



# CAP Reform Briefing October 03

The CAP reform deal was agreed early in the morning on 26<sup>th</sup> June. The following information is designed to help dairy farmers understand the main points of the reform and the possible impact on the dairy industry.

## Overview for Dairy

The thrust of the CAP reform has been to reduce price support for markets, allowing prices to fall closer to world levels. This will help the EU in its negotiations with the World Trade Organisation, which aim to liberalise trade and reduce trade-distorting support from governments to industries such as agriculture. The EU believes it will also help provide what taxpayers want such as environment benefits, and allow farmers to farm how they want to, rather than how subsidies encourage them to. To do this, the main route the EU is following is to cut intervention prices for dairy products, and to provide direct compensation to dairy farmers for the lower farmgate milk prices that are likely to result. The main features of the reform are as follows:

- Intervention price cuts probably leading to lower milk prices
- Direct payments to farmers in compensation
- Modulation and financial discipline/degression of direct payments, reducing payment levels.
- Extension of quota regime until 2014/15.
- Quota increases from 2006 onward.
- Removal of target price

The following document explains all of these concepts and summarise what the possible impact may be on milk prices.

## Intervention Price Cuts and Market Conditions

The EU has tried to reduce internal EU prices for dairy products towards world price levels. They hope to do this by reducing the level of intervention prices and reduce the availability of intervention. The price cuts are:

	<b>Butter Price Cut</b>	<b>Skimmed Milk Powder Price Cut</b>	<b>IMPE £0.70=€</b>	<b>IMPE £0.75=€</b>	<b>IMPE £0.62=€</b>
<b>2004</b>	7%	5%	17.87	19.33	15.52
<b>2005</b>	7%	5%	16.59	17.96	14.39
<b>2006</b>	7%	5%	15.30	16.59	13.25
<b>2007 onwards</b>	4%	-	14.92	16.18	12.91

In addition to the price cuts the amount of butter allowed to go in to intervention automatically will be

subject to a ceiling (which will fall from 70,000t in 2004 to a level of 30,000t in 2008 onwards). After the fixed amount of butter has been entered into stores, the EU can operate a tender system, and take in more butter, but this will probably operate at a lower intervention price, if it operates at all. This will effectively reduce the amount of support available to the market place.

## Direct Payment Compensation

The whole ethos of these reforms is to reduce the amount of support for the market place, allow prices to fall, and to compensate farmers directly. In order to do this, dairy farmers will be paid the following sums (gross):

<b>GROSS (ppl)</b>	<b>Payment</b>	<b>Payment £0.70=€</b>	<b>Payment £0.75=€</b>	<b>Payment £0.62=€</b>
<b>2004</b>	€1.81/tonne	0.85	0.91	0.75
<b>2005</b>	€23.65/tonne	1.70	1.83	1.51
<b>2006 onwards</b>	€35.5/tonne	2.56	2.74	2.27

The EU plans for this direct payment (dairy premium) to initially be coupled to production – i.e. you must produce milk to receive the payment, and the 2004 payment will be based on quota held on 31/3/2004.

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However, it is likely that the UK will decouple the dairy payment in 2005. This will mean that farmers will receive the payment in the future regardless of whether or not they continue to produce milk after that point. After decoupling, any money that would have been paid to dairy farmers through the dairy premium will be included in the single farm payment, which will replace all other subsidies from 2005.

The amount of dairy premium that is transferred to a dairy farmers' single farm payment will be based on either how much quota they hold on the 31/3/2005 (if decoupling takes place in 2005), or on the amount of land that they farm. These two options are the historic or regional averaging options respectively. The amount of money paid to farmers in the case of the single farm payment being based on quota is as in the above table (before deductions). If the regional averaging option were taken up, the amount of money paid per acre would vary depending on the exact arrangements, but would probably be around 300 euro/hectare (£80/acre) in England.

A decision on the method of calculating dairy farmers' entitlement to the single farm payment is unlikely to be announced until after the New Year.

In addition, it appears that the direct payment, whether decoupled or coupled will be subject to both modulation and financial discipline, as well as cross compliance.

## Modulation of Payments

Direct payments will be modulated (reduced) by the EU to pay for the rural development policy part of CAP that is being introduced. The first €5,000 of subsidy will be exempt from modulation, but all subsidies above this level will be modulated by:

2005	3%
2006	4%
2007 +	5%

In addition to this modulation imposed by the EU, the UK government can choose to increase modulation to pay for domestic rural development programmes (such as agri environment schemes etc.) established before 2006. Therefore the level of total modulation is unknown at present.

## Financial Discipline/Digression of Payments

Financial Discipline/Digression of direct payments is designed to allow the EU to take a percentage of each direct payment in order to fund some of the other parts of the CAP scheme if the cost of the CAP reform is bigger than the budget. Due to some of the uncertainties about how much the reforms will cost each year, the EU has retained this flexibility to ensure that it can afford to pay for all the reforms. It will be difficult to tell if and how much of a reduction will be applied until the reforms begin to take effect. The first €5000 of a farmers' payment will be exempt from this reduction.

## Cross Compliance

To receive direct payments, farms will have to comply with certain conditions. These include existing specific EU statutory standards on environmental standards, animal welfare, food safety, animal and plant health, all of which are currently already enshrined in UK law, meaning that if you already comply with all UK law – you comply with the current EU legislation. In addition, farmers will have to abide by a requirement to maintain farmland in a good agricultural and environmental condition. There is still no final detail on this requirement – and standards will be set independently by each region (England, Scotland, Wales, Northern Ireland).

## Quota Increases

Quota will be kept until 2014/15, and there will be an increase of 0.5% per year in 2006, 2007 and 2008 (approximately 71 million litres per year in the UK). Evaluation of the need for additional increases after 2008

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will be carried out closer to the time. DEFRA will have some flexibility in deciding how this is allocated to farmers, and are likely to consult with the industry over this issue over the next few months.

There will now be two potential reasons for holding quota – one for entitlement to direct payments until the payments are decoupled, and secondly to avoid superlevy.

## Impact on Milk Prices

The tables below lay out the possible positions for UK dairy farmers over the next few years at different exchange rates and assuming that the agreement goes ahead in its current format, without any significant reductions in direct payments due to financial discipline.

ppl	Exchange Rate £x=€	IMPE	Farmgate IMPE (-1.3)	Premium	Possible Average Milk Price
2003	0.7	19.15	17.85	1.5	19.35
2004	0.7	17.87	16.57	1.5	18.07
2005	0.7	16.59	15.29	1.5	16.79
2006	0.7	15.30	14.00	1.5	15.50
2007+	0.7	14.92	13.62	1.5	15.12

ppl	Exchange Rate £x=€	IMPE	Farmgate IMPE (-1.3)	Premium	Possible Average Milk Price
2003	0.62	16.66	15.36	1.5	16.86
2004	0.62	15.52	14.22	1.5	15.72
2005	0.62	14.39	13.09	1.5	14.59
2006	0.62	13.25	11.95	1.5	13.45
2007+	0.62	12.91	11.61	1.5	13.11

ppl	Exchange Rate £x=€	IMPE	Farmgate IMPE (-1.3)	Premium	Possible Average Milk Price
2003	0.75	20.70	19.40	1.5	20.90
2004	0.75	19.33	18.03	1.5	19.53
2005	0.75	17.96	16.66	1.5	18.16
2006	0.75	16.59	15.29	1.5	16.79
2007+	0.75	16.18	14.88	1.5	16.38

### Notes:

- *IMPE = Intervention Milk Price Equivalent is the price a processor producing products for intervention can afford to pay for milk at the factory gate.*
- *AMPE = Actual Milk Price Equivalent is the price a processor producing intervention products but selling them in the open market can afford to pay for milk. AMPE will be higher than IMPE if market prices are higher than intervention prices.*
- *Farmgate IMPE is calculated from the true IMPE from the new intervention price levels each year, minus 1.3ppl for transporting the milk from farm to processor*
- *The premium is based on the average difference over farmgate IMPE/AMPE over the past few years, and is simplistic as other factors such as supply of milk and lags in price changes will also impact on the price of milk, as well as IMPE/AMPE.*
- *Possible Average milk price is the farmgate IMPE plus the premium.*
- *IMPE has been calculated on the basis of the intervention price cut that comes into effect on 1 July applying for the whole year, despite the fact that a large amount of peak production will be supported by the previous years higher price..*

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The above prices assume that intervention prices are higher than world prices leading to intervention providing a base to the market and that the same structure operates in the dairy market as at present, leading to similar premium over farmgate IMPE. It is possible that in some of these years, world prices will rise above intervention prices for skimmed milk powder (SMP) at least and farmgate prices will be higher than indicated. In addition, other factors such as supply and demand for milk will impact on prices, and it is possible that the structure of the industry could develop significantly, leading to this 'premium' over IMPE/AMPE changing, and/or fluctuating greatly.

## Other Issues

In addition to these main effects, there are several issues that will impact on dairy farmers.

### Removal of Target Price

The EU has removed the target farmgate price for milk. This will have two impacts – firstly export refunds will now probably be set on the basis of a tender system. This is likely to further weaken the support for the dairy market. The second impact is that superlevy is currently based on 115% of the target price. The EU state that in the future it will be as follows:

Superlevy	euro/litre
<b>2004/5</b>	34.3
<b>2005/6</b>	31.8
<b>2006/7</b>	28.5
<b>2007/8 +</b>	27.8

### National Envelope

The Commission has confirmed that a part of the dairy premium will be in the form of an additional payment at about a third of the total compensation package for coupled payments. If dairy payments are decoupled, the additional payment/national envelope falls to 10%. DEFRA could use this money to fund something other than supporting dairy farmers through a flat rate payment if they wished. All calculations on direct payments in this document have been based on the national envelope being equally spread across all production.

### Rural Development Policy

Under the reforms national governments have been given the option of introducing a large number of initiatives to help the rural economy, including training, schemes to help young farmers, helping farmers adapt to the introduction of new standards, help with the cost of farm advisory services, as well as incentives for farmers using recognised national assurance schemes. However, this is all subject to funds being available for these activities, and these are likely to be limited, and choices over which activities to support will have to be made.

### National Reserve

A national reserve is to be setup to help hardship situations, and there is an opportunity for national governments, if they wish, to set up a siphon system to remove part of any direct payment entitlement to the national reserve to operate when entitlements are transferred. The details of this are somewhat unclear at present.

## Uncertainties

Despite the fact that agreement has been reached there still remains much to be finally decided on the detail of how the reforms will operate. This detail will become apparent over the next few months. The UK government will have to decide how to implement the reform and it is unlikely that this will become finally clear until the New Year, although consultations are taking place with the industry about how to implement reform at the present time.