COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

on risk and crisis management in agriculture

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1. INTRODUCTION

For many years the Common Agricultural Policy (CAP) addressed the objective of securing farm incomes through a series of market and price stabilisation measures. Successive reforms have gradually switched support from market and price management to direct payments, which from 2005 will be largely decoupled. Now that CAP reform has broken the link between direct payments and the type and volume of production, farmers will be better able to adjust their production decisions to economic and agronomic criteria.

The decoupled single payment scheme will continue to provide a significant and stable contribution to farm income, although with notable differences according to the historical distribution of support between different sectors of agricultural production. Farmers will be able to be more market-orientated, while benefiting from this better targeted and more efficient income support.

These economic and social aspects, as well as the environmental considerations incorporated in the new single payment scheme, will mean that the new CAP is more sustainable. It will, however, oblige farmers to take responsibility for managing those risks that were formerly absorbed by market and price support policies. At the same time, EU farmers are increasingly exposed to competition and agricultural price fluctuations, as a result of trade liberalisation.

As in the past, the business of farming will remain vulnerable to specific risks and crises which are beyond the farmer's control. While calculated risk-taking may bring positive results, it is appropriate for farmers to be armed against the possibly negative outcome of the choices they make, as well as against crises provoked by natural disasters and other unpredictable events. Within the context of CAP reform, new instruments – which will not slow down any necessary structural adjustment - could help farmers improve their capacity to manage risks and crises.

This Communication examines these issues and considers what additional measures the CAP could introduce to support farmers, in respect of risk and crisis management. The options put forward for discussion respond to the mandate for this Communication and the conclusions of the December 2003 Agricultural Council. It should be emphasised that they would entail no additional expenditure.

The Communication is accompanied by a Commission Staff Working Document which describes the risk and crisis management tools already available to EU agriculture.

2. BACKGROUND

In January 2001, the European Commission provided a first analysis[1] of risk management tools for EU agriculture, which was discussed by the relevant Council bodies under the Swedish Presidency in 2001. The Spanish Presidency took up the issue of agricultural insurance as a risk management tool in arable and livestock farming with a memorandum in March 2002, followed by an international conference on "Agricultural insurance and income guarantees", held in Madrid on 13 and 14 May 2002. A Greek Presidency memorandum on natural risks and insurance in the agricultural sector was submitted to the Council in May 2003 and a seminar to examine possible responses to natural disasters in the agricultural sector was held in Thessaloniki on 6 June 2003. Most recently, on 15 and 16 December 2004, the Dutch Presidency organised a conference on the "Material and immaterial costs of eradication of animal diseases".

The CAP reform decided in Luxembourg in June 2003 provides for a modified system of farm income support to farmers, decoupled from production. The Council conclusions on this reform incorporated a Commission declaration *"to examine specific measures to address risks, crises and national disasters in agriculture"* and *"present a report, accompanied by appropriate proposals, to the Council before the end of 2004."*

The Commission declaration further indicated two specific issues to be examined: *"…the financing of these measures through the one percentage point of modulation directly re-distributed to Member States as well as the inclusion, in each common market organisation, of an article empowering the Commission to act, in the case of a Community-wide crisis, along the lines established for such cases in the common market organisation for beef."*

In December 2003, under the Italian Presidency, the conclusions of the Agricultural Council[2] invited the Commission:

(1) to continue to lead the debate on risk management tools in agriculture and to provide an updated inventory of risk management tools available in Member States;

(2) to examine the advantages and disadvantages of different risk management options – notwithstanding the agricultural sector's own responsibility. Possible new instruments to replace, if appropriate, current measures should be taken into account and examined on the understanding that distortions of competition must be avoided, WTO rules must be observed and the financing of any new measures must be in keeping with the financial commitments already in place;

(3) to assess the opportunities provided by the Community guidelines for State aids in the agricultural sector and if necessary to suggest adaptations.

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1 "Risk Management Tools for EU Agriculture" – DG Agri Working Document: http://europa.eu.int/comm/agriculture/publi/insurance/index_en.htm

2 OJ C 34, 7.2.2004, p. 2.

3. RISK AND CRISIS MANAGEMENT: OPTIONS

Risk implies a situation which could have a variety of outcomes, for each of which the probability can be estimated. Although risk-taking is often a pre-requisite to making progress, a negative outcome could have serious economic consequences for a business.

The wide range of **risk management** tools available is described in a Commission Staff Working Document accompanying this Communication. They could be developed further to help improve competitiveness and the economic sustainability of farm enterprises, especially those with a high proportion of debt capital, for example young farmers. However, these tools cannot and are not intended to offer the kind of guarantees provided by the former CAP, but would rather help the farm business withstand temporary shocks and improve its access to finance for the development of its activities. It is with this perspective that the development and availability of risk management instruments might usefully be encouraged.

While risk may be associated with either a positive or a negative outcome, the assumption is always made that a **crisis** has significant negative consequences. In this Communication a crisis is understood to be an unforeseen situation that endangers the viability of agricultural holdings, either at a localised level or across a whole sector of production.

Several **crisis management** instruments are available or have recently been established to provide assistance when the individual capacity to cope with substantial losses in assets and/or income, resulting from unforeseeable events, may be insufficient. These instruments are described in the Commission Staff Working Document accompanying this Communication. However, most of these instruments rely on *ad hoc* actions.

In this context, and in accordance with the Commission's commitment of June 2003, the question of generalising the beef crisis clause is addressed in section 3.1.

The Commission has looked at a number of options for encouraging the development of risk management tools and providing an improved response in the event of crisis. The use of modulation funds for this purpose – which would not require any additional Community expenditure - is discussed in detail in section 3.2.

Finally, three options are described that, in combination or individually, could in time complete or partially replace Community and Member States' *ad hoc* emergency measures. These possible new measures are presented in section 3.3.

3.1 Generalising safety net provisions in the event of market crisis

While CAP reform has decoupled income support for the main production sectors, a number of instruments remain to influence the market and price situation and address possible crises. These vary significantly between market organisations, according to the specific characteristics of each market and reflecting the evolution of the previous sector-specific approach.

As early as 1974 a **general provision** on crisis management was introduced into the **beef meat CMO**. Article 38 of the Common Market Organisation[3] for beef still states: *"(1) When a substantial rise or fall in prices is recorded on the Community market and this situation is likely to continue, thereby disturbing or threatening to disturb the market, the necessary measures may be taken. (2) Detailed rules for the application of this Article shall be adopted by the Commission …"*.

A similar clause has never been adopted for other CMOs, since other instruments were considered to be sufficient. With CAP reform, safety net provisions in the event of crisis remain available in several sectors covered by the reform. For other sectors, (fruit and vegetables, wine, and pigs and poultry) there is today no justification to introduce an additional general safety net provision. If required, specific needs could be looked at on a case by case basis in the context of the review of individual CMOs.

More important, income stabilisation is now largely provided by the new system of decoupled payments. With the introduction of the new single payment, most farmers have been guaranteed a secure basis for planning until 2013.

CAP reform has broken the link between income support and the type and volume of production. This means that farmers will be able to orientate their production according to economic and agronomic criteria without losing income support. The new system will allow them to better adapt their production in response to climatic or sanitary risks and according to market developments.

The Commission therefore does <u>not</u> intend to propose the general introduction of a safety net clause to each common market organisation. The Commission rather invites the Council, the European Parliament and other EU Institutions first to discuss the alternative crisis management options presented in section 3.3.

3.2 Financing risk and crisis management measures through modulation

A key purpose of this communication is to discuss how additional risk and crisis management measures could be co-financed by one percentage point of modulation. Designed as a mechanism to strengthen the second pillar of the CAP, modulation reduces direct payments and shifts the funds saved into rural development. Under the 2003 CAP reform, modulation will progressively reduce direct payments on a compulsory community-wide basis, by 3% in 2005, 4% in 2006 and 5% in the years 2007 to 2012.

Community law states that all the funds released by modulation can only be used in the context of **rural development** programmes - including the amount that could possibly be used for risk and crisis management measures.

New risk management measures co-financed from the one percentage point of modulation would aim to improve the **competitiveness** of the agricultural and forestry sector by strengthening the economic sustainability of agricultural holdings. They would therefore enlarge the scope of "Priority Axis 1" of the Commission's proposal for a new rural development regulation. It is in this context that Member

[3] Article 38 of Council Regulation (EC) No 1254/1999 (OJ L 160, 26.6.1999, p. 21).

States would have the choice of introducing new risk and crisis management measures into their rural development programmes.

Under the new Financial Regulation, and in particular the **principle of annuality,** the new regime of compulsory modulation no longer allows Member States to retain funds in view of their redistribution in later years.

Using modulation to finance new risk and crisis management instruments would not require additional Community expenditure; it would simply make it possible for Member States to use a maximum amount of rural development funds for these purposes. The use of **state aids** or top ups for this type of measures would have to be subject to appropriate Community competition rules.

The EU's rural development policy is designed to fully comply with the **green box** criteria established by the WTO. As a consequence, any additional measure financed under modulation must also comply with green box criteria.

In this context, in all cases, the amounts used for risk and crisis management shall be limited to one percentage point of modulation in the Member States where modulation is applied. For the Member States where modulation does not yet apply an equivalent method could be applied to set the maximum level of rural development funds that could be allocated to these measures.

3.3 New options for risk and crisis management tools

The Commission suggests that the potential of three options should be assessed, from the point of view of individually or jointly, completely or partially replacing Community and Member States' *ad hoc* emergency measures. The Commission invites the Council, the European Parliament and other EU Institutions to debate the following options, which would be designed to comply with WTO green box criteria. If introduced to the menu of rural development measures, these options would be available for Member States and regions to take up and use, according to their specific priorities for the next programming period.

Independent of any decision on the following options, the causes of the rather weak development and use of market based risk management tools (insurance, futures market, contract farming) could be addressed by training measures within rural development programmes. This would help improve awareness of current risks, improve risk management strategies and provide know how, for instance on the use of futures and options, which could also lead to a wider use of contracts between the food industry, traders, and farmers.

Option 1: Insurance against natural disasters - Financial participation in farmers' premium payments

Insurance provides an alternative to public ex-post compensation payments for losses caused by natural disasters at EU and national or regional level. Certain Member States have already established national schemes to encourage farmers to obtain insurance cover against such events.

A new measure, eligible under the rural development regulation, could therefore provide a financial contribution towards the premiums paid by farmers for insurance against income loss as a result of natural disaster or disease.

The amount granted per farmer under such a measure by EU and national/regional support should not exceed 50% of the total premium cost for the insurance in question.

To be eligible for support from rural development funding, disaster insurance schemes must comply with EU agricultural state aid guidelines and WTO green box requirements. Insurance schemes eligible for co-financing would determine the level of compensation for production losses, due to the natural disaster in question, that exceed 30% of the average agricultural production in the preceding three-year period, or a three-year average based on the preceding five-year period, excluding the highest and the lowest entry. This measure would require Member States to establish a historical reference system at farm level.

Insurance payments should compensate not more than 100% of the income loss, at the level of the beneficiary, in the year the disaster occurred. The payment should not require or specify the type or quantity of future production. If the natural disaster, in addition to insurance, would trigger eligibility for other public compensation, the overall compensation by all schemes should not exceed 100% of the income loss in the year the disaster occurred.

As many agricultural risks normally affect a large number of farms (systemic risk) insurance companies have to buy relatively expensive reinsurance. This is one of the reasons why private markets for agricultural insurance are not well developed. Thus, a policy measure improving access to reinsurance could also help develop private agricultural insurance schemes. As an alternative to supporting insurance premiums, the encouragement of national reinsurance schemes could also be examined. At the national level, in addition to co-insurance arrangements between private insurance companies, governments could (1) offer full reinsurance at reduced prices, (2) offer part of the necessary reinsurance at no cost, thus reducing the insurance company's overall need for reinsurance, and (3) be a partner for reinsurance via stop loss agreements.

Option 2: Supporting mutual funds

Mutual funds represent a way of sharing risk among groups of producers who want to take their own responsibility for risk management. The fund's capital can be called on by members in the event of severe income losses to be specified by predefined rules.

Up till now agricultural mutual funds, established on private initiative, have been set up mainly at a sector-specific level, where producers share comparable risks. While they are not currently available to all agricultural holdings they have the potential to develop into a more common risk management tool to cover income losses.

With this in mind, the Community could envisage providing support for developing mutual funds in the agricultural sector. Under this option, temporary and degressive support for the administrative operation could be granted per farmer participating in funds formally recognised by the Member State's competent authority.

Option 3: Providing basic coverage against income crises

With CAP reform focusing on income stabilisation and decoupling support from agricultural production, a generalised approach to respond to income crises seems to be more appropriate than any sector-specific approach. A more general coverage against crises that result in severe income losses would allow existing safety net provisions to be further simplified and improve the balance between different agricultural sectors.

Better market orientation and quality production, as promoted by CAP reform, means that many farmers in the EU will need to make substantial investments in restructuring. Rural development programmes will be available to support structural adjustments. However, if the scope of rural development measures should prove insufficient, the question of new instruments to address situations where liquidity problems and serious income losses occur, must be raised. Any such measures should meet the following conditions:

– they should be open to all farmers affected by a crisis;

– farmers can only be eligible for liquidity support payments if their income derived from agriculture in a specific year is less than 70% of the average gross income or the equivalent in net income terms in the preceding three-year period or a three-year average based on the preceding five-year period, excluding the highest and the lowest entry;

– the amount of the payments must compensate for less than 70% of the producer's income loss in the year the producer becomes eligible to receive the income assistance;

– the amount of the income stabilisation payments must relate solely to income, it must not relate to the type or volume of production of the specific producer; or to the prices, domestic or international, applying to such production; or to the factors of production employed;

– where the producer receives payments from other compensation schemes, e.g. for relief from natural disasters, the total payment shall be less than 100% of the loss.

This measure would require agreement on a precise, accounting definition of income and for Member States to establish a system of reference income at farm level.

Finally, in order to guarantee fair competition throughout the Community, the possibility of using state aids or top ups in this context would have to be carefully assessed by the Commission.