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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

Preparing for the "Health Check" of the CAP reform

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1. THE COMMON AGRICULTURAL POLICY TODAY

1.1. A radically reformed and better performing policy

During the last 15 years, the common agricultural policy (CAP) changed radically in response to pressures from European society and its evolving economy. The 2003/2004 reforms marked a new phase in this process, introducing decoupled direct payments via the Single Payment Scheme (SPS) in most sectors of the first pillar of the CAP and strengthening Rural Development (RD) policy as its second pillar. This process continued with reforms in sugar (2006) and fruit and vegetables (2007), and is ongoing with the recent legal proposals for reform in the wine sector.

Producer support is now to a large extent decoupled from production decisions, allowing EU farmers to make their choices in response to market signals, to rely on their farm potential and their preferences when adapting to changes in their economic environment, and to contribute to improving the competitiveness of the agricultural sector.

As a result, CAP reform delivered what was expected from it by shifting away from product support, widely viewed as an origin of the surplus problems of the past. EU support prices, reduced everywhere, are by now close to world markets. The competitiveness of EU agriculture is increasing in key sectors, despite the decline of the EU share in most commodity markets, and the EU is already the largest agricultural exporter, of mainly high value products. It is also the biggest agricultural importer in the world, remaining by far the largest market for developing countries.

Furthermore, the CAP increasingly contributes to heading off the risks of environmental degradation and to delivering many of the public goods that our societies expect. Producer support is now dependent on the respect of standards relating to the environment, food safety and quality and animal welfare.

Finally, the strengthened rural development policy supports the protection of the environment and rural landscapes and creates growth, jobs and innovation in rural areas. Although a growing number of EU rural areas will be influenced by factors outside agriculture, areas which are remote, depopulated or heavily dependent on farming will face particular challenges as regards economic and social sustainability. Thus the role of the agri-food sector, which still represents more than 4% of total GDP and 8% of total employment, remains critical in many rural areas.

1.2. Further improvements to be addressed in the "Health Check"

The above developments indicate that the CAP today is fundamentally different from the one of the past, notwithstanding the often paradoxical gap between the results of its reform process and some perceptions about it (most of them relevant to its pre-reform period). But for the CAP to continue to be a policy of the present and of the future, it needs to be able to evaluate its instruments, to test whether they function as they should, to identify any adjustments needed to meet its stated objectives, and to be able to adapt to new challenges.

That more steps need to follow is inevitable – any policy cast in stone in a rapidly changing environment is bound to become obsolete. The CAP has proven that EU agriculture can take such steps successfully and change, but needs to allow farmers to adjust in the context of a predictable policy path.

The 2003 Reform was the first step to make the CAP fit for the 21st century. Consensus on all the elements of the 2003 Reform could not be reached in one go. Indeed, this is why a number of review clauses were already foreseen in the final agreement, as were in other subsequent reforms since 2003.

These review clauses, without implying a fundamental reform of the existing policies, allow the possibility of further adjustments in line with market and other developments. The topics they cover have been grouped together under the term "Health Check" (HC) in the present communication. The aim is to address three main questions:

- how to make the Single Payment Scheme more effective, efficient and simple?
- how to render market support instruments, originally conceived for a Community of six Member States, still relevant in a more and more globalised world and an EU of twenty-seven?
- how to master new challenges, from climate change to growth in biofuels and water management and ongoing ones such as biodiversity by adapting to the new risks and opportunities?

2. TAKING STOCK OF THE IMPLEMENTATION AND SIMPLIFYING THE SINGLE PAYMENT SCHEME

2.1. Simplifying the Single Payment Scheme

While new Member States (MS) can make use of the simplified Single Area Payment Scheme (SAPS) until end of 2010 (for Bulgaria and Romania end of 2011), EU-15 MS had to implement the SPS by 2007.

They could apply a historic SPS model (payment entitlements based on individual reference amounts), a regional model (entitlements based on regional reference amounts) or a mix of the two approaches.

MS had the possibility to maintain some specific production-related direct aid (partially coupled support) where this was considered necessary in order to ensure a minimum level of productive activity and to generate environmental benefits. They could also retain up to 10% of the national ceilings to support agricultural activities that are important for the environment or for improving the quality and marketing of agricultural products (Article 69 of Council Regulation (EC) No 1782/2003).

Both historic and regional approaches of decoupling fulfil the objective of allowing farmers the choice of what to produce, instead of guiding such choice via product-related support. However, the individual level of support in both approaches, albeit to different extents, is currently based on past levels of production and as time goes by it will become more difficult to justify differences in this support, especially in the historic model. It seems therefore appropriate to allow MS to adjust their chosen model towards a flatter rate during the period from 2009 to 2013. Against this background it should also be considered whether Member States which are applying now the SAPS, should be allowed to continue so until 2013.

Furthermore, as more sectors have in the meantime entered into the SPS and as experience has been gained with operating the system, certain implementing decisions and rules seem unnecessarily rigid and complex.

The HC is the right opportunity to propose changes that, without altering the fundamental structure of the system, adjust and simplify its implementation.

2.2. Qualifying the scope of cross-compliance

The system of cross-compliance, which reduces payments to farmers who do not respect EU-standards associated with agricultural activity, is and will remain an essential element of the CAP. But experience has shown a clear need for simplification.

This process has already started based on the Council conclusions which recently backed the March 2007 Commission report on cross-compliance. Proposals aiming to improve the control and sanctions aspects of the scheme are already in the respective legislative procedure and are foreseen to enter into force 2008/2009. In addition, the work currently under way on further elements for simplifying the cross-compliance scheme will feed into the HC.

The Commission's report, however, did not address directly the scope of cross-compliance. In order to remain an appropriate tool, cross-compliance needs to reflect society's demands and must strike the right balance between the costs and benefits of any requirements. It is the appropriate targeting of Statutory Management Requirements (SMR) and Good Agricultural and Environmental Conditions (GAEC) that enhances the contribution of cross-compliance as an effective mechanism to promote sustainable agriculture.

Following the Council mandate and considering the need for simplification the HC will address the scope of cross compliance in the following areas:

- qualify the SMR by excluding provisions which are not directly relevant to the stated objectives of cross-compliance;
- examine, and where appropriate amend, the present list of SMR and GAEC in order to improve the achievement of the objectives of cross-compliance.

2.3. Partially coupled support

The extent of recent reforms renders partially coupled support less and less relevant from the point of view of producers, as more sectors are integrated into the SPS. Full decoupling leaves producers at least as well off as before, and most likely better off as a result of production flexibility, and it eliminates the complexity and administrative costs of running two systems in parallel. This is clearly the case in the arable crop sector.

However, partially coupled support may retain some relevance, at least for the time being, in certain regions where the level of production is small overall, but important economically or environmentally (such as suckler cows in extensive beef producing regions).

Whether, to which extent, and until when partially coupled support should remain should be seen in a clearly regional context. The Commission proposes a case-by-case analysis to identify the potential risks from a move into full decoupling and the possible alternatives.

2.4. Upper and lower limits in support levels

The issue of distribution of support is not new for the CAP, but has recently been highlighted by the transparency initiative for the publication of beneficiaries of EU-funds. The introduction of the SPS has made the distribution of payments more visible than before, thus raising new calls for limitations to the level of support received by the small number of large farmers. In addition, the implementation of SPS made evident that, among the large number of farmers that receive small amounts of payments often below the administrative cost of managing them, are recipients who are not genuine farmers.

In the context of the HC it would be appropriate to look into the possibility of introducing some form of limitation in payments, both at the higher and at the lower level:

- for the higher level of payments the Commission considers that if a solution is to be found it would be in a model where the support level is gradually reduced as overall payments to the individual farmer increase, while retaining some support even at high overall payment levels[1]. Limitations will take into account the need to ensure that the economic sustainability of large farms is respected and to avoid circumventing such measures by splitting farms;
- for small amounts of payments a minimum level of annual payments can be introduced and/or the minimum area requirement can be set at a higher level in such a way that would not affect real farmers.

The savings thus made should stay in the same MS and could be used for new challenges, notably in the framework of a revised Article 69 of Regulation (EC) No 1782/2003.

3. GRASPING NEW OPPORTUNITIES AND IMPROVING MARKET ORIENTATION

3.1. The role of market intervention and supply controls

In the past, the need for reform in EU intervention mechanisms was linked to developments in world markets, and any eventual stocks had to find a way out, at least partly, via exports. The reality of globalisation and of an EU with 27 MS requires a reflection on the future of the remaining "old CAP" instruments (e.g. quotas, public intervention, price support and refunds), in particular given the current medium-term outlook for markets, especially favourable in cereals and dairy.

Therefore, the question arises of how to create the right intervention system – one which works as a safety net, and which can be used without reliance upon subsidised sales (whether externally or internally). Given that effective competition in the agricultural markets remains one of the objectives of the CAP, the Commission intends to examine whether the existing supply management tools serve any valid purpose now, or whether they simply slow down the ability of EU agriculture to respond to market signals.

Moreover, the Commission intends to monitor closely the present market situation and to analyse whether this is a reflection of a short-term response to poor 2006/07 harvests or indicative of longer-term trends which could put pressure on agricultural

[1] By way of example: payments above €100 000 reduced by 10%, payments above €200 000 reduced by 25%, and above €300 000 by 45%.

markets and the supply situation. On the basis of this analysis, the Commission will conclude whether it is appropriate to propose new measures.

3.2. Cereal intervention

As mandated by the recent Council decision, a full examination of the cereal intervention system is underway, taking into account the growing markets for biofuels and the potential impact from increased demand for cereals.

The 2007 decision to reduce maize intervention was necessary because intervention was used contrary to its primary safety net goal. This may lead to a relative loss of competitiveness for barley and possibly soft wheat, and may trigger the risk of increasing public stocks for these cereals.

Therefore, extending the model of maize intervention reform to other feed grains seems the best solution in the present context. This would allow the Commission to react in crisis situations, but it also would allow farmers to receive their production signals from markets prices. The maintenance of intervention for a single cereal (bread wheat) could provide a safety-net support, whilst allowing other cereals to find their natural price level.

3.3. Set aside: abolish supply-management, strengthen environmental benefits

Set aside was introduced in order to reduce EU cereals production at a time of high stocks, and to let EU cereals adjust to world market conditions. This role has become much less relevant as a result of market developments and the introduction of the SPS.

The foreseeable demand and supply situation for cereals, including the demand linked to the fulfilment of the biofuel target set by the EU, argues for mobilising land which is presently kept out of production through the compulsory set aside scheme.

However, the permanent abolition of set aside will require steps to preserve the environmental benefits accrued from the present scheme. One possibility would be to replace it by locally targeted RD measures, taking into account that agri-environmental conditions are heterogeneous in space.

In order to keep and further enhance such benefits, the aim would be to strengthen RD support to environmental forms of land, water and ecosystem management, such as environmentally managed set aside, the protection of riparian strips, afforestation and measures linked to climate change adaptation and renewable energy policy like biodiversity corridors.

3.4. Preparing the "soft landing" of the dairy quota expiry

Before the end of 2007 the Commission will present a report which will cover in detail the developments of the dairy markets, but one general conclusion is already evident from market developments since 2003. The reasons for which the EU dairy quotas were introduced are no longer valid.

Instead of coping with a growing supply in the face of a stagnating demand for bulk commodities, we are now faced with a growing demand for high value products (especially for cheese and fresh dairy products) internally and externally, high prices and a subsequent decrease in the role of intervention as an outlet for butter and skimmed milk powder.

In this situation the question has to be asked whether and, if so, what measures should be taken to ensure a smoother transition to a more market-oriented dairy policy before the milk quota system runs out on 31 March 2015.

Phasing-out

In market terms, the decision in 2003 not to further increase quotas has limited the capacity of the sector to achieve greater market orientation and increase its competitiveness. In policy terms, the quota regime has widened the gap between the milk sector and other reformed agricultural sectors.

If nothing is done until the quota regime expires in 2014/15 high quota values would prevent the more efficient farmers from benefiting from new opportunities while the least efficient in disadvantaged, especially mountainous, areas would face great difficulties due to significant price falls after the abrupt expiry of the quotas.

This leads to the conclusion that a gradual quota increase could best prepare the ground for a "soft landing" of the sector by the time quotas expire. The appropriate level of the quota increase will be proposed on the basis of an on-going analysis, which aims at identifying both the impact of the expiry of the quota per MS and region and the necessary accompanying measures (such as adjustments to intervention or the super levy) that would render this path as smooth as possible.

Measures for mountainous regions

In general terms, it is expected that the phasing-out of milk quotas will expand production, lower prices and increase the competitiveness of the sector. At the same time, certain regions, especially but not exclusively mountainous regions, are expected to face difficulties in keeping a minimum level of production.

Some of these problems could be addressed with RD measures aiming at developing added value for dairy products. However, since RD policies are not designed to keep production in place, another solution for mountainous areas to accommodate the "soft landing" of quota expiry is needed. One possibility would be to establish specific support measures under a revised Article 69 of Regulation (EC) No 1782/2003. This would require a relaxation of the present rule that such measures can only apply at the sector level.

In summary, the HC orientation for the expiry of the dairy quotas should be to:

- propose the necessary quota increases to prepare the "soft landing" for the expiry of quotas by 2014/15;
- identify any required changes in other dairy policy instruments that would facilitate this transition;
- propose measures that would mitigate the expected negative impact in specific regions.

3.5. Other measures of supply control

In a series of other, generally small, sectors (dried fodder, starch, flax and hemp) measures of supply control and production linked payments are also present. The HC will include a thorough evaluation of the performance of such measures, and of their long-term utility.

This will identify the list of measures and the appropriate timing for shifting the remaining production-linked payments to the SPS. It will also examine whether there

may be cases where continuing some support may be necessary to retain benefits from production to the regional economy that cannot otherwise be obtained.

4. RESPONDING TO NEW CHALLENGES

4.1. Managing risk

Decoupled producer support, by de-linking the level of farm payments from the quantity produced, allows farmers to adjust better to *expected* risks, for example by redirecting their production from low-price markets towards those with a better return. Decoupling also allows producers to mitigate *unexpected* risks.

However, changes in traditional market instruments and the shift towards direct producer support have prompted discussion on different ways of managing risk, with price risk and production risk (e.g. weather-related or sanitary) identified as the two main sources of variation affecting income.

Following the 2005 Council debate the Commission has continued its reflections on risk management based on internal and external analysis, while in the meantime Community support for risk management was introduced in the fruit and vegetable reform by authorising producer organisations to decide to include such measures in their programmes. Furthermore the Commission's proposal on the wine reform foresees risk management measures via the national envelopes.

But Commission analysis and expert opinion indicate that the list of risks and their extent vary, and include so many uncertainties that at this stage, at least as long as intervention as a safety net continues, an EU-wide solution (based on a “one-size-fits-all” approach) would not be appropriate.

In addition, MS should be encouraged to use RD tools because it is exactly the second pillar that is more apt to provide targeted solutions. Not all MS, not all sectors, and more importantly not all regions and sectors even within the same MS, face the same market risks or weather risks. It is preferable to allow MS, regions, or producer groupings, via second pillar measures, to assess better their own risks and their preferred solution.

Therefore, the Commission considers that in the HC it would be appropriate to:

- extend the use of part of modulation savings to allow risk management measures in the framework of RD policy, provided that they meet "green box" criteria;
- examine on a case-by-case basis the need for additional measures in the context of future adjustments in market mechanisms and carry out, at a later stage, a more general examination of risk management for the period after 2013.

4.2. Climate change, bio-energy, water management and biodiversity

Three crucial new challenges for EU agriculture lie in the areas of climate change, bio-energy and water management. Climate change is the pivotal challenge of the three, influencing developments in the other two areas.

In mitigating the effects of **climate change**, EU agriculture has contributed more than other sectors to curbing green house gas emissions. This is mainly due to the improvement of production methods (i.e. more efficient use of fertilizers) and diminishing cattle numbers. But the agriculture sector will be called to contribute more in the future as part of the EU global strategy for curbing emissions.

But EU agriculture is also highly exposed to climate change. A wide range of concerns relates to uncertainties about precipitation patterns, extreme weather events, temperature levels, water availability, and soil conditions. Consequently, there is also the need for adjustments to improve adaptation practices. The recent Green Paper on the adaptation to climate change calls upon EU agriculture to contribute further to mitigating the effects of climate change.

The EU renewable energy roadmap has set binding targets for the share of **biofuels** (10%) and renewable energies (20%) in total fuel and energy consumption by 2020. These targets are closely linked to climate change mitigation objectives and are likely to have a significant impact on EU agriculture. At the same time the primary vocation of European agriculture will continue to be the production of food and feed.

As already stated in the Commission's Communication on water scarcity and droughts of June 2007, the HC provides an opportunity to examine how to integrate further water management issues into the relevant CAP instruments. It is essential for EU agriculture to have sustainable **water management**, otherwise the pressure on the quantity and quality of water for agriculture will increase considerably.

Furthermore, halting **biodiversity** decline remains a major challenge, and climate change and water demand increase that challenge. Member States are committed to stopping biodiversity decline by 2010, but this target is unlikely to be met, and agriculture has a key role to play in protecting biodiversity.

There is a range of possibilities to deal with these challenges in the HC:

- incentives for mitigation and adaptation to climate change, for better water management and for providing environmental services in the area of bio-energy, and for biodiversity protection could be provided through the strengthening of existing RD measures;
- climate change and better water management objectives could be achieved also through cross-compliance, either under SMR or under GAEC;
- research and innovation are crucial to address new environmental and productivity challenges, including second generation biofuels. Furthermore, incentives for developing second generation biofuels should be reinforced within RD measures;
- it should be examined whether the present support scheme for energy crops is still cost effective in the light of new incentives for biomass production (compulsory energy targets and high prices).

4.3. Strengthening the second pillar

The new challenges stemming from the issues identified in this Communication make a further strengthening of the second pillar necessary, in particular in the light of the current constraints that MS are facing due to the cut in their expected RD support after the 2005 decision on the Financial Perspectives. Such reinforcement is also necessary in order to respond to the need for increased efforts in innovation to address those new productivity and environmental challenges, including second generation biofuels.

With the CAP budget now fixed until 2013, strengthening RD funds can only be achieved through increased co-financed compulsory modulation. Such a decision, which will in time affect all MS, once they reach the 100% EU support level, needs

to respect the current distribution of modulation funds among MS and take into account existing rules. To achieve this, it could be envisaged to:

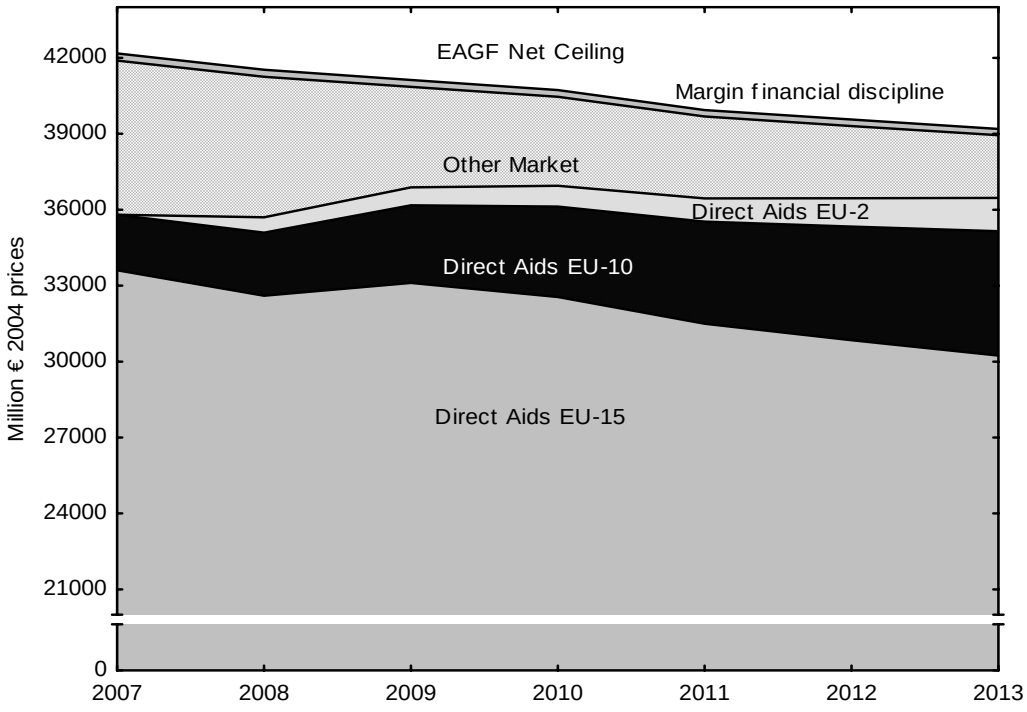
- increase by 2% annually in budget years 2010–2013 existing compulsory modulation;
- analyse appropriate ways to take account of the implied compulsory modulation in EU-10, whilst respecting the current distribution of RD funds between MS.

5. FINANCIAL FRAMEWORK

The underlying financial principle for this Communication is that no additional EU-funding will be available for the first and second pillar of the CAP in the period 2007–2013.

Within this framework, the ceiling for expenditure will be decreasing in constant prices. This implies that the financial discipline could be applicable for farmers during the period, albeit to a lesser extent than previously foreseen if the current market prices will stay at their high level.

As illustrated in the graph below, the net ceiling for the first pillar spending is decreasing in constant 2004 prices and at the same time EU-12 will require steadily increasing amounts for direct aids in accordance with the Accession Treaties.



6. CONCLUSIONS

During 2007 and 2008 the Commission will develop its approach to the budgetary review 2008/2009 as set in the communication "Reforming the budget, changing Europe". The Health Check constitutes a preparatory action within this framework, without prejudging the outcome of this review. It fine-tunes the 2003 reforms and contributes to the discussion on future priorities in the field of agriculture.

The Commission suggests in this communication "Preparing for the Health Check of the CAP" a broad outline of adjustments to several elements of the CAP. These adjustments do not constitute a fundamental reform, but prepare EU agriculture to adapt better to a rapidly changing environment. Based on the conclusions of public dialogue with stakeholders and on-going impact analysis, the Commission will submit appropriate proposals in the spring of 2008.

To promote this dialogue, the Commission plans to organise two seminars with stakeholders[2] which will provide the opportunity to launch public consultation on the communication .

[2] 6 December 2007 and 11 January 2008.