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Your ref:
Our ref:

31 March 2003

Dear Sir/Madam

MILK QUOTAS: CONSULTATION ON AMENDMENTS TO THE DAIRY PRODUCE QUOTAS REGULATIONS 2002

Purpose of consultation

The purpose of this consultation is to seek your views on a proposal to introduce a discretionary element of the Agenda 2000 agreement, namely breaking the link between quota and land, and on some suggested quota administration changes. In addition, we are inviting views on the introduction of a further discretionary element of Agenda 2000, relating to a 70% usage rule.

We have previously consulted on both the Agenda 2000 options but feel that the time is right for them to be reconsidered, in part, as a result of the judgement by the European Court of Justice in the Thomsen case (Case C-401/99, 20 June 2002) under which non-producing quota holders will no longer be able to retain milk quota.

If, following consultation, it is decided to adopt either or both of these changes, it will be necessary to amend the Dairy Produce Quotas (Scotland) Regulations 2002 (SI 2002/110) as amended (DPQR). We have therefore taken the opportunity to propose amendments to the Regulations relating to quota administration.

None of these changes cuts across ongoing discussions on further reforms to the CAP dairy regime.

You should note that the administrations in England, Wales and Northern Ireland are conducting similar consultations because the proposed measures apply throughout the UK.

Consultation documents and responses

I attach for your consideration a consultation document setting out the detailed proposals and a draft Regulatory Impact Assessment. I would be grateful for comments on both of these documents by **Monday 30 June 2003**. All comments should be addressed to Marie Coventry, SEERAD,

Agriculture Policy Division, Room 262, Pentland House, 47 Robb's Loan, Edinburgh, EH14 1TY
(E-mail: Marie.Coventry@scotland.gsi.gov.uk). Telephone 0131 244 6953, Fax 0131 244 6950.

This document is being circulated to those on the attached list. It would be helpful if you could let Marie know if you are aware of any organisation or individual who has been omitted from the list and who you think should receive a copy of the consultation document. You should note that this document will shortly be placed on the Scottish Executive website. <http://www.scotland.gov.uk>

It is the Scottish Executive's policy to make available to the public all replies to the consultation exercise. The papers will be available, on request, from The Scottish Executive Library, Saughton House, Broomhouse Drive, Edinburgh, EH11 3XD, or e-mail Alan.Gold@scotland.gsi.gov.uk. Telephone 0131 244 4552. If you wish to personally view the responses held in the library, it is necessary to telephone and make an appointment at least 24 hours in advance. Small administrative charges may be made to cover photocopying and/or postage.

If you do **not** wish your comments to be made publicly available then please let Marie know when you submit them.

Any comments or concerns about the way in which this consultation has been conducted should be sent to me, Gerry Smith, Senior Policy Manager, Room 247 at the address above.

Yours faithfully

GERRY SMITH

CONSULTATION ON AMENDMENTS TO THE DAIRY PRODUCE QUOTAS REGULATIONS 2002

A. APPLICATION OF 70% USAGE RULE

Reason for Consultation

1. As a result of the Thomsen judgement at the European Court of Justice, non-producing quota holders (NPQHs) will no longer be able to hold quota. These changes should take effect from 1 April 2004. Separately from this, member states have the discretion to introduce a 70% usage rule, whereby if a quota holder (an active producer) produces against less than 70% of his quota, he would have all or part of the unused quota confiscated.
2. On the one hand, in the light of the Thomsen case, the introduction of a 70% rule could be regarded as a further means of aligning quota ownership and production. The absence of such a rule could be considered as giving rise to an anomaly whereby NPQHs have to divest themselves of their quota, but those who use only a small proportion of their quota (effectively quasi-NPQHs) can retain it. There has also been a concern expressed that, in the absence of a 70% rule, active producers may buy in quota purely for the purposes of speculation, or for leasing it out, and that by keeping quota off the sales market, it will force up the purchase price (a concern raised in relation to NPQHs).
3. On the other hand, there is arguably a difference between quota being owned by active producers as opposed to by NPQHs, as at least in the former case the quota leasing revenue is being recycled within the dairy sector. There are also potential concerns about the impact on the leasing market of applying the 70% rule, in combination with the demise of NPQHs. NPQHs have represented a large proportion (60-65%) of the leasing market, and if they do not resume production, the quota held by them will have to be put onto the purchase market. The 70% rule, by further reducing the amount of quota available for leasing, may impair the flexibility of the quota system. However, the overall demand for quota leasing will diminish as active producers traditionally dependent on leased in quota purchase it instead from NPQHs. Furthermore, some of the purchasers of quota released by NPQHs may lease out at least some of it in their turn. The impact of the 70% usage rule on the quota leasing (and sales) market would depend crucially on the way it is implemented.

Legal Base

4. The 70% usage rule was introduced under the Agenda 2000 agreement. Under Article 5(3) of EC Council Regulation 3950/92, if a producer does not produce against at least 70% of his quota for at least one quota year, member states may put part or all the unused quota in the national reserve. Member states therefore have a reasonable amount of latitude in how they apply the 70% rule, if they choose to apply it, as they can determine: -

- The proportion of unused quota to which confiscation applies.
- The number of years that a producer must be producing against less than 70% of his quota before it is confiscated.

The figure of 70% itself, which triggers the application of the usage rule, is laid down in the Council Regulation and is non-negotiable.

Possible Entry into Force Date

5. It is important to note that the 70% rule, if adopted, could not apply to the 2003/04 quota year, because the earliest the legislation could be adopted would be October/November 2003 – a considerable way through the quota year, when production would be well under way. Application of the 70% rule to 2003/04 would therefore be considered retroactive and unacceptable in legal terms.

Number of Producers/Quantity of Quota Potentially Affected

6. In 2001/02, the number of quota holders who leased out 30% or more of their quota, and thus by implication, used less than 70%, was 1,721. (This figure excludes assumed NPQHs). The amount of quota leased out by them was 501 million litres - 3.5% of the national quota, and 25% of total leasings. A further 67% of leasings was accounted for by NPQHs, leaving only 8% of leasings not provided by either group.

Possible Application of the 70% Rule in the UK

7. As stated above, the proportion of unused quota to which confiscation applies is at the discretion of the Member State. We would suggest the following options, although there may be others: -

- confiscating all the unused quota
- half
- only the amount unused below 70% of the total quota.

Impact on Leasing Market

8. Unsurprisingly, the option which would have the least impact on the leasing market would be that of confiscating quota unused below 70%. Based on 2001/02, the amount of quota potentially affected would be 501 million litres if the usage rule applied to all unused quota, 250 million litres if half, and 214 million litres if solely below 70%. Obviously the producer would be more likely to sell the quota, rather have it confiscated. NPQHs will disappear from the leasing market as a result of the Thomsen case. If the leasing figures for NPQHs were combined with those for quota affected by the 70% rule, based again on 2001/02 figures, crudely speaking, 8% of the leasing market would remain if all unused quota were affected by the 70% ruling, and 22% if only that under 70% were affected. (A more detailed analysis can be found in the attached Regulatory Impact Assessment).

Impact on the Part-User

9. Of the options: -

Confiscation of all unused quota could be considered inequitable, as someone who produced against 71% of their quota could retain all of it, while someone else who produced against 69% would face confiscation of 31% of their quota.

Confiscation of half unused quota is less inequitable, but could still possibly be considered disproportionate, again, when taking into consideration the differing treatment of producers on the cusp of 70% production.

Confiscation of quota unused below the 70% threshold would appear to be the most equitable solution, as there would not be the disparity in treatment between producers on the cusp of 70%. Producing against 69% of quota would result in confiscation of only 1% of quota.

Period of application

10. Member states can choose the number of quota years that a producer must be producing against less than 70% of his quota before it is confiscated. The options we suggest are: -

- 1 year
- 2 years
- 3 years

11. There are a variety of reasons why production may be below 70% of quota held in the course of a given quota year, for example: -

- A winding down of production;
- Stopping production definitively in the course of the quota year;
- A temporary downturn in production due to bad weather, disease etc.;
- The purchase of additional quota preparatory to expanding production;
- The purchase of additional quota for the purposes of leasing it out/ speculation.

12. These different circumstances need to be taken into account when deciding the length of time over which the 70% rule should apply. (In the second scenario, as a result of the Thomsen judgement, all the quota would be confiscated if not disposed of in the following quota year).

1 Year

This would seem too short a period. Production could drop temporarily for any number of reasons. Although *force majeure* provisions could be applied, this would not be available in all cases. It would be administratively burdensome both for the RPA and the producer to deal with the confiscation and subsequent restoration of quota, when either production recovered or *force majeure* was established.

2 Years

This would appear preferable to the one-year option, but may still not be sufficient for a producer who has suffered a temporary setback in production, or is building up their herd.

3 Years

This would probably be sufficient for a producer who has suffered a temporary setback in production, or is building up their herd. Of the three options, it would also have the least impact on the leasing market, as those producers who had a significant amount of 'slack' could lease out their quota in the first two years. On the other hand, of the three options it

would be the one which least met the concerns of those who would wish quota to be out on the sales market, rather than leased out by those winding down production or who have acquired quota specifically for leasing/speculation.

Confiscation/Restoration of Quota (for both those subject to the 70% rule and NPQHs)

13 We would envisage that, if the 70% usage rule were applied, the quota holders would sell their quota, rather than allow it to be confiscated (the same applies to NPQHs). However, it may be that there are some confiscations, and so we need to establish how long we would give holders to resume production (if NPQHs) or resume production up to the 70% level (if part-users), before the quota was definitively confiscated for potential reallocation.

14. Under the current EC Council Regulation 3950/92 (Article 5) member states can decide this. In the UK the restoration of production period is currently 6 years, apparently purely because this represented the initial expected 'life' of the quota regime. Thus this period is now rather arbitrary. The new draft Council quotas regulation issued as part of the CAP reform proposals currently specifies that member states should allow 2 years for quota restoration. We, along with some other member states, have argued that the period should still be discretionary.

70% USAGE RULE: QUESTIONS FOR CONSULTEES

- a) Do you think the usage rule should be applied to everyone given, for example, the potential impact on the quota leasing market? (See paragraphs 1-3 above)
- b) If the answer to a) is yes, how much of the unused quota should be confiscated? Do you think all quota, half the quota or only the amount below 70%? (See paragraphs 4-10 above)
- c) Over what period must production be below 70% of quota for the 70% rule to apply? Do you think 1 year, 2 years or 3 years? (See paragraphs 11-13 above)
- d) Assuming member states still have discretion to decide themselves, how long should we give part-users and NPQHs to increase/resume production so that any confiscated quota can be restored to them? Do you think 2 years or 3 years or longer? (See paragraphs 14-15 above)

B. SEPARATION OF QUOTA FROM LAND

Aim of the Proposal

1. The aim of the proposal is: -

- To reduce the bureaucracy attending permanent transfers of quota;
- More generally, to secure greater mobility of quota, so that ownership is shifted to areas where it is actively being used; and
- To enable tenants to buy quota in their own right, without the fear that the quota will be subject to complex compensation negotiations at the end of the tenancy;

2. We do not wish to prevent landlords acquiring quota for use by their tenants. In addition, the new rules would only apply to new transfers - it would not affect existing landlord/tenant relationships with regard to milk quota. We would propose that the new provisions would apply to all permanent transfers, not only those involving tenants.

Legal Basis

3. The current legal base is Article 8a of the EC Council Regulation on quotas - 3950/92. This is likely to be replaced shortly by a new Regulation which the Commission has produced as part of the current CAP reform proposals. Under the current draft of the proposal we could use the new Article 17(1)(d) in combination with Article 17(2), which would allow member states to sever the link at national level '*with the aim of improving the structure of milk production*'.

Applying this provision will improve the structure of milk production by ensuring greater mobility of quota, and by helping to ensure that tenants who are active producers can acquire quota in their own right more easily than at present.

Current State of Play

4. By the last quota year, the most favoured method by far of permanent transfer was by lease of land. Most parties embarked upon this type of transfer because, at the end of the minimum period (eight months in Scotland) the quota could be acquired by the transferee without the accompanying land. This is therefore a means of ultimately acquiring quota without land, but with bureaucratic administrative procedures accompanying the transaction, in the form of contracts/tenancy agreements.

5. Article 8(e) of Council Regulation 3950/92 provides for the producer to make an application for the transfer of quota without land (TWOLs), or vice versa, with the aim of improving the structure of milk production at the level of the holding or to allow for the extensification of production. The Dairy Produce Quotas (Scotland) Regulations 2002 liberalised *the* requirements for such transactions in order to encourage greater use of TWOLs instead of permanent transfers via lease of land, to reduce the bureaucracy attending permanent transfers. TWOLs are very likely to replace lease of land as the most frequently used means of transferring quota in the UK.

6. However, unless the Member State formally breaks the link between quota and land, then the supposition is that quota will lie with the land. As a result, a tenant who buys in quota at

present can not be assured that the quota will remain with him at the end of the tenancy, which acts as a strong disincentive to his acquiring quota in his own right.

Proposals

Scope

7. The proposed breaking of the link between quota and land is not as radical as it would first appear, as it would only relate to new transfers of quota, so, in most cases, the landlord/tenant relationship would remain the same.

Landlord/Tenant Relationship

8. We would wish to ensure that both landlords and tenants' rights are protected: -
- It is already the case that quota transfers can only take place with the permission of all parties concerned (e.g. tenants, landlords, and mortgagees) and this would remain so.
 - At present, if a tenant fails to produce against quota, it is confiscated, despite the fact that it 'belongs' to the landlord. However, if the tenant, landlord, or a new tenant resumes production within the current deadline of 6 years, (2 under the latest dairy CAP reform proposal) then the quota is restored to the landlord. This arrangement would remain unaffected in respect of existing quota in which the landlord has an interest.
 - The compensation provisions of the Agriculture Act 1986 (Schedule 2) would be unaffected by the proposals. Here, compensation is only payable to the tenant where the quota is attached to the land. In the case of quota which has been bought in by the tenant, who then wishes to sell it out, the quota would not be considered to be attached to the land, and thus no compensation would be payable. On the other hand, the tenant, who had bought in the quota, if he did not wish to continue in milk production, would benefit from the full profits of the quota sale.

Entry into Force Date of Provision

9. If we were to introduce this provision, we would hope to do so as soon as the Regulations effecting the change came into force, that is, in the course of the 2003/04 quota year.

SEPARATION OF QUOTA FROM LAND: QUESTION FOR CONSULTEES

We would be grateful for general comments on the proposal but in particular; do you envisage any potential problems with the implementation of this provision?

C. QUOTA ADMINISTRATION

Transfer of Quota without transfer of land (Regulation 12)

If a transferee fails to start production within six months of a transfer without land, the transferred quota may be taken into the national reserve. The current Regulations allow for the quota to be returned when the transferee resumes or commences milk production. There is not a time limit specified for the transferee to resume production. For the sake of consistency, it is proposed that the rules for the return of quota confiscated in these circumstances should be brought into line with those for the return of quota confiscated for non-production (Regulation 32).

Approval and Registration of Purchasers (Regulation 24)

Currently, the DPQR requires an applicant for the status of purchaser to provide documentation which demonstrates that he or she has a sound financial basis on which to operate. This is because purchasers are responsible for collecting any superlevy due. It is proposed that new applicants who have no previous trading record (and therefore no such documentation) should be able to lodge a security with the RPA, instead, which would provide an indicator of the good intentions of the applicant.

Administrative Penalties (Regulation 30)

It is proposed to introduce a penalty for understatement of both wholesale and direct sale annual declarations. This would be at a rate equivalent to 0.5% of the theoretical amount of levy payable on the amount underdeclared. This rate of penalty already applies to overstatements. It was previously considered that the payment of the levy due on the undeclared amount was sufficient sanction. However, for the past couple of years no levy has been payable in the UK, as national production has been within quota. As a result, no penalty has been applicable to underdeclarations.

Confiscation and Restoration of Quota (Regulation 32)

Restoration of Quota to Direct Sellers who have failed to submit an annual declaration within deadline - Paragraph (2) (b)

Introduction of a tightened penalty for direct sellers who fail to submit an annual declaration of production by 1 July after the quota year in question. Under the proposal, quota confiscated from such direct sellers, if they still fail to submit the declaration after repeated warnings, will not be restored until the beginning of the following quota year (as provided for in Article 5 of EC Council Regulation 3950/92). This will make it an effective sanction, as the direct seller will need to lease in additional quota to cover production, or otherwise potentially risk payment of levy. Currently the direct seller can apply to have the quota restored within the same quota year as confiscation, and thus there is no effective penalty, apart from minor administrative inconvenience.

Applications for right to quota restoration – Paragraph 4

It is proposed that this provision be expanded to allow anyone with an interest in the holding/quota to apply for the right to restoration of quota in the future. At the moment the Regulation only provides for the producer to do this, but there have been instances where a landlord has asked if he/she can reserve the right, which appears a reasonable request.

Deadline for Requests for the Restoration of Quota – Paragraph 5

Currently, this paragraph allows, for submitting requests for the restoration of quota, up to 15 July in the year following the quota year to which the request relates. It is proposed to bring this back to ‘before the end of the quota year to which the request relates’. Most people going back into production would in any case request restoration promptly to ensure they are covered. Making this adjustment would help reduce the scope for last minute changes prior to the levy calculation.

Reversion of Quota to a Non-Producing Landlord

As a result of the Thomsen ECJ judgement, quota can only revert to a non-producing landlord on expiry of a tenancy where the landlord is due to start production within a short period of time, or transfers the quota to an active producer (whether a new tenant or another third party) within ‘as short a period as possible’. We would propose that it be stipulated that the landlord should take up production, or transfer of the quota to an active producer ‘as soon as possible and, at the latest, within 6 months’. Exceptional circumstances would be taken into account.

QUOTA ADMINISTRATION: QUESTION FOR CONSULTEES

Do you have any comments or concerns about the proposed amendments to the Regulations?

PARTIAL REGULATORY IMPACT ASSESSMENT

INTRODUCTION OF CHANGES TO THE MILK QUOTA SYSTEM

Purpose and Intended Effect

Objective

1. To implement two discretionary provisions in the EC council regulations on quotas – breaking the link between quota and land, and the possible introduction of a 70% usage rule. To take the opportunity to introduce some other changes to the Dairy Produce Quotas (Scotland) Regulations 2002 (SI2002/110) (DPQR). All provisions would apply to the UK as a whole.

Background

2. Agenda 2000 introduced two discretionary provisions into EC regulation 3950/92: -
- The introduction of a 70% usage rule, whereby if dairy farmers produce against less than 70% of their quota, all or part of the unused quota is confiscated;
 - Breaking the link between quota and land, with a view to improving the structure of milk production. Currently, unless member states formally break this link, then it is assumed that quota attaches to the land. Therefore, under normal circumstances, it can only be permanently transferred to another producer through a sale or lease of land.
3. As a result of a recent European court of justice case, quota holders who no longer produce milk (non-producing quota holders – NPQHs) will not be able to retain their quota. Existing NPQHs will have to sell their quota or resume production by 31 march 2004 in order to avoid having their quota confiscated (currently, to retain their quota, they just need to lease it out each year). The introduction of a 70% rule could be considered as a further means of aligning quota with production – without it there may be dairy farmers with only minimal production who are able to retain their quota, and lease out the unused amount, or who acquire quota purely for the purposes of leasing it, or for speculation. Breaking the link between quota and land will not only minimise the bureaucracy attending quota transactions, but will make it easier for tenants to buy quota in their own right, without fear that the bought quota will attach to the land (and thus effectively the landlord) on expiry of the tenancy. At the moment, tenants tend to be dependent on leasing in quota, and much of the leasing market will disappear with the demise of the NPQH.
4. If introduced, both these changes will require amendments to the DPQR, and so the opportunity has been taken to introduce additional changes to the system of quota administration. The most significant of these are: -
- i. The introduction of a penalty for understatement of deliveries/production on annual declarations at a rate equivalent to 0.5% of the theoretical amount of levy payable on the amount underdeclared. (Annual declarations are essential for the annual return that the UK sends to the commission, and which forms the basis of the levy calculation - the fine payable where a farmer's milk production exceeds quota). The rate of penalty of 0.5% already applies to overstatements. We currently rely on the fact that the purchaser/direct seller must pay full levy on the undeclared production where the UK as a whole is over quota.

However, for the past couple of years no levy has been imposed on producers, as national production has been within quota, and thus no effective penalty has been applicable.

ii. Introduction of a tightened penalty for direct sellers who fail to submit an annual declaration of production by 1 July after the quota year in question. Under the proposal, quota confiscated from such direct sellers (if they still fail to submit the declaration after being given 30 days notice) will not be restored until the following quota year. This will make it an effective sanction, as the direct seller will need to lease in additional quota to cover production, or otherwise potentially risk payment of the levy. Currently the direct seller can apply to have the quota restored within the same quota year as confiscation, and thus there is no effective penalty, apart from minor administrative inconvenience.

iii. Addition of an alternative condition for approval of potential milk purchasers – the lodging of a security. Currently, the DPQR requires an applicant to provide documentation which demonstrates that he or she has a sound financial basis on which to operate. The lodging of a security would apply to new applicants who have no previous trading record (and therefore no such documentation).

iv. Introduction of a requirement that non-producing landlords must either transfer quota to an active producer, or commence production themselves as soon as possible, and in the majority of cases, at least within 6 months of acquiring (or reacquiring) the quota. This would implement an element of the judgement on the Thomsen European Court of Justice case, under which quota can not be retained by non-producers of milk.

Risk Assessment

Introduction of 70% Usage Rule

5. As a result of the Thomsen judgement at the European Court of Justice, non-producing quota holders (NPQHs) will no longer be able to hold quota as from 1 April 2004. Separately from this, member states have the discretion as to whether or not they introduce a 70% usage rule, whereby if a quota holder (an active producer) produces against less than 70% of his quota, he would have all or part of the unused quota confiscated.

6. On the one hand, in the light of the Thomsen case, the introduction of a 70% rule could be regarded as a further means of aligning quota ownership and production. The absence of such a rule could be considered as giving rise to an anomaly whereby NPQHs have to divest themselves of their quota, but those who use only a small proportion of their quota (effectively quasi-NPQHs) can retain it. There has also been a concern expressed that, in the absence of a 70% rule, active producers may buy in quota purely for the purposes of speculation, or for leasing it out, and that by keeping quota off the sales market, it will force up the purchase price (a concern raised in relation to NPQHs).

7. On the other hand, there is arguably a difference between quota being owned by active producers as opposed to by NPQHs, as at least in the former case the quota leasing revenue is being recycled within the dairy sector. There are also potential concerns about the impact on the leasing market of the applying the 70% rule, in combination with the demise of NPQHs. NPQHs have represented a large proportion (60-65%) of the leasing market, and if they do not resume production, the quota held by them will have to be put onto the purchase market. The 70% rule, by further reducing the amount of quota available for leasing, may impair the

flexibility of the quota system. However, the overall demand for quota leasing will diminish as active producers traditionally dependent on leased in quota purchase it instead from NPQHs. Furthermore, some of the purchasers of quota released by NPQHs may lease out at least some of it in their turn. The impact of the 70% usage rule on the quota leasing (and sales) market would depend crucially on the way it is implemented, and options are provided within the consultation paper (also outlined below, under costs/benefits).

8. In 2000/01, the number of quota holders who leased out 30% or more of their quota, and thus by implication, used less than 70%, was 1,721. The amount of quota leased out by them (and thus surplus to requirements and potentially saleable) was 501 million litres. Over the past 4 years, the amount of quota sold out annually was only 500-900 million litres. Therefore the unused quota held by these 'part-users' represents a significant proportion of the current sales market. However, not all of this quota would find itself on the sales market with the imposition of a 70% rule, either because the underuse is temporary, or depending which option is adopted, not all the quota would be in danger of confiscation (see costs/benefits).

9. For many active producers, buying quota would be preferable to leasing it in. The quota market (whether sales or leasing) can be very volatile, varying substantially year-to-year, and within year, depending on the price of milk and whether or not it is likely that production will be within quota. Quota ownership would remove that element of uncertainty, and may be cheaper in the long-term (see costs/benefits)

Break of the Link between Quota and Land

10. There are two principal problems associated with the current link between quota and land: -

- The bureaucracy attending the current arrangements;
- The fact that it inhibits tenants from buying in quota in their own right.

Bureaucracy

11. By the last quota year, the most favoured method by far of permanent transfer was by lease of land. Most parties embarked upon this type of transfer because, at the end of the minimum period (8 months in Scotland) the quota could be acquired by the transferee without the accompanying land. This is therefore a means of ultimately acquiring quota without land, but with bureaucratic administrative procedures accompanying the transaction, in the form of contracts/tenancy agreements which impose costs both on the producer and the Rural Payments Agency (RPA).

Tenants

12. Unless the Member State formally breaks the link between quota and land, then the supposition is that quota will lie with the land. As a result, tenants who buy in quota at present can not be assured that the quota will remain with them at the end of the tenancy. If it stays with the land, its value may be subject to complex compensation negotiations with the landlord. This therefore acts as a strong disincentive to the tenants acquiring quota in their own right.

13. It is believed that a majority of tenant dairy farmers in Scotland could potentially afford to buy the quota that they currently lease in. It is uncertain to what extent these tenants are inhibited from buying the quota because of the link between quota and land.

14. The landlord/tenant legislation is complex. It is possible that, in the course of consultation with industry bodies, both via the formal written consultation, and in meetings, problems may be identified which may force us to reconsider whether it is feasible to introduce this provision.

Changes to Quota Administration

15. In relation to the amendments outlined at Paragraph 4: -

(i) and (ii)

Annual declarations are essential for the annual return that the UK sends to the commission, and which forms the basis of the levy calculation. Without these amendments, there is no effective penalty for the late/non-submission of annual declarations for direct sellers, and for understatements in annual declarations. The absence of such penalties could be regarded as jeopardising the timely and accurate submission to the commission by the rural payments agency of the annual return on production against quota.

For the purposes of illustration, in 1999/00 (the last year the UK was charged a levy) there were 37 understatements by direct sellers, giving rise to invoices totalling £163,000. That year there were also 24 purchasers with understatements totalling £183,000.

The UK faced disallowance in 1998/99 amounting to around £2 million because of an error made by one of the purchasers whose bill was later reduced by some £500,000. That error affected the amount that the UK could have collected by the deadline, below the threshold acceptable to the Commission, and left the UK with total disallowance of the outstanding levy.

(iii)

The failure to introduce a security within the purchaser approval criteria would make it very difficult for a new operator, without a business track record, to obtain purchaser approval. Only one applicant has actively withdrawn because of difficulties in providing evidence, but over the last year (since this provision has been in force) the RPA have had about 20 applicants who have found it difficult to provide the evidence, as their application is in a different name to any other trading entity. This has proved difficult not only for the applicant, but also for the administrators in RPA who have been making great efforts to find means of helping these applicants, so as not to be forced into stopping them from trading or from developing their businesses.

(iv)

The Commission has explicitly stipulated in an interpretative note on the Thomsen judgement that, on expiry of a tenancy, any non-producing landlord must transfer quota to an active producer, or commence production, 'as soon as possible'. Therefore, to fail to introduce a specific provision could leave the UK open to disallowance. The amounts involved would be difficult to quantify. We are proposing to stipulate 'as soon as possible and within at least 6 months' as a clear signal to landlords, while accepting that there may be exceptional

circumstances which mean that the landlord has to take longer, for example, to find a new tenant.

Options

16. All of the above proposals, if adopted, would require amendments to legislation. Doing nothing is clearly an option for the application of *the 70% rule*, and *breaking the link between quota and land*. In the case of the 70% rule, member states have considerable latitude in how they implement this rule, and so a variety of options are outlined in the costs/benefits section below.

17. Doing nothing is not an attractive option in relation to the proposals outlined at Paragraph 15, for the reasons described there. In terms of options for implementation, the measures proposed seem to be the most reasonable, although consultees may have differing views on, for example, whether the 6-month deadline relating to non-producing landlords is reasonable.

Costs and Benefits

Business sectors affected

18. Primarily dairy producers, which numbered 27,000 in the UK in 2001. With regard to the proposals on quota administration: -

(i) and (iii) will affect purchasers of which there are 140. 8 purchasers hold 72% of the quota, 17 hold a further 20%, with the remaining 115 holding only 8%.

(iv) It is difficult to estimate the number of landlords of dairy holdings, but for Scotland, it would be a maximum of 2,000 (and probably much less).

Cost/Benefits

70% Rule

19. The options examined are: -

- confiscating all the unused quota
- half
- Only the amount unused below 70% of the total quota.

20. Member states can also choose the number of quota years that a producer must be producing against less than 70% of his quota before it is confiscated. The options examined are: -

- 1 year
- 2 years
- 3 years

Impact on Quota Leasing Market

21. The amounts concerned would be as follows (the figures again relate to 2001/02): -

Proportion	Amount (million litres)	As % of leasing market*	As % national quota**
All	501	25.0%	3.5%
Half	250	12.5%	1.8%
Unused below 70%	214	10.7%	1.5%

* The total amount of quota leased out in 2001/02 was 2,002 million litres, by 10,087 lessors.

** The UK Quota for 2001/02 was 14,186 million litres.

22. If these figures are combined with the amount of quota leased out by NPQHs in 2001/02 (as again, much of the NPQH quota may disappear from the leasing market as a result of the Thomsen judgement) the amounts concerned, are as follows: -

Proportion	Amount (million litres)	As % of leasing market	As % national quota
All	1,845	92.2%	13.0%
Half	1,594	79.6%	11.2%
Unused below 70%	1,558	77.8%	11.0%

23. It is clear that, under all the scenarios, there would be a potentially large effect on the leasing market, particularly when combined with the effect of the Thomsen judgement. As would be expected, the option of only confiscating unused quota under the 70% threshold having the least impact, with over 20% of the leasing market remaining potentially unaffected.

24. It is very difficult to assess to what extent the leasing market would, in fact, shrink with the introduction of a 70% rule, as any quota sold by a 'part-user' (those producing less than 70%) may then be leased out by the buyer. Alternatively, it is possible that a producer may buy in the quota as an alternative to leasing it in, in which case, there would be a corresponding reduction in demand for leasing (both of these scenarios would also apply to quota sold by NPQHs). Some 'part-users' may, however, decide to produce up to the 70% threshold to avoid confiscation, in which case potential lessees would be affected. If it were assumed that those producing against 55-69% of their quota would be likely to do this, then this would take 100 million litres of quota off the leasing market, on the basis of 2001/02 figures.

25. Overall, there will still be demand for leasing from active producers who are not able to buy in quota, and others who, for example, wish to cover short-term increases in production. The 70% rule, by further reducing the amount of quota available for leasing, may impair the flexibility of the quota system, although the effects would be mitigated by only applying the confiscation provision to unused quota below 70% and allowing 3 years before confiscation.

Impact on the Sales Market

26. It is difficult to assess what the impact on the quota sales market would be, and thus any benefit to any potential buyer. The figures at paragraph 21 give an indication, under the various options of what would *theoretically* be available for sale, if a 70% rule were imposed.

However, although some of these ‘part-users’ would no doubt intend to carry on leasing out a large proportion of their (potentially saleable) quota in the absence of a 70% rule, there will be categories within this group where the situation is a temporary one: -

- Quota holders who have stopped production definitively in the course of the quota year. As a result of the Thomsen ECJ judgement, all the quota held by them would be confiscated if not sold in the following quota year. Therefore the application of the 70% rule would have no additional effect.
- A temporary downturn in production due to bad weather, disease etc. – in these circumstances, any confiscated quota would be restored to the producer once production improved (or may not be confiscated at all, if *force majeure* provisions applied).
- The purchase of additional quota preparatory to expanding production Again, the quota would be restored once production increased.

Therefore, in these cases, there would no additional impact on the sales market as a result of the introduction of the 70% rule. Unfortunately, it is difficult to assess how many ‘part-users’ fall into each category.

Impact on Part-Users

27. The least onerous option for part-users would be for the confiscation provisions to apply over 3 years (or not at all) to unused quota below 70%, as this would allow them to adapt. It would also allow those who have purchased quota to expand production, or who have suffered a temporary downturn in production, to increase their production to the appropriate level to avoid confiscation. It is possible that any shorter period may force them to have to take action, such as selling the quota, or having to increase production at a rate quicker than they would have wished, in order to avoid confiscation, to the possible detriment of their businesses.

Benefits

28. The benefits to ‘normal’ producers in terms of preventing ‘part-users’ from speculating on the leasing or sales market are difficult to quantify, and could be considered simply transfers in most if not all cases (as any benefit to them would be offset by losses by the part-users). Nonetheless, such a move could be considered of benefit to the more active part of the dairy sector, in potentially reducing the price of quota in any given year.

29. If there were to be greater availability of quota on the sales market, this could potentially be of benefit to producers as purchase may ultimately be cheaper than leasing in quota. However this is very difficult to ascertain. Based on current rates of interest, the purchase of quota at 12 ppl repaid over 5 years would cost 14.2 ppl. Under the CAP dairy reform proposals, quotas would be extended to 2015. If the costs of quota bought in 2003 were spread over the life of the quota regime (assuming that the 70% rule influenced sales decisions in 2003) that would average out at an annual cost of 1.18 ppl, at the lower end of quota lease price in the last couple of years.

Cost to Purchasers

30. There would be a need for all milk purchasers to supply delivery figures to RPA for all deliveries made to them. (At the moment, they send this in summary form). This would entail a small additional administrative burden on purchasers. However those purchasers who have already been involved in discussions have suggested that this burden would not be

too onerous as they also foresee advantages to themselves in other areas of RPA's responsibilities.

Cost to RPA

31. The cost in staff time, primarily in determining those whose production fell below the 70% threshold is roughly estimated at £10,000/year.

Break of the Link between Quota and Land

32. There may be savings to tenants through switching from leasing in quota to buying it. The price of quota varies enormously depending on the milk price and whether national production is likely to hit quota in any given year. It is therefore very difficult to predict what leasing prices will be like in the future. Under the current dairy CAP reform proposals, quotas would be extended to 2015. Based on a quota sales price of 12 ppl, with the benefit spread over 12 years would mean an average annual cost of 1ppl, while in the past couple of years leasing prices have tended to run at 1-2ppl.

33. This amendment should also reduce the bureaucracy attending quota transfers. Currently, the majority of permanent transfers take place via lease of land, which results in the producer having to draw up land tenancy agreements and contract services agreements. This new measure should save some hour's worth of time per transfer, and possibly other administrative costs in not having to obtain contracts/agreements. It should also reduce the administrative burden on the RPA, as there would no longer need to be 5% surveillance checks, with a saving roughly estimated at £12,000, annually.

34. No costs have been identified for this proposal.

Quota Administration

35. The costs/benefits are as follows: -

(i) & (ii) Explicit penalty for understatement of deliveries/production on annual declarations and a tightened penalty for direct sellers who fail to submit an annual declaration of production

Benefit

The imposition of penalties should ensure the timely and accurate submission of annual declarations, which are essential for the calculation of an accurate and timely annual return to the Commission by the UK. This would be of benefit to the taxpayer, as it would save administrative costs for RPA, as well as avoiding disallowance for failure to observe the Commission's deadline. As indicated at Paragraph 15, the UK faced disallowance in 1998/99 amounting to around £2 million because of an error made by one of the purchasers whose bill was later reduced by some £500,000. Administrative costs incurred by the RPA in chasing late declarations amount to around £450 per year.

Cost

There will obviously only be a cost to the industry where the purchaser/direct seller fails to comply with the legislation. As stated at Paragraph 15, in 1999/00 (the last year the UK had a levy) there were 37 understatements by direct sellers, giving rise to invoices totalling £163,000, an average of £4,400 each. That year there were also 24 purchasers with understatements totalling £183,000 (an average of £7,600 each).

(i) For the purposes of illustration, the penalty for the understatement of annual declarations by 1%, based on an assumed levy rate of 23 pence per litre, would be: -

For a direct seller producing 500,000 litres/year: -

$500,000 \times 1\% = 5,000$

$5,000 \text{ litres} \times 23 \text{ ppl (assumed rate of levy)} = £1,150$ (levy theoretically payable on the error)
 $\times 0.5\% = £5.75$ (Would incur minimum penalty of £60).

For a purchaser, receiving deliveries of 20 million litres/year:-

$20 \text{ million litres} \times 1\% = 200,000 \text{ litres}$

$200,000 \text{ litres} \times 23 \text{ ppl} = £46,000$ (levy theoretically payable on the error) $\times 0.5\% = £230$

(ii) Those direct sellers who fail to send in their annual declaration by the deadline, and who have their quota confiscated, tend to hold (for historical reasons) a small amount of direct sales quota, in conjunction with a far larger amount of wholesale quota. They also do not tend to make direct sales but request temporary conversion of that quota if necessary. The maximum amount of quota confiscated from a direct seller in the past 10 years has been 100,000 litres, and generally it is less than 1,000 litres. The cost in quota leasing (if necessary) to cover the production and avoid levy would be £10-20 based on 1,000 litres, and on a quota leasing price of 1-2ppl

(iii) Addition of an alternative condition for approval of potential milk purchasers – the lodging of a security by the RPA.

Benefit

This would allow applicants without a track record in business the opportunity of operating as a purchaser, while at the same time, protecting taxpayers' funds, as purchasers are responsible for collecting levy for the government and ultimately the EU. It will help to ensure that only those businesses with a sound background will be eligible for purchaser approval.

Cost

The level of the payment of the security would vary according to the level of deliveries to be covered by the applicant. The average new purchaser takes deliveries of 1 million litres, or (frequently) less.

(iv) Introduction of a time-limit of up to 6 months by which non-producing landlords must either transfer quota to an active producer, or commence production themselves.

Benefit

The UK government would avoid disallowance by requiring compliance with this EC requirement.

Cost/Potential Negative Impact

It may involve landlords in more work/inconvenience in seeking to find a tenant as soon as possible. There would be an extra administrative burden to both landlords and the RPA where the quota is confiscated, for example, in determining whether any failure to meet the deadline may be subject to *force majeure*. The likely scale of such cases is difficult to assess.

Consultation with small business: the Small Firms' Impact Test

36. The measures will in the main affect dairy farms, the vast majority, if not all of which will be small businesses. In the course of the consultation we shall seek views on the two principal proposals (for the application of the 70% rule and breaking the link between quota and land) in discussion with the Scottish National Farmers' Union (SNFU) and the Scottish Landowners' Federation (SLF). Our current understanding is that the SNFU favour severing the link between quota and land, as a positive benefit to tenant farmers wishing to acquire quota in their own right. The view of the SLF is presently unknown.

Competition Assessment

37. We anticipate that implementation of the proposed regulations is likely to have a broadly neutral effect on competition.

38. The effect of introducing the 70% usage rule may reduce quota prices, by reducing the danger of speculation. The proposal to break the link between quotas and land is likely to result in easier trading of quotas. These factors may result in a slight lowering of barriers to entry, which could lead to a small increase in the potential for competition.

39. Implementation of the proposal to allow potential milk purchasers to offer security as a means of gaining approved status (as an alternative to the current requirement to show evidence of past trading performance) will have a positive effect for competition, since it will reduce the current barriers to new entry.

40. We will keep competition impacts under review during the course of consultation, and would welcome any information that stakeholders are able to provide regarding any potential impacts on competition of which they may be aware.

Enforcement and Sanctions

41. Administration of the proposed changes will be undertaken by the RPA.

Monitoring and Review

42. The operation of the DPQR is subject to continual review through mechanisms such as the quarterly meetings of the Milk Quotas Expert Group organised by the RPA and attended by trade interests and the agriculture departments. If, following consultation and approval by

the Scottish Parliament, these changes are made, the Scottish Executive will conduct a review RIA after a period of three years from the date of the revised DPQR coming into force.

Consultations

Within Government

43. There has been consultation with the RPA and the other agriculture departments.

Public consultation

44. We propose to consult trade organisations representing interested parties – including farmers, landlords, quota brokers, and milk purchasers.

Summary and Recommendation

70% Rule

45. The costs and benefits of the application of this rule are difficult to assess and the arguments finely balanced. Whether the rule should be introduced at all, and in what form, should be a matter for the trade to determine in the course of consultation.

Breaking of Link between Quota and Land

46. The advantages of this are more apparent, as it will be of potential benefit to tenants, and should help to reduce the administrative/legislative burden on the sector - assuming that no insoluble problems are identified during the consultation process.

Changes to Quota Administration

47. (i) and (ii) The imposition of the penalties relating to the submission annual declarations should be of benefit to the taxpayer. Timely submission and accuracy of declarations would save administrative costs for RPA, as well as reducing the risk of disallowance for failure to observe the Commission's deadline for the submission of the UK annual return.

(iii) The introduction of an alternative condition for purchaser approval will remove the current barriers to those operators without a previous financial track record.

(iv) We are under an EC obligation to require landlords to transfer their quota to an active producer, or to become one themselves. We are proposing a limit of 6 months, but allowing for exceptional circumstances to be taken into account. We consider this is reasonable.

DECLARATION *[For the final RIA which accompanies legislation]*

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

.....

Date:

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Scottish Executive

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The Consultation Criteria

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
2. It should be clear who is being consulted, about what questions, in what time scale and for what purpose.
3. A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
4. Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.
5. Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.
6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and reasons for decisions finally taken.
7. Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure that lessons are disseminated.