

I

(Information)

COURT OF AUDITORS

SPECIAL REPORT No 7/2004**on the common organisation of the market in raw tobacco, together with
the Commission's replies***(pursuant to the second subparagraph of Article 248(4) of the EC Treaty)**(2005/C 41/01)***TABLE OF CONTENTS**

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EXECUTIVE SUMMARY

I. The EU produces about 5 % of the world's raw tobacco making it the fifth largest producer. It exports more than half its own production however, because the aroma and taste of most of the tobacco cultivated is not in demand within the EU. This production is predominantly of Virginia and Burley varieties of neutral aroma and taste used as the main cigarette filler. Smaller quantities of oriental varieties are also grown which have the required aroma and taste in demand. Consequently, it imports from outside the EU the tobacco which meets the aroma/taste requirements and takes 9 % of the world's production making it the biggest importer. The major EU producers are Italy, Greece and Spain who together account for 87 % of total production. Production is characterised by a large number of growers dedicating small individual areas to its cultivation. Mechanisation is limited and production cost high. EU growers cannot make a reasonable living without the EU aid as the premium represents around 75 % of producers' income from tobacco production. Were EU tobacco production to cease, this would not affect manufacturers of tobacco products who would obtain supplies through increased imports.

II. The EU has been supporting its tobacco cultivation through a common market organisation (CMO) since 1970 and the annual budget is some 1 000 million euro. The market has been reformed substantially first in 1992, 1998 and again in 2004, in efforts to provide appropriate income support within budgetary limits, improve the response to market requirements and thus the value of production. It was hoped that growers would become less dependent on aid. Other measures are targeted towards facilitating voluntary departure from the sector and alternative cultivation.

III. The Court has reported on the operation of the CMO on three previous occasions. It concluded, in its last report in 1997, that the measures adopted in 1992 had achieved no measurable effect on the high level of subvention in relation to the value of production, the areas planted, the level of employment or the EU's market situation.

IV. The objective of this audit was to assess whether the reforms introduced in 1998 were soundly based and well managed by Member States. It also examined how the Commission had monitored and evaluated implementation and whether the objectives of the reformed CMO had been achieved.

V. As a result of its examination the Court concluded that the process by which the Commission elaborated its proposals for the 1998 reform was based on unreliable data and its analysis of the market was inadequate. Because of these failings the measures adopted were largely inappropriate from the outset and proved to be ineffective in many areas. There is no evidence that the CMO has influenced EU production so as to reduce the mismatch of supply and demand. The Court also found that the measures introduced did not achieve significant improvements in the income from tobacco cultivation or the market balance anticipated. The value of production was also put at risk by anti-competitive behaviour, in the form of price agreements, in the three largest producer States.

VI. There were numerous failings in Member States to apply the checks required by the regulations and the verification of key controls and the pursuit of corrections through the clearance of accounts process should have been extended. No clearance of accounts decision has been taken as at June 2004.

VII. The Commission's monitoring was unsatisfactory and the evaluation of the CMO was delayed. The findings of the evaluation carried out by external consultants were made public in a report in October 2003 and are, on common issues, very similar to those of the Court.

VIII. In July 2002 the Commission published its mid-term review of the common agricultural policy and proposed a new strategy for sustainable development across the agriculture sector which would be based on decoupling aid from production and providing support to farmers through a single farm payment scheme. The audit also examined how this might affect the tobacco CMO.

IX. The reform adopted by the Council in April 2004 ⁽¹⁾ envisages phased decoupling of the aid from production. Future support for tobacco producers will be included in the single farm payment scheme. There will also be a specific financial envelope for the restructuring of tobacco-producing areas.

X. The Court welcomes the present reform, which should go some way to addressing many of the weaknesses identified by the audit, although this will take some time. The Court recommends that the Commission pursue their investigations of the anti-competitive behaviour in Member States and, if it is confirmed, take appropriate action. The Member States' failures to apply the checks required by the regulations should also be pursued and corrections applied where possible.

INTRODUCTION

2. The EU produces around 5 % of the world's production of raw tobacco making it the fifth largest producer, but less than half its own production is used within the EU because it does not have the aroma and taste which is in demand by manufacturers. In order to obtain tobaccos with the required characteristics, the EU imports about 9 % of world production making it the biggest importer.

Tobacco cultivation and the EU market

1. Raw tobacco is tobacco in leaves which has been grown and subjected to initial drying by growers (the producers) but not yet processed. The next stage involves more specific preparation of the raw tobacco by companies called first processors who then supply the processed tobacco to the manufacturers of tobacco products such as cigarettes, cigars and pipe tobacco. *Annex 1* shows the tobacco-growing, processing, manufacturing and distribution chain.

3. In the EU, Italy, Greece and Spain are the most significant growers and account for around 38, 36 and 13 % of total production respectively. The *table* shows the EU raw tobacco supply situation for the period 1996 to 2000.

⁽¹⁾ Council Regulation (EC) No 864/2004 (OJ L 161, 30.4.2004, p. 48).

Table
EU raw tobacco supply balance

	(tonnes)				
	1996 01/1996	1997 01/1997	1998 01/1998	1999 01/1999	2000 01/2000
Opening stock	383 263	286 291	244 942	226 565	212 319
Dry weight production	299 274	300 563	306 794	304 148	302 289
Total imports	543 022	536 110	533 411	528 782	528 000
Available	1 225 559	1 122 964	1 085 147	1 059 495	1 042 608
Export	- 219 268	- 168 022	- 178 582	- 172 176	- 170 000
Consumption of EU production	- 135 000	- 125 000	- 120 000	- 115 000	- 120 000
Consumption of imports	- 585 000	- 585 000	- 560 000	- 560 000	- 560 000
Total consumption	- 939 268	- 878 022	- 858 582	- 847 176	- 850 000
Ending stock	286 291	244 942	226 565	212 319	192 608
EU production in % of world production	4,5	4,1	5,1	4,9	5,1
EU import in % of world import	28	27	28	26	26
EU export in % of world export	11	8	9	9	9
EU export in % of EU production	73	56	58	57	56
Domestic consumption in % of EU production	45	42	39	38	40

Source: Agriculture DG and United States Department of Agriculture.

This table shows that domestic consumption of EU production did not change significantly between 1996 and 2000 and that imports have remained stable throughout the same period.

4. Growing of raw tobacco in the EU is characterised by approximately 80 000 producers, mostly dedicating small individual areas to production. Mechanisation of production is limited and production costs high. The EU has been supporting the growing of raw tobacco for more than 30 years and the budget in recent years has been around 1 000 million euro.

Objectives of the CMO

5. Before the establishment of the single market in the EU, tobacco growers benefited from national market arrangements. These provided them with a guaranteed price in order to ensure a 'fair income' ⁽²⁾. This support was considered necessary because levels of return did not always cover the costs of production. In those regions where tobacco was produced it represented a major part of farmers' income. The CMO for tobacco introduced in 1970 replaced the national systems while continuing to provide similar levels of support.

6. Since then the CMO was reformed in 1992 ⁽³⁾, in 1998 ⁽⁴⁾ and again in 2004 ⁽⁵⁾. In addition to achieving the general objectives of stabilising raw tobacco markets and ensuring a fair standard of living for producers, as set out in Article 33 of the Treaty, the CMO set out specifically to:

- (a) limit production and discourage cultivation of tobacco varieties which cannot readily be sold on the EU market;
- (b) encourage improvements in the quality and value of EU production;
- (c) protect public health and meet environmental protection requirements;
- (d) facilitate voluntary departure from the sector;
- (e) reinforce control procedures and simplify the management task for Member States.

⁽²⁾ Council Regulation (EEC) No 727/70 (OJ L 94, 28.4.1970, p. 1).

⁽³⁾ Council Regulation (EEC) No 2075/92 (OJ L 215, 30.7.1992, p. 70).

⁽⁴⁾ Council Regulation (EC) No 1636/98 (OJ L 210, 28.7.1998, p. 23).

⁽⁵⁾ Council Regulation (EC) No 864/2004.

Measures adopted under the 1998 scheme

7. The measures adopted to achieve these objectives are set out below.

Premium payments

8. Producers are required to enter into cultivation contracts with first processors. The EU subsidy is paid as a premium per kilo of tobacco supplied and accepted under these arrangements. The premium supplements the price the producers receive for their tobacco on the market and should provide them with a 'fair income' and encourage to produce good quality tobacco. A rate of premium was set by the Council in 1992 for each of the eight variety groups recognised by the CMO. The rates have remained virtually unchanged since then ⁽⁶⁾.

9. The premium comprises both a fixed and a variable amount the latter presently accounting for between 30 and 45 % according to the variety ⁽⁷⁾. The fixed part of the premium is paid in full to all producers. The variable part of the premium is distributed by the producer groups to their members in proportion to the price which each of them has been paid by the first processors for their deliveries.

Cultivation contract auction scheme

10. For tobacco production to be eligible for aid, regulations require cultivation contracts to be concluded, by variety group of tobacco, between first processors and producer groups or individual producers who are not members of a group. To help contract prices truly reflect market conditions, Member States were given the option, for each harvest year, to operate a cultivation contract auction scheme. The scheme permits individual producers who are not member of a producer group or producer groups to offer their existing cultivation contracts to the wider first processing market. Bids have to be at least 10 % higher than the original contract price and the original first processor has to be given the opportunity to match the new price.

Thresholds, quotas and national reserves

11. In order to orient and limit production while maintaining budgetary control, the Council sets an overall guaranteed quantity for which aid will be paid. This is set per harvest by tobacco variety group and Member State. It is allocated to producers through quotas established on the basis of their production in a reference period. The regime permits Member States to transfer guaranteed quantities between variety groups, with the approval of the Commission, provided the effect is at least neutral for the budget.

⁽⁶⁾ Except for group V for which the premium was decreased by 10 % from the harvest year 2002 onwards.

⁽⁷⁾ The variable part has been increased progressively from 1999 onwards.

12. A quota buy-back scheme also exists whereby individual producers, who wish to cease tobacco cultivation definitively, may sell their quota back to the EU if they cannot be sold to other producers. Buy-back by the EU results in a permanent reduction in the national and EU production threshold.

13. Finally, there is a system of national quota reserves created by Member States from deductions from the quotas allocated to producers. These reserves are intended to encourage existing producers to switch to other crops and/or restructure their holdings and to allow producers who wish to become tobacco producers to enter the market.

Specific aid for producer groups

14. Producer groups are required to play an important role in achieving the market's objectives. Provided they satisfy regulatory requirements and are officially recognised by Member States, they are granted 2 % from the total premium paid to producers. At least half of the funds made available are intended to compensate them for costs on employment of technical staff and purchase of certified seeds or seedlings with the objective to improve product quality and environmental protection measures. Any remainder may be used on infrastructure measures for enhancing the value of the tobacco such as grading, storage and handling facilities and on employment of administrative staff.

The Tobacco Fund

15. The Fund was used to finance research into tobacco varieties, production methods and for combating smoking through information campaigns to increase public awareness of its harmful effects. The research element has now been transferred to the EU's research programme from 2003. From the 2002 harvest onwards, the Fund finances actions primarily to improve public awareness of the harmful effects of all forms of tobacco consumption and other actions to assist producers to convert from tobacco cultivation to other crops or activities. It is currently financed by withholding 3 % from the premium.

Audit objectives

16. The Court has reported on the CMO on three previous occasions ⁽⁸⁾, the last being in its Annual Report for 1996. The purpose of the present audit was to examine the reformed market regime introduced in 1998.

⁽⁸⁾ Special Report No 3/87 on the common organisation of the market in raw tobacco (OJ C 297, 6.11.1987, p. 1). Special Report No 8/93 on the common organisation of the market in raw tobacco (OJ C 65, 2.3.1994, p. 1). Annual Report for 1996 (OJ C 348, 18.11.1997, p. 83).

17. The main objectives were to assess whether:

- (a) the Commission's proposals for changes to the CMO, as subsequently adopted in the 1998 reform, were soundly based;
- (b) the measures introduced were well implemented and managed by the Commission and Member States;
- (c) the Commission's management, monitoring and evaluation processes enabled it to identify the extent to which the objectives of the reformed CMO were being achieved as foreseen.

18. The criteria against which the Court examined the Commission's management derive from the Financial Regulation and focused on whether:

- (a) mobilisation of resources was preceded by an evaluation of the costs and benefits likely to be involved;
- (b) market objectives were quantified and progress monitored;
- (c) the budget was used in such a way as to ensure sound financial management in particular economy and cost effectiveness;
- (d) operations were subject to regular review during the annual budgetary process so that their continued justification could be verified.

19. The main sources of audit evidence were:

- (a) interviews with staff in tobacco-related Commission services, the competent national authorities, producers and processors and other relevant parties acting in the tobacco market;
- (b) documentation obtained from the Commission, Member States, and other informed sources;
- (c) on-the-spot examinations in Germany, Greece, Spain, France and Italy who, between them, receive 97,7 % of the premiums; the transactions examined covered 20 producer groups representing some 40 % of EU tobacco producers.

PREPARATION FOR THE 1998 REFORM

20. The Court examined the process through which the Commission prepared its reform proposal and noted that it had been prepared on certain key assumptions. These were that tobacco was of material importance for employment and the entire population's livelihood in some areas; alternative cultivation was not viable; the existing market imbalance and the need for significant support was attributable to the poor quality of tobacco produced which resulted in low prices being obtained.

It concluded that the only justification for the Community's continued aid for tobacco production was if producers could improve tobacco quality, obtain higher prices and reduce their dependence on aid. The measures introduced reflected this. Accordingly, the Commission expected that the combined effect of all the elements of the reform would improve the quality of tobacco produced in the Community and reduce the exports of subsidised poor quality tobacco.

Information and analysis underlying the 1998 reform proposal

The significance of tobacco production for employment was based on incomplete information

21. One of the key parameters necessary to measure the impact of the CMO's measures is reliable data on employment. The Commission's assessment of the significance of tobacco production in relation to employment in the producing regions and the proposal to continue with the production aid scheme should have been based on up-to-date information from Member States.

22. The Court found that the Commission's 1996 estimate (used in the context of its reform proposals) of 170 000 full-time workers being dependent on tobacco production was based on data relating to 1986 (for man hours per hectare) and to 1993 (for areas under cultivation). More up-to-date information was not requested from Member States.

23. Since this estimate was not reliable, the Court compared it with the most recent data available for the year 1999 in the Commission's 2003 evaluation report. This report suggested that around 64 000 full-time workers were involved in producing 90 % of the EU's production. The Court estimates this meant about 72 000 were involved overall. This is less than half of the Commission's estimate made three years earlier. In the opinion of the Court, this is likely to be closer to the situation actually prevailing in 1996 when the Commission made its proposals.

24. Applying the total budget of about 1 000 million euro per year to the estimated 72 000 full-time workers, aid represents 13 653 euro per person. The difference with the number of 7 600 euro mentioned by the Commission is due to the fact that it uses a number of working units from a different source whereas the Court uses a number based on figures verified by the external evaluator contracted by the Commission.

25. Finally, the Commission considered that tobacco production was important for the entire population's livelihood in some producing areas. This conclusion was based on statements from Member States. When questioned during the audit, Member States were unable to produce any evidence for their statements.

The justification for continuing to support tobacco production was not soundly based

26. When preparing the new policy, the Commission concluded that, if quality did not improve, EU production was doomed in the medium term. It considered that the EU still had the potential to produce better quality tobacco, and therefore decided to provide an incentive by linking premium to the quality produced. The Commission assumed that the market price would reflect the quality of tobacco. However this did not reflect the reality of the market and other errors were made in interpreting the data used.

27. Firstly, the Commission based its policy on the assumption that EU production of certain variety groups could meet EU demand if a larger proportion of better quality tobacco was produced, thus reducing the mismatch between production and demand. The Commission did not take sufficiently into account however, that EU consumer demand had switched from dark cigarettes, produced from dark air-cured tobaccos, to American and English blends which require tobacco which cannot be produced in the EU. Only imported tobacco varieties offered the qualities of aroma and taste which are required. These qualities derived from agronomic and climatic conditions prevailing in the countries of origin. Because the EU cannot produce certain varieties of tobacco required, the possibility to match production to EU demand was limited.

28. Secondly, the Commission's conclusion that modulation of the premium in relation to price would improve quality was based on its assessment that the higher prices obtained for tobacco originating outside the EU were uniquely a reflection of its superior quality. Accordingly the Commission considered that, if tobacco produced in the EU was of better quality producers would receive better prices. However the price comparison it made between the high non-EU prices and the lower internal prices was not reliable for the following reasons:

- (a) the comparison of EU and non-EU market prices in those tobacco producing countries selected for comparison, Malawi, Zimbabwe and the USA, did not take account of the fact that EU prices were subsidised through aid and that non-EU prices were maintained at relatively higher levels because of price support through production restrictions;
- (b) the Commission had no assurance that the export prices it used to value raw tobacco sold represented the value of the sales. Tobacco is often sold initially to multinational companies and traded within them (e.g. for tax reasons), before being sold to manufacturers at a higher price. It is the lower price generated by the initial sale and export which is transmitted by the Member States and used by the Commission. This lower price does not reflect the market value of raw tobacco and therefore it can not be used to reflect the tobacco quality;

- (c) the prices used by the Commission in the comparison did not always reflect the total payments made by first processors to producers for their tobacco. For example they did not include the additional amounts sometimes paid by first processors to growers or benefits in kind (which can account for up to 28 % of the price);

- (d) the Commission made errors in comparing import and export prices because the prices used for imports are on a CIF (cost insurance freight) basis whereas the export prices of EU tobacco are on a FOB (free on board) basis.

29. The Commission's advisory Committee ⁽⁹⁾ indicated that price was affected by factors other than quality such as movements in exchange rates, stock levels and major releases of stock onto the world market by non-EU producers. Moreover, it had advised the Commission that the absence of an objective quality grading system was an obstacle to implementing a policy which relied on measuring quality.

30. Because of these failings the Commission's market analysis did not provide policy-makers with a sufficiently comprehensive and balanced understanding of the market to guide their selection of the market measures.

The possibility of alternative cultivation

31. The Commission argued that, in some cases, alternative cultivation was not possible. For example in Greece, sun-cured varieties were grown under conditions that made the growing of alternative crops impossible. However, a pilot project ⁽¹⁰⁾ for the Commission concluded in 1995 that various alternative crops could be grown with good results ⁽¹¹⁾.

The Commission's analysis did not take into account changes in the character of the market

32. The post 1998 CMO continued to be based on the assumption that first processors were independent in setting the terms of the cultivation contract prices negotiated with producers. This assumption was unrealistic since the situation had changed. There had been a concentration of purchasing in the hands of a small number of multinational first processors, merchants and manufacturers and the latter had become increasingly dominant in price setting.

⁽⁹⁾ The Standing Group on tobacco set up under the Advisory Committee on Specialist Products pursuant to Commission Decision 98/235/EC. This Group comprises experts representing producers, traders, first processors, manufacturers and consumers.

⁽¹⁰⁾ Commission Decision C(92) 3126 3.12.1992 for a pilot and demonstration project according to Article 8 of Council Regulation (EEC) No 4256/88 (OJ L 374, 31.12.1988, p. 25). (Project No 92.EL.06002).

⁽¹¹⁾ Helmico SA (1995) Final Report on Project No 92 EL.06002.

33. Insufficient competition on the market suppresses prices and puts the CMO's premium strategy at risk. The Directorate-General for Agriculture and Fisheries received, in February 1997, a joint letter from producers and cooperative unions indicating that the problem of low prices was attributable to the oligopolistic structure of the processing market but this matter was not investigated at the time. The Court's audit subsequently found out that anti-competitive practices existed (see paragraphs 61 to 71). In its Special Report No 8/1993, the Court had already noted that the increasing involvement of producer groups in first processing had permitted them to limit manufacturers' influence over prices. The Commission's 1996 analysis did not recognise the negative implications for competition arising from the prohibition, in 1993, of such groups from carrying out first processing ⁽¹²⁾.

Insufficient alignment of agriculture and other policies

34. The tobacco CMO contains policy objectives and measures which affect other policy areas. It is important to ensure coherence between them and this is usually achieved through inter-service consultation. Not all relevant services however, were consulted during the preparation of the Commission's proposals (Directorate-General for Development, Directorate-General for Competition).

35. The export of a substantial part of EU subsidised tobacco at very low prices was not discussed with the Directorate-General for Development and Humanitarian Aid in terms of its potentially adverse effect on the exports of developing countries. Such exports are crucial to EU efforts to improve the economic situation of these countries. For example, the Commission grants development aid to small-scale tobacco producers in Malawi where raw tobacco accounts for 70 % of all export income. On the other hand, the CMO supports EU production, most of which is not in demand in the EU and therefore exported. This reduces the export possibilities of developing countries.

36. A report produced in 1994 for the Directorate-General for Environment on eco-responsibility and the common agricultural policy pointed out that tobacco types had varying irrigation and nitrogen application needs and thus impacted differently on the environment. The CMO's premium system encourages shifts in production from sun-cured and dark air-cured towards flue-cured and light air-cured. This leads to undesirable environmental impacts as they require higher levels of irrigation and/or fertiliser. Flue-curing also involved higher energy consumption. Such changes are incompatible with both the Commission's overall environmental objectives and those specific to the tobacco

CMO. The Court noted that, for the 1998 reform, the Commission did not fully take account of the Directorate-General for the Environment's reservations. However, it was the main argument for its proposal for phasing out raw tobacco production subsidies presented to the Göteborg European Council in 2001.

37. The Commission failed to draw Council's attention to the advice given by the Directorate-General for Customs and Indirect Taxation (Taxation and Customs Union DG) that, subsidies impact on retail prices (reduce them). The effect on retail prices is amplified by the excise duty policy adopted by most tobacco producing Member States, who apply a lower rate of duty to their own tobacco. For example, France applied the minimum rate of excise duty to dark-tobacco cigarettes manufactured locally. This is 20 % lower than the rate applied to imported light-tobacco cigarettes. In this way, Member States favour their national cigarette brands, containing a large proportion of subsidised tobacco ⁽¹³⁾. In consequence, retail prices were lowered. Authoritative sources, such as the World Health Organisation and the World Bank ⁽¹⁴⁾, consider that lower prices increase consumption levels and by association, the level of tobacco-related disease.

THE CMO HAS NOT ACHIEVED THE DESIRED IMPACT

The various measures have not achieved their objectives

38. The Court examined whether, overall, the measures introduced since the 1998 reform had achieved the objectives set and found that they had either not been as successful as intended in many respects or impact could not be measured to determine whether they had been successful or not.

The impact of aid on growers' income cannot be assessed

39. By compensating for the greater costs involved, the premium system was intended to help make EU tobacco more marketable and thus achieve a fair income. The Commission did not define what constitutes a 'fair income' from growing tobacco, set quantifiable targets for improvement or ensure that appropriate information on production costs, prices and income from reliable sources was received in order to measure impact. It was therefore unable to evaluate the impact of premium on growers' income overall and their standard of living ⁽¹⁵⁾.

⁽¹³⁾ This situation is confirmed by the Court of Justice's ruling of 27 February 2002, Case C-302/00 *Commission v French Republic*, concerning differential taxation of dark and Virginia type tobacco.

⁽¹⁴⁾ The WHO Framework Convention on tobacco control, World Bank economics of tobacco toolkit: 'Economic analysis of tobacco demand'.

⁽¹⁵⁾ The evaluation report referred to by the Commission does not take into account income from secondary activities which is necessary to evaluate growers income overall and their standard of living.

⁽¹²⁾ Regulation (EEC) No 84/93 (OJ L 12, 20.1.1993, p. 5).

The producers' dependence on aid has not changed

40. The premium represents around 75 % of producers' income from tobacco production but has reached nearly 95 % for production of one variety in Italy. The variable element of premium was intended to provide an incentive to producers to improve quality in order to increase the value of their product thus reducing their dependence on aid. The Commission assumed that the costs to the producer of improving quality would be covered by the variable premium and higher sales prices and thus reduce dependence on subsidies. The evidence available to the Commission however showed the contrary.

41. The information available at the Commission in 1998 indicated that, even for the better quality tobacco, the sales prices communicated by Member States, along with the EU premium did not cover the costs of production (see also paragraph 48). Furthermore, there is no information available showing to what extent the different measures of the CMO would have reduced the dependence on subsidies. The most recent market information shows that EU average sales prices in 2003 were lower than in 2002 making producers more dependent on subsidies in 2003 than in 2002.

The impact of aid on the improvement of tobacco quality

42. The Directorate-General for Agriculture considered that improvements in quality within each variety group could be measured by increases in the quantity of tobacco produced of the higher grades. This however, required a clear definition of quality standards and performance to be measurable on a constant basis.

43. Several factors militated against this. Firstly, there is no standard grading system and there are variations between Member States in the way in which grades are established for the same varieties of tobacco. Secondly, in order to measure quality improvements over time, it is necessary to take into account the composition of producer groups and the characteristics of their production. The effect of a low-quality producer leaving a group, would be to increase the quality of the group concerned even though there would be no improvements of production by producers as a whole. It was not possible to measure the quality improvements because of the changes which occurred in producer groups. For example, the 1998 reform introduced minimum size requirements for producer groups which resulted in significant reorganisation. Also, membership of most producer groups changes from year to year.

44. The way in which producer groups are organised can work against modulation of the variable premium. Whereas the objective of the variable premium is to provide an incentive to grow better quality tobacco, reality can be different: if all the producers in a group are producing the same quality (grade) of a

particular variety the total variable premium available to the group for that variety will be apportioned equally between them (see also paragraph 9). The same applies if producers of a poorer grade of the same variety group together. The members of both groups will get the same amount of variable premium even though the quality they are producing is different. These observations show that, contrary to its objective, the premium system is not necessarily an incentive to improve quality: it allows producers to maximise aid without improvement in quality and as shown in certain cases, identified by the Court and the Commission services, there is no difference in premium payments between good and bad producers.

The rates of premium are inconsistent with the quality of tobacco

45. Differentiation of premium between variety groups was intended to encourage the cultivation of the higher quality varieties: higher premiums would be paid for higher quality as it involved higher production costs. This would have required annual modifications of premium levels when justified by changes in costs and income. Since 1993 however, premium levels set by the Council have remained largely unchanged.

46. In the absence of sufficiently detailed costs and income information from the Commission, the Court made its own analysis to verify the correlation between the level of premium paid, the quality of tobacco production and production costs. For the year 1998, it used data obtained specifically from Greece in relation to production costs and such data as was available from the Commission on sales prices. This analysis was based uniquely on Greece as it provided the most complete data set for EU tobacco varieties.

47. In view of the intention to reward quality and the higher costs involved in achieving it via the premium system, the Court sought to compare the quality of tobacco (which the Commission considered to be reflected in sales prices) with production costs and the level of premium paid. The comparison in *Annex 2* shows that the premium applied to a high quality tobacco such as *Basmas* represented 47 % of production costs whereas that applied to a lower quality such as *Katerini* was 87 %. This was contrary to the objective of seeking to reimburse a higher proportion of the greater costs associated with the production of the higher quality varieties and provide a margin which producers would find an incentive.

48. The reimbursement of a higher proportion of production costs was intended to have a positive effect on income. The results show that, for most varieties in Greece, income was negative. The Court also looked at the reliability of the sale prices communicated to the Commission by the Member States. As a result of its audit in several Member States, including Greece, the Court found that the average sales prices communicated to the Commission, indeed did not always include the additional amounts paid by first processors to producers or the services in kind provided to them (see also paragraph 28). These can represent a substantial source of additional 'income' for producers and in one Member State

such additional payments were as much as 28 %. This suggested that the sales prices supplied to the Commission by Member States might not provide complete information about returns to growers. The Commission was thus unable to obtain satisfactory information on which to base its management of the tobacco regime.

49. The Court again analysed the correlation between the level of premium and the quality of tobacco for the year 2000. Since similar data to those for 1998 were not available, the Court compared the average premium per hectare, per variety and Member State, with the Commission's ranking of varieties by quality. This showed that in four out of five Member States, premium did not correspond to the quality ranking and that the highest premium was paid to lower quality varieties. The results are set out in more detail in *Annex 3*.

Efforts to align production and demand have not been successful

50. In order to stabilise markets and ensure supplies the CMO is, *inter alia*, intended to align production to the EU market's requirements.

51. Analysis of the EU supply balance *table* shows that overall domestic consumption of EU production did not change significantly between 1996 and 2000 at which time it was 40 %. Detailed data by variety group is not available. Imports have remained stable throughout the same period at 65 %. There is no evidence that the CMO has influenced EU production so as to reduce the mismatch of supply and demand. While certain types of tobacco have to be imported, a successful policy would have led to some substitution of domestic products for imports. But this did not happen. The Court notes that the Commission considers that the CMO policy was successful even though it recognises that sufficient data was not available and that the scheme before the 1998 reform was not adapted to solve the most evident problems of the sector, i.e. growing the tobacco in demand (see paragraph 96 of its replies).

Expenditure from the Tobacco Fund has been limited and there were weaknesses in project management

52. The Fund was established in 1993. It was initially funded by 0,5 % withheld from premium which was progressively increased to 3 % and was intended to finance programmes of research and information relating to the harmful effects of tobacco consumption and preventive and curative measures. It was also intended to help orient production towards the least harmful varieties and qualities. Depending on the type of activity funded, such projects fell to be managed by either the Directorate-General for Agriculture or the Directorate General for Health and Consumer Protection. As part of the 1998 reforms, the financing of the fund was doubled even though there had not been much activity.

53. The Court analysed the utilisation of the Fund. *Annex 4* shows that payments during the first five years (1996 to 2000) amounted, on average, to 18 % of the available funding and the

rate of utilisation has continuously increased over the last three years to reach 65 % in 2003. The unused balance of the Fund stood at some 68 million euro.

54. Although modest in extent, the Court identified weaknesses in project management such as ineligible expenditure, expenditure before the date of the contract or in periods other than those stipulated in the contracts, advances paid not covered by guarantees, the existence of a posteriori allocation of appropriations, and contracts not signed by either of the two parties.

55. The Court noted that, in his Annual Activity Report for 2002, the Director-General, Agriculture made a reservation to his declaration to the effect, that he did not have sufficient assurance that the resources transferred to the Fund since 1993 had been used in accordance with the principles of regularity and sound financial management.

56. In contrast, the Director-General of the Directorate-General for Health and Consumer Protection concluded in his 2001 Activity Report that, having assessed the weaknesses concerning the administration of projects under his control, the problems were not sufficiently material to merit formal reservation. The Court noted however, that the weaknesses identified (paragraph 55) mainly related to the Directorate-General for Health and Consumer Protection.

Expenditure on environmental measures financed from the specific aid to producer groups has been very limited

57. As indicated in paragraph 14, specific aid for producer groups was introduced in part to finance environmental activities. But the proportion they were expected to spend on them was not specified and the aid was not made conditional on it being spent on such activities. Actual expenditure on environmental protection activity has been very limited. For the harvest year for which complete information was available at the time of the audit (1999), only one out of the 20 producer groups examined had applied aid to environmental protection measures involving only 1 % (2 648 euro) of the total amount of specific aid it received.

The quota buy-back scheme has had only limited success

58. In order to facilitate voluntary departure from the tobacco sector a quota buy-back scheme was introduced whereby individual producers who wished to cease production could sell their quota. This mechanism was intended to permit the reallocation of resources within the sector and to increase the proportion devoted to measures designed to achieve structural adjustment. The potential success of such a scheme is dependent on the attractiveness of the financial compensation to participants. The Commission considered it would be prudent to set the price at a percentage of the premium for a fixed period. This was eventually set at around 23 % of the premium per tonne during a period of three years.

59. The Commission chose as its performance indicator the quantity offered up, but did not specify the overall levels it wished to achieve. It concluded in 2001 however, that the level of quota bought back in respect of the 1999 and 2000 harvests, at just 729 tonnes or 0,20 % of the guarantee quantity, was too small. It therefore increased the compensation offered to some 25 %. For sun-cured tobacco (group V) which faced marketing problems, the buy back price was increased to 75 % in the first two years and 50 % of the premium in the third year. In 2002 the Commission concluded that, although the take up was much greater than in previous years, the scheme had again not produced the impact foreseen as it was still only around 1 % (3 626 tonnes out of 348 844) of guarantee quantity. It has now further increased compensation, which can be up to 100 % in some cases, extended the compensation period from three to five years and established a possibility for further financing via the Tobacco Fund. In 2003, the quantity bought back was 7 228 tonnes or 2 % of the guaranteed quantity. By not setting an appropriate level of compensation from the outset, the Commission has delayed achievement of the scheme's objectives.

The initiative to encourage alternative activities via the Structural Funds has been misdirected

60. In order to encourage tobacco producers to consider alternative activities, the 1998 reform of the tobacco CMO specified for the first time an option for rural development programmes to include measures for the conversion of tobacco-growing regions to other activities⁽¹⁶⁾. The audit showed that the tobacco measures adopted in Extremadura in Spain and Umbria in Italy, provided for improving productivity and marketing instead of conversion activities. In those regions of Greece (Aetoloakamania, Thrace and East Macedonia) and Italy (Campania), which had the greatest need for help to convert to other activities, no measures at all were directed towards tobacco. This demonstrated that the initiative was failing to meet its objective.

The national quota reserve measure has not been successful

61. The 1998 reform sought to introduce greater flexibility into the quota system. Transfers of guaranteed quantities between variety groups at national level and the transfer of production quotas between individual producers were made easier. As another initiative it also introduced a system of national quota reserves to be created by annual compulsory deductions, of up to 2 %, from the quotas allocated to producers. It was intended to encourage producers to switch to other crops and/or other variety groups and restructure their holdings. The reserves were required to be distributed to existing or new producers on the basis of objective national criteria.

62. Before the introduction of the new measure, producers increased their effectiveness by restructuring through purchasing

quota directly from other growers. Because national quota reserves were created compulsorily without any financial compensation they were reluctant to continue the restructuring of their holdings by purchasing further quota. This was because they would start to lose it through the annual deductions without compensation.

63. The Commission found that, despite the various measures, the majority of producers still had insufficient quota to ensure the viability of their holdings. Enforced reductions of these quotas to create the national reserves exacerbated the situation. Equally, the level of allocations from the national reserve was also insufficient to ensure the viability of new producers. In 2001 the Commission recognised that application at the national level had proved inadequate for achieving their objectives and proposed abolition of the measure. Despite the demonstrated failure of the measure the Council however, rejected the idea of abolition and decided to make it optional for Member States. Only Austria, Belgium and Portugal are presently operating the system.

The cultivation contract auction scheme has not been used by Member States

64. In order to improve competition, which was recognised to be insufficient and to ensure that contract prices reflected market conditions, the Commission introduced an optional cultivation contract auction scheme for Member States. It permitted producers to offer their existing cultivation contracts to the first processing market in order to obtain the best possible price, which has to be at least 10 % higher to qualify. Under the measure cultivation contracts must include the prices to be paid to producers and be concluded before the tobacco is produced. This can be nearly a year before delivery. First processors usually adopt a cautious approach to price-setting and contracts frequently contain provisions for additional, sometimes unquantified, payments after delivery. However, an auction scheme with complete and final payment conditions which need to be fixed a long time in advance prohibits such cautious approach.

65. The measure proved unpopular with the sector and no Member State has yet made use of it. The objective of the measure has therefore not been achieved.

Simplification of administration not achieved

66. In order to help simplify administration, the 1998 reform replaced the annual allocation of production quotas to individual producers with the allocation of production quotas every three years to producer groups and to individual producers. However, the introduction of a national quota reserve through annual deductions from the producers' quotas required annual modifications of the quotas and the issuing of up-to-date quota statements. As a result of its enquiries in Member States the Court found that in practice, national authorities had experienced an increase in their workload compared with the situation before the reform.

⁽¹⁶⁾ Council Regulation (EC) No 1257/1999 (OJ L 160, 26.6.1999 p. 80).

Inappropriate price agreements

67. Article 81 of the EC Treaty sets out the principles for maintaining competition. In general it prohibits all agreements between undertakings and concerted practices which have as their object or effect, the prevention, restriction or distortion of competition within the common market. In September 2003 the Court of Justice confirmed that 'the maintenance of effective competition on the market for agricultural products is one of the objectives of the CAP' ⁽¹⁷⁾. Accordingly the market should ensure that the prices obtained by producers reflect normal competition.

68. In the principal producing Member States, the Court found documents which it considered to be inappropriate price agreements between first processors and/or producer organisations. The agreements examined contained a price ceiling which is incompatible with the Treaty as it restricts competition.

69. For example, in Spain, in addition to price agreements, national authorities confirmed to the Court that, after the break-up of the State monopoly, first processors now operate contracts with producers which correspond to their production capacity. The Court concludes that contractual relations between producer groups and first processors are established according to processors' production capacity rather than on the basis of price competition.

70. In Italy, growers and first processors have traditionally been closely linked. The Court found that there was a global three-year price agreement between producer organisations and associations of first processors representing about 85 % of the raw tobacco production. These agreements fix prices without free competition between the parties involved. In Greece, the national authorities, producers' organisations and first processor's associations informed both the Court and the Commission of the existence of collective agreements in relation to cultivation contract price conditions covering the entire industry.

71. The above practices restrict or at worst eliminate price competition. The Court communicated its findings on such agreements to the Commission. The Directorate General for Competition is investigating all the cases involved.

The procedures to improve control were not effective

72. The checks required of Member States are designed to ensure that the objectives of the CMO are attained and that expenditure is incurred in accordance with regulations. In order to address irregularities found previously by the Commission through the clearance of accounts procedures, in particular in Greece and Italy, the reform introduced new procedures in order

to tighten controls. Prior approval of first processing undertakings was introduced with the objective of ensuring that they were financially sound and were really engaged in first processing, thus excluding speculative transactions by intermediaries to the detriment of producers income. Specific verification of areas declared by producers as being planted with tobacco by variety and crop was also introduced to ensure that claimants themselves had grown the tobacco for which aid was claimed. Examination of the implementation of these procedures and the other controls required by the CMO revealed weaknesses as shown below.

Non-compliance with regulations

73. Annex 5 provides a summary of the cases of non-compliance with the checks and controls required by regulations found by the Court during the audits carried out in the five Member States visited. The main findings are set out below and cross-referenced to the columns in the annex:

- (a) The bodies responsible for controls were not always sufficiently independent to ensure reliable results. In Greece, until 2001, the national body responsible for advising tobacco producers had also been responsible for the control functions relating to producers and first processors required by the CMO. This led to a conflict of interest and insufficient independence for its role as the control body. Although the problem had been identified by the Commission in 1994 it was only in 2002 that the risk was addressed and the control responsibility transferred to another body. In Italy those responsible for operating controls and checks continue to alternate this work with acting as advisors to producers (column 1).
- (b) Administrative cross-checks of parcels to prevent aid being paid twice for the same harvest were either not carried out or did not produce a reliable result (column 2). In addition compulsory checks of areas planted by individual growers were found not to have been carried in Greece (column 3.2) exposing the Community to the risk that production aid for tobacco could be claimed as well as area-based aid for other crops (false claims). Other cases were found in Greece and Italy (column 4) where, contrary to a Court of Justice ruling in 1997, on-the-spot controls of tobacco parcels were carried out after the tobacco had been harvested ⁽¹⁸⁾ thereby rendering them ineffective.

⁽¹⁷⁾ Case C-137/00.

⁽¹⁸⁾ The Court of Justice, in its ruling in Case C-46/97, *Hellenic Republic v Commission of the European Communities*, concluded that, in order to be considered as effective, on-the-spot checks of tobacco fields must be carried out at the time when the tobacco is still in the field. Since the Greek authorities had executed the controls after the harvest, Greece had to accept a 2 % flat-rate reduction of the annual premium granted.

- (c) Checks at first processors to ensure that tobacco is not released from supervision without being processed were either not executed at all, not executed in compliance with regulations or were not sufficiently documented (columns 7 and 8). Therefore, there was inadequate assurance that aid was not paid on raw tobacco submitted more than once or on tobacco imported from third countries which does not qualify for aid.
- (d) Some producer organisations had not complied with recognition conditions which must precede qualification for specific aid, had used the aid for ineligible purposes or had failed to achieve additionality because the specific aid was used to finance existing administrative measures instead of new activities (columns 9, 10, 12 and 13).
- (e) There had been failures to comply with the prohibition of producer groups from carrying out first processing. This is a specific requirement of the Regulations introduced in 1993 to prevent distortion of competition and monitoring difficulties (column 11).
- (f) Premium and specific aid were granted in respect of cultivation contracts concluded after the regulatory deadline or which did not contain the information required for the tobacco to be eligible for aid (columns 14 and 15).

74. The Court notes that until June 2004, the Commission had not finalised its work and imposed financial corrections where deemed necessary (Spain, Greece, Italy).

MONITORING AND EVALUATION OF THE REFORMED CMO

Monitoring

Verification of controls by the Commission

75. The Court examined the work undertaken on tobacco aid in the framework of the clearance of accounts procedure which requires the Commission to perform checks to verify whether Member States have correctly interpreted and applied the regulations relating to aid schemes⁽¹⁹⁾. The Audit Directorate of the Directorate-General for Agriculture made control visits for tobacco to four Member States following the 1998 reform which covered the key controls indicated in *Annex 6*.

⁽¹⁹⁾ Council Regulation (EC) No 1258/1999 (OJ L 160, 26.6.1999, p. 103).

76. The Court considers however that on the basis of the Commission's guidelines regarding the calculation of financial consequences, when preparing the decisions regarding the clearance of accounts of the EAGGF Guarantee Fund, a number of other controls should have been considered and classified as 'key controls' (see *Annex 7*). These key controls should be examined during the clearance of accounts audit, in order to obtain reasonable assurance concerning the correctness of the accounts.

77. The detailed rules to be applied by Member States require them to verify the moisture content of the tobacco for which aid premium is claimed. This is needed in order to verify the permitted levels for tobacco varieties and to calculate the weight of tobacco for which aid can be claimed. The Court's audit of the records in Greece showed that the moisture tests carried out in relation to the 1999 to 2001 harvests were not carried out in compliance with the provisions of the legislation and no weight adjustments were made. Further enquiries made by the Court established that correct checks had not been carried out since 1993. This may explain why the Commission's checks did not identify the problem. The Audit Directorate of the Directorate-General for Agriculture was informed through different sources of the failure but had decided not to apply financial corrections even though there was a systematic lack of compliance. The level of correction would have been between 2 and 10 %⁽²⁰⁾, applicable to all aid claims in the period, had it been imposed.

78. As part of the 1998 reform proposals, the Commission suggested dropping the requirement for the control on the grounds that it was imprecise and difficult. The reforms finally adopted by the Council however, maintained and reinforced the requirement for this test. In 2000, the Commission expressed its intention to pursue corrections for non-compliance but only in respect of future failures. The Court notes that, as EAGGF years from 1997 onwards remain open, corrective action for these years is still possible.

Inadequate review during the budgetary procedure

79. The Financial Regulation requires that the annual budgetary procedure should ensure that the 'mobilisation of Community resources must be preceded by an evaluation to ensure that the resultant benefits are in proportion to the resources applied'. It further requires that all on-going operations 'must be subject to regular review' in order to confirm their continued justification.

80. Examination of the budget submissions by the Commission for tobacco from 1999 to 2002⁽²¹⁾ revealed them to be repetitive and lacking in evaluative comment in relation to the above criteria.

⁽²⁰⁾ Commission Document: Guidelines for flat-rate corrections DOC. VI/5330/97 of 23 December 1997 and clearance of accounts enquiry No 99/902-ES.

⁽²¹⁾ Preliminary draft general budget of the European Commission.

Insufficient information was provided by Member States and by the Commission

81. In order to ensure efficient and effective monitoring of the market the Commission needs relevant, accurate, complete, timely, and unbiased information. This is important, not only from their own point of view as managers, to ascertain whether modification of measures is required, but also where they are required to publish information to be used by interested parties. This was not achieved as explained below.

82. The CMO regulations ⁽²²⁾ require Member States to submit data on cultivated areas, numbers of contracts, quantities, growers and first processors and estimated and actual production to enable the Commission to monitor the tobacco market. Compliance was in general satisfactory. Member States are also required to submit information on cultivation contracts concerning prices, first processors, producers, quotas and the surfaces involved. After harvest, additional data on tobacco deliveries, sales and stocks must also be provided. For the 1999 harvest only Germany, a small-scale producer, submitted the information on time. In respect of the 2000 harvest, the information was supplied by all the Member States, except for Italy. For the 2001 and 2002 harvests the situation deteriorated and only three and four Member States respectively submitted the information on time.

83. The Commission is required to publish timely and up-to-date lists of first processing undertakings approved to sign cultivation contracts ⁽²³⁾. Examination showed that the Commission only published such lists after the deadline for signing contracts. This exposed growers and producer organisations to the risk of contracting with non-approved first processors and losing the right to aid.

84. The 1998 reform required the Commission to submit to the European Parliament and the Council, before 1 April 2002, a report on the functioning of the CMO in raw tobacco. The Commission, considering that the information it had asked for would be insufficient for the purpose of producing the required report, requested additional information from the Member States. It carried out additional work to provide the necessary factual information which was processed and made available to Parliament and the Council in a report in November 2002 ⁽²⁴⁾.

The external evaluation concluded that the CMO was not achieving the intended impact

85. The Commission engaged external consultants to provide an analysis/evaluation of the market for the period 1993 to 2001. Their report was made public in October 2003 ⁽²⁵⁾ and their findings are similar to those of the Court. The evaluation report was an in-depth evaluation including a detailed appreciation of the impact of the CMO.

86. The report concluded that:

- (a) the lack of reliable information had not permitted a quantitative evaluation of the impact of the CMO on the balance of supply and demand;
- (b) the system of guaranteed quantity had controlled production and achieved improved flexibility;
- (c) the approach chosen by the Commission to measure the improvement in tobacco quality could be challenged: the Commission had selected price as the sole indicator of quality; in the evaluator's view, other factors also played an important role and the data on quality/price was not homogeneous and was highly subjective; there were major differences in how variable premiums were applied in Member States and the effect varied widely; as a substitute for direct measurement the consultants had interviewed tobacco professionals and asked whether they were satisfied that quality had improved; their replies indicated that there had been some improvements in the grades of tobacco produced;
- (d) the objective of ensuring a fair income to farmers could not be evaluated with precision as the evaluator had used data which suffered from limitations; it was stated that, except in one region, holdings with diversified activities obtain a better income than those who are specialised in the production of tobacco only;
- (e) as far as the impact of tobacco support on the economic activity and employment in rural areas was concerned the results varied according to the situation of individual regions; it could not be stated whether or not the CMO had markedly improved the quality of life although it was evident that, without support the situation would be worse;
- (f) the CMO had not had any significant impact on public health and cigarette consumption had not been influenced;

⁽²²⁾ Commission Regulation (EC) No 2848/98 (OJ L 358, 27.12.1988, p. 17) and Commission Regulation (EC) No 2636/1999 (OJ L 323, 15.12.1999, p. 4).

⁽²³⁾ Article 54(c) of Regulation (EC) No 2848/98.

⁽²⁴⁾ Commission Staff Working Paper: 'Report to the European Parliament and the Council on the operation of the common organisation of the market in raw tobacco'. SEC(2002) 1183 of 6 November 2002.

⁽²⁵⁾ *Evaluation de l'organisation commune de marché dans le secteur du tabac brut*, Consulenti per la Gestione Aziendale srl (COGEA), 2003.

(g) although management was generally more effective, especially in terms of reducing costs and time and of increasing transparency in the management of premium, system weaknesses remained; for example, an excessively bureaucratic approach to activities and financial stress for producer groups caused by the time lag between calculation and payment of the variable premium.

87. The Court considers that the overall message which emerges is that the CMO has not achieved any material beneficial change in most areas (or cannot conclude in the absence of relevant data) although the continuity of support through aid has permitted growers to survive. Even today ⁽²⁶⁾, tobacco production without aid is not viable for the tobacco growing community.

FURTHER REFORM OF THE CMO

Assessment of options for reform of the CMO

88. In July 2002, the Commission published its mid-term review of the CAP as a whole. It proposed a new strategy for sustainable development which would decouple support from production and provide support to farmers through a payment scheme based on the support payments previously received by the farmer in a reference period. The Council asked the Commission for a specific proposal on tobacco by September 2003 which would respond to the new strategy. To support this proposal, the Commission carried out an extended impact assessment of the options for market reform. The Commission considered the following three options:

- (a) prolongation of the current CMO;
- (b) decoupling along CAP reform lines;
- (c) gradual phasing out of support over a 10-year period.

89. It concluded that neither (a) nor (c) would permit the CAP's new objectives to be met or solve the inherent problems of the current CMO. It decided that option (b) however, should offer a simpler, more efficient means of support for farm incomes while avoiding the undesirable effects of the current coupled regime such as maintenance of production which had no outlet in the EU and potential complications for negotiations with the World Trade Organisation (WTO).

⁽²⁶⁾ October 2003 when the report was published.

90. It envisaged a phased decoupling of the existing aid from production over a period of three years accompanied by a phasing out of the Tobacco Fund (which, in the meantime would continue to fund anti-smoking information campaigns). A specific financial envelope would be established for the restructuring of tobacco-producing areas.

91. The approved reform will begin from 2006 with the transfer of all or part of current tobacco premium into entitlements to a single farm payment. With full implementation, the reform will redistribute 50 % of the current tobacco production premium to the single farm payment and 50 % to the restructuring envelope. It is expected that, in the short term, cultivation of less-profitable tobacco varieties will cease and farmers will be encouraged to convert to other forms of land use.

How the reform will address the weaknesses identified by the audit

92. The reform has the potential to reduce the mismatch between internal supply and demand. There would no longer be an incentive for the producer to grow tobacco with the main objective of obtaining the premium. Producers would be encouraged to respond to the demands of the market. There will no longer be a need for a production threshold system with the objective of guiding production. The reform will also do away with the production quota system and thereby the need for quota transfers, quota buy back and reserves.

93. Reinforcement of structural measures also has the potential to improve the viability of tobacco holdings which have, up to now, been inhibited by the rigid production quota system. It should also improve professional training of producers allowing them to improve production techniques and quality.

94. The switch to the single farm payment scheme and the cross-compliance system will make payments dependent on the respect of environmental requirements thus replacing the present ineffective system linked to the specific aid to producer groups.

95. Finally, it will remove one of the agriculture support system's most complex and expensive control systems.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

96. The Court regrets the Commission's contradictions within its replies which makes the reading of this report more difficult.

Inadequate preparation of the 1998 reform proposals

97. The Commission's proposals for the 1998 reforms were based on unreliable data and its analysis of the market was inadequate. The importance of tobacco production on employment was based on out-dated and incompatible data, and the impact of the premium system on the production of better quality and a reduction of the mismatch between supply and demand although limited in terms of possibilities was not proven. The Commission could not produce evidence in support of its assertion that better 'quality' would increase market prices and make producers less dependant on subsidy. The contention that cultivation of alternative crops was not possible was contradicted by a study in one major producer State. Lastly there had been insufficient inter-service cooperation within the Commission to the extent that the tobacco CMO is insufficiently aligned with the EU's development, environmental and taxation policy. Because of these failings, largely inappropriate policy measures were adopted for the tobacco market and the continuation of the existing aid system (measures) was not justified (see paragraphs 20 to 37).

The CMO has not achieved the desired impact

98. The measures of the CMO were largely inappropriate, from the outset because of the aforementioned failings, these measures proved to be ineffective in most areas. While climatic conditions do not allow production for all EU needs, the premium system was not successful in increasing the production of the quality EU tobacco currently in demand. Therefore it did not change growers' dependence on aid (aid represents about 75 % of their income). In addition and contrary to its objectives, the scheme has been an incentive for the production of low quality tobacco which in certain cases is over-compensated even though it has no outlet in the EU.

99. Voluntary departure from the tobacco sector through the buy-back scheme was unsuccessful (about 1 % in 2002 and 2 % in 2003 of the guaranteed quantity) because of lack in incentive. Competition in the market was not increased through the cultivation contract auction scheme as it was not used. Moreover, free competition was put at risk by inappropriate price agreements in the three largest producer Member States. Little progress was made in achieving the objectives of orienting production towards less-harmful tobacco varieties, of encouraging alternative economic activities and protecting the environment. The Tobacco Fund was under-utilised in the early years. Moreover, its limited expenditure was characterised by weaknesses in project management (see paragraphs 38 to 73).

100. The Commission carried out audits to ensure that the aid scheme is correctly applied and interpreted by the Member States. The Court considers that this work should have been extended to cover the key controls outlined in Annex 7. No clearance of accounts decision was taken before June 2004 and therefore the Commission did not take corrective action when required.

Monitoring and evaluation

101. Monitoring of progress made in the implementation of the CMO was deficient because of insufficient information and the reviews made during the annual budgetary procedure, required to justify continuing with the market's measure, were inadequate (see paragraph 74 to 83).

102. The reports from the Commission required by the Parliament and Council to assess the effectiveness of the 1998 reforms were delayed. The results were communicated in November 2002 and September 2003. A further reform has now been decided. On 22 April 2004 the Council of Agricultural Ministers took a decision to fundamentally reform the support for the tobacco sector. It provides that, from 2010 onwards, tobacco aid will be completely de-linked from production (see paragraphs 84 to 99).

Recommendations

103. As the situation of tobacco production has not significantly changed over the years (market imbalance, unviable production holdings, ...), the Commission should pursue its strategy to give public health and sustainable development priority over (in this case) tobacco production of questionable viability. The Court considers that its observations show that the Commission missed the opportunity in 1998 to propose a reform of the market in the way it is now envisaged.

104. The Commission should address the failings identified in relation to preparation for the 1998 reform and seek to ensure that any reform proposals are supported by sufficient, relevant and reliable data and that the impact of the proposals on the sector is analysed.

105. With its approved reform in 2004 however, the Council has chosen to continue partial support of the tobacco sector between 2006 and 2009, though the total package of aid will be distributed differently. Notwithstanding the improvements which the reform should bring, the Commission should ensure that it monitors and addresses the fact that EU produced tobacco

cannot meet all demands; that the EU production is not viable without aid; that it is one of the most expensive market schemes, that it is not in line with the EU's public health and sustainable development policy objectives and, finally, that the market prices are suppressed through uncompetitive practices.

106. It is under these conditions that the Court welcomes the Commission's reform proposals as adopted by the Council. The Court however points out that, because the production based aid will phase out over time, the weaknesses identified in this report

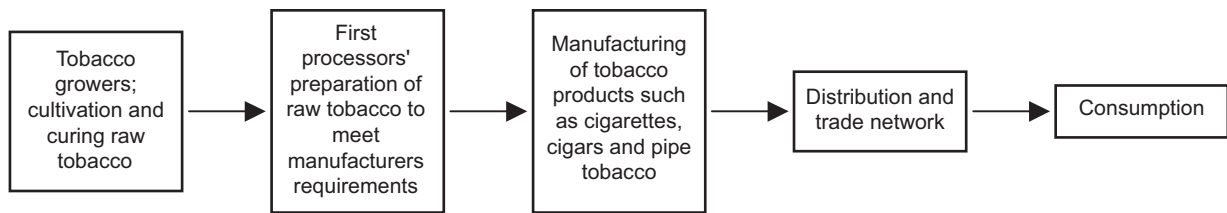
should be addressed. Also, the co-existence of producers receiving aid coupled to production and others receiving a decoupled lump sum could create the risk that producers will collaborate to maximise and share the aid available under both systems.

107. The Court recommends that the Commission pursue the outcome of the investigation into anti-competitive behaviour and, if it is confirmed, take appropriate action. The failures by Member States to operate the required checks and controls should also be followed up and corrective action taken where justified.

This report was adopted by the European Court of Auditors in Luxembourg on 21 July 2004.

For the Court of Auditors
Juan Manuel FABRA VALLÉS
President

ANNEX 1

The tobacco supply chain

ANNEX 2

Production costs, income and profit/loss by kilo by 0,1 ha (stremma) in Greece, harvest 1998

(1 ECU = 327,086 DRA)

		Group of varieties					
		I Virginia	II Burley	V Sun-cured	VI Basmas	VII Katerini	VIII Kaba K. Classic
A	Costs DRA/kg	1 209	936	1 172	2 872	1 332	1 265
B	Sales price/kg average	195	141	158	939	541	357
C	Net aid DRA/kg	966	773	773	1 338	1 136	812
D	Total income DRA/kg (B + C)	1 161	914	931	2 277	1 677	1 169
E	Net income/loss (D - A)	- 48	- 22	- 241	- 595	345	- 96
F	Net aid in % of costs	80	83	66	47	85	64

Sources: Production costs: National Tobacco Board Greece (EOK).

Sales prices: Member States' returns to the Commission in respect of Regulation (EEC) No 1771/93. These prices do not always include all payments and services received by the producers in return for their tobacco.

ANNEX 3

Average premium by variety group per hectare in 2000

Member State	Variety group	Premium in euro per ha	Rank overall
Germany	Group I	7 282,65	11
	Group II	9 113,34	6
	Group III	8 012,90	10
Greece	Group I	9 806,24	3
	Group II	9 203,13	5
	Group V	5 643,48	18
	Group VI	5 285,85	20
	Group VII	7 218,14	12
Spain	Group VIII	5 533,33	19
	Group I	9 836,05	2
	Group II	6 747,37	16
	Group III	7 033,48	14
France	Group IV	7 185,33	13
	Group I	9 338,51	4
	Group II	8 917,35	7
Italy	Group III	8 570,58	9
	Group I	8 792,83	8
	Group II	11 015,14	1
	Group III	6 723,53	17
	Group IV	6 869,49	15
	Group V	5 171,40	21
	Group VII	3 258,67	22

Source: Member States' return to the Commission

It is the Commission's objective to support the following quality ranking in descending order:

Quality 1 Group VI	Basmas
Quality 2 Group VII	Katerini and similar varieties
Quality 3 Group I	Virginia, Virginia D and hybrids thereof, Bright
Quality 4 Group IV	Kentucky, Moro di Cori, Salento
Quality 5 Group VIII	Kaba Koulak (classic), Elassona, Myrodata Agrinion, Zichnomyrodata
Quality 6 Group II	Burley, Badischer Burley, Maryland
Quality 7 Group III	Badischer Geudertheimer, Pereg, Korso, Paraguay, Dragon Vert, Philippin, Semois, Appel terre, Nijkerk, Misionero, Rio Grande, Forchheimer Havanna Ilc, Resistente 142, Goyano, Hybrids of Geudertheimer, Beneventano, Fermented Burley, Havanna, Brasile Selvaggio and similar varieties Petit Grammont, Nostrano del Brenta
Quality 8 Group V	Xanthi-Yaka, Perustitza, Samsun, Erzegovina and similar varieties, Myrodata Smyrmis, Trapezous and Phi I, Kaba Koulak (non classic), Tsebelia, Mavra

ANNEX 4

Amounts withheld from tobacco production aid for the financing of the Community Tobacco Fund and payments by type of action

Year	Withheld (deduction in year [t - 1])	Appropriation uti- lised for the infor- mation component	Appropriation uti- lised for the research component	Reconversion	'Unused amounts'	TOTAL
	A	B	C	D	E(A - B - C)	E in % of A
1994	289 744,00				289 744,00	100,0
1995	4 839 200,00				4 839 200,00	100,0
1996	8 390 773,00		1 017 647,00		7 373 126,00	87,9
1997	9 454 679,00		1 570 658,00		7 884 021,00	83,4
1998	9 371 382,00	1 393 467,15	915 468,00		7 062 446,85	75,4
1999	7 951 889,00	128 308,78	143 857,00		7 679 723,22	96,6
2000	8 498 972,00	1 108 067,10	1 301 843,00		6 089 061,90	71,6
2001	19 167 708,00	6 321 097,00	544 461,00		12 302 150,00	64,2
2002	18 867 346,00	6 933 341,00	3 759 836,00		8 174 169,00	43,3
2003	18 744 984,00	2 519 660,00 ⁽¹⁾	225 108,00	9 500 000,00 ⁽²⁾	6 500 216,00	34,7
Total	105 576 677,00	18 403 941,03	9 478 878,00	9 500 000,00	68 193 857,97	64,6

⁽¹⁾ State: 23 May 2004.

⁽²⁾ OJ L 164, 2.7.2003.

N.B.: The amounts withheld are not allocated to a 'Fund'. In the preparation of the budget, the amount withheld for the financing of the 'Fund' is deducted from the calculated premium appropriations, whereby the final appropriation in the budget is only the net amount. Consequently, future expenditure from the 'unused amounts' must be covered by future revenue. i.e. it represents 'a burden of the past'.

Sources: Commission DG-AGRI and DG SANCO.

ANNEX 5

Cases of non-compliance with legislative requirements in either one or all of the harvest years 1999 to 2001

	Type of failure ⁽¹⁾																		
	1	2	3.1	3.2	3.3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
Germany (central level)		X							X								X		
At beneficiary level												X		X	X				
Greece (central level)	X	X	X	X	X	X		X	X	X				X					
At first processor level							X												
At beneficiary level											X		X	X ⁽²⁾	X				
Spain																			
At regional level			X		X				X	X									
At beneficiary level														X	X				
France (central level)		X			X														
At first processor level													X ⁽²⁾						
Italy (central level)	X		X			X			X	X			X			X		X	X
At beneficiary level											X		X		X				

⁽¹⁾ The numbers refer to the type of failure listed in the attached notes.

⁽²⁾ These failures were also being committed in respect of the harvest years prior to 1999.

Notes to Annex 5 ⁽¹⁾:

Legal requirements

1.	According to the provisions of Article 44 of Regulation (EC) No 2848/98, Member States shall set up inspection arrangements to ensure effective verification of the compliance with that Regulation and with Regulation (EEC) No 2075/92 and shall adopt all the additional measures necessary for the application of those Regulations.
2.	According to Article 45 of Regulation (EC) No 2848/98 Member States administrative checks shall include cross-checks: <ul style="list-style-type: none"> — on declared tobacco parcels against the database provided for in Article 2 of Regulation (EEC) No 3508/92 to prevent aid being wrongly paid twice for the same harvest. Cross-checks for 1999 harvest may be carried out on a sample.
3.	According to the provisions of Article 46 of Regulation (EC) No 2848/98 on the spot checks of parcels: <ul style="list-style-type: none"> 3.1. must be carried out unannounced; 3.2. shall cover at least 5 % of the individual producers for each processing undertaking; 3.3. must be made on a sample selected on the basis of a risk analysis taking account of at least the quantities covered by contracts in relation to the areas declared as under tobacco (the production yield) and the results of the checks carried out in previous years.
4.	In a ruling of 13 July 2000 in Case C-46/97, the Court of Justice states that in order to be considered as effective, the on-the-spot checks of tobacco fields must be carried out at the time when the tobacco is still in the field.
5.	According to Article 47 of Regulation (EC) No 2848/98, in case deliveries are made to distinct purchasing centres, transport of the raw tobacco from these centres to the processing plant must be authorised in advance. This advance notice shall allow the competent control body to accurately identify the means of transport used, the route, and the time of departure and arrival together with the quantity of tobacco transported in each separate instance.
6.	When determining the quantity eligible for premium payments, predetermined reference moisture values must be respected. Both at the purchasing centres and at the processing plant, the moisture content of the tobacco must be determined, and eventual adjustments to the weight must be applied. Annex VI to Regulation (EC) No 2848/98 sets out the methods to be used, the sampling level and frequency and the calculation methods to be applied.

⁽¹⁾ When the Commission finds that expenditure has not been effected in compliance with Community rules, it shall evaluate the amounts to be excluded from Community financing. The Commission must have regard, in particular, to the degree of non-compliance found, the nature and gravity of the infringement and the financial loss suffered by the Community. Such corrections are generally between 2 and 10 % of the expenditure. Higher rates of correction, up to 100 %, may be decided in exceptional cases.

Legal requirements

7.	<p>According to the provisions of Article 48 of Regulation (EC) No 2848/98, checks during first processing and market preparation of tobacco shall be carried out after risk analysis.</p> <p>Checks shall at least include:</p> <p>(i) an unannounced check of the processing undertaking's stocks,</p> <p>(ii) a check when the tobacco leaves the place in which it was under supervision, having undergone first processing and market preparation (see note 8).</p>
8.	<p>Article 1(3) of Regulation (EC) No 1636/98 defines 'first processing' as the processing of raw tobacco delivered by a producer into a stable, storable product put up in uniform bales of a quality meeting final user (manufacturer) requirements.</p>
9.	<p>Since the 1993 harvest, producer groups can obtain the status of 'recognised producer groups' by complying with a number of requirements specified in the provisions of Article 2(1) of Regulation (EEC) No 84/93. From the 1999 harvest the requirements are specified in Article 3(1) of Regulation (EC) No 2848/98.</p>
10.	<p>According to Article 3(f) of Regulation (EC) No 2848/98 members of the producer group who wish to withdraw from membership, may do so after they have been members of the group for a minimum of one year following its recognition.</p>
11.	<p>The provisions of Article 2(2) of Regulation (EC) No 2848/98 prohibit producer groups from carrying out first processing of tobacco.</p>
12.	<p>Article 4(a) of Regulation (EEC) No 2075/92 provides for the granting of specific aid to recognised producer groups, Article 7 of Regulation (EEC) No 84/93 and Article 40(2) of Regulation (EC) No 2848/98 provide the details of the purposes for which specific aid may be used. In 1995 the Commission (DG VI/E3) issued an interpretative note (No VI/5711/95) to Member States on the use of the specific aid in particular to ensure the effect of additionality of this subsidy.</p>
13.	<p>According to Article 6(1a) of Regulation (EC) No 2848/98 recognition of producer groups shall be withdrawn by the Member State concerned if specific aid is used for other than the purposes laid down in Article 40(2). Only recognised producer groups may be paid the specific aid and the variable part of the premium.</p>
14.	<p>According to Article 5 of Regulation (EEC) No 2075/92, it is a condition for granting of premiums to producers that leaf tobacco delivered is covered by a cultivation contract with an approved first processor. The contract must be concluded at the latest by 30 May of the year of harvest.</p>
15.	<p>According to Article 11 of Regulation (EC) No 2848/98, where a cultivation contract is concluded between a processor and a producer group, it shall be accompanied by a list containing the names of the producers concerned.</p>
16.	<p>The provisions of Article 18(2) of Regulation (EC) No 2848/98 require the competent body to pay the premiums to the producer groups within 30 days of submitting the required documentation.</p>
17.	<p>Article 6(2) of Regulation (EEC) No 2075/92 provides for an arrangement of prior granting of entitlement to first processors to sign cultivation contracts if they comply with certain specific conditions. Cultivation contracts must be signed on 30 May at the latest.</p> <p>According to Article 7 of Regulation (EC) No 2848/98 the Member States shall decide on approval of the first processors also taking into account other conditions, which they have laid down themselves.</p>

ANNEX 6

Registration of coverage by the clearance of accounts units of Member States administration and control systems (limited to systems classified by the Commission as key controls) 1999 to 2003

	Member State					
	Italy	Spain	France	Greece		
Dates of control	12 to 16.7.1999	20 to 24.9.1999	2 to 6.7.2001	14 to 18.5.2001	10 to 14.11.2003	
Nature of control	Preventive audit (1) (Field control — Conformity audit)	Preventive audit (Field control — Conformity audit)	Conformity audit	Conformity audit	Conformity audit	Conformity audit
Feoga years covered	1998, 1999	1998, 1999	1999, 2000	1999, 2000	2002 contracts 2003	
Checks carried out (Yes/No):						
Physical on-the-spot field control	No	Yes (4)	No	No	No	No
On-the-spot control of delivery	No	Yes	No (6)	No	No	No
On-the-spot control of processing	No	Yes	No	No	No	No

(1) The objective of preventive audits is to deal with Member States' questions on the interpretation of the EU legislation.
(2) The objective of conformity audits is to verify Member States' compliance with the EU legislation as requested by Regulation (EC) No 1287/95.
(3) The check covered an assessment of irregularities already found by the control CSIA in respect of the 2000 harvest.
(4) Only in part, Burley parcels had already been harvested rendering, physical control 'impossible'.
(5) The control was limited to the classification of the tobacco delivered and the moisture measurement
(6) Considering that the mission report only includes the description 'via les tests de corroboration, au travers de l'existence de bons d'apport pour le contrôle des livraisons' the control appears to be an *ex post* control with a limited scope.

Sources: The mission reports transmitted to the Court and additional information submitted.

ANNEX 7

Key controls additional to those identified by the Commission

No	Regulation (EC) No 2848/98	The control measure
1	Article 46	On-the-spot checks of parcels in respect of an assessment of the reliability of the quantity of tobacco (the production yield) actually delivered.
2	Article 47(2)	On-the-spot control of transport between remote purchasing centres and the site of the first processing establishment.
3	Article 48(2)(a)	An unannounced on-the-spot control during first processing and market preparation of the undertakings stocks.
4	Article 40(2), (2a) and (3) Article 51(2)	On-the-spot check of specific aid to producer groups.

THE COMMISSION'S REPLIES

EXECUTIVE SUMMARY

I. The Commission welcomes the report of the Court of Auditors, but has difficulty in endorsing a number of the Court's conclusions.

V. The Commission's proposal for the 1998 reform was based on a report presented in 1996. This report was based on the most reliable data available at that time, which suffered from some limitations. The Commission does not consider that its market analysis was affected by this lack of data. The reform did significantly reduce the production of the two lowest quality groups of tobacco, thereby addressing the problem that the qualities grown were not suited for the market demand. The alleged anti-competitive behaviour within the tobacco sector is being followed up by the Commission (see also point X).

VI. The Commission's clearance of accounts departments were not inactive as regards tobacco. Based on their own risk analysis, and taking into account certain preliminary remarks of the Court of Auditors, they launched an investigation into tobacco in 2001 (audits in Greece, Italy, France and Germany) plus another three audits in 2003 (Greece, Italy and Spain). The procedures following the 2001 audits have been finalised for Germany and France. For some of the other Member States, however, the Commission is aware of some delays and will attempt to finalise its investigations as soon as possible.

The Commission notes the extended list of key controls now proposed by the Court. However, the Commission defined the key controls to be carried out in the tobacco sector in 2001 and is of the opinion that they cover the essential controls laid down in the Regulation.

VII. The Commission is of the opinion that its monitoring proved satisfactory.

Article 26 of Regulation (EEC) No 2075/92 required the Commission to submit a report on the functioning of the common organisation of the market in raw tobacco to the European Parliament and to the Council before 1 April 2002. The Commission submitted the requested report ⁽¹⁾ in November 2002, seven months behind deadline.

⁽¹⁾ Report to the European Parliament and the Council on the operation of the common organisation of the market in raw tobacco, SEC(2002) 1183, 6.11.2002.

In the meantime, the Commission had employed an external evaluator to examine the CMO. This evaluation ⁽²⁾, was available in October 2003. Furthermore, in preparation for a reform of the raw tobacco sector, the Commission carried out an Extended Impact Assessment ⁽³⁾, which was completed on 23 September 2003.

IX. On 22 April 2004 the Council of Agriculture Ministers decided to fundamentally reform the support for the tobacco sector. The 2004 Reform provides that, from 2010 onwards, tobacco aid will be completely decoupled from production. Half of the aid will be transferred to the single farm payment and the remaining half will be used for restructuring tobacco-producing regions under the rural development policy. In a four-year transition period, between 2006 and 2009, at least 40 % of the aid will be decoupled and integrated in the single farm payment. Member States may decide to retain up to 60 % as a coupled payment. The coupled payment has to be granted in such a way as to ensure equal treatment between farmers and/or according to objective criteria such as for tobacco producers situated in Objective I regions or for tobacco farmers producing varieties of a certain quality. Further criteria may be considered in the future. The 2004 reform should in principle resolve all of the present difficulties.

X. The Commission has issued Statements of Objections concerning alleged cartels in the raw tobacco markets in Spain and Italy (in December 2003 and February 2004 respectively). These Statements of Objections contain the preliminary conclusions of the Commission's investigations on alleged anti-competitive behaviour by producer groups and processors in the two Member States which started in October 2001 and January 2002 respectively. Issuing a statement of objections is a preliminary step in the procedure that may lead to the adoption of a prohibition decision imposing fines on the companies concerned.

As regards possible financial corrections the Commission refers to the ongoing clearance of accounts procedure following the 2001 and 2003 audits.

INTRODUCTION

13. The instrument of the national reserve has favoured the conversion to other variety groups in association with other instruments such as the transfer of guarantee thresholds.

The national reserve has become an option for the Member State since the 2002 harvest.

⁽²⁾ Evaluation of the common organisation of the market in raw tobacco, COGEA, 2003. Rome. 220 pp.

⁽³⁾ Tobacco sector, Extended Impact Assessment, COM(2003) 554 final, SEC(2003) 1023.

PREPARATION FOR THE 1998 REFORM

21. to 23. The main objective of the CMO is to support production of leaf tobacco. The socio-economic impact of employment has also been an important consideration for the Council during the history of the tobacco scheme.

In its 1996 report, the Commission used the best data available at the time.

In a working document ⁽¹⁾, the Commission points out that, according to Eurostat, the tobacco sector employed a larger labour force in 2000 than the 72 000 full-time workers estimated by the Court using a theoretical calculation. The Eurostat figure is 126 070 annual working units, corresponding to 212 960 people as the share of seasonal and part-time employment is remarkably high.

24. As regards the average aid per person, the Commission would refer to its recent study ⁽¹⁾, which indicates average assistance of EUR 7 600 per person employed in the tobacco sector in 2002 ⁽²⁾.

25. In some tobacco-producing regions tobacco is the main product grown. The majority of the agricultural population in such specialised regions is occupied in production, first processing, transport or supply of materials involved in the production of this crop. Hence a large part of the agricultural population is dependent on tobacco production.

Eastern Macedonia and Thrace, western Greece and continental Greece, central Macedonia, western Macedonia (Greece) and Campania (Italy) can be regarded as the most specialised regions. In these regions, consequently, tobacco cultivation plays an important role both in structural and production specialisation and, therefore, plays an important economic and social role. The evaluation study used quantitative parameters (% tobacco farms over total farms versus % tobacco area over total agricultural area) to describe the degree of specialisation of tobacco-producing regions ⁽³⁾, thus providing evidence for tobacco production's importance in relation to other crops.

26. The Commission approach was justified and reflected market reality. EU production of those variety groups in demand, quality and market prices increased (also influenced by the cyclical trends in world market prices).

⁽¹⁾ Tobacco Sector, Extended Impact Assessment, 23.9.2003 (COM(2003) 554 final, SEC(2003) 1023).

⁽²⁾ EUR 7 600 equivalent to EUR 963 million divided by 126 000 people working in the tobacco sector.

⁽³⁾ Evaluation of the common organisation of the market in raw tobacco. COGEA, 2003. Rome. 220 pp.

27. When preparing the 1998 reform, one objective was to gear production more closely to market needs. The Commission proposed transferring production rights between variety groups depending on market demand. More flue-cured and light air-cured tobacco of better quality was produced in order to cope with an increased demand for these variety groups. There is evidence that both exports and certain imports have decreased. EU exports show a marked decrease in volume, especially of low quality tobacco (semi-oriental varieties, dark air-cured varieties) while value has increased.

28. The key objectives of the reform, based on a modulation of part of the premium, were to achieve both a better quality and an improved price level within the EU, and these objectives have largely been achieved. The most recent evidence available to the Commission shows that for certain variety groups prices (also influenced by cyclical trends in world market prices) have improved.

29. The Commission took account of the fact that price is affected by supply (production, import, stocks) and demand (consumption, export) as well as exchange rates. However, within a given market situation in a given harvest year, it is obvious that differences in quality lead to differences in price. It is often argued that for a given quality the producer will not always receive the same price. This is, however, the consequence of free competition between first processors when contracts are negotiated.

The lack of a single objective quality grading system was not an obstacle to implementing a quality policy. The various national and local quality grading systems can differentiate according to variety groups and specific first processing needs.

30. The Commission considers that its market analysis was based on the best available information at the time and provided policy-makers with an appropriate understanding of the market to guide their selection of the market measures.

31. The issue of the lack of alternative crops has to be seen in relation to the whole production chain and not just primary growing of tobacco on the farm. In some regions, local communities have become so dependent on tobacco that conversion to other productions would only be possible over a considerable period of time.

32. The post-1998 CMO took into account the concentration of purchasing by a limited number of multinational first processors, merchants and manufacturers and their more important role in price setting. In order to counterbalance the increased integration and concentration at processor level, the Commission provided strong incentives (access to the variable premium) for producers to join producer groups and reinforced the role of producer groups.

33. DG AGRI informed DG COMP of possible anti-competitive practices in June 2001. This information, amongst others, led to an investigation by DG COMP in October 2001, which subsequently confirmed that such alleged practices did exist in Italy and Spain (see paragraphs 67 to 71).

The Commission's 1993 prohibition on producer groups from carrying out first processing aimed to separate the functions of producer (organisation) and first processor in order to avoid conflicts of interests between the two parties. Integration of producer groups in processing was not favoured because of the high degree of specialisation and capital input required. The separation of the functions of producers and processors was maintained in order to safeguard a fair price formation for raw tobacco.

34. The interdepartmental consultation on reform of the CMO carried out in 1998 followed normal practice within the Commission at the time. In January 1998, DG AGRI consulted five other directorates-general on the proposal: DG XIX (Budget), DG V (Employment), DG XI (Environment), DG XX (Financial Control) and LS (Legal Service).

All Commissioners and cabinets were consulted as part of the normal procedure for adopting Commission proposals.

Prior to the 1998 proposal, the Commission published a report to the Council on the common organisation of the market in raw tobacco in 1996 ⁽¹⁾ which was widely discussed with Member States and included all possible options, some of which were included in the 1998 proposal.

In 2001 the Commission introduced a broader and more systematic interdepartmental consultation. In addition, since 2003 an extended impact assessment is carried out for all major proposals made and presented to the other institutions along with the legislative proposal. The tobacco reform adopted by the Council in April 2004 was subject to this new procedure and 16 departments took part in the impact assessment, including DG DEV, DG ENV, DG COMP and DG TAXUD.

35. Community development policy recognises the key role of agricultural and rural development in economic growth and reducing poverty in many developing countries, which may include tobacco production in certain regions. Tobacco from developing countries may in some cases compete with EU tobacco on different markets. Although no export refunds are granted, the subsidies benefiting EU tobacco can affect competitive positions and world market prices. However, as EU tobacco production only accounts for 5 % of world production and 11 % of world exports any impact would be limited. The recently adopted reform of

the tobacco CMO should alleviate any potential distorting effect of the present scheme as, when it is fully implemented, there will be no link between the aid and production.

36. The orientation of production toward flue-cured and light air-cured tobacco is governed by market demand and not the CMO premium system. Restructuring of production has favoured concentration and intensification of production on larger farms. As total EU production is limited by quantitative thresholds, the total production area has considerably decreased as a result of the higher yields.

From a solely environmental point of view it would have been desirable to have a system with area references (limitations) rather than quantitative thresholds. This possibility was disregarded as the incentive to produce higher quality tobacco would largely have been lost.

At the Gothenburg European Council in 2001, the Commission proposed reorienting support from the CAP to reward 'healthy, high-quality products and practices rather than quantity' (see COM (2001) 264 final). The latest tobacco reform responds to the Gothenburg declaration.

37. The share of the primary material (raw tobacco) in the price of cigarettes is estimated to be very low. Therefore the impact of subsidies on the reduction of retail prices is negligible.

Under Article 8(2) of Council Directive 95/59/EC the rate of proportional excise duty and the amount of specific excise duty must be the same for all cigarettes. Consequently Member States cannot apply a lower rate of duty on their own tobacco. The judgment of the Court of Justice quoted by the Court (Case C-302/00) confirmed that France, which maintained in force a system imposing a different tax for dark-tobacco cigarettes, failed to fulfil its obligations under Directive 95/59/EC and Article 90 of the Treaty. Following this judgment France has brought its rates of excise duty into line with Community legislation (Law No 2002-1487 of 20 December 2002).

THE CMO HAS NOT ACHIEVED THE DESIRED IMPACT

38. As indicated in paragraphs 28, 31 and 59, the reform significantly reduced the production of the two lowest quality groups of tobacco, thereby partly addressing the problem that the qualities grown were not suited for the market demand.

⁽¹⁾ Report from the Commission to the Council on the common organisation of the market in raw tobacco (COM(96) 554 final, 18.12.1996).

39. In order to measure the impact the Commission used the term 'fair income' as in the Treaty, set as a quantifiable target an overall improvement in price (and quality), and used information on production costs and income⁽¹⁾, available from the FADN (Farm Accountancy Data Network). Information on prices, processing and stocks was obtained through Regulation (EC) No 2636/1999 (currently replaced by the consolidated version: Regulation (EC) No 604/2004). The impact of premiums on growers' income was evaluated in the 2003 extended impact assessment.

40. The information available to the Commission shows that, for certain varieties, quality and prices have improved (this has also been influenced by cyclical trends in world market prices).

41. Average selling prices in two consecutive years are not a representative indication of a long-term trend. Observations over several years (1993 to 2002) show a net long-term price increase. Slight variations from year to year reflect the cyclical nature of tobacco price trends.

42. The Commission considers that improvements in quality can be measured in two ways: firstly by increases of the quality variety groups in demand. The net increase in production of variety groups I (flue-cured) and group II (light air-cured) as a result of market demand and the fall in production of variety groups V (sun-cured) and III (dark air-cured) which faced marketing difficulties indicates an overall improvement in quality and market orientation. Secondly, improved quality can be measured by price increases taking account of the overall market price evolution.

44. Most tobacco growers produce varying amounts of tobacco of different qualities leading to a proportional distribution of the premium. However information available to the Commission shows that, in certain cases, there is an even distribution of the variable premium. Such cases are relatively rare, but an increase was observed in 2000 compared to 1999, the first year of application of the variable premium.

Moreover, except for groups V and III, the variable premium enhanced the price level, which was the main objective of the reform.

⁽¹⁾ According to FADN, the most common farm income indicators are net added value per annual working unit or the family farm income. The calculation procedure is described under http://europa.eu.int/comm/agriculture/rca/annex002_en.cfm.

45. Since 1993, premium levels have remained largely unchanged, except for group V. The policy adopted by the Council was based on providing a steady income support, but to allow guarantee thresholds to vary according to demand. In 2002, the Council chose to decrease the guaranteed thresholds in order to decrease supply versus demand, thus creating a relative shortage, encouraging competition and improvement in prices.

The Commission proposed to differentiate between a fixed portion of the premium (providing a minimum income) and a variable portion (providing the economic function) which is paid according to sales prices.

46 to 48. In its Extended Impact Assessment, the Commission established average production costs and margins per ha of tobacco on specialised farms (average 1999 to 2000), based on the FADN (Farm Accountancy Data Network).

The main problem is putting a precise value on family work on the farm. If work by family members is considered at the same cost as that of paid labour force, then income is negative. On valuing family work at a lower level, an equity or profit situation occurs. Total margins (tobacco output + premium) over total input (variable + fixed costs) are largely positive in all regions. It was concluded that income (total receipts minus total costs) from tobacco was only negative in Thessaly and Continental Greece, representing 34 % of all Greek producers. Income in Italy, Spain and other Greek regions was positive.

47. The Commission has complied with the provisions of Council Regulation (EEC) No 2075/92.

The 1998 reform specifically targeted the modulation of the variable part of the premium in order to reward better quality. As there were continuing problems in disposing of group V tobacco, the Commission proposed a 10 % reduction of the premium. It also proposed a reduction in the guarantee threshold.

48. Price is a function of supply and demand, and of quality of a commodity. In the context of the raw tobacco market, the price is stated in the contract.

49. The aim of the Regulation is to provide a fair income. The premium level is fixed by the Council. At the time of the 1992 reform, the value of the premium was calculated, for each variety group, as the average of premiums of the varieties in the group. There was no longer any provision for a mechanism to adjust the premium to price and/or cost variation.

51 and 52. As pointed out in paragraph 28, for agricultural and climatic reasons, the EU is unable to produce all the tobacco required for the manufacture of tobacco products. Between 1990 and 2000, raw tobacco imports remained stable. However, as stripped tobacco constitutes the majority of imports, data on the variety group are not available and substitution of imported tobacco by domestic products cannot be confirmed or denied. The CMO policy was successful as over the 1990 to 2000 period EU exports decreased in volume but increased in value, indicating that production of low-quality tobacco decreased considerably. Furthermore, the composition of EU production changed according to demand as a result of the transfer of thresholds.

54. The Commission agrees with the Court that the expenditure from the communication part of the Tobacco Fund for the years before 2001 was limited.

With the adoption of the Commission implementing regulation of the Tobacco Fund (Regulation (EC) No 1648/2000) on 25 July 2000, the launch of audits of former commitments and the modification of contracts, the Commission started seriously tackling the problem. The number of opened contracts has now been substantially reduced (7). The Commission departments are still seeking a solution in this respect.

55. Following the Director-General for Agriculture's declaration for 2001, intensive efforts were launched to solve the problems stemming from discrepancies in the financial field between multi-annual research contracts and annual budget allocations on the one hand and certain internal organisational shortcomings on the other. An internal task force was set up in 2002 to make up the backlog for nine outstanding projects.

An action plan was successfully carried out in 2002 and the management of the projects could then be deemed as normalised, and the reservations raised in the Director-General's annual declaration for 2002 were therefore not repeated.

56. Although the Directorate-General for Health and Consumer Protection did not raise any formal reservations in its 2001 Annual Activity Report, it did raise concerns about weaknesses related to the management of past projects.

In fact, since 1999 it had started introducing corrective measures to improve management of the fund. The effect of these measures could be seen after 2001. From a budget point of view, the level of budget consumption has reached an average over 80 % during the last three years and this despite a huge increase in the budget (from EUR 3 million to 14,4 million in 2004).

With its new communication strategy, the Commission is now able to manage the Tobacco Fund adequately and even to handle a new increase in the budget.

57. The proportion of the specific aid the producer groups were expected to spend was outlined in Article 40 of Regulation (EC) No 2848/98.

The evaluation of the sector showed that most producer groups have developed orientation, assistance and training measures which aim to reduce plant protection product residues and other harmful elements (heavy metals, nitrosamines, plastic wires, etc.), by improved farming and harvesting techniques (reduced use of chemicals, rationalisation of water distribution, waste collection, etc.). However, the evaluator was not able to find objective proof of the effects of these activities.

Based on the FADN data, checks on the use of plant protection products and fertiliser showed an intensification of farming practices and therefore some worsening of the environmental impact of the crop, albeit on a much reduced total area (- 43 % in 10 years). This intensification favoured the improvement of production quality in terms of colour and leaf integrity and increased yield.

58 and 59. In the framework of sound financial management the Commission has chosen to set the buy-back price initially at a low level and gradually increased this level in order to improve the performance of the buy-back instrument.

Although the cumulated quantity bought back might be low in terms of percentage of the total, both buy-back and transfer of thresholds have led to a decrease in variety group III with 10 569 tonnes (- 33 %) and group V with 12 365 tonnes (- 78 %). This achievement can be deemed a success.

Finally, between 1999 and 2002, although other factors could also be taken into account, the buy-back scheme favoured restructuring of production: 10 671 producers left the sector and 12 549 tonnes of production quota were sold to other producers who were then able to develop their production structure.

59. It should also be noted that since 2003, Member States have set up reconversion programmes under the Community Tobacco Fund. Actions to convert producers to other crops or economic activities as well as studies on the possibilities of such conversion or actions of general interest are financed by the Community Tobacco Fund. 192 individual reconversion projects and 17 studies or actions of common interest were launched in 2003. There are 498 individual reconversion actions and 10 studies or actions of common interest which are being financed in 2004.

60. Although Council Regulation (EC) No 1257/1999 provides for the possibility of including measures in the Rural Development Programmes (RDPs) for the conversion of tobacco-growing regions to other activities, the programming is decentralised and therefore drawn up by the Member States according to their needs and priorities. Moreover, the Regulation does not limit conversion only to other tobacco related activities. The Rural Development Programme (RDP) for Umbria provides two measures where aid is granted to companies who dry tobacco if they invest in the renewal of drying installations on condition that the new machines have at least a 10 % lower production capacity.

As regards investments in agricultural holdings, specific investments are allowed as long as they are consistent with the production quota. Conversion measures can be included in the diversification measure. For the regions where there is the greatest need to convert to other activities, like eastern Macedonia and Thrace, these tobacco areas have limited potential for conversion and other off-farm activities.

62. The examination in the external evaluation report (see ECA's footnote 25) demonstrates that the national reserve did not in any way hamper the continued restructuring of the tobacco holdings. The area and number of holdings have constantly decreased.

63. Enforced reductions of all quotas to create the national reserve did not exacerbate the situation as quota reductions were limited to only 0,5 to 2 % and were proportional to the quota volume. However, the level of allocations from the national reserve was sometimes insufficient to ensure the viability of new producers. The administrative burden also increased. The measure became an option for the Member States from the 2002 harvest year onwards.

64 to 65. The auction system could possibly have had a role in the producing Member States where the number of first processors was sufficient to allow fair competition (e.g. in Italy, Greece or Spain). In Greece and Italy however, small first processors, which feared too much competition from larger firms, considered the bidding system not in their interest. In the Member States with a highly concentrated structure of the first processing industry the auction system is more difficult to set up.

66. The calculation and distribution of the national reserve increased the workload of the national administrations. In 2001, therefore, the Commission proposed abolishing the national reserve. The Council decided that the reserve could remain an option for the Member States. Since 2002, most Member States have abandoned the national reserve.

Compared to the situation before the reform, the national authorities had a lower workload because they only had to pay premium amounts to producer groups. Producer groups were responsible for distributing payments to individual producers. Furthermore, computerised information systems considerably facilitated data management. In practice, however, some Member States preferred to handle the premium payment themselves. It is true that control measures had increased with the 1998 reform.

68. The matters referred to by the Court are currently being investigated by the Commission's departments.

69. Given the overcapacity in the processing sector in Spain and the concentration of most of it in one first processor, the Commission considers that production capacity is not the leading factor in the contractual relation between parties.

70. The Italian global three-year price agreement is one of the elements on which the Commission has based its Statement of Objections (see point X). With regard to the situation in Greece the Commission is currently assessing whether the matters referred to by the Court and those which the Commission identified in the course of its subsequent investigation represent an infringement of Article 81 of the EC Treaty.

72. The Member States are responsible for approval of first processors (and, where necessary, withdrawal thereof). This has been checked in audits by the audit services, in particular to verify the existence of proper approval of first processors authorised to sign cultivation contracts with producer groups.

Particular attention was paid to checks on areas to be planted with tobacco, defined as a key control by the audit services, as the audit reports show.

73. The Commission carried out a series of audits in 2001 and 2003 which revealed some findings similar to those made by the Court of Auditors and which have been taken into account in the ongoing clearance of accounts procedures.

74. Council Regulation (EC) No 1258/1999 provides that, before a decision to refuse financing is taken, the results of the Commission's checks and the replies of the Member State concerned shall be notified in writing, after which the two parties shall endeavour to reach agreement on the action to be taken. For all audits carried out in 2001, bilateral procedures took place. The Commission, noting that the procedures for France and Germany have been completed, is aware that there are some delays with certain dossiers in other Member States and will endeavour to complete them as soon as possible.

MONITORING AND EVALUATION OF THE REFORMED CMO

76. The Commission notes the Court of Auditors proposal concerning the issue of 'key controls'. However, the Commission defined the key controls to be carried out in the tobacco sector in 2001 and is of the opinion that they cover the essential controls foreseen by the Regulation.

77. From the information gathered in the audits by its departments and the subsequent clearance of accounts procedures, the Commission has been unable to conclude that the similarity in moisture content results from a lack of compliance with the control procedures in Greece.

78. The audit services have drawn up a programme to check expenditure in the tobacco sector in all Member States with sizeable production (Italy, Greece, Spain, France) over the years 2001 and 2003; some points raised by the Court that were already known to the Commission have been checked.

79. The Financial Regulation and its implementing rules provide for regular evaluation, but not on an annual basis. It cannot therefore be expected that an evaluation or related information on each budget line or spending programme will be found in the material provided for by the Commission in the annual budgetary procedure. The Commission applies the legislation in force in order to quantify the annual budgetary requirements. Evaluation results can be used to improve the budgetary procedures but only after amendment of existing legislation.

80. The Commission, however, systematically informs the budgetary authority each year about all evaluation activities carried out in a specific document entitled 'Annual Evaluation Review'. In the case of tobacco, an evaluation of the CMO was carried out by the Commission departments in 2002 and subsequently reported in the Annual Evaluation Review 2002. In addition, the full report was published on the Commission's EUROPA website.

83. Article 54 of Regulation (EC) No 2848/98 does not specify a deadline for the publication of a list of approved first processors.

84 and 85. Article 26 of Regulation (EEC) No 2075/92 required the Commission to submit a report on the functioning of the common organisation of the market in raw tobacco to the European Parliament and to the Council before 1 April 2002. The Commission submitted the requested report⁽¹⁾ in November 2002, seven months behind deadline.

⁽¹⁾ Report to the European Parliament and the Council on the operation of the common organisation of the market in raw tobacco, SEC(2002) 1183, 6.11.2002.

In the meantime, the Commission had employed an external evaluator to examine the CMO. This evaluation⁽²⁾ was available in October 2003. Furthermore, in preparation for a reform of the raw tobacco sector, the Commission carried out an Extended Impact Assessment⁽³⁾, which was completed on 23 September 2003.

86. The Commission considers that other elements of the evaluation report's conclusions should be considered as well (see Chapter 9, pp. 212 to 220):

(a) with respect to the 'lack of reliable information', the evaluator referred only to insufficient data on processed production, stocks, and marketed quantities by first processors (see paragraph 4.1.5. in the Evaluation report, p. 46).

The CMO instruments helped improve the balance between supply and demand; however, the information available did not show the precise extent to which the CMO had influenced the balance of supply and demand (see Evaluation report, p. 212, final three paragraphs);

(c) only the quality/price classification grids were not homogeneous and highly subjective (the statement did not relate to all data) (see Evaluation report, p. 213, third paragraph). Tobacco professionals however indicated that there had been improvements in the quality grades of tobacco produced (their degree of satisfaction had improved by 30 %) (see Evaluation report, p. 213, seventh paragraph);

(d) the objective of ensuring a fair income was evaluated, but the result must be considered with care due to limitations of data; it was stated that the support system allowed tobacco producers to obtain a better income compared to the income of other farming types analysed. As income was largely determined by farm size, restructuring helped improve income (see Evaluation report, p. 215, fifth and second last paragraph; p. 216, fourth paragraph);

(e) in areas where tobacco production was critical for rural activity, tobacco-related activities allowed by the Community support had a large impact on employment (see Evaluation report, p. 217, eighth paragraph);

(f) the research projects financed by the Fund have produced valid results, but few of the conclusions have been passed on to producers (see Evaluation report, p. 219, sixth paragraph).

⁽²⁾ Evaluation of the common organisation of the market in raw tobacco, COGEA, 2003. Rome. 220 pp.

⁽³⁾ Tobacco sector, Extended Impact Assessment, COM(2003) 554 final, SEC(2003) 1023.

As regards the impact of the CMO, the Commission would also like to point out that the measures launched in 2002 under the Community Tobacco Fund have been shown to have an impact on public awareness of the negative impact of tobacco consumption.

87. The Commission recognises that the evaluation report pointed out weaknesses, but is nevertheless of the opinion that the evaluation report demonstrates that the CMO instruments have improved supply versus demand, improved quality and enhanced continued restructuring of holdings. Sector management efficiency improved, although some weaknesses remain. The continuity of support through aid has permitted growers to survive. Prices have increased, but not to a level allowing production costs to be covered.

FURTHER REFORM OF THE CMO

88 to 90. The Commission proposed a new reform of the CMO in a comprehensive, in-depth procedure which produced numerous analyses, all of which are available on the Commission website:

- an economic report on the tobacco sector and the CMO,
- an extended impact assessment on three different reform options involving six months of the collaboration with experts from 16 directorates-general,
- in this context, a tobacco forum was organised in June 2003 to allow all stakeholders to comment,
- a seminar was also organised in November 2003 on the same principles, for all products concerned by the reform proposal (olive oil, cotton and tobacco).

On the basis of these analyses and organised debates the Commission drew up the legislative proposal that it submitted to the Council and which was agreed on 22 April 2004.

During a four-year transition period, starting in 2006, at least 40 % of the tobacco premiums have to be included in the decoupled single payment for farmers. Member States may decide to retain up to 60 % as a coupled payment. The coupled payment has to be granted in such a way as to ensure equal treatment between farmers and/or according to objective criteria such as for tobacco producers situated in Objective I regions or for tobacco farmers producing varieties of a certain quality. Further criteria may be considered in the future. After the four year transition period, from 2010, tobacco aid will be completely decoupled from production. 50 % will be transferred to the single farm payment and

the remaining 50 % will be used for restructuring programmes in tobacco-producing regions under the rural development policy.

In 2006, the reform will start with the transfer of all or part of the current tobacco premium into entitlements for the single payment.

In 2006 and 2007, information actions under the Community Tobacco Fund will be financed with a deduction of 4 % and 5 % respectively of the coupled payments.

92. The introduction of decoupling will help improve producers' market orientation and considerably simplify the tobacco regime.

94. The reform adopted will allow application of conditionality and thus improved respect of environmental requirements.

CONCLUSIONS AND RECOMMENDATIONS

96 and 97. The Commission cannot endorse a number of conclusions of the Court.

The Commission's proposals for the 1998 reform were based on the most reliable data which could be obtained at the time and its analysis of the market was adequate.

The CMO instruments have contributed to a better quantitative balance between supply and demand. The 1998 reform has led to a sharp decrease in the production of the two lowest quality tobacco variety groups with limited outlets and favoured production of variety groups in demand on the market. The variable premium encouraged farmers to produce a better quality and professionals have indicated that quality has improved. Prices, although equally influenced by supply and demand, show a tendency to increase.

The issue of the lack of alternative crops has to be seen in relation to the whole production chain and not just primary growing of tobacco on the farm. In some regions, local communities have become so dependent on tobacco that conversion to other productions would only be possible over a considerable period of time.

The interdepartmental consultation on reform of the CMO carried out in 1998 followed normal practice within the Commission at the time. Nevertheless, the Commission has since introduced a much more elaborate system of interdepartmental collaboration.

Clearly, the tobacco support regime in place prior to the 1998 reform was not geared to solving the key problem in the sector: the growing of qualities which were not suited to the market. The 1998 reform helped significantly reduce the production of the two tobacco groups facing the biggest marketing problems. The problem should be fully addressed by the 2004 reform. The decoupled premium means producers can decide to produce what the market demands.

The Commission does not share the Court's conclusion that the continuation of the existing aid scheme was not justified, given the findings presented in this report.

98. Prevention of tobacco smoking became one of the main political priorities after 1 October 1999 and started impacting on the way the Fund was managed. The effects started to become visible only after 2001. For instance, the significant campaign 'Feel free to say no', is strong evidence of the Commission goals in this respect.

The Commission chose to set the buy-back price initially at a low level and gradually increased this level in order to improve the performance of the buy-back instrument and to practise sound financial management. The cumulated quantity bought back might be low in terms of percentage of the total, but both buy-back and transfer of thresholds have led to a decrease of the low quality variety groups. In addition, between 1999 and 2002, the buy-back procedure favoured restructuring of production.

The Commission investigated the risk of limitation of free competition by inappropriate price arrangements between first processors and producer organisations. As regards Spain and Italy these practices as well as others discovered during the investigation led the Commission to address a Statement of Objections to representatives of producers and processors. For Greece, the investigation is still ongoing.

Since 2003, Member States have set up reconversion programmes under the Community Tobacco Fund. Actions to convert producers to other crops or economic activities as well as studies on the possibilities of such conversion or actions of general interest are financed by the Community Tobacco Fund. In 2003, 192 individual reconversion projects and 17 studies or actions of common interest have started. In 2004, 498 individual reconversion actions and 10 studies or actions of common interest are being financed.

Concerning the under-utilisation of the Tobacco Fund, the payments during the first five years 1996 to 2000 amounted on average to 17 % of the available funding. Over the last three years the rate of utilisation has increased constantly to reach 65 % in 2003. The shortcomings in the management of the Fund identified in the past have been corrected.

99. The Commission notes the extended list of key controls now proposed by the Court. However, the Commission defined the key controls to be carried out in the tobacco sector in 2001 and is of the opinion that they cover the essential controls laid down in the Regulation.

Regarding the criticism of the lack of action taken by the Commission, Council Regulation (EC) No 1258/1999 provides that, before a decision to refuse financing is taken, the results of the Commission's checks and the replies of the Member State concerned are to be notified in writing, after which the two parties must endeavour to reach agreement on the action to be taken. For all audits carried out in 2001, bilateral procedures took place. The Commission, while noting that the procedures for France and Germany have been completed, is aware that there are some delays with certain dossiers in other Member States and will strive to complete them as soon as possible.

Hence, the Commission has taken appropriate steps as provided for by the existing legal framework and the statement by the Court that the Commission did not take corrective actions when required is not accurate.

100. The Commission's monitoring proved to be satisfactory. In 2002, the Commission proposed an adjustment of the CMO instruments (premium, guarantee thresholds and Tobacco Fund actions) in order to improve market orientation.

The tobacco regime was evaluated in 2002. This complies with the Financial Regulation and its implementation rules, which foresee regular evaluation, although not on an annual basis.

101. Article 26 of Regulation (EEC) No 2075/92 required the Commission to submit a report on the functioning of the common organisation of the market in raw tobacco to the European Parliament and to the Council before 1 April 2002. The Commission submitted the requested report ⁽¹⁾ in November 2002, seven months behind deadline.

In the meantime, the Commission had employed an external evaluator to examine the CMO. This evaluation ⁽²⁾ was available in October 2003. Furthermore, in preparation for a reform of the raw tobacco sector, the Commission carried out an Extended Impact Assessment ⁽³⁾ which was completed on 23 September 2003.

⁽¹⁾ Report to the European Parliament and the Council on the operation of the common organisation of the market in raw tobacco, SEC(2002) 1183, 6.11.2002.

⁽²⁾ Evaluation of the common organisation of the market in raw tobacco, COGEA, 2003. Rome. 220 pp.

⁽³⁾ Tobacco sector, Extended Impact Assessment, COM(2003) 554 final, SEC(2003) 1023.

102. Endeavours to ensure improved consistency between Community policy in the tobacco sector and the public health sector while also ensuring sustainable development prospects in tobacco regions have been a key element of the reform of the tobacco sector proposed by the Commission in 2003. The Council's approval of the reform on 22 April 2004, in particular of the new mechanisms for decoupling direct aid and the restructuring envelope proposed by the Commission represents a fundamental change to the regime which should allow it to achieve these objectives in their entirety.

In the hope of abolishing some of the existing mechanisms of coupled payments which have proved lacking, as the Court points out, the Commission has proposed a new regime which, in line with the Court's wishes, aims to:

- improve market orientation and quality, and increase the prices paid to producers,
- improve the effectiveness of income support for farmers without increasing overall support,
- improve support for research and development into alternative and diversified production,
- improve consistency with Community public health policy and its policy in favour of developing countries,
- simplify the regime and its management.

103. The 1998 reform was based on a preliminary report from 1996. The reform of the tobacco sector proposed by the Commission in 2003 was based on data from improved statistics sources. This reform was also the subject of a prior extended impact assessment to analyse all likely impacts of the three different reform options.

104. The Commission would like to emphasise that, for reform to be successful and effective, it must be acceptable socially, economically and environmentally. This assumes that the production and processing structures will be allowed to adapt to the new economic and regulatory environment.

Taking these constraints into account the Commission proposed an in-depth reform of the common organisation of the market in tobacco which the Council adopted in April 2004. As the Court points out (and as the Commission explained in response to question 102), rapid introduction of this reform will help eradicate the weaknesses identified by the Court while avoiding a disruptive impact on tobacco-producing regions.

105. As pointed out by the Court, the Commission proposed a reform in 2003 which aims to phase out the weaknesses of the existing regime. The Council came to an agreement on this proposal on 22 April 2004. From 2006 to 2009, the Council decided on a transitional period with at least 40 % of direct aid payments decoupled. The Commission will ensure that the gradual introduction of decoupling, which will involve the coexistence of coupled and decoupled payments over a four-year period, is carried out in compliance with the provisions of the regulations adopted.

106. The Commission has issued Statements of Objections concerning alleged cartels in the raw tobacco markets in Spain and Italy (in December 2003 and February 2004 respectively). These Statements of Objections contain the preliminary conclusions of the Commission's investigations on alleged anti-competitive behaviour by producer groups and processors in the two Member States which started in October 2001 and January 2002 respectively. Issuing a statement of objections is a preliminary step in the procedure that may lead to the adoption of a prohibition decision imposing fines on the companies concerned.