Dairy UK

The CAP Health Check
and the
Dairy Sector

February 2008

THE VOICE OF THE DAIRY INDUSTRY

THE CAP HEALTH CHECK AND THE DAIRY SECTOR

Foreword

As progress on the CAP Health Check is starting to quicken this is the second booklet published by Dairy UK examining the issues at stake and their potential impact on the dairy sector.

The issues raised are important and we want to keep you informed of the state of the debate. At the same time, as a valued industry stakeholder, we are equally keen to hear your views. If you have any thoughts or queries arising from this booklet please don't hesitate in letting us know.

Jim Begg
February 2008

SUMMARY

- **The Commission's proposals for the CAP will simplify single payments, scale back market support and create the framework for the abolition of dairy quotas.**
- **Dairy UK supports the creation of a market led industry, and the abolition of quotas is a necessary part of that process.**
- **Whilst the prospects for the industry in the long term are positive, overall the medium term effect of the Commission's proposals for the dairy sector would be to create downward pressure on milk prices.**
- **The Commission must create a market management strategy that ensures that the scaling back of support does not de-stabilise the market. This may require export refunds to be retained for butter for as long as possible.**
- **Residual market management mechanisms, such as a safety net intervention system, need to be retained to address price volatility.**
- **The most effective method for the removal of quotas is through gradual flat rate quota increases applied equally across all Member States until quotas have no value attached to them.**
- **A 2% quota increase for the 2008/09 quota year will prejudice a 'soft landing' for the removal of quotas as the scale of this increase could result in market instability.**
- **Caps on direct payments will discriminate against more efficient UK farmers and greater modulation will reduce the value of the single farm payment.**
- **The UK dairy industry is engaging constructively on all aspects of the environmental agenda.**

THE COMMISSION'S PROPOSALS

The Commission has recently published its proposals for the Health Check. The outcome of the debate on these proposals will set the framework for the management of the EU dairy market up to the expected abolition of quotas in 2015.

The issues raised are of great importance to the UK dairy industry. This document:

- Reviews the Commission's proposals.
- Discusses the economic position of the dairy industry.
- Sets out the position of Dairy UK.

The Commission published its proposals for the Health Check in November 2007 for agreement in 2008 and implementation from 2009. In summary the Commission is proposing:

Single Farm Payment

- Permitting member states to move from payment systems based on historic entitlements to area based payments.
- Capping individual payments.
- Eliminating the remaining coupled payments.
- Qualifying the scope of cross compliance.

Dairy Sector

- Permitting the quota regime to lapse on the 31st March 2015.
- Increasing quotas annually to generate a soft landing.
- Scrapping all dairy sector market management instruments with the exception of an intervention safety net and Private Storage Aid.

Other issues

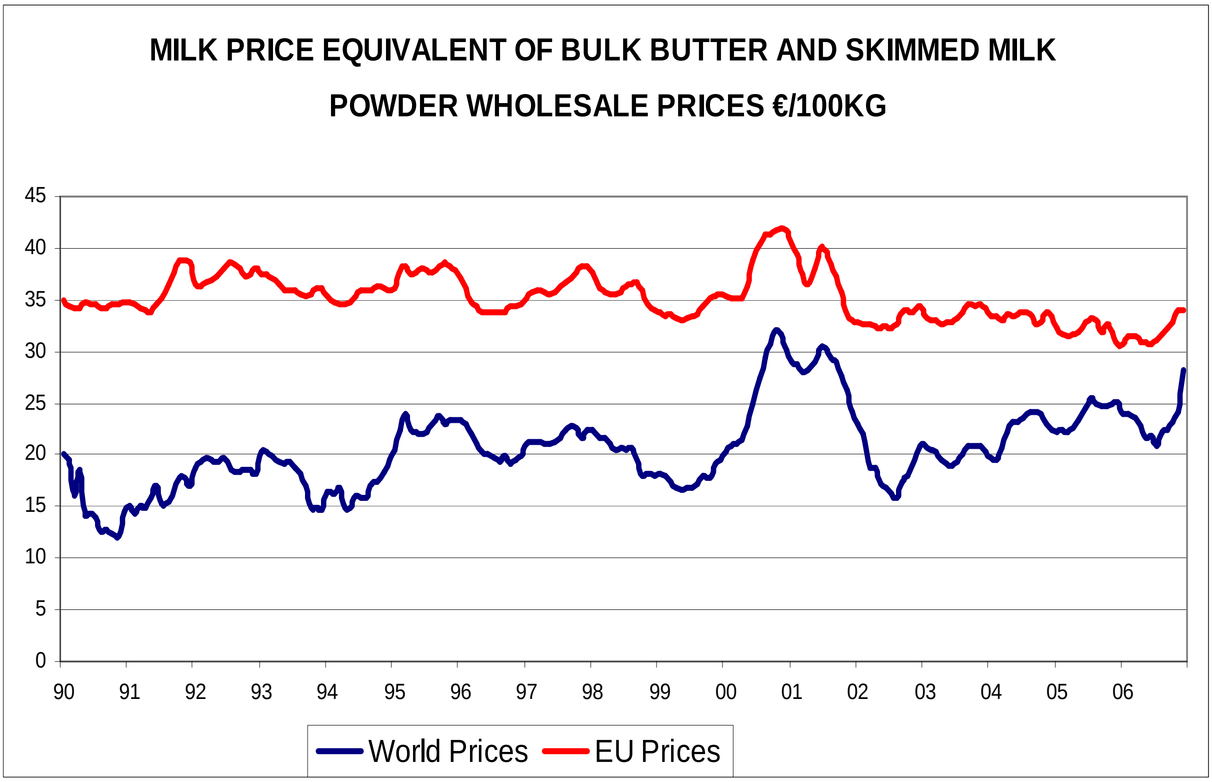
- Greater compulsory modulation to fund Rural Development.
- Addressing environmental issues such as climate change, bio-energy, water management and bio-diversity.

THE ECONOMIC POSITION OF THE DAIRY INDUSTRY

The Commission's overall objective is to liberalise the dairy sector by phasing out the dairy sector market management regime. This regime has kept EU prices above world prices and phasing it out will imply a greater degree of convergence with world prices.

The policy of the European Commission is to disengage from market management for agricultural products. Instead income support for farmers is to be provided by the single farm payment.

Market support in the dairy sector has maintained EU prices higher than world levels.



EU prices have been held higher than world prices through:

- Prohibitive import tariffs, which have prevented imports entering the EU.

- Export refunds, which have allowed the EU to clear its exportable surplus from the EU market at prices which are competitive.

The Commission has clearly signalled its expectation that the days of export refunds are numbered. The EU has already entered into a conditional commitment to abolish export refunds by 2013 as part of the WTO negotiations.

Without export refunds a greater convergence with world prices is necessary if the EU is to continue to export dairy products. This will be all the more necessary as the removal of quotas will allow an increase in the volume of product that the EU could have available to export to the world market.

The impact the loss of export refunds will have on the sector depends on the future relationship between EU and world prices.

There are a variety of reports that cover trends in the world dairy market. The majority only attempt volume forecasts. All of these are very bullish about the prospects for the growth in world demand in the long run. By way of example:

FAO – OECD Agricultural Commodity Markets; Outlook 2007 – 2016

% Annual Change in Global Demand 2007 - 2016

Butter	+2.3%
Cheese	+1.3%
Skimmed Milk Powder	+1.1%
Whole Milk Powder	+2.5%

ZMP Forecasts 2007 (German Market and Price Reporting Bureau)

Increase in demand

	Increase in annual demand by 2015: million tonnes	Annual % change to 2015
India	28	2.8%
Latin America	16	3.2%
China	9	8.6%
North America	8	0.9%
EU 27	7	0.6%
Other	56	
Total	125*	

(current total world production is 551 mt)*

However, only two organisations have attempted price forecasts for the world market over the next decade. They are:

- OECD: Organisation of Economic Co-operation and Development.

- FAPRI: Food and Agriculture Policy Research Institute.

Assuming no change in the dairy sector CAP, these organisations predict that the world price of Skimmed Milk Powder would be above the EU's intervention buying price, which itself was reduced as a result of the 2003 round of CAP reform. For butter, the relationship would be the other way round, with world prices significantly below the EU intervention price.

When the commodity price forecasts are converted into their milk equivalent, the resulting prices are generally just below the support levels provided by the EU's much reduced intervention support price level.

World Price Forecasts and EU Support Prices: Milk Price Equivalent €/100kg

	2007	**2010**	**2013**	**2016**
Current EU Intervention price	22.0	22.0	22.0	22.0
OECD	19.0	21.0	20.4	21.1
FAPRI	21.8	21.9	21.4	22.1

The EU support price compares with the average UK milk price over the last 12 months of around €27/100KG. It is widely accepted that milk production would not be viable at the intervention support price.

The normal relationship between the world and EU markets was briefly transformed in the second half of 2007 when world prices rose close to EU levels. This was due to sustained increases in demand as a result of economic growth, especially in the Far-East, and buoyant oil prices boosting the purchasing power of many food importing countries.

This interacted with shortfalls in availability of milk supply due to drought in Australia, the imposition of export taxes by Argentina and an export ban by India.

The surge in prices has begun to unwind and there is no certainty as to where they will stabilise. Most commentators expect prices will move to a higher level than they were previously but, a recent study by Ireland's RERC predicts that over time the normal relationship between EU and world prices will re-emerge.

Further reform of the dairy sector CAP implies further price deflation for the dairy sector.

Assuming world prices remain below EU levels, then removing export refunds would mean that the EU would have to adjust its prices to become more competitive on the world market. Removing quotas would potentially increase the supply of exportable surplus from the EU. Overall the effect would be to subject the sector to further downward price pressure.

According to a study commissioned by Defra and the devolved administrations from AFBI (Agri-Food and Biosciences Institute Northern Ireland) and Queen's University Belfast, which used the FAPRI econometric model, the effect of the removal of export refunds and the abolition of quotas would be an increase in EU milk production of around 2% along with a fall in milk prices of 11.8%.

In this environment UK milk production is forecast to fall by 6% (around 800million litres).

This analysis is broadly confirmed by a study for the European Commission which shows that lifting quota limits by an annual increase of either 1 or 2% would result in a decline in EU prices of between 3.5% to 4% relative to the prices prevailing in 2008. By 2015 EU prices would be 11% lower than a baseline scenario of no change in policy. Whilst total EU output would rise, the Commission's research also forecasts a contraction of UK output.

The short-term quota increase proposed by the Commission will also negatively impact on prices.

Independently of the Health Check, the Commission has proposed a 2% increase in quotas for the 2008/09 quota year in response to recent market developments. The thinking behind this is set out in its 'Market Outlook for the Dairy Sector' and comes down to forecasts that internal EU demand will rise by 8 million tonnes over the next six years.

Nevertheless, the Commission's research on the effect of 2% annual quota increases showed that the greatest impact can be expected in the first year of implementation. This is contrary to the Commission's stated aspiration of ensuring a 'soft landing' whereby any instability arising from the abolition of quotas is minimised.

Any conclusion to the WTO negotiations on agriculture will reinforce the impact of the CAP reform process on the EU.

Because the WTO negotiations will accelerate the process of abolishing export refunds, and also result in greater import penetration into the EU market, then any WTO agreement will magnify the impact of the CAP reform process.

Currently the EU has been unsuccessful in obtaining in the negotiations any of the objectives requested by the EU dairy sector, which are aimed at facilitating the process of adapting to life without refunds, and minimising the impact of price volatility arising from more imports.

Dismantling the dairy sector market management regime will increase price volatility.

It is generally recognised that prices will become more volatile in future.

The dairy sector CAP regime has had a stabilising influence on prices, most notably through milk quotas controlling the supply of milk.

Dairy markets are very sensitive to changes in milk supply. This is because demand for dairy products is relatively unresponsive to changes in price. This means that small variations in milk supply can result in major changes in prices. This relationship is demonstrated by the experience of the USA, which does not have quotas. As a result prices oscillate wildly in response to changes in supply.

In addition to quotas the EU market management regime gave the European Commission a variety of tools to manage the market place.

These include:

- Changing aid rates for consumption programmes such as the incorporation of butter into pastry products and SMP into calf feed.
- Intervention purchasing, which places a floor in the market, and sales of stocks accumulated in intervention, which subdues price rises.
- Changing export refunds. This is possibly the most powerful tool for managing the market in the short-term.

Currently aid rates for all consumption subsidy programmes and export refunds are at zero because of high market prices.

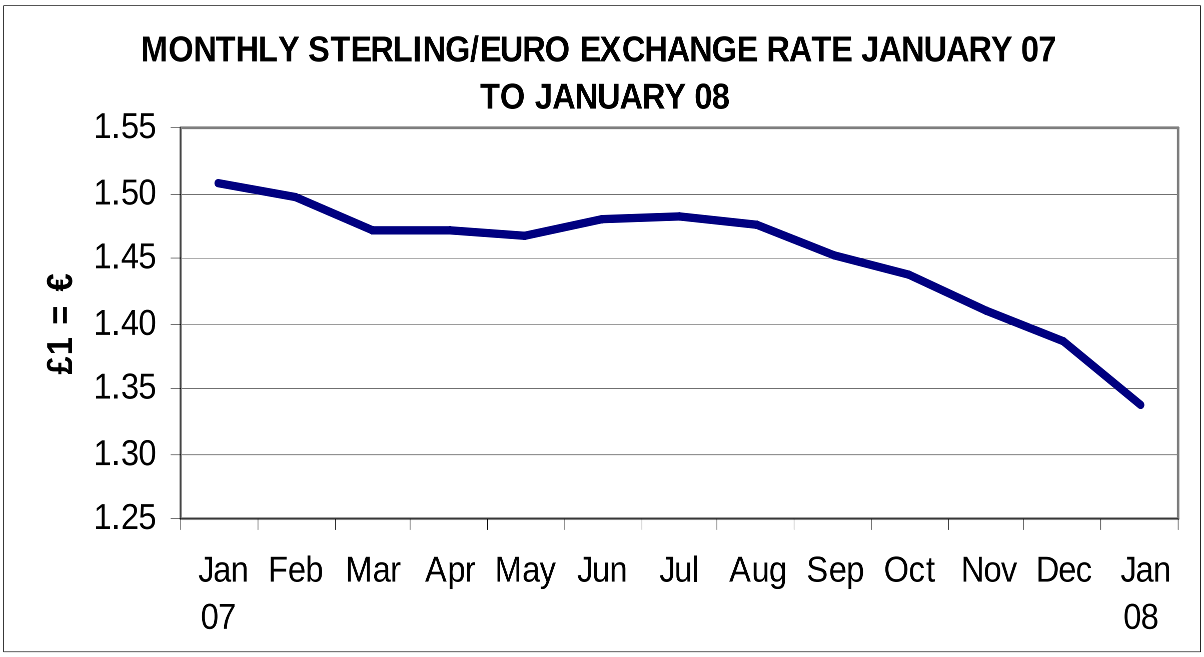
It can therefore be expected that dismantling the dairy market management regime and the scrapping of quotas will create a volatile price environment. Supply will fluctuate in response to changes in price which will in turn exacerbate price fluctuations.

Another source of instability will come from the seasonal interaction between the different milk production cycles in the Northern and Southern hemispheres. During the European autumn EU supplies to the world market will be less competitive due to the increase in production from Oceania, which has a lower cost base. In the spring and summer the EU will be more competitive because world demand cannot be met by Oceania. This variation in competitiveness over the year will create seasonal price changes.

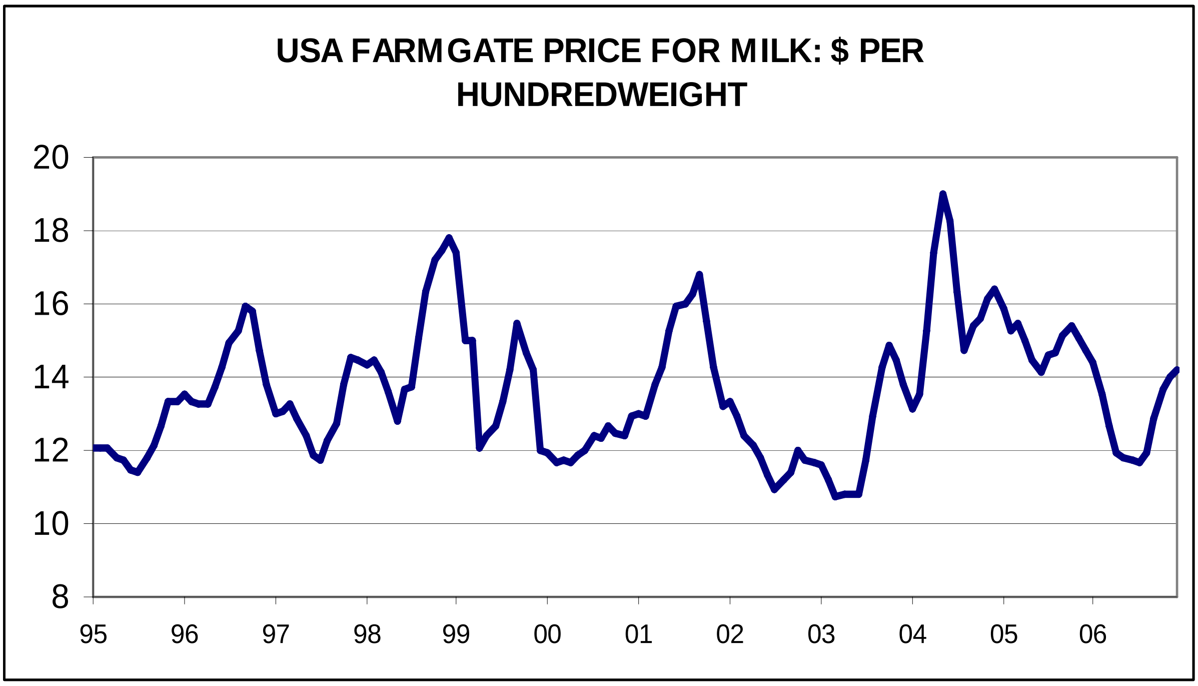
A further potential source of instability is currency. Changes in the value of sterling have significantly affected the UK dairy industry in the past. As the UK is fully integrated into the EU single market for agricultural produce then changes in euro-sterling exchange rate directly affect market returns.

In addition, changes in the dollar exchange rate affect the returns from exports, as dairy products are traded in US dollars on the world market.

The UK has benefited from a reasonably stable relationship with the euro over the past five years but recently this has changed with sterling devaluing against the euro by 11% since the beginning of 2007.



There are no financial tools readily available from the private sector to address the problem of price volatility, such as futures contracts for dairy products. Even in the USA, where a futures market exists for some dairy products, farmgate prices are volatile.



Changes in supply chain relationships and product differentiation will help to mitigate the impact of CAP reform on some dairy farmers.

The extent to which the effect of further CAP reform affects any individual dairy farmer depends on their position in the raw milk market. There have been developments in the industry's relationships with retailers that could help to soften the impact for many farmers.

Several of the major retailers have put in place dedicated supply arrangements whereby they obtain their supplies of drinking milk exclusively from a defined group of farmers. The price that these farmers are paid is a commercial matter but generally retailers pay a price premium to these farmers to ensure their sustainability. In some instances a formula has been agreed that acknowledges changes in input costs and builds in a premium over returns from commodity markets. It may therefore be the case that farmers included in these arrangements will be less affected by the impact of further CAP reform. However, at present, these arrangements only cover around 20% of farmers.

The development of integrated supply chain relationships is part of a more general trend in the industry away from price pooling where producers share in the returns from a multiplicity of markets. Instead producers are more likely to receive a price based on the end use of their milk.

The impact of CAP reform will be further muted by the industry's efforts to differentiate its product offering. Product differentiation reduces the impact of competition on price and generates more value from the market place.

However, those producers outside integrated supply chains and not supplying differentiated markets will be more exposed to the impact of CAP reform.

DAIRY UK'S POLICY POSITION

Abolition of Quotas

Dairy UK supports the abolition of the quota regime.

Dairy UK supports the creation of a market led industry free from dependency on taxpayer support or market interference. Abolition of quotas is a necessary part of that process. Dairy UK therefore does not wish to see the retention of quotas after 2015.

The dairy sector CAP has nevertheless created serious distortions;

- In the distribution of milk production within the EU and within EU member states. Removal of quotas will allow some regions to expand whilst milk will migrate away from other areas.

- In the relationship between the EU and the world market.

A transitional period must be agreed in consultation with the industry to allow these distortions to unwind. Dairy UK would like to see the highest degree of clarity and certainty arising from the debate on the Health Check to give the industry time to plan for its future.

Market Management

Export refunds for butter should be retained as long as possible.

One of the key elements in the reform process is how the EU will continue to manage the EU dairy market during the transition period. The Commission's objective is to realign EU prices to be more competitive with the world market, particularly for butterfat, whilst eliminating those market management instruments that would allow it to intervene in the market place.

Market management instruments influence demand in the EU market whilst quota controls affect supply, so they are the two sides of the same coin.

Consequently, in order to ensure that the lifting of quotas does not destabilise the dairy market, it is vital that the realignment of EU prices is integrated with, and harmonised to, the measures taken to lift quota constraints.

Given the importance of export refunds in managing the relationship with world prices we would argue that the Commission should retain export refunds for as long as possible. Particular emphasis should be given to retaining export refunds for butter, given the greater divergence between EU prices for butterfat and the world market.

Quota Increases

Removal of quota should be by flat rate quota increases.

The lifting of quota restrictions should be achieved by flat rate quota increases applied equally across all Member States. Granting discretionary quota increases for each Member State would not be transparent and could lead to discrimination.

The rate of quota increase should be determined every year according to market circumstances subject to a minimum rate, as predetermined increases could destabilise the market.

Dairy UK is opposed to a cut in the rate of superlevy as the sole mechanism used to lift quotas as this would penalise producers who expanded their production in response.

Dairy UK is opposed to reallocating un-used quotas between Member States to determine a country's liability to superlevy. The amount of unused quota would not be known until the end of the year, so producers would not know whether their country was liable for superlevy. This would increase the level of risk.

Dairy UK is strongly opposed to allowing quota to be permanently transferred between Member States. This would create the risk of the UK quota ceiling falling to current production levels, which would expose the industry to the risk of superlevy. This in turn would create demand for quota, which would drive up the price of quota and impose costs on expanding producers.

Dairy UK does not support tinkering with the butterfat mechanism. This mechanism adjusts an individual producers' levy liability by the extent to which the average fat content of their deliveries is above a pre-agreed limit. Changing the mechanism now would only exacerbate the EU's butterfat problem.

Price Volatility

Mechanisms need to be retained to reduce price volatility.

The issue of increased price volatility arising from the reform of the CAP needs to be addressed. De-regulated agricultural commodity markets are inherently unstable. Price volatility can drive revenue from the industry and can be needlessly destructive productive capacity. Family farms can often only cope with price volatility by forgoing drawings from the business.

A lot of the challenges created by price volatility can be addressed by closer integration within the supply chain and contractual arrangements that spread price risk within the chain. However, not all of the customers served by the industry are in a position to participate in such arrangements. This is particularly true of the food ingredients sector, smaller retailers and export markets. This means that, potentially, a large number of producers will remain exposed to price volatility.

It is conceivable that the private sector could develop risk management instruments, such as a futures market. However, whilst these instruments may provide for greater certainty, they will not necessarily reduce price volatility.

Dairy UK therefore strongly supports the retention of a safety net intervention system that would reduce the impact of downward price oscillations but which would not affect overall average prices. It should be noted that a properly run safety net system should not impose a burden on the EU budget. Stocks would only accumulate when prices were genuinely below the market average and these could then be sold out at a profit when the market recovered.

Maintaining aid for a private storage scheme would also help to dampen down the effect of seasonal variations in supply.

Short-term Quota increase

A 2% quota increase for the 2008/09 quota year will prejudice the Health Check and de-stabilise the market.

UK milk production is significantly below quota so the opportunity for UK producers to expand already exists. The effect of any short-term quota increase would be to increase supplies to the EU market, which would subdue prices. It would also inject a degree of instability into a situation where producers are looking for certainty and predictability.

Quota increases should be implemented as part of a structured process of reform phased in after agreement of the Health Check package. This would be from 2009 to 2015. The Commission's research shows that a 2% quota increase would prejudice a soft landing.

Single Payment

Caps on direct payments will discriminate against more efficient UK farmers and greater modulation will reduce the value of the single farm payment.

Capping payments to individual farmers will discriminate against the UK, which has generally larger farm sizes than those in the EU, although the UK would not be the sole country affected.

Direct payments are conceived of as payments in exchange for public goods such as environmental benefits. There are no proven economies of scale in the provision of these benefits. The compensation for providing these benefits would be reduced.

It would also be a largely wasteful exercise as farms would be split up to come in under any ceiling. This process is already underway.

Further modulation to fund the second pillar of the CAP would reduce the value of direct payments to farmers. UK dairy farmers are already subject to very high rates of voluntary modulation to finance Rural Development measures. In addition the UK's share of Rural Development funds is low because of the UK's historic lack of take up of these measures. On this basis Dairy UK would not support more compulsory modulation until the allocation of Rural Development funds between Member States is fundamentally reviewed.

However, if compulsory modulation is to be extended, the EU legislation should at the same time require corresponding reductions in voluntary modulation rates. This will ensure UK farmers do not continue to be disadvantaged by a higher total modulation rate than elsewhere in the EU.

Climate Change, bio-energy, water management and biodiversity

The UK dairy industry is engaged constructively on environmental agendas.

These are huge environmental issues but the Commission's communication is relatively brief and sketchy on what is being proposed.

The UK dairy industry fully recognises the importance of green measures and is engaged with Defra in creating a road map for the sector that will identify targets for improvements in environmental performance up to 2020. Finalisation of the road map will constitute a major commitment by the dairy sector towards sustained and demanding improvements in its environmental performance.

The road map will operate in conjunction with other commitments the sector is entering into. An Environmental Plan for Dairy Processors is being drawn up with the Environment Agency and an Environmental Plan for Dairy Farmers is already in place. This identifies the key messages for farmers that will significantly improve the environmental performance of the milk production sector. Dairy UK itself also administers the industry's Climate Change Agreement.

Dairy UK notes that the Commission's document acknowledged the importance of research and innovation in addressing new environmental and productivity challenges. Dairy UK thinks this is a correct observation but its importance is underestimated and much greater emphasis needs to be given to the role the EU and government can play in this area.

Peter F Dawson
Policy Director
Dairy UK

Dairy UK
93 Baker Street
London W1U 6QQ

Tel: 0207 486 7244
Fax: 0207 487 4734
[e] info@dairyUK.org
[w] www.dairyUK.org