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Director-General for Agriculture and Rural Development
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Dear Mr Haniotis

1ST PUBLIC CONSULTATION ON THE CAP HEALTH CHECK

Please find below the submission by Dairy UK to the Commission's consultation on the Health Check.

If you have any queries on this document please don't hesitate to contact me.

Yours sincerely,



Peter F Dawson
Policy Director
Dairy UK

**SUBMISSION BY DAIRY UK TO THE 1ST PUBLIC CONSULTATION ON THE
CAP HEALTH CHECK**

Dairy UK

1. Dairy UK is the trade association that represents the dairy industry supply chain in the United Kingdom. Dairy UK's remit covers the interests of dairy farmers, producer co-ops, dairy processors and doorstep deliverymen.
2. The milk processed by Dairy UK members equates to 90% of the milk produced in the UK.

Introductory Comments

3. The UK dairy industry is market focused, competitive and highly efficient. Herd sizes in the UK are the third highest in Europe.
4. Dairy UK's aspiration is the creation of a market driven dairy 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.
5. The dairy sector CAP has nevertheless created serious market distortions;
 - in the distribution of milk production between and within EU Member States. Removal of quotas will allow some regions to expand production whilst milk will migrate away from other areas,
 - in the relationship between the EU and the world market.
6. A transition period will therefore be required to allow these distortions to unwind. The EU must develop a clear pathway through this transition period in consultation with the dairy industry. 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.
7. The principle issue in determining a pathway to the abolition of quotas will be the role of the remaining elements of the dairy sector market management regime, principally intervention purchasing and export refunds. In the absence of any constraint on production through the abolition of quotas, then the extent of the support provided by intervention and export refunds needs to be reconfigured. In particular this will necessitate changing the EU's relationship with the world market.

8. The dairy sector market management regime has generally resulted in EU prices being higher than the world market. The 2003 reform brought greater convergence between the world and EU market in the value of dairy proteins, but there still exists a considerable disparity in respect of the value of butterfat. Whilst this divergence exists there will remain a role for the European Commission in managing the EU dairy market to achieve a gradual and phased convergence with world prices. This will assist the dairy industry to develop new products and marketing structures in response to the challenge of obtaining a more competitive valuation for butterfat.

Response to Questions

Simplifying the Single Payment Scheme

Do you agree that Member States should be allowed to adjust their SPS model towards a more flat rate of support, at national or regional level?

9. Dairy UK would not object to Member States being allowed to adjust their SPS models towards a more flat rate system of payment. This would introduce a sensible degree of flexibility within the system that would allow Member States to adapt their implementation model to the changing expectations and demands of their electorates. However, it is important that any shift to a flat rate system remains entirely optional. There should be no compulsion involved in the process and it should remain entirely at the discretion of Member States or regions whether they would wish to move away from historic payment systems.

Cross Compliance

What impacts do you see emerging with the possible addition/deletion of certain legal requirements or GEAC standards?

10. Cross compliance standards will inevitably need to evolve to reflect the continuous refinement in standards and legislation governing cross compliance requirements. However, changes should essentially be confined to legislative developments within the areas already covered by existing obligations. The logic of the single farm payment is that it is a payment in exchange for achieving the range of obligations required by cross compliance. Therefore fundamentally new obligations should not be added unless this is matched by a re-evaluation of the value of the single farm payment.
11. For the dairy sector the benefit dairy farmers will derive from the CAP will be further reduced by the abolition of quotas. There is no expectation that dairy farmers will receive compensatory payments for the adjustments to price support that will follow from the abolition of quotas. In this environment it would not be equitable to increase the cross compliance obligations on the sector.

Partially Coupled Support

Should decoupling be applied in full extent to all sectors? Would there be specific impacts with this option?

12. In a situation where the majority of payments are decoupled, then the retention of coupled payments for any sector essentially distorts the commercial environment farmers operate in. Therefore in principle Dairy UK would support the abolition of all remaining coupled payments.

Upper and Lower Limits of Support Levels

How effective do you think capping will be in addressing the problem of the uneven distribution of payments between farmers?

13. Dairy UK is strongly opposed to the imposition of upper limits on payments to farmers. There is no economic justification for this measure. There are no demonstrable economies of scale in meeting cross compliance obligations. No evidence is available that larger farms have a lower unit cost in complying with cross compliance obligations than smaller farms. The proposed measure would only discriminate against larger more efficient farms. As UK dairy farms are generally larger it would create competitive distortions to the disadvantage of the UK dairy industry.

14. The proposal is a political response to the public's erroneous perception that it is unfair that larger and therefore 'richer' farmers should receive larger payments. This perception should not be pandered to by capping payments, but by educating the public that payments are essentially made for the farm, and not the farmer, and consequently larger farms deserve larger payments. Introducing payment caps will only reinforce the public's negative perception of larger farms and introduce a market distortion that will retard the continuing evolution of production structures at farm level.

15. The proposal is also essentially futile in that farms will restructure themselves to circumvent any legal definitions put in place by the Commission.

What potential impacts do you see in the option of adopting a minimum level in payments?

16. In respect of instituting a lower limit there are strong arguments to exclude hobby farms where the agricultural activity is trivial in scale and not a serious commercial undertaking. In the UK this population of claimants clogs up the administrative system and significant savings could be achieved if they were removed.

Cereals Set Aside

Do you consider that abolition of set-aside in the current context of market and policy developments is appropriate?

17. Dairy UK supports the abolition of set aside. The support given to bio-energy produced from crops has created serious distortions in the arable sector which has driven up the price of feed inputs for dairy farmers. Removal of set aside constraints will help the EU to increase production to meet the demand for biofuels and reduce the price pressure on the feed market.

18. The range of options permitted under the Rural Development Regulation should allow Member States to put in place measures to maintain the environmental benefits associated with set aside.

Dairy Quota

Do you consider that the quota system is still fulfilling its stated objectives?

19. The quota regime is acting as an effective constraint on total EU milk production.

What benefits and what risks do you see from doing nothing and simply letting the quota regime expire in 2015?

20. All available studies indicate that the removal of quotas would result in an expansion of total EU production with a consequential downward impact on prices. It would therefore be irresponsible simply to do nothing and let the quota regime expire. This would impose a rapid and disruptive price adjustment on the industry. We therefore support the Commission's aspiration for a smooth landing.

What kind of effects do you see emerging in the case of a gradual phasing-out of quotas through increasing their annual level? What would you propose as an alternative or accompanying transition measure?

21. A smooth landing should be achieved by manipulating both the supply constraint (quotas) and demand management tools (refunds, intervention purchasing) under the dairy sector CAP. The policy for each of these areas will be equally important in managing the EU market towards a smooth landing. It is therefore essential that the Commission's strategy for both sides of the market management regime is made clear before the abolition of quota.

22. The determination of policy towards intervention purchasing and export refunds is currently distorted by the abnormally high world prices seen over the last six months. This has led to the view that the abolition of the dairy sector market management regime could be undertaken without any fundamental impact on farm incomes. This is an unrealistic assumption as the surge in prices is already beginning to unwind.

23. Recent studies undertaken using the FAPRI econometric model for the world and EU dairy markets, which take into account the recent price increases in the world market, show that after a few years the normal relationship between EU and world prices can be expected to re-emerge, with world prices significantly below EU levels.

24. Whilst EU internal demand will continue to rise the EU will still have a requirement to export product on to the world market. This will be even more necessary once quotas are abolished and production increases. Consequently the prices achieved for world market sales by the EU will have a major impact on the EU's internal price. The fact that the majority of EU product is sold internally within the EU does not isolate the EU from the effect on marginal prices of the world market. The policy towards export

refunds therefore becomes crucial in shaping the market returns of the EU dairy industry and consequently equally crucial in determining the impact quota abolition will have on the industry.

25. It is therefore necessary to know how the EU's export refund resources are to be used and for how long and how policy on refunds will be co-ordinated with any increase in quotas. In particular the industry needs to know for which product provision of export refunds will be given priority.
26. Clarity on this issue cannot be provided by relying on the WTO negotiations to provide a framework for the elimination of refunds. At present it is unlikely that the talks will conclude for some time and in the absence of any agreement any dispute panels brought against export refunds by WTO members will take a long time to resolve. Even if there is a WTO agreement the EU will need to decide how it will use the flexibility available to it to manage the elimination of refunds. Dairy UK also does not believe that world prices can be expected to reside so close to EU price levels over the next seven years that there is no need to address the issue of refunds.
27. In Dairy UK's view there are strong arguments that a managed convergence in the future relationship between EU and world prices is required to be initiated first before quota increases are undertaken. This is because the alternative strategy is to remove quota limitations and allow producers to speculatively invest in increased production and then to find out how much they can afford to produce at the lower prices that will result from increased output from their more competitive colleagues. This is an expensive way of determining the equilibrium price that would stabilise EU output. It would be far more rational to adjust the price support provided by the CAP first.
28. The convergence with world prices should be achieved primarily by changes in export refund support against pre-agreed target returns. As stated above the disparity between world prices and EU prices exists primarily for butterfat. Consequently Dairy UK would argue that refunds for butter should be retained for as long as possible to smooth any convergence between EU and world prices. The next product to be given priority for refunds should be whole milk powder as this removes more butterfat by volume from the EU market than cheese or skimmed milk powder.
29. The lifting of quota restrictions should be achieved by uniform flat rate quota increases across the EU. Dairy UK would be opposed to cuts in the rate of superlevy as the sole mechanism used to lift quota restrictions as this would penalize expanding producers. However, this mechanism could be used in conjunction with flat rate quota increases.
30. Dairy UK would be concerned about country specific quota increases. This approach would lack transparency and there may not be enough reliable data available to determine how to equitably apportion quota increases amongst countries that are seeking to expand production.
31. Quota increases could be varied every year according to market circumstances or made according to a pre-agreed schedule. Whilst pre-agreed increases could create certainty, under certain situations they could also de-stabilise the market. On this basis a variable increase is to be

preferred, but possibly set against a pre-agreed market measure that would deliver some predictability.

32. Dairy UK is strongly opposed to allowing quota to be 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.
33. Dairy UK would not support liberalizing the butterfat mechanism. This would only exacerbate the EU's butterfat problem.
34. Dairy UK is opposed to balancing quotas at the EU level to determine countries superlevy liability. The amount of unused quota would not be known until the end of the year and therefore producers would not know whether their country was liable for superlevy. This would increase the level of risk they were operating under.

Managing Risk

Do you consider that currently available policy instruments provide adequate coverage to manage price risks?

35. 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.
36. A lot of the challenges created by price volatility can be addressed by closer integration within the supply chain and contractual arrangements that spread the risk of price volatility within the chain. However, not all of the customers in the markets served by the industry are in 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.
37. Dairy UK is of the view that the retention of an adequate safety net intervention system is therefore of considerable importance to the sector. The current value of intervention expressed at its raw milk price equivalent should be retained unchanged, although the balance between SMP and butter could be adjusted.
38. Any lower milk price equivalent would be too low to provide an adequate safety net. The Commission should not be concerned that the current level is too high as it is clear that milk production in the EU is not sustainable in the long term at the current value of intervention.
39. 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.

40. Over an annual time frame the continuation of aid for a private storage scheme would also dampen down variations in price created by seasonal variations in supply. This would benefit the consumer as much as the industry. It would also reduce the Commission's exposure to the risk of intervention purchasing. Against this range of benefits PSA is a cost effective measure. It is important that the Commission realises that PSA is valued by the industry not as a price support mechanism, but as a tool to address price volatility.

Do you consider that currently available policy instruments provide adequate coverage to manage weather-related or disease-related risks?

41. Other than localized extreme weather events, weather related risks in the dairy sector are translated into price volatility, which can be dealt with by the retention of intervention.

42. Disease related risks fall under the scope of animal disease control measures. This is currently being subject to a separate review by the Commission through the development of proposals for animal disease cost and responsibility sharing. Dairy UK is concerned that whatever proposals emerge they recognize:

- a. the fundamental interest society has in maintaining a viable livestock sector,
- b. the limited ability of individual farmers to finance disease risks
- c. the need to match cost and responsibility sharing with sharing of control and management

Do you see scope for the application of EU-wide measures to better address price and production related risks, or should such measures be applied more at the MS and regional level?

43. It is essential that any measures to manage price and production related risks are managed at the EU level. Delegation of this area to Member States would be invitation to re-nationalise the CAP.

Climate Change, bio-energy, water management and biodiversity

Do you consider that existing instruments under both pillars of the CAP are sufficient to respond to these challenges?

44. These are huge areas which the Commission's Communication and questionnaire does not do justice to and for which the challenges have yet to be clarified. Consequently they should be subject to a further separate review.

45. We would only note that:

- a. Adaptation to climate change and the reduction of the negative environmental impacts of agriculture still requires a great deal of fundamental research which could effectively be undertaken at the EU level.

- b. The dairy sector is potentially a major source of bio-energy through the generation of bio-gas from anaerobic digestion. Greater consideration should be given to how dairy farmers can make a contribution in this area. At the same time the sector is potentially subject to negative impacts from the support given to bio-fuels and the impact this is having on feed prices. These impacts need to be closely monitored.

Strengthening Rural Development

Do you think the proposed increase in modulation will help in achieving RD objectives, especially those linked to new challenges?

46. UK dairy farmers are already subject to very high rates of voluntary modulation to finance pillar II measures. In addition the UK's share of EU pillar II funds is unfairly low. On this basis Dairy UK would not support more compulsory modulation until the allocation of pillar II funds between Member States is fundamentally reviewed.
47. 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 and to remove an anomaly in policy between member states.