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**REPORT FROM THE EUROPEAN COMMISSION TO THE EUROPEAN
PARLIAMENT AND THE COUNCIL**

**Evolution of the market situation and the consequent conditions for smoothly phasing
out the milk quota system**

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MANDATE

Article 184(6) 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) provides for the Commission to present a report before 31 December 2010 and 31 December 2012 to the European Parliament and Council regarding the evolution of the market situation and the consequent conditions for smoothly phasing out the milk quota system, accompanied if necessary by appropriate proposals. The present report is the first of the two above mentioned reports.

INTRODUCTION

This report is made up of two parts: the first part describes the evolution of the market situation for cow milk from 2008, the year when the Health Check was decided, till the middle of 2010 and outline medium term prospects. A second part examines the phasing-out of the milk quota system.

1. EVOLUTION OF THE MARKET SITUATION FOR MILK AND MEDIUM TERM PROSPECTS

After a significant fall in prices and producers' incomes in 2008-09 that followed the price spike of 2007, the dairy market situation has recovered in the second half of 2009 and continuously improved in the first half of 2010.

1.1. Market developments to date

Cow milk deliveries remained relatively stable for the EU-27 over the past 3 years, with only small variations in percentage from one year to the other (+ 1% in 2008, - 0.6% in 2009, + 0.03% in the first 7 months of 2010).

The development of milk prices is shown in Annex I. Since the exceptional peak registered in 2007, farm gate milk prices have come down following the decline in dairy product prices. After a slight recovery between July and September 2008, prices fell to a low level in May 2009, a bit above safety net levels on average. Milk prices have increased from May 2009 until November 2009 and have stabilised around that level in the 1st quarter of 2010, contrary to the seasonal pattern that normally shows a decreasing trend during winter and spring. Milk prices have been increasing since spring 2010 to reach about 31.5 c/kg in August as a weighted average for the EU-27. For an overview on the significant variation in prices between Member States, please refer to Annex 2 comparing milk prices in August 2010 with those of August 2009 in the various Member States.

Intervention stocks of butter and skimmed milk powder (SMP) were empty in 2008, but private/industry stocks have been increasing both for SMP and butter throughout 2007-2008, indicating that while the markets were bullish, there was an increasing amount of EU bulk product that did not find its way to the market. Intervention stocks grew rapidly in 2009 in the wake of a drop in demand. The deterioration of the market in 2009 created an incentive for dairies to turn away from high value added dairy products (like cheese, fresh products,

yoghurts, etc.) towards intervention products (SMP and butter). In total, 76 367 t butter and 256 982 t SMP were bought into intervention in 2009. The safety net proved effective to rebalance the market by withdrawing from the market products corresponding to 1 or 2% of overall milk production. Thanks to a significant recovery in butter prices at the end of 2009 and in 2010 so far and favourable market developments for dairy products in general, there has been no buying-in into intervention in 2010 and intervention stocks are now nearly empty for butter and are gradually being reduced for SMP thanks to release under the most deprived persons' scheme and sales by open tender. The recovery in dairy commodity prices was due notably to reduced supplies from the Southern Hemisphere and better than expected recovery in world demand for dairy products. Improved market conditions have made dairies return to high value added dairy products.

Developments in average EU prices for the main dairy commodities have been volatile from 2008 till now. While prices were still at very high levels at the beginning of 2008, they fell to very low levels in the first half of 2009 and continuously recovered in the second half of 2009 and first 3 quarters of 2010.

EU dairy exports experienced a drop in 2008, especially for butter and butteroil, the only major exception being whole milk powder (WMP). The trend was halted in 2009 with the introduction of export refunds to cover part of the increasing gap between world market and EU prices. EU exports recovered in the first months of 2010 without export refunds due to increased world demand.

1.2. Medium term market development

Medium-term market prospects for the EU have been simulated with the Aglink-Cosimo model. The world market and policy environment is based on the *OECD-FAO Agricultural Outlook 2010-2019*, applying latest available macro-economic projections and assuming no changes in the CAP following the Health Check decisions and no changes in trade policies. Some of the most important drivers of the market projections are the improved GDP growth prospects, the assumption about a gradual strengthening of the Euro versus the US Dollar and the OECD-FAO world market price projections¹ for dairy commodities. If any of these projections/assumptions do not materialise, this would affect the resulting projections significantly. Furthermore, greater price volatility expectations are not incorporated into the Aglink-Cosimo model.

Based on this model and the above mentioned assumptions, milk production is projected to return to an increasing path from 2011 onwards, driven by a fairly optimistic demand outlook based on improved macroeconomic prospects. EU-27 milk production in 2020 would exceed the 2009 level by about 3%. Milk deliveries would be expected to increase by a slightly higher rate, the difference being due to a gradually declining on-farm consumption in the EU-12. In the context of quota abolition, the EU-27 milk production is projected to depict a very modest reaction to the end of the quota regime with EU deliveries (see graph 2 of Annex 3).

The outlook appears favourable for higher value added dairy commodities, driven by growing demand for cheese and fresh dairy products. Production of fresh dairy products (including drinking milk, cream, yoghurts, etc.) is projected to increase by about 8% (from 2009 to 2020) and cheese output is depicted to grow by about 10%. Prospects for cheese exports can be deemed as favourable, notwithstanding an assumed gradual strengthening of the Euro currency, with the EU maintaining a steady share in global cheese exports above 30%.

¹ In the OECD-FAO Agricultural Outlook 2010-2019, world market prices are based on Oceania price quotations.

With regard to WMP, production is projected to fall only marginally below the 2009 level and EU exports would remain firm over the medium term, driven by firm global demand. Nevertheless, the EU market share of global exports would decline gradually to 21% by 2020 (from 24% in 2009).

The outlook depicts continued market stability for butter but conditional on firm domestic demand. The increase in projected production for 2015 (year of quota abolition) would lead to an increase in EU exports.

SMP export perspectives are less favourable given the assumed strengthening of the Euro and strong supply from other exporters. Despite the relatively favourable outlook and apparent market stability for SMP, the nearer term prospects remain sensitive to global supply-demand developments and the EU market's ability to absorb the release of intervention stocks.

Corresponding graphs are attached in Annex 3.

2. EVOLUTION IN TERMS OF SMOOTHLY PHASING OUT THE MILK QUOTA SYSTEM

2.1. Milk production below quota

The Council decided to increase milk quotas by 2% on 1 April 2008. The Health Check decisions of November 2008 resulted in an annual increase in milk quotas by 1% over 5 consecutive years, beginning on 1 April 2009, plus an adjustment of the fat correction factor which resulted in a further de facto 1% increase in quotas. There remains 3 times 1% annual increase until the expiry of the quota system on 1 April 2015 (except for Italy where it was decided to frontload the 5% increase already as of 1 April 2009).

Year on year, milk quotas are gradually becoming less relevant, as milk production falls short of quota in an increasing number of Member States. While surplus levy had to be paid by 6 Member States in quota year 2008/09, only 3 are on course to pay one in quota year 2009/10. According to official notifications by the Member States, the 2009/10 quota year is estimated to have ended with EU milk deliveries approximately 7% under quota (see graph in Annex 4).

EU milk production grew only marginally in 2008 despite the 2% quota increase decided for the 2008-09 quota year and the relatively favourable milk price paid to producers over the calendar year. The economic recession impacted negatively EU and global demand for value added dairy commodities, which put dairy product prices under pressure and led to a significant fall in milk producer prices in 2009. These low milk prices contributed to a slight contraction in EU milk production in 2009 and early 2010. As a consequence, the 2008-09 quota year finished with a record undershoot of EU deliveries in relation to quota. This undershoot increased even further in the 2009-10 quota year. EU milk production recovered in the course of 2010, but remained significantly below quota level.

The slow response to quota increase is linked to economic recession, which triggered lower demand for dairy products, but also to higher production costs and resulting lower margins. Experience gained from the impact of the 2008/09 quota increase indicates that the response of milk production at the aggregate EU level remained fairly modest, despite a significantly higher average producer price for milk. Latest figures until July 2010 show a stronger production response to increased milk prices.

Milk quotas becoming less and less relevant, EU milk supply can better respond to market opportunities, farmers' response to price signals is less distorted and efficiency gains can be achieved through restructuring.

In Member States where the quota continues to be exceeded, this is probably due to the fact that certain producers have a sufficient margin over their costs to take the risk of an overshoot of deliveries, and fully use their capacity, hoping that others would not use theirs fully. Increasing production, even attracting a lower price, is seen as necessary by those farmers to cover their investment costs as long as prices cover marginal production costs. For some Member States whose dairy processing sector is export oriented, it is also linked to the fact that their product mix allow them to produce for export markets and find an outlet for their products.

2.2. Decreasing milk quota prices

One of the main signals that a "soft landing" is on track is the gradual erosion of the "quota rent". The quota rent is defined as the difference between the price under quota (higher than market price when quotas are binding) and marginal costs of production. A good indicator of the quota rent is the quota price. As detailed in Annex 5, the milk quota price is decreasing with the shortening life of the quota regime and is already low or close to zero in a vast majority of Member States. The situation may be seen from 3 perspectives:

1) Member States whose milk deliveries are well below the quota ceilings

In Member States whose milk deliveries are well below quota ceilings, the quota price is already very low or even equal to zero. In some of them, national administrative arrangements have been adopted to fix a decreasing quota price year on year to reach zero in 2015.

Provided production levels follow recent trends, for those Member States where the quota price is not fixed administratively but is already very low or equal to zero, quota prices are not expected to vary much from current levels. In Member States where there is a market for quotas, there is still a price for milk quotas notwithstanding the fact that no surplus levy is paid. Once closer to 2015, all quotas would lose value completely as their significance to the market diminishes and the writing-off term becomes shorter.

2) Member States whose milk deliveries are close to the quota ceilings

In Member States whose milk deliveries are close to the quota ceilings, the quota price is influenced by the prediction or expectation of the surplus levy. In case of under use of the national milk quota, quota prices decline. In the future, quota purchases are predicted to be further declining towards zero, with fluctuations due to surplus production and milk prices.

3) Member States whose milk deliveries exceed quota

In the limited number of Member States whose milk deliveries exceed quota, quota prices remain relatively high and have recently increased. In these Member States, producers appear to be sufficiently competitive or obliged to fully use their capacity to continue producing, and ultimately paying a surplus levy. In those Member States, a soft landing may not be guaranteed.

2.3. Expected evolution and sensitivity analysis

The evolution of milk production after quota abolition depends on various factors: the shape of the CAP after 2013 (market measures, direct payments, rural development), production costs, environmental obligations, alternatives in terms of job and production, evolution on the national and international milk markets including milk prices.

According to the econometric model used in DG AGRI to produce medium and long term prospects, the increase in milk production is projected to remain modest in the coming years, even after the abolition of the quota regime (see point 1.2 above). Some national studies suggest potential big increases in milk production; however most of them do not take account

of the whole EU-27 picture. Structural surpluses should be avoided thanks to the price mechanism. Various studies² carried out in the context of the Health Check show that only a limited number of Member States are expected to fully use increasing milk quotas for various reasons, while most Member States are expected to produce less, due to the expected overall decrease in milk prices.

2.4. Member States on track for “soft landing”

Both the evolution of milk production versus milk quotas, and the downward trend in quota prices show that the “soft landing” is on track. In the vast majority of Member States, quotas are no longer relevant to restricting production and the quota price has already reached zero or is on course to reach it.

As part of the Health Check and in the context of quota abolition, the milk sector has been added to the so-called "new challenges" under the second pillar of the CAP, where the increase in modulation funds was to target these new challenges. This is providing for further support to dairy farmers in preparing for the end of quotas.

3. CONCLUDING REMARKS

The milk sector went through a period of high price volatility from 2007 to 2009. Since then, the market situation has improved and prospects are broadly positive.

Overall, the milk sector is gradually heading towards more market orientation. The process has been affected by the economic crisis in 2008 and 2009. Volatility, which is a standard phenomenon in a market oriented sector, has become more pronounced and therefore damaging due to the convergence of exogenous factors, among which the fall in household consumption for lack of purchasing power in the wake of the economic crisis.

"Soft landing" is on track in an overwhelming majority of Member States. Milk quota prices have a very low value, already at zero in some Member States, and decreasing in most of the others with a view to reach zero in 2015. Milk quotas have ceased to work as a production limit in most Member States, especially in the new Member States, and market orientation is already the leading principle in a number of them.

The conclusion is that under these circumstances there is no reason to revisit the Health Check decisions with regard to the gradual increase in quotas and the end of the quota regime on 1 April 2015.

In order to further pave the way towards quota abolition in 2015, the Commission would like to raise for consideration a further step to assist in the process of soft landing: in order to increase awareness and reinforce the responsibility of operators in the dairy chain to better take into account market signals and adapt supply to demand, transparency should be enhanced, as pointed out by the High Level Group on Milk. In addition to the information systems already in place, meetings would be organised for the experts of the Management Committee for the single CMO jointly with the Advisory group on milk to follow market developments in order to assess the market situation and prospects.

In case of serious imbalance, as a further tool to stabilise the market and as an exceptional measure if other measures available under the single CMO appeared insufficient, the

² *Economic analysis of the effects of the expiry of the EU milk quota system* (http://ec.europa.eu/agriculture/analysis/external/milk/index_en.htm)
Economic Impact of the Abolition of the Milk Quota Regime – Regional Analysis of the Milk Production in the EU (http://ec.europa.eu/agriculture/analysis/external/milkquota/index_en.htm)

Commission could consider a system based on Article 186 of the single CMO ("disturbance clause") that would allow milk producers, on a voluntary basis, to reduce their deliveries against compensation. Experience gained during the milk crisis shows that it may be sufficient to take 1 or 2% of overall milk production out of the market to correct imbalances and restore stability, as mentioned under point 1.1 above.³

A further report will be tabled by the end of 2012.

Annexes: I. Milk price development

II. Farm gate milk prices in the various Member States

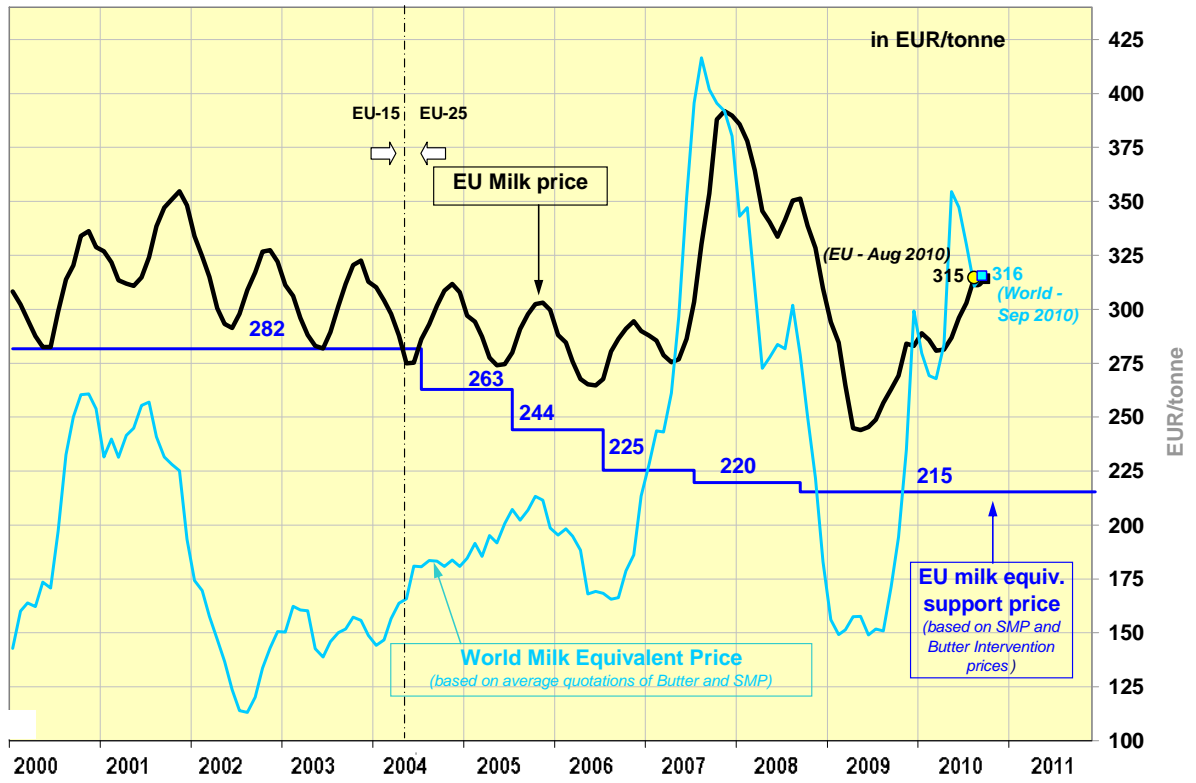
III. Medium term prospects in the dairy sector

IV. Milk production versus quota

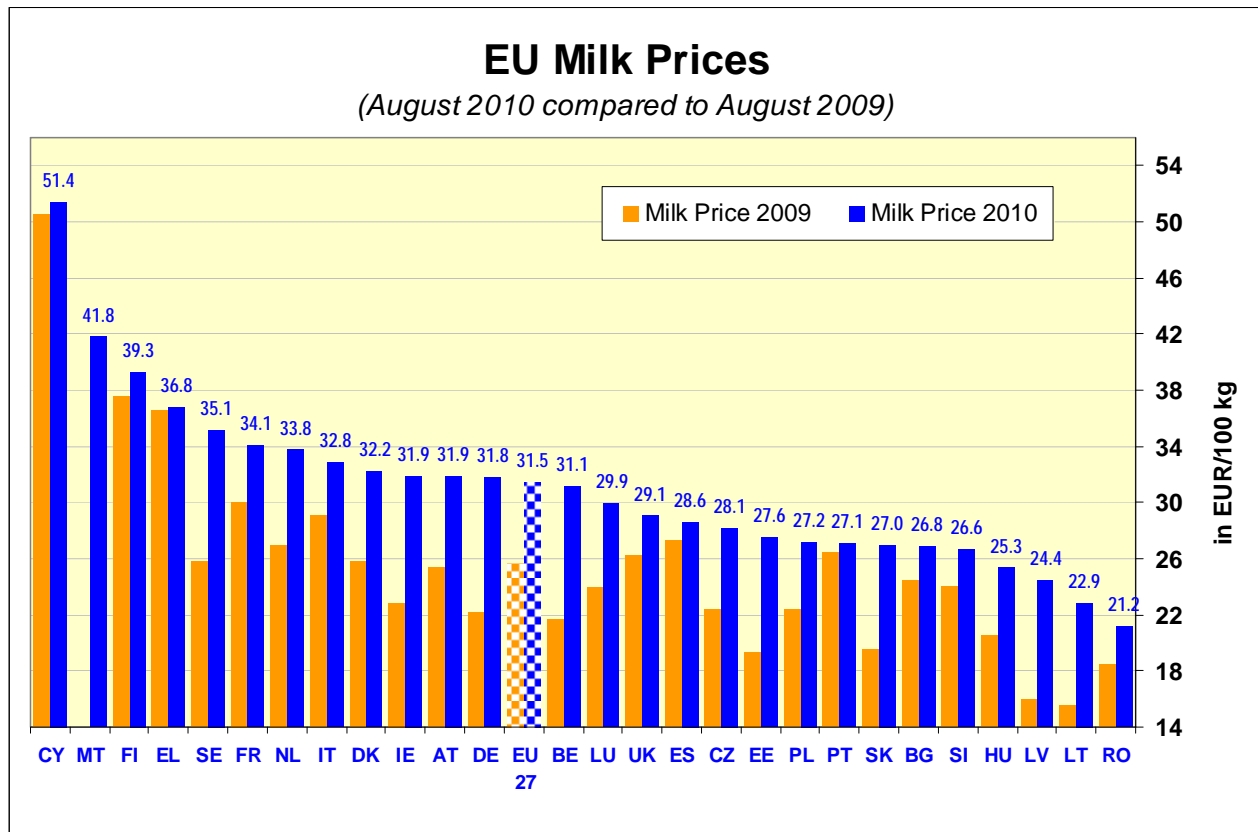
V. EU milk quota price development

³ The evaluation of such a scheme, including its financial impact, will be undertaken at the time of the presentation of a possible proposal.

ANNEX I : 1. Milk price development

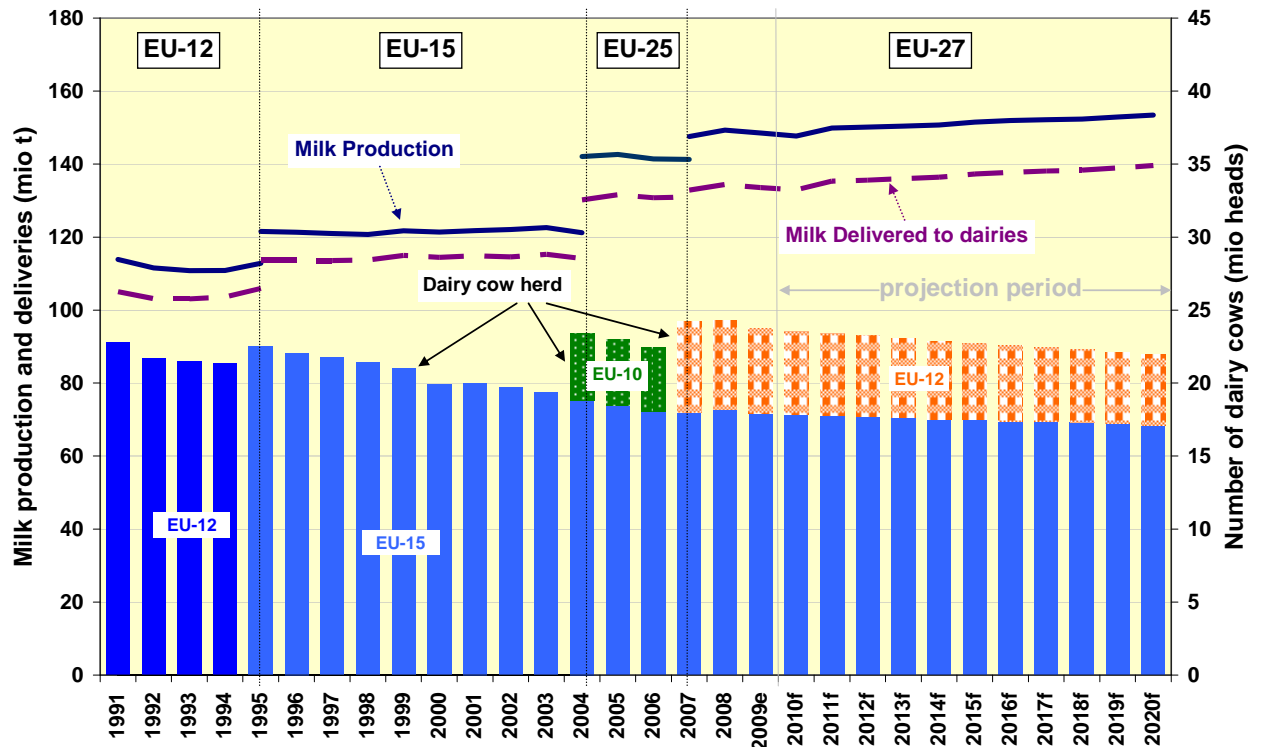


ANNEX II : Farm gate milk prices in the various Member States
August 2010 / August 2009

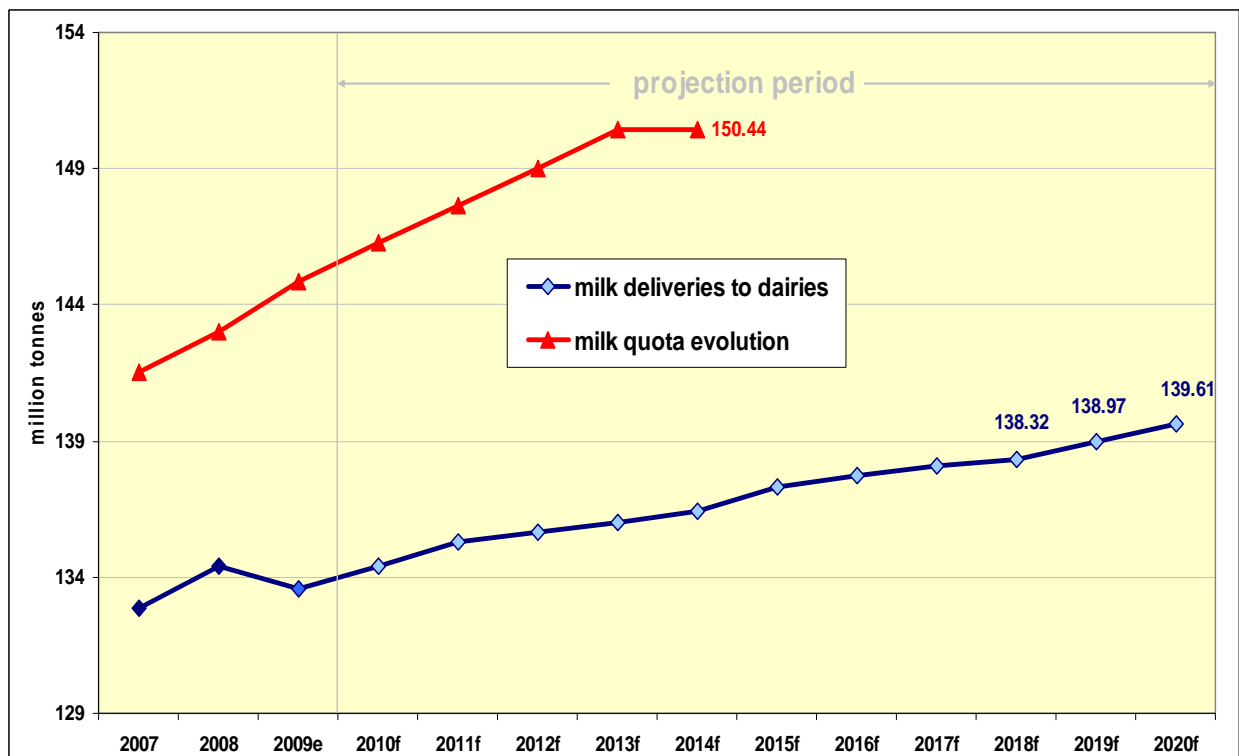


ANNEX III : Medium term prospects in the dairy sector

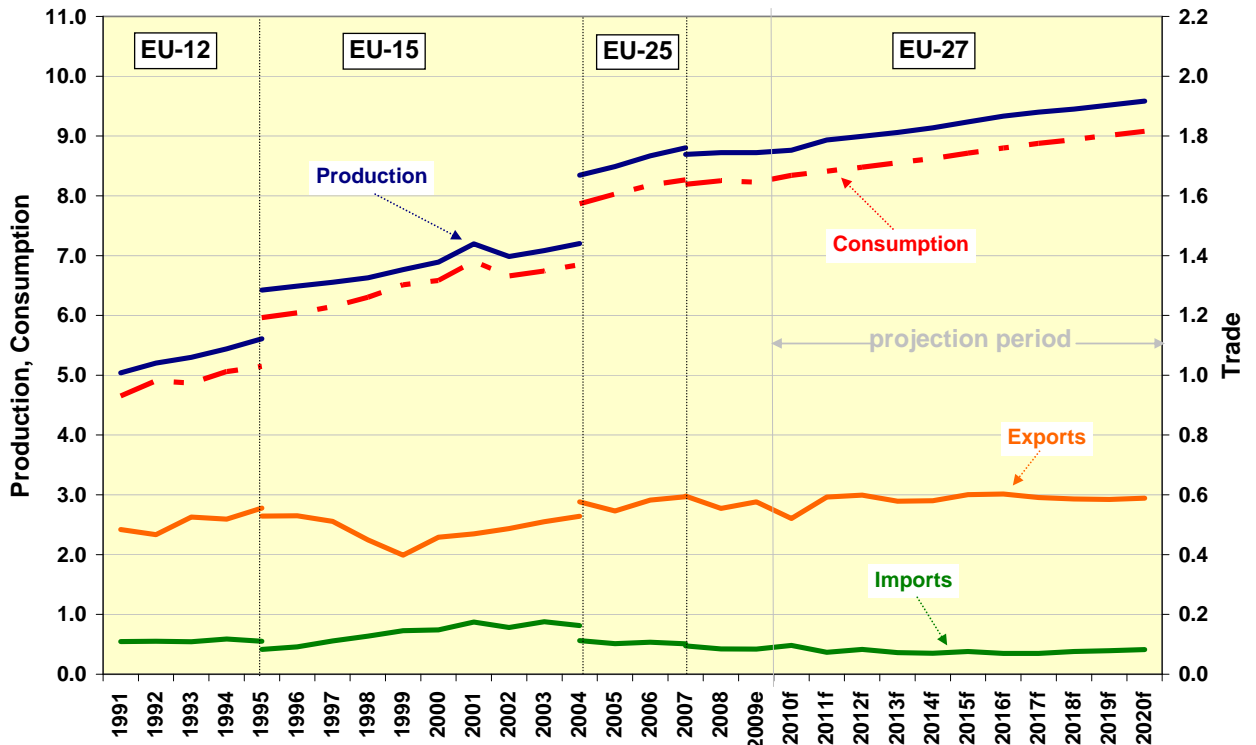
Graph 1. Milk supply and herd size



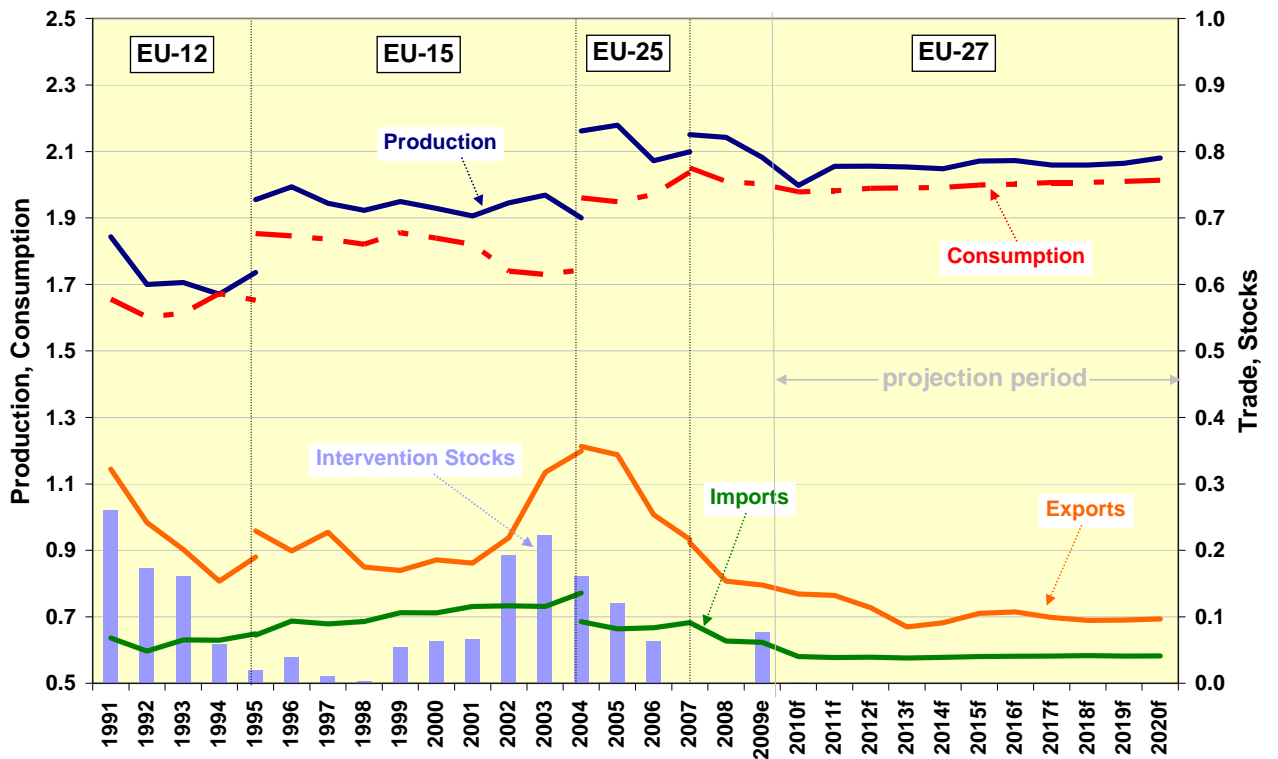
Graph 2. Prospective milk supply development versus quota



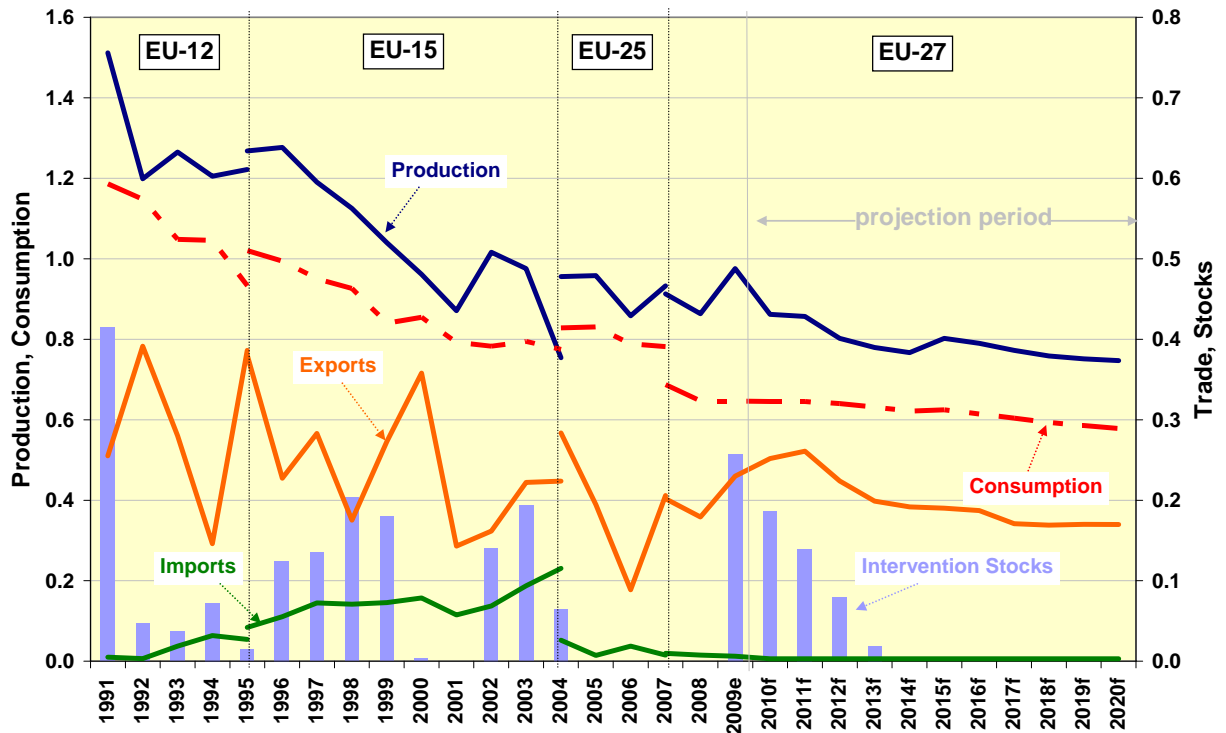
Graph 3. Cheese market balance



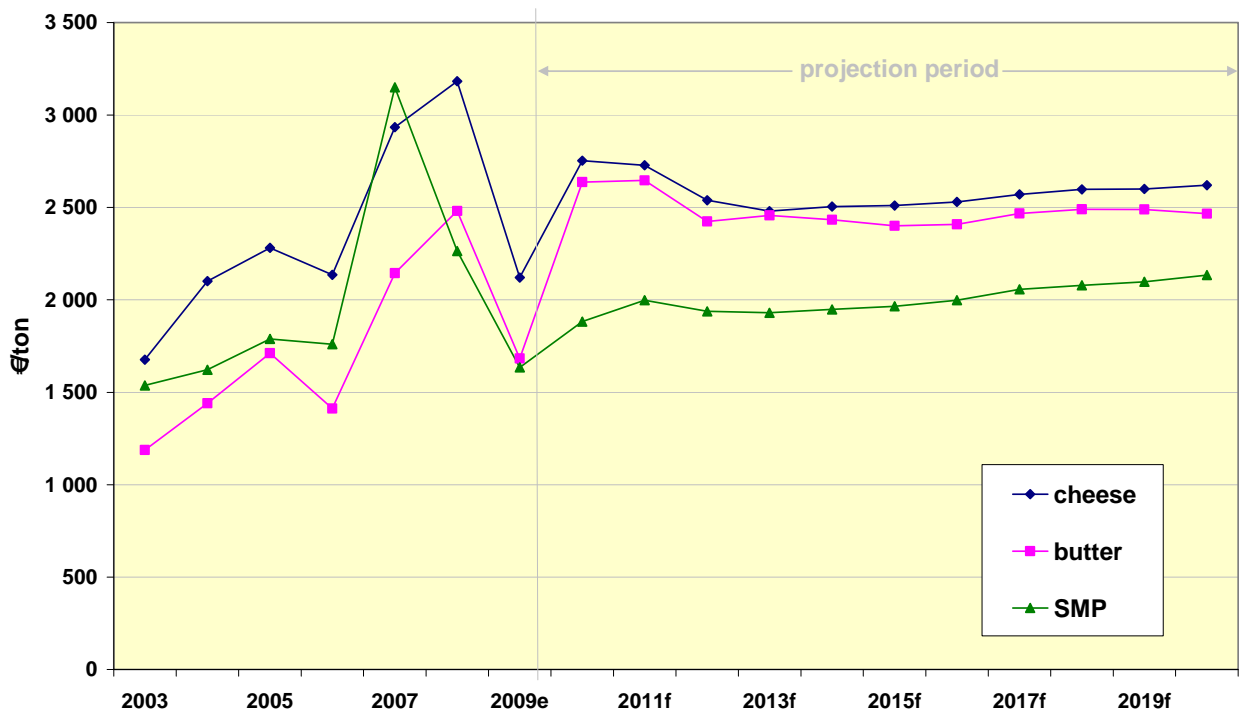
Graph 4. Butter market balance



Graph 5. SMP market balance

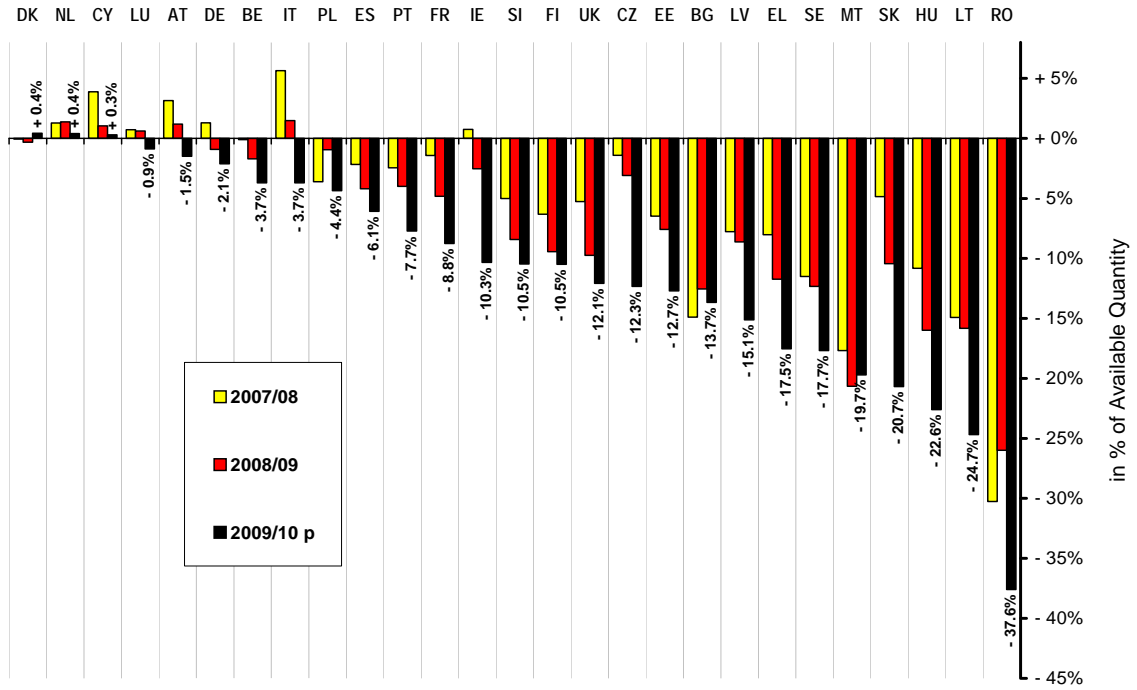


Graph 6. World market price projections

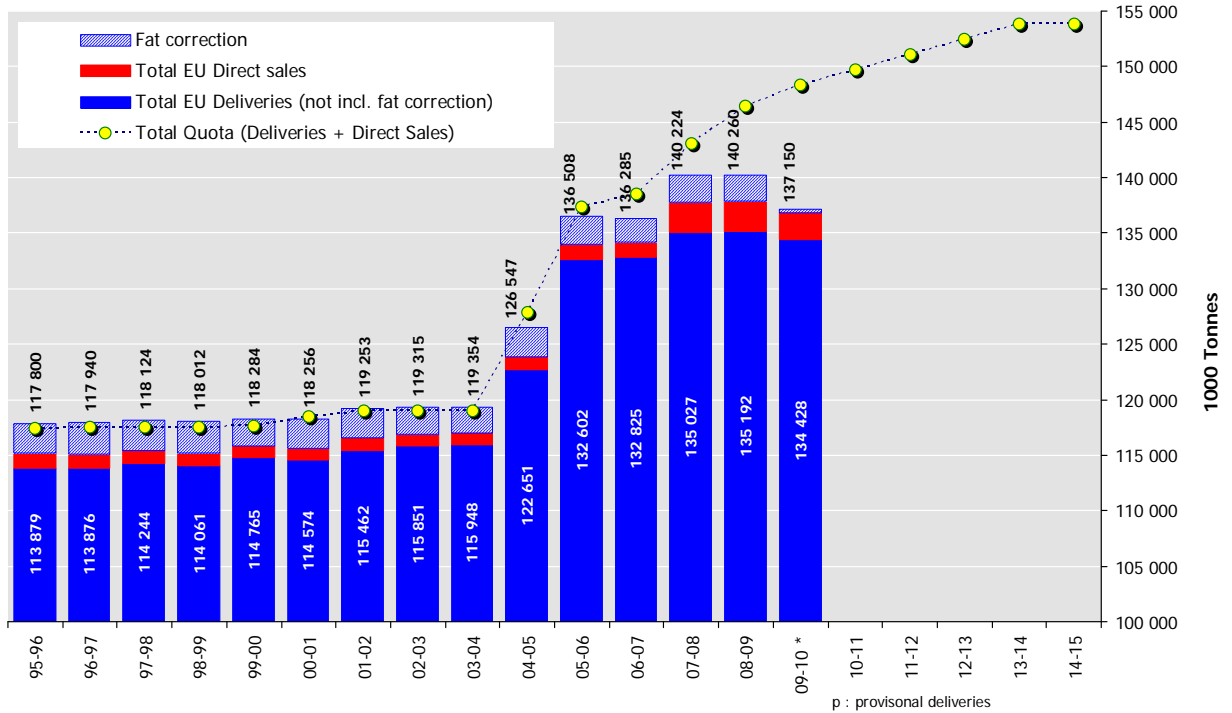


ANNEX IV : Milk production versus quota

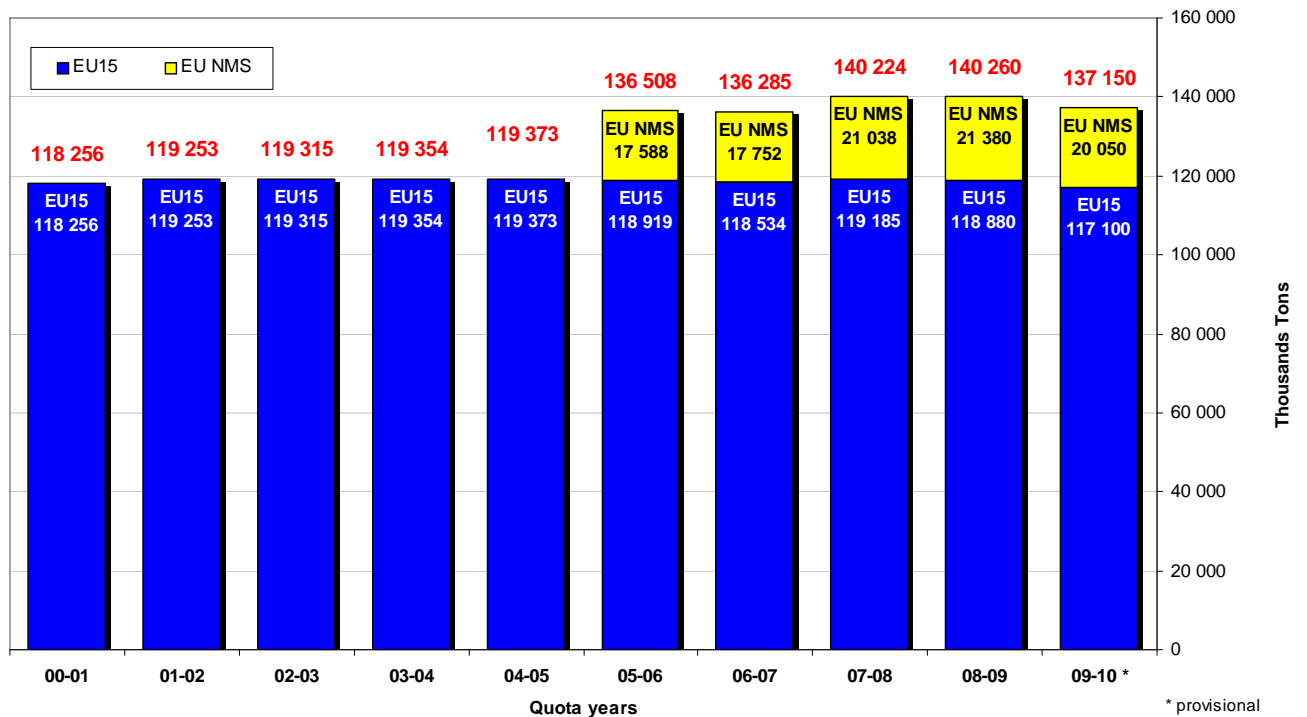
EU Deliveries Overshoot/Under use (in % of quota)



Evolution of EU Milk deliveries and Direct sales versus quota



EU milk deliveries (including fat correction) and direct sales



ANNEX V : . EU milk quota price development

