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Proposal for a Council Decision

authorising Portugal to apply a reduced rate of excise duty on certain alcoholic products produced in the autonomous regions of Madeira and the Azores

{COM(2020) 240 final}

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Glossary

Term or acronym	*Meaning or definition*
ABV	Alcohol by volume
DG	Directorate General
EC	European Commission
EU	European Union
ESI	European Structural Investment
FTE	Full Time Equivalent
GDP	Gross Domestic Product
GRP	Gross Regional Product
GVA	Gross Value Added
HLPA	Hectolitres of pure alcohol
ORs	Outermost Regions
POSEI	Programme of options specifically relating to remoteness and insularity
PPS	Purchasing Power Standards
SMEs	Small and medium-sized enterprises
TFEU	Treaty on the Functioning of the European Union
UAA	Utilised Agricultural Area
VAT	Value Added Tax
WHO	World Health Organization

1. INTRODUCTION: POLITICAL AND LEGAL CONTEXT

1.1. Introduction: Outermost Regions

Several regions of the European Union (EU), known as the outermost regions, are located in areas that are remote from Europe. These are the French regions of Guadeloupe, French Guiana, Réunion, Martinique, Mayotte and Saint-Martin; the Portuguese Madeira and the Azores; and the Spanish Canary Islands. These regions are an integral part of the EU and therefore need to comply with EU legislation. At the same time and unlike the rest of the EU territory, they have to deal with a number of difficulties related to their characteristics, in particular to remoteness, insularity, small size, difficult topography and climate, and economic dependence on a limited number of products.

Figure 1: Geographical distribution of EU outermost regions

The special situation of these regions is recognised under Article 349 of the Treaty on the Functioning of the EU (TFEU). This article allows for specific measures for these regions to be taken as it acknowledges that the permanent and combined constraints affect their economic and social situation and severely restrain their development. It permits such measures provided that they do not undermine the integrity and the coherence of the Union legal order, including the internal market and common policies. Such measures concern various policies, including taxation, support to create jobs, boosting competitiveness, and preserving the environment.

1.2. Portuguese outermost regions

This report concerns the outermost regions (ORs) of Portugal: The Autonomous Region of Madeira and the Autonomous Region of the Azores, both of which are small and remote groups of islands several hundred kilometres from mainland Portugal. Madeira is comprised of two inhabited islands, Madeira and Porto Santo as well as two smaller uninhabited archipelagos (Desertas Islands and Selvagens Islands). The Azores are composed of nine inhabited islands as well as several uninhabited smaller islands. The population of each region is approximately 250,000. Both Madeira and the Azores are autonomous regions of Portugal with their own political and administrative regimes and governing bodies[1].

The economies of Madeira and the Azores are significantly below the level of gross domestic product of mainland Portugal. In 2017, gross domestic product (GDP) for Madeira was €4.6 billion and €4.1 billion for the Azores (2.5% and 2.2% respectively of total Portuguese GDP). Real growth has been low over the last ten years, averaging 0.76% in Madeira and 1.4% in the Azores, although above the average of 0.4% in Portugal. Economic development in terms of output per capita in both Madeira (€18,100) and the Azores (€16,900) is below the level of mainland Portugal (€18,900), and each OR is significantly below the EU average of €30,000[2].

The main economic activities in Madeira are tourism and financial services. In 2015, approximately 17% of employment was in the tourism industry, which accounted for around 22% of Gross Value Added (GVA)[3]. The Azores' economy is mostly based on services (40% of GVA), although agriculture plays a more significant part of the economy than in Madeira or mainland Portugal, at 8% of GVA. The rate of unemployment is higher than on the Portuguese mainland in both outermost regions. In 2018, the Portuguese rate of unemployment was 7.1%, whereas the rate of unemployment in Madeira and the Azores was 9% and 8.6%, respectively[4]. Worryingly, youth unemployment is significantly higher in the outermost regions compared to the Portuguese rate[5]. Furthermore the percentage of the OR population in the agricultural sector has increased since 2012, possibly due to the financial crisis forcing people to seek alternative sources of income or returning to family farms. The most recent data estimates that 8% and 13% of workers are employed in agriculture in Madeira and the Azores, respectively.

1.3. Specific measure for the Portuguese outermost regions

This report focuses on analysing the effects of the existing derogation for the reduced rate of excise duty on specific alcoholic drinks produced and consumed in those two autonomous regions of Portugal, which expires on 31 December 2020.

Excise duties are indirect taxes on the sale or use of specific products and are usually applied as an amount per quantity of the product. All revenue from excise duties goes

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[1] Their status as autonomous regions allows both ORs to set their own policies, except in foreign policy, defence and internal security. This includes the constitutional right to all tax revenues generated in their territories in addition to transfers from the state budget.

[2] https://ec.europa.eu/eurostat/documents/2995521/9618249/1-26022019-AP-EN.pdf/f765d183-c3d2-4e2f-9256-cc6665909c80

[3] Measure of the value of goods and services produced in an area, industry or sector of the economy

[4] https://ec.europa.eu/eurostat/statistics-explained/index.php/Unemployment_statistics_at_regional_level#Regional_unemployment_rates_and_the_EU_average

[5] The most recent data for youth unemployment is for 2014, when the rate of unemployment in Madeira and the Azores was 50.5% and 41.5%, respectively. The overall rate of youth unemployment for Portugal for the same time period was 34.8%. Source: Eurostat

entirely to the Member States, and in the EU, Member States must apply excise duties to alcohol, tobacco, and energy products.

Union legislation on the classification and taxation of alcohol and alcoholic beverages allows for duty rate reductions under certain circumstances and for certain regions. Council Directive 92/83/EEC[6] allows all Member States to apply a reduced rate of excise duty to distilled alcoholic beverages produced by small independent distilleries not producing more than 10 hectolitres of pure alcohol per year. In addition, Council Directive 92/84/EEC allows for a 50% reduction of excise duty on certain alcoholic beverages[7] consumed in the Portuguese outermost regions.

To date, these possible reductions have not been considered appropriate for Madeira and the Azores because of their limited scope and excise duty reduction. Therefore, in order to assist the economies of these two regions, several tax measures have been adopted in accordance with Article 349 TFEU in the last two decades. The first legislative act to support the spirit drinks industry was adopted in 2002. This measure[8] authorised Portugal to apply a reduced excise duty rate of 75% to rum and liqueurs made and sold in Madeira and liqueurs and eaux-de-vie made and sold in the Azores (see box 1 for product details). Upon its expiry in December 2008, the measure was renewed through a second legislative act[9]. As the measure was valid until December 2013, Council Decision 376/2014/EU[10] was adopted in 2014, which renewed the measure until 31 December 2020.

Box 1 – overview of the spirit drinks at stake[11]

Rum is an unflavoured spirit drink produced exclusively by fermentation and distillation of molasses or syrup produced in the manufacture of cane sugar or from sugarcane juice itself. Rum must have a minimum alcoholic strength of 37.5% alcohol by volume (ABV).

A ***liqueur*** is a spirit drink with a minimum alcohol content of 15% by vol. and a minimum sugar content as provided by point 32(a)(i) of Annex II to Regulation (EC) No 110/2008[12]. It is produced using ethyl alcohol of agricultural origin or a distillate of agricultural origin or one or more spirit drinks or a combination thereof, which has been sweetened and to which one or more flavourings, products of agricultural origin or foodstuffs have been added. ***Crème de (supplemented by the name of a fruit or other raw material used)*** is a type of liqueur with a higher sugar content.

[6] Article 22 of Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages
[7] Article (7)3 of Council Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages allows Portugal to apply reduced rates to wine, rum and liqueurs in Madeira and liqueurs and eau-de-vie in the Azores. See Annex 6 for further details.
[8] Council Decision 2002/167/EC
[9] Council Decision 2009/831/EC
[10] Council Decision 376/2014/EU
[11] Further details of the spirit drinks legislation is provided for in the Annex 6.
[12] Regulation (EC) No 110/2008 of the European Parliament and of the Council of 15 January 2008 on the definition, description, presentation, labelling and the protection of geographical indications of spirit drinks and repealing Council Regulation (EEC) No 1576/89

Eaux-de-vie are spirit drinks produced from the distillation e.g. of wine, fortified wine or grape marc.

The objective of the existing Council Decision is to promote the socioeconomic development of the Portuguese outermost regions. The Decision takes account of the higher production costs of specific products in these regions and allows Portugal to apply a reduced rate of excise duty taxes to offset the competitive disadvantages faced by the producers in these regions, without undermining the integrity and coherence of the Union legal order, including the internal market and common policies. The table below shows the impact of the derogation to both regions.

Table 1. Impact of derogation

Impact of Council Decision No 376/2014/EU for the period 2014-2019 to the regional economies					
	Producers market share increase %	**Gross Value Added € m**	**Producers Sales increase %**	**Total employment**	**Support to employment**
Madeira	2,1	14,2	25,9	260	26
The Azores	3,5	10,7	26,6		14

Source: PwC et al, 2020

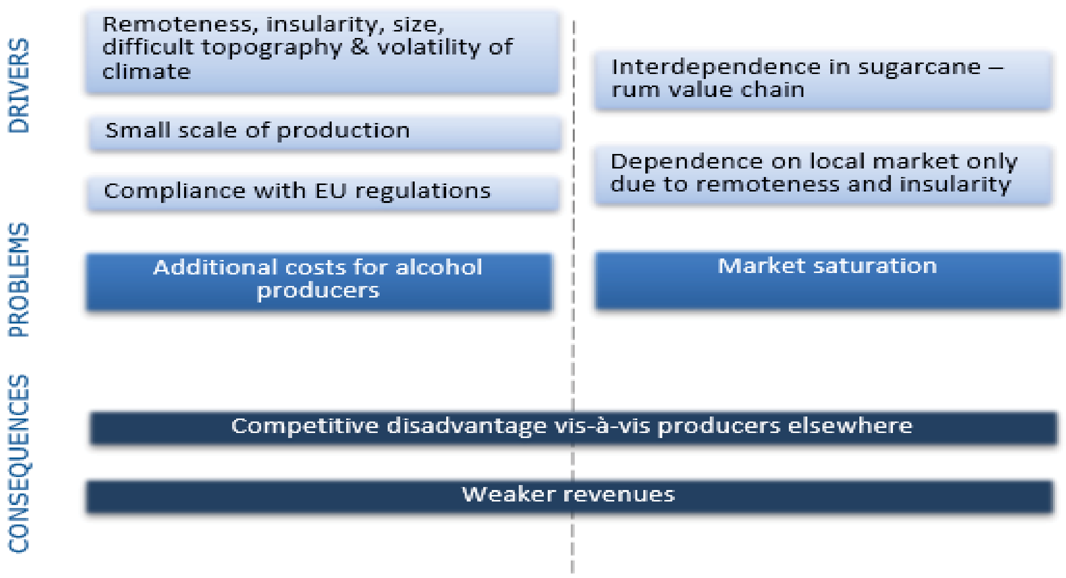
The objective of this report is to evaluate the current regime and analyse possible future options upon the expiry of the current measure on 31 December 2020. This includes the option of extending the regime to include sales of these specific spirit drinks on mainland Portugal, as requested by the Portuguese authorities. This report is based on an external study by PricewaterhouseCoopers[13] ("the study") commissioned by the European Commission.

2. Problem definition

The challenges noted in Article 349 TFEU result in several problems for producers of spirit drinks in the Portuguese outermost regions. The following problem tree outlines the problems, the drivers and their consequences.

[13] Study on reduced excise duty rates in the Portuguese outermost regions of Madeira and the Azores, PwC et al, 2020

Figure 2



2.1. Additional costs for spirit drink producers

The spirit drinks industry in the Portuguese outermost regions consists of 35 producers, all of whom are small and medium enterprises (SMEs). 90% of the production is accounted for by the largest five producers. Due to several factors, it is more expensive to manufacture these spirit drinks in the Portuguese outermost regions than on the Portuguese mainland.

The overarching additional cost for the producers is the cost of the ***ingredients*** used to produce rum, liqueurs and eaux-de-vie in Madeira and in the Azores.

In 2018, sugarcane grown in Madeira cost €110[14] per tonne, whereas Brazilian sugarcane cost €14,82 per tonne[15]. Local fruits from the region are the main ingredient used in the production of liqueurs. Based on information provided by the producers, the Madeira Statistics Authority and the Portuguese Authorities, for the wide variety of fruits used in liqueur production, the regional prices were, on average, 77% higher than mainland prices. In the Portuguese outermost regions, eaux-de-vie are produced from wine or grape marc, either local or imported. The local wine from the Portuguese outermost regions is four times more expensive, due to higher production cost and lower yield, than wines produced on the mainland. While wine produced outside the islands may be initially cheaper to buy, the cost of transportation to the outermost regions also results in the final cost of this ingredient being four times higher. Producers also noted the cost of ***shipping*** production materials (such as bottles) within mainland Portugal is approximately one third of the cost of shipping to the ORs.

[14] Sugarcane producers receive a subsidy through the EU Programme of Options Specifically relating to remoteness and Insularity (POSEI). This aid is directed at sugarcane processing and has been deducted from the full cost of growing sugarcane of €270 per tonne.
[15] OECD-FAO Agricultural Outlook database 2018

All producers on the islands are SMEs and noted that the short production season results in the ***underutilisation of their manufacturing equipment.*** On average production was 47% of total available capacity and economies of scale are difficult to achieve. This results in a 50% increase in capital cost and depreciation. Producers noted that ***general costs***[16] are higher on the islands, which is also reflected in the fact that minimum ***wages*** in Madeira and the Azores are currently set at 102% and 105%, respectively, of the rate paid on the Portuguese mainland.

The following table provides the additional cost per product and per region.

Table 2. Ranges of additional cost by product per 70 cl bottle

Ranges of additional cost by product per 70cl bottle					
	MADEIRA		THE AZORES		
Product	RUM 40% ABV	LIQUEUR 20% ABV	LIQUEUR 20% ABV	EAUX-DE-VIE 40% ABV	
				Mainland base wine	Local base wine
Additional cost (€)	1,60-1,96	0,80-0,97	1,68-2,05	4,23-5,17	4,30-5,26

Source: PwC et al, 2020

2.1.1. What are the drivers of the additional costs for spirit drink producers?

Remoteness, insularity, size, difficult topography and volatility of climate

Remoteness has a negative impact on most sectors because of the transport costs, which affect mobility of labour, capital, raw materials, trade and in general all forms of integration with the EU.[17] Accessibility issues affect these regions not only in their trade and exchanges with the EU but also within their geographic areas and within the same archipelago.

Lying 1,000 km south west of Portugal, Madeira is comprised of two main inhabited islands. The islands are spread over 801.1 square km with a population of just over 250,000 (under 2.5% of Portugal's 2018 population). Approximately 40% of the population are living in the capital, Funchal, on the island of Madeira.

The Azores are composed of nine inhabited islands in three groups lying approximately 1500 kilometres west of Lisbon. The islands are stretched over 600 km from points furthest east and west and have a population of just under 250,000. Approximately 28% of the population live in the capital Ponta Delgada on São Miguel, with the rest of the population distributed throughout other municipalities.

Madeira and the Azores are of volcanic origin and are characterised by green landscapes, rugged coastlines and mountainous terrain. Madeira’s total Utilised Agricultural Area

[16] Rum producers receive an EU subsidy for aging rum. However as 90% of rum sales are currently unaged rum, this subsidy has little impact on reducing costs and has been discarded for the purposes of estimated additional costs for rum producers.
[17] http://www.et2050.eu/TechNotes/ET2050_DiscNote16_OutermostRegions_v(27_02_12).pdf

(UAA) is 5,000 hectares, just 6% of the total area of the islands[18]. The islands' mountainous terrain means that farming typically takes place on land with a slope between 16% and 25%. The terrain makes farming labour intensive because it is difficult to mechanise given the steep slopes. In addition, a relatively large proportion of the population are employed in agriculture (8% in 2017). Over half the area of the Azores is suitable for agriculture (123,800 hectares). Livestock farming accounts for 80% of the UAA with only 20% of the UAA in the Azores being arable. Small scale farming and a wetter climate mean that output per hectare is lower in the Azores for many crops than on the Portuguese mainland or Madeira[19].

Madeira enjoys an average annual temperature that varies between 16°C and 22°C. Precipitation rates can be high[20] and the islands were hit by damaging floods and mudslides in 2010. The climate of the Azores is maritime temperate and is characterised by very changeable weather with occurrence of severe phenomena with relative frequency (e.g. storms, strong winds, heavy rains, etc.), affecting agriculture[21]. The Azores have experienced the effects of several storms, including hurricane Lorenzo in 2019 which caused an estimated €330 million in damages.[22]

The difficult topography and volatility of climate mean that ingredients grown in the Portuguese outermost regions are systematically more expensive than world prices. Furthermore these factors impact the quality of sugarcane cultivated in Madeira, which has a lower sugar yield (approximately 50% less) than sugarcane grown in Brazil. This lower yield results in less alcohol being produced from one ton of sugarcane and consequently producers in Madeira need more sugarcane to distil the same volume of alcohol as a rum producer using Brazilian sugarcane.

Small scale of production

Across both Madeira and the Azores, there are 35 spirit drink producers operating within the derogation, and all are small and medium-sized enterprises. Three quarters of these producers are micro enterprises and only 5 producers have more than 20 employees. There is a strong seasonal component to employment with some producers only operative for two or three months a year due to the short growing season.

There are substantial variations in output in terms of hectolitre of pure alcohol (HLPA) per worker reflecting the variety in business models, beverages produced and size. The smallest producers in the ORs make less than 10 HLPA of spirit drinks each year and labour productivity per employee for these producers is lower than other SMEs.

SMEs in general face significant obstacles in terms of development. SMEs in the outermost regions are further hampered in increasing production and therefore achieving economies of scale due to the small scale of the regional markets and seasonal nature of production. This results in underutilisation of machinery designed for higher volumes of production. A lack of financial and human resources also impacts on marketing for the

[18] 2016 data
[19] Statistics Portugal. Agriculture and Fisheries - Time Series - 1976-2018
[20] https://ec.europa.eu/regional_policy/sources/policy/themes/outermost-regions/pdf/rup_2017/rup_eu_lands_world_en.pdf
[21] http://www.euroconsulting.be/wp-content/uploads/2017/01/fullrep_en1.pdf
[22] https://www.jn.pt/local/noticias/acores-grupo-oriental/ponta-delgada/furacao-lorenzo-provocou-prejuizos-de-330-milhoes-de-euros-11405185.html

producers in the outermost regions and pales in comparison to the resources large global spirit drink brands have.

Compliance with EU legislation

Point 1 of Annex II of Regulation (EC) No 110/2008[23] on the definition, description, labelling and the protection of geographical indications of spirit drinks sets out the definition for rum. In general, rum is an unflavoured spirit drink with a minimum alcohol content of 37.5% produced exclusively by fermentation and distillation of molasses or syrup in the manufacture of cane sugar or from sugarcane juice itself, with certain sweetening limitations.

For the outermost region of Madeira, rum is defined as:

> *a spirit drink produced exclusively by alcoholic fermentation and distillation of sugar-cane juice which has the aromatic characteristics specific to rum and a volatile substances content equal to or exceeding 225 grams per hectolitre of 100 % vol. alcohol. This spirit may be placed on the market with the word 'agricultural' qualifying the sales denomination 'rum' accompanied by any of the geographical indications of the French Overseas Departments and the Autonomous Region of Madeira as registered in Annex III.*

In order to avail of the reduced rate for Madeiran rum, producers must use the more expensive sugarcane grown in Madeira and cannot source cheaper sugarcane elsewhere.

The reduced rate of excise duty is applicable to liqueurs produced in Madeira from regional fruits or plants. These liqueurs must satisfy the definition of liqueurs set out in Annex II to Regulation (EC) No 110/2008. In the Azores, liqueurs made from regional fruit or raw materials receive the reduced rate. Compliance with the legislation means that producers must use local fruits, plants or raw materials, which drives up the production costs for the producers[24].

2.2. Market Saturation

Since 2010, sales within the derogation have grown significantly. In Madeira, rum and liqueur sales have increased at an average rate of 8% and 6.9%, respectively. For rum, the average annual growth rate has increased to 12.8% since 2014. In the Azores, sales of liqueurs have increased on average by 9.7% per annum. In contrast to these positive growth rates, eaux-de-vie sales in the Azores have fallen on average by 2.6% since 2010.

[23] Regulation (EC) No 110/2008 of the European Parliament and of the Council of 15 January 2008 on the definition, description, presentation, labelling and the protection of geographical indications of spirit drinks and repealing Council Regulation (EEC) No 1576/89

[24] In the Azores, reduced rates are also possible for eaux.de-vie made from wine or grape marc having the characteristics and qualities defined in categories 4 and 6 of Annex II to Regulation (EC) No 110/2008. This legislation does not include a requirement that the wine or grape marc must be from the Portuguese outermost regions.

The regional markets of Madeira and the Azores are smaller domestic markets than Malta, the least populated Member State near the mainland of EU with only 250,000 people living in each region. Given the high levels of tourism seen in the Portuguese outermost regions, it is likely that increased consumption of these locally produced spirit drinks is, to some extent, driven by tourists rather than the population of the ORs. In 2018, 1.4 million tourists visited Madeira, a slight fall on the previous year. Approximately 0.7 million tourists visited the Azores during the same period. The local population and tourists currently purchase 90% of the production of these specific spirit drinks.

It is assumed that growth rates will gradually converge to 2%, in line with the average growth of the regional economies for the period 2010-2018, suggesting that the local markets, even with the tourists, may become saturated in the near future.

2.2.1. What are the drivers of market saturation?

The Madeiran rum industry is the main purchaser of local sugarcane and since this regime was first introduced in 2002, land used to produce sugarcane has increased significantly from 110 hectares (2002) to the current acreage of 172 hectares in 2018. The financial crisis of 2013 resulted in an increase in employment in agriculture of approximately 6% and together with the increase in land used for sugarcane, production of sugarcane in Madeira has increased from 2,900 tonnes to 7,600 tonnes. This has resulted in rum production by the SMEs in the outermost region, exceeding sales by on average 40% in each of the last years.

While some production is aged or used as a base for liqueurs, producers estimate approximately 2,850 HLPA is currently being stockpiled at a cost[25].

Producers note the difficulty of accessing other larger markets due to the competitive disadvantage they face as they are unable to compete on price against international brands. As outlined above, producers face higher costs for the main ingredients of these spirit drinks. In addition to this cost, remoteness and insularity result in significant transportation costs for producers, who attempt to access the Portuguese mainland market. The additional shipping costs of freight to the mainland add approximately €0.17 per bottle[26].

2.3.How will the problems evolve?

In the 2017 Communication “A stronger and renewed strategic partnership with the EU's outermost regions”[27], the Commission noted that despite progress made over the years, the ORs continue to face serious contraints, many of which are permanent. Furthermore, globalisation and climate change are amplifying theseconstraints. Diversification

[25] Storage costs of this excess production is included in the global additional costs described in section 2.1 above.
[26] Based on 9600 bottles in a 20ft shipping container
[27] COM(2017) 623 final

opportunities are limited due to the few resources at their disposal and the geographical and natural characteristics specific to their remoteness. Consequently, the economies of the outermost regions are fragile and any sustainable economic growth or desirable structural changes insecure. Economic crises are bound to affect the economies of the outermost regions to a greater extent than of mainland Europe, and recovery is slower. Any such effect and developments are however difficult to determine as regional statistical data are not always available and if available, unreliable.

The Communication stresses the need to build on the assets of the ORs, identifying new sectors of growth to enable growth and job creation. While this approach is important to address the numerous threats and challenges for the ORs, the traditional activities are also vital to the development of the regions as any sustainable structural changes to the economies of the ORs will take time to materialise.

The costs faced by producers in the regions are higher than the costs faced by the mainland producers and they are attributable to the factors identified in Article 349 TFEU. Overall, the derogation has increased production levels, and as such, supported employment in the regions. Along with the benefits provided to producers, other stakeholders in Madeira and the Azores also benefit from this derogation. This includes operators in the tourism sector along with those involved in the value chain of the derogation, such as fruit producers.

With no change in the derogation, the fiscal costs of the regime are estimated to increase by approximately €7.3 million in 2027 (an increase of 45% in real terms since 2018). The administrative costs of the regime will remain relatively low, (approximately €38,500 per annum) increasing only with inflation.

As many of the underlying drivers, such as remoteness, insularity or climate, are of permanent nature, they will always act to the ORs' disadvantage. There are no grounds to consider that they would diminish significantly in the near future as they are inherent to small insular economies in general, as well as the traditional methods of spirit drinks production in the ORs. Unfortunately, there are no coherent data series assessing all the components of the cost of these specific spirit drinks in a consistent way, making it difficult to predict how these can evolve.

Transport infrastructures have been steadily built and a mildly positive trend in the maritime and air transport of freight could be observed in the last decades in the ORs but accessibility issues will always affect the trade and exchanges of the ORs with the EU as and within their geographic areas alike.

What we can carefully conclude from the nature of the costs is that they can fluctuate but will never disappear altogether.

2.4. Why should the EU act?

On the basis of Article 349 TFEU, the Council can adopt specific measures in favour of the EU outermost regions to adjust the application of the Treaties to those regions, including the common policies, because of the permanent constraints which affect the economic and social conditions of the outermost regions. In its judgement of 15 December 2015[28], the European Court of Justice clarifies the scope of the application of Article 349 TFEU on the basis of which the Council is entitled to adopt specific measures for the outermost regions.

The EU has been building a strong partnership with the outermost regions. In 2004, the Commission presented its first strategy for the regions, which was renewed in 2008, in 2012 when the strategy was aligned with the Europe 2020 goals of sustainable growth, social development and creation of jobs; and in 2017, when the Commission strengthened and renewed its strategic partnership with these regions. Access to the EU single market is vital for the continued development of the ORs as underlined in the 2017 Commission Communication [29].

Maximising the potential of each outermost region can only benefit both the outermost regions and the EU as a whole.

3. Objectives: What is to be achieved?

3.1. General objectives

The situation of the ORs is recognised in Article 349 TFEU, which envisages specific measures for those regions to take account of the structural, social and economic situation of these regions. Measures adopted must mitigate the constraints of the ORs without undermining the integrity and the coherence of the Union legal order, including the internal market and common policies.

3.2. Specific objectives

Specifically, the objectives of Council Decision No 376/2014/EU are:

- Offset the competitive disadvantage of producers of rum, eaux-de-vie and liqueurs in the Portuguese outermost regions, which are linked to the permanent constraintsof the ORs;
- Support the spirit drinks industry in the Portuguese ORs, which is important for the development of the ORs economy, and diversification of local activities;
- Ensure the smooth functioning of the single market for spirit drinks.

4. What are the available policy options?

4.1.What is the baseline from which options are assessed?

For the purposes of this report, there is a difference between ‘no action’ and the ‘status quo’. Given that the Council Decision authorising the reduced excise duties expires in 2020, a ‘no action’ scenario would imply that the current system of reduced rates expires

[28] Joined Cases C-132/14 to C-136/14
[29] COM(2017) 623 final

in 2020 with no other regime put in place. This is, however, not considered to be a realistic baseline scenario.

As such, we assess non-renewal of the regime as a ‘new policy option’, whereas the baseline option for this regime is defined as a ‘business as usual’ scenario, in which the derogation is renewed for a further seven years. The baseline assumes that the 75% reduced rate for rum and liqueurs on Madeira and liqueurs and eaux-de-vie on the Azores continues after 2020.

4.2.Description of the policy options

Option 1 – Termination of the OR specific support

Under this policy option, the existing regime for the Portuguese outermost regions would not be renewed and would therefore expire on 31 December 2020. In the absence of the specific regime, the Portuguese authorities may apply Article 7(3) of Directive 92/84/EEC, which allows for a 50% reduced rate to certain spirit drinks made and consumed in the Portuguese outermost regions. Small independent distilleries producing less than 10 hectolitres of pure alcohol per annum will be subject to a reduced rate of 50% of the standard Portuguese rate of excise duty in accordance with Article 22 of Directive 92/83/EEC. These provisions are not cumulative as in both cases the maximum relief possible is 50% of the standard Portuguese rate of excise duty.

Box 2: Application of Article 7(3) of Directive 92/84/EEC

If the derogation was not renewed, the Portuguese authorities could use Article 7(3) of Directive 92/84/EEC to apply a reduced excise duty rate of up to 50% of the standard rate to:

In Madeira

rum as defined in Article 1(4)(a) of Regulation (EEC) No 1576/89 having the geographical characteristics set out in Article 5(3) and Annex II, point 1, of that Regulation,

liqueurs produced from sub-tropical fruit enriched with sugar cane eau-de-vie and having the characteristics and qualities defined in Article 5(3)(b) of Regulation (EEC) No 1576/89;

In the Azores

liqueurs as defined in Article 1(4)(r) of Regulation (EEC) No 1576/89 produced from passion fruit and pineapple,

eau-de-vie made from wine or from grape marc having the characteristics and qualities defined in Article 1(4)(d) and (f) of Regulation (EEC) No 1576/89.

This provision applies to a limited number of liqueurs and no crème de in comparisons to the Council Decision.

Option 2 – Extension to rum produced and consumed in the Azores

The current Decision applies a reduced rate of excise duty on the sale of specific spirit drinks in Madeira (rum and liqueurs) and in the Azores (liqueur and eaux-de-vie). In accordance with this policy option the regime would be renewed as it is with an amendment to enlarge its scope to cover sales on the Azores of locally produced rum.

This would address the current imbalance between rum producers in the Portuguese outermost regions and ensure all rum producers in both Madeira and the Azores are treated equally. This option would apply a 75% reduced rate for rum and liqueurs on Madeira and rum, liqueurs and eaux-de-vie on the Azores.

Option 3 – Extension of the current 75% reduced rate to Azorean rum consumed in the Azores and a 50% reduced rate on the Portuguese mainland for all spirit drink products (rum, liqueurs, eaux de vie).

The current Decision applies a reduced rate of excise duty on sales of specific products in Madeira (rum and liqueur) and in the Azores (liqueur and eaux-de-vie). Under this option, the scope of the regime would be amended in order to extend the existing reduced rate of 75% to include rum sold in the Azores and also allow a 50% reduction in excise duty on sales of these rum, liqueurs and eaux de vie on the Portuguese mainland. Within this option, there are two possible sub-options:

- **Option 3.1** – The reduced rate of 50% on the mainland applies to a quota of 6,000 hectolitres of pure alcohol per year
- **Option 3.2** – The reduced rate of 50% on the mainland applies to all sales of the specific alcoholic beverages, with no annual quota applied.

The Portuguese authorities requested option 3.1 including a quota of 6,000 hectolitres of pure alcohol per year in order to address the issue of market saturation for rum and to remove the barriers facing producers accessing markets outside of the local outermost regions. This volume was based on projections from various stakeholders and is approximately 9% of the current total spirits market in mainland Portugal. While this is significantly below the current quota of 144,000 hectolitres of pure alcohol per annum applied to rum produced in the French outermost regions and sold on the French mainland in absolute terms, relative to the size of the spirits market in each country it is similar.

4.3. Options discarded at an early stage

Direct support to production

Under this alternative, the derogation would not renewed but alternative support would be provided to the industry via a direct subsidy to producers. This support could be through an approved EU mechanism for State aid, or a subsidy either with the intention of targeting employment or supporting small producers, or regional operating aid.

While this option could potentially target support better to the producers, it would result in increased burdens and costs for stakeholders. The current regime is administered through excise duty returns, with low costs for both producers and authorities. A new delivery system would be required, which may involve significant costs for little benefit. For these reasons, this option would not be a viable option and will be discarded.

Lower the reduced rate to 50% with extension to Azorean rum and mainland sales

Under this policy option, the maximum reduction in excise duty would be set at 50% of the standard excise duty (instead of the current reduction of 75%). The 50% reduction would apply to the rum, liqueurs in Madeira, rum, liqueurs and eaux-de-vie in the Azores and all products on the Portuguese mainland with no quota.

Producers in the outermost regions are small medium enterprises who are faced with additional costs which are compensated by the existing regime. However, some producers, particularly smaller producers and those in the Azores are undercompensated by the 75% reduction.

The local outermost regions' market is vital to the producers as currently 90% of their production is sold in the local market with producers noting the additional freight costs associated with mainland sales as a major barrier. The negative impacts of lowering the reduced rate to 50% from the current rate of 75% would not be offset by the benefits of extending the reduced rate to the mainland. For these reasons, this option would not be effective or coherent with OR policy.

5. What are the impacts of the policy options?

5.1.Methodology

The impacts of the policy options have been assessed mainly on the basis of a study by the external contractor, PricewaterhouseCoopers. The study was based on a combination of primary research, that is, on data gathered from all relevant stakeholders and independent research to triangulate findings, review of the existing literature and data, and economic and policy analysis. The data collected from institutional stakeholders and the producers, across both islands covering approximately 90% of production under the derogation, was a key focus of the study.

Appropriate, but limited, adjustments were made on specific points where this was warranted by newer information becoming available or by fine-tuning of the policy option. For the quantitative estimates, the impacts are measured as the deviation of the variable assessed from the baseline, at the conventional date of 2027. This is sufficiently distant to allow short-term effects play out with the exception of the emerging effects of COVID-19. Full details on the methodology are provided in Annex 4.

Effects of the COVID-19 pandemic on the projections underlying the assessment

It should be noted that the baseline scenario as well as the impacts from the various options have been assessed on the basis of the study carried out in late 2019-early 2020. As such, the effects of the COVID-19 pandemic are not taken into account. The COVID-19 pandemic will certainly reduce tourists to the outermost regions and demand for spirits in the first half of 2020. At the time of writing, it is too early to assess whether the impact on the tourism and the demand for spirits will be limited to 2020 or will stretch into the future. While in the first case the projected baseline may not be affected to a large extent, in the second case, the baseline scenario may overstate growth. The impacts of the options, however, are calculated on the basis of long-term elasticities and should, as a result, be less affected than the baseline.

5.2. Baseline

Historical growth rates of all products, with the exception of eaux-de-vie, have significantly exceeded GDP growth rates and tourist expenditure during the period 2010 and 2018. In the medium term this is unlikely to continue and it is probable that the growth rate will slow down. It is expected that the growth rate will converge to 2%, the average growth rate of the economies of outermost regions. Based on this growth rate, total sales are expected to increase from 4,230 to 6,560 hectolitres of pure alcohol under the baseline scenario. Market distortions will continue to be limited due to the small volumes involved.

Additional costs for producers will continue to be broadly offset by the regime and production across the relevant spirit drinks industry is expected to grow by 3.3% on average per year. An increase in land use for sugarcane production is expected with no major environmental effects.

Compliance costs and minor administrative burdens are assumed to remain broadly the same in the baseline scenario. The fiscal costs are estimated to increase to €7.3 million by 2027 and will remain relatively modest in terms of its share of tax receipts in the outermost regions.

The regime is expected to remain coherent with EU policies for the outermost regions and State aid guidelines.

5.3. Option 1 – termination of OR specific support

Market and employment impact

Option 1 means specific spirit drinks produced and sold in Madeira and the Azores would be subject to 50% relief. The relief in Directive 92/84/EEC is more limited in scope compared to the Decision and more than 85% of the liqueurs produced in the Azores would be ineligible for this reduced rate of excise duty as they are made with fruits other than passion fruit or pineapple. Producers of rum in Madeira and eaux-de-vie would still receive relief, albeit at 50% rather than the current 75%. Separate to Directive 92/84/EEC, small independent distilleries with an annual production of less than 10 HLPA would be entitled to 50% relief on all products consumed in all of Portugal. Based on annual production only, 21 producers may fall under this regime[30], including 7 distilleries in the Azores producing liqueurs.

In this scenario, additional costs for products covered by Directive 92/84/EEC would be undercompensated on average, particularly in the Azores. Small independent distilleries in the Portuguese outermost regions would not be compensated for the additional costs they face due to the location. In response to this, sales would decrease by 510 HLPA, with the production of Azorean liqueur declining by 11%. This drop in sales would directly affect employment with an estimated loss of 39 jobs. This would reduce the GVA by 1,533.

Fiscal and administrative impacts

Lowering the reduced rate to 50% instead of 75% and reducing the number of eligible spirit drinks would result in an additional €3.4 million in excise duty and VAT receipts.

[30] This relief is for legally and economically independent distilleries, who produce less than 10 HLPA per annum. Compliance with both criteria is necessary in order to avail of this relief.

This includes €1.2 million more on Azorean liqueurs. Ongoing administrative costs would be expected to remain broadly the same as the current derogation. However, the change in products scope may result in new costs due to uncertainties regarding eligibility.

Table 3: Comparison of Option 1 with the baseline

	Change in sales (HLPA)	Change in GVA (€,000)	Change in jobs (FTE)	Change in tax paid (€'000)
Compared to baseline (2027)	-510	-1,533	-39.3	+3,414

Source: PwC et al, 2020

5.4. Option 2: Extension of the 75% reduced rate to rum produced and consumed in the Azores

Market and employment impact

Rum production in the Azores is limited with one producer distilling rum since 2018. Sugarcane is produced on a low level in the Azores, due in part to the fact that the archipelago lies at the northernmost extremity of sugarcane production and is not ideal for cultivation. Costs of sugarcane production is estimated to be 30% higher than sugarcane grown in Madeira and rum producers in the Azores would be undercompensated by the reduced rate. Taking these factors into account, it is estimated that production of Azorean rum would reach 589 HLPA by 2027. This would result in 7 additional jobs and increase GVA by €270,000.

Fiscal and administrative impacts

Extending the 75% reduced rate to rum produced in the Azores would increase the fiscal cost by €619,000, a modest increase. Ongoing administrative costs would be expected to remain broadly the same as the current derogation.

Table 4: Comparison of Option 2 with the baseline

	Change in sales (HLPA)	Change in GVA (€,000)	Change in jobs (FTE)	Change in tax paid (€'000)
Compared to baseline (2027)	+589	+270	+7.2	-619

Source: PwC et al, 2020

5.5. Option 3 – Extension of the 75% reduced rate to Azorean rum consumed in the Azores and a 50% reduced rate on the Portuguese mainland for all products

Market and employment impact

The production of Azorean rum is limited and the impacts of this option alone are presented in section 5.4 above. A reduced rate of 50% for all products released for consumption on the Portuguese mainland would primarily affect rum producers, who are producing more than 10 hectolitres of alcohol per year and therefore not eligible for the 50% reduced rates for small independent distilleries.

Land use for sugarcane production has increased by 40% between 2010 and 2018. During the same period, rum production has doubled indicating an improved cane yield. As discussed in section 2.2, this has resulted in the stockpiling of rum as the local market is becoming saturated. Access to the Portuguese mainland market with reduced rates would contribute to resolving this issue. Both options apply a 50% reduced rate, however option 3.2 limits this to 6,000 HLPA.

This quota would have no immediate impact as projected sales are well below this volume. The situation is likely to remain for several reasons including the limited amount of Utilised Agricultural Area (UAA) available for sugarcane production the unfavourable climate, and the expected negative impact of the COVID-19 pandemic on production and consumption of alcohol products. Therefore, the impacts of both sub-options are expected to be the same. sales were expected to increase by 953 HLPA by 2027. This would result in 11 additional jobs and increase GVA by €430,000.

Fiscal and administrative impacts

The introduction of a 50% reduction in excise duty for specific OR products consumed in mainland Portugal will generate new administrative and compliance cost.

The costs of **option 3.1** are higher than o**ption 3.2** as option 3.1 would increase the administrative costs due to the costs of setting up an IT system to manage and monitor the application of a quota. It is estimated that such a system would add a further 20% (€3,600 per year) to the costs faced by the producers, who are SMEs. This system would also create similar costs for the authorities, with a larger proportion borne by the authorities in the outermost regions.

Extending the regime to apply a reduced rate to sales of specific OR spirit drinks sold on the Portuguese mainland would increase the fiscal cost of the regime by €805,000. The table below provides a comparison with Option 2 to show clearly the impact of the mainland extension.

*Table 5: Comparison of Options 3.1 and 3.2 with the baseline**

	Change in sales (HLPA)	Change in GVA (€,000)	Change in jobs (FTE)	Change in tax paid (€'000)
Compared to baseline (2027)	+953	+430	+11.2	-805
Compared to Option 2 (2027)	+364	+161	+4.1	-128

*The impacts of both suboptions are the same. Source: PwC et al, 2020

The following table provides a comparison of all options with the baseline.

Table 6: Comparison of all options with the baseline

	Change in sales (HLPA)	Change in GVA (€,000)	Change in jobs (FTE)	Change in tax paid (€'000)

Option 1	-510	-1,533	-39.3	+3,414
Option 2	**+589**	**+270**	**+7.2**	**-619**
Option 3.1 and option 3.2	+953	+430	+11.2	-805

Source: PwC et al, 2020

6. HOW DO THE OPTIONS COMPARE?

For the purposes of this analytical report, all options have been assessed whether they have a positive, negative or neutral effect relative to the baseline for effectiveness, efficiency and coherence.

Effectiveness

Effectiveness is assessed by reference to how successfully an option meets the objectives of supporting the development of the outermost regions, through compensating the specific OR spirit drinks industry for the additional costs, while mitigating any negative impacts on the smooth functioning of the internal market.

The **baseline** is a continuation of the current regime, which has effectively compensated the specific producers in the outermost regions for the additional costs to date. Maintaining the rate reduction at 75% would mean that additional costs would continue to be broadly offset. Production levels of the specific spirit drinks would continue to grow by 3.3% on average each year and support employment in the outermost regions. This increased production means however, that stockpiling of excess production would also continue. The baseline would continue to support other stakeholders in Madeira and the Azores including operators in the tourism sector along with those involved in the value chain of the derogation, such as fruit, wine and sugarcane producers. While volumes sold under the derogation continue to grow over the period, its overall size as a proportion of the Portuguese market continues to mean that the scope for market distortions is limited.

The effectiveness of **option 1** would be less than the baseline as the derogation is not renewed and the Portuguese authorities revert to the provisions in Directives 92/84/EEC and 92/83/EEC that allow a 50% excise duty rate reduction. This option would not fully address the additional costs faced by OR producers of all the current spirit drinks as the provisions in these Directives have a narrower product scope as well as a smaller rate of reduction. For most products, the impact is relatively modest, however liqueur production in the Azores would fall by approximately 11%. Overall moderate negative effects are expected, reducing the effectiveness of this option.

By extending the current regime to include rum production on the Azores, **option 2** would result in a small increase in the support to industry. Production levels would increase supporting additional jobs with moderate positive effects expected compared to the baseline.

Option 3[31] would be the most effective option as rum producers in the Azores would be supported and a reduced rate of 50% would apply to these specific OR products, if sold on the Portuguese mainland. This would offset the additional shipping costs incurred by OR producers in accessing the Portuguese mainland market. This access to another market will allow rum producers in Madeira the opportunity to sell their excess stock at competitive prices. Furthermore it will provide access to a larger market for all producers in the outermost regions, enabling them to possibly increase their production and ultimately revenues. No market distortions are envisaged due to the low volumes involved and overall a moderate positive effect on effectiveness is anticipated.

Efficiency

Efficiency is assessed in terms of how well the costs of the measure, in terms of fiscal and administrative costs, translate into benefits for the outermost regions.

The baseline scenario will see a relatively modest increase in fiscal and administrative costs, which will be offset by the benefits for the stakeholders. **Option 1** would result in a decrease in fiscal costs due to the lower reduced rate of 50%, which is applicable to a smaller number of spirit drinks. This would reduce the compensation for producers and overall benefits of the regime. Overall, no effect on efficiency is expected with this option as the change in the product scope could also result in additional administrative costs and some legal uncertainties for producers and authorities. A neutral impact on efficiency is also expected for option 2, albeit for different reasons. **Option 2** would result in an increase in fiscal costs in the Azores but the benefits would be consistent with this increase. **Option 3.2** with no quota for mainland sales would have a moderate positive effect on the efficiency of the regime. **Option 3.1** with a quota would be less efficient due to the administrative and IT costs associated with a quota.

Coherence

The baseline and **option 2** would continue to be coherent with regional and economic policy. Both scenarios would have only modest impacts on trade and be consistent with State aid guidelines. A moderate positive outcome is expected with **option 3** with or without a quota, due to the low volumes involved. **Option 1** is less coherent with the overall EU policy approach to provide tailor made support to the outermost regions pursuant to Article 349 TFEU, as the policy would no longer compensate some producers for the additional costs they face producing specific spirit drinks in the outermost regions.

Table 7: Summary of estimated impacts for each of the options considered (see key below)

Option theme	Effective	Efficient	Coherent

[31] Both sub options are equally effective as the estimated volumes are significantly below the proposed quota of 6,000 hectolitres of pure alcohol.

Option theme	Effective	Efficient	Coherent
Baseline: The derogation is renewed with no further policy changes	0	0	0
Option 1: Termination of the OR specific support	-	0	-
Option 2: Extension of the 75% reduced rate to rum produced and consumed in the Azores	+	0	0
Option 3.1: Extension of the 75% reduced rate to Azorean rum consumed in the Azores and a 50% reduced rate on the Portuguese mainland for all products with a quota of 6,000 HLPA per year	+	0	+
Option 3.2 Extension of the 75% reduced rate to Azorean rum consumed in the Azores and a 50% reduced rate on the Portuguese mainland for all products with no quota applied	+	+	+

Legend: + moderate positive effect expected; 0 no effect or neutral impact expected; - moderate negative effect expected; (all relative to baseline)
Source: PwC et al, 2020

7. Preferred option

Option 3.2 with no quota is the preferred option. This would renew the special rules beyond 2020 and extend the scope of the current regime of a reduced rate of 75% to include rum produced and consumed in the Azores. This option would also allow a 50% reduced rates for the specific spirit drinks consumed on the Portuguese mainland. This 50% rate would apply to all sales of these specific spirit drinks on the Portuguese mainland, without a quota (i.e. it would not be subject to quantitative limits). Due to the limited volumes involved, a quota is not necessary to ensure the smooth functioning of the internal market. Therefore option 3.2 with not quota means that unnecessary IT and administrative costs, for both authorities and economic operators, are avoided.

This option addresses the additional costs faced by spirit drinks producers in the outermost regions as a result of the specific constraints of the regions as set out in Article 349 TFEU. Producers of rum in the Azores would be subject to the same reduced rate as rum producers in Madeira, removing the current imbalance in treatment and ensuring a level playing field. This option supports the economies of the outermost regions with little impact on the smooth functioning of the internal market. Moveover, access to the mainland market would be possible under this option, as the additional shipping costs would be compensated to an extent through the reduced rate of 50%. This would address the emerging issue of market saturation that was identified in the review of the regime.

8. How will actual impacts be monitored and evaluated?

The monitoring of the implementation and functioning of the derogation will be the role of the Portuguese authorities and the Commission, as it has been to date.

In accordance with Article 4 of the current Decision, the Portuguese authorities were required to submit a report, halfway through the life of the Decision to the Commission. This report was to enable the Commission to assess whether the reasons justifying the derogation still exist and whether the fiscal advantage granted by Portugal has remained.

It is important that the Portuguese authorities continue preparing a monitoring report as they are best placed to gather the precise information from the impacted stakeholders. Portugal will be asked to submit a report by 30 September 2025 for the period from 2019 to 2024[32]. This report will include any relevant information as regards the additional costs involved in the production of the specific spirit drinks in the Portuguese outermost regions, economic distortions and market impacts. This report will contain the necessary information for the evaluation of the effectiveness, efficiency, coherence with other EU policies, continued relevance and EU added value of the new legislation. The evaluation should also seek to collect input from all relevant stakeholders as regards the level and evolution of their additional production costs, compliance costs and any instances of market distortions.

To make sure that the information collected by the Portuguese authorities and analysed in the report contains the necessary data that the Commission must know to take an informed decision on the validity and viability of the scheme in the future, the Commission will draw up specific guidelines on the required information. Such guidelines will be, to the extent possible, common to other similar schemes to the EU's outermost regions, governed by similar legislation.

This will enable the Commission to assess whether the reasons justifying the derogation still exist, whether the fiscal advantage granted by Portugal is still proportionate and whether alternative measures to a tax derogation system which are also sufficient to support a competitive spirit drinks industry can be envisaged, taking into account their international dimension.

[32] The report should include 2019 data so that a baseline is established and that the Commission is able to review the impact of the derogation covering the period post 2020. The report should contain the most up to date data up to and including 2024, where possible.

Annex 1: Procedural information

1. Lead DG, Decide Planning/CWP references

The lead Commission service for this file is the Directorate General for Taxation and the Customs Union (DG TAXUD).

This initiative got the following political agreements:

- Agenda Planning and roadmap: Proposal for a Council Decision replacing Council Decision 376/2014/EU authorising Portugal to apply a reduced rate of excise duty for rum, liqueurs and eaux-de-vie produced in Portuguese outermost regions (period post 2020) (PLAN/2019/5285)

Due to its limited impacts, the file was not included in the Commission Work Programme.

2. Organisation

The following Commission services were invited to the Inter-Service Steering Group: AGRI, BUDG, CLIMA, COMP, DEVCO EMPL, ENV, GROW, HOME, JRC, MOVE, REGIO, SANTE, SG, SJ, and TRADE.

A consortium led by PricewaterhouseCoopers LLP – PwC and CASE - Center for Social and Economic Research, (hereinafter collectively referred to as "the Consultant") undertook the assignment titled "Study on reduced excise duty rates in the Portuguese outermost regions of Madeira and Azores".

The study has established the basis for a so-called back-to-back exercise with evaluation and a forward-looking assessment carried out simultaneously in accordance with Better Regulation Guidelines.

The objectives of the study were to analyse whether the reduced excise duty rate applied on rum and liqueurs produced and consumed in the Portuguese region of Madeira and liqueurs and eaux-de-vie produced and consumed in the Portuguese region of the Azores is fit for purpose and the scale of the issues or weaknesses encountered in its application.

The study assessed the evolution of the problems of the current regime and the impacts of the possible options to address the problems identified.

Annex 2: Stakeholder consultation

Background

The study has been commissioned to evaluate the regime of reduced excise duty rates applied to certain spirit drinks made and sold in the outermost regions of Madeira and the Azores and to assess future options for the period after the current regime expires in 2020. Under this derogation, excise duty rates can be reduced by up to 75% on rum and liqueurs made and sold in Madeira and liqueurs and eaux-de-vie made and sold in the Azores.

The objectives of the regime are to support the production of certain spirit drinks in Madeira and the Azores and, through that, the development of the economies of these regions. Specifically, the derogation is intended to provide compensation for the additional costs faced by producers in Madeira and the Azores. The derogation is permitted under Article 349 of the Treaty for the Functioning of the European Union, which allows for the adoption of specific measures to take account of the structural, social and economic situation of the ORs[33].

Outline of the consultation strategy

The consultation was needed to provide information related to the industry and the operation of the derogation in order to inform both the evaluation and assessment of impacts. The main objectives of the consultation are set out below:

- Collect data from relevant stakeholders involved in the current derogation in order to undertake the evaluation;
- Collect opinions from stakeholders affected by the derogation (both directly and indirectly) on the current derogation and on options for the derogation after 2020;
- Identify areas where the current derogation is achieving its objectives and areas where it could be improved; and,
- Better understand the costs and burdens on relevant stakeholders associated with the derogation.

All questionnaires were issued with a letter of introduction provided by the European Commission. The questionnaires were issued with an initial four-week time frame for responses, with email follow-ups being issued during this period for recipients who had not responded. The time period was extended for two further weeks in order to encourage responses. Most responses were received in the sixth week of the consultation period.

[33] Article 349 specifies the situation of the ORs '*is compounded by their remoteness, insularity, small size, difficult topography and dependence, economic dependence on a few products, the permanence and combination of which severely restrain their development*'.

In order to collect the information set out above, several groups of stakeholders were identified for consultation. The table below sets out stakeholders consulted and tools used.

Table 8 Stakeholders consulted and tools used

Stakeholder	Method of consultation	Consultation period	Content	Language
EU Commission and Portuguese/ regional authority officials	Scoping discussions, targeted questionnaires followed up by ad-hoc interviews if required.	Q3 and Q4 2019	The functioning of the current system Coherence with wider EU/Portuguese policies Possible future policy options The impacts of policy options	EN/PT
Authorities in Madeira and the Azores	Targeted questionnaires followed up by ad-hoc interviews if required.	Q3 and Q4 2019	The functioning of the current system Possible future policy options The impacts of policy options	EN/PT
Economic operators (producers and distributors)	Initial discussions, targeted detailed questionnaires followed up by ad-hoc interviews if required for economic operators with detailed involvement in the working of the derogation, alongside data gathering.	Q3 and Q4 2019	The functioning of the current system Coherence with wider EU/Portuguese policies Possible future policy options The impacts of policy options	EN/PT

Consultation activities undertaken

In order to implement the approach set out in the above table, seven targeted questionnaires were developed. The table below sets out the activities undertaken and responses received.

Table 9 Questionnaire response rates

Target group	Key topics covered	Recipients	Total responses received	Response rate
European Commission	Administrative process and costs Future of the derogation Associated costs Expansion of derogation	8	4	50%
Portuguese authorities	Impact of the derogation Procedures and costs Future of derogation Expansion of derogation to mainland	3	1	33%
Producers in Madeira	Administrative process and costs Future of derogation Associated costs Alternative suggestions	11[34]	5	45%[35]
Producers in the Azores		13	5	38%[36]
Portuguese distributors	Main distribution activities Future of derogation Associated costs Market size and product quantities Market in mainland	14	2	14%
Civil society	Awareness of derogation Impact of ending the derogation Potential future options	13	0	0%

Approach and methodology used to process the data:

The approaches used to process questionnaire responses were proportionate to the response rates. The table below outlines the key approaches used.

[34] Data received from the OR authorities indicated that not all of the recipients of the producer survey were active. Comparison suggests that two recipients in Madeira and one in the Azores did not produce alcohol within the scope of the derogation.

[35] Estimated percentage of total sales captured by survey in Madeira - 97.5% Rum, 85.4% Liqueurs, N/A Eaux-de-vie

[36] Estimated percentage of total sales captured by survey in the Azores - 100% Rum, 81.3% Liqueurs, 98.9% Eaux-de-vie

Table 10 Questionnaire response rates

Type of data collected	Approach	Questionnaires
Qualitative and quantitative information on current administrative processes surrounding the derogation	Data was collected for each of the stakeholders in terms of the steps and costs of overseeing the derogation and in relation to the Council Decisions required for the derogation. These data were combined across questionnaires (each questionnaire related to the costs of a specific department or Directorate-General) in order to describe the steps and costs required across the EC and Portuguese government. Clarification was sought via email / phone to clarify responses that were unclear and to follow up on questionnaire responses which had not been completed to a sufficient standard of detail.	European Commission; Portuguese and regional authorities
Quantitative data on production and production costs	Data was collected which provided information on the scale of their operations, their revenues, and their cost of operations. This was used to distinguish between production type, size of producer and better understand the cost burdens on different producers.	Regional producers questionnaires
Opinions on the current derogation and future of the derogation	Thematic analysis of responses was undertaken to understand the main opinions for each stakeholder type. Ideas put forward were collected.	European Commission; Portuguese, Regional producers and authorities
Qualitative data collected on additional costs of production	Producers provided qualitative data on the impact of additional costs on competition, and the importance of the derogation in helping to alleviate these factors. There was also information related to the advantages and disadvantages of the derogation and suggested policy options.	Regional producers questionnaires
Quantitative data on operations and additional costs of production	Quantitative data was collected from regional producers on the current scale of their operations, their revenues, and their cost of operations, total costs and volumes of inputs used in the production of alcohol and an estimation of extra time required. Thematic analysis of responses was undertaken to identify the categories of production costs such as raw materials and transportation, as well as the impact of the special characteristics of the regions (e.g. the effect of higher prices and missed economies of scale) on the costs of production.	Regional producers questionnaires

Summaries of stakeholder consultation

European Commission

The purpose of the stakeholder questionnaire was to understand the impact of the derogation, and to gather views from the Commission on its overall operation. The survey was sent to the following European Commission stakeholders. We had four total respondents from DG REGIO, DG AGRI, DG TAXUD and DG COMP.

- Significance of the derogation

Based on the results provided by the stakeholders, two of the respondents stated that according to their DG/unit's perspective, the derogation is significant as it impacts on its operations. One of the respondents stated that the derogation is very significant, as it has a consequential impact on its operations. The final respondent stated that the derogation brings minimal significance as the derogation is of little importance to its operations. There was a general understanding among the respondents that the end of the derogation would lead to negative consequences for the Portuguese ORs and the objectives of their DG/unit.

Some of the possible consequences are that the wider development aims of the Portuguese ORs would be inhibited and limitations would be placed on the realisation of employment, agriculture and environmental objectives. Other consequences were that the stakeholder would stop monitoring the regime. In addition to this, it was noted that if the derogation was to end in 2020, the unit would immediately be called upon to find means to mitigate effects on farmers and local businesses who rely on the derogation. Additionally, the unit would also need to set up a task force to search for alternative solutions.

- *Current procedures around the existing derogation*

Table 11 Steps taken by the DG related to administration of the decision and appropriate costs incurred by the unit

Explanation of the complete steps required to oversee and administer the derogation.

Question: Please describe each step associated with overseeing and administering the decision whilst it is in force, from your section's perspective? Please indicate the length of this step and insert as many as required.

Step	DG TAXUD	DG REGIO	DG AGRI	DG COMP
1	Set up study contract	Assessment of current Council Decision in place, as well as (legal) developments in the past Comparison of derogation with similar derogations in the concerned outermost region and in other ORs. In case of elaboration of a study, contributing to Terms of References and participating in Inter-Service Steering Group.		Assessment of documentary evidence justifying the Commission's proposal to the Council
2	Manage the Interservice Steering Group	In case of elaboration of a study, contribute to feedback on questionnaires; take part in questionnaires and interviews and contribute feedback; Provide input to the shaping of the options of the forward looking assessment and	Inter-service consultation	Assessment of the Commission's proposal to the Council

		analysis of the impact under each option Provide input and comments to the draft proposal, at the ISSG and bilaterally, provide a response to the inter service consultation, support the adoption of the Commission proposal		
3	Draft the Evaluation Report and the forward-looking assessment	Contribute to the preparation of briefings and communication on the Commission's proposal		
4	Steer the proposal, including the Evaluation Report and forward looking assessment, through Interservice Consultation	Assessment of final proposal and forward-looking assessment by lead DG and feedback in the framework of inter-service consultation		Assessment of the Commission's proposal to the Council
5	Negotiate the proposal with Council and with Parliament and the Committee of the Regions	Follow legislative work in Council and if applicable initiative report in European Parliament. Assessment of final Council Decision		Follow up of the decision (mid-term review, modifications etc.)
Cost and Description of Cost **Question:** For each step, please describe approximate costs (person-days) and any other costs incurred from your unit. Please insert as many as required.				
DG **Total**	134 person- days	15.5 person-days	2 person-days	2 person-days

- *Ongoing administration the existing derogation*

Table 12 Steps associated with overseeing and administering the decision whilst it is in force and associated costs

Question: Please describe each step associated with overseeing and administering the decision whilst it is in force, from your unit's perspective? Please insert as many as required.				
Step	**DG TAXUD**	**DG REGIO**	**DG AGRI**	**DG COMP**
1	Assessment of report			
2	Assessment of possible amendments			
Question: Cost and Description of Cost - For each step, please describe approximate costs (person-days) and any other costs incurred in your unit.				
Total	10 person days			

- *Questions on the future of the derogation*

One stakeholder suggested extending the derogation to spirits produced in Madeira and the Azores consumed in mainland Portugal if the study demonstrates added value for the outermost regions' economies. This would be similar to the derogation on excise duty for rum produced in four French outermost regions and consumed in mainland France.

It was also suggested that, if a quota is established, there would be a possibility of adapting to this quota without going through the whole special legislative procedure, i.e. adapting a potential quota via delegated acts.

- *Expansion of the derogation for exports to mainland Portugal*

The extent of the implications of the extension of the derogation were subject to the role played by each of the DG units. Two stakeholders declared that there would be no operational implications for the respondents unit and extension of the derogation will not significantly affect the operations of the DG/unit, if Portugal uses the possibility offered by the Council, DG COMP has to assess the derogation (including extension to Portuguese mainland) with regards to State aid rules.

It was also felt that an extension would result in increased competitive prices between OR and non-OR rums or – given the existing substitution effect – with other spirit drinks. It was also noted that given that financial support is already granted under POSEI and Rural Development, it should be ascertained that the proposed derogation does not result in an overcompensation of the overall costs deriving from the outermost nature of Madeira and the Azores, as such undue advantage would jeopardize the level playing field that should exist among EU spirit drink producers.

However, in relation to quotas for consumption one stakeholder stated that they would need to provide inputs/comments in relation to this. It was also mentioned that there would be need for some risk assessment in relation to the purchase of concerned spirits in mainland Portugal under lower excise duty and the further shipment to another EU Member State.

Portuguese authorities

Limited responses were received from Portuguese authorities and the questionnaires were distributed to the Portuguese Authorities respondents. We received a formal response from one of three Portuguese Authorities which were contacted (the Azores), however we received relevant data over the course of the study from all authorities, including multiple calls.

Regional producers

The purpose of the producer questionnaire was to understand the impact of the derogation, and to gather views from the relevant producers on its overall operation. The respondents to the questionnaire were assured of the confidentiality of their responses and that is reflected in the summary below. The survey was sent to a group of producers across Madeira and the Azores.

The table below outlines the share of production that has been captured in the responses that we have received to date from producers.

Table 13 Producer questionnaire coverage

Madeira	Rum	Liqueurs	Eaux-de-vie
Reported total sales received from Portuguese Authorities (HLPA)	2,455	637	N/A
Total 2018 sales covered by questionnaire responses (HLPA)	2,394	544	N/A
Estimated percentage of total sales captured by survey	**97.5%**	**85.4%**	**N/A**
Azores	**Rum**	**Liqueurs**	**Eaux-de-vie**
Reported total sales received from Portuguese Authorities (HLPA)	N/A	846	280
Total 2018 sales covered by questionnaire responses (HLPA)	7.5	688	277
Estimated percentage of total sales captured by survey	**100%**[37]	**81.3%**	**98.9%**

[37] Currently only one producer of Rum in the Azores.

Total coverage	**92.5%**

Responses came from a range of different sized producers. In Madeira, 2018 production reported by respondents varied between 1,300 HLPA and under 2 HLPA. In the Azores, it varied between just over 450 HLPA and around 20 HLPA (6,000 bottles). We received responses from four producers of rum and liqueurs in Madeira one of just liqueurs.

In the Azores, we received responses from two producers of liqueurs and eaux-de-vie and three who just produced liqueurs. Six respondents sold some products on the Portuguese mainland and five in third countries.

- *Costs of production*

Respondents provided details of the costs of production broken down by categories of spend. All but one producer reported that costs were significantly higher than on the mainland, with the other saying they were somewhat higher.

The most recognised factor driving those costs (by seven out of ten responses) was the higher cost of raw materials and labour, although there was broadly a consensus about the factors affecting costs. We asked respondents to quantify these factors and while, overall, the responses showed some consistency, with additional costs consistently around 25-30% of production costs excluding raw materials, there was some variation in how these were attributed.

- *Future policy options*

Five producers from Madeira and three producers from the Azores stated either that their company would not survive if the derogation ended in 2020 or there would be a significant impact on the company. In Madeira, one producer mentioned that exporting to the continent would be a way of disposing of production as the regional market did not absorb all products produced.

In the Azores, four producers stated that they expected to increase the level of production and, therefore, they would be able to operate on an equal footing to operators in the continental Portuguese markets. It was also mentioned that applying the derogation to products from the Azores was logical in order to remain competitive in the face of higher transportation costs.

In regard to the extension of the derogation, three stakeholders in Madeira stated that they agreed with the application of the quotas for rum destined for the Portuguese market.

In the Azores, two producers appreciated the introduction of a quota-based system as it would allow access to markets which were now currently closed to Azorean companies due to an inability to compete on price. It was also felt that this would be advantageous, as it would increase the competitiveness of the product and introduce economies of scale.

- *Rankings of possible policy options*

In Madeira, all recipients favoured continuing the derogation beyond 2020 and extending it to cover all sales of products included in the current derogation in mainland Portugal was the most favoured option. Support was less strong in the Azores with the extension to mainland Portugal only being the favoured option of two producers. Two producers preferred the option where the current derogation system ended and other forms of subsidies were used to support the local spirit drinks industry. One producer preferred that the derogation continued beyond 2020 in its current form (reduced taxation is only applicable to locally produced and consumed spirit drinks).

There was general support for continuing the derogation although one producer in the Azores favoured alternative means of support but did not provide further details. We also asked about alternative options and improvements to the derogation, and two provided responses. One mentioned potential extensions to gin made in the Azores and liqueurs flavoured by non-local ingredients in the Azores/Madeira, where those were not available in the ORs.

Portuguese distributors

There was a limited response from the Portuguese distributors, with only two of the fifteen distributors surveyed providing a response: one operating in Madeira and the other largely on the Portuguese mainland where it is currently involved in distributing Madeiran rum. Each displayed a good awareness of the derogation and supported its continued operation.

The distributor operating in Madeira reported concerns that there would be a sharp reduction in consumption if the derogation was not extended. There was limited further quantitative information provided in this case. Both distributors supported an extension to the mainland, reporting that the higher cost of regional products was the most significant factor affecting sales on the mainland of these products.

The mainland focused distributor would expect to increase sales in these circumstances. The main other factors impacting mainland sales were identified as marketing and quality of products. Availability of sufficient products was not seen as a significant factor. Some further information on distribution costs was provided. Follow up via email and telephone was tried multiple times in order to receive a response and increase the sample size of distributors contacted.

Mainland producers

No response was received from any of the 14 mainland producers which were contacted for a response. Follow up via email and telephone was tried multiple times in order to receive a response.

Civil society

Civil society questionnaires were sent to 13 different organisations that were researched, however none replied. They were followed up via email and telephone and focused on health and industry related stakeholders. While a promise of responses from two groups was received, it was not the case in the end.

Feedback

The data collected was instrumental in the evaluation of the derogation over the period 2014-2019. It formed the basis of the analysis of additional costs, administrative burdens and the assessment of EU value added, coherence, relevance, effectiveness and efficiency. It also provided valuable context for the analysis of the assessment of the impacts of various options for the future of the derogation.

The analysis supported by the stakeholder consultation will be considered by the European Commission and will form the basis of their recommendations on the future of the derogation.

Annex 3: Who is affected and how?

The table below compares the benefits of the Council Decision No 376/2014/EU derogation for each stakeholder group over the period 2014-20 against the associated costs. It has not been possible to quantify the benefits and costs for every stakeholder group.

Table 14 (summary of benefits and costs per stakeholder group)

<table>
<tr><th>Stakeholder group</th><th>Madeira</th><th>Azores</th></tr>
<tr><td rowspan="2">Spirit drinks producers</td><td>Benefits: Based on data received from the Portuguese authorities, the total tax benefit in reduced excise tax and associated decreases in output VAT was €19.6 million over 2014-19.</td><td>Benefits: Based on data received from the Portuguese authorities, the total tax benefit in reduced excise tax and associated decreases in output VAT was €7.8 million over 2014-19.</td></tr>
<tr><td>Costs: spirit drinks producers within the scope of the derogation face a total administrative cost of around €42,000 over the period 2014-19.</td><td>Costs: spirit drinks producers within the scope of the derogation face a total administrative cost of around €66,000 over the period 2014-19.</td></tr>
<tr><td rowspan="2">Agricultural producers</td><td>Benefits: The derogation helps support the sugarcane industry in Madeira along with producers of certain fruits and other ingredients such as milk, that are used in the production of liqueurs.</td><td>Benefits: The derogation helps support the producers of certain fruits and other ingredients such as milk and wine, that are used in the production of liqueurs in the Azores.</td></tr>
<tr><td colspan="2">Costs: No evidence of material costs for agricultural producers.</td></tr>
<tr><td rowspan="2">Distributors</td><td colspan="2">Benefits: Distributors of OR products will gain from increased sales under the derogation. In the Azores, distributors will often carry other local products and the increase in sales could help support these industries.</td></tr>
<tr><td colspan="2">Costs: No evidence of material costs for distributors.</td></tr>
<tr><td rowspan="2">Tourism industry</td><td colspan="2">Benefits: By helping maintain the production of unique locally produced spirit drinks, the derogation may help encourage interest of tourists in the spirit drinks industry in the ORs and allows the products to be priced favourably for tourists.</td></tr>
<tr><td colspan="2">Costs: No evidence of material costs for the tourism industry.</td></tr>
</table>

<table>
<tr><th>Stakeholder group</th><th>Madeira</th><th>Azores</th></tr>
<tr><td rowspan="2">OR authorities</td><td>Benefits: The derogation has supported the spirit drinks industry and the wider economy in Madeira. The derogation boosted sales by around 26% over 2014-19.</td><td>The derogation has supported the spirit drinks industry and the wider economy in the Azores. The derogation boosted sales by around 27% over 2014-19.</td></tr>
<tr><td>Costs: The total fiscal cost of the derogation was €16.9 million over 2014-19.

The administrative costs associated with monitoring the derogation are negligible.</td><td>Costs: The total fiscal cost of the derogation was €6.7million over 2014-19.

The administrative costs associated with monitoring the derogation are negligible.</td></tr>
<tr><td rowspan="2">Portuguese authorities</td><td colspan="2">Benefits: The derogation has supported 40 jobs in the spirit drinks value chain and related industries across Madeira and the Azores and employment throughout the wider economy in each OR.</td></tr>
<tr><td colspan="2">Costs: The fiscal costs of the derogation are borne by the OR authorities. However, transfers from the national budget could create indirect exposure to the fiscal costs of the derogation.

It was estimated the Portuguese authorities bear an administrative cost of around €11,000 per annum to monitor and assess the derogation. These costs include the costs of work undertaken by external consultants to support the analytical content of the mid-term report.</td></tr>
<tr><td rowspan="2">European Commission</td><td colspan="2">Benefits: Although no direct benefits would accrue to the European Commission, the derogation has supported the achievement of regional policy objectives and has, in part, addressed the characteristics unique to ORs outlined in Article 349 TFEU.</td></tr>
<tr><td colspan="2">Costs: It was estimated that the European Commission bears an administrative cost of €9,500 per annum to assess, evaluate, manage, provide input for feedback and evaluation of the derogation.</td></tr>
</table>

Annex 4: Analytical methods

Analytical approach and methodology

The study has been based on a combination of primary research, that is, on data gathered from producer and distributor questionnaires, interviews with the authorities in Madeira, the Azores and mainland Portugal and independent research to triangulate findings, review of the existing literature and data, and economic and policy analysis. The data collected from institutional stakeholders and primary data collection from the producers themselves was a key focus of the study. The study was able to collect data from producers across both islands covering around 90% of production under the derogation.

Consultation activities undertaken

In order to implement the approach, seven targeted questionnaires were developed. The table below sets out the activities undertaken and responses received.

Table 15 Questionnaire response rates

Target group	Key topics covered	Recipients	Total responses received	Response rate
European Commission	Administrative process and costs Future of the derogation Associated costs Expansion of derogation	8	4	50%
Portuguese authorities	Impact of the derogation Procedures and costs Future of derogation Expansion of derogation to mainland	3	1	33%
Producers in Madeira	Administrative process and costs Future of derogation Associated costs Alternative suggestions	11[38]	5	45%[39]
Producers in the Azores		13	5	38%[40]
Portuguese distributors	Main distribution activities Future of derogation Associated costs Market size and product quantities Market in mainland	14	2	14%

[38] Data received from the OR authorities indicated that not all of the recipients of the producer survey were active. Comparison suggests that two recipients in Madeira and one in the Azores did not produce alcohol within the scope of the derogation.

[39] Estimated percentage of total sales captured by survey in Madeira - 97.5% Rum, 85.4% Liqueurs, N/A Eaux-de-vie

[40] Estimated percentage of total sales captured by survey in the Azores - 100% Rum, 81.3% Liqueurs, 98.9% Eaux-de-vie

Civil society	Awareness of derogation Impact of ending the derogation Potential future options	13	0	0%

The study's objectives

The study had two objectives. The first was to evaluate the current system of reduced rates in terms of the fiscal, social, environmental, economic and trade impacts, including impacts on small and medium enterprises (SMEs) and competitiveness. This included an estimation of the size of the impact of the existing measure. It also included an evaluation of whether the fiscal advantage was still proportionate and whether the measure was sufficient to enable a competitive production environment, taking into account any cost disadvantage of operating in the ORs.

The second was to assess alternative policy options to address the issues identified in the evaluation, including the introduction of a new derogation for rum consumed and sold in the Azores as well as extending the derogation for all products when sold to the Portuguese mainland. The study considered how the system interacted with other EU policies including competition, trade, agricultural policy, environment, regional development and, insofar as the regimes subsidised the production of spirit drinks, health policy. When developing alternative policy options, the study also analysed their expected impact on these EU policies.

Economic analysis

The study results are also based on an economic analysis using three notions, pass *through, price elasticity of demand and tax elasticity of demand*, which described connections between consumption, tax incidence and the final price. The economic analysis focused on the product market analysis and production costs analysis, as well as a few parameter values, which were calibrated using historical data and the literature. The analysis required also several assumptions for setting the baseline scenario. For this purpose, historical trends describing developments of the Azores and Madeira economies as well as trends describing market for relevant spirits were used.

Current derogation and future options

In order to evaluate the impact of the derogation over the period 2014-19, production and fiscal cost data has been compared with counterfactual generated over the same period[41].

The counterfactual assumed that the derogation was not in place over the period 2014-19 and that all consumption of spirit drinks produced in the ORs attracted the regular rate of excise.

[41] Impacts over the period 2014-2018 are based on analysis of historic data. The impacts for 2019 are based on projections.

To assess alternative policy options different options were assessed against the baseline of continuing with the current derogation. While this option would require action on the part of the EC and Council to extend the derogation post 2020, it continues the status quo treatment and therefore did not require a constructed counterfactual to underpin the assessment of other options

The current derogation could be potentially replaced by any of a large number of possible options. There were policy choices about the products covered, the locations where the derogation applies, and whether to apply any limits to volumes covered. Several options were identified. The combination of options provided realistic and plausible options. It allowed significant policy questions to be considered in isolation, and it avoided less realistic options such as ending support for sales on the ORs while providing for an extension to mainland sales.

Assessment of the impact of prospective options

- Definition of options: The option development used research on existing precedent in the EU, analysis of market trends, and information gathered from stakeholder questionnaires to translate a broad set of option categories into an actionable set of options for consideration.
- Assessment of options: The impact of each option was assessed in terms of its support to the ORs and the extent to which it would allow producers to access markets for their products, and wider costs and coherence.
- Monitoring framework. A potential monitoring framework was developed, setting out the data needed and proposing the frequency and form of collection.

Annex 5: Evaluation

The scope of the evaluation is a retrospective assessment of the derogation during the period 2014 to 2019. In particular, the evaluation assessed the extent Council Decision 376/2014/EU contributed to:

- Reducing the competitive disadvantage of producers of specific spirit drinks in the ORs, which are linked to the permanent challenges of the ORs;
- Support the spirit drinks industry, which is important for the development of the Portuguese ORs;
- Ensuring the smooth functioning of the single market for spirit drinks.

The evaluation assesses the performance of the Directive against the basic evaluation criteria of relevance, effectiveness, efficiency, coherence and EU added value, in line with the Better Regulation Guidelines[42]. The evaluation is based on the external 'back to back' study with an evaluation and forward-looking assessment of the Decision carried out simultaneously in accordance with Better Regulation Guidelines.

Relevance

This section evaluates the scope and objectives of Council Decision 376/2014/EU compared to the current needs of all stakeholders. The needs of the ORs can be linked back to Article 349 TFEU. The Decision's objectives are to support producers by reducing their competitive disadvantage, which in turn assists with the regional development of the ORs, while not impacting the smooth functioning of the single market.

- *To what extent does the scope of the Decision still match the current needs of the ORs and of the economic operators concerned?*

Based on the study, the costs of production across Madeira and the Azores indicate that their remoteness, small size, insularity and challenging climate and topography drive significant additional costs for ingredients, labour and transportation. In the case of rum, the combination of these factors makes sugarcane grown in Madeira around ten times more expensive than sugarcane sourced elsewhere. Wine produced in the Azores is around four times more expensive than mainland wine for eaux-de-vie producers. Fruits for liqueurs are also consistently more expensive in the Portuguese outermost regions compared to fruits grown elsewhere. These additional costs faced by producers in the two regions mean that they remain at a competitive disadvantage to producers on the Portuguese mainland. While ingredients are the main driver of additional costs for the producers, other production costs add to their overall costs as shown in the table below.

Table 16 Additional costs other than ingredients per hlpa (€)

	Madeira Rum	Madeira Liqueurs	Azores Liqueurs	Azores Eaux-de-vie
€	238.58	398.39	446.05	277.53

[42] Better Regulation Guidelines

All these additional costs impact the ability of producers to access markets other than the local OR markets. This has resulted in producers relying on the regional markets, which are small and are almost at saturation point. This is an area of concern, as the study found that all producers currently have capacity to produce more and in the case of rum, production of rum exceeds sales by approximately 40%. Underutilisation of equipment also means that producers are unable to achieve economies of scale, further impacting on their costs. An extension of the derogation to mainland Portugal would remove the barriers to enter this market and offer the producers the opportunity to utilise their spare capacity and develop their business further and by default the local OR economy. The need to ensure the smooth functioning of the single market remains an important element for all stakeholders.

Development of the economies of Madeira and the Azores remains an important objective for all stakeholders. Economic development in terms of output per capita in both Madeira (€18,100) and the Azores (€16,900) is below the level of mainland Portugal (€18,900), and each OR is significantly below the EU average of €30,000[43].

Effectiveness

The effectiveness of Council Decision No 376/2014/EU was evaluated by assessing the extent to which the regime supported the industry, while not undermining the integrity and coherence of the EU market. The evaluation question was:

To what extent has the fiscal advantage contributed to realising the objectives of Article 349 TFEU by

- *maintaining, promoting and developing the local economic activities and employment in the different ORs; and,*
- *compensating for higher production cost of goods in the different ORs?*

Given the overall small size of the derogation, with the fiscal cost of the excise reduction for 2018 of €3.4 million and €1.2 million for Madeira and the Azores respectively, any effects will be relatively modest. That aid amounts to only approximately 0.07% of 2018 GRP in Madeira and 0.03% in the Azores.

Despite this caveat, the study estimated that the current derogation increased the gross value added (GVA) of the local value chain in Madeira and the Azores by approximately 62.9% and 57.3% respectively over the period 2014-19. Over the period of the Decision, this equated to an increase in GVA of €14.2 million for Madeira and €10.7 million for the Azores.

The study estimated that the industry was supported as follows:

- The number of producers has increased by 78% and sales increased by 18.2% in Madeira and 12.5% in the Azores;

[43] https://ec.europa.eu/eurostat/documents/2995521/9618249/1-26022019-AP-EN.pdf/f765d183-c3d2-4e2f-9256-cc6665909c80

- Since 2014, the market share of OR producers has grown at an average rate of 2.1% and 3.5% for Madeira and the Azores respectively. Only the market share of eaux-de-vie in the Azores has declined over this period;
- 26 jobs in Madeira and 14 in the Azores have been supported by the derogation over 2014-19;
- production under the derogation has increased by 25.9% (3,357 HLPA) for Madeira and 26.6% (1,363 HLPA) for the Azores.

In terms of compensating the additional costs of production, the study estimated the additional costs as follows:

- Rum produced in Madeira - €573-700 per HLPA
- Liqueurs produced in Madeira - €569-696 per HLPA
- Liqueurs produced in the Azores - €1,304-1,594 per HLPA
- Eaux-de-vie produced in the Azores - €1,511-1,879 per HLPA

The study concluded that the derogation compensated producers across the ORs for these costs. When viewed against the value of the full excise rate reduction (€1,040 per HLPA) the analysis suggests that there is a degree of overcompensation in Madeira and some undercompensation in the Azores. However, the full excise rate reduction is not applicable to 65% of the producers, who are in fact eligible for the reduced rates for small independent distilleries of €347.73.

Currently, the market costs are generally close to non-OR competitors. However, this was not the case when the current derogation was introduced in 2002, suggesting that it has supported OR producers to become price competitive in regional markets.

The study found that the regime is effective as it has positively impacted the regional economic activities and employment in the regions. It has also compensated for the additional costs faced by OR producers.

Efficiency

The efficiency of the Decision was assessed by examining the relationship between the costs of implementing Council Decision 376/2014/EU and the resulting benefits for all stakeholders. The costs involved included the administration and financial costs for all stakeholders. To assess the efficiency of the Decision the questions below were used:

> *To what extent are the benefits of the fiscal measures compensating for the loss of fiscal revenue in Portugal?*
> *What is the "additional cost" by product to which differentiated taxation may apply?*

The study estimated the fiscal cost of the Decision was €23.6 million for the period 2014 – 2019 while the total tax benefit was €27.3 million. This suggests the derogation has been efficient in providing support to the industry.

In addition to the net monetary gain, during the same period the producers of the products under the derogation increased their market share. The increase in market share is 2.1% in Madeira and 3.5% in the Azores. Given the economic realities of the ORs, and the reliance on certain sectors of the economy, the assistance provided to the various spirit drinks producers under the derogation is a valuable support. It allowed the industry to operate more effectively in the regional market, boosting sales by 26.1% over the period 2014-19 and supporting around 40 jobs on the ORs.

The additional costs of producing the different spirit drinks varies depending on several factors. These factors include the cost of the ingredient for the beverage and the size and location of the producer. Given that these costs are aggregated at the producer level, they do not take account of the fact that some of these producers are micro entreprises, who typically face even higher costs than SMEs, as they are unable to make use of economies of scale. Overall, however the evaluation estimates that the 75% reduction in excise duty is relatively efficient in compensating the production costs of all producers in the Azores. In Madeira, this rate of reduction is also efficient in compensating the additional costs faced by small producers, however it may overcompensate those who are producing between 500 and 1000 HLPA. Nonetheless, due to data limitations, quantifying the full range of additional costs was not always possible. Therefore, this overcompensation may be limited in reality.

The excise rate reduction permitted by Council Decision No 376/2014/EU has generated an administrative burden for all stakeholders. The ongoing administrative burden for producers is estimated at approximately €7,000 and €11,000 in Madeira and the Azores respectively. The study found that the Portuguese authorities and distributors faced negligible ongoing administrative costs. The authorities in the ORs and the European Commission do have periodic administrative costs, which were estimated at approximately €11,000 and €9,500 respectively.

Coherence

The questions below were developed to evaluate the extent to which Council Decision No 376/2014/EU is complementary to other EU policies.

To what extent does the current system address EU regional and employment policy, State aid aspects and trade issues?

Which other measures (European, national or regional) do the products benefit from, including measures related to agricultural policy?

Are there any obstacles arising from the current levels of taxation in other policy areas?

Do the current levels of reduced excise duties distort competition with firms situated in the mainland or in other EU Member States?

The current system addresses wider EU objectives in the following ways:

EU regional and employment policies: The derogation has helped maintain and grow production on both ORs sustaining around 40 jobs in the ORs in the direct production and the value chain (including through allowing greater diversification of income from agriculture). Related to this, the derogation has also increased the contribution of the industry to the local economies, boosting GVA by €14.2 and €10.7 million in Madeira and the Azores respectively over 2014-19. This continues to meet the needs of the ORs in light of their overall economic development relative to mainland Portugal and EU wide levels. More broadly, the derogation generates demand for a range of locally grown produce, which supports crop diversification, and it also helps to preserve distinct cultural traditions in Madeira and the Azores aiding the tourist industry.

State aid aspects: Following the estimates of additional costs, the value of the derogation broadly aligns with them and there are no significant State aid concerns.
Trade issues: The market supported by the derogation is small, currently around 5.0% of the Portuguese spirits market in 2016. Consumption of non-OR spirits has been broadly flat over the period and the vast majority of OR products are consumed in the local market, and do not impact sales outside Madeira and the Azores.

Health aspects: The World Health Organization (WHO) lists increasing excise duty as one of the most cost-effective ways of reducing harmful alcohol consumption. It ranks Portugal above average for the use of pricing to reduce alcohol harm. The derogation has boosted sales of OR products by 26% over 2014-19 and overall spirit consumption by around 3% per year. While consumption by tourists would account for a significant proportion of the uplift, this suggests there may be some health impacts. The mortality rate due to alcoholic-related diseases is higher in Madeira per 100,000 inhabitants (77.2) than it is in the Azores (56.4) and mainland Portugal (55.8). Consumption patterns among Portuguese drinkers indicate that spirits account for around 8% of total alcohol consumption in terms of litres of pure alcohol while wine and beer account for around 80%. Assuming consumer preferences remain unchanged; this suggests that the health impacts across the population of the ORs would be modest.

Regarding other measures (European, national or regional) that the products benefit from, including measures related to agricultural policy, there are a range of other measures supporting the ORs, including aid from the EU, aid from the Portuguese government and regional aid. EU policy towards the ORs has thus been designed to aid their economic development through a variety of measures, largely funded through European Structural Investment (ESI) funds[44].

[44] Outermost Regions. Available at: http://www.europarl.europa.eu/factsheets/en/sheet/100/outermost-regions-ors- (page accessed on December 10, 2019).

While the aid strategy for the regions have broad and far-reaching goals, there are certain types of aid, largely driven by the agricultural support, POSEI, which have direct impacts on the spirit drinks production value chain. This measure supports the primary sector and the production of raw foodstuffs, including sugarcane, fruits and wine. The derogation's position at the end of the value chain in the ORs helps to create a market for a product which relies on locally grown raw materials. This makes it coherent with the goals of promoting economic diversification and self-sustainability in the ORs.

Concerning any obstacles arising from the current levels of taxation in other policy areas, the only significant area of tax that stakeholders highlighted as providing obstacles to the aims of the derogation was the application of normal excise rates on mainland consumption. This was raised explicitly by 50% of respondents who indicated that this, in their view, renders them less price competitive in the mainland market due to additional costs incurred in the ORs.

In relation to distortion of competition study found that Madeira and the Azores had a more challenging overall economic environment, which significantly increased production costs. The reduced rate mitigates these additional costs and enables OR producers to access the regional market and as such 90% of the products within the scope of the derogation are consumed in the regional market.

These specific spirit drinks are generally of unique characteristics with strong connections to the local environment in which they are produced. It is unlikely that they are in direct competition with non-OR products. The study found that these products were most likely not considered as substitutes for generic mainstream brands of common spirit drinks such as vodka or gin and distortion of competition was therefore limited.

EU value added

The question below is used to evaluate the EU value added, that is, the extent to which the outputs, results and impacts generated by Council Decision No 376/2014/EU were enhanced by intervention at the EU, rather than the Member State level. As set out in Article 349 TFEU, only the Council is authorised to adopt specific measures in favour of the outermost regions. Therefore the costs and benefits of the Decision measure its added value.

To what extent did the Decision generate benefits for the regional markets of the Portuguese outermost regions and the EU Internal Market?

The benefit of the derogation to Madeira and the Azores has been expressed both as a benefit to producers through increased revenue, and as an overarching benefit which provides support throughout the value chain. Producers have noted that it has allowed them to compete more successfully on price, something they indicated is crucial for their success in the OR market.

The fiscal cost of the derogation for the period 2014-2019 was €23.6 million while the total tax benefit was €27.3 million. Given the small size of the producers, the derogation supports an industry which does not benefit from economies of scale to the same extent as mainland competitors and one that operates in a very small consumer market. In light of the goals surrounding Article 349 TFEU and the general EU policies surrounding support to the ORs, the derogation has provided measurable benefits to Madeira and the Azores overall.

The Decision allows for a reduced rate excise duty in Portugal only. There is minimal impact on the EU internal market.

Annex 6: Legislation

Council Directive 92/83/EEC on excise on duties sets out the structures of excise duties on alcohol and alcoholic beverages and the basis on which the excise duty is calculated. Article 22 of Directive 92/83/EEC allows all Member States to apply a reduced rate of excise duty to distilled alcoholic beverages produced by small independent distilleries not producing more than 10 hectolitres of pure alcohol per year.

Council Directive 92/84/EEC sets out minimum rates that must applied to each category of alcoholic beverage as well as reduced rates for certain Greek, Italian and Portuguese regions. Article 7(3) of Directive 92/84/EEC allows for a 50% reduction of excise duty on the certain alcoholic beverages consumed in the Portuguese outermost regions.

Regulation (EC) No 110/2008 lays down rules on the definition, description, presentation and labelling of spirit drinks as well as on the protection of geographical indications of spirit drinks. This Regulation defines rum, liqueurs and eaux-de-vie.

From 25 May 2021, the new Spirit Drinks **Regulation (EU) 2019/787**[45] will become applicable. From 25 May 2021 rum may not contain more than 20 grams of sweetening product per litre, expressed as invert sugar. However, in the case of geographical indications, the legal name rum may only be supplemented by the terms ‘tradicional’ or ‘agricultural’ if it complies with the provisions laid down in point 1(g) of Annex I to Regulation (EU) 2019/787, among which it is provided that it is not sweetened at all.

[45] Regulation (EU) 2019/787 of the European Parliament and of the Council of 17 April 2019 on the definition, description, presentation and labelling of spirit drinks, the use of the names of spirit drinks in the presentation and labelling of other foodstuffs, the protection of geographical indications for spirit drinks, the use of ethyl alcohol and distillates of agricultural origin in alcoholic beverages, and repealing Regulation (EC) No 110/2008