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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

**Evolution of the market situation and the consequent conditions for smoothly phasing-
out the milk quota system - second "soft landing" report**

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MANDATE

Article 184(6) of Council Regulation (EC) No 1234/2007 of 22 October 2007 establishing a common organisation of agricultural markets and on specific provisions for certain agricultural products (Single CMO Regulation) provides for the Commission to present a report before 31 December 2010 and 31 December 2012 to the European Parliament and Council regarding the evolution of the market situation and the consequent conditions for smoothly phasing out the milk quota system, accompanied if necessary by appropriate proposals. The so called first soft landing report was published on 8 December 2010 under COM(2010) 727 final while the present one constitutes the second report of the series.

STRUCTURE

This report is made up of three parts: the first one describes the evolution of the market situation for cow milk from the middle of 2010 (end date of the first soft landing report) and outlines medium term prospects, the second section examines how the phasing-out of the milk quota system has occurred while concluding remarks are presented in the third chapter.

1. EVOLUTION OF THE MARKET SITUATION FOR MILK AND MILK PRODUCTS

1.1. Market developments to date

Volatility – although not to the extent observed in 2007-2009 – persisted in the dairy market until the end of 2010. It has somewhat receded in 2011 and in 2012 so far. Prices in 2010 and 2011 fluctuated at high levels, leading to increased production and a price correction in the first half of 2012. Prices have started to move upwards again in the third quarter of 2012.

1.1.1 Milk production

Cow milk collection in the EU has consistently increased over the past three years: + 1.4% in 2010, + 2% in 2011 and some 1.5% in the first seven months of 2012 compared to the same period in 2011.

Milk output also expanded in the main milk supplying regions of the world: the combined production of USA, New Zealand, Australia and Argentina increased by 5.3% during 2010-2011. The trend is continuing in 2012, although some slowdown is observed in the USA after this summer's heat wave. As compared with the same period of 2011, milk production increased in 2012 by + 2.8% in the USA, +11.4% in New Zealand (until July only), +4.7% in Australia and + 5.9% in Argentina in the first eight months of 2012 (see graph 1 in Annex I).

1.1.2. EU farm gate milk prices

Average EU farm gate milk prices constantly increased from April till November 2010. They stayed around 33 c/kg until April 2011 and increased again to 35.1 c/kg in November 2011 as a weighted average for the EU-27 (see graph 2 in Annex I). A seasonal correction appeared in December 2011, January and February 2012, amounting to – 2%. As a matter of comparison, the seasonal correction had been - 3% at the beginning of 2010 and - 1% at the beginning of 2011.

However, in 2012, the downward pattern continued until the summer, exceeding the seasonal trend and responding to pressure from increased milk supply in and outside the EU. The latest EU average farm gate milk price is estimated at 31.3 c/kg for August 2012, which is 9.5% below the average price of July 2011, but 1.2% above that of July 2010 and 27% above the lowest level reached in May 2009.

The latest available spot milk prices and dairy product prices at the time of drafting the report were both pointing to a recovery in the near future, which should be followed at a later stage by higher farm gate milk prices.

1.1.3. Dairy product prices, stock levels and exports

Thanks to a significant recovery in prices in 2010 and most of 2011 together with a series of favourable market developments, there has been no buying-in into intervention in the period 2010-12 and public stocks are empty for both butter and skimmed milk powder. The 76 000 t butter and 257 000 t skimmed milk powder bought into public stocks during the 2009 crisis were released back onto the market, part by open tender, part under the most deprived persons' scheme, without disturbing the market.

The recovery in dairy commodity prices in 2010 was due to increased demand, notably from emerging economies, and limited supplies from the Southern Hemisphere. The same situation prevailed in the first half of 2011. But from the middle of 2011 dairy product prices came under pressure following increased availability of dairy products from the main dairy supplying regions of the world. Downward pressure continued in the first months of 2012 until EU dairy product prices found a bottom level around 120% of the (virtual) intervention price at the end of May. In June prices started to increase and developments till the date of drafting the present report have continued upwards, notably due to reduced milk availability from the US in the wake of an unprecedented heat wave and to a simultaneous drop in milk production in the EU as well, while the Southern Hemisphere was in its winter – low production - season.

EU exports increased in 2010 and 2011 for all major dairy products, with the exception of butter/butteroil and whole milk powder. EU exports have been particularly dynamic for skimmed milk powder. Good export performance has been confirmed in 2012 so far including a noticeable recovery of butter exports which, on a cumulative basis, outpaced 2011 levels in the first seven months of 2012. This has been achieved without export refunds.

1.1.4. Estimated dairy farms' margins in the EU

Based on FADN data, during most of 2011, increasing operating costs were compensated by increasing milk prices. In the 1st quarter of 2012, milk margins in the EU declined in the wake of decreasing farm gate milk prices while still remaining above those of the first quarter of 2011.

According to first estimates for the second quarter of 2012, purchased feed costs increased by 6% while total operating costs slightly decreased (- 2%) due to a significant drop in energy costs (- 10%). The gross margin index fell by 17% due to an 8% decrease in the farm gate milk price. The gross margin index is now 24% below that of the 2nd quarter of 2011, which was the second highest since 2007 (year of reference for the EU-27).

The situation varies from Member State to Member State and even within Member States, depending on the milk farming system chosen and on the product mix used by the dairy sector.

1.2. Medium term market prospects

Medium-term market prospects for the EU have been simulated with a modified version of the Aglink-Cosimo model and assume no changes in the CAP following the Health Check decisions and no changes in trade policies. This outlook is not intended to constitute a forecast of future market developments, but rather to describe what would happen under a specific set of assumptions and circumstances, which were judged plausible at the time of projections. Moreover projection results presented in this report are provisional and may differ from final values, which are to be published by November 2012.

The world market and policy environment is based on the *OECD-FAO Agricultural Outlook 2012-2021*, adapted to more recent macro-economic projections as of September 2012. Some of the most important drivers of the market projections are the EU GDP growth prospects (a slight decline in 2012, followed by economic recovery thereafter), the assumed depreciation of the Euro during the first three years of the projection period followed by an appreciation in 2014 and 2015, and an update of OECD-FAO world market price projections for dairy commodities that incorporates the impact of the 2012 drought in US and some European countries. If any of these projections/assumptions do not materialise, this would affect the resulting projections significantly. Furthermore, as in any other medium to long term model, greater price volatility expectations are not incorporated into the Aglink-Cosimo model.

Based on these projections, medium-term prospects for dairy markets appear favourable. Continued expansion of world demand, resulting from global population and economic growth, combined with increasing preference for dairy products (also as a result of growing per capita consumption) are expected to be the main drivers. Sustained import demand, particularly from emerging countries, would have a positive impact on dairy commodity prices, thus fuelling EU export potential. Nevertheless, EU market shares are projected to slightly deteriorate for most dairy products, as a result of a higher rate of increase in exports from other countries

EU milk production is projected to continue increasing from 2012 onwards at a moderate growth rate but to remain below the potential growth rate provided by the phasing-out of the milk quota regime (see graph 3 and 4 in Annex II). EU milk production is projected to register a cumulative increase of about 8% from 2009 to 2022, while milk delivered to dairies would increase by around 10%. By the last quota year (2014-15), EU milk deliveries are projected to be some 6% below quota. The expiry of the milk quota regime is projected to have a limited impact on milk deliveries at the aggregate EU level.

Projections for cheese and fresh dairy products are quite positive (see graph 5 in Annex II). EU production of fresh dairy products (including drinking milk, cream, yogurts, etc) is projected to increase by almost 8% (from 2009 to 2022) and cheese by almost 10%. Demand

prospects on both the domestic and world markets look positive, and despite a strengthening EUR towards the second part of the projection period, substantial demand on the world market would allow for a progressive increase of EU exports. However, due to more dynamic developments in the world market the EU will gradually lose world market share, though it still account for around 31% of global exports in 2022.

Whole milk powder production in the EU is expected to stay relatively stable over the short term (see graph 6 in Annex II). The medium term prospects for exports are supported by an increase in world demand, led by China. The EU share in global exports is expected to decline gradually to 14% by 2020 (from 25% in 2009).

EU skimmed milk powder production is projected to increase by about 28% throughout the outlook (see graph 7 in Annex II). A strong global import demand would contribute to a balanced market, driving a favourable outlook for exports. The EU would see its world market share reaching almost 31% of global exports in 2022.

The outlook indicates continued market stability for butter, resulting from positive market conditions over the projection period, with prices at relatively high levels and firm EU demand (see graph 8 in Annex II).

2. SMOOTH PHASING OUT OF THE MILK QUOTAS

2.1. Milk production compared to quota ceilings

Further to the decision to increase milk quotas by 2% on 1 April 2008, the Health Check deal of November 2008 resulted in an annual increase in milk quotas by 1% over five consecutive years, beginning on 1 April 2009, plus an adjustment of the fat correction factor which resulted in a further de facto 1% increase in quotas. There remains one 1% annual increase (on 1 April 2013) until the expiry of the quota system on 1 April 2015¹.

Year on year, milk quotas are gradually becoming less relevant, as actual milk output falls short of these ceilings in a majority of Member States. In quota year 2010-11, only five Member States exceeded their milk quota, while overall EU production was 6% below quota. According to notifications received from Member States, the 2011-12 quota year is estimated to have ended with EU milk deliveries approximately 4.7% under quota and only six Member States exceeded their national quotas (see Annex III). The number of Member States exceeding their quotas remains limited and the concerned surplus production accounts for less than 0.2% of all milk delivered or covered by direct sales.

After a slight contraction of milk deliveries in 2009, favourable farm gate milk prices and good weather conditions prompted increased production levels in both 2010 and 2011. When increased production – not only in the EU but in all milk supplying regions around the world – exerted downward pressure on farm gate milk prices, milk production started to respond by slowing down in the subsequent months. Those developments show that production response is gradually shaping according to market signals but also that weather conditions are a true player in the dairy market.

¹ Except for Italy for which the cumulative 5% increase was frontloaded on 1 April 2009.

With milk quotas becoming less and less relevant, EU milk supply can better respond to market opportunities, farmers' response to price signals is less distorted and efficiency gains can be achieved through restructuring.

2.2. Milk quota price evolution

The milk quota price should be decreasing with the shortening life of the quota regime and this is actually the case in a majority of Member States where the quota price is very low or equal to zero (see Annex IV).

In Member States whose milk deliveries are well below quota ceilings, the quota price is already very low or equal to zero, and no fundamental changes are expected before the expiry of the quotas regime.

However, in Member States whose milk deliveries are close to the quota ceilings and in the limited number of Member States whose milk deliveries exceed their ceilings, the quota price depends on the expectation of a surplus levy. In the future, quota purchases are projected to be further declining towards zero, with fluctuations due to occasional surplus production under favourable weather conditions and remunerating milk prices.

3. CONCLUDING REMARKS

Medium and long term prospects are favourable for the dairy sector in line with population growth and appetite for western diet in emerging economies. This does not however prevent short term market fluctuations. Price developments since the publication of the first soft landing report show a trend towards higher levels with some ups and downs along the curve. Within the latter, the current difficulties endured by dairy farmers in certain areas more severely hit by the hike in the price of feedstuffs cannot hide the overall positive picture of the sector.

In the long run, the balance between supply and demand depends on a large variety of factors, ranging from economic parameters to policy decisions. In this respect, the so-called Milk Package² which has been fully applicable from 3 October 2012 offers tools for operators in the dairy supply chain to attune their supply to the market.

Both the evolution of milk production versus milk quotas, and the downward trend in quota prices show that “soft landing” is on track. In the vast majority of Member States, quotas are no longer relevant to limiting production and the quota price has already reached zero or is approaching it.

Against this analysis, the Commission is of the view that no change is required in the existing framework, which has been providing certainty to milk producers since 2008 and is proving its efficiency in securing a smooth phasing-out towards a quota free environment.

Aside from the very concept of soft landing, some concerns are voiced with regard to rural areas in which milk production is playing a central role, in particular in the context of milk quota expiry. In this respect, the inclusion of the milk sector in the so-called "new challenges"

² Regulation (EU) No 261/2012 of the European Parliament and of the Council of 14 March 2012 amending Council Regulation (EC) No 1234/2007 as regards contractual relations in the milk and milk products sector

under the second pillar of the CAP is providing further support to dairy farmers in preparing for the end of quotas.

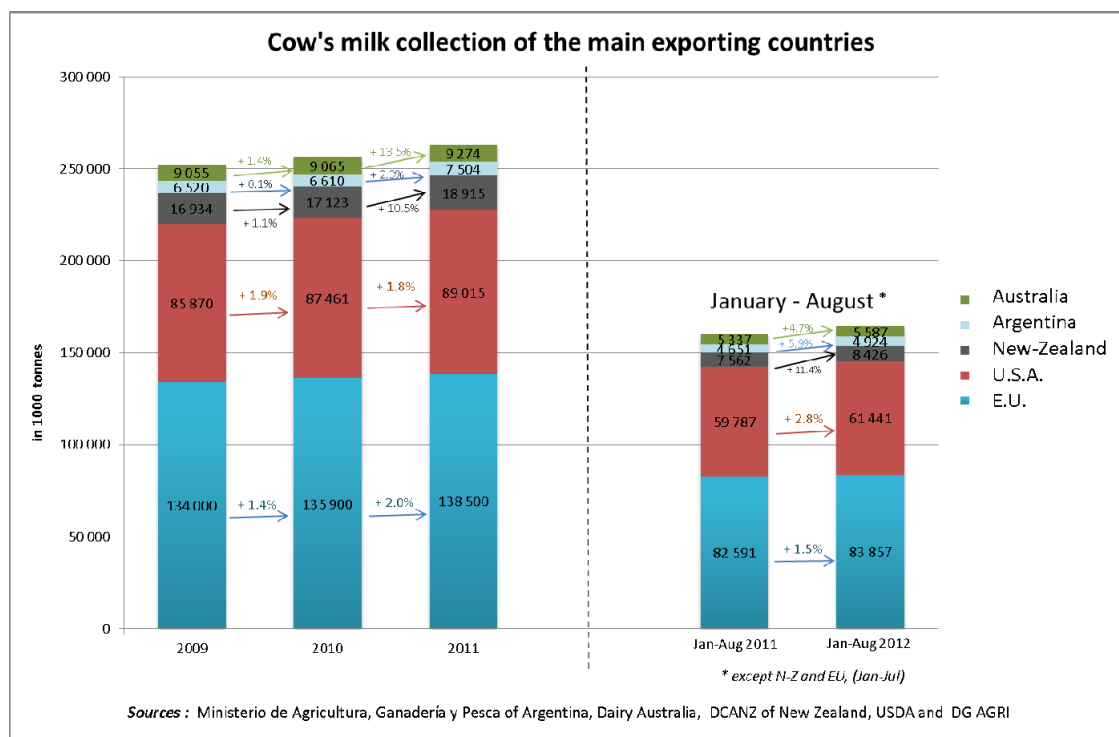
The CAP reform proposals contain instruments that could mitigate potential impacts. Furthermore, the Commission has issued an open call for tenders for an analysis by independent experts of future developments in the milk sector from 2015 onwards, and will report to the European Parliament and the Council by 30 June 2014 on the concrete operation of the Milk Package provisions³, assessing, in particular, the effects on milk producers and milk production in disadvantaged regions in connection with the general objective of maintaining production in such regions, and covering potential incentives to encourage farmers to enter into joint production agreements.

- Annexes:
- I. Milk price development
 - II. Medium term prospects in the dairy sector
 - III. Milk production versus quota
 - IV. EU milk quota price developments

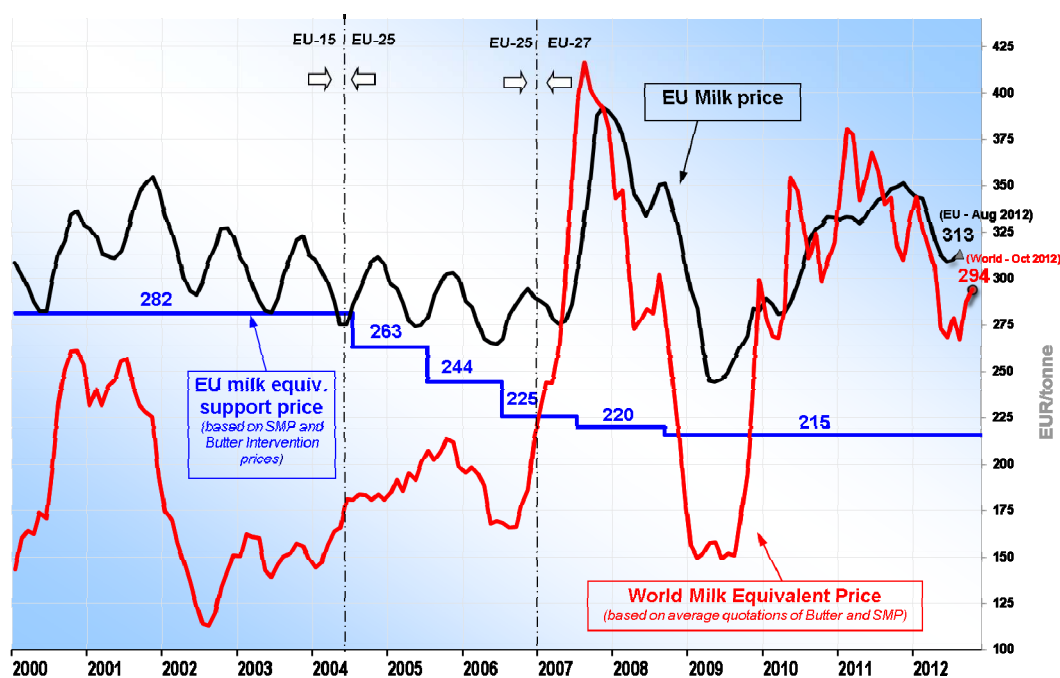
³ See point 9 of Article 184 of the single CMO Regulation 1234/2007, as inserted by the so-called Milk Package Regulation 261/2012.

ANNEX I. MILK PRODUCTION & PRICE DEVELOPMENTS

Graph.1 Milk collection developments

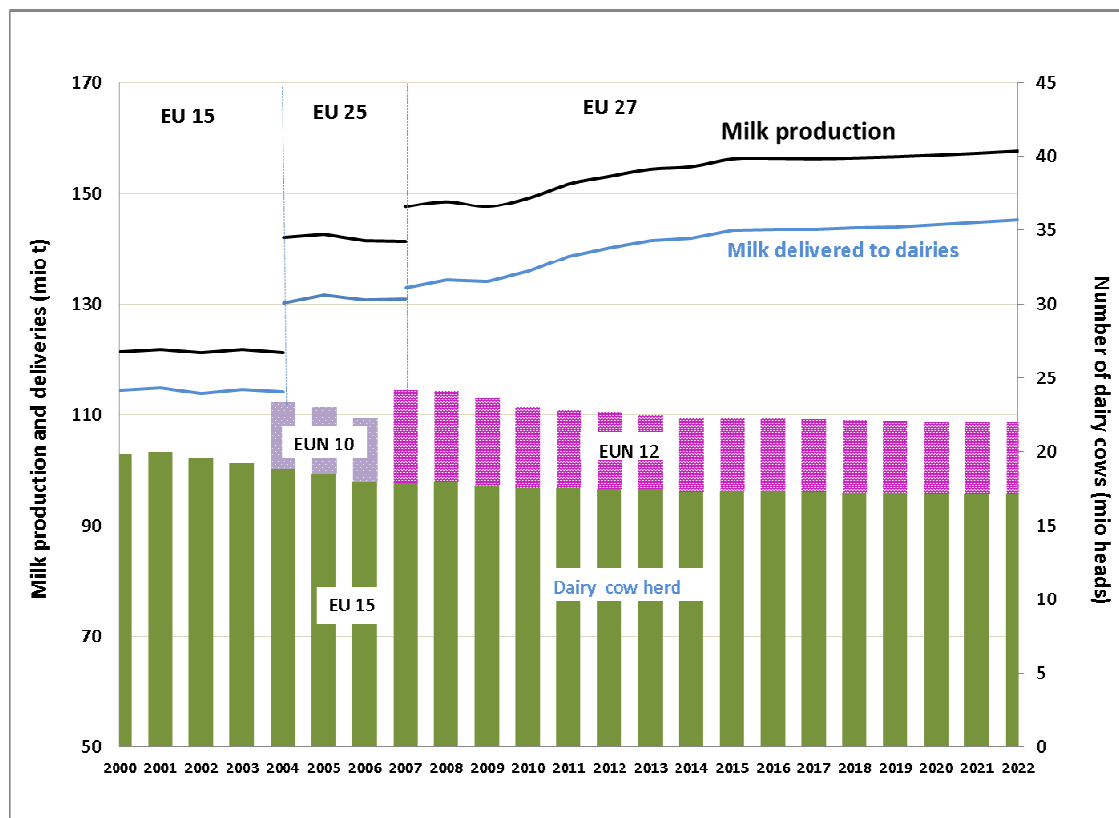


Graph.2 Milk price developments

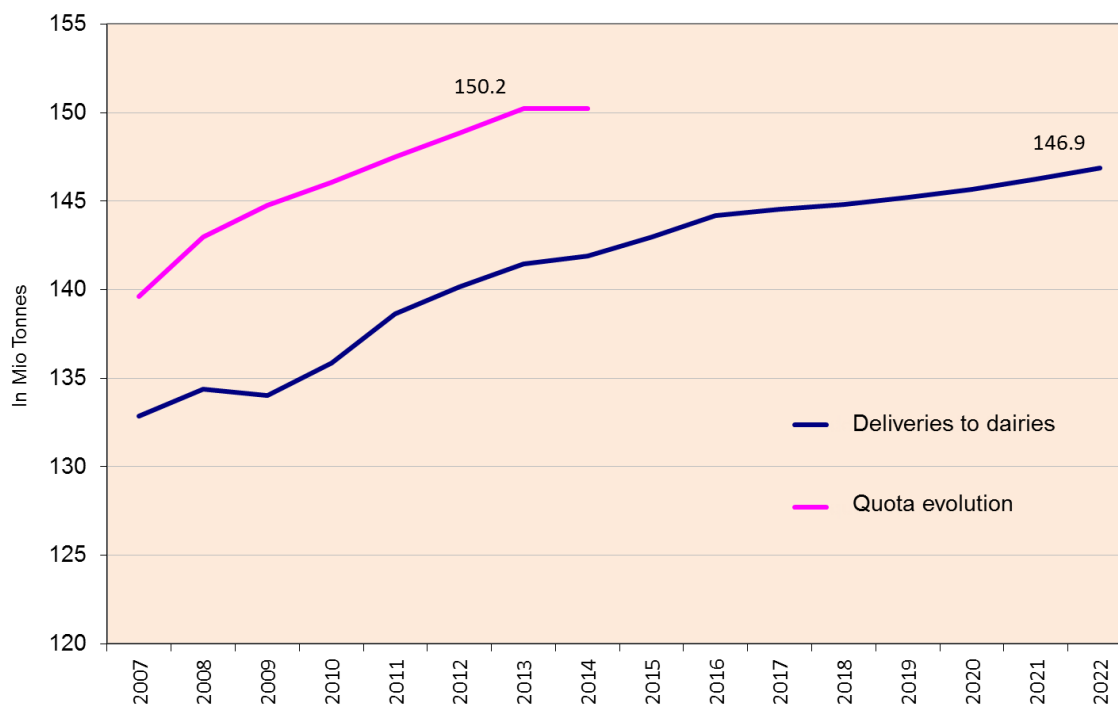


ANNEX II. MEDIUM TERM PROSPECTS IN THE DAIRY SECTOR

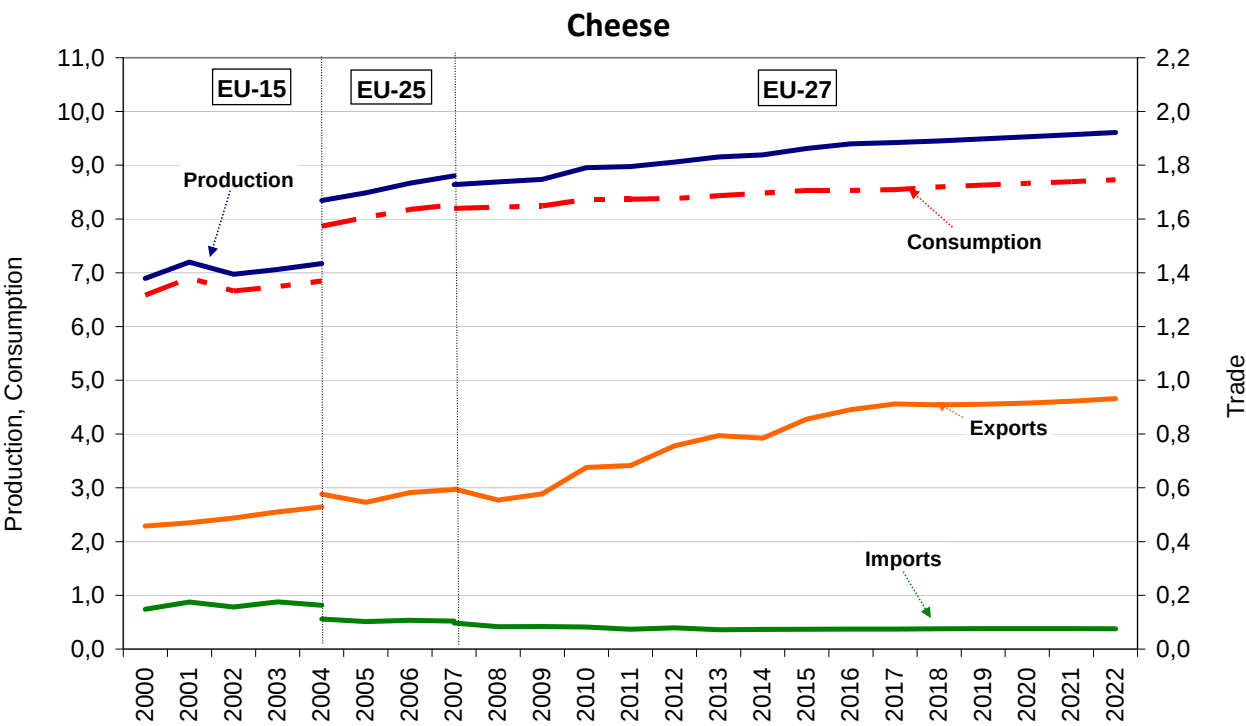
Graph.3 Cow's milk supply and dairy herd developments, 2000-2022



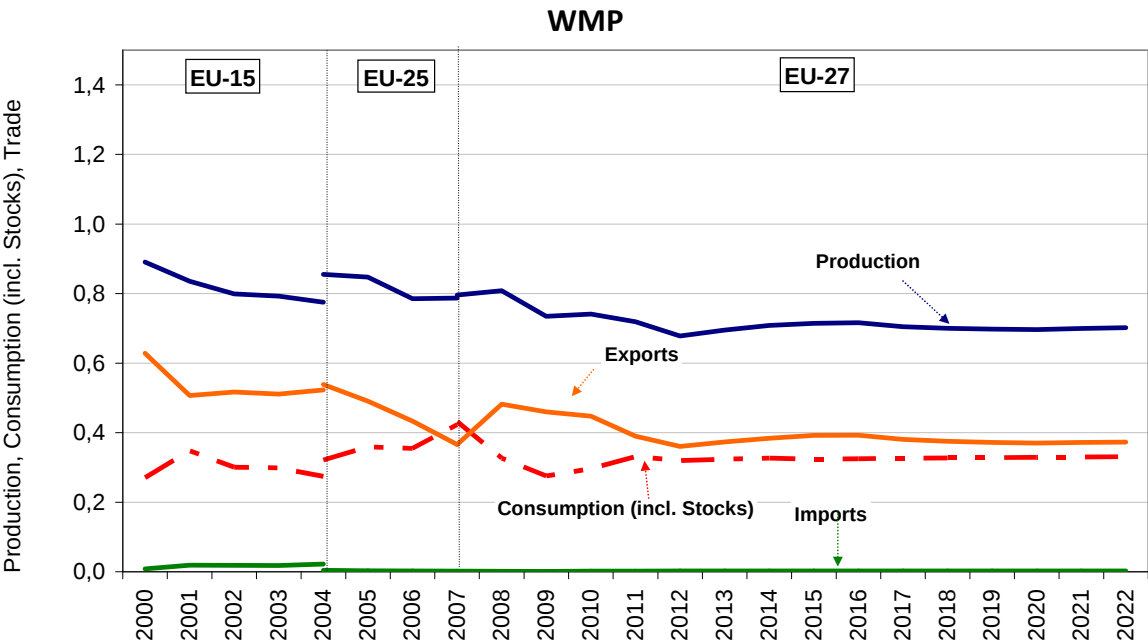
Graph.4 Milk deliveries and quota utilization for cow's milk



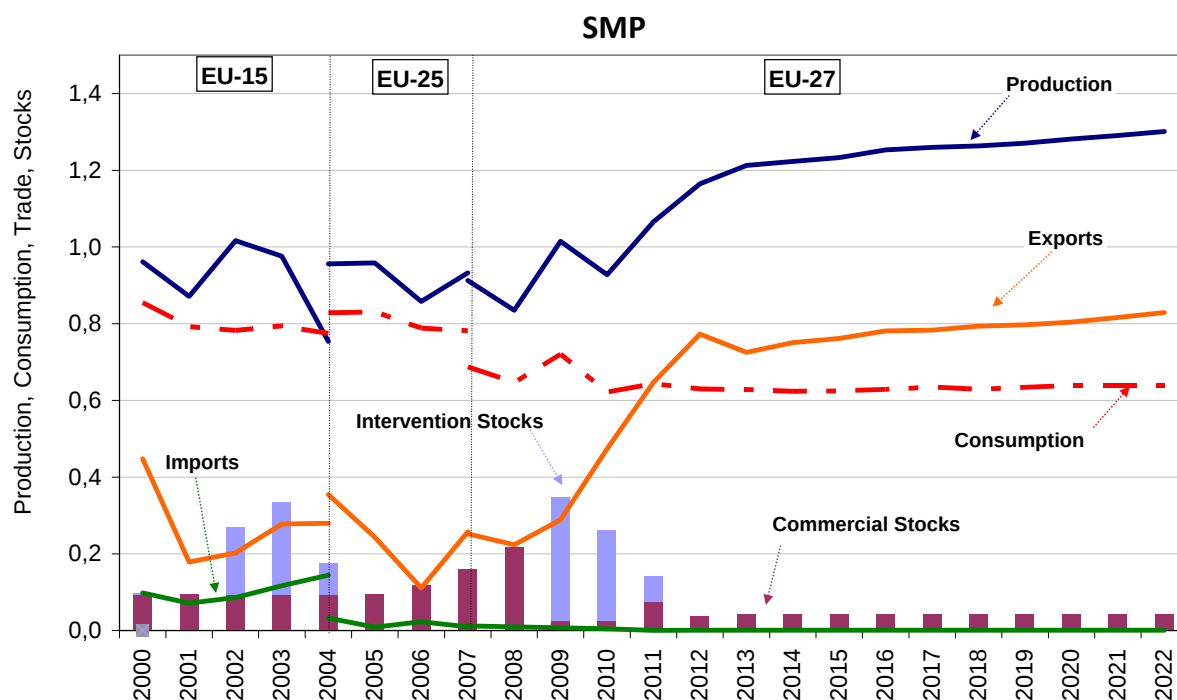
Graph.5 Cheese market developments, 2000-2022



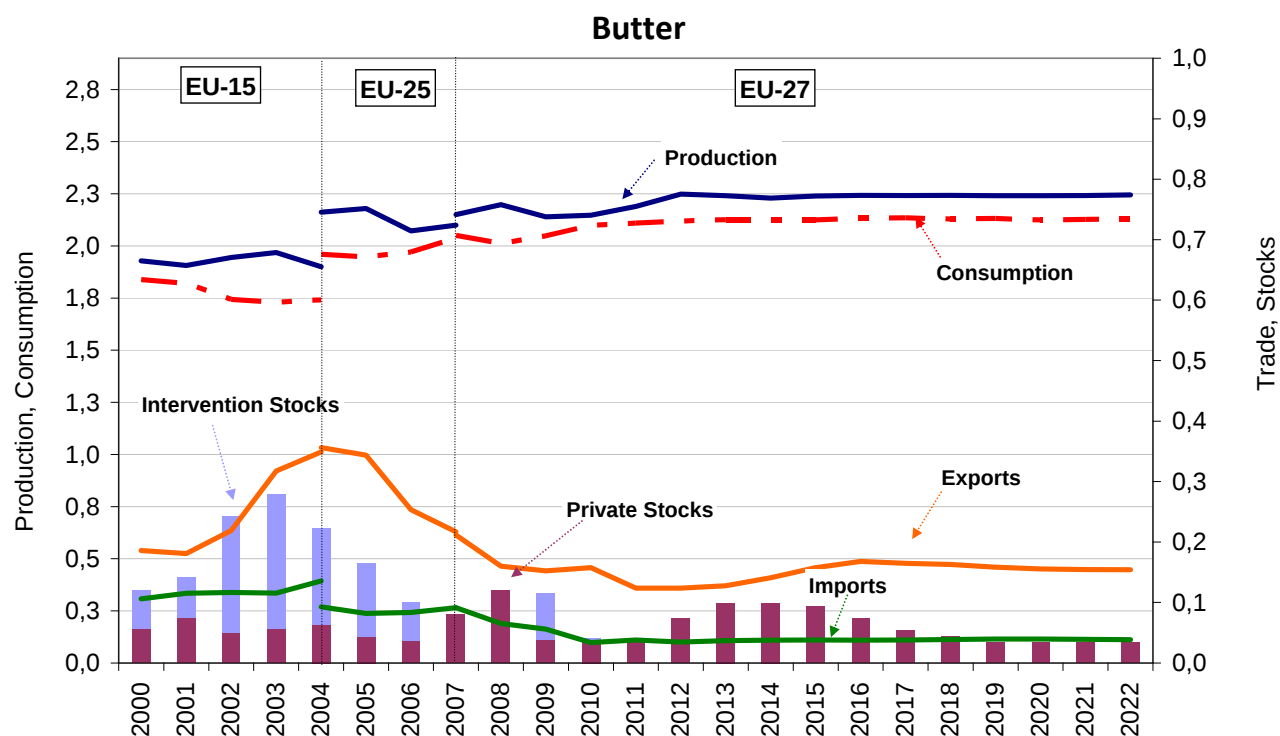
Graph.6 WMP market developments, 2000-2022



Graph.7 SMP market developments, 2000-2022

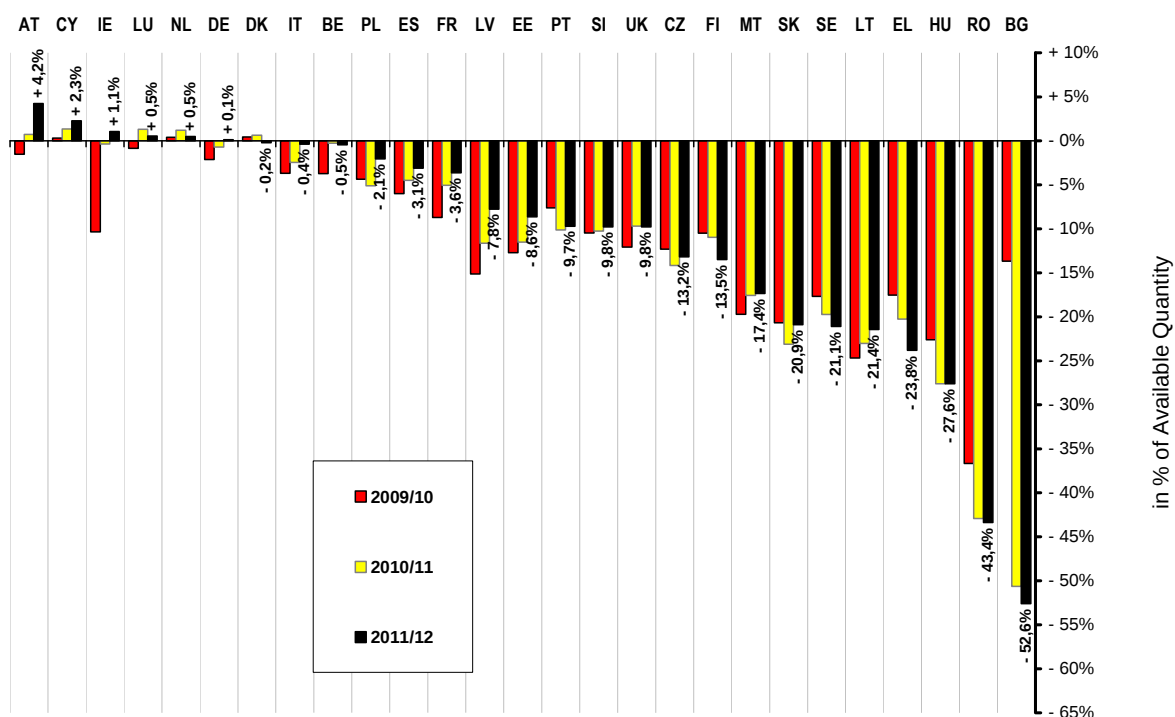


Graph.8 Butter market developments, 2000-2022

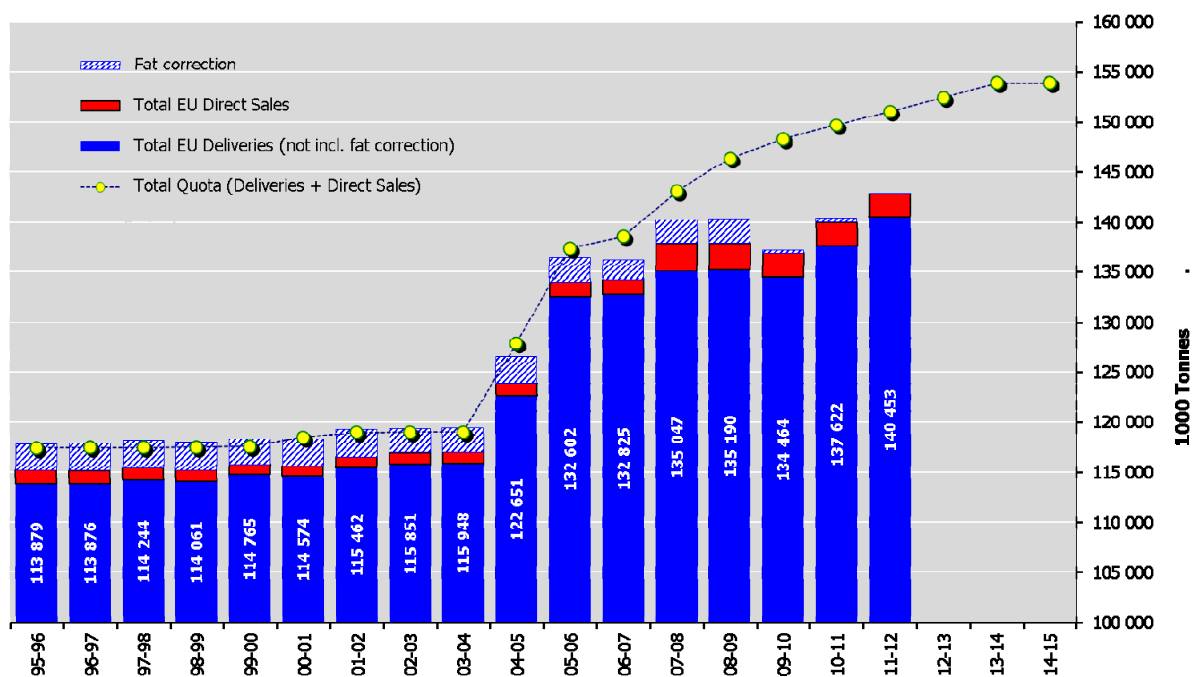


ANNEX III. MILK PRODUCTION VERSUS QUOTA

EU Deliveries Overshoot/Under use (in % of quota)



Evolution of EU Milk deliveries and Direct sales versus quota



ANNEX IV. EU MILK QUOTA PRICE DEVELOPMENTS

