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HAVE THE MANAGEMENT  
INSTRUMENTS APPLIED TO THE  
**MARKET IN MILK AND MILK PRODUCTS**  
ACHIEVED THEIR MAIN OBJECTIVES?



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Special Report No 14 // 2009

# HAVE THE MANAGEMENT INSTRUMENTS APPLIED TO THE MARKET IN MILK AND MILK PRODUCTS ACHIEVED THEIR MAIN OBJECTIVES?

(pursuant to Article 248(4), second subparagraph, of the EC Treaty)

EUROPEAN COURT OF AUDITORS  
12, rue Alcide De Gasperi  
1615 Luxembourg  
LUXEMBOURG

Tel.: +352 4398-1  
Fax: +352 4398-46410  
E-mail: [euraud@eca.europa.eu](mailto:euraud@eca.europa.eu)  
Internet: <http://www.eca.europa.eu>

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# ABBREVIATIONS

**CAP:** common agricultural policy

**CMO:** common market organisation

**COPA-COGECA:** *Comité des organisations professionnelles agricoles — Confédération générale de la coopération agricole*, Committee of Professional Agricultural Organisations in the European Union — General Committee for Agricultural Cooperation in the European Union (Brussels)

**EDA:** European Dairy Association (Brussels)

**EU:** European Union

**Eurostat:** Statistical Office of the European Communities

**FAO:** Food and Agriculture Organisation of the United Nations (Rome)

**OECD:** Organisation for Economic Cooperation and Development (Paris)

**SMP:** skimmed milk powder

**USDA:** United States Department of Agriculture

**WTO:** World Trade Organisation (Geneva)

**ZMP:** *Zentrale Markt- und Preisberichtsstelle GmbH*, Central market and price reporting office in Germany (Bonn)





# GLOSSARY OF KEY TERMS ASSOCIATED WITH DAIRY POLICY

**Milk equivalent:** amount of milk used to manufacture a milk product.

**Target price:** price fixed by the Council corresponding to the desired level of payment for producers. The 2003 CAP reform abolished the milk target price and established a direct payment decoupled from production as a producer income support.

**Intervention (or reference) price:** for butter and skimmed milk powder (SMP): prices fixed by the Council at 246,39 euro/100 kg for butter and 174,69 euro/100 kg for SMP from 1 July 2007. The intervention agencies may intervene (public storage) if there is market disequilibrium by buying butter and/or SMP during the intervention period (1 March to 31 August) if market prices fall below a certain level (92 % and 100 % of the intervention price for butter and SMP respectively). The purchases are made at 90 % and 100 % of the reference price for butter and SMP respectively. The intervention is suspended when the market price recovers or when stocks reach the ceiling authorised by the Council (30 000 tonnes for butter and 109 000 tonnes for SMP). However, the Commission may authorise purchases above these amounts using a tendering procedure.

**Delivery quota:** milk delivered by producers to approved purchasers. Normally, the milk is collected by dairies.

**Direct sales quota:** milk sold or transferred directly by producers to consumers and other dairy products sold or transferred by producers.

**2003 reform:** CAP reform based on an agreement reached in Luxembourg on 26 June 2003, reinforcing the process begun in 1992 (McSharry reform), and confirmed in 1999 (Agenda 2000 reform), which aimed to reduce price support and compensate for this reduction by direct income aid. The 2003 reform introduced the decoupling of aid and conditionality while reinforcing rural development assistance.

# SUMMARY

## I.

Milk production is of major importance in the European Union's agricultural economy. More than one million producers supply 148 million tonnes of milk annually with an approximate value of 41 000 million euro at the farm gate. The milk processing sector employs around 400 000 people and generates turnover of 120 000 million euro. Milk fat and proteins are put to use in the production of cheese, butter and drinking milk.

## II.

The EU has put in place a dairy policy which aims essentially to achieve equilibrium on the milk market, stabilise prices, ensure a fair standard of living for producers and improve their competitiveness. The milk CMO, which has been in existence since 1968, has been profoundly influenced by the introduction of milk quotas in 1984. The 2003 reform continued the Agenda 2000 programme and marked the beginning of sector liberalisation by weakening the price support mechanism and introducing direct income support. The health check in 2008 confirmed that liberalisation of the milk sector would continue with quotas to be dismantled by 2015. Total expenditure for the milk sector rose from 2 750 million euro in 2005 to around 4 500 million euro in 2007. This figure includes an estimated amount for direct aid, which has been integrated in the single farm payment.

## III.

The Court's audit considered how effectively the Commission manages the market for milk and milk products with reference to the main objectives of EU dairy policy.

## IV.

With regard to market equilibrium, the Court concludes that milk quotas have imposed strict limitations on production but that their level proved to be too high for a long period of time compared to the market's capacity to absorb the surpluses. The Community had to finance surplus industrial production (butter and powder). For a long time, the Community delivery quota had been very marginally exceeded, but since 2004, there has been consistent under-usage of the quota. In the 2007/2008 marketing year the under-usage was the equivalent of 1 % of total quota for the EU-27. The current quota regime no longer really represents a restriction on production except in a small number of Member States. Measures to aid disposal which aimed at encouraging consumption of milk fat (butter) or milk proteins (milk powder) on the European market have played only a minor role in the last few years.

## V.

As for the objective of stabilising prices, the Court finds that the nominal milk producer price varied little during the 1984–2006 period compared with the period before the introduction of quotas. However, in real terms, the milk producer price has fallen continuously since 1984. The producer price for milk and the consumer price do not follow parallel trends because they are subject to different parameters. Between the beginning of 2000 and mid-2007 nominal consumer prices for milk products increased by 17 % while the nominal price paid to the producer fell by 6 %.

## SUMMARY

### VI.

As far as the objective of guaranteeing the incomes of producers is concerned, the Court notes that the incomes of milk producers remain slightly above average farm incomes, which have followed a downward trend in real terms. Assistance measures are a major and increasing part of milk producers' incomes but this varies considerably between the Member States. The effect of the restructuring of the dairy sector and the steady fall in the number of holdings is that the statistical average for producer incomes remains unchanged. The EU-15 lost half its dairy farms between 1995 and 2007; more than 500 000 producers gave up during this period.

### VII.

Considering the objective of competitiveness, the Court finds that the EU share of world trade in milk products has been declining since 1984. European export assistance for milk products has been considerably reduced during the last few years. The fact is that European producers of basic milk products (butter and milk powder) have only been competitive on world markets when prices have been high. When this was not the case, they exported with assistance from the Community budget. World prices have less impact on exports of high added value products such as cheeses.

### VIII.

In the context of the progressive liberalisation of the European dairy sector, the Court must emphasise the importance of three factors which deserve the attention of the Commission and Member States:

- the instability of the markets, which is likely to lead rapidly to new large surpluses;
- the increasing pace of restructuring, with the risk of a geographical concentration of production as large numbers of producers disappear from less-favoured areas;

- and lastly, the issue of the competitiveness of the European milk sector, which depends on its ability to adapt to world demand in terms of the price and quality of its products.

### IX.

Taking these factors into consideration, the Court recommends:

- that monitoring the development of the market in milk and milk products should continue, so that liberalisation of the sector does not lead once again to over-production;
- that the price formation process in the food industry should be subject to regular monitoring by the Commission. The concentration of processing and retailing companies must not reduce milk producers to 'price-takers', and must not restrict opportunities for final consumers to benefit fairly from decreases in prices;
- that in-depth reflection should be given to strategies to tackle the special problems of those regions where milk production is most vulnerable, in particular in mountainous areas, and to tackle the environmental consequences of a geographical concentration of milk production;
- that efforts should be continued to focus milk production, as a matter of high priority, on meeting the needs of the domestic European market and, in addition, on producing cheeses and other high added value products which can be exported on the world market without budgetary support.

# INTRODUCTION

## THE MILK AND MILK PRODUCT MARKET

1. Milk is one of the main agricultural products of the European Union; more than one million farms produce 148 million tonnes annually with an approximate value of 41 000 million euro, which is 14 % of the value of European agricultural production (EU-25, 2006)<sup>1</sup>. More than 60 % of beef and veal produced in Europe comes from dairy farms<sup>2</sup>. The European Union is the world's biggest producer of milk (27 %), ahead of India (20 %) and the United States (16 %) and well ahead of Oceania (5 %)<sup>3</sup>.
2. Milk processing employs around 400 000 people in Europe with total turnover of approximately 120 000 million euro<sup>4</sup>. Raw milk delivered to dairies is processed into a wide range of products for both human and animal consumption, or for use in industry (**Figure 1** and **Annex I**). Cow's milk is essentially made up of water, lactose, fats and proteins. Separating the fat from the proteins produces butter and skimmed milk, the latter being mainly used for making skimmed milk powder and casein. Cheeses, fresh milk products, concentrated milk and whole milk powder are made up of both fats and proteins. The main use of raw milk is in cheese-making, ahead of butter and drinking milk. In 2008, 46 % of the protein and 34 % of the fat taken from the milk collected in the EU-27 was used to produce cheeses; drinking milk accounted for 23 % of the protein and 13 % of the fat, while butter used up 32 % of the fat and virtually no protein. It should be noted that although butter production requires more milk than the production of drinking milk, the latter is nevertheless a more effective end use as it uses both the protein and the fat in the milk.

<sup>1</sup> International Dairy Federation, *Production of cow milk*, 2007 <http://www.fil-idf.org>. European Commission, *Agriculture in the European Union — Statistical and economic information*, 2008.

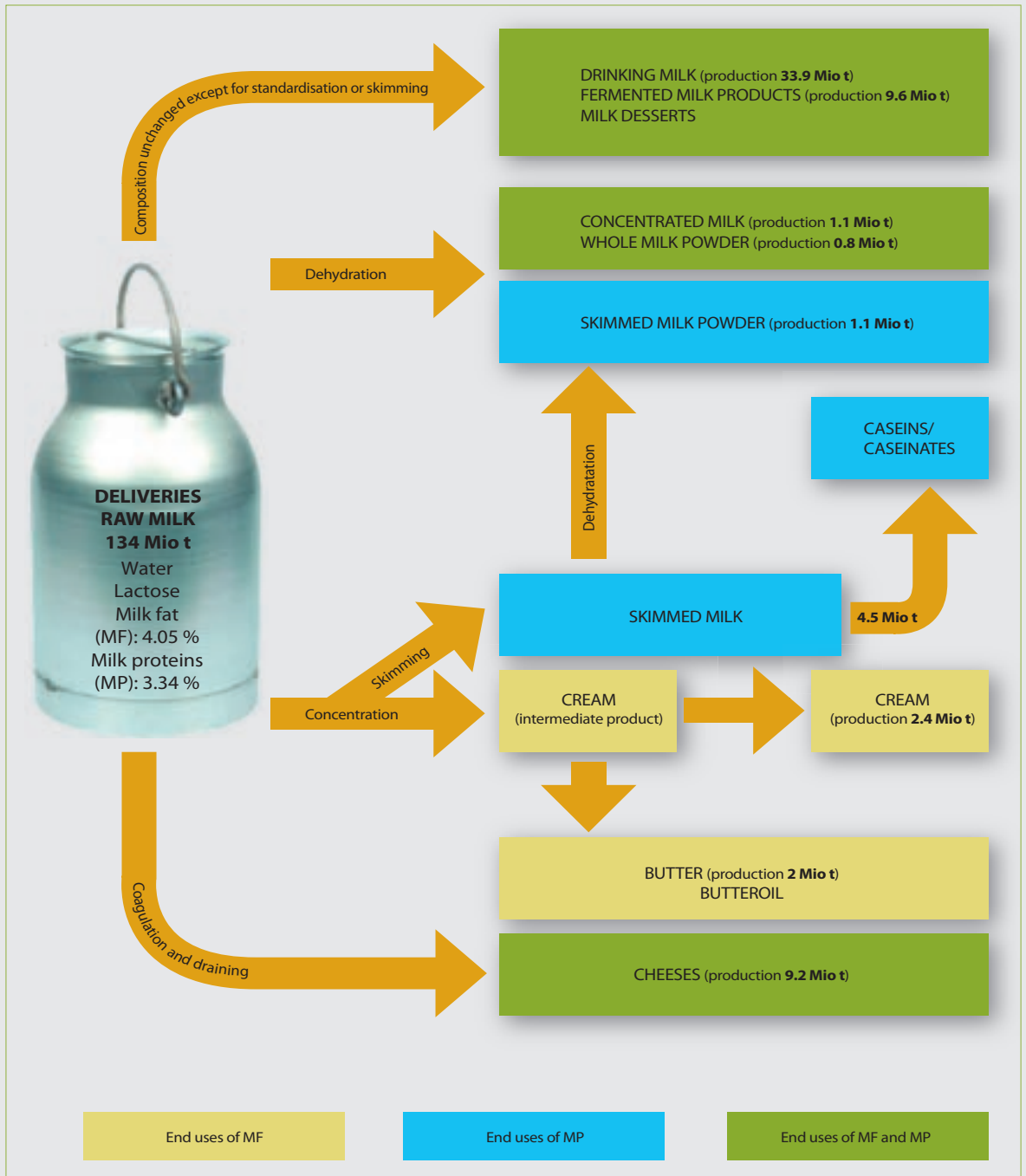
<sup>2</sup> Ernst and Young, *CMO for beef and veal. Evaluation of market measures in the beef and veal sector*. Final report, December 2007.

<sup>3</sup> International Dairy Federation, *Production of cow milk*, 2007, <http://www.fil-idf.org>.

<sup>4</sup> Eurostat, 2006 data.

FIGURE 1

THE MAIN END USES FOR MILK DELIVERED TO DAIRIES



Source: ZMP statistics (EU-27, 2007).

## THE OBJECTIVES OF THE COMMUNITY DAIRY POLICY

3. The Community dairy policy, as is the case with other agricultural sector policies, is based on the global objectives set out in Article 33 of the Treaty establishing the European Community<sup>5</sup>. Because of the difficulty of fulfilling all these objectives simultaneously, their order of priority in respect of the organisation of the markets may change over time<sup>6</sup>. The rules governing the CMO in milk explicitly refer to the following four objectives:

- to provide equilibrium to the milk market. Equilibrium refers to matching supply to demand on the milk market and reducing structural surpluses<sup>7</sup>;
- to stabilise the prices of milk and milk products. Stability can be evaluated on the basis of changes in producer prices<sup>8</sup>. Changes in consumer prices also give some indication of the impact the CMO is having on consumers;
- to ensure a fair standard of living for the agricultural community<sup>9</sup>. An improvement in the incomes of individual farmers can be obtained by increasing farm productivity. Structural adjustments are an integral part of the CMO in milk even if the application of agricultural policy must take into account the necessity of carrying out such adjustments gradually<sup>10</sup>;
- to improve the sector's competitiveness on international markets<sup>11</sup>. Competitiveness must be attained by, among other things, aligning European prices with world market prices, which are structurally lower. The competitiveness objective has become one of the main priorities of Commission action since the decision was taken in 2003 to reduce the level of market support and to introduce direct income support for milk producers.

<sup>5</sup> According to Article 33 of the EC Treaty, the objectives of the common agricultural policy are:

- a) to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;
- b) thus to ensure a fair standard of living for the agricultural community, in particular by increasing the individual earnings of persons engaged in agriculture;
- c) to stabilise markets;
- d) to assure the availability of supplies;
- e) to ensure that supplies reach consumers at reasonable prices.

<sup>6</sup> The Court tackled this question in Special Report No 2/99 on the effects of the CAP reform in the cereals sector, OJ C 192, 8.7.1999. Moreover, according to Court of Justice case-law, 'the Community institutions must secure the permanent harmonisation made necessary by any conflicts between those objectives taken individually and, where necessary, give any one of them temporary priority in order to satisfy the demands of the economic factors or conditions', judgment of the Court of 19 March 1992 in Case C-311/90, *Josef Hierl v Hauptzollamt Regensburg*, Grounds (13), *European Court Reports* 1992, p. I-02061.

## MANAGEMENT INSTRUMENTS

4. The common market organisation (CMO) in milk and milk products, which entered into force in 1968, was one of the first CMOs under the common agricultural policy (CAP). There have been many reforms, the most radical of which was the introduction of milk quotas in 1984 to deal with structural surpluses resulting from the imbalance between supply and demand for milk and milk products<sup>13</sup>. In accordance with the decisions contained in the Agenda 2000 action programme, the 2003 reform initiated the liberalisation of the milk sector by reducing price support<sup>14</sup> and creating direct income support. In 2007, as part of the simplification of Community rules, the Council included all the milk sector regulations in a single common market organisation for all regulated agricultural production<sup>15</sup>.
5. In addition to the ceiling on production through the use of quotas, the 2003 reform retained most of the traditional market management instruments for the milk sector, i.e. internal support, protective measures at the external frontiers and export assistance (**Box 1**).

<sup>7</sup> Whereas (3) and (9) of Council Regulation (EC) No 1255/1999 of 17 May 1999 on the common organisation of the market in milk and milk products, OJ L 160, 26.6.1999, p. 48, and Whereas (19), (36), (43) and (60) of Council Regulation (EC) No 1234/2007 of 22 October 2007 establishing a common organisation of agricultural markets and on specific provisions for certain agricultural products (Single CMO Regulation), OJ L 299, 16.11.2007, p. 1.

<sup>8</sup> Whereas (2), (5), (9) and (25) of Regulation (EC) No 1255/1999 and Whereas (10), (19), (43) and (60) of Regulation (EC) No 1234/2007.

<sup>9</sup> Whereas (2) of Regulation (EC) No 1255/1999 and Whereas (10) of Regulation (EC) No 1234/2007.

<sup>10</sup> Article 33(2)(b) of the EC Treaty.

<sup>11</sup> Whereas (4) of Regulation (EC) No 1255/1999 and Whereas (16) of Regulation (EC) No 1234/2007.

<sup>12</sup> Whereas (4) of Regulation (EC) No 1255/1999 and Whereas (10) of Regulation (EC) No 1234/2007.

<sup>13</sup> Council Regulation (EEC) No 856/84 of 31 March 1984 amending Regulation (EEC) No 804/68 on the common organisation of the market in milk and milk products, OJ L 90, 1.4.1984, p. 10.

<sup>14</sup> The price support mechanism was weakened by the abolition of the milk target price, by the lowering of the intervention prices, by the increase of 1,5 % in national quotas and by the gradual reduction in the levy payable by producers if they exceeded their quota.

<sup>15</sup> Council Regulation (EC) No 1234/2007.

## MARKET MANAGEMENT INSTRUMENTS

The regulations in force since 2003 made provision for the following market management instruments:

- **the milk quota regime**, which the Council has extended until 31 March 2015. The scheme gives each Member State a national delivery quota for milk delivered to buyers (mainly dairies), and a national direct sales quota for direct sales and transfers of milk to consumers, and for all sales and transfers of other milk products. Producers receive individual quotas for their deliveries and/or their direct sales within the limits of national ceilings. If either national quota is exceeded, the Member State becomes liable to pay a 'levy' to the Community. The 2003 reform led to an increase in national milk quotas by 1,5 % (for 11 Member States of the EU-15) and set out a gradual reduction in the levy down to 27,83 euro per 100 kg (quota year 2007/08), a reduction which was proportional to the reduction in intervention prices;
- **public storage of butter and skimmed milk powder**, which is the instrument of direct intervention used to maintain market prices at a level near to 'intervention prices'. Purchases are nevertheless restricted to a certain period of the year (from 1 March to 31 August);
- **aid for private storage** of cream and skimmed milk powder (abolished in 2007), of certain butter products and certain cheeses in order to regulate the volumes on the market;
- **measures to aid disposal** on the internal market (chiefly in the form of aid for skimmed milk for animal feed, aid for processing skimmed milk into casein, aid for the use of butter in pastry products, and school milk). The aim of these forms of aid is to limit use of the intervention mechanism;
- regulation of foreign trade using **import levies**<sup>16</sup> and, when European prices are higher than world prices, **export refunds** for certain products;
- **income support for milk producers during the period 2004–07** (milk premium and additional payments), intended to partially compensate for the fall in milk prices following successive reductions in intervention prices<sup>17</sup>. Since 2007, there has been a mandatory requirement to decouple the milk premium and additional payments from production and include them in the single payment<sup>18</sup>.

The 2008 health check resulted in the following main adjustments: another increase in production quotas (see paragraph 48), abolition of seasonal storage aid for certain cheeses, abolition of aid for the use of butter in pastries, inclusion of accompanying measures for restructuring the milk sector in the list of priorities which Member States may incorporate in their national and regional rural development programmes and the possibility for the Member States to grant special aid to producers of up to 3,5 % of the amount of direct aid.

<sup>16</sup> The milk and milk products CMO initially consisted of a mechanism of import levies based on a 'threshold price'. This system was abandoned in 1995 (GATT Accords of 15 December 1993) and replaced by fixed customs duties.

<sup>17</sup> Articles 95 to 97 of Council Regulation (EC) No 1782/2003, OJ L 270, 21.10.2003, p. 1.

<sup>18</sup> Article 47(2) of Regulation (EC) No 1782/2003.

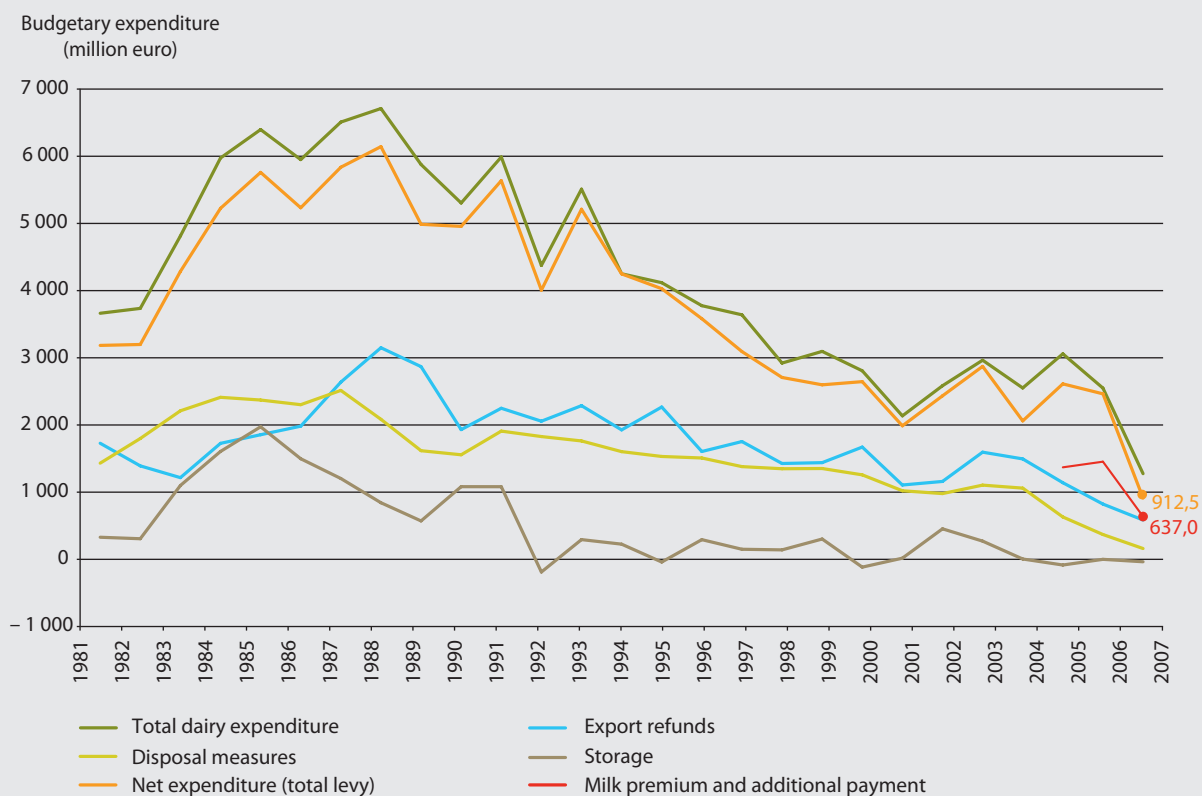


## BUDGET EXPENDITURE

6. Budget expenditure on market support for the milk and milk products sector fell considerably after the introduction of milk quotas, and even more in the period when the development of world prices made it possible to suspend the intervention mechanism, measures to aid disposal and export assistance (**Figure 2**).

FIGURE 2

### EU DAIRY EXPENDITURE (1981–2007)



Source: European Commission, Budget DG and Agriculture and Rural Development DG.

**7.** The 2003 reform had an impact on the organisation and interpretation of the budget. Expenditure on markets was separated from direct support for farmers as a result of the progressive introduction of decoupling. The dairy expenditure budget therefore only shows costs relating to market support. The dairy premium and the supplementary premium have been entered in the accounts as decoupled direct aid since 2005 for Denmark, Germany, Ireland, Luxembourg and the United Kingdom, since 2006 for Belgium, Spain, France, Finland and Italy, and since 2007 for the entire EU-15. In the new Member States<sup>19</sup> aid for milk producers was included in the per hectare flat rate paid on the basis of a simplified and transitional model single area payment scheme. As from the 2008 budget, direct aid to milk producers has been completely integrated in the single payment.

<sup>19</sup> Except in Malta and Slovenia, which opted to apply the normal single payment scheme as from 2007 at regional level.

<sup>20</sup> The Commission's replies to Special Report No 6/2001 on milk quotas.

<sup>21</sup> Expenditure under budget headings 050212, 05030216 and 05030217

**8.** In 2001, the Commission was still dismissing the idea of liberalising milk production using the model of the arable crop sector, on the grounds that the budgetary cost was too high<sup>20</sup>. Since then, the Commission has come down in favour of liberalisation in spite of its inherent cost. Available data in fact confirm that reorientation of the milk CMO will not result in any new budget saving, as explained below.

**9.** In 2005, net expenditure on the milk sector was more than 2 750 million euro, of which 50 % (1 370 million euro) was for the milk premium and additional payments<sup>21</sup>.

**10.** In 2007, in spite of the accessions in 2004, net expenditure recorded in the accounts under the budget headings relating to the milk sector did not total more than 912 million euro, of which 637 million euro were for the milk premiums and additional non-decoupled payments. For the same year, the total of milk premiums and additional decoupled payments is estimated to be 3 600 million euro. The total cost of the milk sector for the taxpayer therefore came to more than 4 500 million euro in 2007, or 64 % more than the expenditure entered in the 2005 budget<sup>22</sup>.

<sup>22</sup> In 2004, the OECD had come to the conclusion that the premium for milk products could only decrease taxpayers' 'welfare'. See *Analysis of the 2003 CAP reform*, OECD, Paris, 2004.

**11.** In 2014, when the new Member States receive the full payment, the milk premiums and additional decoupled payments alone might add up to more than 4 700 million euro. Expenditure on intervention, measures to aid disposal or export refunds will also have to be added, insofar as these market instruments have not been totally phased out. However, it should be noted that transition to decoupled aid could lead some beneficiaries to give up milk production.

# AUDIT OBJECTIVES AND APPROACH

- 12.** The audit considered how effectively the Commission manages the market for milk and milk products. The report therefore hinges on the following key question:

## HAVE THE MANAGEMENT INSTRUMENTS APPLIED TO THE MARKET IN MILK AND MILK PRODUCTS ACHIEVED THEIR OBJECTIVES?

More precisely, the audit dealt with the following specific questions:

- Has market equilibrium been achieved?
- Has the milk price been stabilised?
- What has been the impact on producers' incomes?
- Have European milk products become more competitive on world markets?

The Court also highlighted the most critical issues to be considered in the market liberalisation process, which among other things will involve withdrawal of the milk quota scheme.

- 13.** The audit findings are based on an analysis of the documentation available and interviews with the different stakeholders in the sector. The Court examined statistical material, articles, studies, activity reports and the results of previous evaluations and audits. Interviews took place with the Commission (Eurostat and Agriculture and Rural Development DG, Directorates C and D) and visits were made to bodies and associations which are active in the milk sector or which have expertise in this area. The aim was to complete the analyses made and test the relevance of the initial conclusions on the situation in the milk sector and its prospects, and on the management of the CMO<sup>23</sup>.

<sup>23</sup> Visits were made to the following organisations:

- the European Dairy Industry (EDA), which represents the interests of the European dairy industry towards the European institutions and towards international bodies like the World Trade Organisation or the Codex Alimentarius;
- COPA-COGECA, the Committee of Professional Agricultural Organisations in the European Union (COPA) and the General Committee for Agricultural Cooperation in the European Union (COGECA), which represent the political interests of European farmers and cooperatives in the European Union;
- Institut für Ökonomie der Ernährungswirtschaft (Institute of Food Business Economics);
- the International Farm Comparison Network;
- the Organisation for Economic Cooperation and Development (OECD).

Finally, the auditors attended two seminars on the future of the milk sector: the International Management Forum Milk (Riga) and the World Dairy Summit 2007 (Dublin), and they also attended information and consultation sessions organised by the Commission as part of the 2008 CAP health check.

# OBSERVATIONS

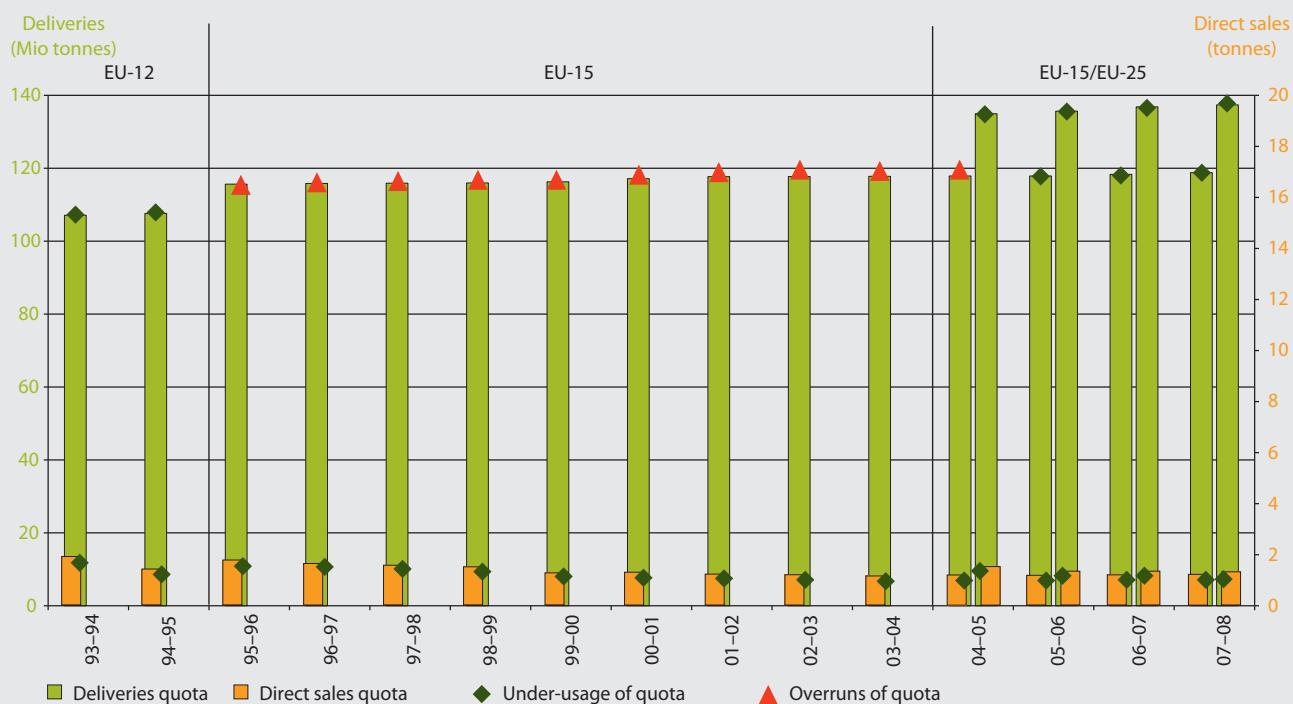
## HAS MARKET EQUILIBRIUM BEEN ACHIEVED?

### THE QUOTA REGIME HAS MADE IT POSSIBLE TO LIMIT MILK PRODUCTION...

14. As from 1984 most Member States managed fairly rapidly to bring the quantities of milk marketed in their territories, either in the form of deliveries or direct sales, into line with their respective quotas. After some initial reticence, the use of quotas was accepted by a majority in the sector as a powerful and politically acceptable instrument for regulating production. Since its introduction the system has been effective in the sense that, generally, Community production complies with the ceiling imposed. The fact that the production ceiling decided by the Council remained fixed for a long time at a level above that of internal demand certainly contributed to the scheme's acceptance.
  
15. *Figure 3* shows the recent development of the total of the national quotas allocated and their actual use by the Member States. During the period under review, the quota for deliveries was frequently exceeded in the EU-15, but the scale of the overrun was limited, i.e. less than 1 % for most of the 1995/96 to 2004/05 marketing years. In contrast, in the EU-25 and EU-27, for the 2004/05 and subsequent marketing years, the Community delivery quota was under-used (**Box 2**).

FIGURE 3

### UTILISATION OF THE COMMUNITY MILK QUOTA (MARKETING YEARS 1993/94 TO 2007/08)



Source: European Court of Auditors on the basis of replies by the Member States to the questionnaire specified in Article 26 of Commission Regulation (EC) No 595/2004.

## BOX 2

### A RECENT PHENOMENON: UNDER-USAGE OF THE COMMUNITY MILK QUOTA FOR DELIVERIES

Since the 2004/05 milk marketing year, the overruns of their delivery quotas by a number of Member States have no longer made up for the under-usage noted in the other Member States. For the EU-25, net under-usage came to 0,613 million tonnes for the 2004/05 marketing year (**0,5 %** of the quota), 0,524 million tonnes for the 2005/06 marketing year (**0,4 %** of the quota), 1,919 million tonnes for the 2006/07 marketing year (**1,4 %** of the quota). For the 2007/08 marketing year, under-usage amounted to 1,682 million tonnes for the EU-25 (**1,2 %** of the quota), and 2,222 million tonnes (**1,0 %** of the quota) for the EU-27.

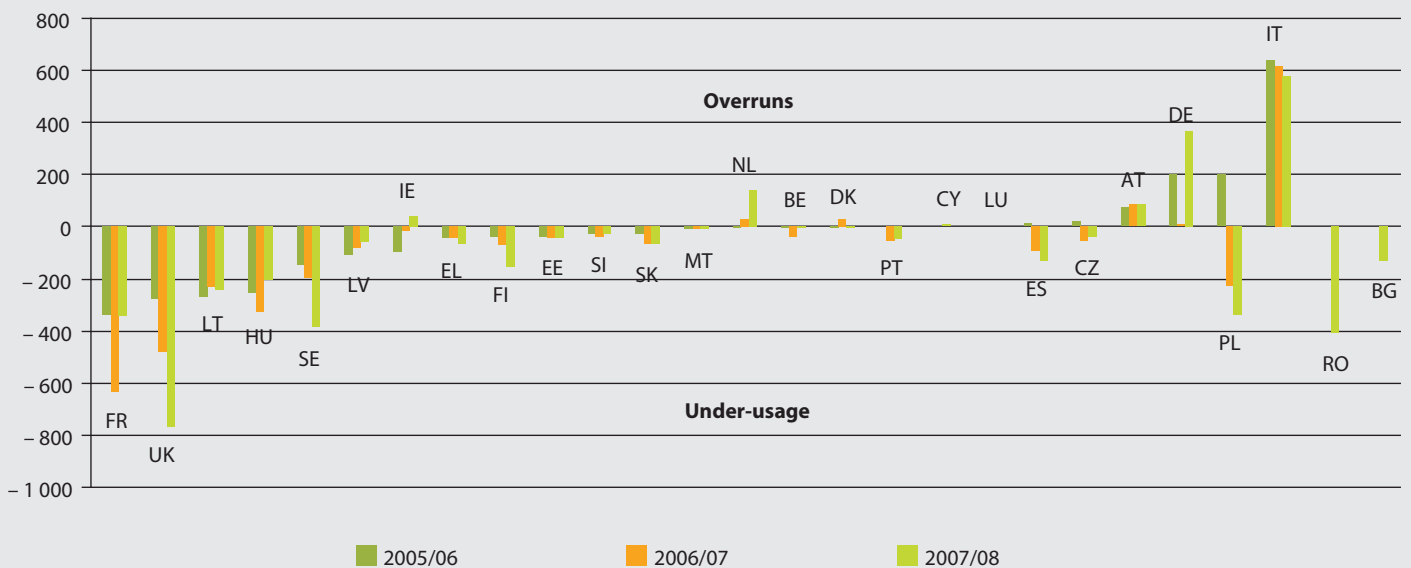
Obviously, the reasons for the under-usage of quotas vary according to the specific conditions in each Member State. No in-depth study has yet been made of the impact of decoupling aid on the abandonment of milk production.

16. At national level, certain constants can be observed. Recently (2002/03 to 2007/08 marketing years), the Member States most frequently exceeding their quotas have been, in the order of the size of the overrun, Italy, Germany, the Netherlands, Austria, Denmark<sup>24</sup>, Cyprus and Luxembourg. The major part of the total overrun has been repeatedly recorded in Italy (approximately 80 % for the 2006/07 marketing year). From the outset, the situation in Italy has been affected by the fact that its national quota was set, as for the other Member States, by reference to the quantities produced in the past, which were less than domestic consumption. Italy's production has been stimulated by its position as a net importer of milk and milk products, which explains the constant pressure on its national delivery quota. The United Kingdom, Sweden and, recently, France are the Member States making less and less use of the quota available to them (*Figure 4*).

<sup>24</sup> Although Denmark under-used its quota in the 2007/08 marketing year.

FIGURE 4

#### UTILISATION OF NATIONAL MILK QUOTAS (DELIVERIES IN 1 000 TONNES)



Source: European Court of Auditors on the basis of replies by the Member States to the quarterly questionnaire specified in Article 26 of Commission Regulation (EC) No 595/2004.

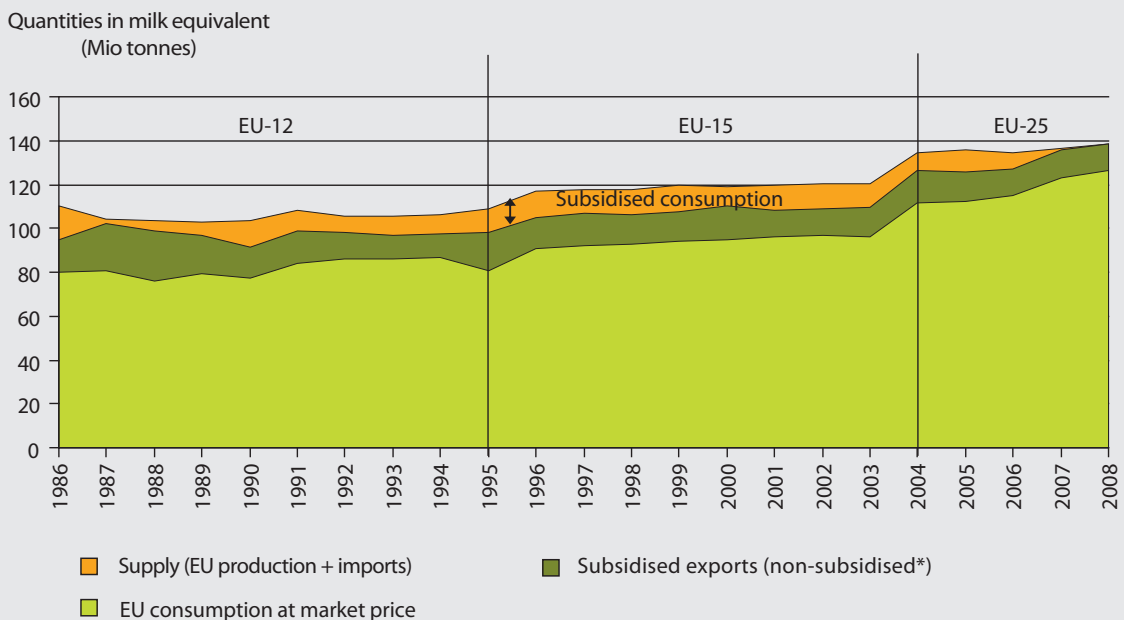
## ...BUT HAS NOT PUT AN END TO OVERPRODUCTION

17. Milk quotas imposed strict limitations on European milk production but for 20 years it has been necessary to resort to intervention buying, subsidised exports and aid to consumption in order to regulate the market as a whole and dispose of structural surpluses of industrial products<sup>25</sup>. From 1984 to 2004 the quota regime did not put an end to overproduction (**Figure 5**). Within the framework of the quota regime major structural surpluses subsidised by the taxpayer were not considered to be at variance with the objective of equilibrium.

<sup>25</sup> European Commission, DG VI, *Situation and outlook: Dairy sector. CAP 2000*, working document, April 1997. AND-International/ABTQ. *Evaluation of the CMO in 'Milk and milk products' and of the 'Quota' regulation*, Final report, March 2002.

FIGURE 5

### SUPPLY, CONSUMPTION AND SUBSIDISED QUANTITIES OF MILK PRODUCTS IN MILK EQUIVALENT (1986–2008)



\* Completely non-subsidised exports from 2006 to 2008: export refunds were set at zero on 16 June 2006 for skimmed milk powder, on 26 January 2007 for concentrated milk and whole milk powder and on 16 June 2007 for butter and cheeses.

Source: European Court of Auditors on the basis of ZMP and AND-International data.



**18.** In its Special Report No 6/2001, the Court found that quotas had been set at too high a level. European milk production was still in surplus because it had not been brought into line with consumption and non-subsidised exports, and this led the Court to recommend abolition of the milk quota regime<sup>26</sup>. The level of quotas has been corrected on a number of occasions to bring it more into line with demand but these adjustments were inadequate. In 2002, the Commission proposed extending the milk quota regime until 31 March 2015 considering that 'quotas would remain necessary to maintain a reasonable market equilibrium'<sup>27</sup>. Another argument in favour of retaining quotas was that by freezing production structures the quotas were helping to maintain the territorial distribution of milk production, particularly in less-favoured rural areas<sup>28</sup>.

<sup>26</sup> Special Report No 6/2001 of the European Court of Auditors, OJ C 305, 30.10.2001.

<sup>27</sup> European Commission, *Report on milk quotas*, Commission working document, SEC(2002)789 final of 10.7.2002.

<sup>28</sup> The Commission's replies to Special Report No 6/2001 on milk quotas.

**19.** As from 2004, and as a result of the 2003 reform, surpluses began to shrink because of the decline in the production of milk powder and butter in favour of cheeses and because of an increase in internal consumption, particularly in the new Member States. Nevertheless, in 2006, subsidised milk products still accounted for 15 % of European milk production but the level of aid was lower because of the reduction in the intervention prices for butter and skimmed milk powder. It was only as a result of a surge in world prices at the end of 2006 and in 2007 and of the continued growth in the consumption of cheese that the surpluses temporarily disappeared and this therefore made measures to aid disposal and export refunds unnecessary.

## MEASURES TO AID DISPOSAL HAVE HAD A LIMITED EFFECT ON MARKET EQUILIBRIUM

**20.** To support milk market equilibrium and to stabilise market prices, the milk CMO set out a variety of measures to aid disposal<sup>29</sup>:

<sup>29</sup> Whereas (19), (43) and (60) of Council Regulation (EC) No 1234/2007.

- private storage of cream, certain butter products and certain cheeses;
- provision of milk to schools;
- use of milk powder in animal feed;
- processing of skimmed milk into casein and caseinates;
- the use of butter under the butter for pastry/ice-cream products scheme.

**21.** After measures to aid disposal were set at zero in 2006 and 2007, recent growth in internal consumption of milk fat (butter, **Figure 6**) and milk protein (skimmed milk powder, **Figure 7**) indicates that the additional demand generated by measures to aid disposal had a limited effect on market equilibrium. The increase in consumption at market prices compensated completely (butter) or to a large extent (milk powder) for the reduction or disappearance of assisted consumption.

FIGURE 6

## BUTTER: SUBSIDISED CONSUMPTION IN 2006 AND NON-SUBSIDISED CONSUMPTION IN 2007 AND 2008

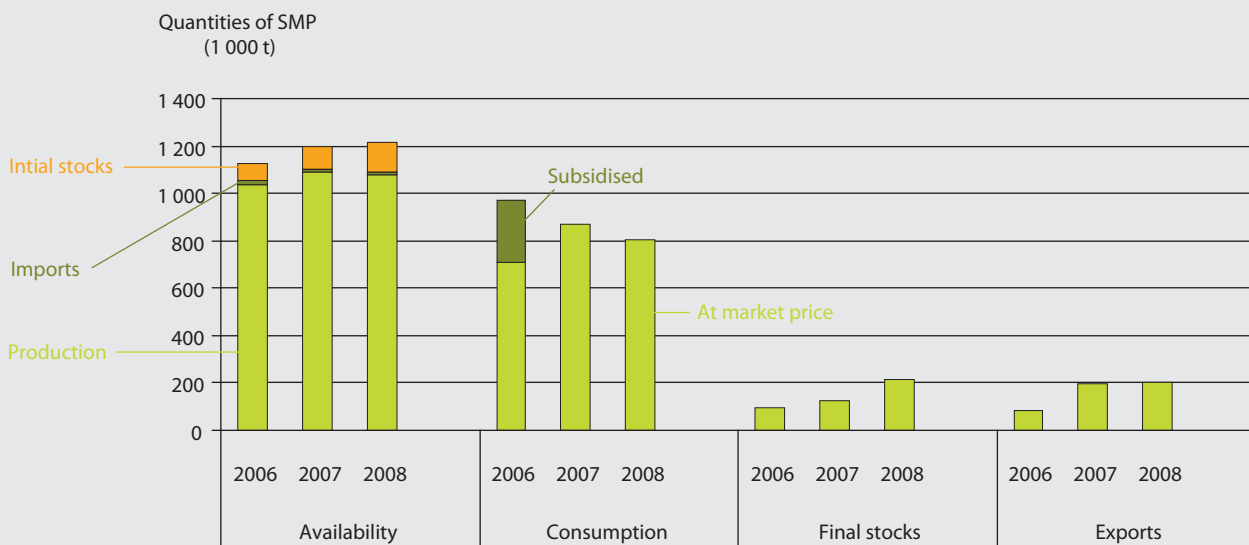


Date of aid being set at zero: 26 April 2007.

Source: European Court of Auditors on the basis of ZMP data.

FIGURE 7

## SMP: SUBSIDISED CONSUMPTION IN 2006 AND NON-SUBSIDISED CONSUMPTION IN 2007 AND 2008



Date of aid being set at zero: 26 October 2006.

Source: European Court of Auditors on the basis of ZMP data.

## HAS THE MILK PRICE BEEN STABILISED?

### PRODUCER PRICES: NOMINAL PRICES STABLE BUT IN DECLINE IN REAL TERMS<sup>30</sup>

#### MILK QUOTAS HAVE STABILISED NOMINAL PRICES

- 22.** The first phase of the milk CMO gave rise to an untenable situation. Until 1984, the effect of the CMO was to encourage investment and achieve a continuous increase in production. Producers relied on permanently rising nominal prices to finance expansion and were encouraged in this by the annual increase in the target price. The market situation created by the CMO in the period until 1984 was neither stable nor in equilibrium since there was a rise in nominal producer prices at the same time as massive overproduction. For producers, however, market growth was predictable and the expected price changes were always increases.
- 23.** Not until the introduction of milk quotas in 1984 did the CMO's management begin to take into consideration the objectives of stability and equilibrium at one and the same time. The milk quota system limited supply and allowed nominal prices to be maintained at a relatively high and stable level<sup>31</sup>. Allowing for seasonal variations, prices recorded in the EU for raw milk varied little during the 1984–2007 period compared with the period before the introduction of quotas. The average nominal price calculated by the Commission was 29 euro/100 kg in 2006; this average corresponds to a price range of between 20,1 euro/100 kg in Lithuania to 40,4 euro/100 kg in Cyprus<sup>32</sup>.
- 24.** **Figure 8** shows the growth in the average producer price in the five large milk producing countries, from 1971 until recently<sup>33</sup>. These Member States account for approximately 75 % (EU-15) or 65 % (EU-25) of milk deliveries.
- 25.** Overall, the objective of price stability had therefore been achieved after 1984. The priority given during this period to the stability of nominal prices is also reflected in the virtual stagnation of the target price, before its abolition in 2004.

<sup>30</sup> Nominal and current prices — including monetary inflation; real prices — monetary inflation deducted.

<sup>31</sup> Price volatility tends to fall in a system regulated by quotas: see in particular J.M. Boussard, *Price risk management instruments in agricultural and other unstable markets*, FEA 'Thursday seminar', Sao Paulo, October 2003.

<sup>32</sup> European Commission, *Statistics from the Management Committee for Milk and Milk Products*, data forwarded by Member States (22 January 2009).

<sup>33</sup> As short-term price fluctuations reflect seasonal variations in milk production, the annual average change in the producer price is used as an indicator of stability in the Member States. However, the prices in absolute figures forwarded by the Member States to Eurostat are of variable reliability and do not allow a weighted average price which is statistically representative to be calculated. This is why the growth in EU prices is synthesised here by weighting the indices of the Member States which are largest in terms of production.

FIGURE 8

### NOMINAL MILK PRICE IN GERMANY, FRANCE, ITALY, THE NETHERLANDS AND THE UNITED KINGDOM (1971-2007) (Annual weighted averages of indices)

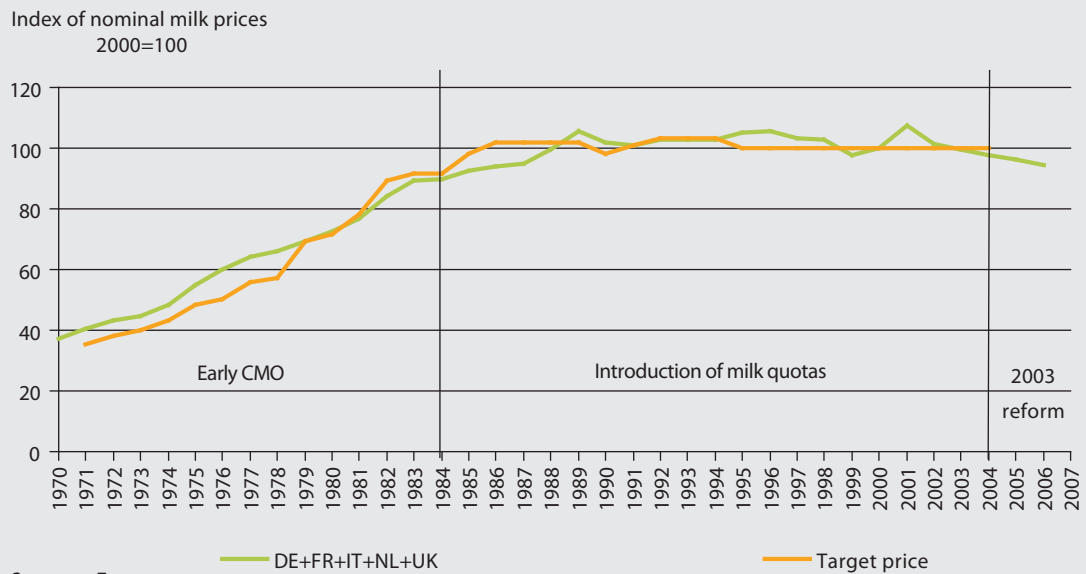
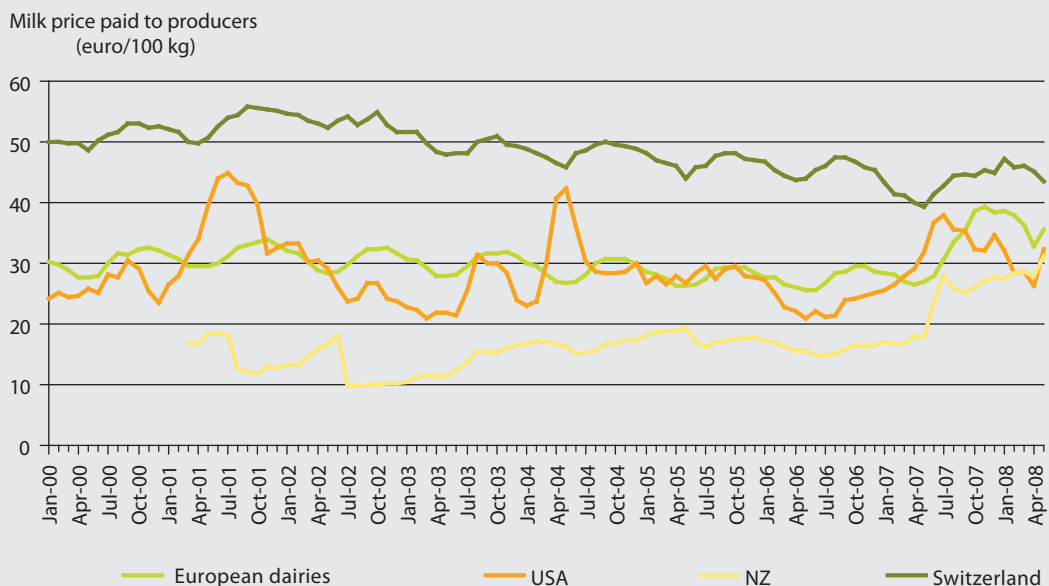


FIGURE 9

### NOMINAL PRICE PAID TO MILK PRODUCERS IN EUROPE, THE UNITED STATES AND NEW ZEALAND (2000-08)



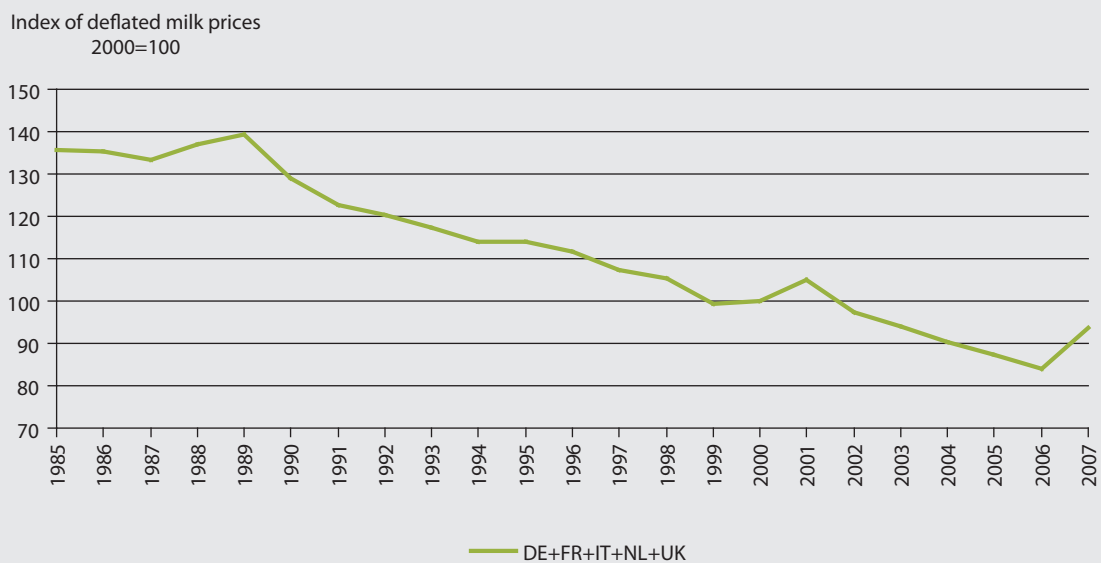
26. European milk producers generally receive higher prices than those obtained by producers in New Zealand but lower than those paid to Swiss producers. European prices are quite close to those in the USA but more stable (**Figure 9**).

**IN REAL TERMS THE PRODUCER PRICE HAS FALLEN CONTINUOUSLY**

27. The constant increase of the milk price in the 1970s and until 1984 occurred during a period of generalised inflation. Following the introduction of quotas, the fact that nominal producer prices were maintained masked the reality that, in real terms, prices suffered a distinct erosion. Over a long period, milk producers never actually benefited in real terms from stable prices. **Figure 10** shows this deterioration using an index of deflated prices.

FIGURE 10

**DEFLATED PRICE OF MILK PAID TO PRODUCERS IN GERMANY, FRANCE, ITALY, THE NETHERLANDS AND THE UNITED KINGDOM (Annual weighted averages of deflated indices)**



Source: European Court of Auditors on the basis of Eurostat data.

## CONSUMER PRICES FOR MILK HAVE LITTLE TO DO WITH THE PRICE PAID TO PRODUCERS

- 28.** On the whole, there is little connection between the price paid by the consumer for milk and the price paid to producers, as shown by a Commission study, according to which between the beginning of 2000 and mid-2007 nominal consumer prices for milk products rose by 17 % while the nominal price paid to producers fell by 6 %<sup>34</sup>.
- 29.** Eurostat data confirm that, generally, consumer prices follow a different pattern from producer prices<sup>35</sup>. Between 1996 and 2000 the Eurostat consumer price index including milk, cheeses and eggs remained practically unchanged (**Figure 11**), while the index of the price paid for milk to producers fell, then rose again (**Figure 8**). Between 2000 and 2007 consumer prices showed an almost linear increase of approximately 15 %. Over the same period the index of prices paid to producers showed a decrease over five consecutive years, followed by an increase.
- 30.** In the milk sector, as for the entire food supply chain<sup>36</sup>, consumer price formation is a complex process. While the prices paid to producers by dairies closely follow developments on the international market, consumer prices are influenced not only by the cost of the raw material but also by other parameters, such as energy and labour costs. The raw material, the milk, actually accounts for a relatively small share of consumer prices for milk products, between 30 and 50 % depending on the products<sup>37</sup>.
- <sup>34</sup> European Commission, Agriculture and Rural Affairs DG, *The impact of the developments in agricultural producer prices on consumers*, document CM/WM/PB D(2007) 34703, 13.11.2007.
- <sup>35</sup> The data are not exactly comparable: **Figure 8** summarises trends in the price paid to producers in the five main milk-producing Member States in the EU-15. Apart from the fact that it includes data relating to eggs, **Figure 11** shows consumption by the entire EU population. The size and structure of this population changed considerably during the period under review.
- <sup>36</sup> The food supply chain covers three sectors of the economy: the agricultural sector, the agri-food industry and the distribution sector.
- <sup>37</sup> According to a survey carried out in Belgium the agricultural value only represents 30–40 % of consumer prices for milk products (*Évolution récente des prix et des coûts dans la filière du lait* (Recent price and cost developments in the milk sector), Service public fédéral Économie, Brussels, 2008). According to other sources the percentage is close to 50 % for cheeses of the gouda or cheddar type (see in particular European Commission, *The impact of the developments in agricultural producer prices on consumers*, p. 22).

- 31.** Another characteristic feature of the European milk sector is the extreme concentration of processing and distribution companies<sup>38</sup> which may give them a predominant weight in determining prices. In a communication concerning food prices<sup>39</sup> the Commission highlighted the phenomenon of concentration in the food supply chain, which has a particular impact on milk products, and stated that the 'Competition authorities at the same time need to make sure that the on-going consolidation process does not worsen upstream and downstream competition conditions at the local level to the detriment of consumers and businesses'.
- 32.** New Zealand and Australia began liberalisation of their milk sectors in 1985 and 2000 respectively. Deregulation was followed by a marked increase in consumer prices in New Zealand and by a very small decrease in Australia<sup>40</sup>.

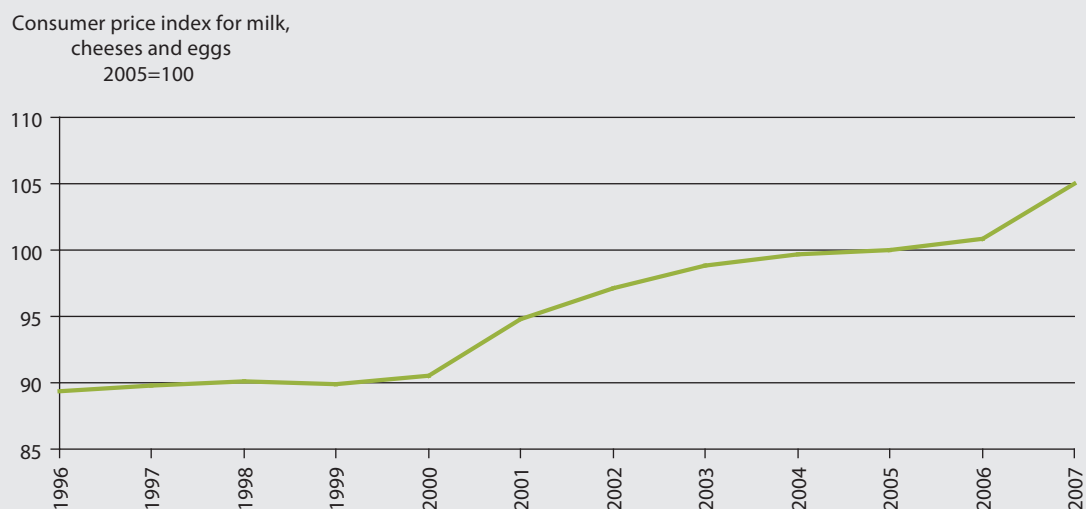
<sup>38</sup> Total turnover of the 15 largest European mass retailers accounts for approximately 77 % of the European food market. *Source: European Commission, Rural development in the European Union — Statistical and economic information — Report 2008.*

<sup>39</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 'Food prices in Europe', COM(2008) 821 final, 9.12.2008.

<sup>40</sup> Gouin, D-M., *Supply management in the dairy sector, still an appropriate regulation method*, Laval University, May 2006.

FIGURE 11

### THE EUROPEAN MARKET: HARMONISED INDEX OF NOMINAL CONSUMER PRICES FOR MILK, CHEESES AND EGGS (1996–2007)



*Source:* Eurostat food item F 0114; European Union geographic unit (EU-12 1994, EU-15 2004, EU-25 2006, EU-27).



## WHAT IS THE IMPACT ON PRODUCERS' INCOMES?

### THE DEVELOPMENT OF PRODUCERS' NET INCOMES HAS BEEN UNEVEN AND SUBSIDIES FORM A MAJOR AND INCREASING PART OF THIS INCOME

**33.** The average net income of agricultural enterprises, in real terms, has shown a downward trend (**Figure 12**). At current prices farms specialising in milk have maintained, on average, slightly higher incomes than farmers as a whole, according to information collected by the Farm Accountancy Data Network (FADN)<sup>41</sup>. The net incomes at current prices of agricultural enterprises specialising in milk<sup>42</sup> grew at the same pace as the incomes of farms as a whole during the 1989–2006 period (**Figure 13**). There is a variety of reasons for the growth in dairy farmers' incomes:

- sectoral reorganisation: in recent years the number of producers has fallen by more than 50 % (see paragraph 34);
- an increase in the size of holdings and a steady increase in productivity: efficient dairy farmers are compensating for the decrease in prices by continuously increasing production;
- increases in subsidies (milk premiums, single payment, rural development aid). According to FADN data, milk accounts for approximately 60 % of the income of specialist dairy farms but this percentage is falling. FADN also shows that subsidies as a percentage of gross farm income vary considerably from one Member State to another; this percentage increased greatly between 2000 and 2006 but to varying degrees depending on the Member States (**Table 1**).

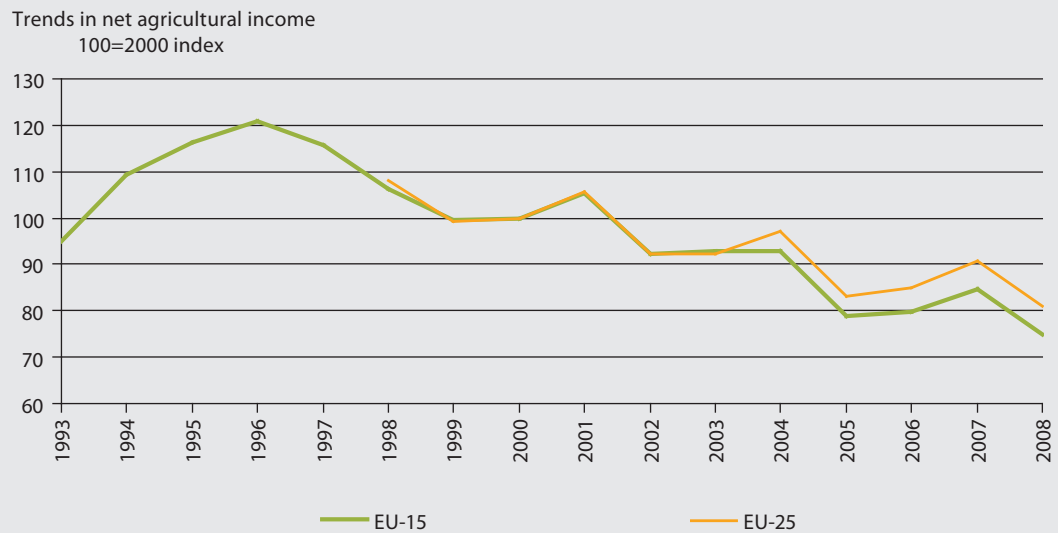
<sup>41</sup> The FADN data are not representative for the whole of the sector, however, because the specialist dairy farms registered in FADN only represent 60 % and 25 % respectively of farms with at least one cow in the EU-15 and EU-25. In 2006 specialist dairy farms included in the FADN covered 78 % of specialist dairy farms in the EU-25 (according to Eurostat's *Farm structure survey 2007*).

<sup>42</sup> FADN, OTEX 41 (bovine animals — milk). See also European Commission, Agriculture and Rural Development DG G3, *Milk margins in the European Union, 2004*.

<sup>43</sup> Aid entered in the FADN variable SE605 covers total subsidies — European and national, first and second pillar of the CAP, coupled and decoupled — excluding subsidies on investments.

FIGURE 12

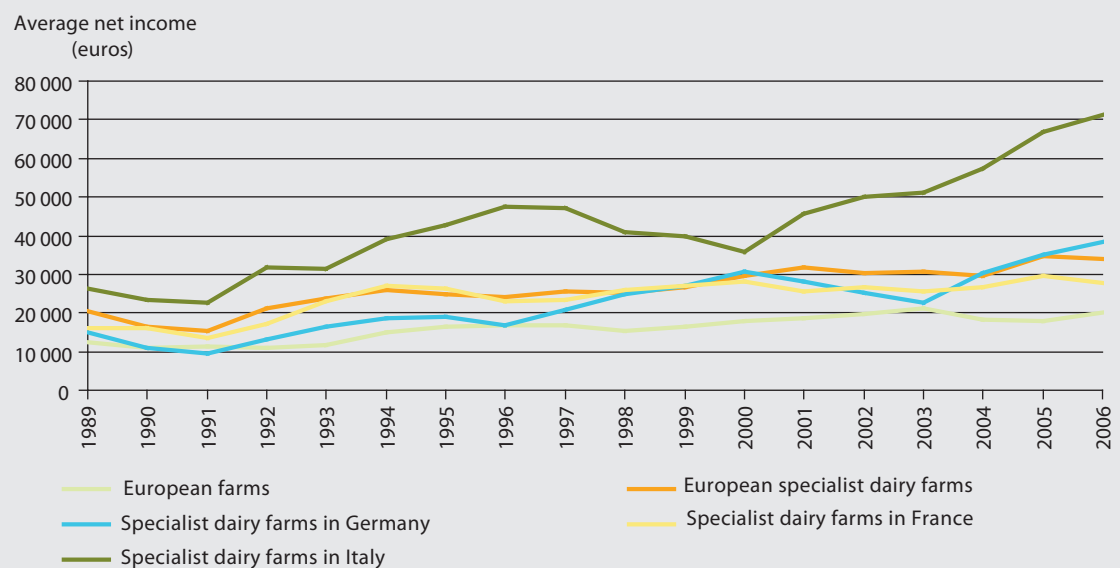
### TRENDS IN NET AGRICULTURAL INCOME IN REAL TERMS (ALL TYPES OF PRODUCTION, 1993–2008)



Source: Eurostat, *Economic accounts for agriculture — Agricultural income*  
(Indicator C: Real net entrepreneurial income from agriculture)

FIGURE 13

### TRENDS IN NET INCOME AT CURRENT PRICES OF SPECIALIST DAIRY FARMS (1989–2006)



Source: FADN database: Family farm income (SE 420) of specialist dairy farms

TABLE 1

### SUBSIDIES AS A SHARE OF GROSS INCOME OF DAIRY FARMS BEFORE TAXES AND LEVIES (2000, 2004 AND 2006)

	2000	2004	2006
<b>Belgium</b>	11 %	19 %	28 %
<b>Czech Republic</b>		44 %	60 %
<b>Denmark</b>	18 %	28 %	31 %
<b>Germany</b>	18 %	31 %	36 %
<b>Greece</b>	14 %		46 %
<b>Spain</b>	5 %	12 %	17 %
<b>Estonia</b>		32 %	43 %
<b>France</b>	22 %	33 %	40 %
<b>Hungary</b>		42 %	41 %
<b>Ireland</b>	15 %	22 %	36 %
<b>Italy</b>	10 %	11 %	16 %
<b>Lithuania</b>		35 %	37 %
<b>Luxembourg</b>	31 %	43 %	46 %
<b>Latvia</b>		58 %	63 %
<b>Netherlands</b>	4 %	12 %	23 %
<b>Austria</b>	32 %	44 %	42 %
<b>Poland</b>		22 %	35 %
<b>Portugal</b>	18 %	27 %	37 %
<b>Finland</b>	72 %	73 %	77 %
<b>Sweden</b>	36 %	41 %	56 %
<b>Slovakia</b>		43 %	65 %
<b>Slovenia</b>		37 %	37 %
<b>United Kingdom</b>	16 %	23 %	34 %

Source: FADN Gross farm income before taxes, levies and VAT = Gross farm income (SE 410) — the balance of current farm subsidies and taxes (SE 600) + total farm subsidies (SE 605).

## RESTRUCTURING HAS ENTAILED A CONSIDERABLE FALL IN THE NUMBER OF FARMS

- 34.** The objective of ensuring a fair standard of living for milk producers, in particular by raising their individual incomes, has mainly been achieved by increasing farm productivity. The restructuring of the milk sector and the constant fall in the number of farms has meant that the statistical average income of milk producers has remained steady or even increased. The EU-15 lost half its dairy farms between 1995 and 2007; in other words more than 500 000 producers gave up during that period. Restructuring is particularly obvious in Denmark, Greece, Spain, Italy and Portugal.
- 35.** In all Member States restructuring has led to a steady increase in the average size of farms, of the average delivery quota and of herd productivity (*Annex II*).
- 36.** There is considerable diversity of production structures both between the Member States and within them:
- in Denmark, the Netherlands and the United Kingdom the average size of herds and of delivery quotas is much higher than in the other EU-15 Member States;
  - there are great disparities between the new Member States. In the Czech Republic, Estonia, Hungary and Slovakia the average delivery quota is quite high because the sector is dominated by a number of very large farms; these coexist with numerous small producers, many of whom have not received any delivery quota; in contrast, in Latvia, Lithuania and Poland, the vast majority of quota-holders are very small family farms;
  - overall, in the Member States of central and eastern Europe, the majority of dairy farms carry on semi-subsistence farming; in 2005, 67 % of herds consisted of a maximum of two cows.

37. There is a considerable difference of scale between European dairy farms and those of Europe's main competitors on the world market (**Table 2**). Small operations (1 to 29 cows) still account for 30 % of European production, but only 1,2 % in the United States, where herds of more than 2 000 cows account for 23 % of national milk production. Most of European production comes from farms with between 30 and 49 cows (20 %) and more than 50 cows (50 %)<sup>44</sup>.

<sup>44</sup> Eurostat, *Dairy cows: Number of farms and heads by size of farm (UAA) and size of herd in 2005*.

TABLE 2

### PRODUCTION STRUCTURES IN EUROPE (2005), THE UNITED STATES AND NEW ZEALAND (2006)

	Average herd size
EU-25 (1)	15
EU-15 (1)	35
EU 10 (1)	5
New Zealand (2)	322
United States (3)	120

*Sources:*

(1) Eurostat (average herd = number of cows/number of farms in 2005).

(2) Livestock Improvement Corporation (LIC), *New Zealand Dairy statistics 2005/06*.

(3) USDA, *Profits, costs and the changing structure of dairy farming*, September 2007 and USDA, *World markets and trade*, July 2008.

## HAVE EUROPEAN MILK PRODUCTS BECOME MORE COMPETITIVE ON WORLD MARKETS?

### EUROPEAN EXPORTS OF BASIC MILK PRODUCTS ARE FALLING

- 38.** The world market for milk products is very limited: it only accounts for 6 % of world milk production (2007) and its prices are volatile<sup>45</sup>. It is mainly a market for processed products with low water content, such as milk powder, butter and cheeses. In 2007 the EU exported approximately 9 % of its total production in milk equivalent<sup>46</sup>, which makes it the second largest exporter in the world after New Zealand.
- 39.** World prices for milk powder and butter are practically always lower than prices within the EU. The world market, being less profitable, is therefore mainly used as the final outlet for produce that the domestic market cannot absorb. World market prices have less impact on exports of products with greater added value, such as cheeses.

<sup>45</sup> FAO, *Food outlook*, June 2008 and November 2008.

<sup>46</sup> Source: ZMP.

TABLE 3

### WORLD EXPORTS OF CERTAIN MILK PRODUCTS — EU SHARE (IN %)

	1984	1995	2000	2001	2002	2003	2004	2005	2006	2007
	EU-10	EU-15					EU-25			EU-27
<b>Butter/butteroil</b>	48,4	27	20,8	19,6	21,8	30	41,4	39,7	29,9	29,1
<b>Skimmed milk powder</b>	30	31,6	29,1	12,7	13,3	19,4	27,4	17,4	7,2	19,7
<b>Cheeses</b>	52	48,6	28,6	30	32,3	30,3	38,8	34,8	34,1	35,9
<b>Whole milk powder</b>	70,2	48,1	37,6	29,8	28,3	27,6	28,3	27,2	23,9	22
<b>Condensed milk</b>	67,7	61,7	51,6	44,4	45,5	38,9	30,7	28,5	29	36,1

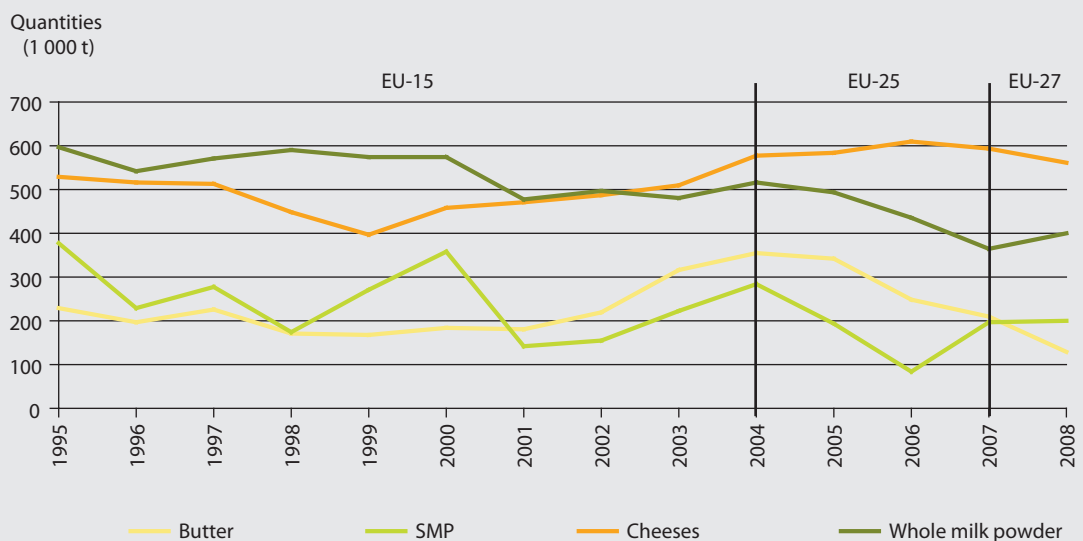
Source: European Commission, Agriculture and Rural Development DG.

40. The EU's position on the world market deteriorated after the introduction of milk quotas, mainly to the advantage of New Zealand and Australia. The EU's share in world trade in milk products continues to fall (**Table 3**)<sup>47</sup> and the trend is for European exports of basic milk products to shrink (**Figure 14**).
41. Exports fell steeply in 2008, except for whole milk powder. Nevertheless, the quantities exported are greater than those of non-subsidised exports achieved before June 2007.

<sup>47</sup> European Commission, data taken from various reports under the title, *The agricultural situation in the European Union*. With regard to **Table 3**, it should be noted that the EU's share of world trade in milk products has been affected by the EU's successive enlargements; every enlargement has automatically increased the volume of intra-Community trade and reduced the volume of exports.

FIGURE 14

### EU EXPORTS OF BUTTER, SMP, CHEESES AND WHOLE MILK POWDER (1995–2008)



Source: European Court of Auditors based on ZMP data.

## THE EUROPEAN UNION HAS GREATLY REDUCED ITS EXPORT AID FOR MILK PRODUCTS

**42.** The objective of export aid is to safeguard the Community's international trade in milk and milk products<sup>48</sup>. Export refunds on milk products are based on the difference between internal and world prices. However, subsidised exports are limited in value and volume by GATT quotas on four categories of product: butter and butteroil, skimmed milk powder, cheese and other milk products<sup>49</sup>.

<sup>48</sup> Whereas (77) Regulation (EC) No 1234/2007.

<sup>49</sup> This category mainly covers whole milk powder, concentrated milk, drinking milk and fresh milk products.

**43.** As from 2004, the rate of refund was progressively reduced to allow for the planned decreases in intervention prices for butter and skimmed milk powder. European exports continued to be subsidised because of the difference in price which still existed between the European and world markets after the reduction in the intervention prices. From June 2007 to December 2008 the rate of refund set by the Commission was zero for all products.



## ACCESS TO THE WORLD MARKET IS DIFFICULT WITHOUT BUDGETARY AID

- 44.** For basic products, i.e. butter and milk powder, the world market remains a second choice for European producers. In the past they could only gain access to it with assistance from the Community budget, except during periods of high world prices. Any significant drop in world prices rendered European products insufficiently competitive on the world market.

<sup>50</sup> Institut d'économie industrielle (IDEI, Toulouse University), *Economic analysis of the effects of the expiry of the EU milk quota system*, March 2008, p. 5.

- 45.** As demand for milk products on the European market is inelastic, an increase in production following the abolition of milk quotas will lead to a significant increase in exports of milk products from the EU. The scenario adopted by the Commission during the health check anticipates that 70 % of additional production will have to be exported. The Commission is seeking to develop exports without having recourse to export refunds, which should disappear by 2013. Achieving this objective will depend on the EU industry's capacity to respond to world demand but also on monetary factors. At the beginning of 2009 the fall in world prices together with the fall of the dollar against the euro highlighted the problem of European producers' competitiveness and induced the Commission to revive the export refund system.

## THE MOST CRITICAL ISSUES TO BE TAKEN INTO CONSIDERATION IN THE PROCESS OF LIBERALISING THE MILK SECTOR

### PRELIMINARY REMARK: THE 2003 REFORM PAVED THE WAY FOR THE WITHDRAWAL OF MILK QUOTAS

- 46.** The reform decided by the Council in 2003, based on the options outlined in Agenda 2000, placed the milk sector firmly on course for the abolition of quotas: the end of milk quotas is scheduled for 2015. The Commission has regularly informed the sector of the situation on the markets and of the change in milk policy towards liberalisation<sup>51</sup>.
- 47.** As part of progressive deregulation, decisions abolishing the target price, the lowering of intervention prices<sup>52</sup> and quantitative restrictions on intervention have already considerably weakened the price support mechanism which was the counterpart of production ceilings. With these decisions the Commission was alerting the sector to the fact that production of butter and skimmed milk powder would become less profitable and that a changeover to products with greater added value, such as cheese, was advisable<sup>53</sup>.
- 48.** In 2008 the special procedure for consulting stakeholders within the framework of the health check mainly focused on managing the transition to the withdrawal of quotas. The Council approved the principle of increasing the national quotas in stages in order to allow a 'soft landing' for the system<sup>54</sup>. The Member States' quotas will be subject to five annual increases of 1 % between the marketing years 2009/10 and 2013/14 before being withdrawn on 31 March 2015. By way of derogation, the Italian quota has been raised by 5 % for the 2009/10 marketing year. These increases will be added to the overall increase of 2 % for the quotas which took effect on 1 April 2008 (2,5 % for 11 EU-15 Member States)<sup>55</sup>. In addition, from the 2009/10 marketing year the adjustment of the quantities delivered, calculated on the basis of the difference between the actual fat content and the reference fat content allocated to every producer, will be relaxed, to the producer's advantage<sup>56</sup>. One immediate effect of these measures will be to solve, completely or to a large extent, the problem of those Member States with insufficient quota, in particular Italy.
- <sup>51</sup> Under 'comitology', the Commission manages milk policy together with the Member States within the framework of the Management Committee for Milk and Milk Products.
- <sup>52</sup> For butter, a decrease of 7 % in July 2004, 7,5 % in July 2005, 8,1 % in July 2006 and 5,1 % in July 2007. For milk powder, a decrease of 5 % in July 2004, 5,3 % in July 2005, and 5,5 % in July 2006.
- <sup>53</sup> Report from the Commission to the Council, 'Market outlook for the dairy sector', COM(2007) 800 final.
- <sup>54</sup> Health check agreement, 20.11.2008, <http://ec.europa.eu/agriculture/healthcheck>
- <sup>55</sup> Council Regulation (EC) No 248/2008 of 17 March 2008 amending Regulation (EC) No 1234/2007 on national milk quotas, OJ L 76, 19.3.2008, p. 6.
- <sup>56</sup> Relaxation of the fat content parameter would be equivalent to an increase of 1,5 to 1,7 % of the Community milk quota (i.e., for example, + 0,9% for France, + 2,2% for Denmark, + 3,4 % for the Netherlands), Normandy Chambers of Agriculture, Bilan de Santé de la PAC – *Expertise technique*, November 2008 (CAP health check — Technical report).

**49.** The Commission estimates that, following withdrawal of the milk quotas<sup>57</sup>:

- the majority of specialist dairy farms will be able to continue milk production;
- consumers will benefit from a slight fall in prices for milk products.

<sup>57</sup> European Commission, *CAP health check, Impact assessment note No 6*, document D(2008) MK / 15332, 20 May 2008.

<sup>58</sup> Institut d'économie industrielle, *Economic analysis of the effects of the expiry of the EU milk quota system*, March 2008.

OECD, Food, Agriculture and Fisheries Directorate and Trade Directorate, *An analysis of dairy policy reform and trade liberalisation. Trade and economic effects of milk quota systems*. COM/AGR/TD/WP(2004)19/Final, <http://www.oecd.org/dataoecd/1/37/34456378.pdf>.

S. Langley, A. Somwaru and M.A. Normile, USDA, *Trade liberalization in international dairy markets. Estimated impacts*, Economic Research Report No 16, February 2006.

Consortium INRA-University of Wageningen, *Study on the impact of future options for the milk quota system and the common market organisation for milk and milk products*, June 2002.

**50.** According to various studies, the overall effects to be expected from the withdrawal of quotas are the following<sup>58</sup>:

- an increase in milk production which should lower the market price<sup>59</sup>;
- a reduction of producers' incomes, in spite of an increase in the quantities produced;
- the transfer of 'welfare' from producers to consumers;
- a stimulation of the EU's exports, possibly causing a downturn in world prices.

**51.** While admitting that forecasts based on these models are of limited value<sup>60</sup>, the Court would like to highlight the most critical issues to be given particular attention when liberalising the market in milk.

INRA-ESR, 'Quelle politique laitière pour l'Europe ? Sortir du régime des quotas laitiers ? Paramètres à considérer et illustration dans le cas français', *Journée lait du département Économie et sociologie rurales de l'Institut National de la Recherche Agronomique (INRA)*, Paris, 8 October 2001.

<sup>59</sup> In the European Union, an increase of 1 % in the production of milk will bring about a fall in the producer price of between 3 and 4 % (see Institut d'économie industrielle, *Economic analysis of the effects of the expiry of the EU milk quota system*, p. 47).

<sup>60</sup> The European milk sector is particularly complex and its development will depend on a multitude of parameters, the combined effect of which is difficult to anticipate. Even at the mega-trend level the models could prove wrong, as witnessed by the fact that prices did not evolve as forecast after the 2003 reform.

## MARKET EQUILIBRIUM: INSTABILITY ON THE MARKETS CAN RAPIDLY LEAD TO THE RE-EMERGENCE OF SURPLUSES

**52.** According to the Commission, on agricultural markets 'Prices are expected to show greater fluctuations than observed over recent decades [...] As a result, any significant changes to supply or demand could quickly result in higher price volatility. An improved capacity to adjust production through an increased market orientation combined with adequate safety nets is instrumental in facilitating farmers' response to more volatile market conditions'<sup>61</sup>.

<sup>61</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 'Food prices in Europe', COM (2008) 821 final, 9.12.2008.

**53.** Within the framework of the health check, the Council decided, on a proposal by the Commission, to retain public intervention on the market as a 'safety net' of intervention purchases of butter and skimmed milk powder. The ceilings for these purchases at fixed prices are 30 000 tonnes for butter and 109 000 tonnes for skimmed milk powder. The Commission may make additional purchases above these limits by invitation to tender. When the ceilings have been reached, the Commission alone will decide on the volumes for intervention buying and at what price, depending on developments on the markets.

<sup>62</sup> Coefficients of equivalence: 1 kg for 20,5 litres (butter) and 1 kg for 11 litres (skimmed milk powder).

**54.** As the EU produces approximately 2 million tonnes of butter and 900 000 tons of skimmed milk powder, surplus production of only 1,5 % (butter) and 12,11 % (milk powder) will be enough for the intervention ceiling to be reached. In other words, the two ceilings equal the purchase of approximately 1,8 million tonnes of milk equivalent, of the 148 million tonnes produced in Europe, i.e. 1 %<sup>62</sup>. Given the very narrow margin, there is a risk that the safety net will only be of limited use, out of all proportion to the scale of the risks and surpluses to which the EU might be exposed in a major crisis. At the end of 2008, in the context of the financial and economic crisis, the instability of the markets led to the re-emergence of surpluses of butter and milk powder. Although intervention stores remained empty in 2007 and 2008, they contained 36 700 tonnes of butter and 67 500 tonnes of milk powder by the end of the first quarter of 2009. In three months therefore, the Commission's purchases had exceeded the intervention ceiling for butter and reached 60 % of the ceiling for milk powder.

## RESTRUCTURING MILK PRODUCTION: RISK OF CONSIDERABLE REDUCTION OF PRODUCTION IN LESS-FAVOURED AREAS AND OF GEOGRAPHICAL CONCENTRATION OF PRODUCTION

- 55.** The Commission estimates that restructuring will continue in the sector. It puts the annual rate of loss of farms for the 2003–13 period at between 2,8 % and 3,7 %<sup>63</sup>.
- 56.** The disappearance at a steady pace of agricultural holdings, and dairy farms in particular, presents a socio-economic challenge for less-favoured areas, particularly in mountainous regions where producers have limited opportunities for restructuring and conversion<sup>64</sup>.
- 57.** In addition, the milk quota system was originally organised on a national basis, inter alia, to avoid a gradual shift of production to those areas with the most favourable conditions for dairy farming. However, in 2005, most European milk production, i.e. approximately 50 %, was already concentrated on 11 % of the EU's territory<sup>65</sup>. The environmental risk is obvious: one expected effect of deregulation and the fall in prices is that production will be intensified in high-yield areas where pressure on the environment is already considerable, while in less productive regions numerous farmers will have to abandon dairy farming, in particular in mountainous areas<sup>66</sup>.
- 58.** In 2001 the Commission implicitly acknowledged the socio-economic and environmental risks associated with the restructuring of the sector, the greatest of which concerned the maintenance of production in 'the less-favoured regions of the Community, especially in mountain areas, where production costs are higher and dairy farming is often the only agricultural activity available'. The Commission also felt that 'concentrating milk production could well give rise to major environmental problems' and furthermore 'would lead to a standardisation of products and, therefore, to lower quality'<sup>67</sup>.

<sup>63</sup> European Commission, *Development in the structure of the agricultural sector*, TV D(2007) of 27 March 2007.

<sup>64</sup> Chatellier V. and Delattre F., *Les soutiens directs et le découplage dans les exploitations agricoles de montagne*. Economie rurale n°288/juillet-août 2005.

<sup>65</sup> European Commission, *Agricultural development in the EU — Statistical and economic data — 2008 report*, December 2008.

<sup>66</sup> In the new Member States, very small dairy farmers who have been able to integrate in the market by obtaining milk quotas are at risk of being the first affected by a fall in prices.

<sup>67</sup> The Commission's replies to Special Report No 6/2001 on milk quotas.

59. The Commission has acknowledged that specific measures are required in less favoured areas (24 % of the EU's territory, accounting for 57 % of its usable agricultural area), in particular in mountainous regions. Following the 2008 health check, restructuring the dairy industry has become one of the new challenges which the Member States may include in their rural development programmes<sup>68</sup>.

<sup>68</sup> Council Decision 2009/61/ EC of 19 January 2009 amending Decision 2006/144/EC on the Community strategic guidelines for rural development (2007–13 programming period), OJ L 30, 31.1.2009, p. 112.

### COMPETITIVENESS ON WORLD MARKETS: AN OBJECTIVE WHICH WILL HAVE A SIGNIFICANT IMPACT BOTH ON PRODUCERS AND PROCESSORS

60. The objective of making European milk producers competitive is at the heart of the reform. Achievement of this objective will depend on the European milk sector's capacity to adapt to world demand in terms of the price and quality of its products.
61. For European prices to become competitive, they must be brought into line with world prices, which are structurally lower, bearing in mind that since 2003 direct aid and additional payments have partially compensated for the fall in prices. The result of liberalisation is to accentuate the influence of the world markets for butter and milk powder on the prices paid to producers in the EU. The convergence of these prices will render further restructuring inevitable, because European production structures are still very different from those of competitors outside the Community (see paragraph 37). However, in the EU-15 there is no direct correlation between dairy farms' margins and the size of their herds<sup>69</sup>. The farms with positive margins are not necessarily the biggest but those with a higher stocking density, higher yields and a lower annual work unit.
62. As for its products, although the EU is the leading exporter of cheeses, basic products still account for the majority of its sales on the world market, i.e. milk powder and butter (2008 data). In the past, European makers of these products were only competitive when world prices were high. Retaining substantial market shares on the world market thus requires producers of cheeses and other high added value products to play a more significant role, in accordance with the objectives of liberalisation, which are to bring the sector more into line with the market.

<sup>69</sup> A diseconomy of scale might appear when production costs rise as production increases. This situation occurs when 'some inputs are in fixed supply and cannot be easily adjusted to the level needed to achieve the efficiency frontier, because of a poor operating environment (weather, topography) or because the operator is less effective than other operators.' MacDonald James M., O'Donoghue Erik J., McBride William D., Nehring Richard F., Sandretto Carmen L. and Mosheim Roberto, *Profits, costs and the changing structure of dairy farming*, United States Department of Agriculture, Economic Research Report No 47, September 2007.

# CONCLUSIONS AND RECOMMENDATIONS

- 63.** The EU's milk policy was designed to meet a complex range of objectives, in particular to reach a situation of market equilibrium, to stabilise the prices of milk and milk products, to ensure a fair standard of living for producers and to improve the competitiveness of European milk products on international markets. The Court's report analyses the degree to which these objectives have been achieved and draws attention to those facts which are proving to be the most critical in the process now underway of liberalising the European milk sector.

## MARKET EQUILIBRIUM

- 64.** Since 1984 milk quotas have been the keystone of European milk policy. Since their introduction they have imposed strict limitations on production but for a long time they were too high in relation to the market's absorption capacity. National ceilings were set on the basis of historical production and a number of national quotas, notably Italy's, have been systematically exceeded.
- 65.** Subsidised structural surpluses have thus been an attendant feature of the quota system for a very long time. Following the surge in market prices at the end of 2006 and in 2007, for the first time the surpluses almost disappeared but this situation could not be considered a permanent achievement, as proved by the reappearance of surpluses in 2008 and 2009.
- 66.** On a market liberalised by the abolition of quotas, production capacities will remain relatively inflexible and producers might not be in a position to adapt rapidly to fluctuations in demand. The Council has decided to retain public intervention as a 'safety net'. Nevertheless, this safety net is so thin that there is a risk it will be of only limited use in a major crisis and quite inadequate in relation to the risks in respect of the surpluses that the EU might face.

### RECOMMENDATION 1

The Commission must continue to supervise the development of the market in milk and milk products by implementing the measures required to make sure deregulation of the sector does not lead to the recurrence of overproduction. Failing this the Commission's objective of keeping to a minimum level of regulation, of the safety net type, might rapidly prove impossible to fulfil.

### THE PRICE OF MILK

- 67.** The establishment of reference prices together with quotas has kept nominal prices particularly stable over the past 20 years. Taking inflation into account, however, real prices have been considerably eroded over this same period and, as a result, producer margins have been significantly reduced. These margins have been squeezed by the constant pressure to improve efficiency and productivity, forcing less efficient producers out of the market, even though the effects may have been mitigated in some cases by the capitalisation of quotas. Changes in consumer prices for milk and milk products do not necessarily reflect changes in the prices paid to producers.

#### RECOMMENDATION 2

While acknowledging that price formation in the food sector is particularly complex, the Court considers that it must be subject to regular monitoring by the Commission. The Commission and the Member States must ensure that the concentration of processing and distribution companies does not reduce milk producers to mere price-takers and does not restrict the final consumer's possibility of enjoying an equitable share of price reductions.

### PRODUCERS' INCOMES

- 68.** In the context of an overall depreciation of agricultural incomes, dairy farmers have retained incomes which, on average, are slightly above those of other farmers. In fact, it is structural adjustment which has allowed the average statistical income of milk producers to remain steady. The EU-15 lost half its dairy farms between 1995 and 2007.



- 69.** This trend towards consolidation of production is expected to continue, and even accelerate, with production declining or disappearing in less-favoured areas and a concentration of production in intensive areas. This development may prove to be negative for the environment and the social fabric of less-favoured areas in which milk production is one of the few farming activities possible.

### RECOMMENDATION 3

As far as the dairy sector is concerned, in practice both the former policy of price support and the current policy of direct income support lack regional and social focus<sup>70</sup>. In view of the importance of milk production in the agricultural economy and its impact on the management of the countryside, the Court recommends that the Commission should intensify its reflection on the strategies to be applied to tackle:

- the specific problems of the regions in which milk production is more vulnerable, in particular in mountainous areas;
- the environmental consequences of the geographical concentration of milk production.

<sup>70</sup> With the introduction in 2005 of the single payment scheme the Member States had greater possibilities to target direct aid at certain areas by applying the regional model. However, in practice, decoupling the milk premium and additional payments has not led to any redirection of aid towards producers in less-favoured areas. In all the EU-15 Member States, the outcome of decoupling was the allocation of a special entitlement to holders of milk quotas or an increase in the unit value of the payment entitlements quota holders already had.

### COMPETITIVENESS ON WORLD MARKETS

- 70.** The EU's share in world trade in milk products has been in steady decline since 1984. The objective of making European milk producers competitive is at the heart of the current trend towards liberalisation of the sector. In line with WTO agreements, European aid to milk product exports has been considerably reduced in the past few years.

- 71.** In actual fact the world market in milk products is mainly one for basic products, such as milk powder and butter. European producers of these products have only been competitive on world markets when prices have been high. Outside these periods they can only export with the assistance of the Community budget.
- 72.** After the initial strong growth in recent years, world market demand is currently contracting, which is why the Commission reactivated the system of export refunds in 2009, although this had been set at zero in 2007. However, this option would no longer be available in the medium term if the world trade agreements now being negotiated were to lead to the abolition of export refunds. The future development of exports will depend on developments in world demand and on the capacity of the EU's dairy industry to satisfy that demand.

#### RECOMMENDATION 4

For the European milk sector, the world market will remain a secondary market to which it will only have access during periods when world prices are high. Only producers of cheeses and other products with high added value will be able to claim sustainable market shares. It is therefore indispensable for the Commission and the Member States to pursue their efforts to bring about a reorientation of milk production, primarily towards satisfying the needs of the European domestic market and also towards the production of cheeses and other products of high added value which can be exported without budgetary assistance

This report was adopted by the Court of Auditors in Luxembourg at the Court meeting of 23 July 2009.

*For the Court of Auditors*



Vitor Manuel da Silva Caldeira  
*President*

## PRODUCTION AND CONSUMPTION OF MILK IN THE EU

(in 1 000 tonnes)

	1984 EU-15 (1)	1994 EU-15 (1)	2004 EU-25 (2)	2008 EU-27 (2)
Production of cows' milk	136 247	120 179	136 752	150 647
Deliveries	123 588 (91 %)	111 515 (93 %)	124 928 (91 %)	134 346 (89 %)
Production of drinking milk	26 449	30 320	31 942	32 120
Production of butter				
Industrial production	2 622	1 799	1 979	2 072
Total	2 657	1 817	2 015	2 167
Consumption of butter	1 893	n.d.	1 973	1 882
Production of cheeses				
From industrial production (cow)	4 508	5 650	7 399	8 163
Total	4 882	6 168	8 341	9 547
Consumption of cheeses	4 201	n.d.	8 024	7 748
Production of milk powder				
Skimmed	2 364	1 232	891	928
Semi-skimmed + whole	867	1 001	870	864
Buttermilk in powder form	52	52	73	70
Total	3 283	2 285	1 834	1 862
Consumption of skimmed milk powder	n.d.	n.d.	n.d.	660 (3)
Production of condensed and concentrated milk	1 645	1 284	1 188	1 138
Production of casein and caseinates	127	111	122	137

Sources: (1) Cronos, (2) European Commission: replies by the Member States to the quarterly questionnaire and (3) European Commission: *Dairy Monthly*, January 2009.

## BASIC DATA ON DAIRY FARMING IN THE EU

	Number of cows (1 000)				Number of cow holders (1 000)				
	1985	1995	2005	2007	1985	1995	2005	2007	
Belgium	951,19	683,80	549,33	523,70	44,58	22,05	15,18	13,32	
Denmark	913,00	714,00	564,27	545,42	31,77	16,39	6,51	5,38	
Germany	n.d.	5 229,40	4 235,96	4 076,38	369,00	209,42	110,37	101,07	
Greece	218,91	185,00	167,92	150,00	73,42	28,00	9,78	n.d.	
Spain	1 880,20	1 281,00	1 001,92	903,00	n.d.	114,60	42,39	37,29	
France	6 506,10	4 700,40	3 883,84	3 758,50	328,70	158,57	103,85	93,12	
Ireland	1 495,20	1 220,79	1 081,96	1 058,21	76,70	42,10	23,82	21,32	
Italy	2 804,00	2 080,00	1 860,18	1 890,91	337,69	113,19	61,02	62,79	
Luxembourg	70,29	47,75	39,34	40,04	2,31	1,42	0,97	1,09	
Netherlands	2 333,00	1 777,00	1 433,20	1 468,30	61,31	40,06	23,53	24,51	
Austria	n.d.	706,49	535,79	521,68	n.d.	90,73	54,58	49,45	
Portugal	n.d.	384,00	287,29	272,66	n.d.	86,00	15,86	13,50	
Finland	n.d.	402,30	318,76	296,07	n.d.	32,36	16,94	14,39	
Sweden	n.d.	481,70	393,26	369,65	n.d.	17,74	8,55	7,10	
United Kindom	3 256,47	2 631,93	2 065,07	1 978,00	52,88	36,68	26,31	28,14	
<b>EU-15</b>		<b>22 525,56</b>	<b>18 418,09</b>	<b>17 852,52</b>		<b>1 009,32</b>	<b>519,65</b>	<b>472,47</b>	
Czech Republic	n.d.	713,00	440,50	416,52	n.d.	n.d.	6,78	5,62	
Estonia	n.d.	185,40	115,23	107,84	n.d.	n.d.	9,21	6,08	
Cyprus	n.d.	29,50	24,25	23,70	n.d.	n.d.	0,24	0,24	
Latvia	n.d.	291,90	172,36	182,32	n.d.	n.d.	50,90	43,69	
Lithuania	n.d.	586,00	493,89	398,37	n.d.	n.d.	170,79	123,17	
Hungary	n.d.	390,00	286,83	265,43	n.d.	n.d.	16,25	12,17	
Malta	n.d.	n.d.	7,27	8,08	n.d.	n.d.	0,15	0,19	
Poland	n.d.	n.d.	2 853,74	2 767,78	n.d.	n.d.	727,10	651,05	
Slovenia	n.d.	n.d.	130,68	124,19	n.d.	n.d.	19,71	19,20	
Slovakia	n.d.	n.d.	193,20	177,22	n.d.	n.d.	13,46	11,54	
<b>EU-10</b>			<b>4 717,95</b>	<b>4 471,45</b>			<b>1 014,58</b>	<b>872,95</b>	
Bulgaria	n.d.	n.d.	n.d.	335,90	n.d.	n.d.	n.d.	n.d.	
Romania	n.d.	n.d.	n.d.	1 572,90	n.d.	n.d.	n.d.	1 012,40	
<b>EU-2</b>				<b>1 908,80</b>					

Source: European Court of Auditors based on Eurostat data.

	Average herd size (cows per holder)				Yield per cow (kg)			
	1985	1995	2005	2007	1985	1995	2005	2007
	21,34	31,02	36,19	39,32	3 990,79	4 935,65	5 622,55	5 490,44
	28,74	43,56	86,73	101,38	5 584,88	6 544,82	8 218,64	8 137,21
	n.d.	24,97	38,38	40,33	n.d.	5 470,42	6 833,09	6 721,96
	2,98	6,61	17,17	n.d.	3 499,34	4 127,03	5 000,00	4 819,40
	n.d.	11,18	23,64	24,22	n.d.	4 800,62	6 445,73	n.d.
	19,79	29,64	37,40	40,36	n.d.	5 406,56	6 334,43	6 344,43
	19,49	29,00	45,42	49,63	3 894,13	4 380,03	4 631,79	6 111,47
	8,30	18,38	30,48	30,11	n.d.	5 046,73	5 958,20	5 581,96
	30,42	33,63	40,72	36,73	4 278,84	5 625,13	6 567,08	6 450,25
	38,06	44,36	60,91	59,91	5 379,34	6 356,22	7 298,47	7 247,40
	n.d.	7,79	9,82	10,55	n.d.	4 173,02	5 826,32	5 074,15
	n.d.	4,47	18,11	20,20	n.d.	4 583,33	6 361,56	n.d.
	n.d.	12,43	18,82	20,57	n.d.	8 212,78	7 775,04	7 744,07
	n.d.	27,15	46,01	52,06	n.d.	6 859,04	8 206,20	8 163,25
	61,58	71,76	78,49	70,29	4 956,41	5 578,63	7 073,20	6 899,29
		<b>22,32</b>	<b>35,44</b>	<b>35,24</b>	<b>4 486,21</b>	<b>5 396,16</b>	<b>6 549,51</b>	<b>n.d.</b>
	n.d.	n.d.	64,97	74,11	n.d.	4 378,58	6 434,91	6 002,75
	n.d.	n.d.	12,51	17,74	n.d.	3 812,84	5 927,50	5 705,22
	n.d.	n.d.	n.d.	98,75	n.d.	4 711,86	5 990,65	6 079,32
	n.d.	n.d.	3,39	4,17	n.d.	3 233,64	4 356,37	3 496,12
	n.d.	n.d.	2,89	3,23	n.d.	3 087,88	4 450,42	3 330,36
	n.d.	n.d.	17,65	21,81	n.d.	5 054,95	6 767,51	5 442,59
	n.d.	n.d.	49,12	42,53	n.d.	n.d.	5 296,30	5 340,79
	n.d.	n.d.	3,92	4,25	n.d.	n.d.	4 328,07	3 266,12
	n.d.	n.d.	6,63	6,47	n.d.	n.d.	5 479,59	4 525,34
	n.d.	n.d.	14,35	15,36	n.d.	n.d.	5 538,47	5 350,83
			<b>4,63</b>	<b>5,10</b>		<b>3 958,77</b>	<b>4 830,06</b>	<b>3 866,06</b>
	n.d.	n.d.	n.d.	n.d.	n.d.	n.d.	n.d.	2 219,41
	n.d.	n.d.	n.d.	1,55	n.d.	n.d.	n.d.	1 168,03
								<b>1 353,04</b>

# REPLIES OF THE COMMISSION

## EXECUTIVE SUMMARY

Milk quotas will end on 1 April 2015 as decided by the Council, acting on Parliament's opinion from 2003. This was based, inter alia, on the conclusions and recommendations in the European Court of Auditors' (ECA) Special Report No 6/2001. The purpose of the reform of the dairy sector, in line with CAP reform in general, was to make production more market-oriented. Consequently, intervention measures were redefined with lower intervention prices gradually being implemented. As compensation, 5 billion euro was distributed among dairy farmers as direct support to their revenue, linked to production. This is now fully decoupled and subject to public and animal health and environmental standards (cross-compliance). All these measures were intended to support increased competitiveness and help milk producers prepare for future challenges on international markets, whilst providing income support by way of direct payments.

The Commission was aware of the challenges involved in implementing such reform. Rural development measures have therefore been and continue to be available to help farmers restructure and adapt to new market conditions. The recent health check as well as the European economic recovery package offer additional possibilities for Member States to support the dairy sector and provide a soft landing in light of the expiry of the quota system.

## REPLIES OF THE COMMISSION

Farmers have experienced volatile milk prices over the past two years with a rapid increase in 2007 followed by a significant drop in 2008. Consumer prices of dairy products also increased in 2007 but did not fall in 2008 to the same extent. This asymmetric development in producer and consumer prices has raised concern about the functioning of competition in the chain from stable to table. The Commission is examining the situation closely.

### II.

The health check was a further step towards a more market-oriented CAP where decoupled direct aid plays an important role in securing farm revenue, and where the market-support instruments should play a lesser role. After the health check, the import-sector instruments are still applicable as intervention mechanisms. The dairy premium and additional payment were abolished from 2007 at the latest. The related amounts were included in the single payment scheme. As a consequence, dairy farmers no longer receive any support related to their milk production.

### IV.

It should be pointed out, as the Commission did in response to the European Court of Auditors' Special Report No 6/2001 on milk quotas, that adapting milk production to the level of internal consumption was neither a political nor an economic objective.

The Commission considers that the internal disposal measures for butter were indispensable in the past and proved to be an efficient means of maintaining stability and avoiding more expensive buying into public intervention. Nevertheless, in line with the reduction of the intervention price for butter and the consequent changes in market conditions, the aid was reduced to zero in 2007. The confectionery sector can now buy butter at prices similar to the earlier net price (prices net of aid).

The disposal schemes for butter have been abolished by the health check, while the schemes for skimmed milk powder have been made discretionary, based on the Commission's assessment of whether they are appropriate in prevailing conditions.

### V.

The stability of nominal prices and the fall in real prices is a phenomenon common to several sectors, not just the milk sector. Milk producers have not been alone in experiencing the absence of 'stable prices in real terms' as described by the Court.

Moreover, price developments must also be assessed in the light of international market developments and the price differential with the world market price must be reduced.

## REPLIES OF THE COMMISSION

### VII.

A variety of factors has influenced the relative position of the EU as an exporter, not least the enhanced production capacity of certain third countries. However, together with the effects of the recent reforms, this has encouraged EU producers to focus on developing and expanding high-value markets for products where Europe has a more sustainable competitive advantage, such as cheese.

### VIII.

- The Commission notes that market volatility can lead to shortages as well as surpluses.

- The CAP has a range of instruments, in particular in the field of rural development, that, in addition to promoting competitiveness, seek to prevent land being abandoned, to preserve and improve the environment, to better integrate agricultural activity into the socio-economic context of rural areas and to support restructuring in the sectors most exposed to change.

- The EU dairy sector faces competition from a number of sources; the dairy sector in other parts of the world in particular, but also from other similar products in Europe. Each part of the hugely diverse sector must identify and develop an optimal strategy to address these challenges.

### IX.

- The Commission will continue to monitor developments in the sector closely. In this regard the market reports to be submitted to Parliament and the Council in 2010 and 2012 will provide useful indications on production and market developments as the expiry of the quota regime in 2015 approaches.

Following a request by the European Council, on 22 July 2009 the Commission adopted a communication 'Dairy market situation 2009' (COM(2009) 385) that included possible options to stabilise the market, while complying with the outcome of the health check. The Council will discuss the communication in September 2009.

- A High Level Group<sup>1</sup> on the Competitiveness of the Agro-Food Industry recently proposed a series of initiatives that the Commission intends to implement over the coming months. These initiatives are part of the implementation of the roadmap to improve the functioning of the food supply chain that was presented by the Commission at the end of 2008 in its communication 'Food prices in Europe' (COM(2008) 821 final). Among the five main components of the roadmap agreed by the Council in December 2008 was permanent European monitoring of food prices and the supply chain. This monitoring tool should provide better information to consumers, public authorities and market operators and so ad-

<sup>1</sup> The main role of the High Level Group (chaired by one of the Commission Vice-Presidents with the participation of the Commissioners responsible for Agriculture and Rural Development, Consumer Protection and Health, was to provide advice to the European Commission with a view to enhancing and promoting leadership of the European agro-food industry. It was designed to provide a political momentum for the process and a platform for discussion on sector-specific recommendations (but not to follow the dynamics between producer and consumer prices). The Group aims to bring together key stakeholders in the food industry. Representation was at the highest level.



## REPLIES OF THE COMMISSION

dress the lack of transparency of prices and improve the knowledge of the impact of regulation along the food supply chain. The Commission will present a follow-up report on this roadmap at the end of 2009. In addition, a fast-track survey of dairy markets was recommended to the European Competition Network Food Sub-group meeting in early July 2009, to stimulate and coordinate simultaneous monitoring and data collection by national competition authorities. Furthermore, as part of the retail market monitoring exercise, the Commission is also examining best practices across Member States in terms of contractual relations between suppliers and retailers. The work will be completed by the end of 2009.

At the moment, concentration is much more important at the retail level than at the processing level.

- The Commission has been looking at the problems of less-favoured areas since 2005, taking account inter alia of the Court of Auditors' Special Report No 4/2003. The discussion has already resulted in amendments to the legislative framework for these areas and is still ongoing (see the recent communication from the Commission COM(2009) 161 of 21 April 2009). The specific situation of mountain areas will be addressed by a Commission working paper to be presented in November 2009.

With regard to the environmental consequences of any territorial concentration of production, the Commission is convinced that action should be taken at two levels: (i) the legislative level, while monitoring compliance with environmental protection standards and good agricultural and environmental practices that are requirements for direct aid and aid under the second rural development axis; (ii) the incentive level, through aid for introducing greener agricultural practices, such as agro-environmental measures under rural development.

- The Commission agrees that providing value and satisfaction to consumers and users of European dairy products is essential to securing a sustainable income for producers. It recognises the importance of satisfying consumer needs for a range of high-value and basic products, the need to exploit all milk constituents, including protein and fat, and takes account of the diversity of milk production conditions throughout the Community

# REPLIES OF THE COMMISSION

## INTRODUCTION

### 3.

#### First indent

It should be pointed out, as the Commission did in the European Court of Auditors' Special Report No 6/2001 on milk quotas, that it is clear from the Council's decisions that adapting milk production to the level of internal consumption was neither a political nor an economic objective (see the Commission's reply to paragraphs 68–69 of Special Report No 6/2001).

#### Third indent

In light of the expiry of milk quotas, the Commission has proposed and the Council and the European Parliament have accepted a gradual and planned increase in quotas. This will allow milk producers to adapt to the new situation during the transitional period in order to ensure a soft landing by 1 April 2015.

In addition, the adjustment of farm structures to new market opportunities or changes in policies is supported to a great extent via rural development funding.

#### Fourth indent

Price is one of the factors that can improve the competitiveness of EU products on international markets, but in many product segments other factors, including product innovation and high quality, are critical to satisfying consumer and user needs.

### 8.

The change in policy not only influences the EU budget and the farmers receiving direct aid. As institutional prices decrease, market prices will also adjust, depending on supply and demand, and consumers should also benefit from lower market prices, dependent on the efficiency of price transmission.

Furthermore, this has reduced the cost not only for Member States but also for industries selling the products and/or using the supported products. Moreover, the policy change offers a better negotiating position in the multilateral context.

### 10.-11.

The dairy premium and additional payment were abolished from 2007 at the latest. The related amounts were included in the single payment scheme. As a consequence, dairy farmers no longer receive any support related to their milk production.

The Commission considers that a comparison of the total cost of the dairy sector in 2005 and 2007 should be based on total expenditure incurred, regardless of how it was financed (annual appropriation from the budget, negative expenditure or assigned revenue — changes were made to the treatment of assigned revenue from budget year 2007). Based on total expenditure of 3,202 billion euro in the 2005 budget year and an estimate of 4,875 billion euro in 2007, the increase is 52 %.

The increase in budget expenditure between 2005 and 2007 is also due to the enlargement of the Communities.

## REPLIES OF THE COMMISSION

### OBSERVATIONS

#### 14.

As already mentioned in relation to paragraph 3, reference should be made to the Commission's replies to the Court of Auditors' Special Report No 6/2001 on milk quotas. The Commission stressed that 'it is clear from the Council's decisions that adapting milk production to the level of internal consumption was neither a political nor an economic objective' (see the Commission's replies to paragraphs 68–69 of Special Report No 6/2001).

#### Textbox 2

Second box : So far it has been too early to conduct a comprehensive study of the impact of decoupling on the abandonment of milk production, particularly since decoupling only entered into force in calendar year 2006 (budget 2007). The Agriculture and Rural Development DG evaluation plan for 2009–11 provides for an evaluation of the market effects of partial decoupling that was launched this year, with the objective of examining the market effects of the aid schemes that remained coupled or partially coupled. The contract is expected to be signed in autumn 2009, and the evaluation will be carried out in 2010. Furthermore, two evaluations are planned in 2010–11 for the income effects of direct support and for the dairy sector respectively.

#### 16.

When the milk quota scheme was introduced, a guaranteed total quantity was set for most Member States corresponding to milk delivered during 1981, plus 1 % (Article 5c(3) of Council Regulation (EEC) No 804/68 as amended by Article 1 of Council Regulation (EEC) No 856/84). In recognition of the particular circumstances of milk production in Ireland and Italy, the guaranteed total quantities for these Member States were based on 1983 deliveries (with regard to Italy, see recital No 9 of Council Regulation (EEC) No 856/84). Italy was therefore treated more favourably than other Member States. The increasing quota under-use in the UK, Sweden and France has different reasons: for instance, the French under-use is due to the strict quota management system of the French administration.

#### 17.

As already explained in the reply to paragraph 16, in 1984 the Council fixed the level of quotas for Member States with reference to a common base.

Subsequently, the Commission received a mandate to manage the quantities produced within the quotas.

The main aim of the quotas was to limit production and consequently put a stop to the accumulation of stocks of butter and milk powder, which had reached excessive levels. For example, at the end of 1986, total butter stocks were 1.3 million tonnes, which represents 59 % of the 2.2 million tonnes produced that year, compared with stocks of slightly over 80 000 tonnes or 4 % of EU butter production in 2007.

## REPLIES OF THE COMMISSION

The objective of reducing stocks was achieved and accordingly it was no longer possible to talk of major structural surpluses.

Moreover, under the quota system, production of butter and of skimmed milk powder was never regarded as surplus production; it is a way of using milk that is necessary for the needs of the internal market but is nonetheless more fragile, more exposed to external competition and less profitable. This production will not disappear, but it may be made less appealing by the lack of aid.

### 18.

See the reply to paragraph 14.

### 21.

The Commission considers that the internal disposal measures for butter were indispensable in the past and proved to be an efficient means of maintaining stability and avoiding more expensive buying into public intervention. Nevertheless, in line with the reduction of the intervention price for butter and the consequent changes in market conditions, the aid was reduced to zero in 2007. The confectionery sector can now buy butter at prices similar to the earlier net price (prices net of aid).

The disposal schemes for butter have been abolished by the health check, while the schemes for skimmed milk powder have been made discretionary, based on the Commission's assessment of whether they are appropriate in prevailing conditions.

### 26.

Compared with the trend in milk equivalent prices on the global market, the price of European milk has been very stable thanks to the different management instruments.

### 27.

The stability of nominal prices and the fall in real prices is a phenomenon common to several sectors, not just the milk sector. Milk producers have not been alone in experiencing the absence of 'stable prices in real terms' as described by the Court.

Moreover, price developments must also be assessed in the light of international market developments and the price differential with the world market price must be reduced.

### 33.

The report by the Commission's FADN unit entitled 'EU dairy farm economics' (2009) shows that the income of milk-specialised farms in terms of net value added per work unit in real terms is above the average of all farms for the period (2000–06). However, profit per work unit (amount estimated to remain after the remuneration of all the factors of production) of EU-15 milk-specialised farms has been above the average only since 2005. Lastly, the income per work unit of EU-15 milk-specialised farms has increased at the same rate as the average of all farms for the period 1998/2005 (in real terms, see the report 'Milk margins' evolution in the European Union (1998–2005)'). In the EU-10, the increase is largest for milk-specialised farms.

## REPLIES OF THE COMMISSION

### Third indent

It is normal that the share of aid increased as a proportion of dairy farms' income between 2000 and 2006 given that the milk premium compensated for lower intervention prices. Direct aid is calculated by kilogram of milk included in the quota on a reference date. It is logical that there is variability between producers and Member States since there are differences in structures, quota size, etc.

### 45.

While our analysis shows some additional production after quotas have expired, this outcome is based on certain assumptions about EU and world market prices and the conclusion of the Doha Development Agreement.

### 54.

The global financial and economic crisis in 2008 and 2009 is a highly significant factor in declining demand on internal and external markets.

The intervention ceilings (on intervention prices) are 30 000 tonnes for butter and 109 000 tonnes for SMP. Under Regulation (EC) No 1234/2007, the Commission may decide to continue public intervention above those amounts (by tender) if justified by the situation on the market, and in particular the trend in market prices.

That happened in 2009. At the end of June 2009, stocks contained 81 237 tonnes of butter and 202 914 tonnes of SMP.

### 55.

Structural adjustment in the agricultural sector in the European Union and elsewhere is a slow process that has been under way for many years. Since the vast majority of land on farms that cease agricultural production is generally taken over by other farms, the reduction in the number of farms is not in itself a problem for the production of positive externalities for agriculture. Eurostat surveys noted a 5 % annual reduction in the number of EU-12 milk-specialised farms between 1990 and 2003. The surveys also indicate that the reduction between 2003 and 2007 for the EU-27 is some 2.3 % per annum for all farms, but only 1.0 % for milk-specialised farms.

### 56.

Restructuring the milk sector is a particularly important challenge in mountain areas and other less-favoured areas since 60 % of EU-25 dairy farms are located in less-favoured areas. The CAP health check identified additional resources as a result of compulsory modulation to finance, inter alia, flanking measures for restructuring the sector under rural development programmes. The same measures may qualify for aid intensity increased by 10 percentage points. The maximum aid intensity for investments in farming in less-favoured areas is already 10 % higher than in other areas.

## REPLIES OF THE COMMISSION

In addition, Article 68 of Council Regulation (EC) No 73/2009 allows Member States to grant additional support to farmers to address specific disadvantages affecting farmers in the dairy sector (among others) and in areas subject to restructuring and/or development programmes in order to ensure against land being abandoned and/or to address specific disadvantages for farmers in those areas.

### 57.

The quota system was introduced in 1984 to respond to the over-supply of milk products. However, the system had to facilitate quota mobility within Member States to allow producers to achieve sufficient scale as production costs and income requirements increased. The Member States were free to choose how to organise the quota system, either at national or regional level. Community and national agri-environmental legislation and the cross-compliance requirements for the single farm payment provide appropriate means to ensure that any changes to productive structures or farming practices do not harm the environment.

### 58.

The Commission took account of the issues mentioned by the Court during the CAP health check (see reply to point 56).

### 59.

The Community strategic guidelines allow regional priorities to be taken into account, depending on the specific situation, and provide for restructuring and modernisation of priority sectors. In rural development programmes, the specific situation can be taken into account by two means. First, by targeting investment measures on clearly defined objectives reflecting identified structural and territorial needs and structural disadvantages (Article 43 of Regulation (EC) No 1974/2006). When it approved the programmes, the Commission insisted on such targeting.

Second, less-favoured areas can benefit from aid intensity that is 10 percentage points higher for modernisation of agricultural holdings (Annex to Regulation (EC) No 1698/2005).

Moreover, the 2008 health check led to the strengthening of the restructuring instruments applicable to structural and territorial needs.

### 62.

The EU dairy sector is highly competitive in many market segments because of the quality and innovativeness of its products. For instance, cheese is the EU dairy sector's biggest export product, and most exports do not qualify for export refunds.

## REPLIES OF THE COMMISSION

### CONCLUSIONS AND RECOMMENDATIONS

#### 64.

It should be pointed out, as the Commission did in the European Court of Auditors' Special Report No 6/2001 on milk quotas, that adapting milk production to the level of internal consumption was neither a political nor an economic objective.

When the milk quota scheme was introduced, a guaranteed total quantity was set for most Member States corresponding to deliveries in 1981 plus 1 % (Article 5c(3) of Council Regulation (EEC) No 804/68 as amended by Article 1 of Council Regulation (EEC) No 856/84). In recognition of the particular circumstances of milk production in Ireland and Italy, the guaranteed total quantities for these Member States were based on 1983 deliveries (with regard to Italy, see Recital No 9 of Council Regulation (EEC) No 856/84). Italy was therefore treated more favourably than other Member States.

#### 65.

The exceptional and unforeseeable economic conditions are a highly important factor influencing the operation of the market measures in 2008 and 2009.

#### 66.

The flexibility provided to the Commission by the Single CMO Regulation in relation to the operation of intervention measures by tender after specified quantities have been bought, and the Commission's use of that flexibility, was referred to by the Court in paragraph 53. This highlights the scope of the market management measures to help provide stability even in a major crisis.

#### Recommendation No 1

The Commission will continue to monitor developments in the sector closely. In this regard the market reports to be submitted to Parliament and the Council in 2010 and 2012 will provide useful indications on production and market developments as the 2015 expiry of the quota regime approaches.

Following a request by the European Council, on 22 July 2009 the Commission adopted a communication 'Dairy market situation 2009' (COM(2009) 385) that included possible options to stabilise the market, while complying with the outcome of the health check. The Council will discuss the communication in September 2009.

#### 67.

The stability of nominal prices and the fall in real prices is a phenomenon common to several sectors, not just the milk sector. Milk producers have not been alone in experiencing the absence of 'stable prices in real terms' as described by the Court.

## REPLIES OF THE COMMISSION

Moreover, price developments must also be assessed in the light of international market developments and the price differential with the world market price must be reduced.

The structural adjustment of the sector to new market opportunities is supported by rural development funding, while decoupled direct aid should help to secure farmers' income.

As pointed out by the Court in Recommendation No 2, price formation at the retail level is a complex issue, with the cost of raw milk playing a limited role in the process. However, in order to provide better information to consumers, public authorities and market operators, permanent European monitoring of food prices and the supply chain was proposed in the Commission communication 'Food prices in Europe' (COM(2008) 821 final).

### **Recommendation No 2**

A High Level Group<sup>2</sup> on the Competitiveness of the Agro-Food Industry recently proposed a series of initiatives that the Commission intends to implement during the coming months. These initiatives are part of the implementation of the roadmap to improve the functioning of the food supply chain that was presented by the Commission at the end of 2008 in its communication 'Food prices in Europe' (COM(2008) 821 final). Among the five main components of the roadmap agreed by the Council in December 2008 was permanent European monitoring of food prices and the supply chain. This monitoring tool should provide better information to consumers, public authorities and market operators and so address the lack of transparency of prices and improve the knowledge of the impact of regulation along the food supply chain. The Commission will present a follow-up report on this roadmap at the end of 2009. In addition, a fast-track survey of dairy markets was recommended to the European Competition Network Food Sub-group meeting in early July 2009, to stimulate

<sup>2</sup> The main role of the High Level Group (chaired by one of the Commission Vice-Presidents with the participation of the Commissioners responsible for Agriculture and Rural Development, Consumer Protection and Health, was to provide advice to the European Commission with a view to enhancing and promoting leadership of the European agro-food industry. It was designed to provide a political momentum for the process and a platform for discussion on sector-specific recommendations (but not to follow the dynamics between producer and consumer prices). The Group aims to bring together key stakeholders in the food industry. Representation was at the highest level.



## REPLIES OF THE COMMISSION

and coordinate simultaneous monitoring and data collection by national competition authorities. Furthermore, as part of the retail market monitoring exercise, the Commission is also examining best practices across Member States in terms of contractual relations between suppliers and retailers. The work will be completed by the end of 2009.

At the moment, concentration is much more important at the retail level than at the processing level.

### 69.

The CAP has a range of instruments, in particular in the field of rural development, that, in addition to promoting competitiveness, seek to prevent land being abandoned, to preserve and improve the environment, to better integrate agricultural activity into the socio-economic context of rural areas and to support restructuring in the sectors most exposed to change.

### Recommendation No 3

- The Commission has been looking at the problems of less-favoured areas since 2005, taking account inter alia of the Court of Auditors' Special Report No 4/2003. The discussion has already resulted in amendments to the legislative framework for these areas and is still ongoing (see the recent communication from the Commission (COM(2009) 161 of 21 April 2009)). The specific situation of mountain areas will be addressed by a Commission working paper to be presented in November 2009. Under both the first and second pillars, Member States may adapt the instruments available to the specific needs of regions. Measures available are the possibilities under Article 68 of Regulation (EC) No 73/2009 and the possibility to offer specific rural development measures in regions according to their needs.

- The environmental aspect must be taken into account at two levels: (i) the legislative level, at the same time monitoring compliance with environmental protection standards and good agricultural and environmental practices that determine direct aid and aid under rural development priority 2; (ii) the incentive level, through aid for the introduction of greener agricultural practices, such as agro-environmental measures under rural development.

## REPLIES OF THE COMMISSION

**71.**

The world cheese market is very significant and the EU is the world leader in this product category. The EU dairy sector is highly competitive in many market segments because of the quality and innovativeness of its products.

**72.**

The Doha Development Agreement has not been reached and for the moment there is no obligation for the EU to abolish its export subsidies.

**Recommendation No 4**

The Commission agrees that the EU dairy sector must strive to optimise its returns from value-added products, while recognising the importance of satisfying consumer needs for a range of high-value and basic products, the need to exploit all milk constituents, including protein and fat, and takes account of the diversity of milk production conditions throughout the Community.





European Court of Auditors

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MILK HAS ALWAYS BEEN A STRATEGIC SECTOR OF THE COMMON AGRICULTURAL POLICY. IN THIS SPECIAL REPORT, THE EUROPEAN COURT OF AUDITORS REVIEWS THE OPERATION OF THE MARKET IN MILK AND MILK PRODUCTS SINCE THE INTRODUCTION OF MILK QUOTAS IN 1984, AND ANALYSES HOW THE COMMISSION IS MANAGING THE PROGRESSIVE DEREGULATION OF THE MILK SECTOR INITIATED IN 2003.

BASED ON THE SITUATION AT THE END OF 2008, THE COURT MAKES RECOMMENDATIONS TO THE COMMISSION ON A NUMBER OF REQUIREMENTS: TO AVOID A RETURN TO OVERPRODUCTION, TO MONITOR PRICE FORMATION WITHIN THE FOOD CHAIN, TO INTENSIFY REFLECTION ON THE PROSPECTS FOR PRODUCERS IN LESS-FAVOURLED REGIONS AND ON THE ENVIRONMENTAL CONSEQUENCES OF A GEOGRAPHICAL CONCENTRATION OF PRODUCTION, AND FINALLY, TO REORIENT MILK PRODUCTION TOWARDS THE NEEDS OF THE EUROPEAN DOMESTIC MARKET AND TOWARDS HIGH ADDED VALUE PRODUCTS WHICH CAN BE EXPORTED WITHOUT BUDGETARY ASSISTANCE.



EUROPEAN COURT OF AUDITORS



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