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COMMISSION STAFF WORKING DOCUMENT

Evolution of compulsory contracts, Producer Organisations and the market situation for milk and milk products.

Accompanying the document

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Development of the dairy market situation and the operation of the "Milk Package" provisions

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COMMISSION STAFF WORKING DOCUMENT

Evolution of compulsory contracts, Producer Organisations and the market situation for milk and milk products

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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Development of the dairy market situation and the operation of the "Milk Package" provisions.

1. EVOLUTION OF COMPULSORY CONTRACTS AND PRODUCER ORGANISATIONS SINCE THE PREVIOUS MILK PACKAGE REPORT (JUNE 2014)

The situation regarding **compulsory contracts** in Member States has evolved since June 2014 as follows:

- Contracts in Cyprus are only compulsory for recognised POs and APOs, and for a minimum duration of one year.
- Compulsory contracts have been introduced in Slovenia and Poland since January and October 2015 respectively.
- Contracts are no longer compulsory in Latvia since April 2015.
- The minimum duration of contracts in Italy has been extended to one year.

Written offers have also been compulsory in Spain since February 2015.

Minimum size requirements set by Member States for the recognition of producer organisations (POs) have slightly changed since the previous report:

- Bulgaria introduced minimum criteria (5 producers) in January 2015.
- Portugal changed the criterion on minimum marketable production, from a volume of 20.000 tonnes of milk per PO (1.000 tonnes for sheep/goat milk POs) to a value of EUR 8 million for cow milk POs and EUR 1 million for sheep/goat milk POs.
- Hungary has reduced the minimum marketable production of POs from 30.000 tonnes to 15.000 tonnes.

- Croatia has increased the minimum number of members to constitute a PO, from 5 to 7 farmers.

The **number of recognised POs** has evolved as follows since 2014:

- 11 POs were recognised in France in 2014 and 4 more in 2015.
- 1 PO was recognised in Portugal in 2014.
- 1 PO was recognised in Belgium in 2015.
- 2 POs were recognised in Bulgaria in 2015.
- Following a change in the national law, only 1 out of 8 POs remained in the Czech Republic by the end of 2015.
- 2 POs were recognised in Germany in 2014 and 19 more in 2015. 16 POs lost their recognition between 2014 and 2015.
- 1 PO was recognised in Spain in 2015 while one existing PO lost its recognition in the same year.
- 2 POs have been recognised in Croatia, one in 2014 and the other one in 2015.
- 9 new POs have been recognised in Italy in 2015.
- 2 POs were recognised in Romania in 2015.
- 1 PO was recognised in the United Kingdom in 2015.

In Germany, two **associations of POs** have been recognised in 2014 and 2015 resulting in a total of four. Italy has reported the recognition of one APO in 2015 although no minimum criteria have been notified yet.

2. MARKET DEVELOPMENTS TO DATE[1]

Having observed historically high prices reached for milk and milk products by the end of 2013 and the beginning of 2014, the milk sector entered a phase of global supply-demand imbalance. This imbalance has characterised the market throughout 2015 and the first half of 2016. While world demand suffered due to the introduction of the Russian import ban in August 2014 coupled with the slowdown of imports in China during the first half of 2015, global supply - fuelled by remunerating prices and favourable weather conditions - was boosted. Milk production increased in the EU, the US and New Zealand in 2014 and 2015, reaching a combined additional 15 million tonnes. However, growth in domestic consumption and exports barely absorbed half of that volume.

As projected in the 2014 report, the expected correction in prices took place as a result of increase in milk production observed across major exporting countries. This projected correction occurred in the EU from early 2014 and sped up since mid-2014 onwards due to the Russian import ban. In the absence of a reaction on the supply side, the deterioration of milk prices continued for two and a half years, causing the price of milk in the EU to plunge by 37 % by July 2016 (compared to the historical peak of 40.3 c/kg in December 2013). Milk prices also dropped by 44 % in the United States and by 50 % in New Zealand.

The impact on the price of EU milk products has been particularly severe, notably for skimmed milk powder which experienced an overall drop of 51 %. The price of butter, after a significant drop (41 %), remained somewhat stable throughout 2015 owing to relative strong demand. The Commission has kept the safety net instruments (public intervention and private storage aid) in operation without disruption since September 2014. Skimmed milk powder has been offered to public intervention from July 2015 until September 2016.

In addition to maintaining the safety instruments, the Commission has launched three comprehensive support packages (September 2014[2], March 2016[3] and July 2016[4]) as a response to the difficult situation witnessed notably on the EU dairy market, but also in other agricultural sectors.

Market conditions started to improve in spring 2016, when prices for EU dairy products bottomed out. By September 2016, prices for EU butter, whole milk powder and whey

[1] based on data available by end-September 2016 (therefore milk production updated up to July 2016 and milk prices up to August 2016)

[2] http://ec.europa.eu/agriculture/newsroom/231_en.htm

[3] http://europa.eu/rapid/press-release_IP-16-806_en.htm

[4] http://ec.europa.eu/agriculture/newsroom/295_en.htm

powder had recovered their levels of 2014. At the time of this report, these positive signs were expected to materialise into better farm gate milk prices as of August 2016.

2.1. MILK PRODUCTION

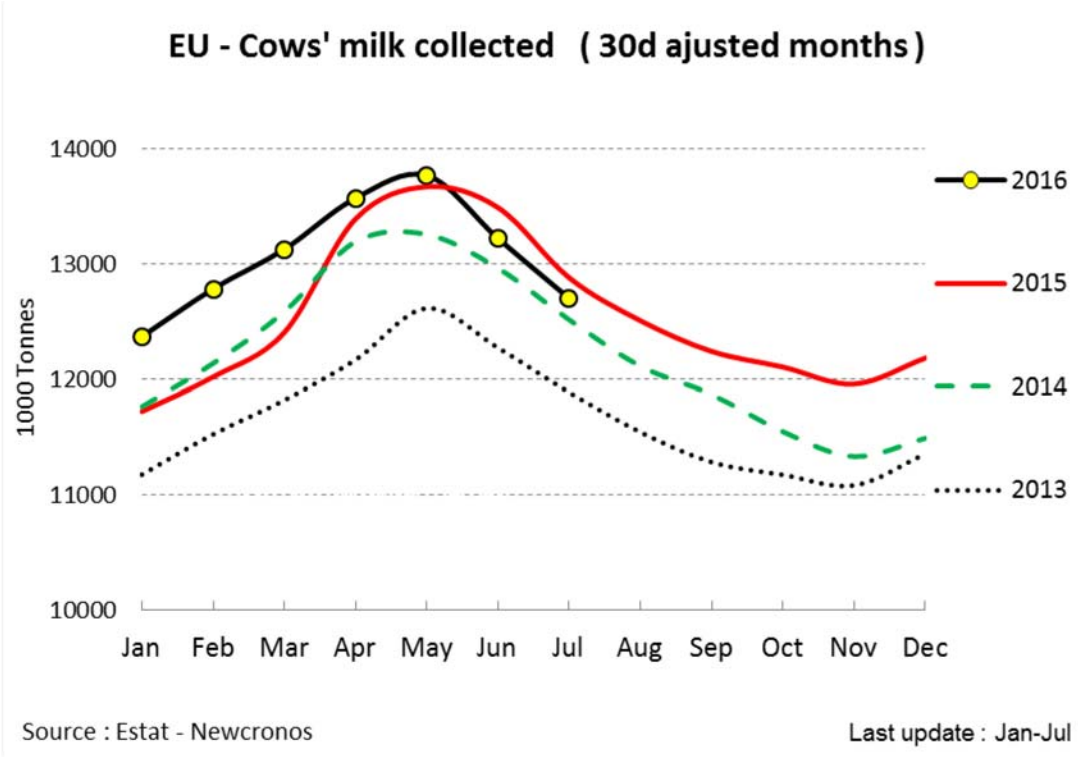
EU milk deliveries increased by 4.5% **in 2014** (more than 6 million tonnes in one year) resulting in 148 million tonnes of milk. This equals the cumulative quantity increase in deliveries during the previous five years (during which quotas increased progressively by 1% annually). A slowdown was observed towards the end of 2014, in line with efforts to limit the milk quota surplus levy in a context of decreasing milk prices.

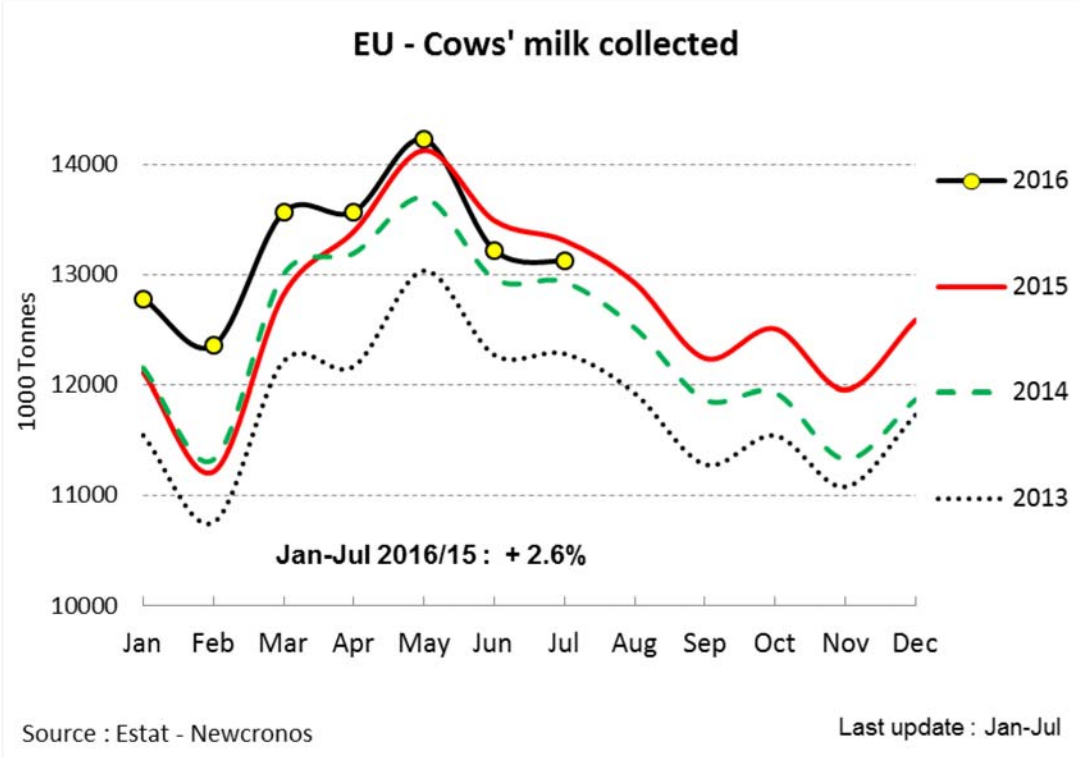
The decrease in deliveries continued during the first quarter of **2015**, which was particularly noticeable in Member States at risk of exceeding quota. By contrast, deliveries in other Member States continued to substantially increase despite low milk prices. Milk collection has surged since April 2015 in some Member States previously limited in their expansion by the quota regime. Weather was extremely mild in the autumn and cows fed on grass much longer than in the previous year, resulting in 5% higher deliveries during the last quarter of 2015 compared to 2014. In addition, in certain Member States, the good quantity of forage available, affordable feed prices and low energy costs encouraged farmers to continue producing. Year 2015 closed with a 2.5% increase compared to 2014 (3.7 million tonnes more milk).

Milk production growth in the first quarter of **2016** was remarkably high due to the combination of an increase in deliveries, the extra leap-day in February, and the statistical effect of comparing with the same period in 2015 when quotas were still in place. As a result, milk deliveries in January-March 2016 were 7.1% higher than in the same period in 2015 (+5.9% with the correction of the leap day). Monthly delivery figures converged in April-May 2016 and have been showing a decrease since June (-2% in June and –1.4% in July). Estimates point to a continued decline through the rest of the year, which could finish with an overall annual increase of close to +0.6%.

Milk production in the main exporting regions experienced also a remarkable surge in 2014 and 2015 with a combined two-year increase of 18% in New Zealand, 10% in Australia and 3.4% in the US. While a slowdown was observed by the end of the 2015-16 season in Oceania, monthly milk deliveries have continued to increase steadily in the US through 2016 (+1.7% by August 2016).

Graph 1 Milk collection developments





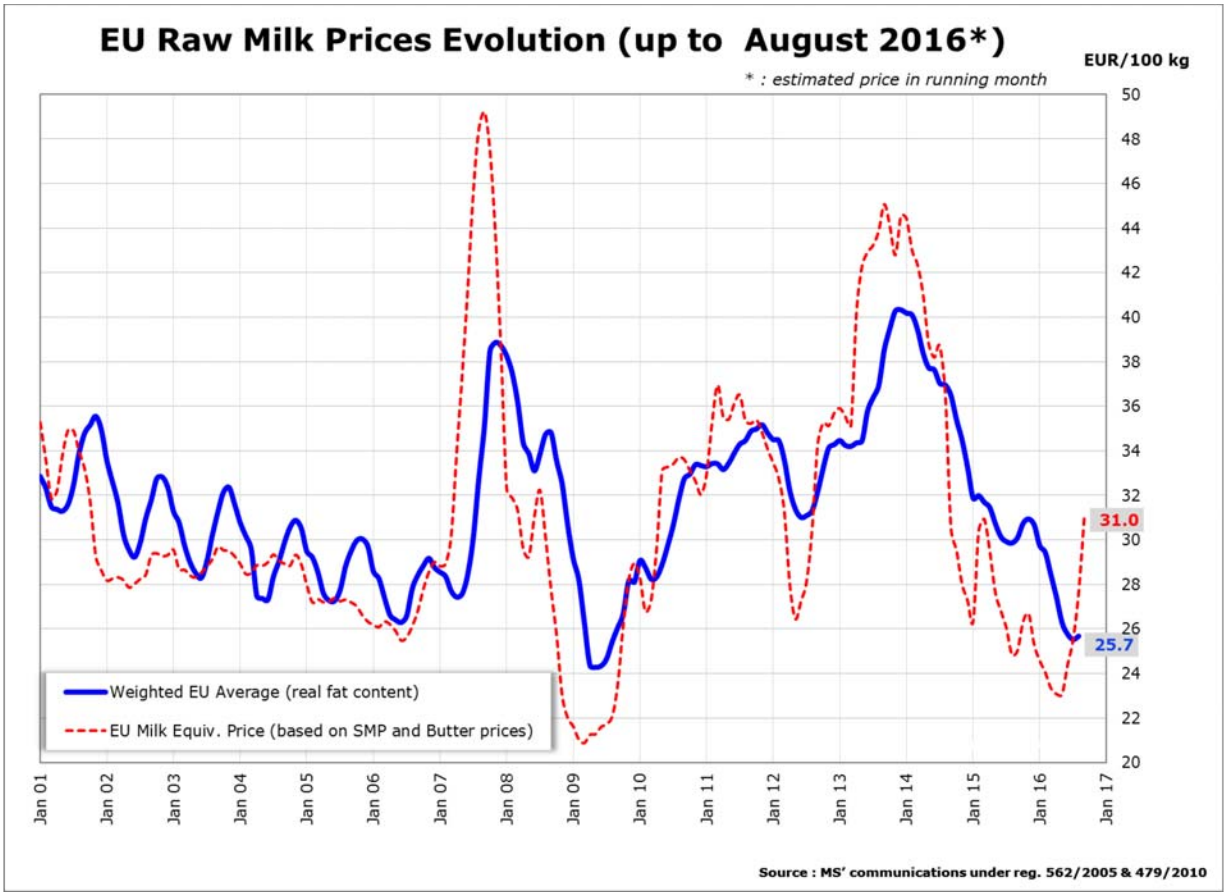
2.2. EU FARM GATE MILK PRICES

EU weighted farm gate milk prices reached a record level of 40.3 EUR/100 kg at the end of 2013. The surge in milk supply previously described, together with the weakening of global demand, have translated into a downward trend for EU milk prices since the beginning of 2014, which was exacerbated in August that year due to the introduction of the Russian import ban. By December 2014, the EU average milk price had fallen to 33.3 EUR/100 kg, meaning a 18% decrease year-on year. The situation was diverse across Member States, with the biggest price decrease (around 30%) reported in the Baltic countries and NL, followed by BE, DE, LU and DK. EU raw milk prices found some stabilisation in February 2015 owing to the limited milk supply in the last months of the milk quota system, but the decline resumed from March onwards. Despite a slight recovery observed in autumn, EU milk prices experienced an overall drop of 8% in 2015 (-13% when comparing to a 5-year average).

The deterioration of farm gate milk prices continued throughout 2016 owing to the oversupply situation, with a cumulated drop of 17% by July, to 25.5 EUR/100 kg, the lowest EU average price level reached since August 2009. The reaction in milk deliveries observed since June 2016, together with the sharp recovery of dairy product prices initiated in May, makes hopeful of a change in the trend of raw milk prices to materialize as of August 2016.

Similar milk price developments occurred in the US and New Zealand over the period 2014-2016. The price fall has been deeper in these two countries (-44% in the US, -50% in New Zealand) but the recovery started already in May 2016 (+22% in the US and +29% in New Zealand between May and July 2016).

Graph 2 Milk price developments



2.3. DAIRY PRODUCT PRICES, STOCK LEVELS AND EXPORTS

Dairy product prices experienced increasing downward pressure in years 2014, 2015 and in the first half of 2016. EU butter prices started suffering the effects of the oversupply situation early **2014**, followed by SMP prices. Prices stabilised and even increased after the seasonal production peak in spring but the abrupt introduction of the Russian import ban in August 2014 changed dramatically the trend. While the first immediate impact of the ban was observed on cheese exports and prices (being the product most traded with Russia), processors diverted more milk into butter and SMP production, thus increasing the pressure on these commodities. By the end of 2014, EU butter and SMP prices had decreased by 30% and 43% respectively while cheddar prices dropped by 22%, with most of these price decreases taking place after the Russian ban was introduced.

Despite the Russian ban, **EU exports in 2014** outpaced previous year's level for most dairy products, with the only exception of cheese. The loss of the Russian market for butter was partially compensated by increasing exports to the US and Saudi Arabia. As regards cheese exports, the share of Russia in EU exports decreased from 33% to 18%, and the US became the main outlet for the EU in the second half of the year. SMP was, by far, the most dynamic

export product in 2014, with a year-on-year increase of 62% and Algeria as the main destination followed by China, Egypt and Indonesia.

The slowdown in EU milk supply in the first quarter of **2015** had a positive effect on market sentiment and EU dairy prices benefited from a temporary recovery (+12% for butter and +7% for SMP by mid-April). The downward trend resumed once signals of overproduction became more evident and dairy prices declined throughout spring and summer. SMP prices hit public intervention levels in July 2015 and offers have been being submitted ever since until September 2016 with the only exception of one week in November 2015, in line with a temporary rally in prices. EU dairy price drops ranged from -3% for WMP to -34% for wheypowder. Only butter prices remained firm, with even a 4% increase, thanks to robust global demand (notably in the US).

EU **exports** of dairy products performed well in 2015, benefitting from the reinforcement of certain outlets (Egypt, the US, Japan, Saudi Arabia, South Korea) and the recovery of China's imports which became evident in the last quarter of the year. EU exports increased in volume for most dairy products, except for cheese whose exports remained overall stable (they overtook 2014 levels from August, and increased year-on-year for all EU outlets, except for Russia).

Despite this recuperation in global demand, it was largely outstripped by the production pace. The surge in EU milk deliveries during the spring flush translated into increased volumes of SMP (+18%) and butter (+12% by May). EU SMP prices remained supported by the public intervention mechanism throughout **2016.** Since mid-August prices have started to pick up and volumes offered to intervention to recede. By the third week of September 2016, when no more offers to public intervention were reported, a total volume of 334 000 tonnes was applied for in 2016[5] (in addition to some 40 000 tonnes offered in 2015). The level of public stocks of SMP by the end of July 2016 was reported to be at 327 000 tonnes.

In addition to public intervention, private storage aid has remained available without disruption for butter and SMP since the introduction of the Russian ban (for SMP with the possibility of an enhanced scheme since October 2015, with higher aid rates and longer storage periods). By the end of July 2016, subsidized private stocks were reported at 53 000 tonnes for SMP and at 102 000 tonnes for butter.

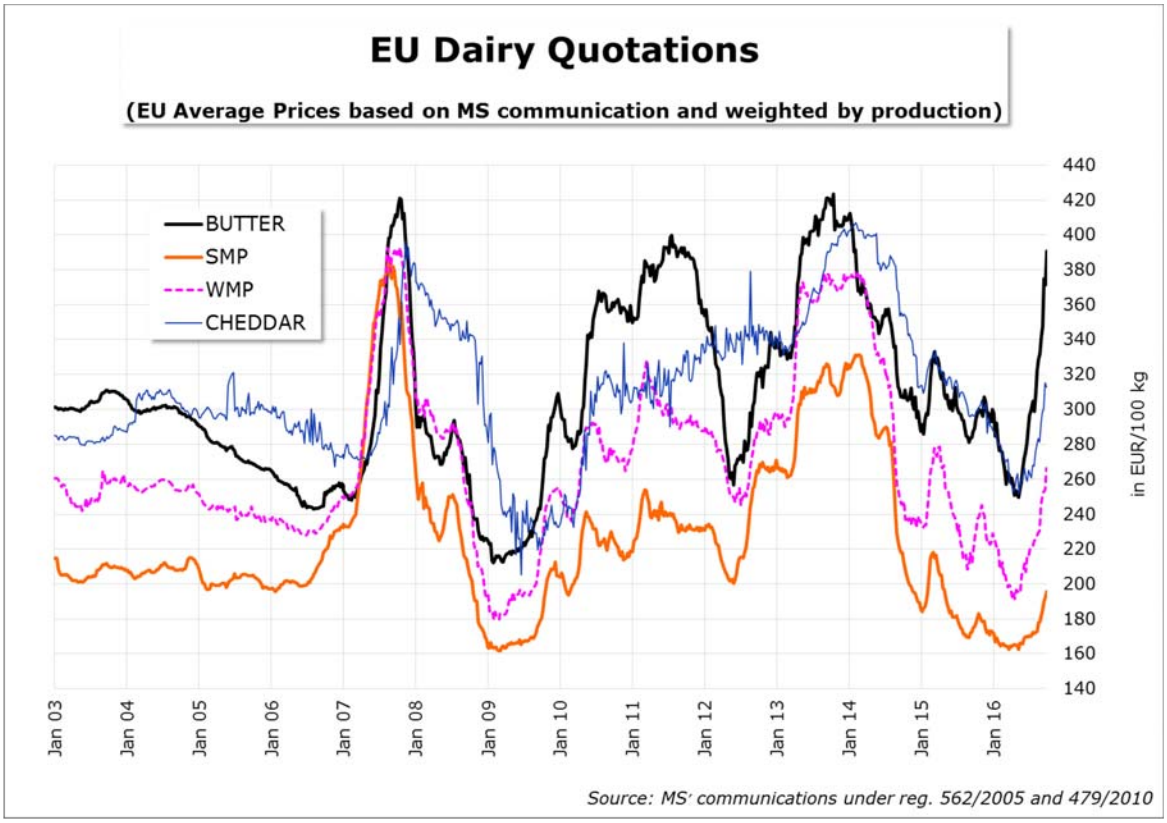
A private storage aid scheme for cheese was put in place for a few weeks in September 2014. It covered some 83 500 t. Another one was introduced in October 2015. Out of a maximum volume of 100 000 tonnes, some 84 000 tonnes were applied for in two rounds. The level of stocks by the end of July 2016 was 25 000 tonnes.

[5] In order to help the sector find a new balance under the severe market situation, and preserve confidence in the effectiveness of intervention mechanisms, the ceiling under which SMP could be bought-in at fixed price in 2016 was increased to 218 000 tonnes in April and to 350 000 tonnes in June.

EU butter prices plunged between January and April 2016, while remaining well above public intervention levels. In week 18, EU average butter prices hit a bottom of 250 EUR/100 kg (lowest level since September 2009) when they commenced a steep increase reaching +56% by the end of September (having outpaced 2015 and 2014 price levels, and approaching those of 2013).

Global demand remains healthy in 2016 and even outpaced 2013/14 levels in June. The EU and NZ stand as first world exporters, with similar volumes in milk equivalent. The market for SMP has remained bearish in 2016, affected by reduced imports by Algeria (due to low oil price). Trade flows for the other main dairy products have improved in line with growing demand. The main destinations for EU products are Saudi Arabia (butter), the US (cheese), China (whey powder and infant formula), Algeria (SMP) and Oman (WMP). Liquid milk and cream exports are playing an increasingly important role for the EU, with China (UHT bricks) and Belarus (bulk whole milk and cream) as the main outlets. By the end of July 2016, EU exports of dairy products expressed in milk equivalent had increased by 3.5%.

Graph 3 **Dairy products price developments**



2.4. ESTIMATED DAIRY FARMS' MARGINS IN THE EU

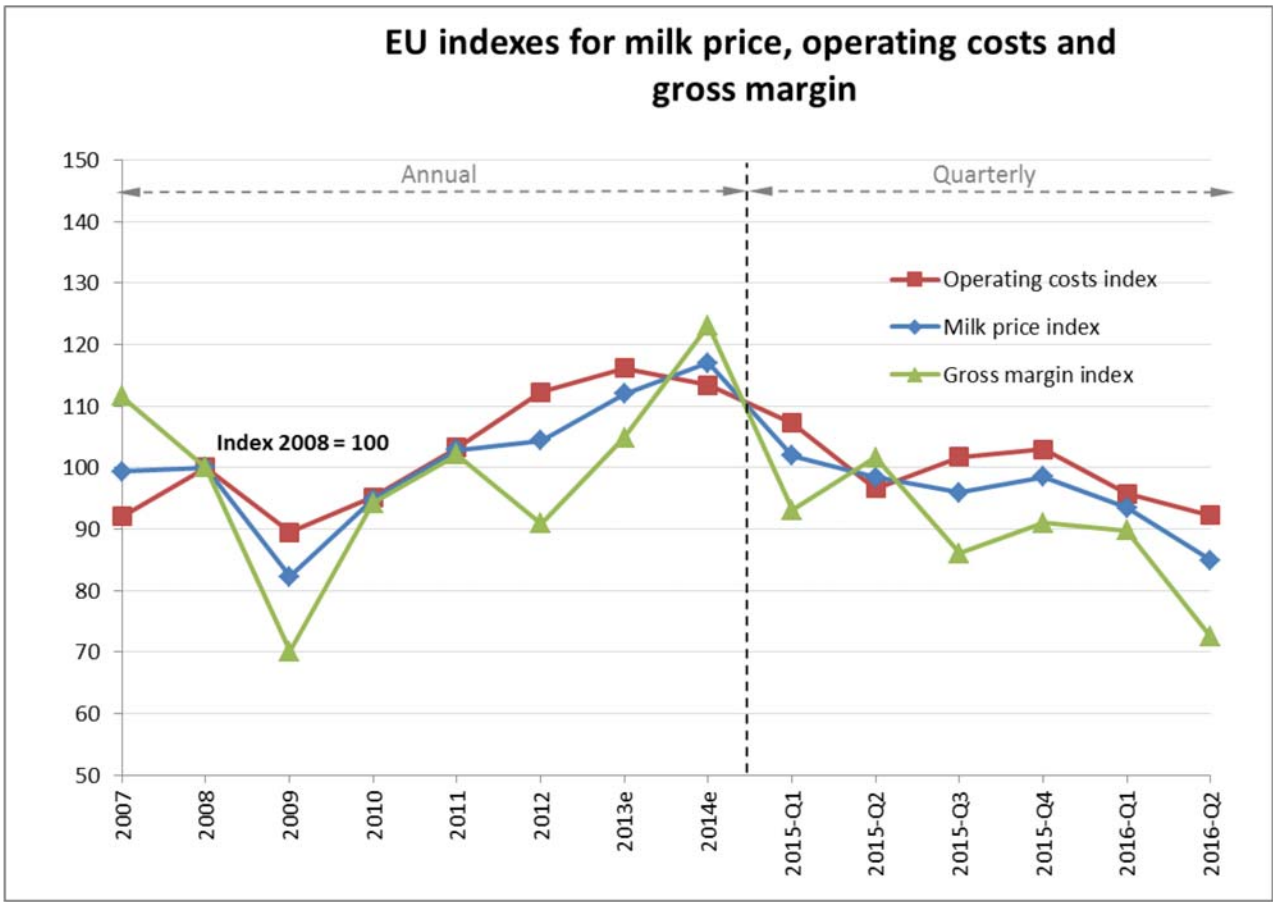
The model developed in DG AGRI for monitoring milk price, operating costs and gross margin indexes provides results in line with the market developments previously described.

After two consecutive yearly increases in 2013 and 2014 (having reached a maximum in the first quarter of 2014 of 49% over the base set in 2008) the gross margin index started a declining trend due to the fall in milk prices, which was not fully offset by decreasing operating costs (notably feed and energy). The margin index hit a bottom in the third quarter of 2015 (8% below the base) followed by an upturn due to the slight recovery in prices observed in late 2015. However, the fall in milk prices in 2016 was more pronounced than the easing of production costs (-14% for the milk price index versus -10% for the operating costs index in the first half of 2016), translating into a substantial drop in the gross margin index by June 2016 (28% below the base). The trend is expected to reverse in the fourth quarter of 2016 with the prospect of improving milk prices in August and September 2016.

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 in dairy processing.

Graph 4 Gross margin index evolution[6]

[6] Source : FADN - base year 2012 + indexes: Eurostat, DG AGRI



3. MEDIUM TERM MARKET PROSPECTS 2015-2025

The medium-term prospects[7] for milk and dairy commodities remain favourable. World and domestic demand are still expected to increase steadily, giving the possibility for the EU dairy sector to improve its position and share in the world markets.

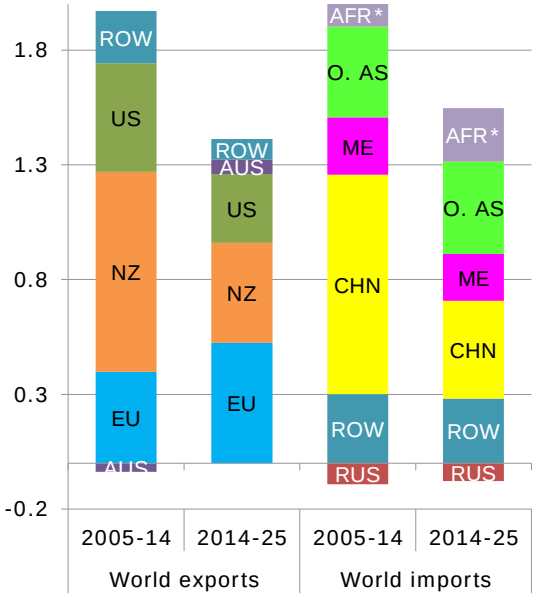
In the period 2015-2025, world trade for dairy products is expected to increase by 2.4 % (over 1.4 million tonnes) a year. This is less than in the last decade when trade increased by close to 1.9 million tonnes a year, mainly due to slower import growth in China not fully compensated by increased imports in Africa. China will remain the world's main importer, accounting for 22 % of world dairy trade.

Among the world's main exporters, the EU is expected to see the highest increase in production and exports. Production is no longer constrained by quotas and production capacity is strong, given very good agronomic and climatic conditions for milk production, big processing capacity, a wide variety of products and significant yield growth potential. By contrast, expansion of production in New Zealand will be more limited than in the past, with

[7] DG AGRI projections based on OECD-FAO agricultural outlook and macroeconomic assumptions. See http://ec.europa.eu/agriculture/markets-and-prices/medium-term-outlook/index_en.htm

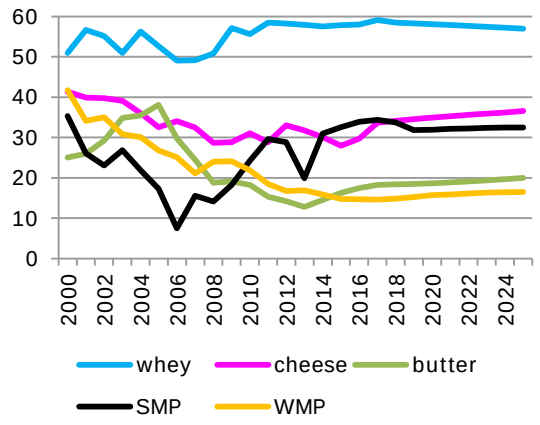
1.7 % expected annual growth (OECD-FAO), as compared with 5.2 % in the last decade. Nevertheless, any additional volume of milk produced in New Zealand will be sold on the world market and its exports are expected to grow by 440 000 tonnes a year (in milk equivalent). In the USA, out of 1.1 million tonnes extra milk produced each year in the next decade, 800 000 tonnes will be used domestically leaving 300 000 tonnes for extra exports as compared with 500 000 tonnes in the EU.

Graph 5 Annual change in trade of dairy products (million t of milk equivalent)

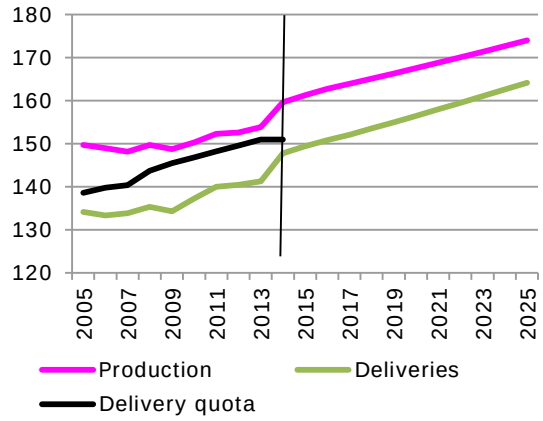


Note: Trade in milk solid equivalent of cheese, butter, SMP, WMP and whey powder[8]. NZ: New Zealand, ME: Middle East, ROW: Rest of the world. *South Africa excluded.
Source: DG Agriculture and Rural Development based on OECD-FAO *Agricultural Outlook 2015-2024*.

Graph 6 EU share in world trade (%)



Graph 7 Milk supply and deliveries in the EU (million t)



Milk supply in the EU is expected to increase by 13 million tonnes in the coming years (0.8 % a year), driven by growing world demand and sustained domestic consumption. Close to 90% of the milk is used to supply the domestic market in the EU and not only the population, but also per capita consumption of cheese, butter and fresh cream are growing steadily. Moreover, powders are increasingly used to produce processed products (bakery, viennoiserie, patisserie (BVP) and biscuits, etc.).

[8] Coefficients used: 3.6 for cheese, 6.57 for butter, 7.6 for SMP, 7.56 for WMP and 7.48 for standard whey powder

After a few years of turmoil, it is expected that supply expansion will remain moderate and driven by market fundamentals: favourable demand, relatively moderate milk prices and costs of production, etc.

Competition with other sectors might have less incidence than in the past, given the expected, rather low crop prices. However, environmental constraints may also play a role: dairy cows are concentrated mainly in areas where a surplus in nitrates is recorded. The potential fixing of targets for GHG emissions reductions might affect dairy cows as a major source of methane, limiting expansion of milk production and favouring yield increases at the expense of herd numbers.