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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Dairy market situation 2009

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MANDATE:

The June European Council conclusions stated: "The European Council discussed the current situation on the dairy market. It invited the Commission to present an in-depth market analysis within the next two months, including possible options for stabilising the dairy market, while respecting the outcome of the Health Check".

BACKGROUND:

The dairy market situation has deteriorated dramatically during the last 12 months. After a price spike in 2007 alongside the high food prices in general, prices have dropped substantially affecting dairy producers' income. Prices for milk delivered to the dairy have come down from 30-40c/l to an EU-27 weighted average of 24c/l with prices for many producers at 20-21c/l or less. This has triggered substantial unrest amongst dairy farmers with many demonstrations.

1. INTRODUCTION

This Communication describes the dairy reform process up to the Health Check, given that the European Council has determined its outcome as the basis for examination of further measures. It contains an EU and international market situation analysis, a summary of Commission market support measures, other instruments available to the Commission and the Member States within existing legislation and options for further action and discussion. It is accompanied by a Commission Staff Working Document (CSWD) with further detail.

2. THE REFORM PROCESS

2.1. Agenda 2000 and the 2003 CAP reform

The reform of the dairy sector, in line with the CAP reform in general, has aimed at a greater market orientation of production. Therefore, intervention measures were redefined with lower intervention prices gradually being implemented. As compensation, EUR 5 billion were distributed among dairy farmers as direct support to their revenue and linked to the production. This is now fully decoupled and subject to public and animal health and environmental standards (cross-compliance). Also, the intervention quantity (the Community purchase of market surpluses at fixed prices) was limited to 30 000 tonnes of butter and 109 000 tonnes of skimmed milk powder per year. The Commission may however continue intervention for greater quantities should the market situation require it. Last, milk quotas were increased by 1.5% (by more and sooner for some Member States) and extended to 31 March 2015.

All these measures were meant to support increased competitiveness and help milk producers prepare for future challenges on the international scene, whilst providing income support by way of direct payments.

2.2. Health Check

Following the Commission Communication on the Health Check and in anticipation of the final Health Check decisions, there was strong pressure in the Council to increase production possibilities. As a result quotas were increased by 2%. The outcome of the Health Check confirmed the logic of the reforms since 1992. Quotas will expire in 2015. To ensure a controlled and soft phasing-out, quotas are increased by 1% each year from 2009 until 2013, with an additional measure (fat correction reduction) which further increases production potential. Ideally the "soft landing" should be ensured by gradually eroding the value of quotas to reach zero at 1 April 2015. Already the value is low or near to zero in several Member States whose production is below their quotas. Additionally, under the second pillar of the CAP, support for "dairy restructuring" was acknowledged as an additional priority theme. This allows Member States to use additional funds from modulation to support dairy farmers in preparing for the end of quotas.

Finally it was agreed that the Commission should present two market reports, before December 2010 and December 2012 to see if additional measures would be needed to ensure the soft landing, without questioning the phasing out of the quota system.

3. MARKET SITUATION

3.1. Market situation to July 2009

EU milk production has not increased as a result of the various quota increases. By 31 March 2009, total milk production is estimated at 4.2% below the overall quota. Demand however has decreased both in the EU and on the world market. The drop in the EU demand was mainly affecting quality products like cheese, which is particularly important as more than 40 % of EU milk is processed into cheese.

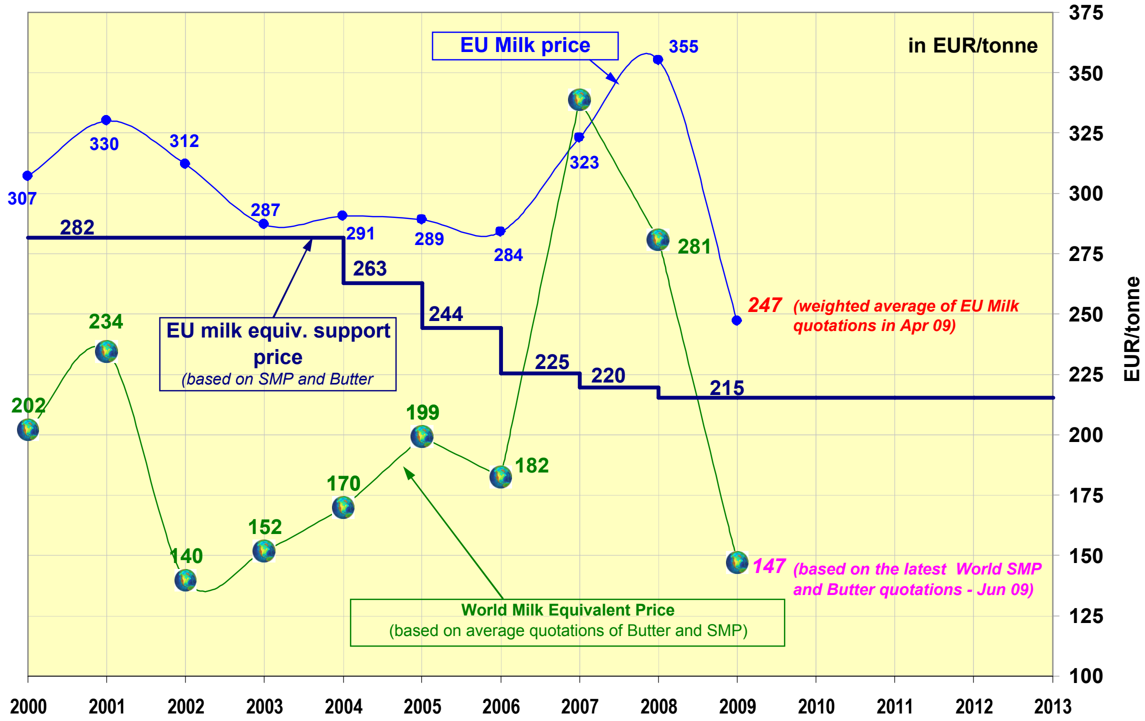
The world market shows a high degree of volatility, due to the fact that quantities traded are small in comparison to total production and consumption. Prices on world markets decreased considerably due to a combination of production increases by other suppliers (New Zealand, Australia, Argentina, Brazil and until recently also the US) and a drop in global demand connected with the economic crisis.

Reduced demand in the EU and collapsing world market prices had a direct effect on EU market prices. The result has been milk prices moving towards 21c/l and even below in some Member States (see CSWD for further details).

3.2. EU prices

In 2007, world market prices increased substantially above EU intervention levels and EU prices climbed in line with them. In the second half of 2008 world market prices dropped below EU intervention levels, reinforced by the weak US dollar, and EU prices again dropped in line with them. The Commission applied support measures which prevented EU prices from falling even further.

Average EU raw milk prices have always been somewhat above the milk equivalent support price for milk, see graph below. The reduction of the intervention level has had little impact after the 2003 reform and prices increased significantly in 2007/8. However the current lower demand caused a market imbalance and prices fell towards the milk equivalent support price, which is much lower than before the 2003 reform.



At the current average EU milk price of about 24 c/l with significant variation between Member States, (see details on national prices in CSWD), farmers still cover their variable costs. As feed, fertiliser and other inputs may have been bought at the start of the year and grass is still readily available in many regions, farmers continue to produce milk to be able to pay a higher share of their fixed costs, which are not covered for many farmers.

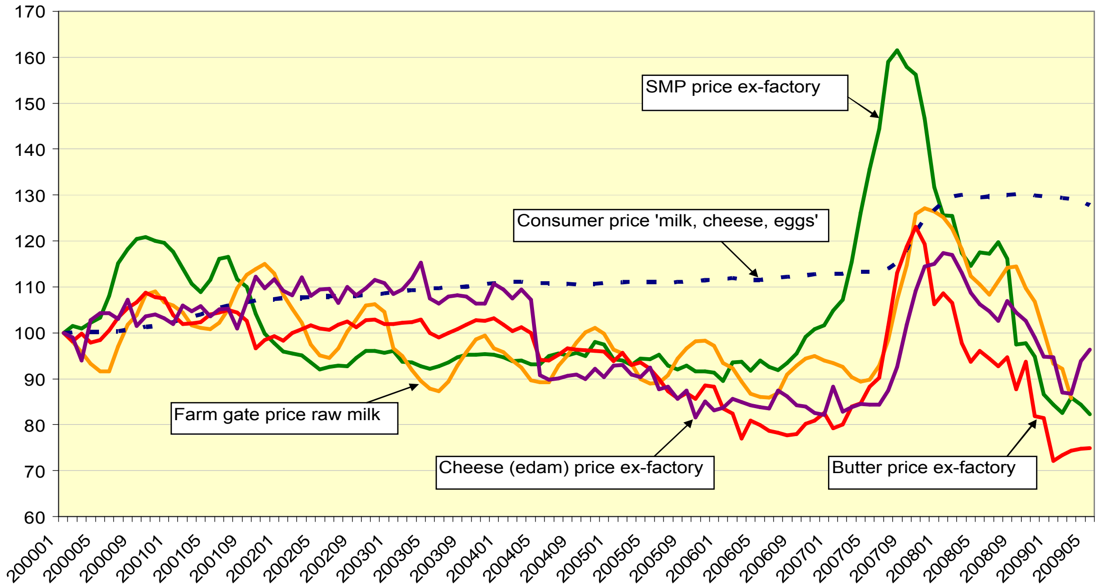
3.3. Consumer prices versus farmers' prices

The commodity price surge during the second half of 2007 generated a rapid increase in milk producer prices and a strong increase in consumer prices which peaked in spring 2008. By contrast the pronounced fall in the prices of milk and dairy commodities since the end of 2007 (-39% for butter, -49% for SMP, -18% for cheese, -31% for milk), only triggered a slight decline in the consumer prices of dairy products by some 2 %. The lack of adjustment of consumer prices to the fall in ex-factory prices is even more striking when assessed over a longer time period: whereas the ex-factory prices of most dairy products have now fallen below their levels before the price surge, dairy consumer prices have remained at high levels (more than 14 % before the price rise).

There could be several reasons why consumer prices of milk have remained stable while raw milk prices and ex-factory prices have declined as milk is only one of the costs in the consumer price of dairy products. However, the magnitude, the delay and asymmetry in the downward adjustment of dairy consumer prices - which is particularly marked in some

Member States – clearly shows that the EU dairy supply chain does not function efficiently. Preventing consumers to benefit from lower prices constraints the development of demand for dairy products and thus hinders the strength and pace of recovery of the dairy sector. This situation also raises serious concerns regarding the distribution of value-added in the chain between farmers, milk processing factories, the dairy industry and retailers.

Graph 2 Price index developments at different stages of the EU dairy supply chain (Jan 2000=100)



Note: The consumer prices for the "milk, cheese and eggs" category do not cover the consumer price of butter.

Improvement in the effectiveness and efficiency of the dairy supply chain appears essential to raise its competitiveness, to mitigate the fall in the producer prices and to ensure that price changes are passed on to final consumers. This will hinge on addressing certain issues, notably the lack of comprehensive and reliable data on prices and margins in the whole food chain. Greater transparency, a better understanding of value-added distribution and price transmission, and a clearer view of the structural factors would be a significant first step in identifying the appropriate measures which could contribute to improve the efficiency of the dairy supply chain and secure a fair outcome for each actor (see point 10). This could in turn contribute to enhance the countervailing power of the actors concerned.

3.4. Market developments: short to medium term

The short-term perspectives remain dominated by the economic crisis. Prospects for cheese and value-added fresh dairy products markets are determined by restrained EU and world demand and show a production decline in 2009 and marginal improvement in 2010 driven by a slight demand recovery. As a sufficient revival in the EU and world market prices is not expected in the short term, the accumulation of intervention stocks for butter and SMP is projected to continue in 2009 and 2010. Furthermore, export refunds can for the time being contribute to balance the EU market, although low world demand and strong competition from lower-priced exporters limit EU export potential.

The medium- and long term outlook for the EU dairy market is expected to remain positive in the light of the eventual economic recovery, which should help supporting the growth in demand for higher value added dairy products.

4. DEMAND SIDE

4.1. Action taken by the Commission: market support measures

The Commission rapidly recognised the seriousness of the dairy market situation due to the expected seasonal increases of milk deliveries in the first half of the year and so decided on a pro-active support policy:

a) Private storage aid for butter started at the beginning of January, two months earlier than usual. It is open until 15 August and up to 28 June, 105 800 t had been stored, 14 000 t less than 2008.

b) Export refunds were reactivated for all dairy commodities to the usual destinations on 23 January (in full compliance with the EU's international commitments). Since the introduction of refunds the EU has been able to maintain exports at about the same level as the previous year. However, in June, there has been a sharp drop in the demand for export certificates, which might point to a further weakening of world market demand.

c) Intervention buying started on 1 March for butter and SMP:

– 81 900 t of butter have been bought, about 8% of January-June production of butter. Beyond the 30 000 t fixed price ceiling, bids were accepted up to a 99.2% of the fixed reference price of EUR 2 218/t.

– 231 000 tonnes of SMP were bought, about 43.5% of January-June 2009 production of SMP. Beyond the 109 000 t fixed price ceiling, bids were accepted up to a maximum price of 98.9% of the fixed reference price of EUR 1 698/t. Payments have also been advanced by 2 to 3 months.

The butter stock of 81 900 t is equivalent to 1.1% of EU milk production, and the SMP stock of 203 000 is equivalent to 1.8% of EU milk production.

4.2. Budgetary consequences

The estimated total cost of the measures taken to date is about EUR 350 million. A major part of this expenditure has not been paid yet (e.g. the lag in payment of refunds after issuing certificates). However, the estimated total costs of the measures foreseen including prolonging intervention (see point 5) is more than EUR 600 million.

4.3. Other measures to support milk production outlets

a) Marketing standards

Community law definitions require dairy products (including milk, butter, cream, whey, yogurt and cheese) to be 100% dairy-based. The appearance on the market of substitute products like so-called "analogue" cheese or ice cream where milk fat is replaced by vegetable oils further erodes the market outlet of dairy products.

As regards existing dairy denominations Member States need to pro-actively take action to enforce the dairy definitions to prevent further damage to the dairy market.

b) Other measures

With regard to school milk, the scheme has been recently adapted, making it simpler, extending it to secondary school and increasing the product coverage. As to the latter discussion are on going to make the scheme more attractive (for example adding products with 75% milk and 25% fruit content). As regard aid for SMP for feed, the analysis shows that such a production aid is economically not justifiable (see further details in CSWD).

5. FURTHER COMMISSION ACTION TO SUPPORT DAIRY AND OTHER FARMERS

a) Advanced direct payments

The Commission will allow Member States to pay up to 70% of direct payments from 16 October instead of from 1 December. Member States may also grant *de minimis* state aid or loans at market conditions to help milk producers with liquidity problems.

b) Promotion

The Commission will propose, to a July Management Committee, an additional round of dairy product promotion programmes on the internal market with submissions to the Member States by 30 September, forwarding to the Commission by 15 October, and Commission decisions by 15 December (see further details in CSWD).

c) Intervention

On 13 July the Commission presented a proposal to continue butter and SMP intervention buying after August, on a temporary basis for 2009/10 and potentially 2010/11.

Intervention stocks will remain in store until the internal or world market is able to absorb them without disturbance.

d) Private storage

Private storage will be extended beyond 15 August.

e) Refunds

The Commission will continue to provide export refunds on an objective basis for as long as needed bearing in mind ongoing international negotiations.

f) Quarterly report

The Commission will report on the dairy market to the Council every quarter.

6. 2010 CAP BUDGET

The Preliminary Draft Budget for 2010 leaves a theoretical margin of manoeuvre of EUR 1 000 million for market measures and direct aids but EUR 300 million of this amount must, in line with sound budgetary management, be kept under the sub-ceiling. The Council and the European Parliament will decide later this year on the final 2010 budget along with the still outstanding decision on the financing of the EUR 2 400 million in the European Economic Recovery Plan. The Recovery Plan already foresees that an additional EUR 420 million must be reserved in Heading 2 in 2010 for rural development, including measures for restructuring the dairy sector.

The possibility to finance new measures in the dairy sector in budget year 2010 therefore seems quite limited. As part of the annual budget procedure in autumn, the Commission will of course examine all consequences for the 2010 budget in the Amending Letter for agricultural expenditure. In budget year 2011, the margin of manoeuvre is similarly limited, mainly due to the phasing in of the EU-12 direct aids.

7. MEASURES TO REDUCE SUPPLY

7.1. Changes to quota regulation

Quota system changes would not respect the outcome of the Health Check since these matters were discussed in depth during its negotiation which would exclude ideas such as a 5 % quota reduction or a freeze on quota increases. Such measures would have no immediate effect, since they could not be applied before the new quota year on 1 April 2010 due to the legitimate expectations of producers.

7.2. Quota management on an individual producer level

Much subsidiarity is already built into the dairy quota system allowing Member States to manage national quotas based on objective criteria and their specific need and structures (see CSWD).

Regarding application of quotas at individual level under current Community law there are two situations:

1) If the national quota is exceeded, Member States may use the excess of contributions paid by producers to finance voluntary retirement from milk production or redistribute it to priority groups, but

2) If the national quota is not exceeded the advances collected by Member States are reimbursed to individual producers.

An option would be, on a temporary basis, to allow Member States to use the advances collected also in the second case. This would give Member States the possibility to apply a brake to production by penalising those producers exceeding their individual quota in favour of a restructuring of the dairy sector. The Commission will reflect on the most efficient way on how to implement this.

7.3. EU Cow Slaughter Scheme

The most direct way to reduce supply is to eliminate production before it takes place by reducing cow numbers (not necessarily whole herds). However an immediate effect can only be reached by slaughtering cows with an EU subsidy. It will be difficult to justify spending taxpayers money for such a measure. (See further details in the CSWD).

8. MEASURES TO SUPPORT INCOME

8.1. Increasing intervention prices

Current market prices have for the first time since 2003 reached the lower intervention price level decided during Agenda 2000 and 2003 reform. However increasing intervention prices is not an option. Such a policy would be a total reversal of the last 15 years of CAP reforms towards market orientation and ensuring that the reduced intervention prices work as a safety net for exceptional circumstances and not a permanent feature of the market. It would certainly not be in line with the Health Check, since it would increase the value of quota contrary to the objective of reducing it as we approach the end of quotas.

Further there would be a political as well as a practical problem as dairy farmers have received a decoupled payment (3.5c/kg) on the basis of the reduced intervention prices. The decoupled amounts cannot be returned as many farmers have stopped dairy farming between 2004 and today and the dairy premium is included in the single farm payment.

8.2. Redistribution of direct aids – specific support

The provisions provided for in Article 68 of Regulation (EC) No 73/2009 will allow a certain degree of redistribution of direct payments between farmers, sectors and regions within a Member State. Member States may set up schemes to improve quality and marketing of agricultural products and enhance the environment or animal welfare. More specifically and to buffer the consequences of the phasing out of milk quotas, Member States can establish specific aids for vulnerable areas or vulnerable types of farming in the dairy sector.

Member States have the possibility to apply decoupled measures (granting new SPS payment entitlements or increasing its value) in areas under restructuring or development programmes, up to a level of 10% of the SPS and SAPS envelope, representing about EUR 4 000 million.

Within this limit of 10%, 3.5% can be coupled, representing about EUR 1 400 million.

Member States decisions on specific support for 2010 are needed by 1 August 2009. However, Member States that would wish to apply specific support as from 2011 could still decide so by 1 August 2010. The Council regulation allows Member States to revise their decisions by 1 August 2011. If this creates difficulties it could be considered to make these provisions more flexible.

The Health Check also enlarged the scope of state aid to dairy farmers. In order to avoid reducing the payments to farmers more than necessary, Member States are allowed to finance up to 55%, within the 3.5% limit, by way of specific state aid to dairy farmers.

8.3. State aids

As a consequence of the financial crisis, farmers encounter increased difficulties to obtain credit. The Temporary Framework for State Aid measures to support access to finance foresees that aid not exceeding a cash grant of EUR 500 000 can be granted to undertakings until 31.12.2010, but at the moment excludes primary agricultural producers. Any *de-minimis* aid already received by individual undertakings since the beginning of 2008 has to be deducted from this amount. In light of the exceptional and transitory financing problems linked to the financial crisis, a modification providing a similar possibility for farmers, but at a substantially lower level in order to avoid distortion of competition in the agricultural sector could be examined.

For farmers a separate limited amount of aid could be introduced by modifying point 4.2.2 of the Temporary Framework. An amount of EUR 15 000 could be appropriate to limit distortions of competition between farms located in different Member States. This aid would benefit all producers, not just dairy. An urgency procedure would be possible for the modification of the Temporary Framework and the subsequent approval of the national aid schemes notified to the Commission under Article 87(3)(b) of the Treaty.

(See further details in CSWD)

9. RESTRUCTURING OF THE DAIRY SECTOR

The CAP has a number of instruments available to help restructuring in the dairy sector. These are available to Member States as an option.

9.1. Rural Development

Rural Development policy does not aim at immediate income support but provides options to support dairy farmers to become more competitive and to keep milk production in traditional dairy regions where it contributes to maintain the countryside.

EU rural development funds in 2007-13 are EUR 91.3 billion with about EUR 70 billion more of national public support. The Health Check and Recovery Package have added EUR 4.2 billion to address new challenges. "Dairy restructuring" has been identified as one of the new challenges.

Options under rural development for dairy producers include:

– Investment support, e.g. to improve the efficiency of milk production or enhanced animal welfare,

– Payments for dairy farmers in Less Favoured Areas,

– Support for environmentally friendly forms of dairy production, e.g. organic production, grassland management with reduced fertiliser use or mountain pasture management,

– Support for specific livestock-keeping practices improving animal welfare e.g. grazing premiums,

– Support diversification their activities, e.g. support for on-the-farm shops or renewable energy production,

– Support for dairy farmers who would like to leave the sector including possibly early retirement.

Moreover, as a further element for the restructuring of the dairy sector Members States could promote the formation of strong producers organisation in the dairy sector.

9.2. Other restructuring Measures

As mentioned in 8.2, restructuring in the dairy sector can also be encouraged by granting specific support under Article 68. The Temporary Framework for State Aid measures to support access to finance provides for the period until end of 2010 further aid instruments (notably subsidised interest rates and loan guarantees) which can be used to stimulate the restructuring process. Moreover, as noted in 7.2, Member States may use the excess to finance voluntary retirement from milk production or redistribute it to priority groups.

10. MARKET TRANSPARENCY AND COMPETITION

The market analysis above underlines current concerns about price transmission and the distribution of value-added in the dairy food chain between producers, processors and retailers. The best way to tackle such concerns would be effective and efficient functioning of the supply chain, in particular by enhancing market transparency and helping a fairer market operation. Competition Authorities at EU and national level should remain vigilant and effectively cooperate with a view to addressing any potential anti-competitive practices which may affect dairy markets. Farmers should be actively encouraged to work together to improve the efficiency of their operations by increasing their economies of scale and scope. This could also contribute to strengthen their countervailing power vis-à-vis larger processors and retailers. The dialogue between all actors in the food chain could also be further stimulated including a possible adoption of a European-wide code of conduct as recommended by the High Level Group on the Competitiveness of the Agro-Food Industry. But there can be no place for anti-competitive measures such as price-fixing and production restraints, which amount to hardcore cartels, national product labelling or national origin requirements.

10.1. Market transparency

The Commission is implementing the roadmap proposed in its Communication on Food Prices in Europe. The final report is expected at the end of 2009 including a specific analysis of the food chain in the dairy and pig meat sectors.

Without anticipating its full scope, it is worth noting that more transparent price information may facilitate competition law enforcement and consumers' choice. A permanent Europe-wide system for monitoring food prices could be set up, with comparable price and quality information at producer, processor and retail levels, as planned in the roadmap. This should cover all sectors, not just dairy, using statistical reporting mechanisms run by Eurostat.

Meanwhile, it would not seem useful to replicate the reporting of price data to Eurostat by Member States (to the extent that they currently collect such data) by the creation of *ad hoc* systems in the dairy sector. Member States could nevertheless reinforce their own statistical services to gather more complete data at all levels of the food chain.

10.2. Competition

The Commission, led by DG Competition, is examining potential anti-competitive practices in the food supply chain, especially the dairy sector. Competition policy plays a key role in maintaining a level playing field and ensuring that competition is not distorted in the sector. If the Commission finds competition is not functioning, it will not hesitate to act using all its powers under the Treaty. National competition authorities have similar powers and must play an equally important role in applying competition law due to the particularities of national markets. Therefore, co-operation and exchange of best practices between these services will be strengthened formally by a reinforced dialogue in the European Competition Network and by further informal discussions. A fast-track survey on dairy markets has been recommended to the ECN Food Sub-group meeting in early July, to stimulate and co-ordinate simultaneous monitoring and data collection by national competition authorities and a working group will be set up to that end.

Actors in the market should also look to improve its efficiency. Many dairy farmers are already organised in processor cooperatives that could look for better ways to adapt their members' milk supply to existing and future demand. Dairy farmers could also co-operate more effectively through producer organisations to increase their countervailing power vis-à-vis processors and retailers.

Inter-branch organisations – involving all the actors in the dairy food chain – could also foster a useful dialogue between all the players active in dairy markets. However, initiatives such as the above remain subject to the limits and conditions laid down in the competition rules applicable to the agricultural sector and it would be unprecedented and highly undesirable to allow anti-competitive practices in any sector.

In its Retail Monitoring communication the Commission is also examining best practices across Member States in terms of contractual relations between suppliers and retailers. This should help identify means to improve and render more transparent contractual terms between for example farmers co-operatives and the retail sector.

Member States could use the possibilities under Community law to encourage the formation of producer organisations in the dairy sector. To go further, to allocate specific financial support for the operating costs of producer or marketing organisations:

– At Community level, Council legislation and additional financial resources would be needed. Funds for olive oil and hops organisations were originally taken from direct payments in those sectors. There is a specific budget for fruit and vegetables where all the sector-specific support is paid via the operational programmes of producer organisations. The current scope under the direct payments legislation for such support is very limited, even under specific support measures since these require support to be paid directly to farmers and not to producer organisations,

– at national level it can be done by state aid authorisation. Start-up aid for producer groups for up to 5 years and EUR 400 000 in total is already allowed under the Agricultural Block Exemption Regulation and the Agricultural State Aid Guidelines. Those rules could be amended to allow more long-term aid and/or higher amounts.

11. CONCLUDING REMARKS

The Commission is committed to continue to support dairy farmers and stabilise the dairy market with the means at its disposal.

The catalogue of measures shows that the Member States have a considerable number of instruments available to them to alleviate the situation, to assist in the restructuring process and contribute to a soft landing for the dairy sector in light of the disappearance of quotas on 1 April 2015.

The European Council has asked for possible options for stabilising the dairy market, while respecting the outcome of the Health Check and thereby excluding policy changes for the dairy sector due to short-term difficulties.

Putting this policy into question, would only create uncertainty, delay the restructuring process and render no service to the many dairy producers who need clear guidance as they plan for their future. A steady course must be kept with the long-term perspective in mind.