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*(Information)*

## COURT OF AUDITORS

## SPECIAL REPORT No 8/2001

**concerning refunds for the production of potato and cereal starch and potato starch aid, together with the Commission's replies***(pursuant to Article 248(4), second subparagraph, EC)**(2001/C 294/01)*

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**SUMMARY**

I. The Court's previous inquiry into refunds for the production <sup>(1)</sup> of cereal starch and potato starch covered the period from 1986 to 1988. The Court re-examined the operation of this system, as amended as a result of the 1992 reform of the common agricultural policy (CAP), and broadened the scope of its audit to include specific direct support measures for the production of potato starch. In 1999, the European Union (EU) produced 6,2 million tonnes of cereal starch and 1,9 million tonnes of potato starch. In 2000, total expenditure relating to cereal starch and potato starch stood at 900 million euro or 5,4 % of total Community expenditure on arable crops. Leaving aside per hectare aid, the expenditure in question amounted to around 400 million euro in 2000, or less than 1 % of total EAGGF-Guarantee expenditure.

II. As the Court emphasised in its Annual Report concerning the financial year 1988, these different forms of aid were established because the support system for the cereals sector had the effect of maintaining Community cereals prices at a level higher than the world price.

III. The Court has examined the system for the payment of refunds and direct aid over the period 1998 to 2000 in Germany, France and the Netherlands. This examination has revealed that the administrative controls are of a satisfactory level overall. Nevertheless, these administrative controls are still by far the most predominant form of control, and are not sufficiently supported by physical checks, including ones to guarantee the reliability of stock accounts. The level of on-the-spot controls carried out in potato starch mills by national auditors varies from one Member State to another, due to a lack of clarity in the relevant texts and the absence of any precise instructions from the Commission as regards the checks to implement.

IV. The Court's other observations essentially concern the flexibility of the method for calculating production refunds, the justification for and the difficulties of implementing the special monitoring system required for modified starch, the risk of fraud inherent in the quota system for the production of starch potatoes, and the difficulty of managing quotas in a way that is in line with the realities of the market.

V. The Commission does not have at its disposal an adequate information system enabling it to assess whether the basic objectives of the system are being achieved, in particular concerning the competitiveness of starch-user industries, the income levels of farmers in receipt of direct aid, or compensation for the structural disadvantage specifically experienced by potato starch mills.

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<sup>(1)</sup> In the Community regulations concerning cereal starch and potato starch, the expression 'production refunds' is used to describe the aid paid to the industry for the utilisation of cereal starch or potato starch in the manufacture of certain goods.

## THE MARKET IN CEREAL AND POTATO STARCH

1. Potato starch and cereal starch are products of first stage processing and are interchangeable for most purposes. Cereal starch is mainly obtained from maize and wheat, but also from barley, rye and rice; non-cereal starch is obtained from potatoes and manioc. In 1999 the EU produced around 8,1 million tonnes of

starch (see Table 1). The United States of America, with an annual production of around 30 million tonnes, is the world's largest producer of cereal starch. Potato starch is produced almost exclusively in northern Europe, mainly in Germany, the Netherlands, France and Denmark. The main market outlets for these products are the food, chemicals, paper and textile industries (see Diagram 1).

Table 1  
Cereal and potato starch — Output and sales in the EU

|   | 1995       | 1996       | 1997       | 1998       | 1999       |
|---|------------|------------|------------|------------|------------|
| (Million tonnes)                              |            |            |            |            |            |
| <b>Output</b>                                 |            |            |            |            |            |
| Maize starch                                  | 3,6        | 3,6        | 3,7        | 3,7        | 3,7        |
| Wheat starch                                  | 1,6        | 1,8        | 2,2        | 2,2        | 2,4        |
| Potato starch                                 | 1,7        | 2,0        | 2,0        | 1,8        | 1,9        |
| Other starches (barley, rice)                 | 0,1        | 0,1        | 0,1        | 0,1        | 0,1        |
| <b>Total</b>                                  | <b>7,0</b> | <b>7,5</b> | <b>8,0</b> | <b>7,8</b> | <b>8,1</b> |
| <b>Sales <sup>(1)</sup> including exports</b> |            |            |            |            |            |
| Foodstuffs                                    | 3,8        | 4,1        | 4,3        | 4,2        | 4,4        |
| Non-food use                                  | 3,2        | 3,4        | 3,7        | 3,6        | 3,7        |
| <b>Total</b>                                  | <b>7,0</b> | <b>7,5</b> | <b>8,0</b> | <b>7,8</b> | <b>8,1</b> |

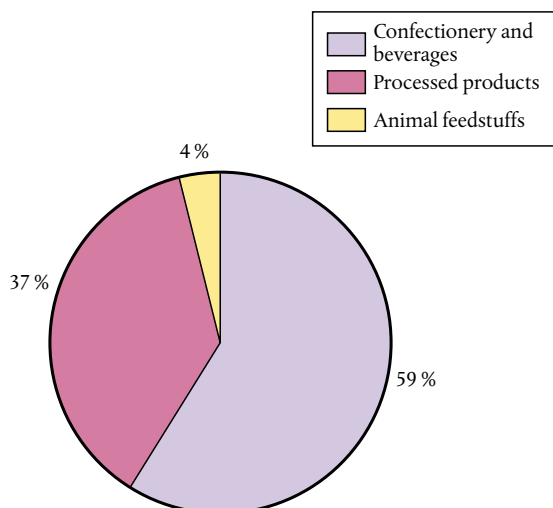
(<sup>1</sup>) Native cereal and potato starch in the form of derived products or incorporated into manufactured products.

Source: European Commission (DG AGRI) estimates.

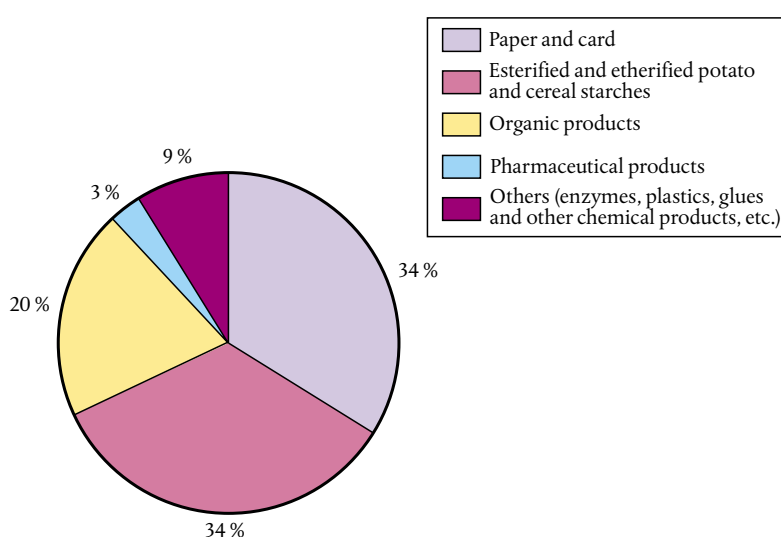
Diagram 1

### Sales of potato and cereal starch and derived products on the EU internal market in 1998

#### A. Foodstuffs sector



#### B. Non-foods sector



Source: Commission, DG Agri.

2. Customs duties, which represent approximately half the value of the product, protect the Community market, which is already more than self-sufficient in starch supply. No starch is therefore imported into the Community and export refunds are available for the surplus starch exported from the Community. In 1999, the EU exported 1,7 million tonnes of cereal and potato starch, or 21 % of its production, in its unprocessed state or in the form of derived or manufactured products.

3. The EU has 75 production sites, 23 of which are potato starch mills. Around 10 million tonnes of cereals are processed into starch, which is to say almost 5 % of European cereal production. The entire starch potato output, which is generated by nearly 18 000 farmers, is processed into starch. For these farmers, the production of starch potatoes often complements that of sugar beet and cereal crops.

#### **THE COMMUNITY AIMS TO GUARANTEE THE COMPETITIVENESS OF EUROPEAN STARCH**

4. The objective of the system of support for the production of cereal and potato starch is to secure the competitiveness of the European non-food, starch-user industries against external manufacturers that are able to sell goods containing starch purchased on the world market at prices lower than the Community prices. Under Council Regulation (EEC) No 1766/92 of 30 June 1992 on the common organisation of the market (CMO) in cereals <sup>(1)</sup>, a refund is granted to manufacturers for starch obtained from cereals, for potato starch or for derived products where they are used for the manufacture of certain non-food products that are not subject to import duties or are only subject to low duties.

5. Approximately one third of all non-food cereal and potato starch produced in the EU is processed into modified cereal or potato starch. Since modified cereal and potato starches take up a

very significant share of the market, and particularly because of the lack of protection in this sector, they have, since 1986, been included on the list of products eligible for a production refund.

6. The system of production refunds is complemented by special measures in respect of starch potatoes intended for the production of starch, on the grounds that they are in direct competition with cereals used for the production of starch. These special measures provide for payment by the starch industry of a minimum price to producers of starch potatoes, the payment of direct Community aid to these same producers (around 41 % of the minimum price <sup>(2)</sup> prior to 2000) and the allocation of a premium to the potato starch mills to compensate for the structural disadvantages <sup>(3)</sup> suffered by manufacturers of potato starch in comparison with manufacturers of cereal starch. In addition, there is a quota system, the object of which is to keep both potato starch production and budgetary expenditure under control. The support measures only apply to the quantities of potatoes produced under grower contracts.

#### **BUDGETARY EXPENDITURE**

7. During the period from 1997 to 2000 budgetary expenditure on refunds for the production of cereal and potato starch varied between 49,6 and 169,2 million euro per year. The level of expenditure is directly influenced by fluctuations in world maize prices. Annual expenditure on direct aid for potato starch varies little and amounts to an average of around 200 million euro. In 2000, total expenditure on cereal and potato starch, including export refunds and per hectare aid for cereals used to produce starch, totalled 898,5 million euro, representing 5,4 % of Community expenditure on arable crops (see Table 2). Leaving aside per hectare aid, the expenditure in question amounted to around 400 million euro in 2000, or less than 1 % of total EAGGF-Guarantee expenditure.

<sup>(1)</sup> OJ L 181, 1.7.1992, p. 21.

<sup>(2)</sup> With the Agenda 2000 reform, this percentage rose to 51 % for 2000/01 and to 62 % as from 2001/02.

<sup>(3)</sup> This structural disadvantage arises from environmental constraints and from the fact that potatoes keep badly. Potato starch mills only receive delivery of their raw materials for six to eight months per year, whereas cereal starch mills are able to work all year round.

Table 2

## Changes in expenditure on potato and cereal starch (1997 to 2000)

(Mio EUR)

|  | 1997            | 1998            | 1999            | 2000            |
|--|-----------------|-----------------|-----------------|-----------------|
| <b>Expenditure on potato and cereal starch</b>                         |                 |                 |                 |                 |
| <i>Production refunds</i>  |                 |                 |                 |                 |
| Potato starch  | 18,2            | 14,2            | 54,9            | 47,8            |
| Maize starch   | 33,6            | 28,0            | 86,3            | 94,0            |
| Wheat starch   | 7,6             | 7,0             | 27,5            | 25,5            |
| Other cereal starches  | 0,2             | 0,4             | 0,5             | 0,8             |
| <b>Total</b>   | <b>59,6</b>     | <b>49,6</b>     | <b>169,2</b>    | <b>168,1</b>    |
| <i>Potato starch production premium</i>                                |                 |                 |                 |                 |
| Potato starch premium  | 42,4            | 41,6            | 37,3            | 39,1            |
| Compensatory payment   | 165,7           | 162,7           | 145,6           | 154,1           |
| <b>Total</b>   | <b>208,1</b>    | <b>204,3</b>    | <b>182,9</b>    | <b>193,2</b>    |
| <i>Export refunds</i>  |                 |                 |                 |                 |
| Potato starch  | 19,1            | 17,1            | 29,7            | 37,5            |
| Cereal starch  | NA              | NA              | NA              | NA              |
| <b>Total</b>   | <b>19,1</b>     | <b>17,1</b>     | <b>29,7</b>     | <b>37,5</b>     |
| <b>Subtotal 1</b>  | <b>286,8</b>    | <b>271</b>      | <b>381,8</b>    | <b>398,8</b>    |
| <b>Expenditure on cereals used to produce starch</b>                   |                 |                 |                 |                 |
| Per hectare aid for cereals <sup>(1)</sup>                             | 526,2           | 538,4           | 527,7           | 499,7           |
| <b>Subtotal 2</b>  | <b>526,2</b>    | <b>538,4</b>    | <b>527,7</b>    | <b>499,7</b>    |
| <b>Total expenditure on potato and cereal starch (subtotals 1 + 2)</b> | <b>813</b>      | <b>809,4</b>    | <b>909,5</b>    | <b>898,5</b>    |
| <b>Total expenditure under the arable crops chapter</b>                | <b>17 462,1</b> | <b>17 945,2</b> | <b>17 865,9</b> | <b>16 663,1</b> |
| <b>Relative share (%)</b>  | <b>4,7</b>      | <b>4,5</b>      | <b>5,1</b>      | <b>5,4</b>      |

<sup>(1)</sup> It is estimated that around 5 % of the Community output of cereals is processed into starch (the expenditure shown here does not take into account expenditure on proportional set aside).

NA: data not available (budgetary nomenclature makes no distinction between expenditure on potato starch/cereal starch).

Source: EAGGF-Guarantee documents, expenditure taken into account up to 15 October each year.

## THE COURT'S AUDIT

8. The regulations in force at the time of the audit were introduced as part of the reform of the common agricultural policy (CAP) in 1992. The Court's previous inquiry into 'refunds for the production and use of cereal and potato starch' covered the period 1986 to 1988 <sup>(1)</sup>. The special support system for potato starch had never been audited by the Court.

9. The Court examined to what extent the system had achieved its objectives. It also verified the legality and regularity of transactions on the basis of payments effected during the years 1998 to 2000 in Germany, France and the Netherlands, and verified the functioning of the control systems in these three Member States, which together receive around 70 % of the budgetary expenditure concerned.

## PRODUCTION REFUNDS

*Management by the Commission***The method for calculating refunds allows for considerable flexibility**

10. The production refund rate is decided on a monthly basis <sup>(2)</sup> by the Commission after consulting the Management Committee for Cereals. The refund may be modified during the month if the prices of maize and/or wheat in the Community or on the world market change significantly. For this reason, there were 17 different refund rates in 1998, 13 in 1999 and 21 in 2000. As maize is the reference cereal for the manufacture of cereal starch, the refund is calculated, among other things, on the basis of the difference between the market price for maize in the Community

<sup>(1)</sup> Annual Report of the Court of Auditors concerning the financial year 1988 (OJ C 312, 12.12.1989, p. 73).

<sup>(2)</sup> Article 3 of Commission Regulation (EEC) No 1722/93 of 30 June 1993 (OJ L 159, 1.7.1993, p. 112).

and its price on the world market. As it is authorised to do by the wording of Regulation (EEC) No 1722/93, the Commission applies such parameters as it considers appropriate to the calculations. These parameters were the subject of a Commission working document approved by the Management Committee in November 1997 and amended in February 1999.

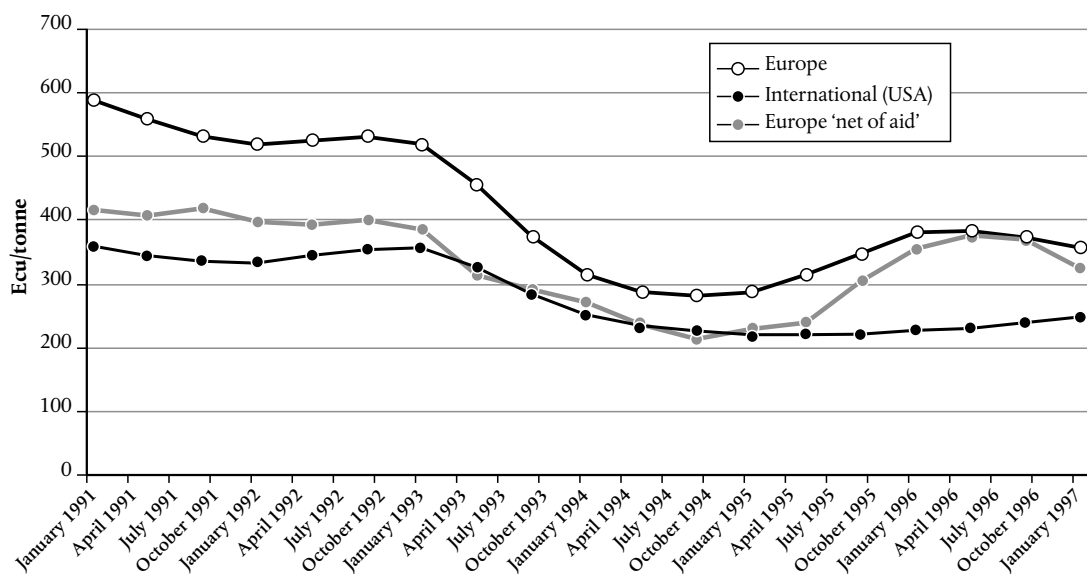
11. The Court examined a sample of files relating to the fixing of the refund amount by the Commission. The value of the data used by the Commission varies in its comprehensiveness from period to period, depending on whether data are available on the price of maize, transport costs and other costs. In certain cases, the Commission adjusts the calculation methods set out in its working document. This flexibility in calculating the refund has been fiercely criticised by the cereal and potato starch-user industries. The latter deplore the method's lack of transparency and the fact that the refund is unpredictable and believe that their production and marketing programmes are adversely affected by this <sup>(1)</sup>.

### There is a lack of information on the state of the market

12. Not much information is available on movements in the prices of cereal and potato starch because there is no world price quotation, properly speaking, for these products. This is due, amongst other things, to the diversity of raw materials used in the manufacture of starch, each of which has its own market, and to the fact that prices vary greatly depending on the type of starch (native or modified). *Diagram 2*, taken from a study published in July 1999 <sup>(2)</sup>, nevertheless traces, for the paper industry <sup>(3)</sup>, the changes between 1991 and 1997 in the difference between the price of starch on the American market, which is considered to be the world reference price, and the average estimated price for starch on the European market. This shows that, apart from the period between April 1993 and April 1995, production refunds have systematically failed to eliminate a more or less substantial difference in price in favour of the non-European industry. At its maximum, in 1996, the non-compensated difference amounted to approximately 30 % of the purchase price of starch.

Diagram 2

#### Price of potato starch and cereal starch for the paper industry in Europe and the world and the effect of production refunds



Note: The European 'net of aid' price curve has been added on the basis of data received from the Commission.

Source: Joint study by the European Commission and the Confederation of European Paper Industries (CEPI), published in 1999: 'Competitiveness study of the European pulp, paper and board manufacturing industry 1998', p. 15.

<sup>(1)</sup> Sources: Association des amidonneries de céréales de l'Union européenne (AAC), Union des syndicats des industries des produits amylacés et de leurs dérivés (USIPA), Confederation of European paper industries (CEPI), Committee of the European Starch Potato Producers' Unions (CESPU), Union des féculeries européennes (UFE).

<sup>(2)</sup> 'Competitiveness study of the European pulp, paper and board manufacturing industry 1998', joint study by the European Commission (DG Industry) and the CEPI (Confederation of European Paper Industry), Brussels, 1999.

<sup>(3)</sup> The paper industry absorbs around 15 % of European cereal starch and potato starch output.

13. In 2000, the Commission decided to have an independent body carry out an evaluation of its policy in the cereal starch sector. The results of this evaluation were not available at the time of the Court's audit.

### **Management by Member States**

#### **Progress in administrative controls by national authorities but incomplete on-the-spot controls**

14. Before refunds are paid, the Member State authority responsible must ensure that the cereal or potato starch has been used in the manufacture of approved products, in accordance with the details contained in the refund certificate. Checks are usually carried out by means of administrative controls, but these must, where necessary, be supported by physical checks <sup>(1)</sup>. Refunds must be paid within five months of the date on which the controls are completed <sup>(2)</sup>.

15. The Court did not detect any inaccuracies in the itemised accounts of payments found in the files examined in the three Member States visited. The procedures in force had improved since the Court's previous audit and ensured a satisfactory level of administrative control overall.

16. Nonetheless, the Court's audit did reveal the following shortcomings:

- (a) in France, the controls carried out are almost exclusively administrative. Although the solid content and purity level of basic cereal starch are important parameters for calculating the amount of refund, the procedure laid down in national rules for taking samples of such starch for laboratory analysis is not applied. Chemical analyses of samples of finished products are not carried out either, except for the tests carried out by the customs laboratory prior to granting approval <sup>(3)</sup>;
- (b) in the three Member States visited, traders provide stock account extracts in support of their payment applications. On-the-spot controls to reconcile stock accounting data with physical stocks of basic cereal starch or finished products are not carried out on a systematic basis. However, such reconciliations are the only means of testing the consistency and reli-

ability of stock accounts. In the Netherlands, the Court expressed reservations as to the quality of the stock accounts of a large beneficiary enterprise because some extracts from these stock accounts reported negative stocks at the beginning and/or the end of the processing period;

- (c) in accordance with the regulatory provisions, the system in force in the Netherlands authorises the payment of advances on refunds before the national control body has carried out its checks. However, at the time of the Court's audit, there were long delays (up to a year) in making the necessary corrections to the payment accounts after the checks have been carried out.

#### **The follow-up of modified starch should be reviewed**

17. As the process for producing modified starches has the unusual property of being reversible, Article 10 of Regulation (EEC) No 1722/93 imposes thorough controls on their manufacture and use, to ensure that modified starch for which a refund has been paid is not reprocessed into a basic product in order to obtain a further refund.

18. In its Annual Report concerning the financial year 1988, the Court concluded that the arrangements for checking the final use of modified starches were unsatisfactory as regards both the type of proof accepted in the Member States and the monitoring procedure, which was based on the T5 customs control document <sup>(4)</sup>. Regulation (EEC) No 1722/93, which entered into force on 1 July 1993, set up a system of evidence whereby manufacturers submit quarterly declarations to the responsible authorities, and retained the obligatory use of T5 documents when the product in question is the subject of intra-Community trade or is exported to third countries via the territory of another Member State.

19. However, the follow-up of the use of modified starches is still unreliable. Article 10 of Regulation (EEC) No 1722/93 is not applied in a uniform manner in the Member States and there are practical difficulties in applying it:

- (a) monitoring the product through to its final use may prove quite impossible, as the goods subject to control go to many end-users, sometimes via intermediaries;
- (b) in some Member States, the provisions on the use of T5 documents are not respected by traders;
- (c) risk analysis varies considerably, depending on the departments responsible for checks.

<sup>(1)</sup> Article 9(3) of Regulation (EEC) No 1722/93.

<sup>(2)</sup> Article 11(2) of Regulation (EEC) No 1722/93.

<sup>(3)</sup> On the basis of Article 4 of Regulation (EEC) No 1722/93, only manufacturers approved by the competent authorities in the Member States are entitled to claim refunds.

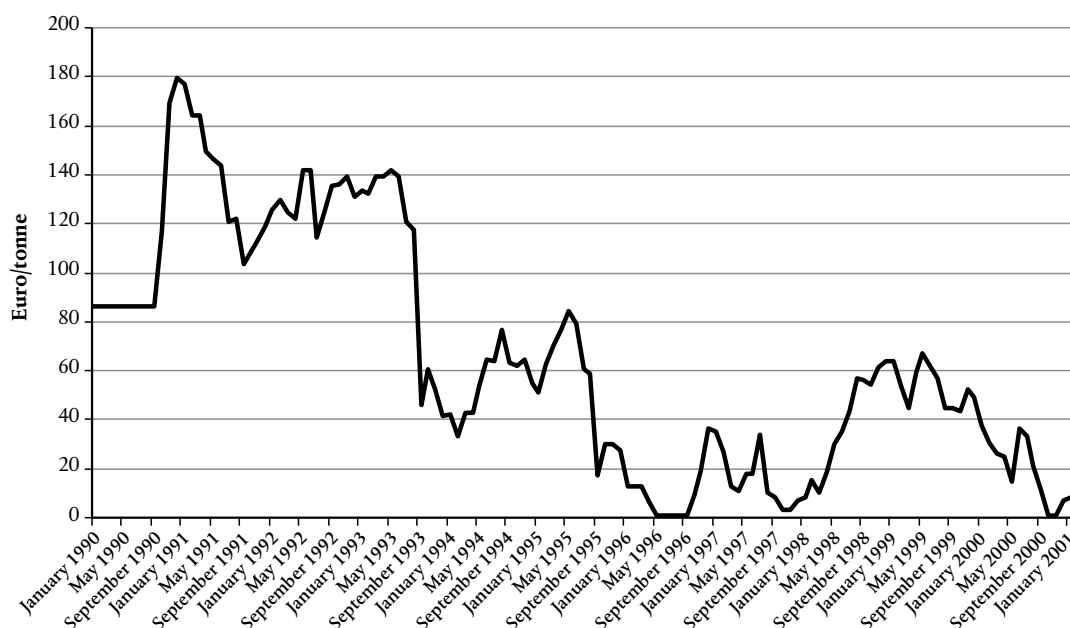
<sup>(4)</sup> Document that accompanies goods and is used to verify their utilisation and/or arrival at their final destination (Articles 471 et seq of Commission Regulation (EEC) No 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code (OJ L 253, 11.10.1993)).

20. The Court's audit made it possible to review certain aspects of the context specific to controls on modified starch. When the system entered into force, refund rates were very high compared with the cost of reprocessing modified starch into basic starch (see *Diagram 3*). According to the national authorities, there is now less risk of fraudulent reprocessing, and refunds are currently far lower than reprocessing costs. The production refund reached

a maximum of 41,44 euro per tonne in 2000, whereas, according to the calculations made by the industry at the Court's request, the cost of reconvertng modified starches into basic starch could be estimated to be, for the same period, 100 euro per tonne. In addition, the national authorities maintain that the control field is limited, as few European factories have plant that is suitable for reprocessing modified starch.

Diagram 3

### Rises and falls in the level of production refund for potato starch and cereal starch



Source: Commission (DG Agri).

## DIRECT AID FOR POTATO STARCH

### Management by the Commission

#### The management of quotas is not consistent

21. Since the 1992 reform, starch potato producers have received direct aid per tonne of starch, in addition to the minimum price. In order to combat the effects of rising production and to prevent any slippage in budgetary expenditure, the Council set up a quota system in 1994 providing for the allocation of quotas to Member States and sub-quotas to potato starch mills.

22. Potato starch mills have some room for manoeuvre in managing their sub-quotas, since they have the option of increasing their sub-quota for one year by using up to 5 % of their sub-quota

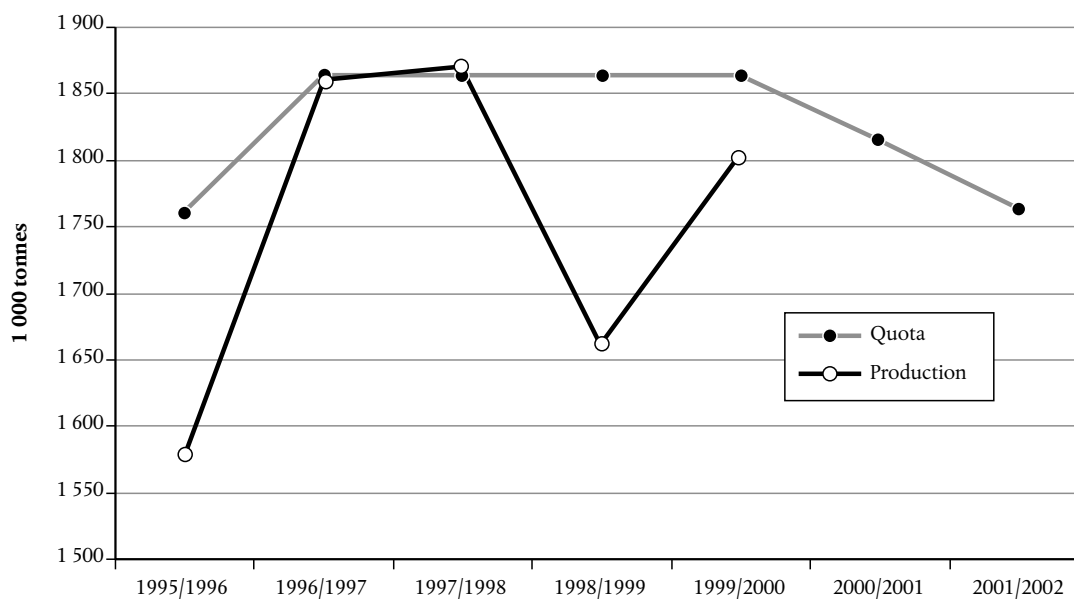
for the following year in advance. Such flexibility is, however, out of phase with the potential variations in production, which can be as much as 20 %, depending on climatic conditions.

23. The ceiling of 1 702 000 tonnes fixed for EU-12 in 1994 included a reserve of 110 000 tonnes for Germany, which the latter was required to utilise as of the 1996/97 marketing year. The additional production for that marketing year amounted to 104 554 tonnes, i.e. an increase in output of 17 % in Germany and 6 % for EU-12. This additional production destabilised the European market for more than two years, until the industry decided to reduce the quantities made available on the market (see *Diagram 4*). According to those involved in producing potato starch, it is only since 2000 that potato starch prices have returned to an advantageous level.

24. The quota established in 1994 also included 2 000 tonnes for Spain, even though Spain has no potato starch manufacturing industry.

Diagram 4

## Changes in potato starch production and quotas in the EU



Source: Commission, DG AGRI.

Table 3

## Breakdown by Member State of changes in potato starch quotas

| Member State        | 1995/1996        | 1996/1997        | 1997/1998        | 1998/1999        | 1999/2000        | 2000/2001        | 2001/2002        |
|---------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Denmark             | 178 460          | 178 460          | 178 460          | 178 460          | 178 460          | 173 439          | 168 215          |
| Germany             | 591 717          | 591 717          | 696 271          | 696 271          | 696 271          | 676 680          | 656 298          |
| Spain               | 2 000            | 2 000            | 2 000            | 2 000            | 2 000            | 1 972            | 1 943            |
| France              | 281 516          | 281 516          | 281 516          | 281 516          | 281 516          | 273 595          | 265 354          |
| Netherlands         | 538 307          | 538 307          | 538 307          | 538 307          | 538 307          | 523 161          | 507 403          |
| Austria             | 49 100           | 49 100           | 49 100           | 49 100           | 49 100           | 48 409           | 47 691           |
| Finland             | 54 750           | 54 750           | 54 750           | 54 750           | 54 750           | 53 980           | 53 178           |
| Sweden              | 63 900           | 63 900           | 63 900           | 63 900           | 63 900           | 63 001           | 62 066           |
| <b>Total</b>        | <b>1 759 750</b> | <b>1 759 750</b> | <b>1 864 304</b> | <b>1 864 304</b> | <b>1 864 304</b> | <b>1 814 237</b> | <b>1 762 148</b> |
| Reserve for Germany | 110 000          | 104 554          |                  |                  |                  |                  |                  |
| <b>Total</b>        | <b>1 869 750</b> | <b>1 864 304</b> |                  |                  |                  |                  |                  |

Source: Regulation (EEC) No 1868/94 and subsequent amendments thereto.

25. Quotas were not changed at the time of the triennial review in 1997. Under the Agenda 2000 reform, quotas were reduced for 2000/01 and 2001/02 (see Table 3).

State that has a shortfall. In 1998, an UCLAF inquiry uncovered the illicit transfer of 20 000 tonnes of potatoes from the Netherlands to Germany. The unduly received aid amounted to 1,5 million euro. The regulations provide for very heavy penalties for potato starch mills that accept quantities of potatoes that are not covered by grower contracts <sup>(1)</sup>.

### There is an inherent risk in the quota system

26. The quota system applied to the production of potato starch involves a major inherent risk, namely the fraudulent transfer of surplus production from one Member State to another Member

<sup>(1)</sup> Article 13(4) of Regulation (EC) No 97/95 (OJ L 16, 24.1.1995, p. 3). According to this Article, the maximum penalty is the cancellation of all premiums to be paid to the starch manufacturer concerned for two consecutive marketing years.

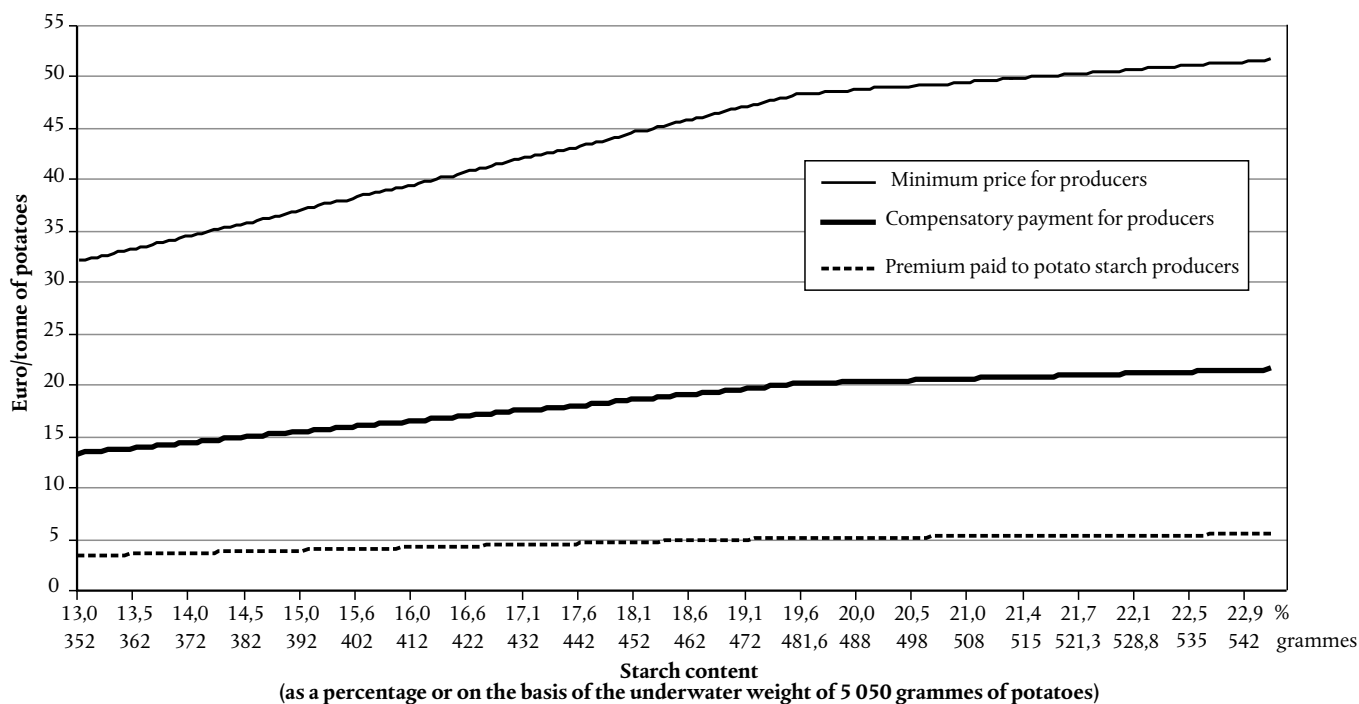
### Starch quantities are determined on the basis of an outdated conversion table

27. Community rules <sup>(1)</sup> lay down the minimum price, the producer payment and the premium paid to potato starch mills for each tonne of starch obtained from potatoes delivered by farmers. These items are adjusted according to the starch content established on the basis of a sample using a method laid down in the regulations <sup>(2)</sup>. *Diagram 5* shows the amounts paid to farmers and potato starch mills per tonne of potatoes delivered, as a function of the starch content calculated on the basis of the Regulation, between 1993/94 and 1999/2000 <sup>(3)</sup>. This graph shows that there is a point of inflection at 19,7 % of the notional content. The inflection point is attributable to the fact that, according to the regulations, part of the starch content of the potatoes cannot be extracted (see *Diagram 6*).

28. The conversion table <sup>(4)</sup> used for all the calculations was already in use by the European potato starch mills before the minimum price was introduced under the first CMO in cereals in 1996. The most recent adjustment to the conversion table, which dates back to the 1982/83 crop year <sup>(5)</sup>, retained the principle of the table being established around the inflection point. Since that time, potato starch mill technology has progressed and starch potato varieties have been improved. As the quantities of starch extracted are higher than those that result from applying the regulations, starch mills obtain 'bonus production' which is not charged to their sub-quota and for which no payment is made. The bonus ranged from 2 % to 10 % in the Member States visited, depending on the starch mill concerned <sup>(6)</sup>.

Diagram 5

Minimum prices and compensatory payments for potato producers and premiums paid to potato starch producers up to 1999/2000 (prior to the Agenda 2000 reform)



Source: Annex II to Commission Regulation (EC) No 97/95.

<sup>(1)</sup> Commission Regulation (EC) No 97/95 of 17 January 1995 (OJ L 16, 24.1.1995, p. 3).

<sup>(2)</sup> Annex II to Regulation (EC) No 97/95.

<sup>(3)</sup> Within the framework of the Agenda 2000 reform, the minimum price has been lowered in two steps. 75 % of the reduction has been offset by an increase in the payment to potato producers.

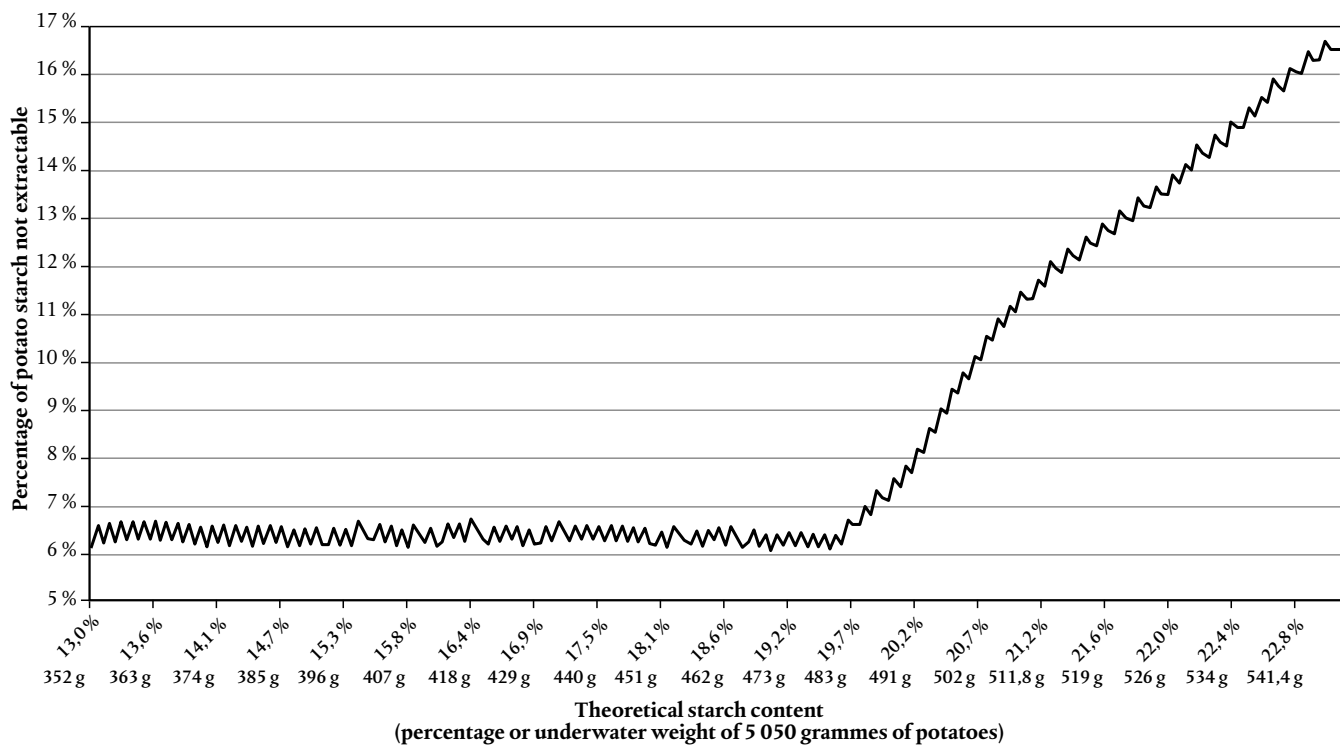
<sup>(4)</sup> Table giving the relationship between the underwater weight of a sample of potatoes and the theoretical starch content of this sample.

<sup>(5)</sup> Commission Regulation (EEC) No 2293/82 of 19 August 1982 (OJ L 245, 20.8.1982, p. 47).

<sup>(6)</sup> It should however be noted that, at the beginning of the 1990s, the production penalty for starch manufacturers in the new *Länder* of Germany could be as much as 15 %.

Diagram 6

## Percentage of potato starch not extractable on the basis of Annex II to Regulation (EC) No 97/95



Note: If the theoretical starch content lies between 13 % and 19,7 %, it is estimated that around 6,5 % of the potato starch contained in the potatoes is lost during the extraction process. Starch loss increases from 19,7 % onwards.

Source: Annex II to Commission Regulation (EC) No 97/95.

### The impact of the direct aid paid to farmers has never been evaluated

29. The establishment of both the minimum price and the direct aid for producers of starch potatoes is entirely bound to the intervention price and the direct aid for cereals. The Commission has no study or analysis that would enable it to verify whether the aid granted to European potato producers helps to give them a fair standard of living.

### Aid for potato starch mills is not based on sufficiently reliable management information

30. According to one of the recitals of the Regulation introducing this form of aid, the aid is justified by the 'increasing advantage enjoyed by the cereal starch industry, particularly because of the by-products obtained from such manufacture' <sup>(1)</sup>. This aid

measure was introduced in 1978 following the great drought of 1976 and has remained ever since. The premium was also justified by the seasonal nature of potato starch production and by specific environmental constraints. The aid was initially set at 10 ecu per tonne of potato starch and went up to 16,93 ecu in 1979 <sup>(2)</sup> and 18,68 ecu in 1982. This amount became 22,25 ecu in 1995, following the adjustment of the green rate.

31. According to representatives of the potato starch industry, the structural disadvantage experienced by potato starch mills in comparison to cereal starch mills is considerably higher than 22,25 euro per tonne of potato starch produced. In 1996, the Union of potato starch manufacturers of the European Union commissioned an economic study by the Dutch Economic Institute for Agricultural Research. According to this institute, potato starch manufacturers were at a structural disadvantage of 81 euro per tonne as compared with maize starch manufacturers in 1995. The study was updated in 2001 and put this disparity at 84 euro per tonne in 2000 <sup>(3)</sup>.

<sup>(1)</sup> Recital 3 of Council Regulation (EEC) No 1127/78 of 22 May 1978 (OJ L 142, 30.5.1978, p. 24).

<sup>(2)</sup> Council Regulation (EEC) No 1555/79 of 24 July 1979 (OJ L 188, 26.7.1979, p. 12).

<sup>(3)</sup> 'The economic position of potato starch after Agenda 2000'. Agricultural Economics Research Institute LEI-DLO (The Hague, Netherlands), 18.6.2001.

### **Management by the Member States**

#### **Member States' on-the-spot controls show some weaknesses**

32. The Member States are required to introduce a control scheme involving on-the-spot checks whose function is to verify the reality of operations qualifying for the premiums and compliance with the sub-quota allocated to each potato starch manufacturer. These checks look at all the operations carried out during the manufacturing process on a basis of at least 10 % of the quantities of potatoes supplied to the mill in question <sup>(1)</sup>. The inspectors are allowed access to all the enterprise's data.

33. The Member States interpret the provisions of the regulations in different ways. The reason for this is that the text is unclear and there are no instructions from the Commission as to exactly what checks should be carried out. In the three Member States visited, labour-intensive checks are carried out on well over 10 % of deliveries, but the quality of these checks is very variable.

34. Although numerous checks are carried out to verify the accuracy of payments, one easily implemented key check — an analysis of the changes over time in the 'production bonuses' — is not carried out in any of the Member States visited. The 'production bonuses' (2 % to 10 % depending on the starch mill) represent the difference between actual potato starch production and the notional production calculated by applying the Community Regulation. This analysis is essential to detect any deliveries of potatoes that have not been declared by mills whose sub-quotas have run out.

35. In the Netherlands, the independence of the checks is not guaranteed, because they are carried out by a foundation financed by the only potato starch manufacturer in the country. The general supervision by the AID (General Inspection Services reporting to the Ministry of Agriculture) does not compensate for this weakness.

#### **The minimum price is not always fully adhered to**

36. Direct payments to producers and potato starch mills are dependent on the mills paying a minimum price. Some practices observed in the Member States visited undermine adherence to the minimum price guaranteed to potato producers by the Regulation:

- (a) in one German plant, a delivery charge equivalent to around 4 % of the minimum price is levied on suppliers who are not company shareholders;

- (b) in the Netherlands, the payment of the minimum price is systematically deferred by a system of interest-free loans which the majority of farmers grant to the mill.

#### **The Commission's work in the context of the clearance of accounts**

37. In 1995 and 1996 the Commission carried out audit visits to several Member States in the context of its work concerning the clearance of accounts for 1993 and 1994. The Commission did not issue any reservations regarding the checks carried out in the Netherlands (independence of the checks, see paragraph 35) and did not make any observations concerning calculation of the minimum price (see paragraph 36).

#### **CONCLUSION**

38. The Court's audit brought to light certain inadequacies or problems in the implementation of the Community schemes in support of industries that use cereal and potato starch and the specific aid measures for the potato starch sector. However, although the beneficiaries feel that the aid system does not fully achieve its objectives, especially as regards competitiveness, they did not question its components or the way it operates.

39. The level of production refunds paid to the user industries is influenced by the fact that Community prices for maize are higher than world prices. The objective of the Agenda 2000 reform was to align Community cereals prices with world prices in the medium term. If this objective were achieved, aid to starch-using industries would automatically cease to exist.

#### **RECOMMENDATIONS**

40. As regards the refund scheme for cereal and potato starch production, the Court recommends that the Commission:

- (a) examine the possibility of making the calculation of refund rates clearer and more predictable (see paragraph 11). It is also suggested that it examine the possibility of simplifying the mechanism;
- (b) develop a method to enable it to assess whether the scheme achieves satisfactory results in terms of the competitiveness of the Community industry (see paragraph 12);
- (c) ask the Member States to remedy the control weaknesses found during the audit (see paragraph 16);

<sup>(1)</sup> Article 13(1) of Regulation (EC) No 97/95 (OJ L 16, 24.1.1995, p. 3).

- (d) given the problems posed by their implementation, carry out an evaluation of the provisions of the regulations relating to the checks on modified starches. The Commission should examine the control mechanism with a view to changing the way it works, and also look into another approach that would involve making detailed accounting checks only on the enterprises that are technically capable of carrying out reprocessing (see paragraphs 18 to 20).
41. With regard to direct aid for the production and processing of starch potatoes, the Commission should:
- (a) examine the possibility of reviewing the 5 % flexibility margin that the mills have for the management of their sub-quotas and ensure that the variation in quotas is compatible with the market's capacity to absorb the product (see paragraphs 22 to 25);
- (b) evaluate the method for calculating the starch content of potatoes laid down by the regulations, given that this calculation directly influences all the amounts disbursed. This evaluation should take into account the general technical level in present and future Member States (see paragraph 28). It is also important for the Commission to obtain data from the mills on the actual production of potato starch eligible for refunds;
- (c) document and analyse the effects of the direct aid scheme on the income of the farmers concerned (see paragraph 29);
- (d) collect relevant information so that the structural disadvantage suffered by potato starch manufacturers can be measured (see paragraph 30);
- (e) clarify certain provisions concerning checks in the Member States (see paragraphs 33 and 35), and recommend that Member States monitor the 'bonus production' obtained by manufacturers of potato starch (see paragraph 34);
- (f) ask the Member States concerned to remedy the anomalies found by the Court in respect of adherence to the minimum price to be paid to farmers by manufacturers of potato starch (see paragraph 36).

This Report was adopted by the Court of Auditors in Luxembourg at its meeting of 11 and 12 July 2001.

*For the Court of Auditors*

Jan O. KARLSSON

*President*

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## THE COMMISSION'S REPLIES

### SUMMARY

I. From the comments of the Court, especially those set out under 'Conclusion', the Commission concludes that the Court is generally of the opinion that the scheme does not give rise to major difficulties in terms of implementation. The Court points to a number of shortcomings but, apart from the problem in one Member State, these do not appear to be of a serious nature. Every system can be improved, however, and the Commission will of course draw the attention of the Member States to the conclusion reached by the Court in its report.

II. While confirming that aid to the cereal and potato starch sector is linked to the policy on cereal prices, the Commission would point to an additional factor, namely production refunds aimed at ensuring the competitiveness of Community starch products in relation to imports incorporated in non-protected non-food products (e.g. cardboard and organic chemicals).

III. Control missions were, in the framework of the clearance of accounts, carried out in 1996 in respect of the 1994 and 1995 budget years. Following the new clearance procedure and the risk assessment of all EAGGF-Guarantee expenditure, and given the results of the audits carried out in 1996, which did not reveal any major problems, no further controls have been carried out by the Clearance of accounts department. Given the resources available, the said department cannot, for the reason given above and as explained in its annual work schedule, cover each scheme. That is also why the Clearance of accounts department uses as a basis sector letters of the Court which, after analysis, are sent to the Member States together with a reference to Article 8 of Regulation (EC) No 1663/95.

IV. The Commission's aim, in ensuring that potato starch production complies with the quota regime, is to eliminate the risks pointed out by the Court of Auditors as regards the supervision of the market and the management of controls covering in particular cultivation contracts.

V. The Commission regularly reviews the situation in the sector and consults the trade and the competent departments in the Member States. Moreover, in the context of the systematic evaluation of sectoral agricultural policies, the Agriculture Directorate-General (DG) included in its programme for the year 2000 the launch of a study centred on an evaluation of the Community policy on starch and starch products. The main evaluation issues relate:

- on the one hand, to the effectiveness and efficiency of the measures adopted in the starch and starch products sector generally, in particular production and export refunds, and measures specific to potato starch, among them aid to starch factories and production quotas, and
- on the other, to farm incomes and the development of the regions concerned.

The results of the study are expected at the end of 2001. A number of items currently under preparation may well prove useful in drawing up the report which, as required by Council Regulation (EC) No 1868/94, the Commission is to present to the Council on or before 31 October 2001. The report is to deal with the allocation of the potato starch quota within the Community and is, if necessary, to be accompanied by appropriate proposals.

**PRODUCTION REFUNDS*****Management by the Commission*****The method for calculating refunds allows for considerable flexibility**

11. All the components used in the calculation of the refund are notified weekly to the Management Committee. Under the method, internal prices may be capped in the event of a significant increase, in particular to avoid a sharper upward trend, thus helping to curb budget expenditure.

It should be stressed that there is no absolute guarantee that the method will be applied; the Commission may, under exceptional circumstances, apply different rules. The Commission takes note of the industry's requests but stresses that when fixing refunds it must take account of budgetary constraints and actual market conditions.

**There is a lack of information on the state of the market**

12. A number of reservations are called for regarding the conclusions to be drawn from Diagram 2.

Although there are no representative quotations for cereal starch, potato starch or derived products, the Commission does not take the view that there is a systematic price gap disadvantageous to the European starch industry. The refund, be it a production or an export refund, is aimed at offsetting differences in the cost of raw materials and not differences in the cost of starch or potato starch as a finished product. The production refund covers the difference between European prices for maize on delivery and cif prices for maize on world markets (in particular the American market); internal prices in the United States of America are accordingly lower, by an amount corresponding in particular to the cost of transport from the United States of America to Europe. The purpose of the production refund is to ensure that industrial products made from starch obtained from raw materials at the Community price can compete with imported products made from raw materials at the world market price; it is not to ensure equality between starch prices on Community and world markets.

13. In the context of the systematic evaluation of sectoral agricultural policies, the Agriculture DG included in its programme for the year 2000 the launch of a study centred on an evaluation of the Community policy on starch and starch products. The main evaluation issues relate:

- on the one hand, to the effectiveness and efficiency of the measures adopted in the starch and starch products sector generally, in particular production and export refunds, and measures specific to potato starch, among them aid to starch factories and production quotas, and
- on the other, to farm incomes and the development of the regions concerned.

The results of the study are expected at the end of 2001. A number of items currently under preparation may well prove useful in drawing up the report which, as required by Council Regulation (EC) No 1868/94, the Commission is to present to the Council on or before 31 October 2001. The report is to deal with the allocation of the potato starch quota within the Community and is, if necessary, to be accompanied by appropriate proposals.

***Management by Member States*****Progress in administrative controls by national authorities but incomplete on-the-spot controls**

16. By virtue of Article 9 of Regulation (EEC) No 1722/93, Member States are not obliged to carry out systematic physical checks. As the Court points out at point 14, the Regulation provides for administrative checks, but these should, where necessary, be backed up by physical checks. It is for the national control departments to determine when physical checks are necessary.

- (a) Under the Regulation, the competent authority must, before payment, establish that the starch has been used for the manufacture of the approved products in accordance with the information stated on the certificate. This will normally be done by means of administrative checks, but these should, where necessary, be backed up by physical checks, possibly including analyses.
- (b) The stock records of the large firm in the Netherlands are the subject of controls in the framework not only of the production refunds for starch, but also of Regulation (EEC) No 4045/89. The Commission will analyse the comments of the Court of Auditors and will, where appropriate, adopt suitable measures.
- (c) According to information in the possession of the Commission the situation in the Netherlands has, since the Court's audit, been corrected by the Member State concerned.

### **The follow-up of modified starch should be reviewed**

17 and 18. In 1987 the security to be lodged (105 % of the refund — released only after proof has been submitted that the applicable requirements have been fulfilled) was increased and, in 1988, a control system based on the T5 form was introduced for products in intra-Community trade. By virtue of Regulation (EEC) No 1722/93 these arrangements were replaced by a system of proof based on quarterly declarations (see point 18 of the Court of Auditors' report), except in the case of intra-Community trade and exports via a Member State. Lastly, in 1998, the conditions for the release of the special security were made more detailed (definition of the principal requirement and specification of the time allowed for processing/export).

The issue of reprocessing of modified starch is referred to in the report on the Clearance of accounts department mission to France of 30 June 1995. It emerged that control procedures in France did not provide sufficient guarantees as regards the avoidance of duplicate aid payments. In the absence of any evidence that such payments had actually occurred, however, no financial corrections were proposed.

19. Aware of the possibility of abuse and irregularities, the Commission has, jointly with the Member States and the trade, regularly reviewed the application of the special measures for modified starch. A number of rules have been adjusted, including the introduction of declarations whereby manufacturers give an undertaking, which Member States are required to comply with and verify, regarding the correct use of the product.

20. The Commission recognises that there is currently less of a risk of fraudulent use of modified starch, given that production refunds are low. The Commission is prepared to look at the conditions applicable and, if necessary, the provisions of Regulation (EEC) No 1722/93.

### **DIRECT AID FOR POTATO STARCH**

#### ***Management by the Commission***

#### **The management of quotas is not consistent**

22. The prime purpose of a quota system is to limit production. The Council has, however, decided to allow a 5 % flexibility margin over and above the quota allocated, subject to the subsequent quota being reduced accordingly.

Greater flexibility in the arrangements could well lead to an increase in potato starch production, especially in the first year, with a consequential increase in budget expenditure.

24. At the Council meeting which adopted the starch regime Spain reported modest domestic potato starch production; the Council accordingly allocated a 2 000 tonne quota which in effect is not produced under that regime.

#### **There is an inherent risk in the quota system**

26. In 1998/99 UCLAF/OLAF investigated illicit transfers of quotas in the potato starch sector, checks having shown that potatoes grown in the Netherlands were, in breach of the regulations, being sold in Germany via middlemen. The total amount to be recovered following the application of sanctions is EUR 6,2 million. The matter is still being looked into.

#### **Starch quantities are determined on the basis of an outdated conversion table**

28. The minimum price, the amount payable to the producer and the starch industry premium (starch scale) are determined by means of the conversion table used to calculate the starch content of the potatoes. The table was drawn up in 1975 and amended in 1982. While it is true that some differences may emerge as a result of the actual starch content of the potatoes or the percentage of starch extracted thanks in particular to technological advances not yet taken into account, the scale has been regularly updated in the light of the data applicable (minimum price, compensatory payment, etc.). Moreover, additional quantities do not qualify for support under the potato starch regime (no premium or payment to the producer). These factors are covered by the evaluation now under way (see point 13).

#### **The impact of the direct aid paid to farmers has never been evaluated**

29. In the Member States in which potato starch is produced, the crop concerned is regarded as being of major importance in production regions; the current regime is expected to provide farmers with a fair income, an evaluation of which will be provided in the course of the current study (see point 13).

### **Aid for potato starch mills is not based on sufficiently reliable management information**

30. The premium to the potato starch industry applies to production under the quota regime. It is provided for in Article 5 of Council Regulation (EC) No 1868/94 and is intended to take account of structural constraints that are specific to the potato starch sector, namely a short production season, few by-products whose value can be enhanced and the cost of disposing of liquid waste. The Commission has already recognised in the past that it is difficult to set a suitable level for the premium and that the data in its possession varies greatly according to the region and the structure of the factories. It is generally accepted, however, that there has been no fundamental change in the economic link with the cereal starch sector. The Commission will look into these factors in the context of the evaluation study now underway (see point 13).

31. It should be noted that the premium of EUR 22,25 per tonne of potato starch was approved by the Council.

The Commission does not, at this stage, wish to comment on the validity of the study referred to. The amount of the premium is covered by the evaluation underway (see point 13).

### **Management by the Member States**

#### **Member States' on-the-spot controls show some weaknesses**

33. The percentage to be checked is specified in Article 13 of Commission Regulation (EC) No 97/95 and so is the general objective of the checks. Once again, it is left to the national authorities to determine the control method. Differences are possible, but cannot be evaluated, given that the scheme has not been checked by the Clearance of accounts department since 1996.

34. The Commission agrees with the Court that the yields have to be evaluated to determine deliveries over and above the sub-quota allocated to the starch-producing undertaking. This point is currently being examined by the Commission departments concerned.

#### **The minimum price is not always fully adhered to**

36 and 37.

(a) The application of the minimum price to be paid to the producer of starch potatoes by the industry is considered a key control. The reduction of the minimum price by a 4 % deliv-

ery charge in Germany might not be acceptable and the Commission will look further into this matter.

(b) the Commission will look into the conformity of this observed practice.

### **The Commission's work in the context of the clearance of accounts**

37. Concerning the Netherlands, the Clearance of accounts department raised the matter in its control report of 1996 and concluded that the situation was, at the time, acceptable.

### **CONCLUSION**

38. From the comments of the Court, especially in the conclusion, the Commission concludes that the Court is generally of the opinion that this scheme does not give rise to major difficulties in terms of implementation. The Court points to certain shortcomings but, apart from the problem in Germany, these do not appear to be of a serious nature. Every system can be improved, however, and the Commission will of course draw the attention of the Member States to the conclusion of the Court in the report.

### **RECOMMENDATIONS**

40.

(a) The Commission will look into the possibility of simplifying the mechanism if such simplification is warranted.

(b) The Commission will continue to scrutinise the method used for calculating the refunds in the absence of representative prices for cereal starch, potato starch and derived products. This item is covered by the evaluation study referred to at point 13.

(c) The Commission refers to the observations made under point 16, but will inform the Member States about the concerns of the Court.

(d) The Commission recognises that there is currently less of a risk of fraudulent use of modified starch, given that production refunds are lower. The Commission is willing to look into the conditions applicable.

- 41.
- (a) The 5 % flexibility margin was introduced by the Council after much discussion. The Commission does not currently intend to propose increasing it, for budgetary reasons and because production might well increase as a result.
- (b) This item will be looked at in the context of the current evaluation and in the light of the potential impact (see point 13); it is being discussed by the Commission departments concerned.
- (c) The Commission seeks to ensure a fair level of income for farmers. The evaluation study currently underway is expected to shed some light on the subject (see point 13).
- (d) The Commission endeavours to collect information on the structural disadvantage of potato starch factories in relation to their cereal starch counterparts. Premiums to potato starch factories are dealt with in the current evaluation study (see point 13).
- (e) It is for the national authorities to determine the control method, although the framework is set by Regulation (EC) No 97/95 (see point 33).
- The Commission agrees with the Court that the yields have to be evaluated to determine deliveries over and above the sub-quota allocated to the starch-producing undertaking. This point is currently being examined by the Commission departments concerned.
- (f) The 4 % price reduction in respect of a delivery charge needs to be investigated further.
-