

IV

(Notices)

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COURT OF AUDITORS

SPECIAL REPORT No 4/2008

concerning the implementation of milk quotas in the Member States which joined the European Union on 1 May 2004 together with the Commission's replies*(pursuant to Article 248(4), second subparagraph of the EC Treaty)*

(2008/C 185/01)

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ABBREVIATIONS

AIRBC (ŽŪIKVC)	The Agricultural Information and Rural Business Centre (Lithuania)
APA Slovakia	Agricultural Paying Agency, the paying agency for agriculture in Slovakia
ARR	Agencja Rynku Rolnego (Agricultural Market Agency), the paying agency for agriculture in Poland
ARSKTRP	Agency of the Republic of Slovenia for Agricultural Markets and Rural development, the paying agency for agriculture in Slovenia
CMO	Common Market Organisation
CVI	Ciltstarba valsts inspekcija (National Inspectorate of Pedigree Breeding), the inspecting agency in Latvia
CY	Cyprus
CZ	Czech Republic
EE	Estonia
GUS	Główny Urząd Statystyczny, National Statistical Office of Poland
HU	Hungary
KSH	Központi Statisztikai Hivatal (Hungarian Central Statistical Office)
LDC	Lauksaimniecības Datu Centrs (Agricultural Data Centre), the managing body for the quota scheme in Latvia
LV	Latvia
LT	Lithuania
MT	Malta
MVH	Mezőgazdasági és Vidékfejlesztési Hivatal (Agricultural and Rural Development Agency), the paying agency for agriculture and rural development in Hungary
NMA	Nacionalinė Mokėjimo Agentūra (National Paying Agency), the paying agency for agriculture in Lithuania
PL	Poland
PRIA	Põllumajanduse Registre ja Informatsiooni Amet (Estonian Agricultural Registers and Information Board), the paying and managing agency for milk quotas in Estonia
SI	Slovenia
SK	Slovakia
SZIF	Státní zemědělský intervenční fond (State Agricultural Intervention Fund), the paying agency for agriculture in the Czech Republic
ZMP	Zentrale Markt- und Preisberichtsstelle für Erzeugnisse der Land-, Forst-, und Ernährungswirtschaft

EXECUTIVE SUMMARY

I. With the enlargement of 1 May 2004, the 10 new Member States took on the obligation to apply the milk quota scheme. The scheme requires Member States to adhere to production thresholds that are allocated to them separately for milk deliveries to dairies and direct sales to consumers, and provides for a financial penalty if the thresholds are exceeded.

II. The Court audited the implementation of the milk quota scheme in the new Member States, carrying out on-the-spot checks in eight of them and basing its work on an in-depth analysis of the information provided by the Commission.

III. In the new Member States, the dairy sector has already experienced profound changes, with the same trends in evidence everywhere: reductions in livestock, enlarged holdings, continuing rises in milk yields and an increased delivery rate. The economic development which followed the transition period has not, however, been accompanied by a reduction in what is still a substantial subsistence or semi-subsistence farming sector, thereby helping to moderate the effects of structural unemployment.

IV. In this very specific context, although the delivery quotas allocated to the new Member States were estimated at levels very close to actual requirements, direct sales quotas were, by contrast, considerably overestimated on the basis of very approximate statistical data.

V. When individual quotas were being allocated to producers, the auditors noted over-allocation of delivery quotas in two Member States. At the end of the first two quota years, the Court must conclude that half of all dairy holdings have not been brought within the milk quota scheme. The fact they have been excluded does not indicate an inability to implement the scheme, but rather reflects the scale of the semi-subsistence farming sector.

VI. In the pre-accession phase, the Commission played an essential role in the negotiations to establish national quotas. As regards the Commission's activities in the 2004-2006 period, the Court noted certain shortcomings.

VII. The implementation of milk quotas posed a major logistical challenge for the new Member States. On the whole, a considerable effort was made to ensure that administrative and control systems were operational in good time. At the time of the audit, these systems were still uneven in quality and were subject to comment by the Court as regards management of the '*acquis communautaire*' and the national reserve, rules for converting quotas, and the planning and implementation of checks.

VIII. Most of the shortcomings noted may be considered as intrinsic to the system's start-up phase. It is up to the Commission and the Member States to continue to ensure that appropriate corrective action is taken. Furthermore, in order to ensure that the scheme is properly managed and that proposals are drawn up for its future, it is vital for the Commission to have reliable, standardised information in order to understand the actual extent of the restructuring process and to corroborate the data on direct sales.

IX. After the first two quota years, restructuring continues in the new Member States' dairy sectors. Milk deliveries have continued to increase as a proportion of total production. National delivery quotas were close to saturation, or even exceeded in the Czech Republic, Cyprus and Poland. Under-use of direct sales quota was mitigated as a result of large-scale conversions of direct sales quotas into delivery quotas. There has been a move towards concentration of production units as the price of milk has risen. As a result of the enlargement, milk products have been traded more widely without destabilising the European market and without leading to budgetary drift.

INTRODUCTION

General observations

1. The milk quota scheme has applied in the European Union since the 1984-1985 milk year and will remain, if the regulations do not change, until the 2014-2015 marketing year ⁽¹⁾. The essential aim of the scheme is to 'reduce the imbalance between supply and demand on the milk and milk products market and the resulting structural surpluses, thereby achieving better market equilibrium' ⁽²⁾.

2. On 1 May 2004, the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia joined the European Union. Earlier, the Copenhagen European Council, in December 2002, had set the national reference quantities applicable to dairy production in the ten candidate countries. The milk quota scheme thus came into full effect in all the

new Member States on the date of enlargement, except for Poland and Slovenia which, at their own request, were granted extra time to implement the scheme completely ⁽³⁾.

3. The accession arrangements for each new Member State, with the exception of Cyprus and Malta, included the creation of a special restructuring reserve for the dairy sector ⁽⁴⁾. This reserve was available for release from 1 April 2006 to support the restructuring of the national dairy sector and, in particular 'the shift from production for on-farm consumption to production for the market' ⁽⁵⁾.

4. After the enlargement of 1 May 2004, the national reference quantities for the 25 Member States totalled 137,3 million tonnes. Together, the ten new Member States had 18,3 million tonnes available to them, i.e. 13,3 % of the EU total (Table 1).

Table 1
Initial milk quotas for the new Member States (1 May 2004)

(tonnes)

Member States	Deliveries	Direct sales	Total	Special reserve
Czech Republic	2 613 239	68 904	2 682 143	55 788
Estonia	537 188	87 365	624 483	21 885
Cyprus	141 337	3 863	145 200	0
Latvia	468 943	226 452	695 395	33 253
Lithuania	1 256 440	390 499	1 646 939	57 900
Hungary	1 782 650	164 630	1 947 280	42 780
Malta	48 698	0	48 698	0
Poland	8 500 000	464 017	8 964 017	416 126
Slovenia	467 063	93 361	560 424	16 214
Slovakia	990 810	22 506	1 013 316	27 472
EU-10	16 806 368	1 521 597	18 327 895	671 418
EU-15	117 771 708	1 241 943	119 013 651	
EU-25	134 578 076	2 763 450	137 341 616	

Sources:

EU-10: Annex I to Regulation (EC) No 1788/2003.

EU-15: Annex to Council Regulation (EC) No 3950/92, as amended by Commission Regulation (EC) No 739/2004.

⁽¹⁾ The milk year, or quota year, is the 12-month period beginning on 1 April and ending on 31 March.

⁽²⁾ Council Regulation (EC) No 1788/2003 of 29 September 2003 establishing a levy in the milk and milk products sector, third recital (OJ L 270, 21.10.2003, p. 123).

⁽³⁾ For these two Member States, the national reference quantities were applicable from 1 May 2004, but the obligation to set individual reference quantities did not take effect until 1 April 2005.

⁽⁴⁾ Annex I(g) of Regulation (EC) No 1788/2003.

⁽⁵⁾ Article 1(4) of Regulation (EC) No 1788/2003.

Box 1 — The milk quota system

Each Member State is allocated a 'national reference quantity', i.e. a national production quota, which is subdivided into a national 'deliveries' quota for milk delivered to purchasers (the majority of them dairies) and a national 'direct sales' quota for milk sold or delivered directly by producers to consumers and for other dairy products sold or delivered by producers. Producers receive individual reference quantities for their deliveries and/or direct sales within national limits.

If a Member State exceeds one of its national quotas, the Member State becomes liable to the EU for an 'additional' levy set at a level deemed to be dissuasive (33,27 euro per 100 kilos of milk for the 2004-2005 period), and separately determined for deliveries and direct sales. Each year before 1 September, the Member States provide the Commission with the information needed to calculate the levy. The Member State liable for the levy is required to divide it up between the producers that have contributed to the overrun of the national reference quantity, after unused reference quantities have been reallocated.

The milk quota scheme imposes a general framework on Member States and guidelines to be respected when calculating the levy. The Member States nevertheless have latitude, in particular when defining the arrangements for transferring quotas between producers, to administer their national reference quantities in accordance with their own economic and social objectives, e.g. regarding the type of holding they consider desirable or even the territorial distribution of holdings. No compensation is possible between the quotas of Member States with surplus production and those with a shortfall.

Audit objectives and approach

5. The aim of the audit was to check the introduction and operation of the milk quota system in the new Member States at the end of the first marketing year in which it applied (1 May 2004 to 31 March 2005) ⁽⁶⁾. The principal audit questions were as follows:

- Did the Commission negotiate the allocation of national reference quantities to the new Member States correctly? How did it support and supervise the extension of the scheme to these new Member States?
- Have the Member States created adequate structures to administer the milk quotas? Do their systems for managing and checking the activities of producers and purchasers comply with EU legislation? Does the milk quota scheme cover all the milk marketed in the new Member States? What influence has the introduction of quotas had on national dairy sectors? How has the introduction of quotas influenced national dairy sectors? How has enlargement affected the milk CMO?

⁽⁶⁾ 1 April 2005 to 31 March 2006 in the case of Poland and Slovenia.

6. In response to these questions, the Court's observations dealt with each stage in the implementation of the scheme, i.e.:

- the specific production structures in the new Member States which directly influenced the implementation of the milk quota system (paragraphs 8-14);
- the setting of national quotas (paragraphs 15-26);
- the allocation of individual quotas (paragraphs 27-34);
- the implementation and administration of the scheme (paragraphs 35-52);
- the organisation and implementation of controls (paragraphs 53-61);
- an assessment of the initial quota years (paragraphs 62-71).

7. The Court visited eight Member States in 2005 (the Czech Republic, Estonia, Latvia, Lithuania, Hungary and Slovakia) and Poland and Slovenia in 2006. The Member States audited on the spot were thus central and eastern European countries (CEECs) which had made the post-Communism transition to a market economy and which together held approximately 99 % of the total reference quantities allocated to the 10 new Member States.

SPECIFIC PRODUCTION STRUCTURES***A plethora of micro-holdings after transition***

8. The agricultural economies of the central and eastern European candidate countries underwent profound restructuring in the 1990s following the collapse of the Communist regimes. At the time of enlargement, and in spite of restructuring, marked differences in productivity still remained between the candidate countries and the EU-15. The handicap that the agricultural sector had to overcome, which varied in scale from one country to another, was mainly a result of under-investment, the low productivity of production inputs and delayed development in the agri-food sector ⁽⁷⁾.

9. A corollary of the relative inefficiency of the agricultural sector, combined with high levels of structural unemployment, was the preservation or creation of a very large number of small-scale individual subsistence or semi-subsistence holdings.

⁽⁷⁾ See, in particular, the study carried out at the request of the European Commission by A. Pouliquen 'Compétitivité et revenus agricoles dans les secteurs agro-alimentaires des PECO', INRA, October 2001.

Box 2 — Semi-subsistence agricultural holdings

No standard definition exists. Semi-subsistence agricultural holdings is the term generally applied to holdings which produce primarily for their own consumption but also market a proportion of their output. This is the definition used in the EU legislation that provides for transitional support measures for rural development in the new Member States ⁽⁸⁾.

On a semi-subsistence holding, the farmer derives income from his agricultural production, although most of his income is actually made up of social benefits such as retirement pensions, or salaries and income from non-agricultural economic activities. Income in kind takes the form of on-farm consumption of food, and the self-supply of current and fixed inputs ⁽⁹⁾.

The restructuring of dairy production, as the European Union understands it, entails the development of commercially viable units. Studies show, however, that traditional agricultural holdings based on semi-subsistence contribute significantly in some central and eastern European Member States to cushioning the effects of structural unemployment and they may thus continue to exist in the long term.

Enlargement tripled the number of EU milk producers but brought an increase in production of less than 20 %

10. Due to the small number of farms in the ten new Member States, the enlargement meant that slightly more than a million milk producers were added to the 500 000 producers already operating in EU-15.

11. However, the million new EU producers produced only 21,7 million tonnes of milk in 2004, whereas the EU-15 producers produced 121,3 million tonnes (*Table 2*). On initial examination, these figures provide an adequate illustration of the difference in average productivity at the time of accession between 'old' and 'new' milk producers. It should also be noted that four Member States accounted in 2004 for 84 % of dairy production in the ten new Member States: Poland (54 %), the Czech Republic (12 %), Lithuania (9 %) and Hungary (9 %).

Table 2

Milk production in the CEECs (1991-2005)

(1 000 tonnes)

	CZ	EE	LV	LT	HU	PL	SI	SK	EU-10	EU-15	EU-25
1991	4 248	1 093	1 771	2 916	2 620	14 022	643	1 573	29 014	122 797	151 811
2000	2 708	630	823	1 725	2 080	11 900	649	1 099	21 807	121 197	143 005
2001	2 702	687	848	1 730	2 080	12 030	653	1 114	22 032	121 398	143 430
2002	2 801	612	814	1 771	2 068	11 776	728	1 163	21 921	122 188	144 108
2003	2 717	647	786	1 796	1 977	11 892	755	1 109	21 869	122 625	144 494
2004	2 673	640	786	1 850	1 939	11 810	815	1 047	21 745	121 307	143 052
2005	2 770	670	800	1 900	1 839	11 905	810	1 068	21 950	121 515	143 464

Source: ZMP-Marktbilanz Milch 2006.

⁽⁸⁾ Council Regulation (EC) No 1698/2005 of 20 September 2005 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD), (OJ L 277, 21.10.2005, p. 1). As part of its rural development plan, each new Member State has to provide its own definition of a semi-subsistence agricultural holding, based on various criteria: the minimum and/or maximum size of the holding, the proportion of production marketed and/or the level of income of eligible holdings.

⁽⁹⁾ See A. Pouliquen, op. cit., p. 41-45.

Production units have increased in size but remained diverse in structure

12. Apart from the individual characteristics of each new Member State, the fundamental trends in the dairy sector between 2000 and 2005 were as follows: a drop in the number of dairy cows offset by an increase in milk yields, and an increase in the average size of holdings, linked to steadily falling numbers (*Illustration 1*).

13. The countries of central and eastern Europe can be placed in two quite distinct categories:

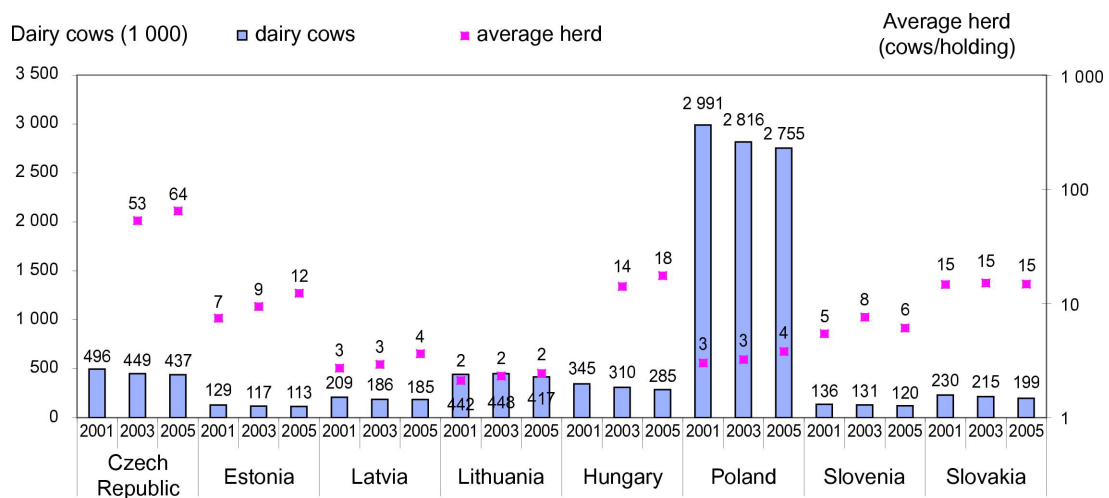
- in the Czech Republic, Estonia, Hungary, and Slovakia, the large holdings (50 cows or more), that generally emerged from the old collective farms, account for a large share of milk production. In these Member States, the average stock

of agricultural holdings is comparable to the stock in some EU-15 regions; in the Czech Republic, it is even much higher than the EU-15 average. The proportion of production delivered to dairies is regarded as an overall indicator of the level of industrialisation in the dairy sector since milk deliveries are subject to strict health standards ⁽¹⁰⁾. The countries where large and medium-sized structures occupy an important position are those with a delivery rate very close (in the case of the Czech Republic, Hungary and Slovakia) or fairly close (Estonia) to the EU-15 average. These Member States also have the largest average delivery quotas and the highest productivity;

- in Poland, by contrast, where there was little collectivisation of agriculture, and in Latvia and Lithuania, where the big State farms were dismantled, the average stock is no more than four cows. The position of Slovenia is somewhere in between.

Illustration 1

Dairy stock and average herd in the eight new Member States (2001-2005)



Sources:

Dairy cows: ZMP-Marktbilanz Milch 2006 based on ZMP, Eurostat and national statistics.

Dairy cows per holding: national statistics, AIRBC, the Slovenian paying agency (2001) and Eurostat (2003-2005).

14. However, despite the differences in production structures in the new Member States, there remains a predominant share of small and very small farms, which are often subsistence or semi-subsistence holdings, within the total number of dairy producers. Only those marketing their production through deliveries to dairies or direct sales were required to participate in the milk quota scheme. A major challenge for each of the new Member States

was to identify the producers concerned and have them join the scheme.

⁽¹⁰⁾ Council Directive 92/46/EEC of 16 June 1992 laying down the health rules for the production and placing on the market of raw milk, heat-treated milk and milk-based products (OJ L 268, 14.9.1992, p. 1).

ESTABLISHING NATIONAL REFERENCE QUANTITIES (NATIONAL QUOTAS)

The Commission applied a standardised methodology

15. National reference quantities were the subject of intense negotiation. The central and eastern European candidate countries, with the exception of Slovenia, could argue that their milk production had fallen sharply during the transition towards a market economy. However, the production statistics for the period prior to transition appeared unreliable. In addition, had they been taken into consideration, this would have departed from the general principle that quotas were to be based on data for the most recent production period for which information was available. Exceptional cases aside ⁽¹¹⁾, in order to adopt the national reference quantities in December 2002, average milk production for 1997-1999 was taken as the starting point for negotiations.

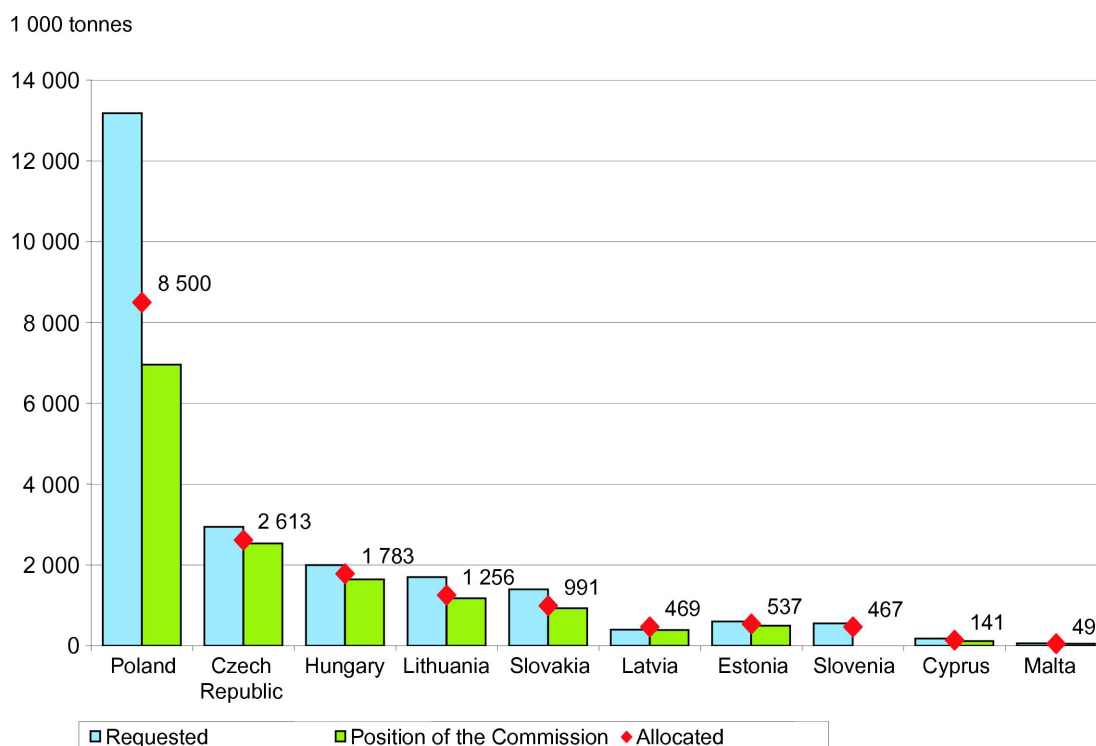
Sound statistical bases for adopting national reference quantities for deliveries

16. The candidate countries were able to provide statistics for their total national production, estimated on the basis of stock size and yields, and precise data on deliveries to dairies accounted for during the reference period. When preparations were being made for enlargement, the Commission (Enlargement DG) coordinated peer review exercises on the progress of milk quota implementation. The reliability of the statistics on milk deliveries to purchasers in the candidate countries was not called into question.

17. For the most part, the negotiations yielded national reference quantities for deliveries that were close to the situations observed immediately prior to accession. No new Member State received an initial deliveries quota that was lower than the quantities delivered in each of the five years prior to accession. Only Poland and Lithuania obtained a deliveries quota substantially lower than they initially asked for, i.e. 65 % and 75 % respectively of their expected quota (*Illustration 2*).

Illustration 2

Deliveries — national reference quantities in the ten new Member States



The numbers indicate the milk quotas allocated.
Source: Commission.

⁽¹¹⁾ For the Baltic States, the data for 1999 were excluded because of the disruption resulting from the economic crisis in Russia.

Data difficult to estimate for direct sales

18. For the years before 2000, no specific data were compiled for direct sales and on-farm consumption of milk in the candidate countries. The Commission did not take into consideration the direct-sales data provided by the candidate countries on the grounds that they were incomplete (Latvia, Lithuania, Slovenia and Slovakia) or too approximate (Hungary and Poland). For these countries, the statistical volume of direct sales was established by

subtracting from the total production volume the quantities delivered to dairies and the estimated on-farm consumption. Only the initial amounts requested by the Czech Republic and Estonia were considered by the Commission as a basis for discussion.

19. The data in *Table 3* show that with the exception of Poland the candidate countries of central and eastern Europe had provided direct sales figures that were far higher than the Commission's estimates in support of their initial requests.

Table 3

Evolution of data on direct sales of milk and milk products

	CZ	EE	LV	LT	HU	PL	SI	SK	Total
Initial request (1)	155 000	90 000	300 000	550 000	200 000	564 000	139 000	61 800	2 059 800
	100	100	100	100	100	100	100	100	100
Commission position (2)	26 686	77 833	84 307	284 667	156 333	1 918 867	92 875	14 000	2 655 568
	17	86	28	52	78	340	67	23	129
Quota accepted (3)	68 904	87 365	226 452	390 499	164 630	464 017	93 361	22 506	1 517 734
	44	97	75	71	82	82	67	36	74
Utilisation of 2004/2005 quota(4)	2 776	9 585	11 380	76 301	25 978	308 934	20 278	6 803	462 906
	2	11	4	14	13	55	15	11	22
Utilisation of 2005/2006 quota (5)	2 600	8 565	10 748	55 985	19 313	195 038	20 085	3 657	315 991
	2	10	4	10	10	35	14	6	15

Sources:

(1) and (2) Commission document SEC(2002) 95 final of 30.1.2002 and documents CONF-H 21/02, CONF-PL 45/02 and CONF-SI 21/02 of 20.6.2002.

(3) Annex I to Commission Regulation (EC) No 1788/2003.

(4) Member States' replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004 (11 months' data extrapolated over 12 months, except for Estonia) and the paying agencies for PL (ARR) and SI (ARSKTRP).

(5) Member States' replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004.

Direct sales declared by producers were systematically lower than all statistical estimates

20. According to the data in *Table 3*, direct sales declared in the first two quota years (2004-2005 and 2005-2006) accounted for only a small percentage of the quotas granted. For the eight CEECs as a whole, there is a difference of over 1 million tonnes between the quantities recorded as direct sales and the reference quantities granted. This phenomenon is at least partly explained by the fact that, in the absence of statistical data, the method used to estimate the volume of direct sales produced results that were far removed from the actual situation, which led to the future Member States' direct sales quota requirements being overestimated on a large scale. This overestimate subsequently favoured professional producers that only delivered to dairies but had been

authorised to apply for direct sales quotas before converting them into deliveries quotas.

21. Comparison of the recent statistics for direct sales with the quantities declared for the two first years (*Table 4*) shows that the quota management agencies are unaware of a considerable proportion of direct sales and that many sales are not charged to the national reference quantity. Undeclared direct sales would appear to account for more than 80 % of direct sales in Estonia and Hungary, 60 %-70 % in Slovenia, 60 %-65 % in Poland and just under 40 % in Lithuania. During the audit, the Estonian, Lithuanian, Hungarian and Slovenian authorities acknowledged that the amount of direct sales had not been declared in their entirety.

Table 4

Statistical direct sales and declared direct sales

(1 000 tonnes)

Direct sales	CZ	EE	LV	LT	HU	PL	SI	SK
Statistical data for calendar year								
1997	n/a	74	467	n/a	146	1 663	n/a	59
1998	n/a	75	345	n/a	150	1 953	n/a	62
1999	n/a	85	294	n/a	148	2 141	n/a	65
2000	22	97	309	n/a	147	1 700	91	n/a
2001	21	120	330	192	85	1 239	84	n/a
2002	13	63	n/a	142	77	1 141	119	31
2003	4	53	n/a	124	168	1 318	78	32
2004	2	67	n/a	76	116	869	65	13
2005	4	66	n/a	91	159	484	58	7
Quantities declared for quota year								
2004/2005	3	10	11	76	26	309	20	7
2005/2006	3	9	11	56	19	195	21	4

Sources (calendar years):

CZ: Report to the Commission for the release of the restructuring reserve.

EE: Ministry of Agriculture (1997) and report to the Commission for the release of the restructuring reserve (1998-2005). Extrapolation over 12 months from nine months for 2005.

LV: 'Additional information to the position paper of the Republic of Latvia (CONF-LV 26/02)'

LT: Ministry of Agriculture (2001-2004) and report to the Commission for the release of the restructuring reserve (2005).

HU: Hungarian Central Statistical Office (KSH).

PL: Central Statistical Office of Poland (1997-1999) and report to the Commission for the release of the restructuring reserve (2000-2005).

SI: Report to the Commission for the release of the restructuring reserve.

SK: Paying Agency APA (1997-1999) and report to the Commission for the release of the restructuring reserve (2002-2005).

Sources (quota years):

Replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004 and information provided by the paying agencies (PL and SI). For 2004-2005 (11 months), extrapolation over 12 months (CZ, LV, LT, HU and SK).

22. The aim of the quota scheme is that the relevant authorities in the Member States should verify that quota holders declare their direct sales in full. They must therefore possess all the necessary information to establish, even on an approximate basis, that the milk production of producers without a quota is not marketed, in other words that it is all consumed on farm.

The Commission released the special restructuring reserve on the basis of information difficult to verify

23. The new Member States of central and eastern Europe were required to present to the Commission, by 31 December 2005 at the latest, a report detailing the results and trends of the restructuring process in their dairy sectors⁽¹²⁾.

⁽¹²⁾ Article 1(4) of Regulation (EC) No 1788/2003.

The special restructuring reserve was available for release with effect from 1 April 2006 insofar as on-farm consumption of milk and milk products in each of these countries had decreased since 1998 in Estonia and Latvia, and since 2000 in the Czech Republic, Lithuania, Hungary, Poland, Slovenia and Slovakia.

24. On the basis of the reports referred to above, the Commission released the whole of the special restructuring reserve for the Member States concerned, i.e. a total of 671 418 tonnes, allowing an increase of 3,7 % in the national reference quantities initially allocated to these Member States⁽¹³⁾.

⁽¹³⁾ Article 1 of Commission Regulation (EC) No 927/2006 of 22 June 2006 on the release of the special restructuring reserve specified in Article 1(4) of Council Regulation (EC) No 1788/2003 (OJ L 170, 23.6.2006, p. 12).

25. Although the figures for direct sales and on-farm consumption are unreliable due to difficulties in dividing undelivered quantities of milk between the two statistical categories, the Commission used the changes in on-farm consumption reported by the Member States as the main assessment criterion, and did not question the data supplied by the national authorities, even after a cross-check with the replies to the annual questionnaires on the implementation of milk quotas. All the Member States concerned, except for Lithuania, reported a decline on national territory of on-farm consumption of milk and milk products.

26. However, the reliability of the data forwarded to the Commission is questionable. In the Czech Republic, for example,

the sharp decrease in on-farm consumption between 2000 and 2004 is chiefly due to the decrease in milk production: production for the commercial market increased by only 0,8 %. The Latvian and Slovakian authorities submitted statistics for on-farm consumption that differ significantly from the data for the same periods that were used in the membership negotiations. The special reserve provided for Lithuania was released in full, although the statistical data provided by the national authorities did not show any significant fall in on-farm consumption. For Estonia, Hungary, Poland and Slovenia, statistical cross-checks (Table 5) show that on-farm consumption was underestimated in the reports submitted by these Member States, and/or that direct sales were under-declared.

Table 5

Comparison between quantities of milk for on-farm consumption and non-marketed quantities

(1 000 tonnes)

Member State	Approach (1) On-farm consumption as reported by the Member States								Approach (2) Estimated on-farm consumption (quantities produced and not declared)	
	1998	1999	2000	2001	2002	2003	2004	2005	2004/2005	2005/2006
CZ			<u>199</u>	174	197	114	70	70	63	72
EE	<u>108</u>	122	111	122	43	66	63	37	123	93
LV	<u>381</u>	349	357	343	350	302	268	251	271	232
LT	n/a	n/a	<u>n/a</u>	554	663	629	632	614	563	615
HU	68	63	<u>53</u>	65	28	26	22	20	284	344
PL			<u>3 408</u>	3 409	3 296	3 039	2 802	2 625	3 167	2 814
SI			<u>99</u>	96	119	85	82	79	131	120
SK	234	176	<u>169</u>	167	163	134	128	102	123	87

Sources:

Approach (1): Reports to the Commission for the release of the restructuring reserve. Reference years are underlined.

Approach (2): Difference between production for the calendar year (per the Reports to the Commission for the release of the restructuring reserve) and the quantities declared to the paying agencies (replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004).

THE ALLOCATION OF INDIVIDUAL REFERENCE QUANTITIES (INDIVIDUAL QUOTAS)

Reference periods differ from one Member State to another depending on Acts of Accession

27. Producers were notified of individual reference quantities by the national authorities before the beginning of the first quota year. Poland and Slovenia, where the obligation to apply individual reference quantities was deferred until 1 April 2005, were nevertheless in a position to allocate individual quotas for 2004-2005 and extended them to the 2005-2006 quota year.

The initial allocation of individual delivery quotas

28. In allocating individual reference quantities for deliveries, Hungary and Slovakia did not take account of the upper limit mentioned in the EU legislation⁽¹⁴⁾; these countries allocated

⁽¹⁴⁾ According to of Article 6(1)(2), of Council Regulation (EC) No 1788/2003, the basis for calculating reference quantities for deliveries and direct sales appeared in Table (f) of Annex I.

delivery quotas to a total quantity above this limit⁽¹⁵⁾. Over-allocation of quotas entailed the risk that the available national reference quantity would be more quickly exhausted by inciting producers to produce more milk.

29. In the case of Hungary, the over-allocation was resolved only in the course of the 2006-2007 campaign year, when the Council authorised the Commission, at the request of the Member States, to convert quantities from the national reserve for direct sales into quantities for delivery for the 2005-2006 quota year⁽¹⁶⁾.

30. The Slovakian authorities took steps to ensure that individual 'delivery' quotas did not exceed the amended national reference quantity at the end of the 2004-2005 marketing year.

However, the method used to achieve this balance does not comply with EU legislation⁽¹⁷⁾. The Commission accepted the Slovakian authorities' proposal for the final distribution of the national quota between deliveries and direct sales for 2004-2005, although the additional quantities allocated to deliveries were greater than the quantities converted by producers.

The initial allocation of individual direct sales quotas

31. As regards direct sales, the Member States allocated individual quotas for total quantities that were generally far lower than the national reference quantities (Table 6). Poland was an exception. The national 'direct sales' reference quantity allocated to Poland of 464 017 tonnes, proved much lower than producer demand (715 921 tonnes). The Polish authorities consequently imposed a ceiling on the quantities allocated of 64 % of the quantities requested by producers.

Table 6

Allocation of individual direct sales quotas (2004-2005 milk year)

Quantities	(tonnes)							
	CZ	EE	LV	LT	HU	PL	SI	SK
Ceiling for direct sales (1)	68 904	87 365	226 452	390 499	164 630	464 017	93 361	22 506
Total quantities initially allocated (2)	4 360	11 585	96 580	115 698	20 018	458 190	69 446	11 250
(2)/(1)	6 %	13 %	43 %	30 %	12 %	99 %	74 %	50 %

Sources:

(1) Regulation (EC) No 1788/2003.

(2) Individual reference quantities allocated to producers at the beginning of the 2004-2005 milk year (data supplied by the paying agencies).

Commercial producers with a quota account for half of all milk producers

32. Milk producers join the quota scheme on their own initiative. Reference quantities are allocated to them on application in accordance with the arrangements adopted by the national

authorities. In most of the new central and eastern European Member States, approximately half of all producers remained outside the quota scheme (Table 7 and Box 3). The estimated participation rates for the scheme are particularly low in Slovakia (6 %), Estonia (less than 20 %) and Hungary (30-40 %). The Court's assessment is that milk production of approximately 3,6 million tonnes⁽¹⁸⁾ is not covered by the quota scheme for the eight new Member States of central and eastern Europe, i.e. 17 % of their total production.

⁽¹⁵⁾ In Hungary a surplus of 23 201,4 tonnes, or 1,3 % of the national reference quantity for deliveries, was allocated to producers at the beginning of the 2004-2005 quota year. In Slovakia, total quotas for deliveries allocated for the 2004-2005 quota year exceeded the national reference quantity by 10 348,4 tonnes (1 %).

⁽¹⁶⁾ Commission Regulation (EC) No 1611/2006 of 27 October 2006 amending Regulation (EC) No 832/2006 on the division between deliveries and direct sales of national reference quantities fixed for 2005/2006 in Annex I to Council Regulation (EC) No 1788/2003 (OJ L 299, 28.10.2006, p. 13).

⁽¹⁷⁾ In accordance with Articles(6)2 and 8 of Regulation (EC) No 1788/2003, Slovakia should have notified the Commission of the quantities finally converted at the request of producers.

⁽¹⁸⁾ This estimate is based on the number of producers without a quota (2004-2005) and on the average productivity of dairy cows (2005), the assumption being that producers without a quota own 1,5 cows on average.

Table 7

Number of dairy holdings and number of quota holders (2004-2005 and 2005-2006)

	CZ	EE	LV	LT	HU	PL	SI	SK	Total
2004-2005									
2005-2006									
(1)	8 450	12 400	61 239	195 231	22 000	734 112	17 190	14 230	1 064 852
Holdings	6 780	9 210	50 900	170 790	16 250	727 100	19 710	13 460	1 014 199
(2)	2 950	1 585	24 409	99 384	5 194	310 460	10 148	800	454 930
Deliveries (producers)	2 871	1 525	22 919	86 601	4 821	284 475	9 509	740	413 461
(3)	252	443	2 253	22 516	1 284	76 014	2 624	99	105 485
Direct sales (producers)	264	437	1 808	16 027	1 561	52 837	2 509	100	75 543
(4)	2 991	1 859	25 457	112 073	6 076	374 000	10 575	814	533 845
Total	2 903	1 752	24 039	98 387	5 980	330 019	9 956	766	473 802
(5)	5 459	10 541	35 782	83 158	15 924	360 112	6 615	13 416	531 007
Holdings outside the system	65 %	85 %	58 %	43 %	72 %	49 %	39 %	94 %	50 %
	3 877	7 458	26 861	72 403	10 270	397 081	9 754	12 694	540 397
	57 %	81 %	53 %	42 %	63 %	55 %	50 %	94 %	53 %

Sources:

(1) 2004-2005 milk year: Eurostat 2003 data for all Member States except LV (2004 data of the Latvian Central Bureau of Statistics), LT (AIRBC 2004 data) and PL (ARR 2004 data); 2005-2006 milk year: Eurostat 2005 data.

(2), (3) and (4) Replies to the questionnaire required by Article 26 of Commission Regulation (EC) No 595/2004 and information from paying agencies (PL and SI for 2004-2005).

33. However, the low rate of producer participation does not suffice as an indicator to cast doubt on the new Member States' administrative capacity to operate the milk quota system. It is worth noting that, overall, 70 % of dairy holdings in the new central and eastern European Member States consist of no more than two cows and may therefore be part of the subsistence or semi-subsistence sector. Since the total number of such micro-holdings (680 000) is more than 25 % of the total number of holdings without a quota, it may be concluded that most of the holdings without a quota are indeed non-commercial or semi-commercial holdings.

34. The level of producer participation varies considerably from one Member State to the next. Some Member States permitted and encouraged the distribution of small and very small quotas. Producers allocated reference quantities under 1 000 kg (deliveries and/or direct sales) for the first year thus accounted for 12 % of quota-holders in Latvia and 6 % in Lithuania. By contrast, producers with quotas under 1 000 kg accounted for under 2 % of quota-holders in Poland, Estonia, Hungary, Slovenia and the Czech Republic. In Slovakia, no producer had been allocated a reference quantity under 1 000 kg. In the Czech Republic and Slovakia, the quota allocation policy was clearly orientated

towards large commercial producers. In these Member States, approximately 75 % of delivery quota holders have a herd of more than 50 cows.

Box 3 — Producers without milk quotas — The cases of Lithuania and Slovakia

In Lithuania, 43 % of milk producers did not receive a quota.

At the time of accession, milk was still produced by a large number of producers (195 231), almost all of which (95 %) had no more than five cows. The process of structural concentration is slow but perceptible, as evidenced, for example, by the increase between 2001 and 2005 in the number of holdings with six or more cows (from 4 501 holdings in 2001, or 2 % of holdings to 11 242 holdings in 2005, or 6,2 % of holdings). There was a parallel decline in the number of very small structures resulting from land privatisation, but these are still very significant in numerical terms.

The audit showed that milk quotas had been the subject of a well-organised publicity campaign aimed at all producers. Given the nature of the dairy sector in Lithuania, the 57 % rate of coverage achieved by the Lithuanian authorities for the first quota year seems reasonable.

For the 2004–2005 marketing year, 77 484 producers with only one or two cows received a quota, although their total number was 138 591 ⁽¹⁹⁾. The difference (61 107 producers) constitutes the majority of the population of producers without a quota (63 723). It is likely that producers that have no quota and only one or two cows, practise subsistence or semi-subsistence farming. It is also the managing agencies' responsibility to check that these producers make no undeclared direct sales.

In Slovakia, 94 % of milk producers received no quota.

Slovakia's agricultural economy divides into two clear parts. A large number of family farms (15 586 in 2001, 9 853 in 2005) co-exist with a limited number of farms set up as commercial entities (2 087 in 2001, 1 696 in 2005). In 2005, 89 % of family holdings had only one cow; 10 % had two or three. In the case of commercial holdings, 38 % had more than 50 cows. Only 6 % of the national dairy stock belonged to family farms and 94 % to commercial holdings.

A system of milk quotas was applied in Slovakia prior to accession. However, there were no 'direct sales' quotas and 'deliveries' quotas were granted only to producers delivering over 20 000 litres per year. In 2002, 950 producers held a quota and around 1 000 small producers ⁽²⁰⁾ made direct sales or deliveries below 20 000 litres per year.

For the first quota year (2004–2005), by allocating only 814 quotas for deliveries or direct sales, the Slovakian authorities gave priority to bringing commercial entities under the system. According to the auditors' estimate, 78 % of delivery quota holders had at least 50 cows, while 21 % had between two and 49 cows. The very small quotas, corresponding to fewer than two cows accounted for 1 % of the total.

INTRODUCTION AND MANAGEMENT OF THE SCHEME

Adoption of the 'acquis communautaire'

35. As part of the shared management that is characteristic of the Common Agricultural Policy, the Member States take appropriate action to implement the regulations on the establishment of a levy in the milk and milk products sector (*Box 1*). The Member States are required to provide the Commission with a limited amount of information. Before 1 September each year, they complete and return to the Commission a questionnaire which is then used to calculate the levy ⁽²¹⁾. Furthermore the

⁽¹⁹⁾ Data at 1 January 2005 (Agriculture Information and Rural Business Centre).

⁽²⁰⁾ Source: Peer Review — Evaluation Mission on Milk in the Slovak Republic, Final report, DG AGRI and DG ELARG, 2003.

⁽²¹⁾ Article 26(1) of Commission Regulation (EC) No 595/2004 of 30 March 2004 laying down detailed rules for applying Council Regulation (EC) No 1788/2003 establishing a levy in the milk and milk products sector (OJ L 94, 31.3.2004, p. 22).

Member States were required to provide the Commission, by 1 September 2004 ⁽²²⁾, with a short report on their system for managing national reference quantities ⁽²³⁾. After a reminder from the Commission, the Maltese and Slovene authorities submitted this short report in February 2007, followed by the Polish authorities in March 2007.

36. Although EU legislation applies directly, all the new Member States have included the EU's milk-quota *acquis* as part of national legislation or administrative provisions. In Hungary, Lithuania and Slovakia the regulatory framework adopted by the national authorities gave rise to the comments below.

37. Since Regulation (EC) No 1788/2003 gives no working definition of deliveries, the Lithuanian authorities decided that deliveries concern milk 'that can be sold to a purchaser'. Thus, any occasional transfer free of charge by a producer should not be counted as a delivery. There is risk that a producer that has exceeded its quota may transfer its milk free of charge so as to avoid paying the levy. Under EU legislation, the Member States must ensure that all milk delivered, even free of charge, is declared.

38. In Hungary, the sum of individual reference quantities for producers in a dairy cooperative may be treated as if it were a single overall quota. If some producers in the cooperative exceed their individual quotas, the cooperative receives compensation. If a levy is payable at national level, the cooperative is not held liable as long as the total for affiliated producers' quotas is not exceeded. Under EU legislation, individual reference quantities may be merged only if the cooperative is an approved purchaser. During the audit, the Hungarian authorities acknowledged the need to amend national legislation on dairy cooperatives that are not approved purchasers.

39. Hungary and Slovakia allowed for the possibility of being an approved purchaser and a producer at the same time. Combining the roles of purchaser and producer entails specific risks that should be taken into consideration in risk analysis and on-the-spot checks. The fact that the entire document chain (registers, declarations, supporting documents and analysis findings) is managed by a single party increases the risk of data being manipulated in the event that the national reference quantity is exceeded and a levy is established. In such an eventuality, producers/purchasers would then have to provide data for calculating a levy for which they themselves were liable.

⁽²²⁾ Before 1 September 2005 for Poland and Slovenia.

⁽²³⁾ Article 27(3) of Regulation (EC) No 595/2004.

Systems introduced by the Member States within the allotted time, but of varying quality and with room for improvement

40. The new Member States visited by the Court (including Poland and Slovenia) had put in place the structures essential for getting the system off the ground and for the everyday management of milk quotas as early as 1 May 2004. In due course, managers had the operational facility to manage the file on holders of reference quantities and the file on purchasers, to charge declared quantities against reference quantities, to use the national reserve, to manage quota transactions (purchase, leasing, transfer, inheritance and cessation of production) and to adjust delivered quantities on the basis of fat content.

41. It is worth underlining this overall result, insofar as it contrasts with the long period of uncertainty which followed the introduction of milk quotas in some old Member States after 1984 due to negligence in the administration of the scheme and a large number of protracted legal cases ⁽²⁴⁾.

42. The systems encountered in the new Member States nevertheless appeared to vary in quality as regards internal control. The audit highlighted transactions that were inadequately traced and delays in updating the quota database in the Czech Republic, Estonia, Lithuania, Hungary, Poland and Slovenia. In Slovakia, the computer system initially in place was rudimentary; in the absence of an integrated database, APA managers created a spreadsheet at the beginning of the year containing the individual quota allocations and another file at the end of the year listing deliveries and individual direct sales. In the meantime, the APA had no information about changes in the situation of producers.

43. At the time of the Court's audit, the Commission had not yet carried out any detailed on-the-spot checks in the new Member States to ensure that the scheme was running smoothly, the checks provided for in the legislation had been implemented and the weaknesses identified in the peer review exercises had been rectified. The visits that it made to the new Member States in 2005 with a view to clearing the accounts gave rise to no specific comments about milk quotas.

Replenishment of the national reserve: options that differ from one Member State to another

44. The milk quota scheme provides for the establishment of a national reserve, distinguishing between deliveries and direct

sales. The Member States may replenish the national reserve by taking back unused reference quantities, retaining part of transfers or making an across-the-board reduction in quotas.

45. The Member States are therefore allowed to recover some or all of the quantities that are not used when a producer does not market at least 70 % of its individual reference quantity over a 12-month period ⁽²⁵⁾. The new Member States have adopted different practices. Producers that under-used their quota during the first quota year were not penalised in Latvia, Lithuania, Hungary and the Czech Republic because the year was based on 11 rather than 12 months. The Estonian authorities did not take this factor into account and reduced quotas. During the first quota year (2004-2005), the Slovakian authorities applied a penalty system that had been in force prior to accession ⁽²⁶⁾ and was stricter than the one laid down in EU legislation.

46. In cases of *force majeure* or in duly substantiated situations, the arrangements for withdrawing quantities belonging to partly or wholly inactive producers do not apply ⁽²⁷⁾. In Poland, withdrawal decisions were made in 2005 and 2006 in respect of producers that were completely inactive or that had used less than 70 % of their reference quantity. Approximately 3 900 producers, i.e. 1 %, were completely inactive in 2004-2005. However, they kept their full quota for 2005-2006 after lodging an appeal with the paying agency. Appeals are assessed and a decision taken by the regional directors of the paying agency (ARR), even though national provisions have not been adopted to guarantee uniform treatment of such appeals.

The use of the national reserve: varying procedures

47. The purpose of the national reserve is to allocate quotas to new producers or additional quantities to existing producers on the basis of objective criteria set by the national authorities. The allocation criteria applied in some new Member States have deliberately excluded certain applicants. Some Member States also used the national reserve to convert available quantities intended for direct sale into delivery quotas on a massive scale (Box 4).

⁽²⁴⁾ Annual Report 1988, paragraphs 5.33 to 5.38 (OJ C 312, 12.12.1989).

Annual Report 1992, paragraphs 2.17 to 2.19 (OJ C 309, 16.11.1993)

Annual Report 1993, paragraphs 2.10 to 2.59 (OJ C 327, 24.11.1994)

Special Reports Nos 2/87 (OJ C 266, 5.10.1987), 4/93 (OJ C 12, 15.1.1994) and 6/2001 (OJ C 305, 30.10.2001).

⁽²⁵⁾ Article 15(2) of Regulation (EC) No 1788/2003.

⁽²⁶⁾ Ordinance of the Ministry of Agriculture of the Slovak Republic of 25 November 2002 No 2953/2002-100, Annex 2, paragraph III. Under this system, the paying agency cut the 'delivery' quotas of milk producers that had used less than 90 % of their quota in 2003-2004. In addition, the utilisation percentage was calculated using the overall quota (deliveries + direct sales), even though it should have been calculated separately for each quota.

⁽²⁷⁾ Article 15(3) of Regulation (EC) No 1788/2003.

Box 4 — Allocation of quantities from the national reserve

In Poland, national legislation did not allow new producers to receive quotas from the national reserve. However, the quotas allocated to existing producers were not limited to the quantities requested by producers. Some producers were therefore allocated reference quantities in excess of their requirements, as a result of which the ‘deliveries’ national reserve was quickly exhausted.

In Lithuania, producers with fewer than five cows were not allowed to receive reference quantities from the national reserve in 2004-2005.

In Estonia and Hungary, during the first two quota years, direct sales quotas were systematically granted from the national reserve to producers that made no direct sales and had no intention of doing so. This practice is explained by the respective allocation criteria applied in Estonia (utilisation rate of the overall quota) and Hungary (inadequate delivery quota).

Hungary and Slovakia continued to allocate additional delivery quotas for 2004-2005 even though the national reserve for deliveries had become negative.

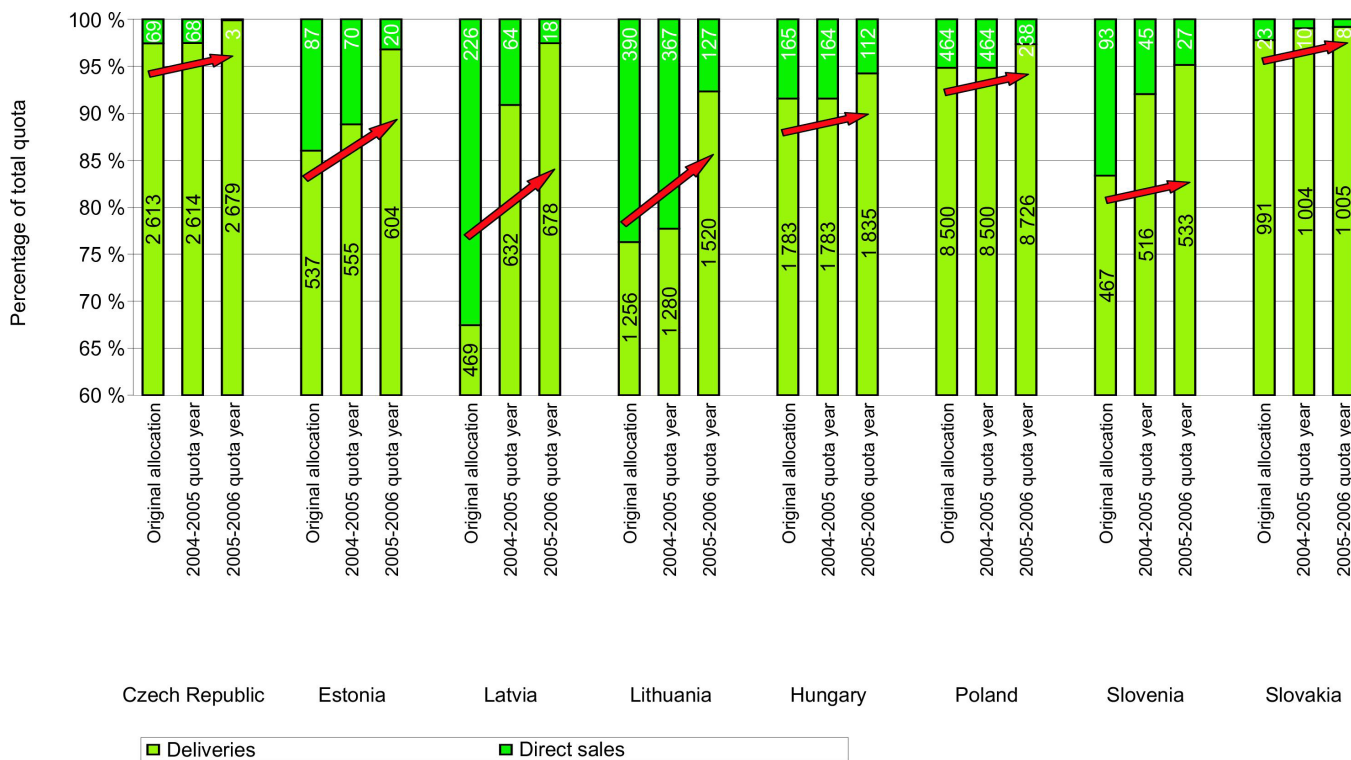
The massive conversion of unused ‘direct sales’ reference quantities

48. The first two milk marketing years in the new Member States were marked by a shortage of reference quantities in the national reserve for deliveries, while sizeable quantities were left unused in the national reserve for direct sales. The twofold problem of overestimating the new Member States’ requirements in terms of direct sales quotas and the under-declaration of direct sales was mentioned above (see paragraphs 20 *et seq.*).

49. In order to increase the quantities available for delivery, the new Member States were allowed to authorise the conversion of ‘direct sales’ reference quantities into ‘deliveries’ reference quantities and vice versa, at the duly justified request of the producer ⁽²⁸⁾. In all of the new Member States these provisions were intensively applied. The transformation of direct sales quotas into delivery quotas was particularly extensive in the Czech Republic and the Baltic States (*Illustration 3*).

Illustration 3

Conversion of direct sales quotas into delivery quotas



All absolute figures are in 1 000 tonnes

Source: Original allocation: Regulation (EC) No 1788/2003; 2004-2005 quota year: Regulation (EC) No 490/2005; 2005-2006 quota year: Regulation (EC) No 1611/2006.

⁽²⁸⁾ Article 6(2) of Regulation (EC) No 1788/2003.

The fat content of deliveries: an important parameter that is sometimes ignored

50. Milk quotas limit the quantities of milk that are marketed but also, where deliveries are concerned, the production of fat. Each delivery quota is therefore allocated a representative fat content or individual reference fat content based on historic yield data for the producer. The quantities delivered are adjusted up or down for each producer, based on the difference between the actual fat content and the individual reference fat content. The latter is therefore an important parameter in the definitive statement of quantities delivered.

51. In Estonia, Lithuania, Hungary and Slovakia, some producers made deliveries during the 2004-2005 marketing year without a quota or a reference fat content. In Poland, the system does not detect producers that have received an unrealistic reference fat content, i.e. beyond the 30-50 g/kg range. For 2004-2005, the Court identified some producers with abnormally low or abnormally high reference quantities.

52. When 'direct sales' quantities are converted into 'deliveries' quantities, the reference fat content associated with the converted quota is 38 g/kg⁽²⁹⁾. The reference content for deliveries may remain the same only if the producer provides supporting documentation deemed satisfactory by the relevant authority. The Czech, Lithuanian and Slovakian authorities do not take account of this constraint; they systematically refrain from changing the reference content of producers that have carried out a conversion.

CONTROLS

53. EU legislation requires a number of controls to be implemented⁽³⁰⁾. The Member States are required to check the accuracy of declarations by producers and purchasers and to ensure, where appropriate, that the burden of the levy actually falls on the producers responsible for the overrun of the national reference quantities.

54. The audit showed that considerable improvements could be made in the way the controls were planned and implemented.

Late and inadequate planning of controls by the Member States

55. The relevant national authorities must draw up a control plan for each 12-month period on the basis of risk analysis. The controls (on farms, during transport and at the purchaser's) must

be carried out during and after the quota year, and no later than 18 months after the end of the marketing year concerned.

56. In some Member States, such as Latvia, Lithuania and Poland, the control plans were published late. The control plan must also include the list of purchasers and producers chosen, which was not the case in Slovakia and Hungary, for the 2004-2005 quota year.

57. The risk analysis for the controls covering the 2004-2005 marketing year was rudimentary in Hungary and Slovakia. In the Czech Republic and Latvia, the risk analysis became available only in March 2005, i.e. at the end of the marketing year. In Poland, the checks performed during 2005-2006 were not based on risk analysis; this was performed after the marketing year had ended.

58. It should be borne in mind that approximately 17 % of the new Member States' milk production comes from producers without a quota, the majority of whom are small producers with herds of no more than four cows. Statistical cross-checks show, however, that a proportion of these producers without a quota market milk, essentially in the form of direct sales. As a rule, risk analysis in the new Member States does not take account of producers without a quota. As these producers are practically never checked, the national authorities have no reasonable assurance that all producers correctly declare the quantities of milk they market. The risk of under-declaration is nevertheless lower for deliveries than for direct sales. The fact is that it is very difficult to check that direct sales made without a quota have been properly declared. Deliveries by producers without a quota can, however, be checked from purchasers' accounts. The Court identified producers who delivered milk without a quota or an individual fat reference quantity, principally in Estonia, Lithuania, Hungary and Slovakia⁽³¹⁾.

59. None of the new Member States visited, except for Lithuania, systematically cross-checked the milk quotas database against the animal identification database. This type of cross-check would, however, identify clear risks to the scheme, e.g. holders of quotas who have no dairy cows, owners of dairy cows with no quota, and quotas allocated or quantities declared with no bearing on the size and composition of the herd. Some Member States have informed the Court that cross-checks are being carried out as a result of its audits.

⁽²⁹⁾ Article 7(2) of Regulation (EC) No 595/2004.

⁽³⁰⁾ Articles 18 to 22 of Regulation (EC) No 595/2004.

⁽³¹⁾ Producers who market milk without a quota allocation may incur heavy financial penalties if the national reference quantity (deliveries or direct sales) is exceeded. In such an eventuality, the 'overrun' corresponds to all quantities marketed by the producer and the levy must be applied to all quantities delivered or sold directly during the quota year.

Late and poorly documented controls

60. In Lithuania, the principle that some of the checks must be carried out during the marketing year⁽³²⁾ was formally observed, as four producers were checked on 31 March 2005. Almost all of the checks were therefore carried out after the end of the year. In Hungary, no producers were checked during the 2004-2005 quota year, only later in September 2006.

61. The Court's audit brought to light a number of shortcomings in the on-the-spot checks:

- in the Czech Republic (2004/2005) and Slovenia (2005/2006), inspection procedures were not precise enough and did not ensure that the checks carried out were uniform in nature. These two Member States told the Court that markedly improved inspection instructions had been issued for the second quota year;
- in Estonia, the compatibility between marketed quantities and production capacity⁽³³⁾ was checked using the holding register. However, the register was not checked for updates as the procedures made no provision for the animals to be physically inspected. Since 2006, a new IT system has allowed the herd register to be cross-checked against the quota database;
- in Poland, the annexes to the reports on the checks carried out at the producers' in the course of 2005-2006 had not been kept, thus making it impossible to monitor the checks. At one dairy visited by the Court, the actual fat contents established by an accredited laboratory differed from the average and varied to an abnormal extent over time. No additional checks had been required by the inspectors even though national instructions provide for such cases. Inspectors' estimates of production capacity were systematically incorrect as they were based on unrepresentative milk yields that were too low; the number of irregularities noted was therefore excessive⁽³⁴⁾;
- in Slovakia, the relevant authorities were able to provide an overall rate of infringement for 2004-2005 (44 % of checks) but there were no statistics on the types and frequency of anomaly.

⁽³²⁾ Article 19(2) of Regulation (EC) No 595/2004.

⁽³³⁾ Article 21 of Regulation (EC) No 595/2004.

⁽³⁴⁾ The inspectors found 755 irregularities for 2005-2006. The Ministry of Agriculture examined 12 cases and no penalty was imposed.

AN OVERVIEW OF THE FIRST MARKETING YEARS***The national reference quantities for 'deliveries' have been attained and the national reference quantities for 'direct sales' have been under-used***

62. The first milk marketing year (2004-2005) in the new Member States (*Tables 8 and 9*) saw no instance of national reference quantities being exceeded. The deliveries quota was, however, very close to saturation, whereas the direct sales quota was significantly under-used.

63. The second year (2005-2006), see (*Tables 8 and 9*), saw an increase in deliveries in all the new Member States, with the exception of Hungary and Malta where they remained stable. The Czech Republic, Cyprus and Poland had to pay a levy totalling 67,7 million euro as they exceeded their national reference quantity for deliveries⁽³⁵⁾.

64. The volume of direct sales stabilised or regressed, particularly in Poland. The general increase in the rate at which quotas for direct sales were used stems from the fact that the national quantities available fell significantly following conversions.

65. In Cyprus, the national reference quantity for direct sales was almost attained, to within one kilo⁽³⁶⁾.

66. For 2006-2007, the quantities released from the special restructuring reserve as from 1 April 2006 reduced the risk of the delivery quota being exceeded in the Czech Republic and Poland. In Cyprus, the national reference quantity was exceeded for both deliveries and direct sales; the levy to be collected is approximately 180 000 euro for deliveries and 16 000 euro for direct sales.

⁽³⁵⁾ The systems in force for the levy were not audited as the national reference quantities were not attained at the end of the first year in which milk quotas applied (2004-2005). As regards the levies owed by the Czech Republic, Cyprus and Poland for 2005-2006, no data were available at the time of the audit.

⁽³⁶⁾ National reference quantity for direct sales: 2 780 863 kg; total quantity declared: 2 780 862 kg.

Table 8

Utilisation of national reference quantities for deliveries in the new Member States (2004-2005 and 2005-2006)

(1 000 tonnes)

Year	Quantities	CZ	EE	CY	LV	LT	HU	MT	PL	SI	SK
2004-2005	Deliveries (1)	2 608	520	141	502	1 209	1 589	46	8 347	499	949
	Available quota (2)	2 616	554	141	632	1 280	1 783	49	8 500	516	1 003
	Utilisation of deliveries quota (1)/(2)	99,7 %	93,9 %	99,9 %	79,3 %	94,5 %	89,1 %	93,8 %	98,2 %	96,7 %	94,6 %
2005-2006	Deliveries (1)	2 696	569	144	568	1 250	1 581	41	8 931	509	981
	Available quota (2)	2 679	605	142	678	1 520	1 835	49	8 730	536	1 005
	Utilisation of deliveries quota (1)/(2)	100,6 %	94,1 %	100,9 %	83,7 %	82,2 %	86,1 %	84,6 %	102,3 %	95,0 %	97,6 %

Sources:

2004-2005 year: Replies to the questionnaire required by Article 26 of Commission Regulation (EC) No 595/2004 (data for 11 months extrapolated over 12 months, except for Estonia) and paying agencies for PL (ARR) and SI (ARSKTRP).

2005-2006 year: Replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004.

Quotas are post conversion (provisional and final).

Table 9

Utilisation of the national reference quantities for direct sales in the new Member States (2004-2005 and 2005-2006)

(1 000 tonnes)

Year	Quantities	CZ	EE	CY	LV	LT	HU	MT	PL	SI	SK
2004-2005	Direct sales (1)	3	10	2	11	76	26	0	309	20	7
	Available quota (2)	67	70	4	63	367	165	0	464	45	10
	Utilisation of direct sales quota (1)/(2)	4,2 %	13,6 %	61,7 %	18 %	20,8 %	15,8 %		66,6 %	45,4 %	66,3 %
2005-2006	Direct sales (1)	3	9	3	11	56	19	0	195	21	4
	Available quota (2)	3	19	3	17	127	112	0	234	25	8
	Utilisation of direct sales quota (1)/(2)	81 %	44,3 %	100 %	63,3 %	44,2 %	17,2 %		83,2 %	83,5 %	44,6 %

Sources:

2004-2005 year: Replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004 (data for 11 months extrapolated over 12 months, except for Estonia) and paying agencies for PL (ARR) and SI (ARSKTRP).

2005-2006 year: Replies to the questionnaire required by Article 26 of Regulation (EC) No 595/2004.

Quotas are post conversion (provisional and final).

Restructuring continues in the new Member States

67. In-depth restructuring of the professional milk sector in the new Member States began long before enlargement (see paragraph 8 et seq.). The introduction of milk quotas did not therefore radically disrupt the production apparatus, which continues to develop gradually towards the technical and economic standards of the old Member States.

68. The most recent comprehensive data on the new Member States' dairy herds relate to 2005. Provisional data show that dairy herd numbers in the new Member States experienced a further fall of approximately 366 000 units between 2005 and 2007, i.e. 8 %⁽³⁷⁾. Restructuring also manifests itself in the dairy industry through a reduction in the number of approved purchasers, which fell from 935 in 2004-2005 to 895 in 2006-2007. The dairy industry in the new Member States has changed its market outlets. It produces more cheese and fewer other low value-added milk products (skimmed milk, milk powder and butter).

69. The introduction of milk quotas coincided with the beginning of a general rise in milk prices. The price paid to producers remains lower in the new Member States than the price paid to EU-15 producers, but the gap is narrowing. Price changes have encouraged milk producers to increase their deliveries to the detriment of direct sales. The new Member States' delivery rate therefore continues to converge with that of the other Member States although a significant gap remains between those countries where milk production is highly concentrated (the Czech Republic, Hungary and Slovakia) and those where production is still fragmented (Lithuania and Poland).

Enlargement has increased crossborder shipments without destabilising the milk CMO

70. Since joining the EU, the ten new Member States have increased their intra-EU trade in milk and milk products (Table 10). A transfer trade in raw milk has developed in some border regions of the new Member States, where the price of milk is lower, towards neighbouring Member States where prices are higher. This phenomenon has affected Slovenia in particular (Box 5).

Table 10

Milk and dairy products — External trade of CEECs

(1 000 tonnes)

Quantities	Intra-EU exports			Intra-EU imports		
	2004	2005	2006	2004	2005	2006
Milk and cream, not concentrated or containing added sugar or other sweetening matter	334	978	1 470	127	322	514
Raw milk included in the above	144	570	905	38	147	292
Milk and cream, concentrated and containing added sugar or other sweetening matter	144	165	160	19	30	33
Buttermilk, curdled milk and cream, yoghurt, kephir, and other fermented or acidified milk and cream	62	124	163	79	106	121
Whey, products consisting of natural milk constituents	68	102	197	38	48	69
Butter and other butterfats	53	49	36	15	18	25
Cheeses	120	170	184	75	114	144

Source: Commission, Eurostat (COMEXT).

⁽³⁷⁾ Source: European Commission, Management Committee for milk and milk products, Quarterly questionnaires (March 2008).

Box 5 — The massive transfer of Slovenian raw milk to Italy

Slovenia is the new Member State whose local milk market has changed the most since joining the EU. Due to price differences with Italy, exports of Slovenian raw milk to Italy have expanded since 2005. In 2006, the price of milk in Slovenia was approximately 18 % lower than in Italy. Approximately 28 % of Slovenian milk production was exported and processed in Italy in 2006. The effect of this phenomenon has been to limit the production of milk products in Slovenia (22 % in the case of butter production in 2006, 13 % for drinking milk, 11 % for cream and 7 % for cheese) and to encourage imports of these products.

71. However, the scenario whereby EU enlargement would create substantial additional surpluses in milk products to be exported as from 2005 ⁽³⁸⁾ did not materialise. Only very small quantities of milk products have been subsidised by the EU since 2004 in the new Member States. In 2005 and 2006, budgetary expenditure on milk in the new Member States accounted for 3,7 % and 4,8 % respectively of total milk-related expenditure on intervention, refunds and disposal measures.

CONCLUSION AND RECOMMENDATIONS

72. The quota scheme limiting milk production was extended to the Member States that joined the European Union on 1 May 2004. Since then, the dairy market has undergone profound change, characterised by rising world prices and the gradual disappearance of the structural surpluses that provided the *raison d'être* for the quotas. Although milk quotas are practically certain to disappear in 2015, until they do so the way they are applied must nevertheless be subject to an adequate level of control.

Did the Commission prepare for and supervise the extension of the milk quota scheme to the new Member States effectively?

73. During the pre-accession phase, the Commission supported the implementation of the scheme, mainly by coordinating peer review exercises and by negotiating national reference quantities with the candidate countries. 'Delivery' quotas were set at levels close to the quantities actually delivered during the reference period. The negotiations for 'direct sales' quotas, by contrast, resulted in the granting of reference quantities that considerably exceeded requirements (see paragraphs 15 to 21).

⁽³⁸⁾ Agenda 2000, volume II, Com(97) final of 15 July 1997.

74. As regards the Commission's activities in the 2004–2006 period, the Court noted the following shortcomings:

- the Commission released the special restructuring reserve for all the new central and eastern European Member States, even though supporting evidence for certain aspects of the restructuring process was lacking. It used the changes in on-farm consumption reported by the Member States as the main assessment criterion and did not question the data supplied by the national authorities (see paragraphs 23 to 26);
- at the time of the audit, the Commission had still not carried out any detailed on-the-spot checks in the new Member States to ensure that the scheme was running smoothly, the weaknesses identified in the peer review exercises had been rectified or the checks envisaged in the regulations had been implemented (see paragraphs 40 to 43).

Recommendation 1

As part of shared management, the Commission should continue to take all necessary action to ensure that the implementation and sound management of the milk quota scheme are effectively monitored.

It is vital for the Commission to have **reliable, standardised information** in order to assess the actual extent of the restructuring process and to corroborate the data on direct sales.

Have the new Member States created adequate structures for administering milk quotas? Do the management and oversight of the scheme comply with EU legislation?

75. The implementation of milk quotas posed a major logistical challenge for the new Member States. For the most part, the new Member States made a considerable effort to ensure that their administrative and inspection systems were operational in good time and have actually created structures that are broadly adequate for administering milk quotas (see paragraphs 35 to 61). Based on the main findings of the audit, the summary table below (*Illustration 4*) assesses how well they have been implemented at each stage of the process and in each of the Member States visited.

Illustration 4

**Evaluation of the implementation of the milk quota scheme in the countries of central and eastern Europe
(based on the situation at the time of the audit in 2005 or 2006)**

	2004-2005 marketing year				2004-2005 and/or 2005-2006 marketing years					
	Deliveries		Direct sales		Adoption of the <i>acquis communautaire</i>	Management of the national reserve	Design and updating of data-bases	Controls		
	Estimated amount required	Quota use	Estimated amount required	Quota use				Risk analysis	Control plan	On-the-spot checks carried out
CZ			(2)	(4)			(10)	(12)		(16)
EE			(2)	(4)		(9)	(10)	(12)		(16)
LV			(3)	(5)				(12)	(13)	
LT			(3)	(5)	(6)	(9)	(10)	(12)	(13)	(14)
HU	(1)		(2)	(5)	(7)	(9)	(10)	(12)	(13)	(15)
PL						(9)	(10)	(12)	(13)	(16)
SI				(5)			(10)	(12)		(16)
SK	(1)		(3)		(8)	(9)	(11)	(12)	(13)	

Good (no problems identified)	Average (room for improvement)	Poor (serious weaknesses)
--------------------------------------	---------------------------------------	----------------------------------

- (1) Over-allocation of individual deliveries quotas (paragraph 28).
- (2) Less than 20 % of the national reference quantity for direct sales quotas allocated (paragraphs 19 and 31, Tables 3 and 6) ⁽³⁹⁾.
- (3) Between 20 % and 60 % of the national reference quantity for direct sales quotas allocated (paragraphs 19 and 31, Tables 3 and 6) ⁽³⁹⁾.
- (4) Utilisation of quotas for direct sales less than 15 % of the national reference quantity (Table 9) ⁽³⁹⁾.
- (5) Utilisation of quotas for direct sales between 15 % and 45 % of the national reference quantity (Table 9) ⁽³⁹⁾.
- (6) Risk associated with the definition of 'deliveries' (paragraph 37).
- (7) Individual quotas pooled by cooperatives (paragraph 38).
- (8) Risks associated with producer-purchasers (paragraph 39).
- (9) Anomalies in the management of the national reserve (paragraph 47 and Box 4).
- (10) Inadequate audit trail for transactions and delays in updating databases (paragraph 42).
- (11) Rudimentary IT system; security unsatisfactory (paragraph 42).
- (12) Risk analysis prone to weaknesses (paragraphs 57 to 59).
- (13) Control plan published late (paragraph 56).
- (14) On-the-spot checks carried out late (paragraph 60).
- (15) No on-the-spot checks carried out in the quota year (paragraph 60).
- (16) Inadequate checks (paragraph 61).

⁽³⁹⁾ Member States were ranked according to their score in comparison with the average rate of allocation (41 %) or utilisation (31 %) of the national reference quantities for 2004-2005. Poor performance = rates less than 50 % of the average rate. Average performance = rates in the range between the average rate - 50 % and the average rate + 50 %. Good performance = rates above the average rate + 50 %.

76. It is reasonable to conclude that most of the problems and shortcomings brought to light by the Court's audit are intrinsic to the system's start-up phase. By way of comparison, it should be borne in mind that in some EU-15 Member States the introduction of milk quotas was followed by a long period of uncertainty during which the levy was not collected correctly due to negligence in the administration of the scheme and a large number of protracted legal cases.

Recommendation 2

It is the Commission's responsibility to continue to ensure that the Member States take **appropriate action to rectify the most significant shortcomings** identified by the Court's audit, as detailed in the summary table evaluating the system (*Illustration 4*).

First and foremost, the Commission should invite the new Member States to improve their **database record-keeping** (identification of cattle, deliveries and direct sales declared, and results of checks) and to optimise **cross-checks**.

As regards direct sales, the legislation requiring controls to cover at least 5 % of producers seems inappropriate to the fragmented structure of the dairy sector in most of the new Member States. The upshot is that the national authorities have to carry out a large number of potentially superficial inspections, which do not allow the probable veracity of declared direct sales to be verified. With a view to the reform of the milk market, and for the sake of simplification, the Commission should examine the possibility of authorising the Member States to **tailor the rate of on-the-spot checks to the structure and size of the holdings concerned**.

The Commission should also encourage the Member States to **combine on-the-spot checks of dairy producers with other CAP checks** (identification of cattle, direct payments and environmental cross-compliance).

Does the milk quota scheme cover all milk marketed in the new Member States?

77. Overall, the introduction of the milk quota scheme concerned only half of all milk producers. The majority of milk producers without a quota practise subsistence or semi-subsistence agriculture. A proportion of them market some milk, however, mainly in the form of direct sales (see paragraphs 14, 21 to 22 and 32 to 34).

Recommendation 3

The Commission should invite the new Member States to adhere to the general principle that **all milk marketed must be recorded**. As long as the milk quota scheme is in force, all producers that make undeclared deliveries or direct sales should be reminded that membership of the scheme is compulsory.

What overall influence has the introduction of quotas had on national dairy sectors? How has enlargement affected the milk CMO?

78. In most of the new Member States, the introduction of milk quotas has not been detrimental to self-sufficiency and has not made the milk sector less dynamic. Milk quotas were generally introduced against a backdrop of rising milk prices, the primary beneficiaries of which have been professional producers that make deliveries (see paragraphs 62 to 69).

79. The semi-subsistence sector still acts as a drag on the new Member States' agricultural productivity but is also a factor for social stability and helps shore up the rural population (see paragraphs 8 to 14). Given this situation, the new Member States have responded differently to the question of whether milk quotas were primarily a restructuring tool for professional producers or whether they could also help to bring certain small producers into the formal market (paragraphs 20, 33 and 34).

80. The 2004 enlargement had no negative impact on the overall balance of the EU's milk and dairy products market. The new Member States' share of responsibility for the milk product surpluses to be subsidised by the EU budget is minimal (see paragraphs 70 and 71).

Recommendation 4

The Commission is invited to take account of all the findings of the Court's audit as part of the 'health check' for the common agricultural policy.

Consideration of possible adjustments to the milk CMO and the milk quota scheme should focus on:

- transitional and accompanying measures to be envisaged in regions where small producers still largely predominate;
- the need for milk producers in the new Member States to have a **stable regulatory framework and clear prospects**, encouraging them to make the investments that are vital if their activity is to remain viable.

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 5 June 2008.

For the Court of Auditors
Vitor Manuel DA SILVA CALDEIRA
President

THE COMMISSION REPLIES

SUMMARY

On 1 May 2004, the system of milk quota entered into force in the 10 new Member States. While evidently not everything went perfectly well from the first day, the overall result can be considered to be very positive given the huge task the enlargement posed for the new Member States. Existing teething problems have been resolved during the first two campaigns, and if/where needed shortcomings will be followed up through the clearance procedures.

IV. The Commission has used the data that were made available to it and its estimations were at the basis of the final decision taken by the Council on the determination of the quota attributed to each new Member State.

Regarding the determination of the direct sales, the Commission has been as restrictive as possible, using an estimation method based on objective criteria. For instance, on-farm consumption has been evaluated on the basis of the number of persons living on the farm and the number of small calves on the farm. These estimations are deemed to be reasonable and have been applied in a uniform way for all Member States.

V. Two instances of over allocation of deliveries quantities occurred in Hungary and in Slovakia.

Both have been dealt with: the case for Slovakia during campaign 2004/2005, the one for Hungary during campaign 2005/2006.

VI. The Commission systematically examined the national implementing measures adopted, and replied to numerous questions from Member States during 2004-2006, either in writing or during the bi-weekly management committee. Moreover, the Commission followed up the Court's observations, and monitored improvements and developments during the bilateral meetings arranged following on-the-spot audit enquiries conducted in 2004 and 2005 under its clearance of accounts procedure. Recent missions enable audit coverage of the years and Member States considered by the Court as most at risk from the shortcomings highlighted by it. So far, no financial corrections have been identified as necessary.

VII. The Commission considers that Community law has been respected and that the management of the national reserve, has been consistent with the provisions in force. See replies to paragraphs 35 to 39, and 44 to 47.

VIII. The Commission accepts the recommendation, and points out that it is already, in a number of cases, following-up the Court's observations in the context of the clearance of accounts procedure. In July 2007, the Commission sent a questionnaire to the Member States and received further information about the structures: number of producers and quota size per producer.

For the Commission, the most relevant data are based on the milk quantities declared by purchasers or by individual producers in direct sales in the Member States concerned. The summary of this information is already provided in the questionnaire sent to the Commission each year before 1 September according to Article 26 of Regulation (EC) No 595/2004.

IX. On-the-spot audit enquiries undertaken in 2007 and early 2008 by the Commission have already targeted those same three Member States mentioned by the Court, thereby providing audit coverage for the earlier and current years in question.

ESTABLISHING NATIONAL REFERENCE QUANTITIES (NATIONAL QUOTAS)

19. The Commission agrees with the Court on the data and concludes that its method of negotiation was well elaborated and based on the most objective criteria possible and aimed to restrict the initial requests which were overestimated.

20. The Commission's estimation methodology can be considered as reasonable. Thanks to this methodology, the initial

request of the new Member States (except Poland) initially evaluated at 1,5 million tonnes have been reduced to the acceptable level of 0,83 million tonnes (negotiation position of the Commission). The volume negotiated in the Council has been in the order of 1 million tonnes.

Subsequently, as explained by the Court, the process of restructuring implied a loss of interest in direct sales. Aware of the need of restructuring and the necessity to authorise the

Member States to manage their reference quantities according to their needs, the Council of Ministers of 18 September 2006 introduced the possibility to transfer reference quantities for direct sales (remaining unused quantities in the national reserve) to the reference quantities for deliveries for campaign 2006/2007 (Council Regulation (EC) No 1406/2006).

21. In Poland, a large number of producers having received a quota for direct sales has subsequently renounced it and the national reserve has increased accordingly.

22. The follow up has to be assumed firstly by the Member States' competent authorities according to Regulation (EC) No 595/2004.

24-25. As foreseen in the act of accession, the Commission has decided to release the restructuration reserve in favour of the Member States concerned after having thoroughly analysed the issue in a report.

In this analysis the Commission has used the data made available to it by the Member States and assessed the shift from production for on-farm consumption to production for the market based on two criteria: the trend of marketed quantities and the on-farm consumption.

26. In its report, the Commission noticed a decrease of auto-consumption in all countries concerned between 2000 and 2005, with the exception of Lithuania where a decrease of auto-consumption was registered between 2002 and 2005.

Regarding the Czech Republic, the production intended for the market has increased by 0,8 % between 2000 and 2004 and then by 3,7 % between 2004 and 2005.

Concerning Latvia and Slovakia, there are no very significant differences between the data estimated by the Commission during the accession negotiations and those in the reports on the restructuration reserve.

The main criteria assessed were the trend in percentage of on-farm-consumption and marketed quantities.

28. Given the production context of the first two milk years 2004/2005, which had only 11 months, and 2005/2006, this over-allocation did not carry much risk of rapidly saturating the available national reference quantity. Moreover, this risk did not arise. In Hungary, 82 % of the delivery quota were used during campaign 2004/2005 and 86 % during campaign 2005/2006.

Similarly in Slovakia the figures were 87 % for campaign 2004/2005 and 97 % for campaign 2005/2006.

30. According to Article 6 of the Regulation (EC) No 1788/2003, the Commission accepted requests about conversion sent in February 2005 for all Member States including Slovakia. In fact for Slovakia, the Commission later realized the inconsistency of the method used, after receiving some extra information from the Slovakian authorities.

Aware of the need of restructuration and the necessity to authorise the Member States to manage their reference quantities according to their needs, the Council of Ministers of 18 September 2006 introduced the possibility of transferring reference quantities for direct sales remaining unused in the national reserve to the reference quantities for deliveries for campaign 2006/2007 (Council Regulation (EC) No 1406/2006).

Box 3, fourth paragraph

The follow up has to be assumed firstly by the Member States' competent authorities according to the Regulation (EC) No 595/2004.

INTRODUCTION AND MANAGEMENT OF THE SCHEME

35. The most important source of information was the national legislation that the Member States have to transmit to the Commission in the month after their adoption. All Member States, including Poland, Slovenia and Malta did this. This was the central element in the monitoring of the implementation of the acquis.

37. The definition of delivery in Article 5(f) of Regulation (EC) No 1788/03 does not refer explicitly to either sales or gratuitous donations by milk producers to their purchasers. The definition of purchaser in Article 5(e) on the other hand states that purchasers 'buy' milk from producers. In line with this, the Lithuanian definitions refer to the producer selling quantities to the purchaser. When asked by the Commission to ensure that all milk movements from producer to purchaser should be declared for quota purposes, the Lithuanian authorities replied that because of the definition of purchaser as 'buying' milk from the producer, producers cannot and do not give away milk to purchasers free of charge.

The Lithuanian authorities have confirmed that all deliveries (including gratuitous deliveries) are declared.

38. The provisions called into question regarding cooperatives in Hungary permit a dairy cooperative to request the competent authorities to treat the individual quotas of its constituent members as one global quota, the management of which is in the hands of the cooperative. Therefore one quota is entered in the quota register in the name of the legal person which is the

cooperative. It is further provided that the cooperative thereafter assumes, on behalf of its constituent members, all the obligations incumbent upon producers under the quota regulations. The Commission does not consider that this regime involves any risk regarding levy collection. The fact that certain types of cooperatives in Hungary may aggregate the individual quotas of the constitutive members without a transfer of ownership rights in the quotas is entirely similar to the situation of partial GAECs (*Groupe-ment Agricole d'Exploitation en Commun* or collective farming grouping) in France, as results from the description of such associations in paragraph 45 of the conclusions of the Advocate General in case C-15/95. The Court of Justice approved in its judgement in that case, recourse to certain forms of company such as partial GAECs for the purposes of milk production under the milk quota regime.

39. Any inherent risk in the status of producer/purchasers can be taken into account in the risk analysis implicit in the control process of producers and purchasers. Evidently, in his capacity of producer, the subject will be registered as a quota holder, and will, as a purchaser, be approved under the normal procedures. He may be subjected to controls in both capacities regarding any given quota period.

It would be disproportionate to exclude the exercise by a producer of the functions of a purchaser and vice versa. Such an exclusion would rule out for example the activities of producers of milk processing their own product increased for reasons of viability by quantities acquired from other producers. Moreover, producer-purchasers have already been recorded in the old Member States without giving rise to contradiction with the milk quota regime.

42. The outcome of the various bilateral meetings and on-the-spot audits undertaken in 2007 by the Commission demonstrate that the problems and criticisms raised by the Court with regard to the quota operations in the first implementing years have been addressed, and that improvements have been introduced.

43. Any potential financial risk to the Community budget began only with the first year of application that could involve the additional levy, namely 2005/2006. The Commission undertook two on-the-spot audit enquiries in 2007 in the two Member States presenting the greatest financial risk (i.e. proximity to or overshooting of the national milk quota) for which, thanks to the clearance of accounts mechanism with its retrospective coverage of 24 months, the quota year 2005/2006 was indeed covered. Furthermore, in the framework of other audits that the Commission did perform in 2005, the resulting bilateral meetings provided excellent opportunities to discuss the Court's findings on milk quotas, and to follow-up relevant developments. A further audit was made in early 2008 in the third new Member State to overshoot the quota, and likewise audit coverage takes in the quota year 2005/2006.

45. The Commission advised the new Member States that the discretion to place unused quantities in the national reserve when the producer failed to produce at least 70 % of his quota in a 12 month period should not be used in respect of production in the first period after accession. Due to the date of accession at 1 May 2004, producers in the new Member States did not have the benefit of the full regulatory reference period of 12 months against which to measure their production, so reductions would not have a sound legal basis.

The Estonian and Slovak authorities demonstrated, on the basis of their national pre-accession provisions that their producers had operated from 1 April 2004 under a reduction clause for a full 12-month period against which to measure their production. The Commission confirmed that they were consequently in a position to make reductions, on condition that the pre-accession higher thresholds of production were relaxed so that no reductions would intervene in respect of the 2004-2005 period which did not respect the 70 % threshold.

Reference is made in footnote 26 to the application by the Slovak Republic of reductions calculated at a higher threshold than 70 % and calculated on the global quota instead of separately for deliveries and direct sales. These reductions were made in respect of production in the pre-accession 2003-2004 period, and were not therefore subject to the post accession regulatory limitations.

46. The first period in respect of which the abrogation of quota in cases of total inactivity became obligatory, except for cases of force majeure or due justification, in Poland is 2005-2006. It was not an obligation for Poland to allocate individual quotas for the period 2004-2005, nor therefore could it have been an obligation to revoke quotas on the ground of underuse in that period. The criticism of the Court regarding the favourable outcome of appeals against revocations which were not obligatory or the rules applying to such appeal procedures is not relevant to Poland's application of the Community milk quota regime.

The procedure as described by the Court related to the 3 900 producers in Poland conforms with Article 15(1) and (3), of Regulation (EC) No 1788/2003.

47. As the Court of Auditors itself observed earlier, the Member States enjoy considerable latitude in managing their national reference quantities in function of their particular economic or social objectives. The exercise of this discretion is regulated by Article 7 of Council Regulation (EC) No 1788/2003 which provides that the Member States shall make allocations to producers of quantities out of the national reserve 'on the basis of objective criteria to be notified to the Commission'.

Box 4, first paragraph

In accordance with the discretion conferred on Member States, the Polish system favours existing producers who expand their production rather than new entrants. According to the legislation notified by the Polish authorities, allocations from the national reserve to existing producers are conditional upon a documented increase in sales compared with the previous quota year. Allocations are determined by a mathematical computation of the average annual sales of the expanded holding. The resulting allocation therefore coincides with actual documented milk sales over a given period and is therefore not more than is required to cover the capacity of the beneficiary. The objectivity of this system appears not to be open to question.

Second paragraph

The Commission considers that production scale and capacity are objective criteria for distinguishing between categories for access to the national reserve.

Third paragraph

On 18 September 2006 the Council, aware of the need of restructuring and the necessity to authorise the Member States to manage their reference quantities according to their needs, introduced the possibility to transfer reference quantities for direct sales remaining unused in the national reserve to the reference quantities for deliveries for campaign 2006/2007 (Council Regulation (EC) No 1406/2006). This also applies to point 49.

51. An individual fat reference can only be fixed with reference to a producer's milk quota. It is therefore inevitable that producers making deliveries without a milk quota do not dispose of a fat reference, in relation to which their deliveries might be adjusted either upwards or downwards.

52. Generally, when producers using 'direct sales' switch to deliveries they do not change their herd. As a consequence, they still have milk cows of the same race and homogenous in terms of quality of produced milk. Therefore, it seems coherent to apply the derogation foreseen in Article (7)(2) of Commission Regulation (EC) No 595/2004.

The reply of the Lithuanian authorities showed their rigour in the analysis on the issue of fat content at the moment of the fixation of the reference levels and during the transfer to deliveries.

Moreover, to avoid risks of deviation of reference levels compared to the value fixed at the start of the regime, in conformity with Article 9(5) of Regulation (EC) No 1788/2003, an adjustment mechanism was foreseen to reestablish the reference levels for fat from the moment there is an increase of more than 0,1g/Kg of fat.

CONTROLS

53. Whilst agreeing the importance of the controls to be installed, it is stressed that, for the first year's implementation examined by the Court, there was an extremely low financial risk as there was little likelihood of over-shooting the national reference quantities given that they applied for an 11-month period (1 May 2004-31 March 2005).

54. The Commission's bilateral contacts with the Member States involved, and recent on-the-spot audit enquiries in Poland and the Czech Republic, indicate that the Court's findings have been taken on board and that improvements have been, and continue to be, put in place.

55. Controls at purchasers are carried out on the basis of his annual declaration of purchases and are therefore best carried out after that declaration has been made.

56. The control plan for **purchasers** would logically only be completed after the end of the milk campaign as it is based on the purchasers' declarations. As regards producers and transporters, the Commission agrees that late control plans hamper proper control.

The Hungarian authorities have explained that all purchasers were controlled for 2004/2005, but risk criteria have been introduced for later years.

Slovakia has explained that some form of risk analysis existed already for 2005/2006, and as from 2006/2007 a points-based system is used. As from April 2007 an independent risk analysis section is established in the control department.

57. It is difficult to conceive a risk analysis for an area that has not previously been controlled and for which all the risks are not yet known. The Commission's bilateral discussions and audit show that risk analysis and control planning in subsequent years have become more sophisticated. In the Czech Republic, for example, the risk analysis was formalised as from 2005/2006.

The Polish authorities carry out their risk analysis for milk purchasers at the end of the quota year. The control verifies the completeness and veracity of the deliveries declaration (made in May) and so it is reasonable that the risk analysis be made after the end of the quota year. In Poland, the control plan was issued in September 2006 — and controls for the 2005/2006 milk period did not have to be completed until 30 September 2007. It has been verified by a Clearance of Accounts mission that the 2006/2007 controls were based on a risk analysis. It was also verified that, while not based on an *ex-ante* risk analysis, the 2004/2005 and 2005/2006 controls were executed.

58. The Commission agrees that the control regime should encompass all farmers marketing milk and, during audit missions and bilateral contacts the Commission has requested Member States to include all producers of milk, whether or not they have quota, in their risk analysis.

However, delivery of milk without a quota is not in breach of the Regulation, and the financial risk for the very small producers cannot be great. The proportion of direct sales to delivery quota is considerably less than 3 % in most cases.

59. Although not required by the milk quota legislation, the Commission also strongly urges the cross-checks described by the Court.

60. The Commission recognises the importance of proper control at the most opportune time. During missions/bilateral contacts, Member States have been reminded that producer controls must be at least partially carried out in-year. For 2005/2006 quota year the Lithuanian authorities performed in-year checks on producers and transport companies.

Hungary, performed no 'in-year' controls on producers in respect of 2004/2005 or 2005/2006, but did make them after the end of the milk years. However, in-year controls were carried out in respect of 2006/2007.

61, *Third indent*

The Polish authorities accepted the Court's recommendation and as from August 2006 agreed to attach the working sheets to the control reports.

The Polish authorities follow-up and sanctioning process is being handled in the context of the Commission's clearance of accounts procedure, which covers the year in question and is on-going.

61, *Fourth indent*

Whereas the keeping of such information may be useful in certain circumstances, for example for adapting risk analysis criteria from one year to the next, it is not a regulatory requirement.

Recommendations to this effect will be made to Member States.

CONCLUSION AND RECOMMENDATIONS

73. Regarding the determination of the direct sales, the Commission has been as restrictive as possible, using an estimation method based on objective criteria. These estimations are deemed to be reasonable and have been applied in a uniform way for all Member States.

Thanks to this methodology, the initial request of the new Member States (except Poland) initially evaluated at 1,5 million tonnes have been reduced to the acceptable level of 0,73 million tonnes (negotiation position of the Commission). The volume negotiated in the Council has been in the order of 1 million tonnes.

74. As demanded by the act of accession, the Commission decided to release the restructuring reserve in favour of the Member States concerned after a thorough examination in a report. The statistics made available by the Member States have been used and cross-checked. Cross-checks have been made between the data in the report and the data in the survey on quota (Article 26(1) of Regulation (EC) No 595/2004) and between the statistics in the report and those of Eurostat and ZMP. See reply to points 24-25.

Any potential financial risk to the Community budget began only with the first year of application that could involve the additional levy, namely 2005/2006. The Commission undertook two on-the-spot audit enquiries in 2007 in the two Member States presenting the greatest financial risk (i.e. proximity to or overshooting of the national milk quota) for which, thanks to the clearance of accounts mechanism with its retrospective coverage of 24 months, the quota year 2005/2006 was indeed covered. Furthermore, in the framework of other audits, that the Commission did perform in 2005, the resulting bilateral meetings provided excellent opportunities to discuss the Court's findings on milk quotas, and to follow-up relevant developments. A further audit was made in early 2008 in the third new Member State to overshoot the quota, and likewise audit coverage takes in the quota year 2005/2006.

Recommendation 1

Second paragraph

In July 2007, the Commission has sent a questionnaire on the application of the quota to collect statistical information on the evolution of the number and size of producers producing for direct sales and for deliveries.

However, whereas a follow-up of the restructuring process is useful in terms of knowledge about the product chain, it is less important for the purpose of monitoring the obligations of the quota regime.

75.

- (1) An over-allocation of deliveries quota occurred in 2 Member States. The allocations were brought within the relevant global quantities within the first period (Slovakia) and with effect in the second period (Hungary). Neither Member State concerned registered production in excess of its deliveries quantity.

- (6) The Lithuanian authorities have confirmed that all deliveries (including gratuitous deliveries) are declared.
- (7) The operation of cooperative level quotas in Hungary is in line with the case-law of the Court of Justice and does not present a risk for collection of levy.
- (8) The Commission considers that any risks inherent in the status of producer-purchasers are to be taken into account in the risk assessment implicit in the control procedure.
- (9) As explained in detail in Commission's replies to paragraph 47 and box 4, the Commission does not consider that anomalies took place in the framework of the operation of the national reserves.
- (10) The outcome of the various bilateral meetings and on-the-spot audits undertaken by the Commission demonstrate that the problems and criticisms raised by the Court with regard to the quota operations in the first implementing years have been addressed, and that improvements have been introduced.
- (11) The outcome of the various bilateral meetings and on-the-spot audits undertaken by the Commission demonstrate that the problems and criticisms raised by the Court with regard to the quota operations in the first implementing years have been addressed, and that improvements have been introduced.
- (12) Teething problems in early years have been rectified with significant improvements by Member States.
- (13) As explained in Commission's reply to paragraph 56, improvements have been introduced by the Member States.
- (14) The Commission recognises the importance of proper control at the most opportune time. Improvements have been introduced by the Member States.
- (15) Hungary, and other Member States concerned, have been reminded that controls on producers and transporters must be at least partially carried out in-year. Improvements have been subsequently introduced by Member States.
- (16) The Commission has followed up the issues raised with the Member States, and is satisfied that improvements have been introduced in years subsequent to the Court's enquiry.

76. The problems encountered are inherent in the inauguration of a new regime. However, it has found that the Court's concerns in respect of first years' implementation, when there was little risk of financial impact on the Community budget, have been addressed and improvements put in place. This continues to be monitored under the clearance procedure, also in respect of the quota years under investigation by the Court, and especially in those Member States where overshoot is apparent or likely.

Recommendation 2

First paragraph

The Commission has followed up developments both in the context of bilateral meetings and on-the-spot audit enquiries conducted in the context of its clearance of accounts procedures.

As regards point 1 of illustration 4: the Hungarian and Slovak overallocations of deliveries quota have been corrected.

Concerning point 10 of illustration 4: the use of the national reserve in Poland and Lithuania was based on objective criteria and is not therefore discriminatory.

Second paragraph

The Commission agrees to further underline the observations of the Court, whose position it shares.

Third paragraph

The Commission, after consulting the management committee for milk and milk products, has already proposed a reduction of the intensity of the controls foreseen in Article 21(2) of Regulation (EC) No 595/2004. A control rate of 1 % has been set for those producers having a production below 5 000 kg. Commission Regulation (EC) No 228/2008 ⁽¹⁾ applies from the 2007/2008 period.

Fifth paragraph

Where possible such practice is indeed encouraged. However, due to the involvement of different services, competences, technical expertise, etc, it is often not practical.

Recommendation 3

There is no obligation to allocate quota to all producers. However, the Commission agrees that all the milk that is commercialised has to be accounted for.

⁽¹⁾ Commission Regulation (EC) No 228/2008 of 13 March 2008 amending Regulation (EC) No 595/2004 with regard to intensity of controls on deliveries and direct sales of milk (OJ L 70, 14.3.2008, p. 7).

Recommendation 4*First paragraph*

The Health Check will allow to verify if the level of quota has to be adjusted or if technical improvements have to be made before 2015, before the end of the regime. The objective is to have a transition before 2015 in a framework as transparent and simple as possible.

First bullet point

Member States have a lot of leeway to organise the transfer of quota. This allows a restructuration which is the most

appropriate to their situation. For instance, they can opt to implement a restructuration programme according to Article 18(a) of Regulation (EC) No 1788/2003.

Second bullet point

The Commission endeavours to propose to the Council a precise framework with stepwise quota increases until their expiry in 2015 in order to give the producers a clear outlook on their future. This allows the active producers to continue developing their business.
