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COURT OF AUDITORS

SPECIAL REPORT No 12/2003

on the sound financial management of the common organisation of the market in dried fodder together with the Commission's replies

(pursuant to Article 248(4), second subparagraph of the EC Treaty)

(2003/C 298/01)

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SUMMARY

I. Protein is important for animal feeding and is present to varying degrees in a wide range of feeding material. Dried fodder is one source but is relatively low in protein. It provides only 1,2 % [1] of the total crude protein fed to EU livestock.

II. A common market organisation (CMO) for dried fodder was first established in1974 with a view to improving the supply by granting aid for processing. Aid is paid for the production of fodder which has been dried naturally and by artificial means. The CMO has been reformed twice in 1978 and 1995, the second time, to cap the cost, which was increasing. A system of maximum guaranteed quantities (MGQ) was introduced to achieve this. The present budget is some 317 million euro. In 2000, the Court commented in its Special Report on 'Greening the CAP' that the dried fodder CMO showed the limited extent to which environmental considerations were taken into account in some markets.

III. Aid is payable to processors who dry permitted plants grown on integrated accounting and control system (IACS) [2] registered land. Aid is paid for quantities that meet the required criteria for protein and moisture content and leave the premises of the processing undertaking. Two rates of aid exist, one for artificially dried material of 68,83 euro/tonne and another for sun dried of 38,64 euro/tonne.

IV. The aid rates set by the Council in 1995 were higher than those recommended by the Commission. Setting the aid rate for artificially dried fodder at nearly twice that for sun-dried fodder, encouraged some processors to switch from sun-drying and to produce to the maximum extent possible. Nearly all Member States produce dried fodder but the major producers are Spain, France and Italy. EU production has continued to increase since 1995. The MGQ has been exceeded since 1998/99. Development of the market has been uneven as some Member States have been able to exceed their MGQ by as much as 60 % whereas others have consistently produced less than their MGQ.

V. Lack of clarity in regulations has created opportunities for different interpretations and practices. Some checks are not being carried out in Member States including, cross-checking with the IACS system, reconciliation of financial accounts of processors and aid claims and verification of plants entering the drying process. In one Member State marketing companies have been created to facilitate claims for aid. This has enabled them to claim aid sooner than if they were transferring ownership to a third party.

VI. Member States are required to produce information for the Commission and the Management Committee. But no information is provided regularly concerning prices for fodder products, or the level of imports or production of competing protein crops and products.

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(1) COM(2001) 148 final 2.

(2) The reform of the common agricultural policy in 1992 increased significantly the number of aid beneficiaries and the potential for irregularity and fraud.
The IACS system was introduced to meet these risks. It consists of five elements, a computerised database; an identification system for agricultural land parcels, a system of identification and registration of animals; aid applications; and an integrated system for administrative controls and field inspections. Member States are responsible for the implementation of IACS. Within the Directorate-General for Agriculture, supervision, coordination and checking of the implementation of IACS in Member States is carried out by the 'Clearance-of-Accounts Directorate'.

VII. The regulations governing the CMO do not specify any requirement for an evaluation. Although the market was programmed for evaluation by the evaluation unit of the Directorate-General for Agriculture in 2001 this was postponed twice in favour of evaluations of other markets. No evaluation has therefore been done.

VIII. Although no evaluation has been done, two major reviews of the market occurred for other purposes and provided an opportunity for the Commission to examine the market and its development. The first was a review in 2001 devoted to examining the options for replacing the processed animal proteins banned as a result of the BSE epidemic. It concluded that it would be more justifiable to increase imports of soya rather than pursue other more costly options such as increasing production of dried fodder. Farmers would remain free to decide how to satisfy their protein needs.

IX. The most significant review occurred however in relation to the Commission's mid-term review of the CAP in July 2002. This proposed a fundamental change in agricultural support, in particular, a move away from product to producer support. As part of a proposal to introduce a decoupled single payment per farm, changes were proposed in specific markets including dried fodder. Accordingly, the Commission has proposed an income support scheme for growers along with a simplified single rate support scheme to facilitate the transition for processors. The latter would be phased out by 2009.

X. The Court welcomes the current efforts to reform the CMO and recommends that the Commission takes this opportunity to ensure that existing weaknesses are not perpetuated.

INTRODUCTION

Protein needs for animal feeding and the role of dried fodder

1. Protein crops are an essential component of the feeding of farm animals. Protein is present to varying degrees in a wide variety of feeding material. It comes from what are considered to be generally 'non-traded' and 'tradable' sources. The first category comprises material such as grass, hay, silage and other roughages and is largely EU-sourced. The second comprises cereals, energy-rich crops (e.g. manioc, corn gluten, brans and molasses) and protein-rich crops (e.g. soya, other oilseeds meal, peas and beans and dried fodder). The largest single source in this category is soya meal which contributes some 20 % of total needs. Most soya meal is imported. *Table 1* shows those most commonly used according to the level of protein they contain. Dried fodder falls into the lowest category.

2. Dried fodder is obtained by drying approved plants either by the application of artificial heat or by other means, mostly sun-drying.

3. *Table 2* shows estimates of the sources of the 64 million tonnes of crude protein in the nearly 400 million tonnes of material fed to EU livestock in 1999/2000. *Table 3* shows that the protein-rich group accounts for around 33 % of total crude protein fed to livestock but dried fodder contributes only 1,2 % of the total.

The objectives of the CMO and how it has evolved

4. EU produced dried fodder is in direct competition with other protein products, in particular, imported soya products. Because EU dried fodder was more expensive than imports, the Council decided to introduce some form of support. Aid for dried fodder production in the EU was first provided in 1974 when a common organisation of the market (CMO) was established by the Council [1].

[1] Council Regulation (EEC) No 1067/74 (OJ L 120, 1.5.1974).

Table 1

Protein content of most commonly used protein crops

	Crude protein, %
High protein content	
Fishmeal	60
Meat and bonemeal	55
Soya meal (high pro)	48- 50
Medium protein content	
Skimmed milk powder	35
Rape meal	32
Sunflower meal	28
Palmist/copra/etc.	23
Peas and beans	22
Corn gluten feed	22
Low protein content	
Dried fodder	15- 20
Cereal	9- 12
Tapioca	>2
Vegetable oil	0

NB: This table shows that dried fodder is in the low protein category.
Source: Commission working paper SEC(2001) 431 dated 16.3.2001.
Supply and demand of protein-rich crops in the EU following the BSE crisis.

Table 2

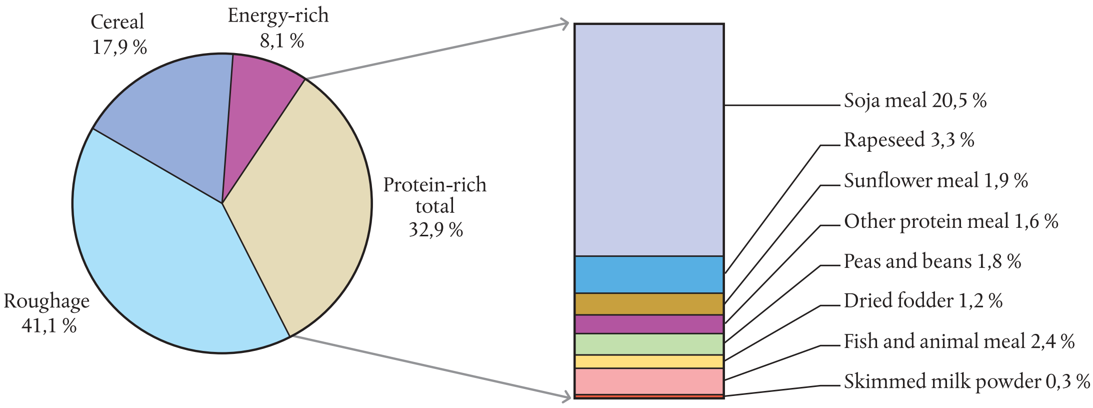
Crude protein use in animal feed broken down by type of feedstuff, EU-15, 1999/2000

		Total quantity fed million t	Total crude protein	
			million t	%
TOTAL TRADABLE		**206**	**37,7**	**59**
Of which:	Cereals	110	11	18
	Energy-rich	40	5	8
	Protein	56	21	33
TOTAL GENERALLY NON-TRADED				
Roughage - 85 % dry matter		*188*	*26,3*	*41*
TOTAL FEED		**394**	**64,0**	**100**

NB: This table shows that protein tradables, which include dried fodder, provided 33 % of the total crude protein.
Source: Commission internal working paper DG Agriculture 'Possible developments regarding protein-rich crops following the BSE crisis.'

Table 3

Sources of crude protein in total animal feed in EU-15, 1999/2000



NB: This table shows the sources of the 64 million tonnes of crude protein referred to in Table 2.

Source: Commission's working paper SEC(2001) 431 dated 16.3.2001
'Supply and demand of protein-rich crops in the EU following the BSE crisis'.

5. It was decided to grant aid to fodder drying/processing facilities to increase the levels of EU production. To ensure that green plants for drying were regularly supplied and to enable growers to benefit, aid was made conditional on processors concluding contracts with growers. A uniform level of aid was introduced with the marketing year running from 1 April. To qualify for aid the dried fodder produced had to meet quality standards as regards moisture and protein content.

6. Following the review of 1978, the Council decided that, to guarantee producers a fair return, a guide price should be set. Because EU fodder was, in general, more expensive than imported products, aid would be granted to dried fodder processors on the basis of a percentage of the difference between the guide price and world market price. It was also agreed that, because sun-dried fodder was also subject to competition from outside the EU and it should also qualify for aid, but at a lower level than that for dehydrated fodder.

7. Production rose continually throughout the 1980s. This resulted in increases in total aid expenditure which could not be controlled as no limit had been placed on the quantities for which aid would be paid. As part of the 1991 review of the common agricultural policy (CAP) the Commission considered proposing the phasing-out of the support for dried fodder. The Council did not support the idea and asked the Commission to seek alternative ways of limiting total expenditure.

8. The Commission eventually proposed a return to a flat-rate system while maintaining the differential between artificially dehydrated and sun-dried fodder. The rates were set by the Council at 68,83 euro/tonne for artificially dried and 38,64 euro/tonne for sun-dried [1].

9. In an effort to limit costs and influence the levels of EU production, the new regulation introduced a maximum guaranteed quantity (MGQ) of 4 412 400 tonnes for artificially dried and 443 500 tonnes for sun-dried fodder, above which, aid would be reduced. *Table 4* shows how the MGQ was attributed between Member States. This was determined on the basis of their production/aid claims in relation to 1992/93 and 1993/94 marketing years.

Table 4

Maximum guaranteed quantities by Member States

Member State	Artificially dried fodder tonnes	Sun-dried fodder tonnes
BLEU (Belgium/Luxembourg)	8 000	0
Denmark	334 000	0
Germany	421 000	0
Greece	32 000	5 500
Spain	1 224 000	101 000
France	1 455 000	150 000
Ireland	5 000	0
Italy	523 000	162 000
Netherlands	285 000	0
Austria	4 400	0
Portugal	5 000	25 000
Finland	3 000	0
Sweden	11 000	0
United Kingdom	102 000	0
EU - 15	4 412 400	443 500

NB: This table shows the attribution of maximum guaranteed quantity. It also shows that most EU production comes from three Member States namely Spain, France and Italy.
Source: Article 4 of Council Regulation (EC) No 603/95.

(1) New regime introduced by Council Regulation (EC) No 603/95 by which detailed rules for the application of the new regulation were introduced via Commission Regulation (EC) No 785/95.

The characteristics of dried fodder production in the EU and how the present aid system works

10. Aid is payable to *processors* who transform permitted green protein-yielding plants into dried fodder either by drying them by the application of artificial heat or by other means, usually sun-drying. The plants supplied must be grown on registered agricultural land and references provided to permit cross-checking through the integrated administrative and control system (IACS) that the same land has not been the source of claims made in respect of other EU area-based aid schemes.

11. Benefit from the aid does not usually accrue directly to growers but is achieved indirectly through contracts for supply to the processing industry. The aid influences on the prices which the processors are prepared to pay to suppliers. But, in those cases where the grower is providing green material for the production of dried fodder for his own use, processors are required to pass the aid on to the grower either in cash or, as is more usual, by adjusting the prices they charge the growers for drying the fodder.

12. In summary, aid is paid under the following conditions:

(a) the plants used qualify for drying;

(b) they have been grown on registered land;

(c) the dried fodder produced meets quality criteria for protein and moisture content;

(d) processing undertakings claiming the aid have been duly approved by the Member State and fulfil the requirements of the regulations;

(e) the product has left the premises of the processing undertaking or approved external storage.

13. The rate of aid to be applied is assessed ultimately on the basis of the actual production recognised as eligible by Member States. When production stays within the MGQ the full rate is paid. When it exceeds MGQ, the rate payable is calculated on the basis of either a standard or specific reduction.

14. Assuring compliance with these conditions falls primarily to Member States who are required to implement the detailed rules. The Commission remains responsible for ensuring compliance with all market requirements and for monitoring and evaluating the implementation and impact of the market's measures. *Annex A* shows that EU production of artificially dried fodder has increased steadily since 1995 eventually exceeding the total MGQ in 1998/99. In contrast the production of sun-dried has fallen by some 60 % over the same period. Production in Spain has consistently exceeded their MGQ reaching 150 % in 2002/03. Italy and Greece have also exceeded their MGQ in most years. The remaining Member States have consistently produced far less than their MGQ.

15. Nearly all Member States produce artificially dried fodder but the major producers are Spain, France and Italy who, between them, produce around 80 % of total EU production. Although Spain and Italy together produce nearly all the EU's sun-dried fodder they have decreased their production of it over the last few years but increased production of artificially dried fodder. In other Member States the production of dried fodder is at a lower level, either because animals have more access to natural grazing, or other protein sources or drying is less viable.

The budget

16. The annual budget has remained at around 300 million euro since the last reform introduced in 1995. The budget for 2003 is 317 million euro.

Previous audit by the Court

17. The CMO featured in the Court's Special Report No 14/2000 'Greening the CAP'. The Court commented in that report that the dried fodder CMO showed the limited extent to which environmental considerations had been taken into account in some markets. It drew particular attention to the higher rate paid for artificial drying which was inconsistent with the EU's energy policy and had encouraged a major switch from sun-drying to artificial methods. As well as criticising the extent of the energy required to dry fodder artificially, the Court also commented on the environmental impact of the resulting carbon dioxide emissions.

18. In its reply the Commission undertook to follow up the Court's comments and to ascertain whether a further reform of the sector should be proposed to the Council, not excluding the possibility of abandoning the scheme. This has been incorporated in the reforms to the dried fodder CMO proposed as a result of the Commission's mid-term review of the CAP discussed later in this report.

The Court's present audit

19. The Court's objectives were to examine whether in modifying the regime in 1995:

(a) alternative ways of achieving increased production of proteins had been considered;

(b) the differential aid rates established for the present system had been determined on a sound basis;

(c) the detailed rules and procedures introduced ensured effective control over the market and the aid measures adopted;

(d) appropriate monitoring had been carried out and the impact of the measures evaluated.

20. The audit focused on the main producer States of Spain, France and Italy and used transactions of the 2000/01 marketing year to examine how the aid system was managed. Germany was also visited to provide a contrast as a less important producing Member State. The audit included visits to individual processors, their representative organisations, national and regional administrations and the Commission services responsible. It also took account of the work of national certifying bodies and the Commission service responsible for clearance of EAGGF accounts as well as other work done by the Court in this area.

MANAGEMENT OF AID

The aid rates established by the 1995 reform were higher than those proposed by the Commission but were subject to the introduction of a budget limit

21. When reviewing the evolution of the market in 1993, the Commission expressed their concern that the aid in this sector did not represent a cost-effective means of supporting farm incomes and that, despite the reductions in aid which had been applied, production had continued to increase with the usual consequences for the budget. On the basis of Commission costings for 1994 and 1993 production levels, the average aid for dehydrated fodder, expressed in per hectare terms, represented some 600 ecu/hectare compared with the aid for other protein crops, actually paid on a per hectare basis, of 390 ecu/hectare. While production costs and selling prices also have to be taken into account in assessing the relative attractiveness of dried fodder production, the aid level contributed to an increase in production in certain Member States.

22. The Commission's proposals on prices for agricultural products for 1994/95 [1] recognised that, despite the Commission's suggestion in 1991 that the support for dried fodder should be phased out, the Council had asked for other proposals based on either continuing the specific aid or including the products in the general framework of aid for arable crops. The latter option was rejected as unsuitable and the Commission eventually proposed a simple flat-rate payment of 40 ecu/tonne for artificially dehydrated fodder and half that for sun-dried, coupled with an increase in the minimum protein content. The difference between the rates was supposed to reflect the higher energy costs required for artificial drying.

23. This received a mixed reception at the Management Committee. During discussions at the Council working group other levels of aid and production limits were discussed. Accordingly, the rates finally adopted by the Council increased to 57 and 32 ecu/tonne respectively, which, after taking account of the special exchange rates which apply to agricultural spending (green ecu) became 68,83 euro and 38,64 euro.

24. The rates originally proposed of 40/20 ecu (see paragraph 22) were intended to permit processors to produce fodder at a price similar to those products with which it was in competition. Examination of the various documents associated with the consideration of the proposal did not explain the increase between the rates proposed and those finally adopted by the Council.

Total aid expenditure has been contained within the budget limits independently of the levels of production in Member States

25. If total EU production exceeds the MGQ the regulations prescribe that, in order to limit expenditure to the budget provided for, a reduction in aid will be applied equally to all Member States provided the excess was no greater than 5 %. If the excess is greater than 5 % a specific additional reduction is applied individually to those Member States who have exceeded their national MGQ.

26. Since 1998/99, the Commission has had to reduce the amount of aid finally paid to beneficiaries as a result of total production exceeding total MGQ. Even though some countries exceeded their national MGQ by substantially more than 5 % the second level of reduction was not triggered because others had produced less than their MGQ. It was not until 2000/01 that production exceeded 105 % of MGQ and the second level of reduction was applied to Greece, Spain and Italy (see *Annex B*).

(1) COM(94) 10 final of 30 January 1994.

DG AGRI identified the key controls to be applied but has not amended the detailed rules to be applied by Member States

27. Communication of controls, which the Commission considers as being required to ensure the proper operation of the market in Member States, are laid down in the detailed rules published as Commission regulations. In general, CMO regulations do not rank the rules/controls to be applied in order of their relative priority, since these regulations regard all controls to be of equal importance.

28. Within the DG AGRI a 'Clearance-of-EAGGF Accounts Directorate' is responsible for on-the-spot examinations of how controls and checks required by these regulations are carried out in Member States in support of aid claims. When they find instances where controls have not been carried out or have not been carried out correctly they propose financial corrections. In its Annual Report for 2001 the Court noted that, in order to make the relationship between systematic weaknesses identified as a result of financial clearance of EAGGF accounts and the corrections proposed clearer, the 'Clearance-of-Accounts Directorate' had developed definitions of key and ancillary controls for various markets and measures including the CMO for dried fodder.

29. The market unit responsible for the overall management of the CMO was not involved in this analysis. There has been no proposal to amend the detailed rules to reflect the resulting identification of the key and ancillary controls which should help focus efforts and facilitate risk analysis.

Lack of clarity in Commission regulations has contributed to different interpretations and practices

The criteria for claiming aid for sun-dried fodder

30. The Council regulation and the detailed rules promulgated by the Commission define those products which are regarded as dried fodder products qualifying for aid.

31. Sun-dried fodder has to be dried otherwise than by the application of artificial heat and also ground before it can qualify for aid. In the case of one Spanish processor audited, fodder was being dried other than by the application of artificial heat but had not been milled as it was produced as long fibre. The authorities informed the Court that, to ensure correct treatment, all the autonomous communities had been reminded in 2001 that, for a product to be defined as sun-dried, it had to be subjected to a process of milling regardless of the manner in which it was finally presented. The Spanish authorities informed the Court that recognition had been withdrawn from the previous operator of the site in question. The authorities are pursuing reimbursement of aid from the operator and have initiated legal proceedings.

Checks on the financial accounts of processors and checks of suppliers and operators

32. The checks of financial accounts play an important role in ensuring the compatibility of the financial information maintained by processors for producing their financial and management accounts and the quantities claimed for aid.

33. The 'Clearance-of- Accounts Directorate' of DG Agriculture had observed that the German text of the detailed rules concerning checks of accounts of processors required such checks only 'in case of doubt' whereas the other language versions contain no such limitation. They had also observed that the checks on suppliers provided for in the other language versions of the regulation did not feature in the German text or the national regulations. The competent authorities consider that the official German text of the regulations has exclusive validity. The Commission has not yet addressed the differences in the German text.

34. In Italy the authorities responsible for the checking of dried fodder aid claims were not themselves carrying out the required checks of financial records of processors. They relied, instead, on inspections carried out by two other services and undertaken for different purposes. As a result, these checks were limited in scope and did not respond to the specific requirements of the dried fodder regulations.

35. The Commission's detailed rules [1] also provide that authorities will make checks on suppliers and operators to whom processed fodder is supplied. This was not being done in all Member States visited and, in certain cases, relied on seeking written confirmation rather than a visit to verify trading activity.

36. Failure to operate such controls coherently and consistently reduces the assurance that the quantities claimed for aid are acceptable.

(1) Article 14(3) of Commission Regulation (EC) No 785/95.

The absence of checks on plants entering the drying process

37. The Council regulation ([1]) specifies the green plants which are permitted to be transformed into dried fodder and thus qualify for aid. The Commission's detailed rules do not include any requirement to verify that only permitted plants are used. In practice, national authorities usually achieve some verification indirectly by means of the contracts for supply. Inspectors also obtain some assurance through physical observations made during their periodic visits to processors though this is not done systematically.

Definition of criteria for leaving the precincts

38. To qualify for aid or advances of aid the fodder must leave the premises of the processor. Fodder products are considered to have left the processing undertaking where they leave in an unaltered state either ([2]):

(a) the precincts of the undertaking; or

(b) where the products cannot be stored in those precincts, any storage place outside them which has been approved in advance by the competent authority.

The criteria that processed fodder must leave the premises of the processor to qualify for aid is open to different interpretations.

39. The instructions for processors issued by the competent authority in France, in relation to 1998/99, recognised that one of the main criteria governing the right to claim aid was for processed fodder to have left the processing undertaking. They also stated that, what generated this condition was usually fulfilled by actual sale supported by an invoice. It went on to advise that the processor could transfer the product to storage external to the main installations without making a sale and that this was, by association, equivalent to the product leaving the premises. A later instruction however, confirmed that products must leave the processor's premises or approved external storage in order to qualify for aid.

([1]) Article 1 of Council Regulation (EC) No 603/95 and Article 2 of Commission Regulation (EC) No 785/95.

([2]) Article 3(1) of Commission Regulation (EC) No 785/95.

40. For one of the processors visited during the audit, output delivered to a common silo as well as to other external storage, qualified for aid. The competent authorities considered that this was consistent with the requirements of the regulations as the fodder had, in both cases, left the precincts of the processing undertaking.

41. In 2001, France abandoned the concept of approved external storage altogether and now regards all storage facilities outside the precincts of the processing facility as being not approved. On this basis they regard all flows to external storage as fulfilling the criteria of leaving the premises and therefore qualifying for aid. This is within the letter but not the spirit of the regulations which the Court considers should require the product to be transferred to a third party.

Processors in one Member State have created their own marketing companies to facilitate aid claims

42. In Italy the authorities have extended interpretation of the leaving the premises conditions to mean that the fodder has to have been sold. To ensure that they can meet this criteria and claim the aid, processors have established marketing companies to whom they 'sell' their production. The system is a device for ensuring that the processors can claim aid sooner than if they had to wait for a sale to a true third party. The marketing companies of two of the processors visited in Italy were legally physically separate entities but remained virtually inseparable from their parent processing companies. The administration and bookkeeping of the marketing companies was provided by the systems and personnel of the processing companies.

43. The 'sale' criteria adopted can, in one sense, be viewed as stricter than just 'leaving the premises', but the creation of such companies can also be seen as exposing the system to the risk of fictitious sales.

44. The Italian authorities carried out sample checks on financial documents (bills and payments) for dried fodder, including the final user of the products. The Court carried out specific tests, during the audit of the processors, relating to stock records of both parties, including clearance of the payments for 'sales', in order to ensure that the transactions between the processors

visited and their marketing companies were genuine. Although the results of the tests were satisfactory in this instance, they required extensive reconciliation which the national authorities were not carrying out. Such tests are essential to ensure that complex beneficiary structures are controlled effectively.

Effective cross-checking with IACS is not being achieved in one Member State

45. In Italy declarations relating to parcels growing green fodder are included in those made for all arable products and recorded for checking to the Land Register database. The areas declared as the source of green fodder under supply contracts to processors are also recorded but in another database. There was however, no cross-checking between these databases thereby creating a risk that inconsistencies would not be detected. New procedures were adopted in 2000 with the aim of making the fodder scheme more compatible with IACS. But the above cross-checks were still not being done at the time of our audit.

MONITORING AND EVALUATION BY THE COMMISSION

Monitoring

46. The market is managed and monitored by a market unit in the Commission and the Management Committee for Dried Fodder set up to assist the Commission [1].

47. The Commission requires Member States to provide limited information to them consisting of:

(a) the average level of humidity of the green fodder to be dehydrated;

(b) the quantities of dried fodder for which aid has been requested and the quantities accepted;

(c) stocks of dried fodder.

48. The Commission provides this information to the Committee along with the calculations of the reduction in aid to be applied in cases where production has exceeded MGQ. Although the primary objective of the CMO was initially to increase protein supply through the aid for processing dried fodder, no information is required to be provided by Member States on total protein supply market prices of protein products or prices and production/imports of other competing protein crops and products.

There has been no evaluation of the CMO

49. The regulations governing the operation of the dried fodder market do not specify that any evaluation of the market is required.

50. Under its evaluation programme for 2001 however, the 'Evaluation' unit of DG AGRI had planned an evaluation of the dried fodder sector but this was postponed in favour of a higher priority project on the wine sector. The fodder project would have been reprogrammed for 2002 but further changes in Commission priorities resulted in it being replaced by one on cereals. To date therefore, the CMO has not been the subject of an evaluation.

OTHER REVIEWS OF THE MARKET AND SECTOR

51. Although there has been no evaluation of the market two major reviews of the sector, for other purposes, provided an opportunity for the Commission and the Council to examine the market.

Supply and demand of protein rich material in the EU following the BSE crisis

52. Following the BSE crisis, the Commission was asked by the 'Agriculture' Council in December 2000 to examine the supply and demand situation of protein-rich crops in the context of the need to find alternative supplies to replace banned processed animal protein. The terms of reference were: '…to analyse the issue (of the production of protein rich plants) in greater detail

(1) Article 17 of Council Regulation (EC) No 603/95 of 21 February 1995.

and to draw its consequences for the policy currently being prepared in this sector…'.

53. The results of this review were set out in a formal communication from the Commission to the Council and the European Parliament ([1]) 'Options to promote the cultivation of plant proteins in the EU'. This assessed the protein market, likely future scenarios and the options available, including:

(a) increasing production of oilseeds by increasing aid;

(b) promoting increased production of aid supported protein crops;

(c) authorising the cultivation of protein rich crops on set aside land;

(d) promoting increased production of dried fodder by increasing the MGQ;

(e) importing more soya.

54. The best option was to increase soya imports as the other options were considered to be too costly or too difficult to reconcile with other objectives. Each option would, however, satisfy additional needs only to a limited extent. Market forces would come into play: the feed industry and farmers would not react to the replacement problem just by using soya meal. They were likely to reduce protein-rich ingredients in feed and increase cereal content, any remaining deficit being covered by additional use of soya via increased imports.

55. Also, increasing the production of dried fodder would increase aid costs by nearly 14 million euro but not necessarily lead to 'real' increases in production rather than just cover for existing production in excess of MGQ.

Changes proposed to the CMO as a result of the CAP mid-term review

56. Following the CAP review published in July 2002 ([2]), the Commission proposed a number of fundamental changes in agricultural support with the objective of achieving more market-orientated sustainable agriculture. The most significant elements were a shift from product to producer support with the introduction of a decoupled system of single payments per farm, based on historical references and conditional upon compliance with environmental, animal welfare and food quality criteria. Adjustments to the dried fodder sector were envisaged as part of this process, in particular to consider the need for further reform of the market or even its abandonment, following the comments made by the Court in its Report 'Greening the CAP'.

57. The Commission proposed replacing the current regime in the dried fodder sector with an income support envelope for growers of up to 132 million euro of the existing budget for aid paid to processors. This would be distributed between Member States in proportion to the national shares of the existing MGQ. Grower entitlements would be based on the quantities of green fodder delivered to processors in a historical reference period. In order to facilitate the transition for the fodder processing industry, a simplified and degressive single-rate support scheme, of 33 euro per tonne of dried fodder produced, would be maintained and the individual national MGQs would be merged.

58. In addition to the Court's environmental arguments on fodder, the Commission also drew attention to the fact that aid now represented up to 70 % of the market price of dehydrated lucerne. They also indicated that they had not excluded the possibility of abandoning the current regime if the reform proposals were not accepted.

59. In January 2003, the Commission brought forward legislative proposals to the Council ([3]) which make clear that, in addition to transferring funds (now some 133 million euro) from the present fodder aid budget to growers via the single farm payment scheme, the revised single rate payable to processors would be phased out by 2009 thus removing all aid for processing. The Commission confirmed to the Court that the money saved would not be transferred to growers and would be a real saving for the budget.

([1]) COM(2001) 148 final 2 16.3.2001.

([2]) Commission Communication to the Council and to the Parliament, COM (2002) 394 final 10.7.2002.

([3]) COM(2003) 23 final of 21.1.2003.

CONCLUSIONS

60. The market was introduced to encourage the production of proteins in the form of dried fodder. Although production has increased, the EU still only produces less than 2 % of its protein requirements in the form of dried fodder. Dried fodder remains of limited economic significance for animal protein consumption in the EU. The MGQ introduced to limit total expenditure has been successful. It has however, influenced production to only a limited extent as some Member States have consistently exceeded their MGQ (see paragraphs 4, and 7 to 9).

61. The Commission has argued against increasing production limits even to the limited extent necessary to make up the deficit in protein supply caused by the ban on processed animal proteins (see paragraphs 52 to 55).

62. There has been a major shift in production from sun-dried to artificially dried fodder. The rates of aid themselves were set by the Council at higher levels than those recommended by the Commission and with an increased differential between the two levels of aid. The existence of the higher rate of aid for artificially dried fodder encouraged processors to produce this form of the product to the maximum extent possible. The production of artificially dried fodder rose by 11 % between 1995 and 2002 whereas the production of sun-dried fell by 50 %. Of the total aid expenditure on dried fodder 87,5 % relates to artificially dried. Development of production has been uneven with some Member States consistently exceeding MGQ and others continually producing less than their entitlement (see paragraphs 14 and 25 and 26).

63. The lack of clarity of the regulations has permitted different interpretations by Member States and exposed the system to the risk of incoherence of approach. In one Member State, marketing companies have been created by processors to facilitate claims for production aid. This permitted them to claim aid sooner than would otherwise be possible (see paragraphs 30 to 45).

64. Some Member States have failed to operate important controls provided for in the regulations which may expose the system to risks that unjustified claims might go undetected (see paragraphs 32 to 36).

65. The Commission has identified key controls in order to focus proposals for corrections to the aid paid in cases of non-compliance with regulations. But the managers of the CMO were not involved in this process and the information has not resulted in amendments to regulations (see paragraphs 27 to 28). The results of the definition of controls work have been communicated to Member States by the 'Clearance-of-Accounts Directorate' through presentations made to the EAGGF Committee.

66. Monitoring of the CMO by the Commission does not cover protein supply or prices of protein products and imports. There is no formal requirement for evaluation in the regulations. Although an evaluation was planned it has been postponed twice in favour of other markets. Other reviews of the market have been made but were initiated for other purposes (see paragraphs 46 to 50).

67. The recent reform proposals are in part intended to address the uneven development which has occurred in the market and continuing concerns about efficiency. The Commission has indicated to the Council that it has not excluded the possibility of abandoning the current regime if the overall CAP reform proposals are not accepted by the Council. Any new scheme would still involve redirecting funds to the growers rather than the processing industry (see paragraphs 56 to 59).

68. The major changes proposed by the Commission following the mid-term review of the CAP would, if approved by Parliament and the Council, eliminate many of the risks associated with aid to processors although some may remain in the interim. The continuance of aid to processors, albeit at a single reduced rate, will still require the application of effective controls. The new system of paying farmers for growing plants has yet to be defined and controls devised.

RECOMMENDATIONS

69. The Court welcomes the Commission's current efforts to reform the market. The Court recommends that the Commission address the following points when implementing the reform and notes the compromise reached by the Council:

(a) emphasise the importance of prioritising checks on the basis of formal risk assessment;

(b) define more specifically what it is prepared to accept as meeting the key criteria of fodder 'leaving the premises' in order to qualify for aid;

(c) introduce checks on the plants actually used to produce the fodder to ensure compliance with those specified;

(d) specify the nature and extent of checks on suppliers and operators to whom fodder is supplied;

(e) specify and define the inspections of stock records and financial records of processors that are required in order to ensure reconciliation of the information as far as possible with the quantities being claimed for aid.

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 24 and 25 September 2003.

For the Court of Auditors

Juan Manuel FABRA VALLÉS

President

ANNEX A

DEVELOPMENT OF EU PRODUCTION OF DRIED FODDER

Quantities recognised as being entitled to aid

(1 000 t)

1. DEHYDRATED FODDER	MGQ	1995/96		1996/97		1997/98		1998/99		1999/2000		2000/01		2001/02		2002/03		Difference		
		production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	02/03-01/02	02/03-MGQ	02/03-95/96
BLEU	8	4	51 %	4	54 %	4	53 %	3	35 %	2	24 %	2	22 %	1	14 %	2	20 %	1	- 6	- 2
Denmark	334	271	81 %	207	62 %	225	67 %	266	80 %	186	56 %	168	50 %	147	44 %	147	44 %	0	- 187	- 123
Germany	421	343	81 %	300	71 %	308	73 %	321	76 %	334	79 %	357	85 %	334	79 %	348	83 %	14	- 73	5
Greece	32	46	145 %	30	94 %	38	120 %	46	144 %	52	161 %	44	136 %	51	160 %	58	181 %	7	26	12
Spain	1 224	1 262	103 %	1 414	115 %	1 571	128 %	1 668	136 %	1 769	145 %	1 955	160 %	1 812	148 %	1 882	154 %	70	658	621
France	1 455	1 307	90 %	1 091	75 %	1 264	87 %	1 346	93 %	1 304	90 %	1 225	84 %	1 167	80 %	1 094	75 %	- 73	- 361	- 213
Ireland	5	5	94 %	6	117 %	6	126 %	5	109 %	5	99 %	5	95 %	5	98 %	4	87 %	- 1	- 1	0
Italy	523	526	101 %	499	95 %	561	107 %	638	122 %	674	129 %	677	129 %	659	126 %	716	137 %	57	193	189
Netherlands	285	221	77 %	176	62 %	210	74 %	223	78 %	194	68 %	214	75 %	181	64 %	203	71 %	22	- 82	- 17
Austria	4	2	50 %	2	45 %	2	48 %	2	42 %	2	45 %	2	47 %	2	45 %	3	61 %	1	- 2	0
Portugal	5	1	16 %	2	39 %	4	71 %	3	50 %	1	19 %	2	44 %	4	74 %	0	2 %	- 4	- 5	- 1
Finland	3	2	60 %	1	44 %	1	35 %	1	40 %	0	17 %	1	19 %	1	17 %	1	21 %	0	- 2	- 1
Sweden	11	9	86 %	7	65 %	5	48 %	7	60 %	6	59 %	6	55 %	8	68 %	9	79 %	1	- 2	- 1
United Kingdom	102	72	70 %	79	77 %	84	82 %	81	80 %	70	68 %	63	62 %	50	49 %	48	47 %	- 2	- 54	- 23
TOTAL EU	4 412	4 070	92,2 %	3 818	86,5 %	4 283	97,1 %	4 610	104,5 %	4 599	104,2 %	4 720	107,0 %	4 421	100,2 %	4 515	102,3 %	94	103	445
																				11 %

(1 000 t)

2. SUN-DRIED FODDER	MGQ	1995/96		1996/97		1997/98		1998/99		1999/2000		2000/01		2001/02		2002/03		Difference		
		production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	production	% MGQ	02/03-01/02	02/03-MGQ	02/03-95/96
Greece	6	3	46 %	2	30 %	0	2 %	0	0 %	0	0 %	0	0 %	0	0 %	0	0 %	0	- 6	- 3
Spain	101	41	40 %	37	36 %	53	52 %	93	92 %	85	84 %	108	107 %	227	225 %	105	104 %	- 122	4	64
France	150	166	111 %	86	57 %	14	10 %	4	2 %	3	2 %	3	2 %	4	3 %	3	2 %	- 2	- 147	- 163
Italy	162	190	117 %	125	77 %	87	54 %	53	33 %	73	45 %	90	56 %	74	46 %	107	66 %	33	- 55	- 83
Portugal	25	3	13 %	4	16 %	3	10 %	1	5 %	2	6 %	2	6 %	1	2 %	1	4 %	0	- 24	- 2
TOTAL EU	443,5	402	90,7 %	253	57,0 %	156	35,3 %	151	34,1 %	162	36,5 %	203	45,7 %	306	69,0 %	216	48,7 %	- 90	- 228	- 187
																				- 46 %

Sources: Information supplied by Member States (Article 15(a), second indent of Regulation (EC) No 785/95).
Working document submitted by the Commission to the Dried Fodder Management Committee in respect of the 2002/03 marketing year.

ANNEX B

ARTIFICIALLY HEAT-DRIED (DEHYDRATED) FODDER — REDUCTIONS IN AID WHEN EU PRODUCTION EXCEEDS MGQ

Table a

General amount to achieve budget neutrality when EU production < MGQ + 5 %

	Production	Quantity 1 000 tonne	Rate of aid euro/tonne	Budget Million euro
Aid payable if EU excess = 0	MGQ	4 412,4	68,83	303,705
Aid payable if EU excess = MGQ + 5 %	MGQ + 5 %	4 633,0	65,55	303,705

Table b

Specific reduction when EU production > MGQ + 5 %

Marketing year 2000/2001	PRODUCTION quantities recognised as being entitled to aid 1 000 t	NGQ (1)			Distribution of Quantities exceeding the NGQ + 5 %		RATE OF AID to be paid by Member States Euro/t
		NGQ 1 000 t	Production/NGQ ratio	NGQ + 5 % 1 000 t	quantity produced over and above the NGQ + 5 % 1 000 t	% of total	
Greece	**43,6**	32	136 %	33,6	10,0	1 %	**63,94**
Spain	**1 954,6**	1 224,0	160 %	1 285,2	669,4	83 %	**63,15**
Italy	**676,8**	523	129 %	549,2	127,7	16 %	**64,23**
Total					807,1	100 %	

(1) NGQ = national guaranteed quantity share of maximum guaranteed quantity for EU as a whole.

NB: Legal basis: Article 5 of Regulation (EC) No 603/95.

The full aid provided for in Article 3 of Regulation (EC) No 603/95 is payable, if the EU production recognised for aid of the marketing year does not exceed the MGQ. If the EU production exceeds the MGQ, two cases are foreseen under Article 5 of Regulation (EC) No 603/95, in order to keep total EU expenditure within the budget limit:

(a) EU production exceeds the MGQ between 0 and 5 %: the aid is reduced in all Member States by an amount which is proportionate to that excess

(b) EU production exceeds the MGQ more than 5 %: all Member States support a 5 % aid reduction and for the Member States in which production exceeds the NGQ increased by 5 %, additional reductions is made proportionate to this excess.

In 2000/01, it was the first time when the EU dehydrated production overshot the MGQ by more than 5 % and therefore the rule (b) applied;

Table b presents a detailed calculation of this situation.

Source: Information supplied by Member States to the Commission and submitted to the Dried Fodder Management Committee.

THE COMMISSION'S REPLIES

SUMMARY

IV. In March 1994, in the framework of the price package proposal for the 1994/95 marketing year, the Commission proposed aid rates without limits on production. In February 1995, the Council agreed in an overall compromise on a level of aid higher than initially proposed by the Commission, but with an effective upper limit on EU budget expenditure by the introduction of maximum guaranteed quantities (MGQs).

The Commission acknowledges that uneven developments in production occurred after the reform of the sector in 1995, in terms of dried fodder type and as between Member States.

V. The Commission's staff also pay great attention to differences of interpretation when conducting audits as part of the clearance of accounts.

For example, in 1999 Commission staff carried out a series of audits of agricultural expenditure relating to dried fodder in the main producing Member States. In the course of these investigations, shortcomings similar to those raised by the Court were identified. However, after taking into account the other elements of the control systems in the Member States, it was concluded that the financial risk for the EAGGF was small, except for specific cases where financial corrections were applied.

The Commission notes the Court's remarks concerning the persistence of these shortcomings and will take account of them in its forthcoming audits.

Specifically concerning the procedures to accelerate the payment of aid, the Commission considers that they are not questionable per se. The criterion of 'leaving the premises' is meant to promote effectiveness of the physical checks and is mainly designed to guarantee that aid on dried fodder is not paid twice.

VI. In order to minimise the administrative burden, the Commission Regulation requires Member States to report the information needed to manage the aid regime. Information on the items raised by the Court is available through other sources such as Eurostat and industry data.

VII. An evaluation of the dried fodder scheme is foreseen in the Council decision and is to be completed in time for the Commission's report to the Council by 30 September 2008. As the Court indicates, it should be noted that the sector was included in the analysis presented in the report on protein supply.

IX. In its proposal on a long-term policy perspective for sustainable agriculture, the Commission took account of the Court of Auditors' report on 'Greening the CAP' as regards the negative effect of the fodder dehydrating process on the environment.

INTRODUCTION

3. Even if the level of protein content as such in feeds is an important element, the protein composition and other qualities required by the different types of livestock must be considered as well.

MANAGEMENT OF AID

21. Since 1995, the budget stabiliser system has ensured that an overshoot of the MGQ does not create any additional expenditure from the Community budget.

24. In March 1994, in the framework of the price package proposal for the 1994/95 marketing year, the Commission proposed aid rates without limits on production. In February 1995, the Council agreed in an overall compromise on a level of aid higher than initially proposed by the Commission, but with an effective upper limit on EU budget expenditure by the introduction of the MGQ.

27 to 29. In the Commission's view, ranking the controls by order of importance in the Community legislation is not desirable.

Such ranking is carried out by Commission staff solely as part of the clearance of accounts process in order to help assess the financial risk to the EAGGF if one or more controls are not applied or are applied wrongly. The division into key controls and secondary controls is based on some general principles adopted by the Commission. It is the responsibility of the departments in charge of auditing agricultural expenditure, independently of the departments responsible for market management.

31. Detailed definitions, particularly of eligible fodder and approved undertakings, have been included through the management committee procedure in the Commission regulation, which must be applied by Member States.

33. At the time of its audit for the clearance of accounts, the Commission found that the German authorities had introduced the other controls required in the rules and that additional controls not required by the rules had also been used to settle cases of doubt. In this context, the Commission judged the control system as a whole to be capable of controlling the financial risks to the EAGGF.

Nevertheless, in the framework of the reform of the sector, the Commission will rectify the problem in the German text.

34. The fact that controls on financial records are delegated to specialised control bodies cannot in itself be regarded as a shortcoming.

Except for specific financial corrections, the Commission judged at the time of its 1999 controls that the Italian system did not present financial risks to the EAGGF. This point will however be analysed again during the next investigations to be carried out in the context of the clearance of accounts.

36. Regarding the differences noted by the Court of Auditors in the detailed rules for applying the controls provided for in the legislation, the Commission considers that this is the result of the differences among the various national organisations. However, the Commission always pays great attention to these aspects during its investigations.

37. Given the broad range of fodder species for dehydration, this issue mainly concerns fodder dried in the sun. The rate of aid is lower by almost half than aid for dehydrated fodder and the level of production is small within the total of dried fodder.

Furthermore, the areas intended for producing dried fodder are covered by the area declaration under IACS and the use must be indicated (dehydrated or sun-dried fodder).

In this connection, the nature of the crops is usually checked during the on-the-spot controls carried out by the Member States.

39 to 41. The criterion of 'leaving the premises' used in the legislation is designed to prevent aid for dried fodder being paid twice. During the 1999 audit by Commission staff, the characteristics of the French system, in particular the non-approved stores, were subjected to thorough analysis; this concluded that the practice is in conformity with the current rules.

42 and 43. The Commission considers that the practice of using firms specialised in marketing dried fodder to assist operators to receive aid more quickly is not objectionable.

44. During their 1999 audit for the clearance of accounts, Commission staff identified weaknesses similar to those raised by the Court. However, taking into account the other elements of the control systems of the Member States, it was concluded that the financial risk to the EAGGF was small, except for specific cases where financial corrections were applied.

As the Court indicates, its tests did not reveal any anomalies. However, the Commission notes the remarks of the Court concerning the persistence of these weaknesses and will take account of them in its forthcoming audits.

45. The audit carried out by Commission staff in Italy in 1999 showed that cross-checking of the plots declared under IACS was carried out but was not documented.

This point will be examined again during the next investigation.

MONITORING AND EVALUATION BY THE COMMISSION

48. The objectives of the scheme are based on the EC Treaty, in particular Articles 36 and 37. Since 1995, a particular focus has been on managing the aid within the MGQ adopted by the Council and thus on respecting the budget limits. The primary aim is no longer to increase protein production.

In order to minimise the administrative burden, the Commission regulation requires Member States to report the information needed to manage the aid regime. Information on the items raised by the Court is available through other sources.

49 and 50. An evaluation of the dried fodder scheme is foreseen in the Council Decision of 26 June 2003 and is to be completed in time for the Commission's report to the Council by 30 September 2008. As the Court indicates, it should be noted that the sector was included in the analysis presented in the report on protein supply.

OTHER REVIEWS OF THE MARKET AND SECTOR

53. The Commission's Communication was the response to a mandate from the European Council in December 2000 requesting analyses in strict compliance with the financial perspective.

56 to 59. The Council compromise of 26 June 2003 adopted the Commission proposal on dried fodder with two amendments.

1. Suppression of the phasing-out of processing aid, but maintenance of the single rate of aid at EUR 33 per tonne.

2. By 30 September 2008, the Commission is to present a report on the dried fodder sector based on an evaluation of the common market organisation, dealing in particular with the growth of areas under leguminous and other green fodder, the production of dried fodder and the savings on fossil fuels. The report is to be accompanied, if necessary, by appropriate proposals.

CONCLUSIONS

62. The recent Council Decision will improve the regime by decoupling the aid and establishing a single aid rate for both dehydrated and sun-dried fodder, while the MGQs will be merged (see paragraphs 56 to 59).

63. During the clearance-of-accounts procedure, the Commission concluded that the national implementing rules cited by the Court did not involve financial risks to the EAGGF.

In particular, the fact that operators implemented procedures enabling them to receive the aid more quickly cannot be considered per se as questionable.

64. The Court's criticisms mainly concern Italy and Germany. These two Member States were the subject of an investigation by Commission staff in 1999 in the context of the clearance of accounts.

After an analysis of their control systems as a whole, it was judged that they were capable of controlling the risks to the EAGGF.

However, the Commission takes note of the Court's remarks and will take account of them when conducting its next investigations.

65. In the Commission's view, ranking controls by order of importance in the Community legislation is not desirable.

Such ranking is carried out by Commission staff solely as part of the clearance of accounts process in order to help assess the financial risk to the EAGGF if one or more controls are not applied or are applied wrongly. The division into key controls and secondary controls is based on a number of general principles adopted by the Commission. It is the responsibility of the departments in charge of auditing agricultural expenditure, independently of the departments responsible for market management.

66. An evaluation of the dried fodder scheme is foreseen in the Council Decision of 26 June 2003 and is to be completed in time for the Commission's report to the Council by 30 September 2008.

68. In the context of the reform of this market organisation, the definition of appropriate controls will be given proper attention by the Commission.

RECOMMENDATIONS

69. The Commission's proposal is largely driven by the Court of Auditors' comments in its report on 'Greening the CAP' about the environmental effects of the drying process.

(a) The need for a formalised risk analysis system was stressed in the documents distributed to Member States in February 2001.

(b) and (c) In the context of the reform, the Commission will continue to pay attention to the criterion of 'leaving the premises' as well as the plant criteria, with the objective of effectiveness in terms of cost/benefit.

(d) and (e) Obviously not all the possible controls can be defined and listed in an exhaustive way, but the Commission will continue to pay attention to the quality and suitability of controls in the context of the clearance of accounts.

However the Commission will re-evaluate all these controls in the context of the forthcoming reform.

SPECIAL REPORT No 13/2003

concerning production aid for cotton together with the Commission's replies

(pursuant to Article 248(4), second subparagraph of the EC Treaty)

(2003/C 298/02)

TABLE OF CONTENTS

EXECUTIVE SUMMARY

I. This report contains the Court's findings from a sound financial management audit of the production aid scheme for cotton. This scheme had previously been audited in the early 1990s and the findings published in the Court's 1992 and 1995 annual reports.

II. The overall objective of the scheme is to support the production of cotton and to allow the producers concerned to earn a fair standard of living. The main producer Member States are Greece and Spain. A small amount of production takes place in Portugal.

III. The aid is granted to the ginners who have to pay a minimum price to the producers. It varies in amount with market prices and on quantities produced. The mechanism used to determine the aid aims to provide the ginners with a constant level of income sufficient to cover their operating costs and to allow EU produced cotton to compete on price with the imported product. When selling the cotton to the ginners, the producers receive an amount approximately two to three times greater than the commercial value of the cotton sold.

IV. The results of the Court's audit are presented under two main headings:

— management by the Commission,

— evaluation of the systems of control operating in the main producer Member States.

V. Since the establishment of the scheme in 1981, annual production of cotton in the EU has increased from 0,3 million tonnes to 1,7 million tonnes. This increase reflects the fact that the aid for cotton production is three to four times that paid for crops grown as an alternative. A comparison of the gross margins for cotton and grain maize indicate a ratio of about 1,5 in favour of cotton. About a quarter of the increase in production is due to the accession of Spain to the EEC in 1986.

VI. In 1987 a stabiliser mechanism was introduced with the objective of reducing the support payable when production exceeds the guaranteed maximum quantity.

VII. In 2001, a reform of the production aid scheme took place and included a strengthening of the stabiliser mechanism, the effect of which causes a sharp drop in the support payable when production exceeds stated thresholds.

VIII. Higher than expected Greek production in 2001/02 led to an application to have certain production eliminated from the scheme. The examination of this application identified a number of issues regarding quantities eligible for aid and the quantities which should be used to determine the penalty for production in excess of the guaranteed quantities. Amending legislation followed which sets down criteria for establishing such quantities because, if ineligible produced cotton goes undetected, all producers are penalised through a higher penalty imposed by the stabiliser mechanism. One criterion for eligibility is that aid should only be paid on quantities coming from areas declared to cotton production under IACS. In practice, the national authorities in Greece, when deciding on eligible production are constrained by the weaknesses in IACS. Moreover, the results of checks by the authorities to determine quantities to be excluded from production for the purposes of applying the stabiliser mechanism are inconsistent with the results of checks on individual producers for the purposes of verifying area declarations. In view of the weaknesses in IACS in Greece, the ability of the

Commission to monitor the correct application of the stabiliser mechanism is diminished. The Commission wished to introduce a reform of the present scheme to be effective from the marketing year commencing on 1 September 2003. This deadline has not been met and the Commission intends to present a proposal for the reform of the aid scheme for cotton to the Council and to the European Parliament in the autumn of 2003.

IX. In any year when the Community expenditure does not reach 770 million euro, the regulations provide for an increase in the amount payable to the producers provided certain conditions are met. In three of the seven years 1995/96 to 2001/02 an increase in support was paid to the producers under this provision. Furthermore, this measure mitigates the effect of the stabiliser mechanism and could be viewed as a bonus payable to the producers. Budget neutrality cannot be assured and expenditure in the other four years exceeded 770 million euro.

X. Within the Commission there is a lack of information on the negative impact which cotton production can have on the environment and there is no continuous monitoring of the environmental situation in the regions within the Member States where cotton is produced.

XI. The Commission is unaware of the effectiveness of the incentive given to the ginners to improve the quality of the cotton produced. The amount paid appears to represent unnecessary expenditure and to be a source of additional revenue, as it duplicates the revenue obtained from the market place when better quality and increased yields are produced. In addition, the Commission has not reviewed the operating costs incurred by the ginners and is thus unaware of whether the potential exists to reduce Community expenditure by altering the amount of aid paid to the ginners.

XII. While the audit in Spain did not give rise to material observations, serious weaknesses were observed in the checks undertaken by the Greek national authorities in relation to the area declarations submitted by the producers. The effects of these weaknesses are compounded by the lack of progress in implementing the IACS in Greece. For the marketing year 2001/02 the Greek authorities have estimated that about 10 % of the land planted with cotton was either not declared under IACS or was declared as cultivated with another crop. In such circumstances and, if not detected, producers receive aid twice for the same parcels of land, once on the basis of the arable crop declaration and again on the basis of the actual production of cotton.

XIII. The Court recommends that the Commission takes the opportunity of the proposed reform to address weaknesses in the present regime (absence of budget neutrality, the attractiveness of the aid rate on quantities produced and the impact of cotton production on the environment). In addition, and with regard to the present scheme, the Court recommends that the Commission reviews the financial arrangements of the ginners and examines the effectiveness of the incentive given to improve quality.

INTRODUCTION

1. A production aid scheme for cotton was introduced with the accession of Greece to the EEC ([1]), and applied for the first time to cotton harvested in 1981. The scheme expanded when Spain and Portugal joined the EEC in 1986.

2. In 2001, the implementing measures for the scheme were simplified and brought together in Council Regulation (EC) No 1051/2001 ([2]). Commission Regulation (EC) No 1591/2001 ([3]), as amended ([4]), lays down the detailed rules for applying the production aid scheme.

([1]) Protocol 4 of the Greek Act of Accession 1979 (OJ L 291, 19.11.1979 p. 174).

([2]) Council Regulation (EC) No 1051/2001 of 22 May, 2001 (OJ L 148, 1.6.2001, p. 3).

([3]) Commission Regulation (EC) No 1591/2001 of 2 August 2001 (OJ L 210, 3.8.2001, p. 10).

([4]) Commission Regulation (EC) No 1486/2002 of 19 August 2002 (OJ L 223, 20.8.2002, p. 3).

3. The overall objective of the scheme is to support the production of cotton in the regions of the Community where it is important for the agricultural economy and which permits the producers concerned to earn a fair standard of living (1).

Cotton plant and production

4. Cotton is planted in spring and harvested in the following autumn. The raw cotton is delivered to ginning undertakings where the fibres are separated from the seeds and waste material by a process known as ginning. The marketing year runs from 1 September to 31 August.

5. Within the EU, cotton is grown almost exclusively in Greece and Spain. Annual production in the three marketing years (1999/2000 to 2001/02) has averaged 1,6 million tonnes which provides a yield of 0,51 million tonnes of ginned cotton. This level of production meets about 47 % of EU internal needs. The balance is made good by imports which enter the Community duty and levy free.

6. EU countries produce about 3 % of world output (estimated at 19 million tonnes of ginned cotton) with the United States of America, China and India being the largest producers.

Budgetary impact

7. Aid for cotton production amounts to an average of 600 million euro for Greece and 200 million euro for Spain and in total equates to almost 2 % of the EAGGF budget.

The main features of the production aid scheme

8. The regulation (2) provides that cotton producers receive an amount (the minimum price (3)) from the ginners greater than the commercial value of the unginned cotton delivered to ginning undertakings. This requirement is one of the conditions contained in the written contract covering the purchase of the cotton by the ginners. Whilst ginners are obliged to pay the minimum price for cotton of standard quality they are also free to offer more.

9. The aid paid to the ginners represents the difference or deficiency between what is termed the *guide price* (4), (which is the minimum price increased by 5 % (5)) and a value placed by the Commission (6) on the unginned cotton acquired from the producers. The regulation provides that the unginned cotton is valued as a percentage of the market price of ginned cotton which is a traded commodity and for which published prices exist.

10. The amount of aid payable changes with movements in the market prices for ginned cotton. When market prices are low, the aid increases to compensate and vice versa. As a consequence, revenue collected by the ginners from the sale of the ginned cotton combined with the aid received remains largely constant for any given level of production. This arrangement provides financial security for the ginners and allows EU produced cotton to compete on price with imports.

11. In any year when the aid does not reach 770 million euro, the regulations (7) provide for an increase in the amount payable when certain conditions are met (8). The increase in aid is limited by the attached conditions and cannot bring total Community expenditure beyond 770 million euro. This measure, which is unique to the cotton regime, mitigates the effects of the stabiliser mechanism when world market prices are relatively strong and could be viewed as a bonus payable to producers. In three of the seven years 1995/96 to 2001/02 an increase in the aid was paid to the producers under this provision (see *Table 1* for detail *)*. For the three years in question (1995/96, 1997/98 and 2000/01), aid paid under this provision amounted in total to 260 million euro.

12. With regard to environmental considerations, the regulations introduced in 2001 place obligations on the Member States to determine measures for the cotton sector.

(1) Protocol 4 of the Greek Act of Accession 1979 (OJ L 291, 19.11.1979 p. 174).
(2) Council Regulation (EC) No 1051/2001 which replaced Regulations (EEC) No 1964/87 and (EC) No 1554/95.
(3) Article 2 of Council Regulation (EC) No 1051/2001. The minimum price is fixed by the Council and currently stands at 100,99 euro/100 kg of unginned cotton.
(4) Article 2 of Council Regulation (EC) No 1051/2001. The guide price is also fixed by the Council and currently stands at 106,30 euro/100 kg of unginned cotton.
(5) A 5 % differential between the minimum and guide price is paid to the ginners to cover their costs in the administration of the scheme.
(6) Article 2 of Commission Regulation (EC) No 1591/2001.
(7) Article 8 of Council Regulation (EC) No 1051/2001.
(8) The conditions require that the stabiliser mechanism was applied, that the weighted average price for unginned cotton used in the determination of the aid is greater than 302 euro per tonne, that producers cannot receive, in total, more than the minimum price and that increase in aid cannot exceed that payable if the guaranteed maximum quantity was increased to 1 120 million tonnes.

Table 1

Amount received by producers

GREECE

Year	Minimum price/tonne in euro	Penalty/tonne (1) in euro	Increase/tonne (2) in euro	Net receipt/tonne in euro
1995/96	1 010	297,64	79,73	792,09
1996/97	1 010	98,86	0	911,14
1997/98	1 010	206,22	46,63	850,41
1998/99	1 010	291,26	0	718,74
1999/2000	1 010	386,93	0	623,07
2000/01	1 010	333,78	69,09	745,31
2001/02	1 010	416,70	0	593,30

SPAIN

Year	Minimum price/tonne in euro	Penalty/tonne (1) in euro	Increase/tonne (2) in euro	Net receipt/tonne in euro
1995/96	1 010	0	0	1 010
1996/97	1 010	109,49	0	900,51
1997/98	1 010	278,51	46,63	778,12
1998/99	1 010	189,21	0	820,79
1999/2000	1 010	342,29	0	667,71
2000/01	1 010	110,55	49,96	949,41
2001/02	1 010	188,15	0	821,85

(1) Penalty imposed for production in excess of guaranteed national quantity.
(2) Increase prompted by Community expenditure being less than 770 million euro.

13. Primarily as a means of limiting Community expenditure, but also as a means of discouraging increasing levels of production, a stabiliser mechanism was introduced in 1987 which has the effect of reducing the support payable on all production when the guaranteed maximum quantity (GMQ) is exceeded (1).

14. In 1995, the GMQ was increased to 1,031 million tonnes and the guide price was proportionally reduced with a view to keeping these changes budgetary neutral. Guaranteed national quantities (GNQ) were allocated to the producer Member States (2). From this point onwards the reduction in the aid rate following overproduction is applied to the Member State in which the overproduction occurs.

15. Following a strengthening of the stabiliser mechanism in 2001 (3), an accelerated reduction in the support payable occurs when production in Spain and Greece exceeds 1,5 million tonnes. The impact of the strengthened stabiliser is such that relatively modest increases in production above this threshold causes a sharp drop in the support payable for all production. No increase was made to the maximum guaranteed quantity in 2001 and no change was made to the procedure for determining the penalty when production lies between 1,031 million tonnes and 1,5 million tonnes. *Diagram 1* demonstrates the impact of the stabiliser mechanism and compares its impact before and after it was strengthened.

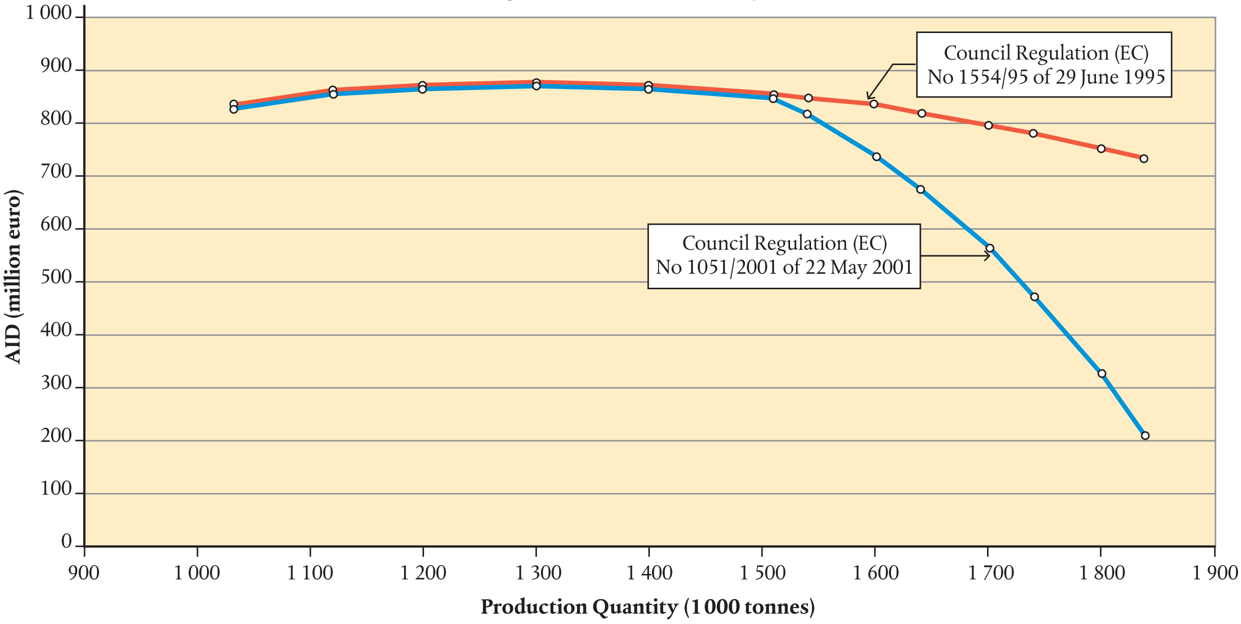
16. In every year since the introduction of the stabiliser mechanism in 1987, production has exceeded the guaranteed maximum quantities and the support received by the producers has been reduced in consequence.

17. While world market prices can be volatile, in general, the minimum price of 101 euro/100 kg payable to the producers is three to four times greater than the value of the unginned cotton produced. After the application of the stabiliser mechanism, the amount received by the producers drops to two to three times that of the value of the unginned cotton. Collectively the amount received by producers increases until production reaches 1,5 million tonnes. Thereafter, the overall amount received falls because the penalty imposed for overproduction outweighs the additional amounts received from increased production (see *Table 2* for detail).

(1) For each of the marketing years 1992/93 to 1994/95, the GMQ was fixed at 701 000 tonnes.
(2) Article 2 of Council Regulation (EC) No 1553/95 of 29 June 1995 (OJ L 148, 30.6.1995, p. 45). GMQ was increased to 1 031 000 tonnes and GNQs allocated to Spain, 249 000 tonnes and to Greece, 782 000 tonnes. When these quantities are exceeded, the guide price is reduced by 50 % of the rate of overshoot of the GNQ.
(3) Article 7 of Council Regulation (EC) No 1051/2001.

Diagram 1 — STABILISER MECHANISM

Impact of stabiliser mechanism on Community expenditure (value of unginned cotton = 250 euro/tonne) ([1])



NB: The diagram demonstrates the aid payable for differing levels of production before and after the modification to the stabiliser mechanism in 2001.
For production increasing from 1,0 to 1,34 million tonnes, the stabiliser mechanism is effective at limiting the increase in expenditure.
Once production exceeds 1,34 million tonnes the stabiliser mechanism causes a decline in the total aid payable.
The decline in total aid payable is much more rapid following the modification introduced by Council Regulation (EC) No 1051/2001.

([1]) A value of 250 euro has been used as this is the average of the values placed on the unginned cotton in the five marketing years 1997/98 to 2001/02.

Table 2

Comparison of aid received by producers before and after stabiliser mechanism was strengthened

Impact of stabiliser mechanism prior to strengthening introduced in 2001

A	B	C	D	E
Production in 1 000 tonnes	Minimum price A × 1 010 EUR 1 000	Penalty EUR 1 000	Received by producers B – C EUR 1 000	Rate/tonne D/A EUR
1 100	1 111 000	39 171	1 071 829	974,39
1 200	1 212 000	104 599	1 107 401	922,83
1 300	1 313 000	180 336	1 132 664	871,28
1 400	1 414 000	266 392	1 147 608	819,72
1 500	1 515 000	362 595	1 152 405	768,27
1 600	1 616 000	469 251	1 146 749	716,72
1 700	1 717 000	586 223	1 130 777	665,16

Impact of strengthened stabiliser mechanism

A	B	C	D	E
Production in 1 000 tonnes	Minimum price A × 1 010 EUR 1 000	Penalty EUR 1 000	Received by producers B – C EUR 1 000	Rate/tonne D/A EUR
1 100	1 111 000	39 171	1 071 829	974,39
1 200	1 212 000	104 599	1 107 401	922,83
1 300	1 313 000	180 336	1 132 664	871,28
1 400	1 414 000	266 392	1 147 608	819,72
1 500	1 515 000	362 595	1 152 405	768,27
1 600	1 616 000	563 135	1 052 865	658,04
1 700	1 717 000	820 780	896 220	527,19

NB: The collective amount received by the producers is maximised when production reaches 1,5 million tonnes.

Table 3

Comparison of aid payable when value of unginned cotton is 200, 250, 300 and 350 EUR/tonne.

A	B	C	D	E	F	G	H	I	J	K
Production tonnes	Guide price A × 1 063 EUR 1 000	Penalty EUR 1 000	Value (A × 200) EUR 1 000	Aid (B – C – D) EUR	Value (A × 250) EUR 1 000	Aid (B – C – F) tonnes	Value (A × 300) EUR 1 000	Aid (B – C – H) EUR 1 000	Value (A × 350) EUR 1 000	Aid (B – C – J) EUR
1 100	1 169 300	39 171	220 000	910 129	275 000	855 129	330 000	800 129	385 000	745 129
1 200	1 275 600	104 599	240 000	931 001	300 000	871 001	360 000	811 001	420 000	751 001
1 300	1 381 900	180 336	260 000	941 564	325 000	876 564	390 000	811 564	455 000	746 564
1 400	1 488 200	266 392	280 000	941 808	350 000	871 808	420 000	801 808	490 000	731 808
1 500	1 594 500	362 595	300 000	931 905	375 000	856 905	450 000	781 905	525 000	706 905
1 600	1 700 800	563 135	320 000	817 665	400 000	737 665	480 000	657 665	560 000	577 665
1 700	1 807 100	820 780	340 000	646 320	425 000	561 320	510 000	476 320	595 000	391 320

NB: For whatever the level of market price, it is in or around production of 1,3 million tonnes that Community expenditure begins to decline.

18. As stated in paragraphs 9, 10 and 13, Community expenditure is determined with reference to the minimum price payable by the ginners to the producers reduced by the application of the stabiliser mechanism and by a valuation placed on the unginned cotton acquired. Community expenditure begins to decline when the additional aid payable from increased production is outweighed by the escalation in the penalty for overproduction combined with the increase in the total value placed on the unginned cotton. This normally occurs when production is in or around 1,3 million tonnes (see *Table 3* for detail).

19. Notwithstanding the fact that the scheme is production based, all Community cotton growers are required to submit an application under the integrated administration and control system (IACS) ([1]) to declare the areas sown. Data from these applications are used to forecast production, to check the existence of producers delivering to ginning undertakings and the reasonableness of the quantities delivered.

The Court's audit

Previous observations

20. The findings from the Court's previous audits were published in its 1992 ([2]) annual report and the results of a follow-up audit were published in 1996 ([3]). The Court criticised the scheme's vulnerability to irregularity and weaknesses in controls, and the inclusion of fictitious quantities on which aid was paid (in Greece). This failure was addressed by amending legislation introduced in 1995 which provides for a reduction in the quantity of unginned cotton on which aid is paid when the yield of ginned cotton is less than the 32 % standard ([4]). In such circumstances aid is paid on that quantity of unginned cotton which, had it been of standard quality, would have yielded the fibres produced. Linking quantities on which aid is paid to the yields obtained is designed to remove the incentive to exaggerate or interfere with the weight of the raw product.

21. The Court also criticised the failure of the stabiliser mechanism to discourage increasing levels of production. In the years 1995 onwards production has continued to increase.

Current audit

22. In its current audit, which covered the years from 1999 to 2002, the Court undertook an assessment of the soundness of the Commission's management of production aid for cotton having regard to the impact, both intended and unintended, of the measure employed and rules laid down to govern the operation of the scheme together with the monitoring of activities in the Member States.

23. Audit visits were undertaken to the Commission services, to four of the main producer areas in Greece ([5]) and to Andalusia in Spain. An evaluation of the control system operating in the Member States was undertaken and included tests of compliance with national and Community rules. Evidence was obtained from

([1]) Council Regulation (EEC) No 3508/92 of 27 November 1992 (OJ L 355, 5.12.1992, p. 1).
([2]) OJ C 309, 16.11.1993, p. 1.
([3]) OJ C 340, 12.11.1996, p. 1.
([4]) Article 3 of Council Regulation (EC) No 1051/2001, defines standard quality of unginned cotton as that which contains 10 % moisture, 3 % impurities and with characteristics capable of producing, after ginning, 32 % grade 5 fibres 28 mm in length.
([5]) Nomoi of Karditsa, Larisa, Rodopi and Evros.

checking documentation and records, observation of the delivery and ginning process together with the various checks undertaken by inspectors present in the ginning mills, the analytical review of data and interviews with the main stakeholders (officials from Commission and national authorities and representatives of the association of ginners and producer groups).

MANAGEMENT BY THE COMMISSION

Concerns for budgetary discipline and the environment lead to a change to the stabiliser mechanism

24. The production of cotton within the EU has increased continuously until 2000. Annual production, which was 330 000 tonnes in 1982/83, rose to over 1,7 million tonnes (see *Table 4*). This increase is a reflection of the relative attractiveness of the aid for cotton when compared to the support offered for other crops, the increase in production following the accession of Spain to the EEC in 1986 and the enhancement of the maximum guaranteed quantity in 1995. In addition, as the support is based on quantities produced, there exists an incentive for individual producers to increase the amounts received under the scheme by maximising production ([1]). The data contained in *Table 5* demonstrates that the aid for cotton is three to four times greater than that payable for crops grown as an alternative. Furthermore, for the three years 1998 to 2000 a comparison was made of the margin over total costs ([2]) achieved for cotton production with that achieved for durum wheat and grain maize in two of the cotton growing regions in Greece and in the main cotton growing region in Spain. In both cases the margin for cotton is higher than for the two other crops. If a comparison is made of the basis of gross margins for cotton and grain maize, the results for 1999 to 2000 indicate a ratio of about 1,5 in favour of cotton.

25. While the application of the stabiliser mechanism limits Community expenditure in the face of increasing levels of production, the amount of the aid is also determined by the value of the unginned cotton acquired by the ginners. When market prices remain low for an extended period of time, expenditure increases. A comparison of the aid payable for market prices varying between 200 and 350 euro per tonne is provided in *Table 3*. In the years 1995/96 to 2001/02 the cost to the Community of supporting cotton exceeded 770 million euro in 1996/97, 1998/99, 1999/2000 and 2001/02 (see *Table 4*).

26. Also, the upward trend in production has led to concerns about the impact on the environment ([3]) from intensive farming and the practice of monoculture ([4]) and the growing of cotton in areas less suited to its production. Such concerns were voiced in a proposal for a Council regulation ([5]), presented by the Commission in 1999 which identified a significant rise in areas sown and output. The regulation adopted in 2001 requires the Member States to take the environmental measures they consider suitable and, before 31 December 2004, provide the Commission with a report on the environmental situation in the cotton sector and of the impact of the national measures adopted ([6]). When this information is received and evaluated, the Commission will be able to make more informed decisions about sustainable levels of production.

27. Included in the 1999 Commission proposal was a revision to the stabiliser mechanism which would have the impact of making the support for cotton somewhat less attractive ([7]) and reduce the amount of Community expenditure. This change was sought to lessen the possibility of expenditure exceeding the reference amount of 770 million euro in those years when market prices are low. The Council did not favour the proposal and, instead, adopted a change to the stabiliser mechanism which applies when production exceeds 1,5 million tonnes ([8]). If this threshold is exceeded, the revision to the mechanism causes rates of support to fall more sharply than previously. As production in the three previous years had averaged 1,6 million tonnes, it was likely that the revised stabiliser mechanism would be applied in the first year of its coming into force.

([1]) This statement holds true until production reaches 1,5 million tonnes. Thereafter, the overall amount received by the producers falls because the penalty imposed for production in excess of guaranteed quantities outweighs the additional support received from increased production.

([2]) Margin over total costs is defined as total production and subsidies less intermediate consumption (seed, fertiliser, crop protection, fuel, water, upkeep, energy, contract work and other direct costs), depreciation, wages, rent and interest.

([3]) Cotton production uses water, chemicals (soil disinfectants, growth regulators, herbicides, pesticides, defoliants), fertilisers and plastic (mulching and containers for chemicals).

([4]) The practice of monoculture, over time, can lead to soil exhaustion and depletion of water stocks.

([5]) COM/99/0492 final.

([6]) Article 17 of Council Regulation (EC) No 1051/2001.

([7]) It proposed an enhancement in the reduction in the guide price from 50 % to 60 % of the rate of overshoot of the GNQs which was estimated would reduce Community expenditure by an annual amount of approximately 75 million euro.

([8]) Article 7(4) of Council Regulation (EC) No 1051/2001. When production exceeds 1,5 million tonnes (Greece 1 138 000 tonnes, Spain 362 000 tonnes), the reduction in the guide price of 50 % of the rate of overshoot of the GNQs is increased by two percentage points for each additional 20 000 tonnes produced (Greece 15 170 tonnes, Spain 4 830 tonnes).

Table 4

Expenditure on aid for cotton production since 1982.

	Quantities eligible for aid (tonnes)					Expenditure (EUR million (*))				
Year	Greece	Spain	Italy	Portugal	EU (10, 12 or 15) (1)	Greece	Spain	Italy	Portugal	EU (10, 12 or 15) (1)
1982/83	333 162				333 162	124,7				124,7
1983/84	428 453				428 453	106,2				106,2
1984/85	481 246				481 246	151,1				151,1
1985/86	561 540				561 540	355,0				355,0
1986/87	667 779	284 550			952 329	468,1	199,5			667,6
1987/88	600 448	275 070			875 518	358,2	164,1			522,3
1988/89	805 856	383 619	99		1 189 574	434,9	207,0	0,1		642,0
1989/90	886 919	211 599	29		1 098 547	398,0	95,0	0,01		493,0
1990/91	709 871	281 838	32		991 743	313,4	124,4	0,1		437,9
1991/92	719 449	279 575	—		999 024	499,1	186,5	—		685,6
1992/93	760 685	223 932	—		984 617	570,1	167,8	—		737,9
1993/94	985 676	98 883	—		1 084 559	602,6	60,5	—		663,1
1994/95	1 191 400	143 249		—	1 334 649	603	72,5		—	675,5
1995/96	1 364 798	104 400		1	1 469 199	671,4	76,2		—	747,6
1996/97	927 650	300 221		—	1 227 871	603,3	191,5		—	794,7
1997/98	1 085 482	379 358		99	1 464 942	590,9	179,1		—	770
1998/99	1 210 900	337 567		147	1 548 614	675,5	220,4		—	895,9
1999/2000	1 350 677	409 518		73	1 760 268	640,1	213,5		—	853,9
2000/01	1 272 873	300 657		0	1 573 530	544,9	190,2		—	735,1
2001/02	1 273 103	336 984		612	1 574 699	571	233			804

(1) The figures for the marketing years 1982 to 1986 (10 EU Member States).
The figures for the marketing years 1986 to 1994 (12 EU Member States).
The figures for the marketing years 1994 to 2001 (15 EU Member States).
(*) Million Ecu up to 1998.
Source: Commission DG Agri/C/200.

Table 5

Comparison of the aid for cotton with that paid for alternative crops
AID PER HECTARE

(EUR/ha)

Crop/Region	Cotton	Maize	Cereals (excluding maize)	Durum wheat	Oilseeds	Protein crops	Non-fibre flax
Andalusia (irrigated)	2 071	478	234	530	584	338	452
Greece (region 1)	1 508	484	191	550	349	275	369

Source: Commission working paper, 'The Cotton Sector in the European Union' (Sec(2000)1630 of 5.10.2000).
NB:
(a) The table ignores costs of production.
(b) Higher profitability in Andalusia compared to Greece is a reflection of higher average yields in Spain.
(c) Average annual aid in the years 1995 to 1999.

Comparison of margins over total inputs for cotton as compared with durum wheat and grain maize

(EUR/ha)

Macedonia-Thrace	**1998**	**1999**	**2000**
Cotton	616	572	572
Durum wheat	301	192	192
Grain maize	144	119	113
Thessaly	**1998**	**1999**	**2000**
Cotton	445	738	989
Durum wheat	341	344	387
Grain maize	15	598	191
Andalusia	**1998**	**1999**	**2000**
Cotton	1 241	1 132	1 253
Durum wheat	545	488	533
Grain maize	736		1 064

Source: Commission DG AGRI/G.3, March 2003.

Stabiliser system

28. When production reaches the stated thresholds for implementing the strengthened stabiliser mechanism (Greece 1 138 000 tonnes and Spain 362 000 tonnes), the minimum price payable to the producer is reduced by 24 % (24,18 euro/100 kg). When production reaches 1,7 million tonnes (an increase of 13 % over the thresholds) the minimum price is reduced by 48 % (48,28 euro/100 kg) and when production reaches 1,840 million tonnes (an increase of 23 % over the thresholds) the support payable to the producer is reduced by 69 % (70,07 euro/100 kg). While market prices do vary, it is in or around this level of penalisation that the amount of the aid diminishes to nothing ([1]) and the amount payable to the producer equates to the commercial value of the cotton.

29. In 2001/02 marketing year, which was the first year of the application of the new Community and national rules, Greek production reached 1,354 million tonnes which is 19 % greater than the threshold for implementing the strengthened stabiliser mechanism. The Greek authorities made application to the Commission to have production totalling 206 362 tonnes regarded as outside of the scheme and neither grant aided nor taken into consideration when deciding the level of penalisation to apply to the aid rate. This procedure was not covered by the regulations. The Commission highlighted certain issues in the conception of the regulations, namely:

(a) there was an absence of precise rules on whether all production or only that produced in accordance with Community rules should be utilised to determine the impact of the stabiliser mechanism;

(b) if, as had been the previous practice, all quantities of sound, fair and merchantable quality produced were used to determine the amount of the penalty, the support received by the producers would have been reduced by 58 % which is considerably greater than the penalty applied in any previous year ([2]); after the examination of the data provided by the Greek authorities the Commission excluded 144 551 tonnes from the scheme which resulted in a 41 % reduction in the minimum price paid to the producers;

(c) the practice of including all production in deciding upon the level of penalisation was at variance with the approach generally followed in other agricultural support schemes;

(d) there was an absence of a specified time limit for completion of the on-the-spot checks of the area declarations submitted by cotton producers; such checks are ineffective if they are not undertaken while the plant is still in the ground; the findings from these checks are necessary in reaching a conclusion as to the reliability of the data on areas declared for cotton production and the probable yield individual growers should produce and deliver to the ginning undertakings.

30. These findings, identified by the Commission in this particular case, prompted the introduction of amending legislation in August 2002, which defines the quantities eligible for aid and the quantities to be included in the determination of the impact of the stabiliser mechanism. Only cotton of fair, sound and merchantable quality, coming from areas declared under IACS and not coming from areas excluded for environmental reasons can be eligible for aid and used to determine the level of penalisation. These rules were applied to the determination of the effect of the stabiliser mechanism on the aid rate for Greek production in 2001/02 and, as stated, resulted in a 41 % reduction in the minimum price paid to the producers.

31. In 2001, actual production in Greece was much greater than that forecasted and a danger existed that the amounts paid by way of advance would be higher than that finally determined as due. When this possibility became apparent, the Greek paying agency instructed the ginners to pay the commercial value only for cotton delivered in excess of thresholds fixed for each producer.

Difficulties in verifying the accuracy of the area declarations and in establishing eligible quantities

32. Previously, aid had been paid on quantities entering the ginning mills in accordance with the rules laid down, one of which was that the producer must have made a declaration of areas sown with cotton. The 2002 amending legislation (introduced because of the necessity to clarify eligibility requirements) specifically excludes cotton coming from an area not declared or coming from an area restricted for environmental reasons from receiving aid. Such cotton cannot be identified with absolute precision and national authorities will be obliged to make a decision as to which quantities are accepted under the scheme and which should be the subject of further checking.

([1]) Aid is the guide price of 106,3 euro reduced by the penalty (in this example 70 euro) and the value of the unginned cotton.

([2]) In the four previous years the penalty applied caused, on average, a reduction of 29 % in the minimum price paid to Greek producers.

33. Over the years, national authorities have undertaken checks of coherence between the quantities delivered and areas declared and obtained data on yields achieved. As there can be many reasons why yields might vary, such as weather conditions, farming practices and varieties sown, it is a matter for the national authorities to make a judgment as to the yields which might reasonably have been obtained from the areas declared. However, weaknesses in IACS in Greece limits the reliability of the system as a source of accurate and comprehensive information on which to base judgments and as a tool for further checking. Furthermore, as it is impossible in practice to check the origin of all deliveries to ginning mills, the risk exists that aid will be paid on quantities cultivated on undeclared areas or from areas excluded for environmental reasons. To the extent that ineligible produced cotton goes undetected, it has the effect of penalising all bona fide producers through the application of higher penalties.

34. The regulations require that the national authorities verify the accuracy of at least 5 % of the area declarations through the use of on-the-spot inspections which compare the area planted with cotton with that declared [1]. Such checks will establish if producers tested have submitted accurate declarations with regard to areas declared. However, on-the-spot inspections may fail to identify areas planted to cotton but not declared.

35. With regard to the on-the-spot inspections undertaken in 2000, the Greek national authorities discovered only three discrepancies in over 5 000 area declarations checked. In contrast, extensive checking undertaken in the following year concluded that about 10 % (44 000 hectares) of the total area cultivated was either not declared under IACS or was declared as cultivated with another crop. In that year (2001) 94 000 producers submitted area declarations showing cotton cultivation on a total of 379 000 hectares. Given that the average area cultivated by each producer was four hectares, it is likely that a substantial number did not declare the full extent of the areas devoted to cotton in 2001. The extensive checks carried out by Greece in 2001 provided the basis for a regulation of the Commission to place a quantity of cotton outside the scheme. This cotton came from areas not eligible for aid pursuant to Article 17(3) of Council Regulation (EC) No 1051/2001 [2] or from areas not declared under IACS or declared as cultivated with another crop. This had an impact of lowering the penalty for overproduction and increasing the support to producers.

The financial position of the ginners under the scheme has not been reviewed in the light of changing circumstances, in particular increasing levels of production

36. The regulation provides that [3], for the purpose of determining the amount of the aid, the unginned cotton acquired by the ginners is deemed to have a value of between 20,6 % to 24,4 % of the internationally quoted price for ginned cotton. The mechanism for determining how much aid is paid to the ginners is designed in such a way as to provide the ginner with a trading profit, sufficient to cover the cost of ginning of between 98,8 euro and 125,4 euro/tonne (see *Table 6* for detail).

37. Prior to 1995, the Commission calculated the cost of ginning and set the value of the unginned cotton at a level which provided the ginners with funds sufficient to cover the operating costs incurred by them. However, as this exercise proved cumbersome and difficulties were experienced in getting sufficient and reliable data, a simplified procedure was introduced [4] which determines the value of the unginned cotton with reference to the historical relationship between the market price of the ginned cotton and the value determined by the Commission for the unginned cotton.

38. The cost of ginning may have changed with the passage of time and with increased throughput but the Commission has not reviewed the funding received by ginners against actual operating costs and is thus unaware of whether a potential exists to reduce Community expenditure by altering the percentages applied. None of the ginners interviewed during the audit expressed dissatisfaction with the mechanism used to determine the value of the unginned cotton.

(1) Article 13(1)(a) of Commission Regulation (EC) No 1591/2001.
(2) Article 17(3) of Council Regulation (EC) No 1051/2001 makes provision for Member States to restrict the areas eligible for production aid for unginned cotton on the basis of objective criteria related to the environment.
(3) Article 2(2) of Commission Regulation (EC) No 1591/2001.
(4) Article 3 of Council Regulation (EC) No 1554/1995 of 29 June 1995 (OJ L 148, 30.6.1995, p. 48).

Table 6

Funding received by ginners

For this table, the harvest is 1,5 million tonnes of unginned cotton, with a standard yield of 32 %, produces 480 000 tonnes of ginned cotton

A	B	C	D	E	F	G	H	I	J	K	L	M
Market value ginned cotton (euro/tonne)	Value of unginned cotton (euro/tonne) (1)	Revenue cotton sales EUR 1 000 (A × 480 000)	Guide price EUR 1 000 (2)	Value of unginned cotton EUR 1 000 (B × 1,5 mio)	Penalty EUR 1 000 (3)	Aid EUR 1 000 (D – (E + F))	Total revenue EUR 1 000 (C + G)	Paid to producers EUR 1 000 (4)	Funds to ginners EUR 1 000 (H – I)	Contribution to administrative costs EUR 1 000 (5)	Trading profit EUR 1 000 (J – K)	Trading profit euro/tonne
900	185,4 (20,6 %)	432 000	1 594 500	278 100	362 600	953 800	1 385 800	1 152 250	233 550	79 650	153 900	102,6
950	195,7 (20,6 %)	456 000	1 594 500	293 550	362 600	938 350	1 394 350	1 152 250	242 100	79 650	162 450	108,3
1 000	206 (20,6 %)	480 000	1 594 500	309 000	362 600	922 900	1 402 900	1 152 250	250 650	79 650	171 000	114
1 050	216,3 (20,6 %)	504 000	1 594 500	324 450	362 600	907 450	1 411 450	1 152 250	259 200	79 650	179 550	119,7
1 100	226,6 (20,6 %)	528 000	1 594 500	339 900	362 600	892 000	1 420 000	1 152 250	267 750	79 650	188 100	125,4
1 150	250,7 (21,8 %)	552 000	1 594 500	376 050	362 600	855 850	1 407 850	1 152 250	255 600	79 650	175 950	117,3
1 200	261,6 (21,8 %)	576 000	1 594 500	392 400	362 600	839 500	1 415 500	1 152 250	263 250	79 650	183 600	122,4
1 250	287,5 (23,0 %)	600 000	1 594 500	431 250	362 600	800 650	1 400 650	1 152 250	248 400	79 650	168 750	112,5
1 300	317,2 (24,4 %)	624 000	1 594 500	475 800	362 600	756 100	1 380 100	1 152 250	227 850	79 650	148 200	98,8
1 350	329,4 (24,4 %)	648 000	1 594 500	494 100	362 600	737 800	1 385 800	1 152 250	233 550	79 650	153 900	102,6
1 400	341,6 (24,4 %)	672 000	1 594 500	512 400	362 600	719 500	1 391 500	1 152 250	239 250	79 650	159 600	106,4
1 450	353,8 (24,4 %)	696 000	1 594 500	530 700	362 600	701 200	1 397 200	1 152 250	244 950	79 650	165 300	110,2
1 500	366 (24,4 %)	720 000	1 594 500	549 000	362 600	682 900	1 402 900	1 152 250	250 650	79 650	171 000	114

(1) Commission Regulation (EC) No 1591/2001, Article 2, provides that unginned cotton be valued as a percentage of the market value of ginned cotton.
(2) Guide price of 1 063 euro/tonne multiplied by 1,5 million tonnes.
(3) Abatement following the application of the stabiliser mechanism.
(4) Minimum price of euro 1 514 850 000 less penalty of euro 362 600 000. (Minimum price = 1 009,9 euro/tonne multiplied by 1,5 million tonnes = 1 514 850 000).
(5) An amount of 53,1 euro/tonne paid to ginners to cover the cost of administration.

Not all ginners differentiate on quality when purchasing cotton and the 'quality incentive' appears to be nothing more than a source of additional income

39. The Community scheme recognises that varying qualities of cotton can be produced and stipulates that producers should be paid according to the quality of the product delivered.

40. In Greece not all ginners pay the producers on the quality of particular batches, preferring instead to offer the producers a price equal to that which would be paid for cotton of above average quality [1]. This practice removes the incentive for producers to apply cultivation and harvesting techniques which result in the delivery of best quality cotton.

41. In addition to the above, provision exists to pay aid to the ginner on a quantity greater than that delivered when the quality of the ginned cotton received in any year is higher than standard [2]. The percentage increase in quantity is limited to 3,125 % [3] and is calculated when all ginning has been completed and is based on the yields achieved for the year taken as a whole. The Commission has no specific knowledge about the success or otherwise of this provision in improving the quality of the cotton produced. Furthermore, there is no requirement within the regulation for the ginner to pass this additional revenue onto the producers.

42. While the wish to promote quality is laudable, the market place, through increased revenues, already offers the incentive to improve the quality and the quantity of the fibres produced. On the basis of the evidence available, it appears that the incentive paid to improve quality is little more than an additional source of revenue for the ginners.

(1) Some ginners take the view that, as the unginned cotton is processed in bulk, there is no incentive for them to measure the specific quality characteristics of individual batches and to determine and pay the producers slightly different amounts for each batch delivered.

(2) Article 15 of Council Regulation (EC) No 1051/2001.

(3) In each year and for both producer Member States, the quantity on which the aid is paid is increased by about 3 % which is close to the maximum percentage applicable. If the average aid rate is taken as 500 euro/tonne, the amount paid to ginners under this provision is in the region of 25 million euro per annum.

EVALUATION OF THE SYSTEMS OF CONTROL IN THE MEMBER STATES

43. In the period between October 2001 and February 2002, the Court undertook a specific examination of aid for cotton in connection with its obligation to provide a statement of assurance on the 2001 financial statements of the Commission [4]. Material observations arose from the Court's audit of the controls operating in Greece only.

Absence of the application of risk criteria and poor quality of checking in Greece

44. One key control is a check on the existence of producers and the reasonableness of the quantities delivered utilising data from the area declarations submitted by producers. The effectiveness of this control relies on the correct application of IACS in the Member States. Many deficiencies have been noted in its operation in Greece. Because these deficiencies continue, the findings reported in the Court's 2001 Annual Report are mentioned hereafter.

45. In Greece, around 30 % of parcels declared use references which are incompatible with the IACS references. This renders it impossible to confirm the area of these parcels. In addition, computerised systems allow multiple entry of reference numbers for individual registration of parcels.

46. Also, risk criteria were not used to select the sample for checking and there were no clear comprehensive instructions as to the timing and methodology to be applied to on-the-spot checks of area declarations submitted by cotton producers and for 2000/2001 marketing year, very few discrepancies were reported (0,05 % of the number examined). An error rate of 0,05 % contrasts with the results of the Court's audit testing on the accuracy of the area declarations for 2001/2002. In 16,7 % of the cotton declarations checked, significant differences were found (exceeding national tolerances) between the areas declared and those cultivated with cotton. The error rate of 0,05 % is also inconsistent with the results of checks by the authorities to identify quantities to be excluded from production for the purposes of applying the stabiliser mechanism.

47. Because of the material difference between forecast and actual production in 2001, the Greek authorities undertook investigations which concluded that about 10 % of the land sown to cotton in 2001 was either not declared under IACS or was declared as being cultivated with another crop. This finding is an indicator that producers submit aid applications for arable crops for areas

(4) OJ C 295, 28.11.2002, p. 1.

on which they produce cotton. In such circumstances and if not detected, growers receive EU aid twice for the same parcels of land, once on the basis of the arable crop declaration and again on the basis of actual production of cotton. This situation illustrates the difficulties in monitoring EU aid payments when the underlying integrated administration and control system (IACS) has not been properly applied.

CONCLUSIONS

48. In its previous audits, the Court criticised the scheme's vulnerability to irregularity and weaknesses in controls and the inclusion of fictitious quantities (in Greece) on which aid was paid. The Commission's revision of the scheme in 1995 addressed this failure (paragraph 20). However, other weaknesses exist in the regime.

Mechanism employed and its effect on Community expenditure

49. The increase in cotton production over the last 20 years, from 0,3 million tonnes to 1,7 million tonnes, reflects the relative attractiveness of the scheme compared to other crops; aid for cotton is three to four times greater than that paid for crops grown as an alternative. Comparison in terms of gross margins per hectare indicate a ratio of about 1,5 in favour of cotton. About a quarter of the increase in production is due to the accession of Spain to the EEC in 1986 (paragraph 24).

50. A stabiliser mechanism introduced in 1987 has been effective at reducing the support payable after production exceeds guaranteed quantities. However, as movements in market prices are also reflected in the aid rate, the Commission does not have control over final expenditure and budget neutrality can never be assured (paragraph 25).

51. When market prices are low, the cost is borne by the Community in the form of an increase in the aid rate payable. In contrast, in those years when market prices and production levels are high resulting in Community expenditure not reaching 770 million euro, additional support is paid to the producers. This measure mitigates the effect of the stabiliser mechanism (paragraphs 11 and 25).

52. Community aid combined with sales revenue provide the ginners with a constant level of income to cover their operating and administrative costs. Since 1995, the Commission has not reviewed the extent to which the funds remaining to the ginners after the payment of the minimum price to the producers reflect the actual costs incurred by them and is thus unaware of whether any potential exists to reduce Community expenditure (paragraphs 36 and 37).

53. Lack of clarity in the rules governing the operation of the scheme led to the introduction of amending legislation in 2002 which defines quantities eligible for receiving aid and the quantities to be taken into account when determining the penalty for overproduction (paragraphs 29 and 30).

54. The amended rules state that aid may only be paid on quantities coming from an area declared under IACS and not from an area excluded for environmental reasons. Weaknesses in the operation of IACS limits the ability of the Commission to monitor the correct application of the stabiliser mechanism. Checks on the origin for all deliveries to ginners is impossible in practical terms. The results of controls undertaken by national authorities in 2000 and 2001 demonstrate variations on the quality of work executed to verify the accuracy of the area declarations and the eligibility to aid of quantities delivered to ginning plants. To determine eligible quantities, national authorities will be required to exercise judgment as to the probable yields of unginned cotton coming from the areas declared. As there can be many reasons why yields might vary, the ability of the Commission to monitor this aspect of the scheme has been weakened. To the extent that ineligible produced cotton goes undetected, all producers, without distinction, are penalised through a higher reduction in the minimum price (paragraphs 32 to 34).

Environment

55. Cotton production can have a negative impact on the environment and the Member States concerned should determine and adopt the measures they consider suitable to regulate the use of land for cotton production. Currently no information is available on the application of this provision since it is not continuously monitored by the Commission. Member States will, as required by the regulations, provide the Commission with a report on the environmental situation in the cotton sector and on the impact of measures taken before 31 December 2004 (paragraph 26).

Promotion of quality

56. The scheme promotes the quality of cotton by allowing adjustments to be made to the amounts paid to the producers on the basis of the quality of the product delivered. In Greece, not all ginners pay differing amounts for differing qualities which removes the incentive to produce best quality cotton. In addition, the Commission is unaware of the effectiveness or otherwise of the

quality incentive given to the ginners. This incentive duplicates the additional revenue coming from the market place when better quality and higher yields are achieved (paragraphs 39 to 42).

Systems of control

57. The Court's examination of the checks undertaken in the Member States has revealed continuing serious weaknesses in Greece, in particular those related to the checking of the areas declared by cotton producers (paragraphs 43 to 47).

RECOMMENDATIONS

58. The Court recommends that the Commission takes the opportunity to address the weaknesses identified in the present regime when formulating its reform proposals. In particular, the Court recommends that the Commission

(a) considers the incorporation of a mechanism which ensures budget neutrality and which does not mitigate against the impact of the stabiliser mechanism;

(b) has regard to the relative attractiveness of the aid for cotton and the effect of the aid on quantities produced;

(c) obtains data on the negative impact of cotton production on the environment.

59. With regard to the present scheme the Court recommends that the Commission:

(a) ensures that the controls operated in Member States for establishing eligibility for aid are transparent, well-founded and applied consistently;

(b) reviews the financial arrangements for the ginners;

(c) examines the effectiveness of the incentive offered to improve the quality of the cotton produced.

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 24 and 25 September 2003.

For the Court of Auditors

Juan Manuel FABRA VALLÉS

President

THE COMMISSION'S REPLIES

EXECUTIVE SUMMARY

IX. In the context of a deficiency payments scheme, expenditure depends by definition, at least partially, on world prices, and consequently budget neutrality as mentioned by the Court cannot be assured.

As an integral part of the stabiliser, this provision is a reduction of the penalty in the level of support when the expenditure does not reach EUR 770 million.

X. Since 2001, on the basis of Council Regulation (EC) No 1051/2002, Member States have applied national environmental provisions, which have been examined by the Commission.

The follow-up of these national measures and the subsequent report to be submitted by Member States before the end of 2004 should give the Commission additional information on the environmental situation in the cotton sector.

XI. The Commission considers that the fact that the yields in ginned cotton are usually higher than the standard 32 % is an indicator of the effectiveness of the provisions relating to the improvement of quality.

The quality premiums on the world market prices for ginned cotton are relatively modest and, considering the level of world prices for ginned cotton, might not be a source of significant additional revenue for ginners.

The Commission has in the past tried to review the operating costs incurred by ginners but discussions with the Member States were inconclusive due to the high variability of the results. Consequently, in the context of the 1995 reform, the Council decided to determine the calculation of the world price of unginned cotton on the basis of the historical ratio between the world price for ginned cotton and that calculated for unginned cotton, which took the ginning costs into account.

XII. The Commission is well aware of the problems linked to deficiencies in the IACS in Greece and in particular the land parcel identification system and controls on it, and they are closely monitored under the clearance of accounts procedure, for area aid and the other aid schemes alike.

The same applies to the phenomenon of the under-declaration of land under cotton in Greece. This phenomenon is the result not only of the problems with the IACS in Greece, but also the new national environmental rules, the fact that some producers are trying to circumvent them, and their underestimation of the importance of the link between the quantities produced (the purpose of the aid) and the land on which those quantities are grown.

XIII. The Commission will take the weaknesses mentioned by the Court into consideration when formulating the reform proposals. In addition, it will also take account of the fact that the present regime is highly complicated and not in line with the recent evolution of the CAP.

INTRODUCTION

11. As an integral part of the stabiliser, this provision is a reduction of the penalty in the level of support when expenditure does not reach EUR 770 million.

17. Both Community expenditure and the amount received by producers are primarily dependent on the quantities produced.

20. The amending legislation introduced in 1995 included several measures with a view to improving the management of the scheme. Among these, the most relevant were:

— the division of the MGQ into guaranteed national quantities so as to make producers in each Member State more accountable for their production,

— the increase in the MGQ accompanied by a proportional reduction in the guide and minimum prices with a view to adapting these quantities to the recorded average production, maintaining budget neutrality,

— the abolition of the special aid scheme for small producers which did not serve its original purpose and,

— as the Court mentions, a provision linking eligible quantities to the yields obtained.

In 2001, a strengthening of the stabiliser mechanism introduced an accelerated reduction in the support payable when production exceeds 1,5 million tonnes. The impact of the strengthened stabiliser is such that relatively modest increases in production above this threshold cause a sharp drop in the support payable for the whole production.

MANAGEMENT BY THE COMMISSION

24. In 1995, the MGQ was increased and the guide price was proportionally reduced with a view to keeping these changes budgetarily neutral.

25. In the context of a deficiency payments scheme, the expenditure depends by definition, at least partially, on world prices.

26. Until 2000, the Commission had limited power to require detailed environmental provisions for cotton growing, as cotton was included neither in the Annex to Council Regulation (EC) No 1259/1999 nor in Council Regulation (EC) No 1257/1999.

Since 2001, on the basis of Council Regulation (EC) No 1051/2001, Member States have applied national environmental provisions, which have been examined by the Commission.

The follow-up of these national measures and the subsequent report to be submitted by Member States before the end of 2004 should give the Commission additional information on the environmental situation in the cotton sector.

28. The penalties applied in each Member State due to the stabiliser system depend almost exclusively on each Member State's production. Therefore, penalties are higher in the Member State mainly responsible for overproduction.

29. After a detailed examination of the figures communicated by Greece as well as a legal assessment of the breakdown of the 206 362 tonnes, the Commission took the following measures:

— 6 376 tonnes were not included in the scheme because they were not of sound and fair merchantable quality;

— 61 811 tonnes were included in the actual production and the remaining 138 175 tonnes were excluded.

(a) Following the same line of interpretation of the legal texts, clarification on the production eligible for aid and on the production to be taken into account for the stabiliser mechanism was straightaway added to the legislation so as to be in force as from the following marketing year, i.e. 2002/03.

(d) Since the 2002/03 marketing year, the deadline for completion of the on-the-spot checks on area declarations has been fixed at 15 November, just before the time of the revised production estimates.

The potential risks to the EAGGF of any inadequacies in on-the-spot checks of land under cotton are allowed for in the clearance-of-accounts procedure. Thus, financial corrections have already been applied and will continue to be applied where necessary.

33 to 35. The Court's comments refer mainly to the weaknesses in the Greek control systems. These weaknesses are well known by the Commission services. The potential risks to the EAGGF of weaknesses in the IACS and the administration and control system for cotton as implemented by Greece are allowed for in the clearance of accounts procedure. Thus, financial corrections have already been applied and will continue to be applied where necessary.

The Commission has also identified the potential risk arising from the method for selecting applicants for direct premiums undergoing on-the-spot checks in Greece. These risks are being analysed under the current clearance of accounts procedures.

36. Due to the absence of international quotations for unginned cotton, its price is calculated on the basis of international prices of ginned cotton, taking into account the historical relationship between the two. This relationship included ginning costs, so consequently these are indirectly considered in the calculation of the world price for unginned cotton.

38. The Commission has, in the past, tried to review the operating costs incurred by ginners but the discussions with the Member States were inconclusive due to the high variability of the results. Consequently, in the context of the 1995 reform, the Council decided to determine the calculation of the world price of unginned cotton on the basis of the historical ratio between the world price for ginned cotton and that calculated for unginned cotton, which took the ginning costs into account.

40. The aid scheme establishes that the price is to be adjusted according to the quality of the cotton delivered. This adjustment is to be determined by agreement between parties on the basis of the necessary samples taken at delivery and must concern each batch of unginned cotton. This is an incentive for individual producers to deliver better quality cotton.

The audits carried out by the Commission under the clearance of accounts have not confirmed that the system in place is failing to achieve the aim of providing an incentive to improve quality.

41. Better quality unginned cotton allows for higher yields in ginned cotton, but this can only be worked out after ginning. The increase in eligible quantities due to this provision is limited to 3,125 %, but there is no limit to the reduction that can be applied

to the eligible quantities in case of low yields due to poor quality unginned cotton. The fact that the yields in ginned cotton are usually higher that the standard 32 % means that the quality of the unginned cotton delivered is good on average. The incentive given to ginners in this way allows them to pay the producers higher prices than the minimum price, as is usually the case.

42. The quality premiums on the world market prices for ginned cotton are relatively modest and, considering the level of world prices for ginned cotton, might not be a source of significant additional income for the ginners.

EVALUATION OF THE SYSTEMS OF CONTROL IN THE MEMBER STATES

45. The Commission is well aware of the problem linked to deficiencies in the IACS in Greece and in particular the land parcel identification system (LPIS).

The resultant risks to the EAGGF are allowed for in the clearance-of-accounts procedure, for area aid and the other aid schemes alike. In the particular case of production aid for cotton, several clearance procedures are currently in progress.

46. The Commission fully recognises the serious failings referred to by the Court as regards on-the-spot checks on land parcels used for growing cotton. On the whole, they mirror the findings regularly made by the Commission in its reports.

47. The land irregularly declared under the IACS as being under a crop other than cotton creates a risk for the area aid, and account is taken of this in the clearance of accounts procedures.

The aspects relating to the common market organisation for cotton are being analysed by the Commission under the current clearance of accounts procedures.

CONCLUSIONS

50. In the context of a deficiency payments scheme, expenditure depends by definition, at least partially, on world prices and consequently budget neutrality as mentioned by the Court cannot be assured. The reform of 2001 introduced a strengthening of the stabiliser mechanism in order to increase accelerated sanctions in the support payable when production exceeds the threshold of 1 500 000 tonnes, which can result in sharp reductions in expenditure in certain cases.

51. As an integral part of the stabiliser this provision is a reduction of the penalty in the level of support when expenditure does not reach EUR 770 million.

52. The Commission has in the past tried to review the operating costs incurred by ginners but the discussions with the Member States were inconclusive due to the high variability of the results. Consequently, in the context of the 1995 reform, the Council decided to determine the calculation of the world price of unginned cotton on the basis of the historical ratio between the world price for ginned cotton and that calculated for unginned cotton, which took the ginning costs into account.

54. The Commission considers that the amended rules produced in 2002 clarify the definition of eligible production and does not think that its ability to manage the scheme has been weakened. The weaknesses described by the Court concerning the IACS and the control system for cotton in Greece are similar to those already identified by the Commission in the framework of the clearance of accounts. Financial corrections have been applied and will continue to be applied where necessary.

55. Until 2000, the Commission had limited power to require detailed environmental provisions for cotton growing, as cotton was included neither in the Annex to Council Regulation (EC) No 1259/1999 nor in Council Regulation (EC) No 1257/1999.

Since 2001, on the basis of Council Regulation (EC) No 1051/2001, Member States have applied national environmental provisions, which have been examined by the Commission.

The follow-up of these national measures and the subsequent report to be submitted by Member States before the end of 2004 should give the Commission additional information on the environmental situation in the cotton sector.

56. The scheme provides for adjustments on the price, by common consent between the ginner and the producer, depending on the quality of each batch of unginned cotton delivered. This is an incentive for individual producers to apply agricultural practice that will result in better-quality cotton. Better quality unginned cotton allows for higher yields in ginned cotton, which can only be worked out after ginning. The fact that the yields in ginned cotton are usually higher than the standard 32 % means that the quality of the unginned cotton delivered is good on average. The quality premiums on world market prices for ginned cotton are relatively modest, so the incentive given to ginners allows them to pay the producers higher prices than the minimum price, which is usually the case.

The audits carried out by the Commission under the clearance of accounts have not formally confirmed that the system in place is failing to achieve the aim of providing an incentive to improve quality.

57. As indicated in paragraphs 42 to 46, the deficiencies relating to declarations and checks on agricultural land in Greece detected by the Court of Auditors were already identified by the Commission in previous audits. The resultant risks are being monitored closely and are allowed for under the clearance of accounts procedure, for area aid and the other aid schemes, such as production aid for cotton, alike.

RECOMMENDATIONS

58. (a) and (b). The Commission will take the weaknesses mentioned by the Court into consideration when formulating the reform proposals. In addition, it will also take account of the fact that the present regime is highly complicated and not in line with the recent evolution of the CAP.

(c) The Commission already collects all information coming to its attention.

59. (a) The Commission accepts the Court's recommendation and, as in the past, will continue to verify correct and consistent application of controls.

(b) The Commission has in the past tried to review the operating costs incurred by ginners but the discussions with the Member States were inconclusive due to the high variability of the results.

(c) The Commission considers that the fact that the yields in ginned cotton are usually higher than the standard 32 % is an indicator of the effectiveness of the provisions relating to quality improvement.