

# Synthetic summary

## Objective and scope

The EU dairy market is regulated by the Common Market Organisation (CMO) for milk and milk products, consisting of the traditional instruments of the Common Agricultural Policy (CAP) (import duties, export refunds, and intervention stockholding for butter and skimmed milk powder). These measures are aimed at directly supporting dairy product prices, and hence indirectly the raw milk price and the incomes of dairy farmers. Alongside public intervention, the private sector's stockholding role has also been stimulated by measures including mandatory private storage aid for butter, and optional private storage aid for skimmed milk powder and cheese. Moreover, in order to stimulate final demand for dairy products, internal disposal aids for butter, cream and skim milk powder have been used.

In 2003, new and revised CAP measures for the dairy sector were adopted. The most radical component was the switch of some income support out of market prices into a direct payment for milk producers, known as the dairy premium. The aim of this reform was to bring dairy policy into line with measures already adopted in other sectors to replace price support with direct income payments, with the aim of promoting a more market-oriented and competitive agriculture. The reform of the measures for dairy was part of a larger, more comprehensive set of policy changes introducing a Single Payment Scheme (SPS) of decoupled income support, which combined several pre-existing direct payments into a single farm payment (SFP). The dairy premium was scheduled to be incorporated into the SFP between 2005 and 2007. The decoupled SFP is intended to maintain income support levels whilst allowing farmers more freedom to respond to market demand.

The Member States that joined the EU after 2003 had the option of applying a simplified decoupled support scheme, the Single Area Payment Scheme. They also had the possibility of granting additional support during the phasing-in period for the direct payments and subject to the approval by the Commission in the form of complementary national direct payments (CNDP).

The objective of this retrospective evaluation is to analyse the economic and structural aspects of the EU dairy sector, and to assess the impacts of the CAP measures applied to this sector since the 2003 CAP reform. Therefore, the first policy changes to be evaluated are those enshrined in decisions legislated in 2003, or decided earlier but not implemented until after 2003. The evaluation period begins on 1 July 2004, when the first cuts to intervention prices were implemented and the phasing-in of the dairy premium began. In order to capture the impacts of implementing the reform, data from the pre-2004 period are used to establish a reference point or period. Most of the indicators on which the evaluation is based are reported up to 2009 or 2010, depending on data availability. Those based on farm accounting data from the EU-FADN extend up to 2007.

## Overview of Evaluation Questions (EQs) and main findings

The analysis is structured according to eleven evaluation questions set out below. The main findings are indicated below:

### **EQ1: To what extent have the CAP measures applicable to the dairy sector contributed to balancing supply and demand of milk and led to production restructuring?**

- Domestic supply became less determined by quota ceilings and more responsive to milk prices, with quota no longer being always filled for most Member States
- The shift of some income support from market price to direct payments, reduced intervention for butter and SMP, and the abolition of the target price for milk led to a falling structural excess supply (from 2004 onwards) and contributed positively to balancing demand and supply
- Structural changes affecting the number of dairy cows and herds, the herd-size distribution and extent of specialisation of farms in milk production have continued, but they cannot be linked to specific CAP measures studied here
- Higher national quota ceilings led to greater geographic mobility of productive capacity in some Member States.

**EQ2: To what extent have the CAP measures applicable to the dairy sector affected prices paid to producers, the payment system and price stability?**

- The abolition of the target price for milk, reduction in intervention prices for butter and skim milk powder, the scaling down of consumption aids and relaxation of quota ceilings led to a reduction in commodity (and hence milk) prices and gradual convergence of the EU towards world market prices during 2004-2006
- The case study surveys suggest that the changes in CAP measures did not affect the milk payment system
- In 2007-2009, the effects of the CAP measures on internal prices were masked by the price turbulence originating in the world market commodity boom
- During 2007-8, which was a period of abnormally high world market prices, export refunds and intervention buying were no longer operational during the months when the world prices exceeded the intervention price levels
- In 2009, on the downside of the price spike, although intervention buying-in was activated, the (average) EU-27 raw milk price fell to below €25/100 kg in June and July.

**EQ3: To what extent have the CAP measures applicable to the dairy sector contributed to maintaining / increasing the farmers' income?**

- Trends in dairy farm income, measured by FNVA/AWU, were maintained
- The profitability of dairying relative to other commodity sectors was maintained
- Maintenance of dairy incomes despite lower institutional prices is largely due to the role of direct payments
- Structural change (farm size expansion) also had a positive effect on maintaining dairy farmers' income.

**EQ4: To what extent have the CAP measures applicable to the dairy sector contributed to increasing farmers' market orientation and competitiveness?**

- Market orientation improved due a reduction in the price gap between the EU and world markets, weaker quota constraints and hence stronger supply response to price signals
- Cost-competitiveness did not improve, and the share of milk from 'profitable' milk enterprises declined after 2003 until the sharp price increase in 2007.

**EQ5: To what extent have the CAP measures applicable to the dairy sector contributed to stabilising the market prices for milk products?**

- EU prices for dairy products were substantially above world market prices prior to 2003, and this situation continued after the 2003 reform until late 2006-early 2007. The price gap was eliminated for nearly two years thereafter, because of exceptionally high world market prices.
- The EU policy reform was not the cause of the increased volatility, which originated in the overheating of world commodity markets and the price spikes for many agricultural commodities, including dairy products, on world markets. However, the episode has revealed three important properties of the reformed CAP:
- When intervention prices are set at low 'safety-net' levels, there is a greater probability of world market price exceeding intervention price and such a situation developing,
- When this happens, the CAP has no effective price stabilisation instrument to dampen upward price surges and
- When prices fall suddenly and steeply, as may easily happen after a price spike, even if world market prices fall below intervention levels, the safety net may be slow to react (if this occurs outside the regular intervention period and additional legislation is needed) and even when extra measures are in place, it may be insufficient.

**EQ6: To what extent have the CAP measures applicable to the dairy sector contributed to balancing supply and demand for milk products?**

- Structural excess supply declined for the main dairy products after 2003
- The main factor driving these falls was an increase in unsubsidised demand

- Because of the absence of lower product prices (apart from weak evidence regarding butter), only a limited impact of policy changes could be identified.

**EQ7: To what extent have the CAP measures applicable to the dairy sector influenced structural changes in the processing sector?**

- Concentration and consolidation of firms increased in some Member States
- No strong conclusions could be drawn with respect to policy impacts.

**EQ8: To what extent have the CAP measures applicable to the dairy sector contributed to improved competitiveness of milk products on international markets?**

- Price gap relative to the world market declined due to lower intervention prices for butter and SMP, and increasing world market prices
- The volume of unsubsidised exports of cheese increased (this holds in particular for quality and PDO/PDI cheeses)
- During the evaluation period, the EU was not competitive at world market prices for all products, but for some products its competitiveness has improved.

**EQ9: To what extent have the CAP measures applied to the dairy sector been efficient with respect to their objectives?**

- Efficiency has generally increased
- The total budget cost of dairy support policy declined, the total budget support to the dairy sector (which includes the decoupled dairy premium) hardly declined, the total cost (budget cost and consumer cost declined
- Market orientation and sector structure improved without any related increase in policy costs
- There was no marked change in the competitiveness of milk or dairy products
- Dairy production became more sustainable but at an additional cost
- Price stability deteriorated, largely due to external factors, whereas costs of intervention and export refunds declined.

**EQ10.1: To what extent have the CAP measures applicable to the dairy sector been coherent with the rural development measures and the national aid granted in accordance with relevant EU rules stated?**

- Good degree of coherence between the CAP dairy measures, and rural development measures and state aids
- Pillar 1, RDP and national aid measures operate at different levels and scales, giving them a complementary character
- Several synergies and one source of potential conflict between CAP dairy measures and RDP objectives were identified.

**EQ10.2: To what extent have the CAP measures applicable to the dairy sector been coherent with the overall concepts and principles of the 2003 reform of the CAP?**

- A high degree of coherence was found ex post
- Market orientation and competitiveness improved to an extent
- Income support was maintained at pre-2003 levels and income trends continued unchanged post-2003
- Environmental sustainability increased
- Socio-economic sustainability in question due to a fall in the rate of entry of young dairy farmers.

**EQ11: To what extent have the CAP measures applicable to the dairy sector been relevant with respect to the needs and problems of farmers, processors and consumers?**

- Milk producers' concerns over income, production flexibility and expansion are met, but at the cost of a heavier administrative burden and more exposure to price risk
- Processors also face more price and market risk

- Society benefits from increased efficiency, and more focus on environmental sustainability
- Consumers face potentially lower product prices, but this benefit is conditional on the transmission lower milk prices along the supply chain.

### The effectiveness of instruments

The following table provides an overview of the effectiveness with which particular instruments were deployed over the period 2004-2010.

### Summary of Instrument Effectiveness

Instruments	Expected effects	Evidence	Success (scale 0 - √√√)
<b>Milk quota system and modifications to it</b>	Market balance	EQ1a	√√√
	Greater confidence for processors (stability of supply, investment decisions, etc.)	EQ7	√√
	Relaxation of quota limits improves market orientation	EQ4	√
	<b>Average score<sup>1</sup></b>		√√
	<b>Unintended side-effects</b> Impedes structural change Creates winners and losers from quota trading in periods of policy transition	Investigated in EQ1b Investigated in EQ9	Not found Some evidence found
<b>Public intervention measures for butter and skimmed milk powder and changes thereto</b>	Use of intervention stocking → milk price stabilisation	EQ2	√√ (as long as intervention prices are higher than world market prices for butter and SMP <i>and</i> there is good price transmission from processors to producers)
	Use of intervention stocking → dairy product price stabilisation	EQ5	√√ ( as long as intervention prices are higher than world market prices for butter and SMP)
	Lower intervention prices → lower milk price	EQ2	√√√
	Lower milk price → reduction of structural surplus	EQ1, EQ6	√√√
	Lower milk price → improvement in international competitiveness	EQ4, EQ8	√
	<b>Average score</b>		√√
<b>Public intervention measures for butter and skimmed milk powder and changes thereto</b>	<b>Unintended consequence</b> Lower safety-net increases the probability of periods of high volatility transmission from world market to domestic prices	EQ2, EQ5, EQ9	Strong evidence found

1. The 'average score' is a subjective assessment based on the distribution of the scores reported for each objective of the corresponding instrument.

Instruments	Expected effects	Evidence	Success (scale 0 - √√√)
<b>Mandatory and optional aid for private storage for butter, skimmed milk powder and cheese</b>	Private storage → market stabilisation	EQ4, EQ5	0
	Deadweight Impacts would have happened anyway	EQ9	Evidence found
<b>Disposal aids for butter and cream, SMP (manufacturing, persons, animal feed)</b>	Well targeted to disposing of the surplus?	EQ1, EQ6, EQ9	√√
<b>Licence system, tariff rate quotas, import duties and export refunds</b>	Export refunds as disposal mechanism for surpluses	EQ1a, EQ6	√√√
	Export refunds as an instrument for price stabilisation of Dairy products  Raw milk	EQ2, EQ5	√√√ (as long as intervention prices are higher than world market prices for butter and SMP and (for raw milk) there is good price transmission from processors to producers)
	Tariffs and tariff rate quotas as a precondition for maintaining higher domestic price	EQ2	√√√
	Export refunds as means of improving international competitiveness	EQ4	√√
	Export refunds as a price stabilising mechanism	EQ2, EQ5	√√√ (providing domestic prices are above world market prices)
	<b>Average score</b>		√√
<b>Single Payment Scheme (SPS) and Single Area Payment Scheme (SAPS) (with respect to beneficiaries in the dairy sector)</b>	Effectiveness in maintaining producers incomes despite the lowering of the milk price	EQ3, EQ9	√√√
<b>Dairy premium and additional payment</b>	Effectiveness in compensating producers for the milk price reduction	EQ9	√√√
	Effect on structural change and the exit rate	EQ1b	√ (not included in the average score)
	Improved market orientation	EQ4	√
	<b>Average score</b>		√√
<b>Additional payments granted in the framework of Art. 69 of Council Regulation 1782/2003 and Art. 68 of Council Regulation 73/2009</b>	Allocation by MS to the dairy sector	EQ10	Art 69 (only one MS), Art 68 (two MS)
	Uptake by producers	EQ10	Partial evidence of strong uptake
	Effectiveness in attaining specific objectives at MS level		Not assessed

## Recommendations

It is assumed the EU will continue to pursue the same policy objectives as those that motivated the policy changes reviewed, and to maintain those measures that were found to have had some success in promoting these objectives. The recommendations made below are based on conclusions drawn from this evaluation regarding gaps or inadequacies in the current set of policy measures.

1. In a rapidly changing global market context with shocks potentially occurring in any period of the year, intervention price levels, buying-in periods and ceilings set some years previously in a multi-annual framework and on the assumption of internally generated (seasonal) price movements are not necessarily able to provide an effective year-round safety net. In order to operate a safety net that is relevant for a more market-oriented sector facing greater exogenously produced price volatility, a more flexible safety net is required. **To this end, we recommend the adoption of more flexible intervention mechanisms so that they can respond more quickly at any time of the year to sharp falls in market price reaching abnormally low levels.**
2. Under the reformed CAP, the probability of fluctuating prices has significantly increased. Price volatility above a certain level creates uncertainty in the market, which inhibits investment, and hampers market orientation, as farmers can no longer appropriately distinguish 'noise' from changes in underlying market fundamentals. **Therefore, it is recommended that private or public risk management tools for farmers (individually or collectively) are facilitated and/or developed that aim to enable farmers to cope with higher levels of market price volatility, so as to counteract its negative effects on sector performance.**
3. The effective operation of the EU's dairy policy with respect to its objectives relies heavily on backward price transmission in the dairy supply chain. A better balance of market power between the various actors along the supply chain, particularly between milk producers and processors, is likely to become more important with the abolition of the quota scheme. **Therefore, it is recommended that the available options for redressing power imbalances in bargaining power be actively studied.** To counteract market power imbalances, several options can be envisaged. They include creating countervailing power (within the limits allowed by competition policy), legislating for more competitive behaviour in the price formation process within the chain, or restricting the build-up of market power concentration at local and national level downstream in the supply chain using new legislation to safeguard competition in the vertical dimension.