarkets and their direct suppliers has a direct impact on the economic viability of farm units. This relationship can work very well, benefiting every link in the supply chain. However, there is evidence that the imbalance in negotiating strength between supermarkets and the rest of the supply chain can lead to abuses of power. There is no effective mechanism to address these situations. **The Scottish food industry, rural communities and consumers therefore require the introduction of an independent ombudsman to enforce a strengthened Supermarket Code of Practice and to police fair trade in the UK food supply chain.**
5. The lack of direct contact between supermarkets and farmers hinders the development of truly collaborative supply chains. Experience in the milk sector, for example, has shown that the short-term desperation of processors to secure retailer contracts far outweighs any long-term attempt to negotiate a price at which farmers, as well as processors and supermarkets, can achieve a sustainable return. **Direct, clear and transparent contracts between supermarkets and farmers could address this situation and provide an element of certainty on both market outlet and price.**
6. The dominance of the supermarkets and their increased power, twinned with an over-zealous interpretation of competition law, is distorting the normal economic rules of the market.

7. **In order for Scotland's food industry to be competitive, the increasing burden of regulation must be addressed.** There must be a full cost/benefit analysis done on all regulation. The implementation of regulation, particularly environmental, is adding costs to farm production, with little evidence of direct benefit to the environment. The pledge from both the Scottish Executive and UK Government to avoid 'goldplating' EU legislation is welcome, but evidence suggests this has yet to be reflected by either those drawing up regulatory proposals or the authorities charged with their enforcement.

In detail

Interpretation of competition law

8. The farming industry fully recognises it has a responsibility to strive for efficiency and, where appropriate, co-operate to improve its returns from the market place. However, the industry faces an over-zealous interpretation of competition law which constrains the ability of businesses to develop, particularly farmer-owned co-operatives.
9. The Office of Fair Trading's apparent interpretation of Scotland as a regional market in its own right leads to acute development constraints. Effectively, the market share of a co-operative is assessed on a Scottish or UK basis, ignoring the fact these businesses operate in a European or global market. This interpretation of competition law contrasts with the interpretation of law in other countries where farmer co-operatives have been allowed to develop into large, vigorous businesses. Not only is this interpretation inconsistent with other countries, but the OFT's attitude towards primary producers contrasts with its apparent unwillingness to scrutinise properly the expansion of market share in the food retail sector.

Case study on competition law: Scottish milk sector

10. Farmer-owned milk groups such as Arla (a Danish and Swedish co-operative) and Frontera (a milk co-operative in New Zealand) have secured between 90-100% domestic market shares. However, because the authorities recognise that they operate in a European and global market place, they are not perceived as anti-competitive despite their domestic dominance.
11. The OFT only has jurisdiction to investigate market share where it can be shown that a company has a market share of 25% or more. A series of OFT investigations into Scottish Milk, then its successor First Milk, could only have been established if Scotland was deemed a market in its own right.
12. Of added concern is the ability of companies to use this complaint mechanism as a means of exerting commercial pressure on farmer co-operatives.
13. The continuing weakness in the farmgate milk price, at a time when processor margins have remained stable and retailer margins have increased sharply, points towards the need for further consolidation in the milk market. The history of investigations gives rise to justifiable concerns that further consolidation would not be permitted and, hence, has stalled developments on that front.
14. Farmers groups in Scotland and the UK must be able to co-operate to the same degree as their counterparts in other countries.

Supermarket/suppliers relationship

15. The major supermarkets are Scottish farming's biggest customers. Therefore, the development of collaborative, transparent and trustworthy relationships is crucial to the sustainability of Scottish farms and to maintain the contribution they make to the countryside, rural communities and consumers.
16. In Spring 2005, an Office of Fair Trading inquiry again failed to uncover evidence of unfair trading practices between suppliers and supermarkets. Yet, once again it identified the fear culture amongst suppliers which resulted in an unwillingness to speak officially about their grievances with supermarkets for fear of reprisals. As a result, NFUS contacted 14 of Scotland's major food and drink processors itself to ask them about the trading relationship with supermarkets, promising strict confidentiality.
17. It is important to stress that some were very positive about their relationship. However, following repeated assurances of strict confidentiality and commitments that there would be no identification of individuals, companies or even the food or drink product concerned, NFUS received evidence that abuses of power, supposedly addressed in the Supermarket Code of Practice, are still ongoing in the food supply chain.
18. As examples, some of the evidence given to NFUS included:
 - The demand from supermarkets for 'loyalty payments', running to six figures. Failure to pay can result in the loss or reduction of business.
 - Payments terms are altered without notice and without any right of appeal.
 - The fees charged for artwork and packaging design are enforced and not negotiated.
 - Supermarkets like to 'manage' the public statements made by suppliers.
 - The re-negotiation in contracts and the shifting of contracts are not always determined by price and quality of service. Indeed, there is evidence that contracts can be awarded to a supplier's competitor simply to prevent that supplier gaining increased market share and negotiating power.
19. NFUS welcomed the recognition four years ago from the OFT that a mechanism was required to ensure fair trade between supermarkets and their suppliers. However, given that the subsequently introduced the Supermarket Code of Practice has failed to address the problem (not a single complaint has gone to mediation under the Code in its four-year existence), this issue must be re-dressed.
20. NFUS fundamentally disagrees with the OFT's current position on its remit. It states that concerns about the effects of supermarkets' growth on suppliers and the rural economy fall outwith the OFT's goal of making markets work well for consumers. In fact, the impact of current market conditions, and the imbalanced trading environment that it perpetuates, will eventually impact on consumers. The financial pressure on supermarkets' suppliers is passed down to farmers in the form of lower prices, many of which are now below the cost of production. The result, which is already evident in some sectors, is a significant decline in activity. Ultimately, if the current market situation continues unchecked, production will decline, restricting consumer choice. Therefore, the current market situation is working against the long term interests of consumers.
21. **The Supermarket Code requires strengthening and proactive enforcement with full protection for suppliers who complain. The ombudsman/watchdog responsible for its implementation must proactively monitor the supermarket and supplier relationship and, where necessary, recommend the intervention of**

Government or the competition authorities where the market is clearly anti-competitive and working against the interests of consumers and suppliers.

22. NFUS recognises that the establishment of such an ombudsman will not in itself fully address the breakdown in trust between supermarkets and suppliers where it has occurred. That can only be achieved over a longer period by the development of collaborative supply chains and improved communication. However, in the short-term, the provision of a more effective ‘check in the system’ will help build confidence amongst primary producers and direct suppliers.

Regulation

23. NFUS supports science-based regulation which protects Scotland’s environment. Indeed, the protection of Scotland’s high soil and water quality is crucial to productive farming. However, the increasing regulatory burden, and its associated cost, is in danger of leading to a significant reduction in food production, ironically, with knock-on consequences for land management and the environment.
24. Given farmers’ weak position as price-takers, rather than price-setters, they not only have to fully absorb the cost of new regulation, but often suffer the consequences of increased costs elsewhere in the supply chain.
25. There is a widespread perception that the UK implements EU legislation according to the ‘letter of law’. This contrasts with other EU countries which implement EU legislation according to the ‘spirit of the law’. Recent examples emphasise this approach by the UK. Whilst the example below relates to new environmental regulation, the problem is not confined to this area of policy.
26. Proposals from the Scottish Environment Protection Agency to implement the Water Framework Directive in Scotland would impose massive new costs on Scottish farms. NFUS fully supports collaborative approaches to tackling local problems, where they are identified. However, the current blunt approach to regulation ignores the fact that Scotland has generally good water quality. We also oppose the cost-recovery approach, which is not fully explained to industry and seems to be rising at an alarming rate.
27. **The Executive’s revised Forward Strategy for Scottish Agriculture must tackle the burden of regulation. NFUS would recommend the establishment of a review group to assess the current levels of red tape and undertake a full cost/benefit analysis of existing regulation.**

Future relationships and role of Scottish Executive strategy

28. There is no doubt that greater communication between farmers, processors and supermarkets is crucial to creating an understanding of economic pressures and to building a sustainable supply chain. To that end, the development of Scotland’s Food and Drink Strategy and the review of the Executive’s Forward Strategy for Scottish Agriculture must stress the need for truly collaborative supply chains. Both documents have clear overlap, therefore it is important that the two strategies are integrated.
29. The Executive’s strategy must include making representation at a UK level to address the issues outlined above (both the interpretation of competition law and enforcement of fair trading terms). Ultimately, the success of much of the strategy will rest on resolving these issues.

30. NFUS has already been in discussions with the major retailers regarding the prospect for direct contracts between farmers and supermarkets. This would improve communication between the two groups and also help develop contracts which reflect the cost of production on farms and secure future supply.
31. NFUS fully accepts that the revised Forward Strategy will place a heavy, but justified, responsibility on farmers to meet the demand of its customers. However, equal emphasis must be placed on the rest of the supply chain to deliver sustainable returns, and therefore an incentive, for quality production.

Other issues relating to Scottish Executive strategy

32. Given the clearly recognised health benefits associated with the local production of food, the Executive must incorporate its existing work on public sector food procurement into the revised Forward Strategy for Scottish Agriculture. On top of the health benefits of local procurement of food for schools, hospitals, prisons and other public institutions, the economic and environmental benefits of supporting local production are significant.

Ends

**ERDC FOOD SUPPLY CHAIN INQUIRY: JOINT PAPER FROM ROSS FINNIE,
MINISTER FOR ENVIRONMENT AND RURAL DEVELOPMENT, AND
ALLAN WILSON, DEPUTY MINISTER FOR ENTERPRISE AND LIFELONG
LEARNING**

Context

1. The food chain in Scotland is diverse with participants ranging from primary producers of agricultural, aquaculture and fisheries produce, through wholesalers and processors, to retailers and the food service sector, both private and public sector. Not all produce goes through each step of the chain. Some produce is sold direct to the public, for example through farm shops or farmers' markets. Some produce arrives part way through the chain by means of imports. On the other hand, some products (such as livestock) may pass through every step in the chain within Scotland.

2. The Committee has indicated that this inquiry will focus on Scottish agricultural production and ways in which the Executive can address supply chain issues in order to encourage the development of sustainable relationships. In its report on CAP reform, the Committee recommended that "it is vital that the industry receives sufficient support and assistance while it adjusts to a more market-orientated future". It also commented on the importance of developing high quality products and examining the benefits of co-operative development. These themes provide helpful context for this paper, which examines: the place of agriculture in the food chain and links with the wider rural economy; strengthening links with the food and drink industry; Enterprise Networks support; competition issues; and the way forward. (The paper does not cover the fishing and aquaculture industries – and is less comprehensive because of that – although they also make an important contribution to the Scottish economy and to sustaining rural and coastal communities: for example, fish products account for over half of Scotland's food exports by value.)

The place of agriculture in the food chain and links with the wider rural economy

3. The food manufacturing industry in Scotland is dependent on Scottish agriculture for 36% of its inputs. There are also important links with the drinks industry and Scottish agriculture provides 24% of the inputs to the food and drink manufacturing industry combined. In its agriculture strategy, *A Forward Strategy for Scottish Agriculture*, the Executive made it clear that Scotland needs a successful and profitable farming industry that meets the needs of the wider food and drink industry and that farming is important to the prosperity of rural Scotland. Recent CAP reform has reinforced the importance of increasing the level of market-orientation in the industry. Considerable support is being given to the agricultural sector during this period of adaptation. Expenditure on Single Farm Payments is expected to be well over £400 million a year. In addition producers may also qualify for payments in recognition of work undertaken to deliver benefits such as environmental enhancement, improved recreational access or animal health and welfare. To help agricultural businesses to restructure or re-orientate their production and to support diversification activities, grants totalling around £34 million have been awarded since 2001 under the Farm Business Development Scheme and Agricultural Business Development Scheme. Help is also available for skills improvement: last year, over 1,800 farmers applied

for grants totalling £780,000. The Whole Farm Review Scheme provides grants to enable farmers to access business advice provided by accredited advisers; the Scheme was launched in July 2004 and over 1,000 farmers have so far taken part. With the Enterprise Networks the Executive has supported local initiatives aimed at improving farmers' business and benchmarking skills. Funding of £2 million a year is available for these measures under the banner of FarmBASS (Farm Business Advice and Skills Service).

4. Farmers receive valuable assistance from the Scottish Agricultural Organisation Society (SAOS) which aims to strengthen the profitability, competitiveness and sustainability of Scotland's farming, food and rural industries through the promotion and development of co-operation amongst farmers and rural businesses; by assisting implementation of the *Forward Strategy for Scottish Agriculture* and the *Scottish Food and Drink Strategy*; and by supporting and representing the interests of co-operative directors and member businesses. SAOS has undertaken valuable work to demonstrate the importance of collaborative supply chains in promoting innovation, competitiveness and market responsiveness. The Executive supports SAOS through grant assistance of some £320,000 a year.

5. Each year the Executive commissions a programme of advisory services from the Scottish Agricultural College. This includes £3.5 million for the Veterinary Services programme to provide advice on a range of issues including animal welfare and biosecurity, which are crucial to consumer confidence in Scottish food. The Advisory Services programme (£2 million a year) provides advice on matters such as food marketing, organic farming and rural diversification.

6. These measures are all aimed at ensuring that Scottish agriculture is competitive in markets and contributes to local rural economies.

Strengthening links with the food and drink industry

7. The Partnership Agreement highlights the importance of building upon the Scottish food and drink industry's reputation for high quality. There are specific Partnership Agreement commitments to ensure that more Scottish produce is processed in Scotland; to encourage localised food distribution systems involving more local processing of produce; to encourage greater sourcing and clear labelling of local food items and food produced by organic and sustainable farming methods; to support local marketing schemes; and to support regional marketing co-operatives.

8. The *Scottish Food and Drink Strategy* was launched in 1999. It provides the overarching strategic direction for the development of the food and drink industry, within the context of a *Smart, Successful Scotland*, and is being taken forward by an Industry Strategy Group (ISG) of senior figures in the industry. The ISG is currently working to ensure greater cohesion in the food and drink industry and to achieve ownership of a shared strategic vision by a broad spectrum of the food chain. The Strategy set ambitious targets for growth and identified six key action areas:

- to develop leading processors
- to exploit premium markets in the UK and internationally
- to increase competitive advantage by innovation and exploiting technology
- to develop an effective and efficient supply chain
- to develop the capabilities of our people

- to effectively communicate the benefits of collaboration.

9. There are about 1,400 food and drink manufacturing businesses in Scotland, employing over 50,000 people. About 40% of these jobs are in rural Scotland. Sales of food and drink were valued at over £6.5 billion in 2002 and the industry contributes £2.2 billion a year to the economy's gross value added (GVA). It represents about one-fifth of GVA and of employment in Scottish manufacturing. It also accounts for 17% of Scottish manufacturing exports.

10. The recently published sustainable development strategy, *Choosing our Future*, explained that the Executive is working with the ISG to identify and address sustainable development priorities within the sector, mainly relating to the use of water and energy and production of waste (including packaging). It also explained that "food miles" are a source of greenhouse gas emissions and can be reduced by more efficient use of transport and noted the need to encourage the industry and consumers to increase the take-up of locally-produced food.

11. A range of support is available to the food and drink industry and the recipients include some on-farm food businesses. The Executive operates grant schemes to encourage Scotland's primary producers and food processors to develop further innovative products, add value, co-operate to exploit new markets and shorten the food supply chain by linking producers with processors. A key criterion of eligibility is that the project should use Scottish primary produce, whether agricultural or fish. Since 2001, the Processing and Marketing Grant Schemes have awarded £56 million to food businesses which has delivered total new investment of over £250 million. Since 2000 more than £5 million has been awarded under the Marketing Development Scheme which aims to improve the efficiency of the food marketing chain. In addition to providing financial support, these grant schemes highlight innovative developments. This information can be made available to the industry – for example to retailers who are seeking new suppliers.

12. The Executive also encourages those companies with innovative products to apply for the Scottish Food and Drink Excellence Awards which recognise quality and innovation within the industry. Such awards can assist companies' marketing efforts. Indeed, as part of the Executive's SAC Advisory programme, courses are run in conjunction with the Royal Highland and Agricultural Society for Scotland to assist companies to use awards to increase their profile and achieve greater sales of their products.

13. A number of organisations, including voluntary interests, are involved in local food initiatives that form part of food supply chain development. These cross a range of Executive policy interests; for example the Health Department has encouraged Food For Life to make effective links with the local implementation of Hungry For Success where appropriate and where this can add value to local strategies.

14. Business opportunities also arise where processors import raw materials that could be sourced in this country. Farmers may be able to capture these potential markets from importers if they know what the processors, retailers and food service sector need in terms of product, quality, price and availability and can demonstrate their ability to meet that specification in order to persuade the buyers to source locally.

15. The food service sector is a fast growing market and it provides a major outlet for Scottish produce. One part of this sector caters for the tourism industry in Scotland. There is a target of generating a 50% increase in tourism revenues by 2015 and much of this will be spent on food, creating further market opportunities for Scottish producers. The *Eat Scotland* initiative is promoting higher standards in the catering industry and its aims include highlighting Scottish produce. Public sector food procurement is another important part of the food service sector with an annual spend of around £85 million. The Executive commissioned research to identify the opportunities for, and barriers to, Scottish suppliers accessing this public sector market more fully. Drawing on the conclusions of the research, regional seminars are being provided through the food forum network to bring together food suppliers and procurement contacts to improve knowledge of the market opportunities.

16. Vertical integration can play an important part in streamlining the supply chain and industry and government recognise its benefits. Grant assistance has been awarded under the Processing and Marketing Grants Schemes to assist companies in vertical integration. Cooperative activity can achieve vertical integration as can the strengthening of links between the agriculture and the food and drink industries.

Enterprise Networks support

17. Scottish Enterprise's recent Clusters and Industries Review confirmed food and drink as one of six national priority industries. These industries are seen as those which should have the greatest economic impact for Scotland and in which Scottish Enterprise involvement can make a significant difference. Scottish Enterprise will tailor their approach to reflect the challenges and opportunities within the food industry and will work to disseminate best practice throughout the sector.

18. Scottish Enterprise account manage over 180 food and drink processing companies via their network of Local Enterprise Companies. It provides financial support and business advice on a range of topics, including strategy, marketing, innovation and workforce development. It has also funded research into supply chains, which could potentially form the basis of a framework to support supply chain development in the Scottish food and drink industry. Funding has also been committed in support of skills initiatives and to assist Quality Meat Scotland, the Soil Association (and the Seafish Industry Authority) to enable more direct retailing and improve the operation of the supply chain.

19. The Scottish Food and Drink Market Development Project, delivered by Scottish Enterprise, aims to help companies to achieve profitable and sustainable sales with the major UK retail and food service operators. The programme helps companies to understand consumer trends; to identify the best channels to market (such as major multiples, speciality businesses or the food service market); to understand the buying strategies of potential customers and details of the key decision-makers; and to improve the suppliers' negotiation, marketing, research and presentation skills to increase their chances of securing profitable sales.

20. Scottish Enterprise meets the major retailers to raise the profile of Scottish food and drink processors and to identify potential opportunities for suppliers. It also provides financial and advisory support to Scottish food and drink producers to help them develop strong brands which will strengthen their presence in the marketplace; this often helps them to secure a better margin for their products and to build consumer demand and loyalty.

21. In the current year about £1.25 million of enterprise funding has been awarded in the Highlands and Island Enterprise (HIE) area to support projects in the food and drink industry, aquaculture, fisheries, shellfish and agriculture. HIE recognises the importance of promoting the region's reputation for high quality products. HIE is also contributing to a number of national programmes alongside Scottish Enterprise and the Scottish Executive, and is supporting various local initiatives, including the Highlands & Islands Food and Drink Forum.

Competition issues

22. Supermarkets are a major force in the UK. Not only do they provide choice for Scottish consumers but they also provide a vital market for Scottish producers. All of the main supermarkets have a presence in Scotland but Tesco has the largest. To take an example, £166m of beef is sold through Scottish supermarkets and Tesco is the largest butcher in Scotland with 24% of meat sold through its stores. Publicity about the role of the major supermarkets has focused to a large extent on competition issues. The Office of Fair Trading (OFT) conducted an audit of compliance with the Supermarket Code of Practice in the light of the OFT's remit for consumer and competition issues, which are reserved matters. They found that by and large supermarkets were complying with the Code and found no evidence that disputes between supermarkets and suppliers were leading to any significant impact on competition in this market. The Competition Appeal Tribunal has asked the OFT to reconsider the decision not to refer the grocery market to the Competition Commission for investigation. It is understood that the OFT hope to publish a draft decision in March.

23. There are concerns about the growing dominance of supermarkets, and their treatment of suppliers, and about the effectiveness of the Supermarket Code of Practice. The Executive recognises producer concerns over farm-gate prices and their wish to secure a fair return for their efforts. This can be helped through open and honest dialogue between all elements of the supply chain. In meetings with the major retailers and other businesses in the supply chain, Ministers continue to emphasise how seriously the Executive views the importance of maintaining a sustainable food chain with healthy trading relationships between suppliers and retailers.

24. There are also concerns about the perceived attitude of the competition authorities towards the dairy sector, given the need to restructure and develop to compete better on European and world markets. Proposed mergers and acquisitions are matters for the competition authorities and the Executive does not determine individual cases. The Executive, however, maintains dialogue with Whitehall counterparts. More generally Ministers continue to encourage all parts of the dairy industry to explore opportunities for increased collaboration and greater vertical integration.

The way forward

25. The Executive is working with stakeholders to update the agriculture strategy. The Agriculture Strategy Group has a vision of a prosperous and sustainable farming industry, one of Scotland's success stories, which benefits all the people of Scotland. Detailed work on the updated strategy has been carried out by three sub-groups, focusing on food production and marketing; rural development; and environment and communications. The Agriculture Strategy Group and the Scottish Food and Drink Strategy Group are working closely together

to ensure that actions in support of the updated agriculture strategy and the Food and Drink Strategy maximise the opportunities for both sectors.