EXPLANATORY MEMORANDUM

REASONS AND OBJECTIVES OF THE PROPOSAL

The main objectives set out for the Commission Communication "Preparing the Health Check of the CAP reform" of 20 November 2007 were to assess the implementation of the 2003 CAP reform, and to introduce those adjustments to the reform process that are deemed necessary in order to further simplify the policy, to allow it to grasp new market opportunities and to prepare it for facing new challenges such as climate change, water management and bio-energy.

The most recent reforms of the CAP marked a new phase in this process by decoupling the majority of direct payments via the Single Payment Scheme (SPS) in 2003 for the sectors of arable crops, beef and sheep, and dairy and in 2004 for olive oil, cotton and tobacco. As part of the 2003 reform, Rural Development (RD) policy was strengthened with additional funds and with the reform of its policy instruments in 2005. Finally, the reform process continued with reforms in sugar (2006) and fruit and vegetables and wine (2007).

The above reforms reflect the significant shift in the orientation of the CAP, which is more capable today to meet its fundamental objectives.

Producer support is to a large extent (90%) decoupled from production decisions, allowing EU farmers to make their choices in response to market signals, to rely on their farm potential and their preferences when adapting to changes in their economic environment. This is the most efficient way of meeting the Treaty obligation of farm income support.

The shift away from product support, widely viewed as an origin of the surplus problems of the past, and the reduction of EU support prices, brought EU agriculture much closer to world markets, improving market balances and reducing the budgetary costs of intervention stocks or surplus disposal.

The results of the reform process increased the competitiveness of EU agriculture, which, despite the decline of EU share in most commodity markets, became the largest agricultural exporter, of mainly high value products, while remaining the biggest agricultural importer in the world, remaining by far the largest market for developing countries.

The CAP increasingly contributes to heading off the risks of environmental degradation and to delivering many of the public goods that our societies expect since producer support now depends on the respect of standards relating to the environment, food safety and quality and animal welfare through cross-compliance.

The strengthened rural development policy supports the protection of the environment and rural landscapes and creates growth, jobs and innovation in rural areas, especially those which are remote, depopulated or heavily dependent on farming.

The above developments indicate a CAP that is today fundamentally different from the one of the past. But the Communication "Preparing the Health Check of the CAP reform" also asserts that, "for the CAP to continue to be a policy of the present and of the future, it needs to be able to evaluate its instruments, to test whether they function as they should, to identify any adjustments needed to meet its stated objectives, and to be able to adapt to new challenges".

In line with the indications given in the Communication, the Commission has prepared legal proposals accompanied by an impact assessment report on the Health Check of the CAP taking on board the result of a wide consultation of stakeholders and the contributions from other European Institutions.

Legal proposals are related to three basic Regulations:

Council Regulation (EC) No 1782/2003 of 29 September 2003 establishing common rules for direct support schemes under the common agricultural policy and establishing certain support schemes for farmers.

Council Regulation (EC) No 1234/2007 of 22 October 2007 establishing a common organisation of agricultural markets and on specific provisions for certain agricultural products (Single CMO Regulation)

Council Regulation (EC) No 1698/2005 of 20 September 2005 on support for rural development by the European Agricultural Fund for Rural Development

These proposals, without constituting a fundamental reform, are a contribution to future developments of the CAP that are consistent with the overall goal of the Commission and the requirements of the Treaties to promote a sustainable and market orientated agricultural sector.

SINGLE PAYMENT SCHEME (SPS) AND SINGLE AREA PAYMENT SCHEME (SAPS)

Simplification

Better regulation and simplification are one of the Commission's political priorities for the period 2004-2009. The CAP started the most important path to simplification with its reform of 2003 by shifting most of direct payments for farmers to the Single Payment Scheme and with the adoption of the Single Common Market Organisation in 2007. On SPS, experience has shown that it has contributed to reduce the administrative burden, to avoid unnecessary public expenditure, to improve public acceptance of the CAP and to improve competitiveness on the CAP. Nevertheless, steps towards more simplification can still be done, especially in cross-compliance and in the existing partial coupled support.

Cross compliance

The 2003 CAP reform introduced cross compliance within the single farm payment. This means that such payments are subject to environmental, food safety, and animal welfare legislation, as well as to the maintenance of the farm in good agricultural and environmental conditions.

Practical problems in the implementation of cross compliance have been raised by the Member States, as well as by the Commission itself through its audits for the clearance of accounts. This has led the Commission to examine the scope of cross compliance in order to simplify and improve its targeting. In particular, the proposals aim at withdrawing certain Statutory Mandatory Requirements that are considered not relevant or linked to farmer responsibility, and to introduce into Good Agricultural Environmental Conditions requirements that retain the environmental benefits from set-aside and address issues of water management.

Partially coupled support

In 2003 CAP reform, some Member States considered that full decoupling could lead to several risks such as the abandonment of production, the lack of raw material supply for processing industries, or to social and environmental problems in areas with few economic alternatives. This was the reason why it was decided to retain certain levels of coupled support in some sectors.

The experience with decoupling shows that in general this move did not imply dramatic changes in the production structure at the EU level and that it has led farmers to produce what the market demands in a more sustainable way. It has also to be stressed that keeping two systems in parallel (coupled and decoupled support) has not contributed to simplification for national and regional administrations in Member States.

Given this, it is proposed to align them with the 2003 CAP reform principles by removing the remaining coupled support and shifting them to the Single Payment Scheme. Nevertheless, an exception is done with suckler cows, sheep and goat meat premia. In these cases it is proposed to allow Member States to maintain the coupled support (as it exists currently) in order to sustain economic activity in regions where other economic alternatives are few or do not exist.

Other issues related to simplification

The proposal also includes other measures focused on providing more simplification to the SPS. In particular, more flexibility has been added to the use of the national reserve and to the transfer of payment entitlements, to the choice of modifying the entitlements and to payment dates. The abolition of the set aside entitlements is also proposed. Finally, more clear rules to the definitions of "agricultural area", "farmer" and "eligible hectare" are introduced.

Moving towards a more flat rate of decoupled support

The 2003 reform introduced the decoupled farm support as the key element of the CAP. The main objective was providing a direct payment system that allows farmers to be market oriented, as simple as possible from an administrative point of view and compatible with WTO. Two basic models were provided to Member States to implement the scheme: the historic and the regional.

historic model: In this model payment entitlements are based on individual historic reference amounts per farmer.

regional model: In this model flat rate payment entitlements are based on amounts received by farmers in a region in the reference period.

The current legislation does not allow Member States to change their decision on the implementation of the SPS model. However, experience has shown that certain adjustments in the existing schemes are necessary or desirable. For example, the differences in support levels resulting from implementation of the historic model will become difficult to justify in the future as reference periods for payments become more distant.

On the other hand, the regional model provides more equitable support to farmers, despite some initial redistribution of support.

This is the reason why the Commission has proposed allowing Member States to adjust their SPS model by moving towards flatter payment rates per entitlement to render the SPS more effective, efficient and simple. In parallel, the proposals include a series of simplification measures in the implementation of SPS.

Extending SAPS

The Single Area Payment Scheme was introduced as a previous step to the inclusion in the SPS in the Member States who joined the EU as from 1 May 2004 to facilitate their adjustment to the EU because of their specific agricultural situation. As a transitional system, SAPS was designed to assist the integration of EU-10 and EU-2 in a smooth manner, given the very significant differences between the level of their general and rural economies and those in the EU-15.

Member States applying SAPS have to move into the SPS in 2010. It seems appropriate to allow those Member States to extend SAPS until 2013 This option is in line with the decision taken for EU 15 Member States because they are allowed to review their SPS implementation and opt to move towards a more flat rate model.

Article 69 of Regulation

Based on Article 69 of Regulation (EC) No 1782/2003 on direct support schemes for farmers, Member States applying SPS may retain by sector up to 10% of their national budget ceilings for direct payments in the sector concerned for measures related to the protection or enhancement of the environment or for improving the quality and marketing of agricultural products. To allow more flexibility in Member State responses to the needs stemming from the overall orientation of the CAP, it is proposed that Article 69 be broadened:

The restriction that linear reductions are taken from and staying in the same sector is removed.

Measures to address disadvantages for farmers in certain regions specialising in the dairy, beef and sheep and goat meat sectors are covered.

It also allows the possibility to use the retained amounts to top up entitlements in areas subject to restructuring and/or development programs

Support for some risk management measures -crop insurance schemes for natural disasters and mutual funds for animal diseases- is also provided under certain conditions.

Measures, which do not with certainty meet the conditions of the WTO Green Box, should be limited to 2,5% of the ceilings.

Finally, Member States applying SAPS will also be allowed to apply this provision.

Modulation

Modulation is a means of budgetary transfer by which a percentage reduction is applied to farmer direct payments (Pillar I) and the budgetary resources released are reassigned to rural development (Pillar II) measures.

With the 2003 Reform, compulsory modulation for all EU-15 Member states was agreed, starting in 2005 with a rate of 3% and increasing to 4% in 2006 and to 5% from 2007 onwards. A EUR 5 000 franchise was also introduced, below which no reduction of direct payments is applied.

The Communication "Preparing the Health Check of the CAP reform" identified a number of new and ongoing challenges facing the CAP such as climate change, risk management, bio-energy, water management and biodiversity and considers the RD policy as one of the possibilities to deal with these changes.

The measures available under RD are already providing various alternatives to address the new challenges and MS have included related measures already in their RD Programs for the period 2007-13. Nevertheless, first experiences with the financial up-take of RD resources in 2007 suggest that Member States have budget needs beyond their financial possibilities.

To allow Member States to support the increasing needs to meet new challenges via the set of measures proposed under RD, it is proposed to increase compulsory modulation by 8% and to add an additional progressive element under a new system which is based on the following principles:

All new receipts from modulation stay within the Member State that generates them.

In EU-15, basic modulation, applying to all payments above € 5 000, increases by 2% annually from 2009 until it reaches an additional 8% in 2012.

A progressive element is introduced; whereby payments are reduced by additional steps of 3% in successive thresholds a new system for the financial management of direct aids, establishing net global ceilings per Member State, is proposed.

Thresholds	2009	2010	2011	2012
1 to 5 000	0	0	0	0
5 000 to 99 999	2%	4%	6%	8%
100 000 to 199 999	5%	7%	9%	11%
200 000 to 299 999	8%	10%	12%	14%
Above 300 000	11%	13%	15%	17%

EU-10 become also eligible for modulation in 2012, with a basic rate of 3% (instead of 13%). Bulgaria and Romania are exempted, in relation to the phasing-out of direct payments.

Payments limitations

46,6% of the total direct payment beneficiaries in the EU-25 receive less than 500 EUR. This number essentially includes small farmers, but it also includes in certain Member States recipients whose value of payment is below the administrative cost of managing it.

In order to simplify and reduce the costs of administration of direct payments, it is proposed that Member States shall either apply a minimum amount of payments of 250 € or apply a minimum size of eligible area per holding of at least 1 hectare or apply both.

SINGLE COMMON MARKET ORGANISATION

Intervention market mechanisms

Based on analysis, the Commission has concluded that market supply control should not serve to slow down the ability of EU farmers to respond to market signals but they should be turned into a real safety net. To do so, it is proposed to simplify and harmonise the current provisions on public intervention via the extension of a tendering system.

In the cereal sector, it is proposed to introduce tendering for bread wheat, while for feed grains, the same model as for maize (reduce quantitative ceiling at zero) will apply. For durum wheat, taking into account current and expected market conditions, it is proposed to abolish intervention. For the same reasons, for rice and pig meat it is also proposed to abolish intervention. Tendering provisions for butter and skimmed milk powder will also apply.

Abolition of set aside

Based on the market outlook situation and the implementation of SPS, it is proposed to abolish set-aside as an instrument of supply control. However, under the proposals for cross compliance and RD, Member States are given the appropriate tools to ensure that the present environmental benefits of set-aside can be retained.

Transition to the end of the milk quota

In 1984, quotas were introduced as a response to overproduction. The current market outlook situation indicates that the conditions for which milk quotas were introduced in 1984 are no longer relevant. Since milk quotas expire in 2015, it is appropriate to help the sector with gradual transitional measures to adapt to a market without quotas post 2015. To allow a "soft landing" of the milk sector to the end of quotas, a gradual annual increase is proposed.

In general terms, the phasing-out of milk quotas would expand production, lower prices and increase the competitiveness of the sector. Nevertheless, there are certain regions, especially but not exclusively mountainous regions, which are expected to face difficulties in keeping a minimum level of production. Those problems can be addressed by applying specific measures through article 69 of Regulation (EC) No 1782/2003.

Dairy sector specific aids

The abolition of the private storage aid for cheese and the disposal aid for butter for pastry and ice cream and for direct consumption is proposed. These schemes are no longer needed to support the market and should therefore be abolished.

For other products as the private storage aid for butter, the skimmed milk powder feeding stuff and the aid for casein production, for which an obligatory aid is provided by the current regulation, it has been proposed to make such a support optional for the Commission to decide if it should be applied when the market situations requires it.

Other support regimes

In a series of small support schemes, it is proposed to decouple and shift them to the SPS because it would contribute to improve competitiveness and to provide them with more simplification. For hemp, dried fodder, protein crops, and nuts the transition to the SPS can take place without a transition period. For rice, starch potatoes and long fibre flax, a transitional period for the shifting to full decoupling is proposed in order to help farmers and processing industries to be adapted gradually to the new support scheme. It is also proposed to abolish the energy crop scheme based on current very strong demand for bio-energy.

NEW CHALLENGES AND RURAL DEVELOPMENT POLICY

With the overall CAP budget fixed until 2013, additional funding for rural development can only be realised through an increase in compulsory modulation.

The additional funding is needed to reinforce the efforts with regard to the EU priorities in the field of climate change, renewable energy, water management and biodiversity.

Climate and energy have moved to the top of the agenda, as the EU is taking the lead to build a global low carbon economy. In March 2007, EU leaders endorsed Commission proposals to cut CO_2 emissions by at least 20% by 2020 (30% if global targets can be agreed on) and to set a binding 20% target for the use of renewable energy sources, including a 10% share of biofuels in petrol and diesel consumption. Agriculture and forestry can make an important contribution in providing the feed stocks for bio-energy, in carbon sequestration and in further reducing GHG emissions.

The EU's objectives with regard to water policy are laid down in the Water Framework Directive, which will start to reach full implementation in the period 2010-2012. Agriculture and forestry as a main user of water and water resources have a major role to play in sustainable water management both in terms of quantity and of quality. Water management will be an increasingly important part of the adaptation strategy to deal with already unavoidable climate change.

Member States have committed themselves to halt biodiversity decline by 2010, a target which increasingly seems unlikely to be met. A large part of Europe's biological diversity is dependent on agriculture and forestry and the efforts to protect biodiversity will have to be increased, particularly in the light of the expected adverse effects of climate change and increasing water demand.

Member States are encouraged to make full use of the additional funding available for the 2010-2013 period and to adapt their strategies and programmes in consequence. In particular support for investments under axis 1 can be targeted towards energy, water and other input saving machinery and equipment and to production of (feed stocks for) renewable energy for on and off farm use. Under axis 2 the agri-environment measure and the forestry measures can be used in particular for biodiversity, water management and climate change mitigation actions. Under axis 3 and 4 local scale renewable energy projects can be supported.

BUDGETARY IMPACT

Since the 2003 CAP reform, the CAP has an in-built mechanism of financial discipline if expected expenditure runs the risk of exceeding the financial ceiling for market expenditure and direct aids. Most CAP support is now fixed and the market outlook has significantly improved since 2003. As a result, the risk that the financial discipline is applied (i.e. reduction in direct aids) have diminished compared to previous expectations.

Proposals for modulation in the Single Payment Scheme and Rural Development are by design neutral with the respect to the EU budget, as it is a simple compulsory transfer between the second and the first pillar of the CAP. For national budget the increased modulation could lead to additional national expenditure in view of the necessary co-financing needed in Rural Development. This would mean that some Member States have the possibility of returning to the (higher) level of national expenditure originally foreseen before the decision on the Financial Framework 2007-2013. As regards the transfer of measures into the Single Payment Scheme there could be moderate financial consequences for the EU-budget, but most of the transfers are also budgetary neutral.

With respect to market measures, the recent increase in world prices has led to a clear improvement of prospects with respect to expectations when the 2003 reform was decided. The reform of maize intervention has since then resolved part of the previously expected problems in cereals market, and the present proposals on cereals intervention improve further the situation. Some additional expenditure towards the end of the present financial framework is relatively small. In dairy the impact is more one of the timing of expenditure (before or after 2013).

The expiry of the dairy quota will bring additional pressure in butter under all options. The present proposal, by initiating a gradual process of a quota phasing-out, is overall more beneficial not just for the sector, but also for long-term developments of the CAP. However, the need for some limited additional expenditure on butter exports cannot be excluded. Whether this materialises will depend on factors that are at this stage unknown (DDA Agreement, world market developments). Therefore the present proposals include a review clause in 2012 that would allow developments in dairy markets to be assessed to determine if additional measures will be needed to avoid any increase in the budget. Some savings are foreseen as a consequence of abolition of existing measures. However, the biggest budgetary effect of the soft-landing on the milk quota is a loss of budgetary revenue due to the foreseen decrease in milk levy.