

I

(Information)

COURT OF AUDITORS

SPECIAL REPORT No 1/99

**concerning the aid for the use of skimmed milk and skimmed-milk powder as animal feed, accompanied
by the Commission's replies**

(submitted pursuant to Article 188c(4)(2) of the EC Treaty)

(1999/C 147/01)

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SUMMARY OF SPECIAL REPORT No 1/99 CONCERNING THE AID FOR THE USE OF SKIMMED MILK AND SKIMMED-MILK POWDER AS ANIMAL FEED

Total production of skimmed milk powder (SMP) in the EU is 1 208 000 t. Only 35 % is sold on the market without subsidy. The rest is either exported or sold in the context of disposal measures on the internal market (see paragraph 11). This report deals with the Community subventions for the use of SMP and skimmed milk (SM) as animal feed. This concerns some 500 000 t per annum for which ECU 386 million was spent in 1997 (see paragraphs 11 and 13).

The Regulations should determine the quality (notably protein content) of the SMP eligible for the aid in order to avoid aid being paid for low grade, non marketable, SMP (see paragraph 16).

The decline in the use of SMP for animal feed continues, not only because of the crisis in the beef and veal sector but also because of competition from other, lower priced, products (see paragraphs 18 and 19).

The level of aid paid for the use of SMP as animal feed is nearly 35 % of its commercial value (see paragraph 21). The same rate of aid has applied since 1993 but no comprehensive document was available at the Commission services showing that the level of aid has been reassessed yearly as foreseen in the Regulation (see paragraph 22). An effective tendering system should provide an optimum aid level, particularly in view of the rising level of stocks (see paragraph 23).

Imports from non-member countries may increase further. Imported SMP is fully eligible for all Community SMP aid schemes (except public storage). Net cost for the EU budget is ECU 18,7 million (see paragraph 27). The WTO Agreement limits the possibilities for subsidised exports of SMP (see paragraph 28).

For skimmed milk and buttermilk the audit revealed weaknesses notably in the determination of eligible quantities (see paragraph 31) and concerning sample taking (see paragraph 32).

SMP aided shall not include whey powder. The audit revealed the importance of systematic checks in this area (see paragraph 42).

There are persistent control weaknesses as regards the particular arrangements applicable for the payment of the aid in the SMP producing country for incorporation into compound feedingstuff in other Member States. Either the situation should be improved or the Regulation abolished, as already suggested by the Court in its annual report concerning the 1988 financial year (see paragraphs 48 and 49).

Public stocks of SMP increased during 1996 and 1997. Most stocks are in Ireland and in the United Kingdom. In Ireland the audit revealed a clear need for an institutional separation of responsibilities and in the United Kingdom inadequate warehousing (see paragraphs 50 to 52).

INTRODUCTION

The product

1. Skimmed milk (SM) is produced during the process of defatting whole milk to obtain cream, the starting point for butter production. It is used in liquid form or in dehydrated form as skimmed-milk powder (SMP). SMP is used in the manufacture of other milk products (together with whole milk) and in the food processing industry. Liquid skimmed milk is mainly used to produce casein, supplying proteins for the agri-food and chemical industries. Buttermilk (BM) is the by-product of butter manufacture obtained after separation of the solid fat in the cream while buttermilk powder (BMP) is dehydrated buttermilk. *Graph 1* shows the principal products derived from milk.

2. Worldwide SMP production is some 3,1 million t⁽¹⁾. The European Union is the biggest producing region of SMP and accounts for nearly 40 % of the world production. Other important regions are Eastern Europe (11 %), North America (19 %) and Australia and New Zealand (14 %).

The Court's audit

3. The Court examined the subsidy paid for the use of SM and SMP as animal feed (ECU 386 million in 1997) at the level of the Commission and in a number of Member States (Germany, Belgium, France, Italy and the Netherlands). Audit visits were also undertaken in Ireland and in the United Kingdom to take into account the increasing public storage of SMP in 1996 in both Member States.

4. Among the risk factors taken into account in the course of the audit were those arising from the vagueness of the legislative provisions and from the problems of determining and controlling the quality and quantity of qualifying products. The specific control problems relating to the SMP subsidised in one Member State for production of animal feed stuffs in another, and the possibilities regarding product substitution (i.e. whey powder) were also considered.

5. The measures for the disposal of skimmed milk have previously been examined by the Court. The main observations in this context were published in the Court's annual reports 1988⁽²⁾ (SMP) and 1993⁽³⁾ (casein).

⁽¹⁾ Latest available data 3,079 million t of SMP (provisional figure) in 1996, 3,128 million t in 1995.

⁽²⁾ OJ C 312, 12.12.1989, paragraphs 6.41-6.73.

⁽³⁾ OJ C 327, 24.11.1994, paragraphs 4.1-4.54.

COMMUNITY AID AND THE MILK MARKET

The common market organisation for milk and milk products

6. Milk accounts for some 18,4 % of the total value of agricultural production in the EU and is therefore the most important agricultural activity in the EU as a whole. The market organisation for the sector has been established by Council Regulation (EEC) No 804/68⁽⁴⁾, which provides the legal basis for support measures aimed at improving the situation of the milk sector in order to absorb excess production.

7. Community milk-price support is provided by aid for the sale of butter and skimmed-milk (in either liquid or powder form) and export refunds for milk products and public storage of butter and SMP when market prices fall. There are also storage grants for certain types of cheese.

8. Since 1984 the production of milk in the EU has been controlled by milk quotas. The system, initially implemented for nine years, has been extended by Council Regulation (EEC) No 3950/92 to the year 2000⁽⁵⁾.

9. Despite the stabilisation of milk production following the implementation of the milk quota system in 1984, there is still overproduction of milk in the European Union. *Table 1* shows the development of the EU dairy production for 1984 and from 1993 to 1997.

10. In the EU approximately 35 %⁽⁶⁾ of the milk produced is either consumed fresh as milk or converted into products such as yoghurt. The remaining 65 % is converted into either cheese, butter or skimmed milk. The skimmed milk that is not used in liquid form is subsequently converted into either skimmed-milk powder or casein (22 kg of whole milk yields around 1 kg of butter and 2 kg of SMP). As regards SMP only 445 000 t of the 1 208 000 t produced in the EU in 1997 could be sold without subsidies at market prices (see *Table 2*).

11. In the context of the disposal measures for the milk sector, the European Union subsidises the use of skimmed milk, liquid or dehydrated, for animal feed (512 000 t in 1997)⁽⁷⁾ and for the production

⁽⁴⁾ OJ L 148, 28.6.1968, p. 13.

⁽⁵⁾ Milk quotas were implemented by Council Regulation (EEC) No 856/84 of 31 March 1984 (OJ L 90, 1.4.1984, p. 10). For the current system Council Regulation (EEC) No 3950/92 of 28 December 1992 which is valid until the year 2000 applies (OJ L 405, 31.12.1992, p. 1).

⁽⁶⁾ There are no definitive figures showing how the milk produced is used because of uncertain statistical sources and also because of different fat/protein contents of milk products of all sorts. Drinking milk production is 30 350 million t or some 25 % of milk production. However, drinking milk has a lower fat content than fresh milk (the fat may be used for butter and cheese). It is estimated that drinking milk and fresh products of all kinds absorb some 35 % of milk production.

⁽⁷⁾ 495 000 t concern the use of SMP as animal feed and 17 000 t SMP equivalent for the subsidised use of skimmed-milk as animal feed (provisional data for 1997).

of casein (some 400 000 t SMP equivalent in 1997) ⁽⁸⁾. Furthermore, SMP exports benefit from refunds (some 280 000 t in 1997).

12. However, these measures could not fully absorb the surplus of skimmed milk powder in recent years, so that, from 1996, public intervention stocks of SMP increased to 135 421 t at the end of 1997. The highest stocks were reported in Ireland (54 634 t) and the United Kingdom (46 400 t). For the overall market balance of SMP see *Table 2*.

13. EAGGF Guarantee expenditure for skimmed milk and skimmed milk powder totalled ECU 875 million in 1997, out of which ECU 386 million (44 %) was paid for the use of SM and SMP as animal feed, ECU 288 million (33 %) for casein production, ECU 171 million (20 %) for export refunds and ECU 30 million (3 %) for public storage (see *Tables 3 and 4*).

The legal context

14. The disposal measures for the use of skimmed milk and skimmed-milk powder as animal feed are provided for by Council Regulation (EEC) No 986/68 ⁽⁹⁾. According to this Regulation buttermilk and buttermilk powder are also eligible for these aids. Regulation (EEC) No 986/68 is completed by Commission Regulations dealing with the specific measures and the implementation rules:

- (a) Commission Regulation (EEC) No 1105/68 ⁽¹⁰⁾ on detailed rules for granting aid for skimmed milk for use as feed ⁽¹¹⁾;
- (b) Commission Regulation (EEC) No 1725/79 ⁽¹²⁾ on the rules for granting aid to skimmed milk processed into compound feedingstuffs and skimmed-milk powder intended for feed for calves ⁽¹³⁾;

⁽⁸⁾ Casein is produced from skimmed milk. For the calculation of skimmed milk into skimmed milk powder equivalent apply the factor of 11: 1 (11 kg skimmed milk = 1 kg skimmed-milk powder).

⁽⁹⁾ OJ L 169, 18.7.1968, p. 4; buttermilk and buttermilk powder are treated as skimmed milk and skimmed-milk powder.

⁽¹⁰⁾ OJ L 184, 29.7.1968, p. 24.

⁽¹¹⁾ The Regulation includes three different types of utilisation of aid:

- (a) the dairy produces and processes SM which is specially denatured and sold to farms where it is used as animal feed at a price for which the maximum may be set (Article 1); a variant of this occurs when dairies sell SMP in liquid form to livestock farmers (Article 1a) as amended by Commission Regulation (EEC) No 2630/84 (OJ L 249, 18.9.1984, p. 8);
- (b) dairies which use their skimmed-milk production solely for feeding their own animals (Article 5a) as amended by Commission Regulation (EEC) No 2863/75 (OJ L 285, 4.11.1975, p. 5);
- (c) breeders using their own skimmed milk as feed (Article 6).

⁽¹²⁾ OJ L 199, 7.8.1979, p. 1.

⁽¹³⁾ Although the Regulation and the related budget lines indicate that the product is for feeding calves, part of the animal feedstuff is used as feed for sheep and piglets. This is not forbidden by the Regulation.

- (c) Commission Regulation (EEC) No 1624/76 ⁽¹⁴⁾ provides for special arrangements for the payment of aid for SMP denatured or processed into compound feedingstuffs in the territory of another Member State ⁽¹⁵⁾.

15. Public storage of SMP is foreseen by Article 7 of the basic Council Regulation (EEC) No 804/68. Detailed rules for public storage of SMP are stipulated by Commission Regulation (EC) 322/96 of 22 February 1996 ⁽¹⁶⁾. Only high quality SMP with a protein content of 35,6 % ⁽¹⁷⁾ of the non-fatty dry extract, is eligible for public storage. The SMP must not include buttermilk or whey and must correspond to a number of additional quality criteria ⁽¹⁸⁾.

Observations on the Commission Regulations

16. Commission Regulation (EC) No 322/96 clearly specifies the minimum characteristics of SMP eligible for public storage but these are not applied to SMP used as animal feedingstuff (see *Table 5*). Both Commission Regulations (EEC) No 1105/68 and (EEC) No 1725/79 set out physical eligibility criteria for SM and SMP to qualify for aid, and also describe the control measures that Member States should apply to ensure that the conditions of granting aid have been met. However, the physical eligibility criteria allow Member States to make inconsistent interpretations of the rules to be applied (see paragraphs 31, 41 and 42). Moreover the control provisions are not sufficiently explicit to indicate when, where and how Member States should carry out checks and, in the case of Regulation (EEC) No 1105/68, which specific laboratory tests should be applied to confirm that the physical criteria have been respected. Examples of these deficiencies are as follows:

- (a) despite the fact that the nutritional value of the product for animal feed is determined by the protein content there is no minimum requirement for this characteristic. Low grade SMP with low protein content is not excluded and receives the same aid as quality SMP ⁽¹⁹⁾;
- (b) notwithstanding the fact that Council Regulation (EEC) No 968/68 stipulates a maximum fat content for SM of 1 % and for SMP of 11 %, Commission Regulation (EEC) No 1105/68 allows that the fat content for SM may be exceeded by 25 %;

⁽¹⁴⁾ OJ L 180, 6.7.1976, p. 9.

⁽¹⁵⁾ The aid is paid to the seller of SMP on the basis of proof from the receiving Member State that a security was taken from the importer.

⁽¹⁶⁾ OJ L 45, 23.2.1996, p. 5.

⁽¹⁷⁾ The protein content is 35,6 %, lower intervention prices apply for each percentage point of protein content which is lower, down to a minimum of 31,4 %.

⁽¹⁸⁾ See also *Table 5*.

⁽¹⁹⁾ The low protein content of SMP included in a compound feedstuff can be compensated for by adding casein, a product that is also subsidised.

- (c) the dry matter of eligible SM is not regulated by strict criteria. Regulation (EEC) No 1105/68 provides for a minimum dry matter to SM of 8,75 % and for BM of 8 % but also allows aid to be granted to SM and BM below these minimum levels in certain cases ⁽²⁰⁾;
- (d) Commission Regulation (EEC) No 1105/68 does not permit dilution with water and whey unless it is 'normally part of the production methods used' ⁽²¹⁾. The production methods requiring this dilution are not contained in the Regulation;
- (e) the control provisions in Commission Regulation (EEC) No 1105/68 (Article 10) stipulate only that 'Member States shall take the measures necessary to check that the conditions governing the granting of aid are fulfilled and that the benefit of the aid is passed on to the farm stage' without giving any indication of the timing, nature or extent of such measures. The control provisions of Commission Regulation (EEC) No 1725/79 (as amended) are more detailed in defining the nature of the checks to be performed, and also indicate both the technical standards of the laboratory tests to be carried out and the accepted result parameters for such tests.

17. Furthermore, Regulation (EEC) No 1105/68, unlike Regulation (EEC) No 1725/79, does not stipulate that skimmed-milk producers must have approval before aid can be granted. The requirement that beneficiaries have suitable technical equipment and adequate administrative and accounting methods to make it possible to comply with the Regulations is particularly relevant in this context.

The market for SMP

18. Annual production of SMP has fallen from 2,4 million t in 1984, before the implementation of the quota system, to 1,3 million t in 1993 and 1,1 million t in 1998. Principal producers of SMP are France and Germany which together account for some 60 % of the total European Union production. The Commission expects a further drop in SMP production and consumption mainly because of declining use of SMP in animal compound feedingstuffs ⁽²²⁾. Human consumption ⁽²³⁾ of SMP, on the contrary, is expected to remain stable ⁽²⁴⁾. *Graph 2*

⁽²⁰⁾ See Article 1 (6), of Commission Regulation (EEC) No 1105/68 as amended by Regulation (EEC) No 1645/78 (OJ L 191, 14.7.1978, p. 23), which stipulates numerous exemptions to the minimum eligibility criteria.

⁽²¹⁾ See Article 1 (4), of Commission Regulation (EEC) No 1105/68 as amended by Regulation (EEC) No 2114/75 (OJ L 215, 13.8.1975, p. 12).

⁽²²⁾ SMP quantities used as animal feed and supported in the context of Regulation (EEC) No 1725/79 developed as follows
(EU- 12): 1993, 675 000 t; 1994, 649 000 t; 1995, 587 000 t;
(EU- 15): 1995, 594 000 t; 1996, 543 000 t; 1997, 495 000 t.

⁽²³⁾ SMP for human consumption is an important ingredient in all kinds of food products such as bakery products, confectionery, certain ice creams, dried soups, sauces, babyfood, etc.

⁽²⁴⁾ Source: Situation and outlook dairy sector, working document of the Commission, Brussels 1997.

shows the evolution of the subsidised and non-subsidised consumption of SM and SMP.

19. According to producers of compound feedingstuff visited, the decline in the use of SMP is partly due to the decrease in the number of calves and partly due to the development of new products and the replacement of SMP by other cheaper products (such as whey powder), despite the EU subsidies paid for the use of SMP.

20. Furthermore, the current minimum percentage of 50 % of SMP in compound feedingstuffs, necessary to qualify for the aid, was considered by certain producers as being too high and a constraint on the use of SMP. In fact, the minimum SMP content has been modified on several occasions in the past ⁽²⁵⁾. The Commission should re-evaluate the minimum necessary SMP content in the light of the evolution of the market and the price of competing products (see also paragraph 22). *Graph 3* shows the development of market prices of SMP in Europe and on the world market.

Fixing the level of aid

21. The current aid level for the use of SMP corresponds to some 35 % of its commercial value. This has not changed since 1 July 1993 when it was fixed at ECU 59,22/100 kg. The rate increase on 1 February 1995 to ECU 71,51/100 kg does not reflect a real increase but the adjustment to take into account the adaptation of 'green' rates in 1995.

22. Under Article 2a(1) of Council Regulation (EEC) No 986/68, the aid level shall be fixed taking into account the following factors: 'the intervention price for skimmed-milk powder applicable during the milk year concerned; the development of the supply situation as regards skimmed milk and skimmed-milk powder and developments in the use thereof as feed; trends in calf prices; and trends in the market prices for competing proteins as compared with those for skimmed-milk powder'. Article 2a(2) ⁽²⁶⁾ of the Regulation stipulates that 'the amounts of aid shall be fixed each year for the following milk year'. The evaluation of these factors and the way they were taken into account as foreseen by the Regulation is not recorded in a comprehensive document. Furthermore, as already observed by the Court in 1988, there is 'no specific analysis to determine an optimum level of subsidy which will achieve a target level of disposals at minimum cost to the budget'.

⁽²⁵⁾ Up to 5.6.1988: 60 %
6.6.1988 to 30.9.1988: 45 %
1.10.1988 to 31.10.1990: -
1.11.1990 to 31.1.1993: 50 %
1.2.1993 to 30.6.1996: 35 %
1.7.1996-: 50 %

⁽²⁶⁾ Articles 2a(1) and 2a(2) were implemented by Council Regulation (EEC) No 666/74 (OJ L 85, 29.3.1974, p. 22).

23. The Court maintains its previous observation ⁽²⁷⁾ that the subsidy may be fixed at an inappropriate level and that the implementation of a tendering procedure would provide more assurance that the subsidy is set at the optimum level.

External trade

24. Imports of SMP increased from 17 500 t in 1993 to some 64 000 t in 1997 mainly as a result of the preferential import regimes implemented during recent years. Exports of SMP amounted to some 281 470 t in 1997. *Table 6* provides the data for imports and exports of SMP from 1993 to 1997.

25. In accordance with the World Trade Organisation (WTO) Agreements, starting on 1 July 1995, import duties for SMP are to be reduced by 20 % over six years ⁽²⁸⁾. However, from July 1995 onwards, for most imports more favourable import duties already exist, because a reduced tariff rate of ECU 47,5/100 kg applies for some 40 000 t of SMP in 1995 increasing to 68 000 t in the year 2000 in the framework of the 'minimum access commitment' accepted by the EU in the context of the WTO Agreement.

26. Furthermore, import quotas are available for milk powder (either whole milk or skimmed-milk powder) in the context of the European Association Agreements with countries from Eastern Europe. These Agreements allow the import of 20 580 t in 1997/98 at a preferential rate of 20 % of the standard customs rate ⁽²⁹⁾. Whereas public storage of SMP is only made for SMP of European origin, imported SMP in free circulation can fully benefit from the subventions for the use of SMP as animal feed. The imported quantities are therefore also eligible for the grants made available for SMP disposal measures.

27. The total SMP imported in 1997 (around 64 000 t) is thus eligible for aid, at a total cost to the European Union's budget of some ECU 42,9 million. Import duties, on the other hand, amount to only ECU 24,2 million. The net effect on the EU budget is therefore around ECU 18,7 million ⁽³⁰⁾.

⁽²⁷⁾ See the Court's 1988 annual report, paragraphs 6.63 to 6.66 (OJ C 132, 12.12.1989).

⁽²⁸⁾ The standard customs rates (import duties) are to be reduced over six years, starting from ECU 143,6/100 kg of SMP in GATT year 1 (1.7.1995/30.6.1996) and developed as follows: ECU 138,6 in 1996/97, 133,7 in 1997/98 and 128,7 in 1998/1999. Further reductions will apply for the years 1999/2000 and 2000/2001.

⁽²⁹⁾ The quotas for preferential imports under the Association Agreements will increase by 990 t each year, to 23 550 t in year 2000.

⁽³⁰⁾ The amount is calculated as follows: importation of 40 000 t under the minimum access commitment at an import duty rate of ECU 47,5/100 kg and 20 000 t under the agreements with the countries of eastern Europe at an import duty rate of ECU 25,74/100kg equals
40 000 t x ECU 47,5/tonne = ECU 19 000 000,
20 000 t x ECU 25,74/tonne = ECU 5 148 000,
amount of import duties: ECU 24 148 000.
The aid amounts to ECU 71,51/100 kg i.e. 715,1/t x 60 000 = ECU 42 906 000
Net expenditure charged to budget ECU 18 758 000

28. Concerning exports, the WTO Agreement stipulates that, by the year 2000/2001, the total amount of refunds for SMP must be reduced by 36 % to ECU 275,8 million ⁽³¹⁾, calculated from a base amount of ECU 430,9 million. Corresponding quantities of SMP exported shall be reduced by 21 % to 272 500 t in 2000/2001, calculated from a base quantity of 344 900 t. As long as the internal market prices remain high relative to the export prices of Europe's competitors in the international market, the Community's exports will continue to be confined to those that qualify for export refunds, subject to the limits provided for in the WTO Agreement. As at 1 August 1997 the export refund rate was fixed at ECU 598,5/tonne and was increased to ECU 680/tonne on 31 October of the same year.

THE MEMBER STATES' MANAGEMENT

Aid for liquid skimmed milk

General remarks

29. Aid for (liquid) skimmed milk amounted to ECU 21,2 million in 1997 which represents 5,5 % of total expenditure for its use as animal feed ⁽³²⁾. This form of aid is used mainly by Italy (36 %), Germany (30 %) and Belgium (15 %). In Italy the aid relates to substantial amounts of buttermilk which is used for pig production, especially in the Parma area.

30. With the exception of the coefficients for a producer's own animals (see paragraph 33), the Regulation does not provide for theoretical or standard calculations to be used for determining quantities eligible for subsidy.

The findings of on-the-spot enquiries

31. In the case of skimmed milk and/or buttermilk supplied to stock farmers directly by the dairy industry, aid applications are seldom based on the real weight of the product supplied for animal feed and the accuracy of the claims submitted cannot therefore be verified. In Belgium the dairies visited based their claims on estimates derived from their records of monthly production of milk products. In France

⁽³¹⁾ Annual quantity commitments for SMP for 1997/1998: 310 000 t, for 1998/1999: 297 500 t, for 1999/2000: 285 000 t and 2000/2001: 272 500 t. Outlay commitments: for 1997/1998: ECU 354 million, for 1998/1999: ECU 328 million, for 1999/2000: ECU 301,9 million and for 2000/2001: ECU 275,8 million.

⁽³²⁾ Aid disbursed in 1997, ECU 386,3 million, of which ECU 365,2 million (94,5 %) for SMP (Regulation (EEC) No 1725/79) and ECU 21,2 million (5,5 %) for SM (liquid).

the amount of skimmed milk is an estimated figure derived from the quantity of butter produced. Furthermore, at one of the major dairies visited in Italy a formula is used by the dairy to derive the quantity of buttermilk produced. In these cases, estimates of weight were used without any evidence being available that they correctly reflected the physical characteristics of the milk in the production process. As a result, there is no assurance that the correct amount of subsidy is being paid by the Commission. The Regulation should be improved to specify the basis for the payment of the subsidy, and to require appropriate control arrangements to enforce it.

32. Article 10 of Regulation (EEC) No 1105/68 does not specify the control measures to be taken by the Member States [see paragraph 16(e)]. In most of the Member States visited (Belgium, Germany, France, Italy) the samples used to check the physical and chemical characteristics of the buttermilk and/or skimmed milk intended for animal feed were not taken from the product that was delivered to the farmers. The samples were taken during the production process or from large tanks at the dairies. However, it could not be established that the sampled product corresponded to what was actually delivered to farmers.

33. Under Article 5a of Regulation (EEC) No 1105/68, as amended by Commission Regulation (EEC) No 2863/75⁽³³⁾, dairies that use buttermilk to feed their own animals may receive, for every kilogram of butter produced and sold, the aid payable for 2,2 kg of skimmed milk. In 1975, when this amendment to the Regulation was introduced, the buttermilk and/or skimmed milk produced would, in many cases, have been consumed directly by animals that were kept on the dairy's own premises. Nowadays, with the exception of a few very small establishments, animals are kept away from the milk-processing plant, for reasons of hygiene. In the mean time some dairies have acquired stock-rearing companies and thus continue to take advantage of the standard calculation, which is considered to be more advantageous than determining the quantities by weighing the delivered product.

34. As animals are not kept on the premises of the dairy where the buttermilk is produced, the abovementioned standard method for calculating the quantities of BM qualifying for aid should not apply. Furthermore, the coefficient of 2,2 kg of buttermilk per kilogram of butter produced was determined in 1968 and the technical justification for establishing this method of calculation is no longer available in the responsible Commission department. In view of the increasing milk fat content, a revision of the 2,2 coefficient is long overdue.

35. To prevent SM being diverted to human consumption it must either be denatured, or be subject to administrative control that provides guarantees equivalent to denaturing, if it is to qualify for aid as skimmed milk⁽³⁴⁾. In cases where the dairies receiving aid have a butter-making unit and a cheese-making unit, whey is added to the buttermilk. This product is automatically denatured⁽³⁵⁾ and cannot be

used for human consumption. It is, however, impossible to determine the exact buttermilk content by analysis, although this is necessary for the aid payment controls.

36. It was found in the Netherlands that the main aid beneficiary (98 % in 1996) supplied buttermilk produced, without denaturing, to a farm in Germany. The Dutch authorities, however, had never checked whether the buttermilk in question was actually used for animal feed and, moreover, they had not asked the German authorities to carry out such checks.

Aid for skimmed milk powder

General remarks

37. Industrial production of compound animal feedstuffs in the European Union is around 122 million t annually and is tending to increase slightly⁽³⁶⁾. The composition of these products vary, but they must all incorporate the necessary nutritional elements for fattening the animals in question. The essential elements are various forms of animal or vegetable protein. Milk-based protein, including skimmed milk powder, is an important element in the composition of these feedstuffs.

38. In the five years between 1993 and 1997 budgetary expenditure for skimmed-milk powder, used in the manufacture of feed compound, was reduced from ECU 495,4 million to ECU 365,3 million, a reduction of 26,3 %, despite the enlargement of the European Union. At the same time, the quantity of SMP subsidised was reduced from 676 000 t to 495 000 t (- 26,8 %). In so far as surplus disposal was possible only because of the Community aid, this was an encouraging development.

39. Regulation (EEC) No 1725/79 provides that aid is to be paid on the basis of monthly records of quantities considered to be eligible. Before the aid is paid the paying agencies are required, among other things, to verify that the results of laboratory analysis of samples for the month to which the application relates are satisfactory. In the absence of these results, the aid cannot be paid unless the results of the previous month's tests are satisfactory.

The findings of on-the-spot enquiries

40. In France aid applications relate to a week, not a month. However, in the absence of appropriate computer systems, it is particularly difficult to check whether the administration is handling the current aid in accordance with the Regulations, because of the number of transactions involved and the necessity of linking them to a specific month.

41. Whey is a by-product of cheesemaking and is in competition with skimmed-milk powder as a raw material. Whey is not eligible for

⁽³³⁾ Commission Regulation (EEC) No 2863/75 of 3 November 1975 (OJ L 285, 4.11.1975, p. 5).

⁽³⁴⁾ Article 1(a) and (b) of Commission Regulation (EEC) No 1105/68.

⁽³⁵⁾ According to Article 2 of Regulation (EEC) No 1105/68 the product is considered as denatured when:

- (i) the product is made sour,
- (ii) whey-concentrate is added,
- (iii) starch paste or puffed starch is added,
- (iv) azorubin E 122 is added.

⁽³⁶⁾ L'économie laitière en chiffres, CNIEL (Centre national interprofessionnel de l'économie laitière), Paris, 1997 edition.

Community aid and there is no aid for using it as an additive. Regulation (EEC) No 3480/90⁽³⁷⁾ amending Regulation (EEC) No 1725/79 accordingly laid down a method of analysis to be applied to the samples required by Regulation, with the aim of preventing the addition of rennet whey to SMP for which the aid is requested. However, as the model of the analysis report (Annex 1 to the Regulation) does not specifically mention the non presence of rennet whey, some Member States did not systematically carry out the test foreseen by Article 10(3) of the Regulation.

42. In Belgium some 20 % of the tests undertaken in 1996 for the detection of the presence of whey were positive. This level of irregularity indicates that these tests should be undertaken on a much more systematic basis. Furthermore, during an audit by the Court in the Netherlands it was found that 3 350 kg of SMP had been treated as eligible, despite the fact that the analysis report indicated that whey was present.

Weaknesses concerning the aid for SMP processed into compound feedingstuff in the territory of another Member State

43. According to Article 3 of Council Regulation (EEC) No 986/68, when skimmed milk powder produced in one Member State is denatured or used in the manufacture of compound feedingstuffs in the territory of another Member State, the first-mentioned Member State is authorised to pay the aid. Commission Regulation (EEC) No 1624/76⁽³⁸⁾ establishes special arrangements for the payment of aid for SMP in these circumstances.

44. According to the Regulations, the quantities are subject to verification by the Member State of destination. For that purpose, a security of 110 % of the aid to be paid must be lodged with the authorities in the Member State of destination which has to certify, on the EU control document (T5), that these requirements have been complied with. The aid is paid to the producer by the consignor Member State on the basis of that certification.

45. These procedures apply particularly to German and French deliveries of SMP to Italian and, to a lesser extent, Spanish producers of compound feedingstuffs. These two countries have a shortfall in SMP. The procedures laid down are of financial interest, because the aid is paid immediately after the receipt of the certificate from the Member State of destination, instead of following denaturing or compounding. In 1997 these particular provisions affected aid payments for 61 000 t in Germany and 4 000 t in France, corresponding to some 15 % of the aid disbursed.

46. In its annual report for 1988 the Court proposed the abolition of this particular system of granting aid. In 1989, for the reasons set out below, the Commission likewise proposed the amendment of Article 3 of Regulation (EEC) No 986/68, which provided the legal base for this practice. The reasons were:

- (a) the factors involved in the operation of the system had evolved considerably, to the point where the grounds cited at the time no longer applied (to facilitate trade);
- (b) since the control systems are, of necessity, more complicated, the measure is more vulnerable to irregularity, far more so than under a normal system such as that provided for by Regulation (EEC) No 1725/79.

47. The last Commission proposal for the abolition of this particular system dates from 1993⁽³⁹⁾. The Council did not follow up the Commission proposal and the system is therefore still in force.

48. Weaknesses of Regulation (EEC) No 1624/76 were again confirmed in the context of the Court's audit, notably:

- (a) the consignor (exporting) Member State is responsible only for the control of the quality of SMP and for the check of copies of the T5 control document with the certificate from the importing Member State stating that the security was received. The importing Member State is responsible for the control of the production of the feedingstuff. The administrations of the two Member States are often not aware of the controls of the other Member State. In fact the Regulation does not require that the results of the inspections about the denaturation or processing in the importing Member States be communicated to the consignor Member State;
- (b) whereas the aid for SMP in compound feedingstuff on the basis of Regulation (EEC) No 1725/79 is paid after the denaturation or processing, Regulation (EEC) No 1624/76 provides for a delay of six months in this respect;
- (c) the quality of SMP is tested in the consignor Member State at its departure but not at its arrival at the Member State of destination. The controls relating to the denaturation or processing in the importing Member State will not necessarily show if there is an unallowed substitution of the SMP for which the aid was granted by the consignor Member State. There is in fact a risk that the SMP delivered is replaced by substitutes, such as SMP of lower quality, either during the transport or at the arrival at the destination⁽⁴⁰⁾;
- (d) the scrutiny, as foreseen by Council Regulation (EEC) No 4045/89⁽⁴¹⁾ is initiated by the exporting Member State. For the companies selected, control requests are sent by the exporting Member State to the importing Member States. However, these requests pertain to export transactions (such as all exports of one particular company) and concern audit at the processor in relation to the selected export transactions only. Therefore the scrutiny audit does not cover all activities and all supplies to a particular producer of feedingstuff.

49. As already indicated by the Commission in 1989 (see paragraph 46), the developed state of the internal market no longer calls for the special arrangements that were established under difficult circum-

⁽³⁹⁾ COM(93) 211 final, of 17 May 1993.

⁽⁴⁰⁾ The risk of non-compliance is even higher if the quantities are transported in bulk.

⁽⁴¹⁾ OJ L 388, 30.12.1989, p. 18.

⁽³⁷⁾ OJ L 366, 1.12.1990, p. 68.

⁽³⁸⁾ OJ L 180, 6.7.1976, p. 9.

stances at a time when it was considered desirable to foster internal trade. The aid could, in fact, be paid on the basis of Regulation (EEC) No 1725/79 by the competent paying agency in the Member State in which processing took place.

Weaknesses relating to public storage

50. The major exporter of Irish dairy products arranges storage facilities for SMP intervention stocks, using private storage facilities. It could therefore be considered, on the one hand, as a delegated service⁽⁴²⁾ of the paying agency, and on the other hand, the almost exclusive tenderer for sales from intervention stocks. In such circumstances there is a clear need for an institutional separation of responsibilities.

51. To ensure that the SMP offered into intervention satisfies the conditions stipulated in Regulation (EC) No 322/96 the responsible dairy inspectors of the Irish paying agency⁽⁴³⁾ take samples for testing in the State laboratories. However, the laboratory analysis bulletins attesting the results of such tests were not validated and only photocopies were made available to the paying agency.

52. Article 5 of Regulation (EC) No 322/96 stipulates that the storage depots for SMP must be dry, well maintained and free of vermin, free of extraneous odours and permit good ventilation. However, the two storage centres visited by the Court in the United Kingdom did not meet these criteria. There were no dehumidifiers installed (traces of humidity were found in one warehouse) and only rudimentary measures were taken against rodents/pests.

CONCLUSION

53. Despite the introduction of milk quotas in 1984 only 37 % of the SMP produced in the European Union is sold at market prices. The remainder (63 %) is exported with refunds that are financed by the Community budget or is sold on the internal market with aid that amounts to approximately 35 % of the market price (see paragraphs 9 and 21).

54. The aid for SM and SMP used in animal feedstuffs (ECU 386 million in 1997) facilitated the disposal of approximately 500 000 t, i.e. 40 % of the Union's annual SMP production (see paragraphs 10 and 11).

⁽⁴²⁾ Delegated service in the sense of Commission Regulation (EC) No 1663/95.

⁽⁴³⁾ DAFF is the Irish paying agency for EAGGF Guarantee expenditure (Department of Agriculture, Forestry and Food).

55. The Commission does not have a comprehensive document, analysis or studies, which would justify the retention of the level of aid that has been in force since 1993, taking account of the rising level of stocks in certain Member States, *inter alia*. In the Court's opinion the implementation of tendering arrangements such as those recommended in its Annual Report, some 10 years ago, concerning the 1988 financial year is still relevant (see paragraphs 21 to 23).

56. The Regulations do not clearly state the specifications that must be satisfied by SM and SMP intended for animal feed if they are to qualify for aid. In line with the other disposal measures applied in the milk sector (butter) the granting of aid for SMP should be subject to minimum product quality standards, in particular with reference to the minimum protein content (see paragraphs 15 to 17).

57. It was found (in Belgium, France and Italy) that the national administrations were paying aid for estimated quantities of SM supplied and (in Belgium, Germany, France and Italy) accepted that the samples for laboratory analysis were taken from quantities of the product in the plant, instead of being taken from the quantities delivered. The Community Regulations do not provide for these practices, which place the reliability of the control systems at risk. There is, therefore, a need for the Commission to review the situation (see paragraphs 30 to 32).

58. The Commission should re-examine the standard method for calculating the quantity of skimmed milk qualifying for aid that dairies use for feeding their own animals. The adequacy of the applicable coefficient should be reassessed and the use of the method restricted to very small dairies feeding their own animals (see paragraphs 33 and 34).

59. The Commission should reassess the controls to ensure non-addition of whey to buttermilk. The controls concerning non-denatured buttermilk delivered to farmers in a Member State different from where the buttermilk is produced should also be reviewed. The initiatives necessary to improve these controls should be taken by the Commission (see paragraphs 35 and 36).

60. Uncertainty exists regarding the systematic testing for the absence of rennet whey in SMP. Because of the risk of irregularities, the Commission should ensure that the Regulations are amended (see paragraphs 41 and 42).

61. Where aid is paid in one Member State for the SMP used in the manufacture of animal feed in another Member State, the SMP should be sampled and tested on arrival at its final destination, so as to ensure that there is adequate control. The test results would confirm whether or not the SMP complied with Community requirements. Should this procedure prove unsuitable, either for administrative reasons or on grounds of cost, the special arrangements introduced by Regulation (EEC) No 1624/76 should be abolished, as the Court suggested in the Annual report concerning the 1988 financial year (see paragraphs 43 to 49).

62. The audit of the implementation of the Community SMP intervention and storage system in Ireland and the United Kingdom (the main beneficiaries) revealed that, in Ireland, the only tenderer for sales of intervention stocks is simultaneously responsible for the organisa-

tion of the public storage arrangements (see paragraph 50). Of the two warehouses that were visited in the United Kingdom neither complied with the regulatory requirements concerning warehouses (see paragraph 52).

This report was adopted by the Court of Auditors in Luxembourg at its meeting of 25 March 1999.

For the Court of Auditors

Jan O. KARLSSON

President

Table 1
Overview of European Union dairy production (EU- 15)

(1 000 tonnes)

	1984	1993	1994	1995	1996	1997
1. Dairy cows' milk production	136 247	119 630	120 179	121 546	121 182	120 653
2. Dairy cows' milk deliveries	123 588	110 854	111 515	113 729	113 697	113 283
3. Drinking milk production	26 449	30 267	30 320	31 003	30 722	30 350
4. Butter						
Dairy	2 622	1 828	1 799	1 854	1 857	1 828
Farm	35	21	18	18	15	12
Total butter production	2 657	1 849	1 817	1 872	1 872	1 840
5. Cheese						
Dairy (cows' milk)	4 508	5 509	5 650	5 874	5 932	5 986
Farm (cows' milk)	81	59	59	57	54	52
Other (goats' milk, etc.)	293	446	459	509	497	502
Total cheese production	4 882	6 014	6 168	6 440	6 483	6 540
6. Milk powders						
Skimmed	2 364	1 307	1 232	1 215	1 192	1 140
Semi-skimmed	199	181	185	177	162	183
Whole	668	773	816	801	734	767
Buttermilk	52	49	52	54	57	51
Total milk powder production	3 283	2 310	2 285	2 247	2 145	2 141
7. Condensed and evaporated milk production	1 645	1 324	1 284	1 340	1 324	1 373
8. Casein and caseinate production	127	116	111	142	133	133
Liquid skimmed milk used	4 225	3 761	3 724	4 714	4 412	4 374
9. Skimmed milk returned to farmers	6 618	422	409	383	357	303

Source: Cronos and forecasts including estimates of the Commission.

Table 2
Skimmed-milk powder (SMP) balance sheet

(1 000 tonnes)

	EUR 12 1995	EUR 15 1995	EUR 15 1996	EUR 15 1997	EUR 15 1998
1. Public stocks at 1 January	72	72	14	125	135
2. Production ⁽¹⁾	1 197	1 268	1 278	1 208	1 185
3. Imports	31	35	50	64	70
4. Quantity available	1 300	1 375	1 342	1 397	1 390
For human consumption (not subsidised)	410	420	440	445	450
For animal feed	587	594	543	495	480
5. Total uses	997	1 014	983	940	930
Commercial exports	336	347	218	276	240
Food aid exports	25	25	9	4	5
6. Total exports	361	372	227	280	245
7. Public stocks at 31 December	14	14	125	135	215 ⁽²⁾
8. Skimmed milk used for the manufacture of casein in SMP equivalent.	434	438	422	395	n/a

⁽¹⁾ The data at row 2 differs from the 'milk powder' data in Table 1 because they were drawn from different databases, and different methods of categorising buttermilk powder were used.

⁽²⁾ Estimated.

Source: Commission DG VI.

Table 3

Expenditure related to skimmed milk and skimmed milk powder compared with overall expenditure on the milk CMO.

(ECU million)

Year	B1-2 0: Milk CMO Overall expenditure (1)	Expenditure on SM and SMP (2)=(3)+(4)+(5)+(6)+(7)	B1-2 0 0 1 SMP export refunds (3)	B1-2 0 1 SMP storage (4)	B1-2 0 2 0 B1-2 0 2 1 Aid for SM/SMP for calf feed (5)	B1-2 0 2 2 B1-2 0 2 3 Aid for SM/SMP for other animals (6)	B1-2 0 2 4 Aid for SM for cassein (7)
1993	5 211	1 005	193	- 45	521	0	336
1994	4 249	922	73	69	501	- 1	279
1995	4 028	901	199	- 89	448	0	343
1996	3 582	1 042	138	155	438	1	311
1997	3 100	875	171	30	386	0	288

Source: DG VI - Evolution of EAGGF Guarantee payments.

Table 4
Aids for skimmed milk and skimmed milk powder for calf feed.

(ECU million)

Member States	SMP (B1-2 0 2 0)					SM (B1-2 0 2 1)					Total				
	1993	1994	1995	1996	1997	1993	1994	1995	1996	1997	1993	1994	1995	1996	1997
Belgium	15,7	15,6	15,3	12,0	8,7	5,8	4,8	4,4	4,6	3,1	21,6	20,3	19,7	16,6	11,8
Denmark	1,0	0,8	1,0	0,8	1,4	0,8	0,7	0,4	0,3	0,2	1,8	1,5	1,4	1,1	1,6
Germany	115,8	117,4	86,8	88,5	77,4	8,8	8,2	7,7	6,6	6,4	124,6	125,6	94,5	95,1	83,8
Greece	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Spain	0,4	0,0	0,1	0,2	0,4	0,0	0,0	0,0	0,0	0,0	0,4	0,0	0,1	0,2	0,4
France	206,3	200,7	182,2	178,0	153,0	2,3	1,4	1,5	1,5	0,9	208,6	202,1	183,7	179,5	153,9
Ireland	8,5	4,3	5,8	3,2	4,1	0,8	0,8	0,7	0,8	0,9	9,3	5,2	6,5	4,0	5,0
Italy	1,1	0,6	0,3	1,0	0,7	5,4	7,5	5,0	9,8	7,7	6,5	8,2	5,3	10,8	8,4
Luxembourg	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Netherlands	137,4	130,4	126,8	114,7	107,6	0,5	0,3	0,4	0,4	0,4	137,9	130,7	127,2	115,1	108,0
Austria	0,0	0,0	1,4	3,7	3,8	0,0	0,0	0,6	2,0	1,1	0,0	0,0	2,0	5,7	4,9
Portugal	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Finland	0,0	0,0	0,3	1,5	1,7	0,0	0,0	0,0	0,2	0,3	0,0	0,0	0,3	1,7	2,0
Sweden	0,0	0,0	0,5	1,2	1,2	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,5	1,2	1,2
United Kingdom	9,1	7,3	6,7	6,3	5,3	0,9	0,6	0,2	0,2	0,2	10,0	7,9	6,9	6,5	5,5
Total	495,3	477,1	427,2	411,1	365,3	25,3	24,3	20,9	26,4	21,2	520,7	501,5	448,1	437,5	386,5

Source: Evolution of EAGGF payments by Member States, DG VI.

Table 5
Quality requirements and definitions for SM and SMP

	Council Regulation (EEC) No 986/68	Commission Regulation (EEC) No 1105/68 (SM)	Commission Regulation (EEC) No 1725/79 (SMP)	Commission Regulation (EEC) No 322/96 (Intervention-public storage)
Skimmed milk (SM)	SM milk or buttermilk with a fat content not exceeding 1 %. Aid is granted for: — SM processed sold to farmers for feed (the modalities of which were to be determined), — SM used for feed on the holdings where it is produced, — SM used for compound feedingstuffs.	The maximum fat content can be exceeded by 25 % under certain conditions. The defatted dry matter content of SM and buttermilk should be at least 8,75 % and 8 %, respectively-subject to certain exceptions. Aid for buttermilk is paid at a reduced rate if the dry matter content is not less than 4 %. 100 litres SM=103 kg No dilution with water or whey 'which is not part of normal production process'.	SM must comply with conditions of Regulation (EEC) No 986/68, and should not contain additives. SM mixed with other products may be eligible for aid if no products apart from fat, vitamins, minerals, sucrose, and certain other agents (anti-oxidants, emulsifiers, anti caking, etc.) are added. The same requirements for testing apply as for SMP (see below).	Not applicable.
Skimmed milk powder (SMP)	SMP: milk or buttermilk powder with a fat content not exceeding 11 %: Aid granted for: — denatured SMP, — SMP included in compound feedingstuffs.	SMP which complies with the conditions of Regulation (EEC) No 1725/79 (but not buttermilk powder) is eligible for aid if sold in liquid form but only if the quantity does not exceed 40 % of SM sold to the livestock farmer in the previous year. Same provisions as for SM apply.	SMP must comply with conditions of Regulation (EEC) No 986/68 and should not contain additives. The maximum water content is 5 % (for each 0,2 % more the aid is reduced by 1 %). SMP mixed with other products may be eligible for aid if no products apart from fat, vitamins, minerals, sucrose, and certain other agents (antioxidants, emulsifiers, anti caking, etc.) are added. Detailed testing is required to check that rennet whey has not been added. Checks must also establish that the following products in particular are not contained in SMP: — lucerne meal or grass meal, — starch or puffed starch, — fish meal.	In order to be eligible for intervention, the SMP should have a protein content of at least 35,6 % of the non-fat dry matter. A lower intervention price is available for SMP with a protein content of at least 31,4 %. The following conditions also apply: — fat content: 1 % maximum, — water content: 3,5 % maximum, — titrable acidity: 19,5 ml maximum, — lactate content 150 mg/100 g maximum, — additives: none, — phosphate test: negative, — solubility index: 0,5 ml maximum, — burnt particles: 15,0 mg maximum, — micro organisms: 40 000 maximum per gram, — detection of coliforms: negative, — no buttermilk, no whey, — antimicrobial substances: negative, — taste/smell/appearance: clean free from impurities and coloured particles.
Other definitions	No additional definitions.	No additional definitions.	No additional definitions.	Buttermilk: the by-product of butter manufacture obtained after churning of the cream and separation of the solid fat. Whey: the by-product of cheese or casein obtained by the action of acids, rennet and/or chemical physical processes.

Table 6
External trade of skimmed milk powder in the European Union

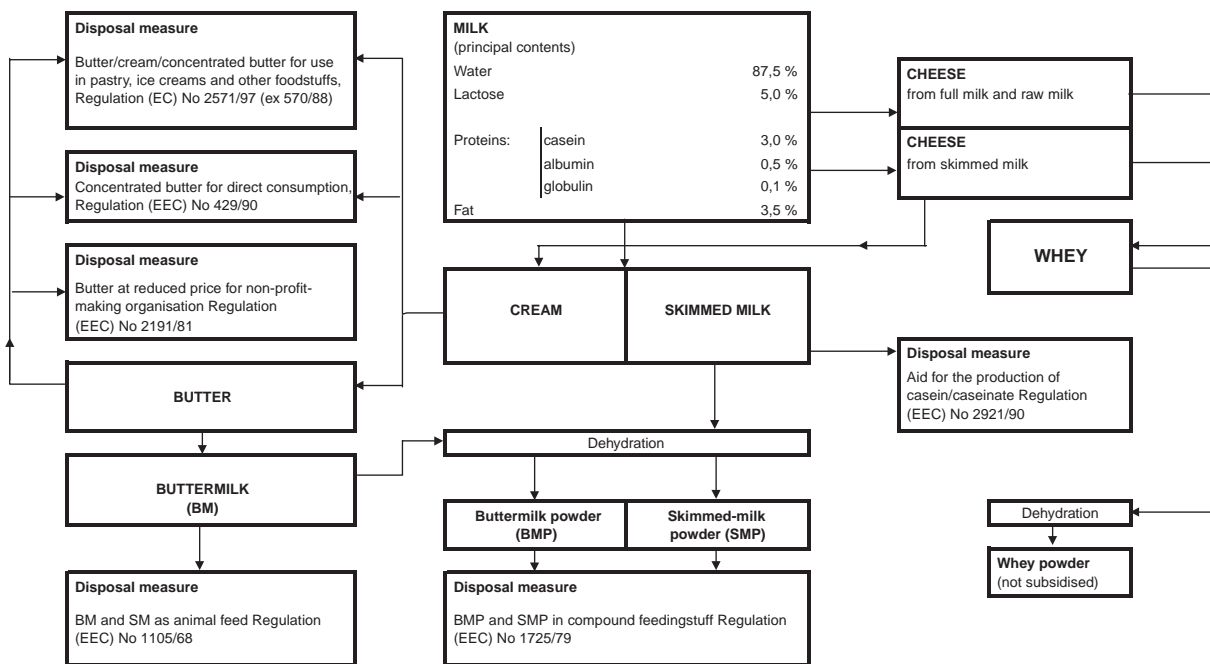
(in tonnes)

Exports	1993	1994	1995	1996	1997	Imports	1993	1994	1995	1996	1997
<i>CEEC countries:</i>						<i>CEEC countries:</i>					
Czech Republic	50	33	4	54	29	Czech Republic	1 980	1 886	2 600	3 397	4 310
Hungary	1	8	13	1	344	Hungary	0	1	3	96	59
Poland	30	1 124	31	23	84	Poland	3 246	3 959	11 477	16 097	25 001
Slovakia	15	0	43	68	37	Slovakia	369	905	1 228	1 484	1 656
Total CEECs	96	1 165	91	146	494	Total CEECs	5 595	6 751	15 308	21 074	31 026
<i>Baltic States:</i>						<i>Baltic States:</i>					
Estonia	8	2	10	2	27	Estonia	142	254	841	7 920	9 551
Latvia	8	1	30	13	26	Latvia	114	0	32	909	2 570
Lithuania	2	72	49	2	24	Lithuania	3 373	368	2 461	7 538	11 062
Total Baltic States:	18	75	89	17	77	Total Baltic States	3 629	622	3 334	16 367	23 183
<i>Bulgaria and Romania:</i>						<i>Bulgaria and Romania:</i>					
Bulgaria	140	148	209	36	55	Bulgaria	0	0	0	0	0
Romania	39	7	231	499	169	Roumania	253	0	58	259	586
Total Bulgaria and Romania	179	155	440	535	224	Total Bulgaria and Romania:	253	0	58	259	586
<i>Other countries:</i>						<i>Other countries:</i>					
Mexico	88 122	28 460	49 648	75 829	99 583	Ukraine	10	40	734	3 628	4 278
Algeria	34 189	6 287	22 828	26 503	22 977	Russia	3 359	215	1 309	5 210	3 435
Philippines	3 780	2 608	13 269	3 901	13 052	Belarus	209	0	860	1 063	540
Malaysia	15 753	6 257	24 240	10 371	12 890	New Zealand	128	6	149	490	406
Indonesia	11 757	5 226	17 290	6 028	11 426	Egypt	0	0	0	0	160
Singapore	3 823	2 709	15 167	5 127	8 983	Moldova	0	0	0	0	80
South Africa	497	183	949	3 343	7 215	United States of America	18	9	5	0	28
Thailand	4 320	4 244	15 186	8 216	6 442	Mexico	0	0	0	575	25
Egypt	2 158	766	1 586	2 601	6 302	India	0	0	0	300	25
Cuba	8 724	977	8 660	3 398	5 783	Others	4 299	1 023	9 398	1 432	117
Other	105 281	79 815	206 242	81 975	85 698	Total others countries	8 023	1 293	12 455	12 698	9 094
Total other countries	278 404	137 532	375 065	227 292	280 351						
Total exports	278 697	138 927	375 685	227 990	281 146	Total imports	17 500	8 666	31 155	50 398	63 889

Source: Commission DG VI-D.1 document reference IV044.xls.

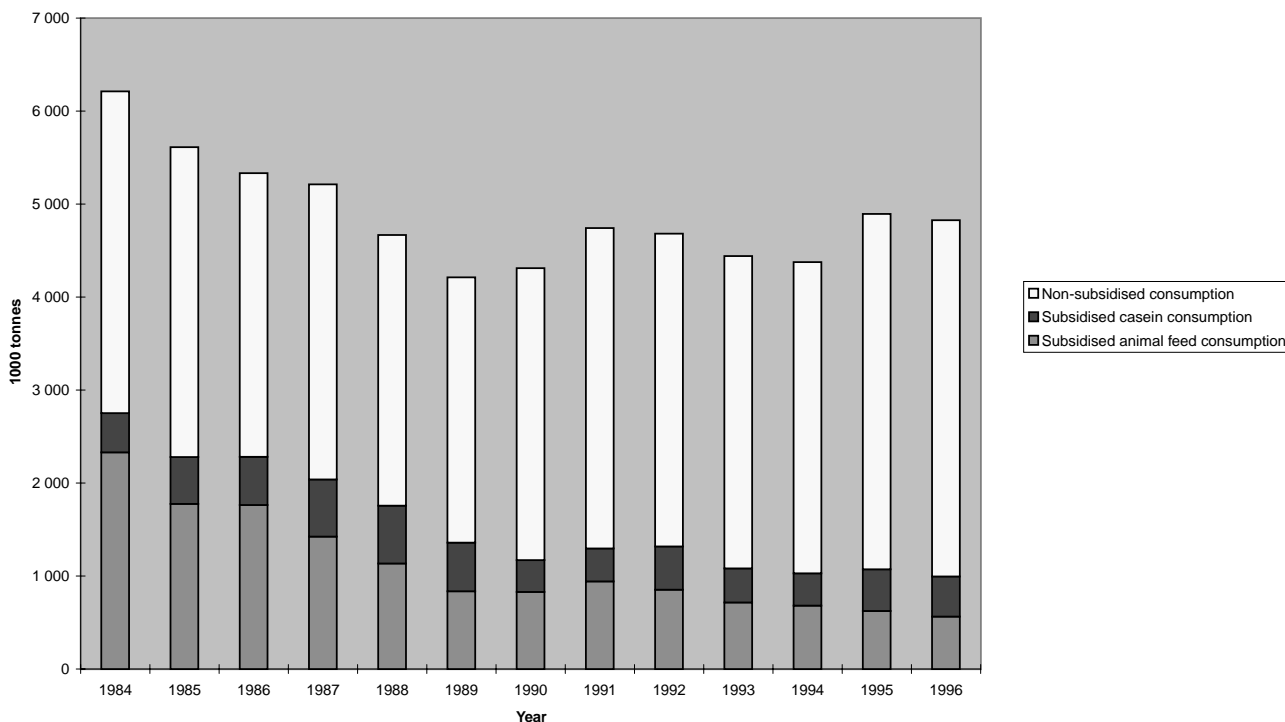
Graph 1

Milk and milk products and existing disposal measures



Graph 2

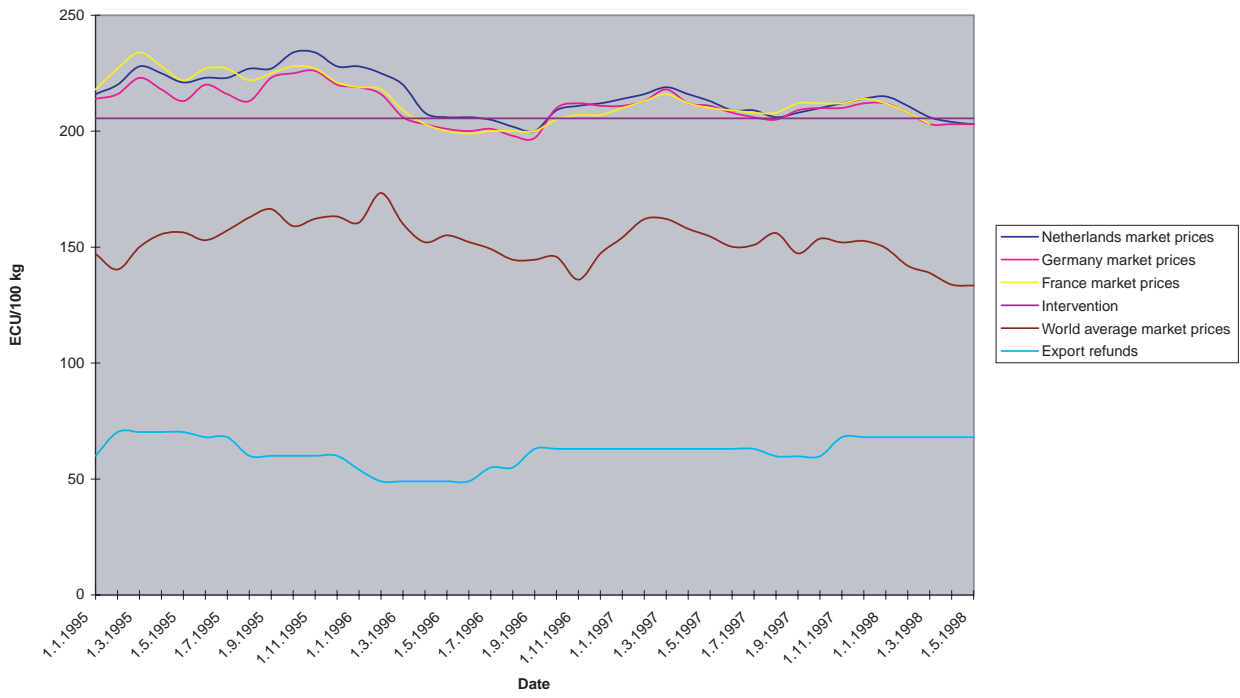
Subsidised and non-subsidised consumption of skimmed milk and skimmed milk powder in the European Union



Note: Liquid skimmed milk is expressed in terms of skimmed milk powder equivalent.

Source: Annexes to Commission (DG VI) document 'Situation and outlook - dairy sector', April 1997.

Graph 3
Key skimmed milk powder prices



Source: Court of Auditor's review of various Commission documents.

COMMISSION'S REPLIES

SUMMARY

To avoid building up of stockpiles, the common market organisation (CMO) for milk and milk products provides for different disposal measures on the internal market. The aim of these measures is to provide for additional outlets for milk ingredients, which would otherwise be replaced by cheaper alternatives. As regards the protein part of milk, three measures are currently in force which absorb a total quantity of some 10,3 million t of skimmed milk (i.e. around 9 % of total European Union milk deliveries). The Court's report examines two measures that relate to the use of liquid skimmed milk and skimmed-milk powder used as animal feed. They account for 3,2 % (Regulation (EEC) No 1105/68) and 50,4 % (Regulation (EEC) No 1725/79), respectively, of the total quantity mentioned above.

Over the past 10 years, the volumes of skimmed milk and skimmed-milk powder (SMP) subsidised for the use in animal feed have substantially declined: from a total quantity of 12,5 million of skimmed milk equivalent in 1988 down to 5,5 million t in 1998. As regards the use of liquid skimmed milk for cattle feeding on farms, the substantial decrease of volumes sold under this scheme is due to the dairy industry's preference for further processing of the skimmed milk whenever possible (to reduce transport costs and create added value). Moreover, cattle farmers prefer using compound feedingstuffs rather than mixing different ingredients themselves. The use of skimmed milk powder for the production of compound feedingstuffs (mainly calf feed) decreased substantially as a result of its substitution, mainly by whey powder.

The Commission agrees with the Court that it would be appropriate to link the aid closer to the quality (protein content in particular) of the skimmed-milk powder.

The Commission examines on a regular basis the market management measures for skimmed-milk powder both within its services and with the Member States in the framework of the Management Committee for Milk and Milk Products. On the basis of these discussions and taking account of the developments on the milk and veal markets in recent years, the Commission is convinced that the aid was fixed at an appropriate level.

The Commission is not convinced that fixing the aid through a tendering procedure would be useful under this aid scheme. The Commission fears that the administrative burden and the financial risks involved in such procedure would, either have a dissuasive effect on the use of skimmed-milk powder, or limit the participation in the tenders to a small group of specialised operators thus limiting considerably the competition within the system.

Imports of skimmed-milk powder from third countries, as part of the Union's WTO commitments, become part of the global surplus on the Community market and cannot therefore be isolated from market management. A differentiated treatment between European Union and imported products would necessitate the introduction of onerous control mechanisms.

The Commission is planning a review of the aid scheme for liquid skimmed milk used as animal feed. If this examination confirms the need to maintain all or parts of this scheme, the implementing rules will be reinforced notably as regards the control procedures and the eligibility criteria.

The Commission proposed to the Council back in 1989 to delete the provision in Council Regulation (EEC) No 986/68 that authorises the payment of the aid in the Member State where the skimmed-milk powder is produced. In the framework of Agenda 2000, the review of the milk policy should result in abolishing this special aid arrangement. The legal situation has changed following the proposal for a new basic Regulation on the milk sector. In Agenda 2000, the Commission proposes repealing Regulation (EEC) No 986/68, which allows the Member States to utilise the above-mentioned payment arrangements. The new Regulation lays down no provisions requiring the Commission to maintain those arrangements from 1 January 2000.

With regard to the problems indicated concerning the application of the regulations and the cases noted by the Court, the Commission will carry out all the checks necessary and will follow them up under the clearance of accounts procedure.

COMMUNITY AID AND THE MILK MARKET***The common market organisation for milk and milk products***

10. The high proportion of SMP that requires aid for its disposal can be explained by the fact that SMP is a residual outlet for skimmed milk. In other words, surplus milk that cannot be processed into other added value dairy products is used for the manufacture of SMP and butter, the two intervention products, which are the basis for the market support mechanism in the dairy sector.

The legal context

14. As part of the Agenda 2000 package, the Commission has submitted a proposal for a new basic Council Regulation on the common market organisation for milk and milk products. One of the aims of this proposal is to simplify the existing legislation, notably by suppressing all Council Regulations laying down general implementing rules. The latter list includes Regulation (EEC) No 986/68. Consequently, once this Regulation is adopted, the Commission will proceed to a redrafting of Regulations (EEC) No 1725/79 and (EEC) No 1105/68, in case it would be decided to maintain the latter scheme.

Observations on the Commission Regulations

16.(a). The Commission agrees with the Court; the scheduled revision of Regulation (EEC) No 1725/79 should include a critical examination of the need to introduce a minimum requirement on the protein content of SMP subsidised under this scheme or, alternatively, to link aid payment to the quantity of milk protein used in animal feedingstuffs.

16.(b). The Commission agrees with the Court; the 25 % tolerance should be removed to ensure compliance with Council Regulation (EEC) No 986/68. However, the Commission underlines that, given the higher value of milk fat *vis-à-vis* milk protein, there is no economic advantage for operators in selling liquid milk with an excessively high fat content.

16.(c), (d) and (e). The Commission intends to examine the situation with regard to Regulation (EEC) No 1105/68 once the new basic Regulation for the milk sector will be adopted by the Council (see remarks on point 14). In view of the marginal importance of this scheme for the balance on the milk protein market (3 % of the total subsidised volume of skimmed milk on the internal market), the need to maintain this measure will be assessed. This examination will take into account that the present Regulation covers four different *modus operandi*, which inevitably requires a multiplication of eligibility criteria and administrative and control procedures.

16 and 17. If the scheme is maintained, the Commission agrees with the Court that the relevant Regulation should provide for detailed rules on the eligibility criteria for aid as well as on the control and administrative procedures.

The market for SMP

20. The Commission is convinced that the rate of incorporation is a useful tool for steering the uptake of skimmed-milk powder under this aid scheme. Taking account of the present market conditions, and of the accumulation of public stocks in particular, the Commission believes that the 50 % rate should be maintained.

As indicated by the Court, the Commission will continue to examine, as in the past, the effects of this rule and adjust the rate when appropriate.

Moreover, it should be underlined that the control procedures relating to the content of skimmed milk powder in feedingstuffs are less reliable in case of low incorporation rates.

Fixing the level of aid

22. The Commission should firstly like to stress that the intervention price for skimmed-milk powder has remained unchanged since 1 July 1993 (except for the green rate adjustment on 1 February 1995). Hence, the main parameter for fixing the aid level has been static since the last aid adjustment.

Furthermore, the other parameters mentioned in Article 2a(1) of Regulation (EEC) No 986/68 are regularly assessed notably in the framework of the decisions on the minimum incorporation rate or in relation to other decisions on the management of the milk protein market. These measures have been analysed in different notes or working documents and were discussed with Member States in the Management Committee for Milk and Milk products. The Commission will examine how to improve the recording of such deliberations.

As regards the level of aid applied since 1993, the Commission is convinced that the decision to maintain the aid at the same level was justified in view of the situation on the market. Moreover, in view of the declining market share of skimmed-milk powder in this sector, there is no reason to assume that the aid level was fixed at too high a level during all or even part of the period examined. Over the past 10 years, whey powder has replaced a large part of the skimmed-milk powder uses in calf feed, to the extent that more than two thirds of the total whey powder production is now absorbed by calf feed. This underlines the strong competition between SMP and whey powder for use in animal feed.

23. The Commission recognises that a tender procedure can be a useful tool for fixing an aid at an appropriate level under certain conditions. However, in the case of the aid schemes for skimmed milk and skimmed-milk powder used as animal feed, the Commission remains convinced that a tender procedure could not play a useful role. There are several arguments in support of this thesis.

Firstly, experience gained on other aid schemes indicates that operators are not inclined to effectively use the tender system as an instrument for aid fixing but rather as a means of prefixing the aid for a

certain quantity of eligible product. In this case, the initiative for changing the aid level is taken by the Commission just as in the case where a fixed aid level applies.

Secondly, participating in a tender procedure requires additional administrative work and related costs for an operator. It may be assumed that these elements will ultimately be discounted in the offer. For the same reasons, it is likely that compound feed manufacturers will try to avoid the risks and burden of the tendering procedure in which case they could ask a trader to deliver this service. In turn this would imply that the participation in the tender would be limited to a small number of specialised traders, who also supply the skimmed milk powder, which would limit considerably the element of competition that is a prerequisite for an efficient tendering arrangement.

External trade

27. As regards skimmed-milk powder imported from third countries, the Commission has submitted a proposal to the Council in 1993 (see COM(93) 211 final) with a view to limiting the amount of the aid paid on these products to the amount of duty paid on import. The Council did not adopt this proposal, because a majority of Member States felt that it would be impossible to control the origin of skimmed-milk powder once it is in free circulation on the Community market. For the same reasons, Member States expressed great resistance against excluding imported skimmed-milk powder from the aid scheme as an alternative option.

THE MEMBER STATES' MANAGEMENT

Aid for liquid skimmed milk

The findings of on-the-spot enquiries

31 to 36. As indicated above, the operation of Regulation (EEC) No 1105/68 will have to be reviewed as a consequence of the proposals related to Agenda 2000. On this occasion, the Commission will examine the need to maintain all or parts of this scheme and will endeavour to introduce specific and binding control procedures taking account of the Court's findings and recommendations.

The Court's observations will be followed up in the clearance of accounts procedure and duly notified to the Member States concerned. If confirmed, they might lead to financial corrections. For the case mentioned by the Court concerning the Netherlands (paragraph 36) the Commission's services have initiated the procedure for the necessary follow-up checks on-the-spot.

Aid for skimmed milk powder

The findings of on-the-spot enquiries

40. Regulation (EEC) No 1725/79 provides that monthly records should be kept on the quantities of products used and manufactured by approved companies (Article 8(1)(b) and (3)). Reconciliation between

the aid application and the monthly records should always be possible. The French practice of weekly payments is acceptable as regards the principle, provided that the practical application allows for the reconciliation of aid claims and monthly records. This matter will be followed up in the clearance of accounts procedure.

41. The Commission certainly agrees with the Court that the testing for the presence of whey must be systematic as foreseen by Article 10(3) of the Regulation and that irregularities detected should be followed up rigorously at Member State and Community level. As regards the high percentage of tests indicating presence of whey in Belgium, the Commission services are of the opinion that normally this should lead to an increase of the number of samples. The Court's observations will be followed up in the clearance of accounts procedure.

42. For the Court's findings concerning 3 350 kg of SMP for which aid had been paid despite the presence of whey, the Dutch authorities have stated that the payment has been recovered. This will be verified in the clearance of accounts procedure.

Weaknesses concerning the aid for SMP processed into compound feedingstuffs in the territory of another Member State

43 to 49. As indicated by the Court, the Commission proposed to the Council back in 1989 (see COM(89) 448 final) to delete the provision in Article 3(1) of Regulation (EEC) No 986/68 that authorises the payment of the aid in the Member State where the skimmed-milk powder is produced. This proposal was discussed in several meetings, but no qualified majority was found to allow the adoption of the text.

As indicated above, the Agenda 2000 proposals for the milk sector have placed this dossier in a new perspective. If the Council adopts the new basic Regulation proposed by the Commission, rules concerning the aid payment will have to be specified in the implementing Commission Regulation. In line with its abovementioned proposal, the Commission does not intend to provide for the kind of payment regime described above.

48. The Court's observations will also be followed-up in the clearance of accounts procedure.

Weaknesses relating to public storage

50 to 52. With regard to the problems indicated concerning the application of the Regulations and the cases noted by the Court, the Commission will carry out all the checks necessary and will follow them up under the clearance of accounts procedure.

CONCLUSION

53. The high proportion of SMP that requires aid for its disposal can be explained by the fact that SMP is a residual outlet for skimmed

milk. Surplus milk that cannot be processed into other added value dairy products is used for the manufacture of SMP and butter, the two intervention products, which are the basis for the market support mechanism in the dairy sector.

55. The Commission underlines that the market management measures for skimmed-milk powder have indeed been regularly examined both within its services and with the Member States in the framework of the Management Committee for Milk and Milk Products. On the basis of these discussions and taking account of the developments on the milk and veal markets in recent years, the Commission is convinced that the aid was fixed at an appropriate level. However, the Commission will continue to reassess the appropriateness of the aid level and the incorporation rate.

The Commission is not convinced that fixing the aid through a tendering procedure would be appropriate in this case. The Commission fears that the administrative burden and the financial risks involved in such a procedure would, either have a dissuasive effect on the use of SMP, or limit the participation in the tenders to a small group of specialised operators thus limiting considerably the competition within the system.

56. The Commission will examine how to improve the link between aid level and quality of the eligible products.

57 to 59. The Commission is planning a review of the aid scheme for liquid skimmed milk used as animal feed (Regulation (EEC) No 1105/68), which accounts for less than 3 % of the subsidised disposal of skimmed milk on the internal market. If this examination confirms the need to maintain all or parts of this scheme, the implementing rules will be reinforced notably as regards the control procedures.

60. In the framework of the planned revision of Regulation (EEC) No 1725/79, the Commission will give particular attention to this point.

61. The Commission refers to its proposal to the Council of 1989, which intended to suppress the regime covered by Regulation (EEC) No 1624/76. In the framework of Agenda 2000, the review of the milk policy should result in abolishing this special aid arrangement.

62. With regard to the problems indicated concerning the application of the Regulations and the cases noted by the Court, the Commission will carry out all the checks necessary and will follow them up under the clearance of accounts procedure.
