The Committee will meet at 10.00 am in Committee Room 5.

1. **Item in private**: The Committee will decide whether to consider item 3 in private.

2. **European issues**: The Committee will consider an update from the Convener on European issues.

3. **Food Supply Chain Inquiry**: The Committee will consider how to proceed with the inquiry.

4. **Crofting Reform etc. Bill (in private)**: The Committee will consider a draft Stage 1 report.

Mark Brough
Clerk to the Committee
Direct Tel: 0131-348-5240
The following papers are attached:

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Background

1. The volume of EU material relevant to the Committee’s remit is very significant. Awareness of European legislation may be helpful in relation to a large portion of the Committee’s referred work, such as petitions and both primary and secondary legislation.

2. Its workload means that the Committee has to be selective in undertaking detailed consideration of any EU issues on its own initiative (e.g. by undertaking inquiries). As part of its agreed approach to gathering information on relevant EU issues and legislative proposals (and integrating those into its work programme discussions) the Committee has therefore asked me to provide an update on relevant issues approximately quarterly as the basis for work programme decisions. This is the seventh such update.

3. Committee members are also informed about relevant EU issues through the Executive’s regular pre-and post-council reports and through the information provided by the European and External Relations Committee.

Sources of Information for the Committee on EU issues

Scottish Executive approach to reporting to the Parliament on EU issues

4. The Scottish Executive has recently revised its approach to reporting to the European and External Relations Committee and has produced a paper on its EU priorities for 2006 along with a Forward Look which provides an overview of EU business for the year. The Executive’s view is that an annual time horizon, rather than reporting on a six month basis at the beginning of each presidency, takes better account of the fact that many major issues remain on the EU agenda for longer than six months and fits better with the EU annual legislative cycle.

5. The Executive’s EU priorities paper sets out the key EU dossiers for each policy area in 2006 and includes a summary of each priority area, the implications for Scotland and the action it is taking. Nine of those priority areas are within the Environment and Rural Development portfolio. They are:
   - lifting the EU beef export ban – Commission proposal;
   - review of the cod recovery plan – Commission proposal;
   - internal EU fisheries negotiations – Pre-proposal;
   - external fisheries negotiations – annual negotiations: no Commission proposals
   - EU trade defence: anti-dumping measures against Norwegian farmed salmon – Commission Regulation published
   - proposals for a new aquaculture health directive – Council proposal;
   - the European Fisheries Fund – Commission proposal;
• the Groundwater daughter directive – common position reached in Environment Council in 2005. European Parliament due to consider the directive in mid-2006, and

6. The Executive envisages revising the key dossiers during the year with new dossiers being added and others falling off the list.

7. The Forward Look for 2006 provides an overview of relevant EU business over the year. It analyses how the key EU institutions are dealing with, and influencing, the EU agenda for 2006. The Executive intends to update this document at the start of the Finnish presidency in July. It contains information on cross cutting issues as well as those relating to agriculture, fisheries and the environment.

8. These two papers provide a considerable depth of information on a number of issues that the Committee has been following through its EU update reports. Copies of both papers have been circulated to members previously and additional copies are available from the Clerks. An update on some of the issues covered in these papers is included in the Annex to my report. However, the Committee may wish to seek an update from the Executive on any of the issues covered in these papers.

European Commission’s Work Programme

9. The Parliament’s European Officer has highlighted some other legislative initiatives that are likely to be of interest to the Committee. They are:

• Adaptation to climate change – Green Paper
• Thematic strategy on the sustainable use of pesticides – Directive
• National emission ceilings (NEC) for certain atmospheric pollutants – Directive
• Market organisation of fresh and processed fruit and vegetables – Regulation
• Animal by-products – Regulation
• Clean Coal Technologies – Communication
• Future prospects for biofuels – Communication
• Action Plan on energy efficiency – Communication
• Halting the decline of biodiversity – Communication
• Results of the review of the community strategy to reduce CO2 emissions from cars – Communication

10. Some of these issues are discussed further in the Annex to this report. However, the Committee may wish to seek an update from the Minister on any of these issues.

Recent Committee activity on EU issues

Ministerial evidence

11. Since my last update in November 2005, the Committee has taken evidence from the Minister for Environment and Rural Development prior to the December meeting of the Agriculture and Fisheries Council and again in January 2006 on the priorities for the Austrian presidency. The Committee has recently agreed to take evidence from the Minister on 21 June on the priorities for the Finnish presidency.
Secondary legislation

12. The Committee has continued to consider a number of Scottish Statutory Instruments (SSIs) that are directly related to EU legislation. For example, it took evidence from the Minister on an increase in the payment rates for the Organic Aid Scheme. The Committee also considered SSIs on the Less Favoured Area Support Scheme and the Rural Stewardship Scheme. The Committee has also considered a number of SSIs relating to Avian Influenza.

Relevant current issues

13. The Annex to my report updates the Committee on some of the issues that it has identified in previous reports\(^1\) and other issues that may be of interest to members. It is not an exhaustive list and it contains a mixture of items – some of which are at an early stage of development or not yet concluded at EU level, and others which are concluded at EU level and await domestic implementation.

14. Members are invited to:

- note the recent and current work programme of the Environment and Rural Development Committee in relation to EU matters.
- consider whether they wish to undertake any further work, or seek further information from the Executive, on any of the EU issues set out in the attached appendices (or on any other EU issue). If so, members are invited to consider whether they wish to:
  - pursue these in evidence with the Minister in writing or in oral evidence scheduled for 21 June;
  - authorise the Convener to seek a detailed briefing from the Minister on any topic of particular interest;
  - request further information and detailed options for further consideration of any particular issue from the Convener as part of future work programme discussions.

Sarah Boyack MSP
Convener
25 May 2006

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\(^1\) These are available on the Committee’s webpage with the papers for the meetings on 3 December 2003, 21 April 2004, 15 September 2004, 19 January, 1 June and 16 November 2005.
ENVIRONMENT

Biofuels Strategy
1. The European Commission proposed a biomass and biofuels action plan on 7 December 2005. The Commission states that the plan is designed to increase the use of energy from forestry, agriculture and waste materials. As part of the action plan, the Commission adopted a strategy for biofuels on 8 February 2006. The strategy relies on a range of potential market-based legislative and research measures to boost production of fuels from agricultural raw materials and has three main objectives:

- to promote biofuels in both the EU and developing countries;
- to prepare for large-scale use of biofuels by improving their cost-competitiveness and increasing research into ‘second generation’ fuels; and
- to support developing countries where biofuel production could stimulate economic growth.

2. A report will be published in 2006 on a possible revision of the biofuels directive. In addition, the EU Council of Ministers is finalising its position on an action plan for biomass energy. The key focus of debate has been to strike a balance between the interests of large agricultural producers and countries with smaller farm economies. Energy ministers are expected to adopt the position formally on 8 June.

Biodiversity
3. In December 2005 the European Commission consulted on the measures which the European Union could adopt to halt the loss of biodiversity by 2010 and to restore biodiversity in the longer term. On 22 May 2006 the Commission adopted a Communication which sets out its policy approach. In particular, it provides an EU Action Plan which proposes concrete measures and outlines the responsibilities of EU institutions and Member States. It also specifies indicators to monitor progress, and a timetable for evaluations. It spells out what needs to be done to halt biodiversity loss in the EU and to meet the international commitments to reduce biodiversity worldwide. It also creates an advisory mechanism to help decision-makers make better use of existing knowledge.

4. The Communication identifies four key policy areas –
- biodiversity in the EU
- the EU and global biodiversity
- biodiversity and climate change
- the knowledge base

It proposes 10 priority objectives in relation to these, addressing the most important habitats and species; actions in the wider countryside and marine environment; making regional development more compatible with nature; reducing impacts of invasive alien species; effective international governance; support to biodiversity in international development; reducing negative impacts of international trade; adaptation to climate change; and strengthening the knowledge base.

Chemicals Policy (REACH)
5. The European Parliament has now adopted REACH. An extraordinary meeting of the Council was called on 13 December 2005 to finalise the agreement and make minor amendments to the UK’s compromise proposals which were agreed unanimously by the Council. The Minister advised that the Executive has been in contact with DEFRA on the
progress of REACH and will continue to liaise with the Department on the next steps, including a public consultation on the establishment of a UK competent authority. The Minister advised that he would ensure that any Scottish-specific issues are fully considered in the establishment of the authority.

6. The Council of Ministers released a draft preamble to REACH in January which sets out a summary of the regulation’s key points and a commentary on the principles and intent behind the legislation. This preamble is currently subject to agreement through the co-decision process between the Council and the Parliament and once agreement has been reached, the second reading can begin. It is anticipated that the co-decision process will be completed in autumn 2006, with entry into force of the Regulation expected for spring 2007. There will then be an additional year before main REACH procedures begin to apply in order to allow a European Chemicals Agency to become fully operational.

**Directives**

**Bathing Water Directive**

7. On 18 January, the European Parliament approved new rules on minimum standards for the quality of bathing water. The EU directive will simplify water tests; classify beaches as excellent, good, sufficient or poor; require water to be tested more frequently, especially when a beach is classified as poor or sufficient; require information to be up-to-date and new standard signs to be devised which must be placed at all bathing sites to indicate the quality of the water. The new standards will replace the existing 1976 directive and the bathing water management programme will be introduced over a 13-year period beginning in 2008. The directive requires implementing SSIs to be introduced by 24 March 2008.

**Batteries Directive**

8. On 3 May, the European Parliament and the Council of Ministers reached agreement, through the conciliation process, on the new batteries directive. The aim of the directive is to ensure the collection and recycling of all batteries at the end of their useful life and to prevent their incineration and disposal. The agreement now requires to be formally adopted by both the Parliament and the Council. Once it has been adopted, the directive will be published in the Official Journal. Member States will be required to transpose the directive within two years of its adoption.

**Energy Performance of Buildings Directive**

9. Following a request from the Committee in November, the Deputy Minister for Communities updated members on the Executive’s position on the implementation of this directive in December last year. The Deputy Minister stated that very significant progress has been made in implementing the directive. In its Climate Change Programme, the Executive stated that it will consult on new energy standards and implementation of the directive in early 2006. In addition, the European Commission is currently consulting on an expansion of the directive to cover small buildings below 1,000 square metres.

**Energy Efficiency Directive**

10. A new EU directive on end-use energy efficiency and energy services came into force on 17 May 2006. This sets an indicative target of a 9% cut in energy use over business-as-usual in the nine years from 2008 to 2017. It requires Member States to draw up a rolling series of energy efficiency action plans. The first plan is to be ready by 30 June 2007, the second by 30 June 2011 and the third by 30 June 2014.
11. Member States must transpose the directive into national law by 17 May 2008, with the exception of three sub-articles to be incorporated by 17 May 2006. These deal with information on existing practices, the submission of national action plans, and the assessment of these plans by the commission. The commission will assess and report on each plan within six months of its submission. Thereafter, it will enter force. Information on existing energy saving practices must be supplied as soon as possible, and no later than 16 November 2006. The Commission will use these reports in developing harmonised European energy efficiency indicators and benchmarks by the end of June 2008.

12. A Commission consultation on a Green Paper on Energy Efficiency closed at the end of March 2006. The outcome of the consultation will be a series of Member State Action Plans indicating which actions should be undertaken, in what fields and in what order of urgency by Member States. The Green Paper identifies a number of areas in which action could be taken to improve energy efficiency through new technologies and consumer action including:

- investment by community and industry into emerging energy-efficient technologies
- promoting best practice to help address non-technological barriers (legal, institutional, cultural, social, financial) in the energy-efficiency and renewable energy fields
- better-targeted State aid in favour of energy efficiency
- public procurement on efficient technologies and transport to encourage market growth.

Flooding – draft Directive
13. The European Commission published a draft directive on the assessment and management of floods on 18 January. The Austrian Presidency hopes to complete the first reading at the Environment Council on 26-27 June 2006. The draft directive lays down a framework for the reduction of risk to human health, the environment and economic activity associated with floods in the Community. The commission proposes a deadline for first national flood risk assessments of three years after entry into force - at the earliest this would be 2009. Thereafter, flood risk maps would be required by the end of 2013 and the first flood risk management plans by the end of 2015.

14. Defra is leading on the issue and is generally supportive of the draft directive’s key purpose with some changes, in particular, a reference to flood risk management and a more qualified reference to the reduction of flood risk. At the Environment Council on 9 March, the Commission’s view was that existing flood management systems in Member States could be built on to form an integrated Community-wide system but that this should not differentiate between transboundary and national waters. The UK, along with other countries, argued that the directive should focus on transboundary waters.

Groundwater Directive
15. On 23 January 2006 the Agriculture and Fisheries Council formally approved a common position on a draft directive on protecting groundwater. This received its second reading on 25 April. The groundwater directive is considered to be a daughter directive to the 2000 Water Framework Directive. It would set a maximum water concentration limit of 0.1 micrograms per litre for pesticides in all EU groundwaters. It would also set a 50 milligrams per litre limit for nitrates in all groundwaters including in nitrate vulnerable zones.

Waste Electrical and Electronic Equipment (WEEE) Directive
16. The Department of Trade and Industry announced in December 2005 that a cross-departmental review will be carried out followed by a formal consultation on draft Regulations and guidance in Spring 2006. The Minister indicated that this review and consultation was necessary because the directive places significant obligations on businesses. The directive was due to have been transposed by 13 August 2004. No revised dates for implementation have been proposed as yet. However, the problems with implementing the directive have been discussed at the European Parliament’s Environment Committee and it is possible that the European Commission may propose fresh legislation.

Environment Policy Review
17. In February the European Commission published its annual Environmental Policy Review for 2005. The Review highlights the most important policies launched last year, including the emissions trading scheme and four thematic strategies on the environment. It includes an overview of Member States’ plans for accelerating economic growth through environment policy.

6th Environmental Action Programme (EAP)
18. The seven thematic strategies being developed under the Environmental Action Programme are progressing. The strategies are intended to tackle environmental issues which are thought to require a holistic approach because of their complexity and the need to find multiple and innovative solutions. Each strategy may be a mix of non-legislative communication, consultation and legislative proposals likely to develop at a later stage. Five of the seven thematic strategies have now been adopted and published by the Commission.

19. The thematic strategies are:
   - air pollution (adopted 21 September 2005)
   - waste prevention and recycling (adopted 21 December 2005)
   - marine environment (adopted 24 October 2005)
   - soil protection
   - sustainable use of pesticides
   - sustainable use of natural resources (adopted 21 December 2005)
   - urban environment (adopted 11 January 2006)

20. The Environment Council held its first debate on the prevention and recycling of waste strategy at its meeting on 9 March. The Austrian Presidency will draft Council Conclusions for adoption at the Council in June. The Presidency also intends to report on progress on the revision of the Waste Framework Directive at the June Council. The Executive reported that the UK, along with other Member States, had concerns about the proposed EU-wide minimum standards for waste disposal and felt waste recovery operations could jeopardise plans to increase recycling levels and wanted barriers to using recycling material removed. The Committee may wish to ask the Minister for an update on this issue.

21. The draft framework marine directive aims to achieve “good environmental status” by 2021. It requires Member States to assess environmental quality in each of their seas, define good environmental status, then set targets and indicators and implement a monitoring and assessment programme. Significant progress is required by 2016 to coincide with a first review of river basin management plans under the water framework directive, the central goal of which is achievement of "good status" of surface and groundwaters by 2015.
22. Member States would not have a legally binding obligation to achieve good environmental status, but the Commission would have right of scrutiny over Member States’ assessment, target-setting and monitoring, and the power to reject national programmes if it feels they would not meet the directive’s aims. European environmental groups have criticised the draft directive because it fails to set legally binding objectives, “including a clear definition of what constitutes a healthy sea”. Sweden's environmental protection agency has also stated that they could not meet national marine environmental goals without binding international rules. The draft directive is in the early stages of the legislative process.

**Sustainable Development Strategy**

23. The European Commission published its review of the EU Sustainable Development Strategy in February. Member states are now considering the revision with a view to final adoption in June 2006. The UK government has published a set of guiding questions and the deadline for comments was 24 February 2006. The strategy has the support of the European Parliament’s Employment and Social Affairs Committee, and the Environment Committee. It is expected to be adopted without major changes.

24. A high level energy/environment group was also launched in October 2005. This aims to examine the links between industrial, energy and environmental policies to ensure that initiatives in each area are mutually compatible. EU carbon trading and energy efficiency are high priorities for this group.

**Green Paper on security of supply, competitiveness and sustainable energy**

25. The Commission launched its Green Paper on Security of Supply, Competitiveness and Sustainable Energy on 8 March 2006. The Commission proposes to develop more specific suggestions which will subsequently be published in an Energy Policy Communication in spring 2007. The areas which the Commission identifies for common action are:

- energy for jobs and growth in Europe
- tackling security and competitiveness of energy supply
- solidarity among Member States
- tackling climate change
- encouraging innovation
- relations with third countries.

In May 2006 the European and External Relations Committee commenced an inquiry into energy efficiency, as a result of which it will respond to the relevant aspect of the green paper.
FISHERIES

Action Plan on Simplification of Common Fisheries Policy Regulations

26. In December, the European Commission adopted an Action Plan for streamlining and improving fisheries legislation over 2006-08. It is part of the Commission-wide process aimed at encouraging better regulation. The plan identifies a series of priority initiatives for the next three years concentrating on conservation and control. The aims of the action plan are:

- to ensure that legislative texts are clear and unambiguous;
- to ensure that both fishermen and national administrators have access to the information they need in a concise and easily-understood form; and
- to reduce the burden of work that currently falls upon these two groups of stakeholders as a result of unnecessary complications in regulation.

27. The Commission has identified a number of regulations currently in force as priority targets for restructuring and has set out a timetable for their revision. These include:

- TACs and quotas and fishing effort
- technical measures for the protection of young fish;
- collection and management of data;
- monitoring measures including computerised monitoring systems;
- reporting obligations; and
- authorisations to fish outside EU waters.

28. The issue was discussed at the Agriculture and Fisheries Council on 25 April. The Commission reported on the result of consultations it has held with Member States on the Action Plan. The first priority for simplification will be the TACs and Quotas regulation which will be adopted in December 2006. Member States called for the practice of frontloading the quotas negotiations to be extended and accelerated further this year. The Commission will provide an update on progress with the simplification initiative during each Presidency.

European Fisheries Fund

29. The European Fisheries Fund provides the main source of financial support for the fishing industry. The use of money from the fund for 2007-13 will be governed by EU Regulations. These set out a “menu” of options including e.g. investments in port and harbour facilities; decommissioning and tie-up schemes; processing; improvements to safety on board fishing vessels; and socio-economic measures, such as early-retirement schemes for fishermen. The Commission made a proposal for these rules in July 2004 and they have been under discussion since then. The Austrian Presidency hopes to achieve political agreement on the Regulation at the May 2006 Agriculture and Fisheries Council. The Executive will then draw up a programme setting out which measures it intends to fund.

Returning fishing fleets to economic profitability

30. The reduction in fish quotas for some species, coupled with increasing fuel prices has created economic hardship for fishermen. This issue has been raised on several occasions by Member States at the Agriculture and Fisheries Council. The European Commission agreed to investigate what more could be done to help and presented a Communication in March 2006, which set out short-term and long-term possibilities for
assistance. This Communication set out how the Commission would interpret state aid rules for the purposes of granting rescue and restructuring aid to fishing enterprises.

31. At the Agriculture and Fisheries Council on 25 April, the Commission explained that state aid for rescue and restructuring could also include investment in the replacement of existing engines by more fuel-efficient models. The Commission is competent to interpret state aid rules, therefore no further decision by the Council is required. Some Member States have begun to prepare restructuring plan submissions.

32. Over the longer term the Commission’s Communication suggests that the European Fisheries Fund will provide the main source of support to help the fishing industry to restructure, and also sets out a number of other actions the Commission intends to take, for example, examining the operation of the market in fisheries products, and also the arrangements for allocating fishing quota, to help alleviate the economic difficulties of the sector. The Communication also highlights the importance of improving the health of fish stocks which will increase the number of larger fish caught and increase the value of catches, as well as the efficiency of fishing. The European Parliament Committee on Fisheries held a hearing on the impact of increased fuel prices on European fisheries on 3 May 2006.

Cod Recovery Plan
33. The European Commission has accepted the advice of the North Sea Regional Advisory Council, the Northwestern Waters Regional Advisory Council and its Scientific Technical and Economic Committee on Fisheries (STECF) that the cod recovery plan should be reviewed. The review will begin in 2006, but may carry over into 2007. The Regional Advisory Councils have been asked to contribute to this review. Depending on the outcome of the review, the Commission may make a proposal to alter the Regulation on the cod recovery plan, or it may make adjustments to the fishing effort limits, which in recent years have been included in the annual TACs and quotas regulation.

Use of non-native species in aquaculture
34. Certain species used in aquaculture in the EU, e.g. rainbow trout and pacific oysters, are not native to Europe. Although such species can be of great benefit to the aquaculture industry, there can also be major risks if non-native species escape into the natural environment. The European Commission made a proposal for controlling the use of non native species in aquaculture in April 2006. The proposal would establish a set of common criteria against which Member States would assess applications to use new species for aquaculture.
Avian Influenza
35. At the Agriculture and Fisheries Council on 25 April, the Council approved a European Commission proposal to allow the EU budget to share the cost of market support measures in the eggs and poultry sector. This measure, introduced because of the negative market impact of the avian flu crisis in some countries, will allow the co-financing of 50 percent of the cost of market support measures linked to a drop in consumption and prices of eggs and poultry. Once it has been published in the Official Journal, Member States will be able to submit proposed market support measures to the Commission for approval, subject to a vote in the management committee for eggs and poultry. A number of preventive measures have also been developed and transposed.

End of beef export ban
36. As a result of EU wide controls imposed because of the human health risk posed by BSE in cattle, exports of beef from the UK to other EU Member States were banned in 1996, and were only allowed again in 1999 under very strict rules under the Date Based Export Scheme. Exports under this scheme were only a tiny fraction of previous exports because of the onerous conditions of the Scheme.

37. Following a decision of the European Commission which came into effect on 3 May 2006, Scottish producers are now able to export live cattle born after 31 July 1996; beef from cattle slaughtered after 14 June 2005; and beef on the bone from cattle slaughtered after 2 May 2006.

Genetically Modified Organisms
38. On 25 October 2005, the EU Agriculture and Fisheries Ministers did not reach agreement on three decisions on marketing genetically modified crops. These decisions will, therefore, now be adopted unilaterally by the European Commission. The Council considered a further marketing authorisation for a variety of GM maize in December 2005. There was not a qualified majority in favour of granting the consent, so again the decision will be taken by the Commission.

39. A general discussion on the future of GM crops was held at the Environment Council on 9 March and the Executive reported that the UK acknowledged the public sensitivities over GMOs and expressed support for the work being done by the European Food Safety Authority. Several Member States expressed their concerns about the long term effects of GMOs and others raised grave reservations over the EU process and questioned the creditability of the European Food Safety Authority. Some Member States called for more publicly-funded research on GMOs. During the course of 2006 the Commission is expected to produce a report on co-existence measures on the cultivation of organic, conventional and GM crops.

Protecting local food and drink
40. The Protected Geographical Indication (PGI) or Protected Designation of Origin status provides protection for consumers and producers against imitation and raises awareness of regional products. In the UK, 29 products have gained this status. The European Commission was obliged to propose a reform to the current system, following complaints to the World Trade Organisation from the USA and Australia that it represents a barrier to trade with non-EU countries. To comply with the WTO Disputes Panel, the EU regulations had to be amended by 3 April 2006.
41. The new regulation adopted on 20 March 2006 now brings the system into conformity in the two areas that were criticised in the WTO ruling: firstly by removing a requirement that non-EU Member States who wanted to register PGI products within the EU should apply similar protection on a reciprocal and equivalent basis, and secondly by allowing producers from non-EU Member States to submit PGI applications directly to the Commission rather than through their governments.

**Organic Food Production - EU Regulation**

42. On 21 December 2005, the European Commission adopted a proposal for a new regulation on organic production. It is anticipated that the new rules will be simpler and will allow some flexibility to take account of regional differences in climate and conditions. Producers of organic food will be able to choose whether or not to use the EU organic logo. If they choose to do so, their products must be labelled EU-organic. At least 95 percent of the final product will have to be organic to be labelled as such. Products containing GMOs will not be able to be labelled as organic, except those containing up to 0.9 percent of GMO content through accidental contamination. Imports of organic products would be allowed, as long as they comply with EU standards or come with equivalent guarantees from the country of origin. For the import regime, the new rules will apply from 1 January 2007. The new regulation is proposed to apply from 1 January 2009.

**Rural Development – budget**

43. A Regulation on the use of money from the European Agricultural Fund for Rural Development was agreed in July 2005, and the Executive is currently consulting on a Scottish Rural Development Programme for 2007-13 which will implement the regulation. The final share out of money between Member States has not yet been decided, but the Scottish Executive estimates that Scotland’s allocation of EU monies from 2007 will be reduced by around 20% compared to 2006. However, since EU money only makes up 30% of total spending on the current programme, if that was the case in the future programme, this would represent a reduction of 6% in overall funding for the programme.

**Simplifying the CAP**

44. In October 2005, the European Commission launched an initiative to simplify the CAP. The Commission intends to produce an action plan during 2006 which will set out concrete proposals.
Dear Mr Fingleton

Competition policy and the food supply chain

The Committee has recently been conducting an inquiry into issues relating to the sustainability of the food supply chain in Scotland and their impact on the rural economy. This inquiry has been conducted with the current review of the Scottish Executive’s agriculture strategy in mind and has raised a range of issues.

Evidence to the Committee has also raised a number of issues relating to the framework within which competition in the supply chain is regulated. The Committee is aware of the Office of Fair Trading’s role in this. The Committee has, therefore, asked me to write to you to seek further information before it decides how to proceed with its inquiry. The following examples are based on the milk market, but the Committee is concerned with all food production sectors.

The Committee is aware of inquiry reports into proposed mergers and acquisitions in the supermarket and dairy sector and, in particular, a report into a proposed acquisition by Robert Wiseman Dairies Ltd of Scottish Milk Dairies Ltd. This proposal was subsequently abandoned after the Office of Fair Trading decided to refer it to the Competition Commission.

A considerable amount of evidence submitted to the inquiry raised concerns about the policy background to this decision, the interpretation of the Enterprise Act 2002 which it illustrates, and the impact on the ability of Scottish farmers to compete effectively and efficiently in the market. The Committee heard evidence that the competition authorities view decisions on issues such as this on the basis that Scotland is a single regional market for liquid milk, and that any one company should not control too large a stake of that specific market. (I understand that Robert Wiseman controls approximately 22% of the UK market, and that the proposed acquisition would have added a further 2% of the Scottish market (0.2% of the UK market).)
The Committee heard suggestions that this illustrates a particularly narrow interpretation of competition law, and one which may be preventing Scottish companies from competing effectively. Evidence suggests that Scottish producers and processors are operating in a market that is at least Europe-wide and probably wider, and that applying competition controls ought to be done with this wide perspective in view. Scottish companies are competing in a market with companies, such as Arla, which we understand may control up to 90% of their own domestic market. The Committee heard strong evidence that increased consolidation, collaboration and co-operation in the supply chain must be permitted in order for it to function effectively in the interests not only of the producer, but in the long-term interests of the consumer. Evidence suggests that other European countries perhaps take a different view of competition law, and are far ahead of us in terms of co-operative development amongst farmers.

The Committee is also aware of previous work by the competition authorities to develop and monitor the supermarket code of practice. The Committee heard evidence that, despite favourable monitoring reports on the code, it is regarded as ineffective because suppliers are afraid to use it in case they lose contracts. Some witnesses suggested that an independent statutory regulator should take over the function of the code, and that that the regulator’s perspective should extend throughout the food supply chain rather than apply only to supermarkets.

The Committee is aware of the complexity of the relationships in the chain, and the difficulty of obtaining transparent information on pricing issues. However, it has been suggested to the Committee that the combined effect of the difficulties outlined above is that the price of liquid milk in Scottish supermarkets is higher than elsewhere in the UK and EU, but the farmgate price paid to producers is lower – creating a disadvantage at both ends. This is obviously of considerable concern to the Committee.

I would be grateful if you could provide the Committee with your comments on the issues I have raised above, and advise members of any work which is underway to examine and review how these issues may be addressed.

I would be grateful if you could reply by 18 May if possible, and if you could copy your reply to the Committee clerk at ERDC@scottish.parliament.uk. You may wish to note that I have written in similar terms to Gerry Sutcliffe MP, Parliamentary Under-Secretary of State at the Department for Trade and Industry.

Yours sincerely

Sarah Boyack MSP
Convener
Ms Sarah Boyack MSP
Environment and Rural Development Committee
The Scottish Parliament
Edinburgh
EH99 1SP

18 April 2006

Dear Ms Boyack

**Competition policy and the food supply chain**

Thank you for your letter of 2 March in which you raise a number of issues regarding the application of competition policy, in particular merger policy, within the UK and the effect this may have on the food supply chain in Scotland. Within this reply I have sought to set out in some detail our approach to mergers within the dairy industry – and how this is reflected in our decision in the Wiseman/SMD merger to which you refer – as well as provide an up-date on the supermarket Code of Practice which you mention.

**UK merger control - Robert Wiseman Dairies plc (Wiseman)/Scottish Milk Dairies Limited (SMD)**

1. As the committee will be aware, in August 2005, Wiseman notified to the OFT the proposed acquisition of SMD. The proposed transaction consisted of the acquisition of goodwill (i.e. a customer list), certain employees and assets of the fresh milk business of SMD. Wiseman did not propose to acquire the SMD processing facility. The transaction was a “relevant merger situation” as defined by s.23 of the Enterprise Act 2002 (the Act), giving the OFT jurisdiction to review it.

2. The test against which mergers are reviewed is set out in s.22/33 of the Act\(^1\), namely whether it is or may be the case that the merger has resulted in, or may be expected to result in, a substantial lessening of competition (SLC) within a market or markets in the UK (which the OFT has paraphrased as the “realistic prospect” test). If there is such a realistic prospect, then the OFT has a statutory duty to refer the merger

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\(^1\) As clarified by decision of the House of Lords in Court of Appeal in IBA Health Ltd v OFT, [2004] EWCA Civ 142. See also OFT Guidance note revising ‘Mergers - substantive assessment guidance’ OFT516a, October 2004.

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to the Competition Commission (CC) for in-depth investigation unless certain limited exceptions apply. The CC has 24 weeks to investigate the merger and publish its report.

3. Our decision in the case of the Wiseman/SMD merger was that there was a realistic prospect of an SLC arising and, therefore, the OFT had to refer (none of the exceptions applied). Our reasoned decision is available in full from our website at www.oft.gov.uk. I have outlined below the main points arising from that merger, referring where relevant to the issues raised in your letter.

4. The starting point for the OFT’s competitive analysis in any merger case is determined by the economic activity affected by the merger. In this instance, the transaction would have merged the fresh milk supply business of Wiseman and SMD. The merger did not affect the market for the procurement of raw milk (both Wiseman and SMD sourced through First Milk). It is therefore extremely unlikely that Scottish dairy farmers, as a group, would be adversely affected by the merger. The OFT, of course, also has regard to previous CC reports covering the same market. There have been a number of CC reports in the milk sector, most recently (i) the report on the proposed merger between Arla Foods amba and Express Dairies (Arla/Express)\(^2\) and (ii) the Scottish Milk Report under the monopolies provisions of the Fair Trading Act 1973 (FTA)\(^3\), and the OFT has taken the findings of these, and other reports into account in reaching its decisions.

5. In respect of raw milk, the OFT and CC have previously concluded, on the basis of evidence provided by processors and farmers, that the market for the procurement of raw milk is no wider than Great Britain. This is because raw milk needs to be transported to the processor within 24 hours. A 100 mile radius is therefore considered, on average, to be a viable delivery range for raw milk to processors. Since there are no clear geographic breaks (raw milk producers and processor collection points are located throughout Great Britain) a chain of substitution is likely to operate within England, Scotland and Wales, leading to the conclusion that the market for raw milk maybe – at its widest - Great Britain.

6. In terms of the market for fresh processed milk (referred to below as “fresh milk”), the OFT and CC have previously considered characteristics

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\(^2\) Arla Foods amba and Express Dairies plc: a report on the proposed merger [Cm 5983], October 2003.
\(^3\) Scottish Milk: a report on the supply of fresh processed milk to middle ground retailers in Scotland, CM 5002, December 2000.
of supply and demand of the product in question. In both of the cases referred to above, the CC concluded that the market for supply of fresh milk could be considered as having three segments:

i. supply to the larger supermarkets;
ii. supply to middle ground customers (i.e. shops other than supermarkets, catering market customers and public sector bodies); and
iii. supply to doorstep customers.

7. The reasons for this segmentation are set out in the CC reports. Of particular relevance in the case of Wiseman;SMD is that SMD did not supply fresh milk to either the larger supermarket chains (such as Tesco, Sainsbury, Asda, etc.) or the smaller chains (middle ground customers such as Aldi, Lidl, Costcutter, etc.). This led to the inevitable conclusion that the merger would not have affected these customers – i.e. before the merger these customers did not have the option of obtaining their fresh milk from SMD, therefore the merger did not result in a reduction in the number of suppliers available to them. Put differently, the merger would not lessen competition for milk supply to these customers.

8. SMD focused its activity on supplying milk to smaller middle ground customers, e.g. small independent retail outlets located in relatively close proximity to its processing facility. The evidence presented to us indicated that SMD’s area of operation was Greater Glasgow, with limited deliveries elsewhere in the Central Belt of Scotland. The corollary is that only small middle ground retailers in the Central Belt of Scotland were likely to be affected by the merger because the merger would lessen competition for these customers (i.e. it is these customers that would face a reduction in the number of milk suppliers as a result of the merger).

9. This was borne out by our investigation. We found that there were a limited number of suppliers who competed for the custom of the retailers supplied by SMD prior to the proposed merger. Moreover, the CC had concluded in relation to the acquisition by Wiseman of Scottish Pride in 1997 that the market power of the dominant milk supplier in Scotland (Wiseman) was not weakened by the presence of smaller suppliers. While smaller processors were deemed unlikely to compete for the customers of the dominant supplier (for fear of retaliation or from a perception of

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4 See Arla/Express, from paragraph 2.34.
mutual benefit), it is important to note that smaller processors did compete for each other’s customers. Therefore the acquisition of a smaller processor by the dominant supplier was likely to substantially lessen competition between the smaller processors for that business.

**Single regional (Scottish) market for fresh milk?**

10. In the Scottish Milk Report, the CC considered extensive evidence (such as pricing differentials, transport costs, market shares, trade between Scotland and England, local distribution issues and consumer preferences) in an effort to determine whether or not there was a separate geographic market for the supply of fresh milk in Scotland. The conclusions of the CC members on this issue were not wholly unanimous. Two CC members opined that the point had been reached where there was a single Great Britain market in the supply of fresh milk to both larger and smaller supermarkets and other smaller middle ground supermarket chains. However supply of milk to the smaller independent stores (which lacked buyer power) continued to constitute a separate Scottish market. In the view of the other two CC members, the evidence supported a conclusion that the supply of fresh processed milk to all categories of middle-ground retailers in Scotland constituted a separate market.

11. Evidence gathered by the OFT in more recent merger cases such as First Milk/Wiseman was inconclusive on the question of whether or not there is a separate market for Scottish milk. Some retail customers contacted by us stated that consumers in Scotland do have a preference for Scottish milk; others indicated that the only (potential) barrier to sourcing fresh milk from across the Scottish border is the cost of transport. Similar to the approach taken in Wiseman/SMD, the competitive analysis of the case focused on the region of overlap and the OFT therefore did not need to conclude on this point.

**Scottish producers and processors operate in a market that is Europe-wide**

12. In assessing whether the geographic scope of a market is national or wider than national, the OFT considers factors such as branding, price differentials, shares of supply, consumer preference, perishable nature of goods, cost of transport, capacity, etc. We also assess the actual level of

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6 See Scottish Milk Report, paragraphs 2.27-2.58.
7 See Scottish Milk Report, paragraph 2.56.
8 See Scottish Milk Report, paragraph 2.57.
9 OFT decision of 7 April 2005 on the completed acquisition by First Milk Limited of a 15% stake in Robert Wiseman Dairies PLC.
imports and exports of the products in question. Where the actual level of imports/exports is negligible this is very likely to lead to the conclusion that the market is national. Evidence available to us suggests that this is the case for fresh milk. The situation is different for other dairy products such as yellow fats/butter, bulk cream, UHT milk, skimmed milk powder, cheese and some cultured milk products. The OFT has recognised that the market for these products is wider than rational.\(^{10}\)

**Narrow application of competition law**

13. As explained above in relation to Wiseman/SMD, in assessing mergers the OFT’s statutory function is to assess mergers based on the test set out in the Enterprise Act (“substantial lessening of competition”).

14. Some Scottish companies may express the view that the OFT’s exercise of its statutory functions under the Act prevents them from competing effectively. However, in reality this is unlikely since the object of the Act is to disallow mergers that result in the creation of an anticompetitive market structure, it does not prevent mergers that would give rise to a more competitive market. It should also be noted that companies active in Scotland are not averse to relying on the Act in support of their representations to the OFT that certain mergers are anticompetitive and merit reference to the CC. In Wiseman/SMD the concerns of customers – in Scotland – were that the merger would lead to a reduction in competition with the result that prices would be higher than they would otherwise have been.

**Consolidation in the supply chain**

15. The mergers in the milk sector referred to above are horizontal mergers, i.e. they are mergers of companies that are active at the same level of the market. Vertical mergers (consolidation in the supply chain) involve the acquisition of a company that operates at a different level (upstream or downstream) of the supply chain. Vertical mergers are generally considered problematic only to the extent that they foreclose a market by facilitating price discrimination, raising rivals costs or by increasing the likelihood of post-merger collusion.

\(^{10}\) See paragraph 15 of OFT decision of 3 December 2004, on the completed acquisition by Dairy Farmers of Britain of Associated Co-operative Creameries Limited: “Butter, cream, milk powders, cheese and cultured dairy products are traded on a European and even global basis. UK levels of imports and exports of such products support an EU-wide frame of reference.”
16. In line with current economic thinking, the OFT considers that this risk is unlikely to arise except in the presence of existing market power at one level in the supply chain at least, or in markets where there is already significant vertical integration/restraints. In cases where there is no such market power, the OFT recognises that vertical mergers are likely to be beneficial in that they lead to greater efficiency and lower prices. Our decisions in the dairy industry have reflected this approach. In DFB/ACC\(^{11}\) we note that third parties expressed the view that creation of a vertically integrated co-operative would help to redress the imbalance of power within the dairy supply chain.

**Higher price of fresh milk in Scotland**

17. As noted at paragraph 13 above, the issue of price differential between two areas is relevant in the assessment of the extent of the geographic market. If two areas are part of the same market one would expect to find only very limited differences between averaged prices for similar products. This is because the seller of the lower price product would have the incentive and ability to sell the product in the higher price area, thereby putting downward pressure on prices in that area and eroding the differential. Where two geographic areas are in the same market, arbitrage opportunities will also limit price differentials. If, on the other hand, factors such as consumer preference, branding, higher transport costs or regulatory barriers mean that the producer of the lower price product does not have the ability to sell his product into the higher price area, the price differential is likely to be maintained, leading to the conclusion (all else being equal) that the higher price area and the lower price area are not part of the same geographic market.

18. “Chain of substitution” arguments are sometimes used in retail or distribution markets to join a series of local areas into a single geographic market. The CC noted in the Scottish Milk Report that:

> “While a commodity such as milk might not be supplied directly from Penzance to Perth or from Dunce to Dover, the fact that all the local areas overlap with one another, so that the price pressures are transmitted from one locality to the next, creates a single geographic market. Stated in those terms, the question is whether there is a break in this chain between northern England

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\(^{11}\) OFT decision dated 3 December 2004 on the completed acquisition by Dairy Farmers of Britain Limited of Associated Co-operative Creameries.
19. The CC evaluated price differentials between England and Scotland and concluded that a significant but varying difference in wholesale prices between Scotland and the North of England persisted until 1998 but that this has since reduced and had by 2000 all but disappeared.

20. A finding of a price differential is not determinative of the issue of geographic market (as noted above, two CC members were of the opinion that for larger supermarkets the market for supply of milk was GB-wide), but it is a persuasive factor. In the context of OFT merger cases such as Wiseman/SMD, some third parties commented that milk prices in Scotland are higher, that this cannot be explained by higher farmgate prices or higher processor costs and they alleged that the higher prices were therefore the result of (illegal) collusion between milk processors in Scotland. On the limited evidence (and time) available to us in the context of the merger, we were unable to conclude on this matter.

21. It follows from the above, however, that there may be a logical inconsistency between the argument that Scottish farmers and processors operate in a European or GB-wide market and that the retail price of fresh milk in Scotland is higher than elsewhere in the UK.

How are the issues being addressed

22. In terms of merger cases, the OFT will continue to fulfil its statutory function under the Act by assessing qualifying mergers against the SLC test. For mergers that may affect the Scottish dairy sector we will continue to consult with the NFU, SEERAD and DEFRA. As has been our practice in the past, we welcome comments and evidence from all market participants, either in response to the invitation to comment that is issued in all merger cases (available from our website and the regulatory news service), or on an ad hoc basis.

The Supermarkets Code of Practice

23. The purpose of the Code aims to put relations between the largest supermarkets and their suppliers on a clearer and more predictable footing in order to help improve competition between suppliers and between those large supermarkets and smaller grocery retailers. It was not designed to

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12 See Scottish Milk Report, paragraph 2.29.
apply to the whole grocery supply chain. The effectiveness of any regulatory scheme designed to oversee or police supermarket-supplier relations (be it done by Code, ombudsman or regulator) depends crucially on the proper recording of those relations and on parties coming forward to negotiate or complain when they consider they are not being properly treated.

24. The Code already incorporates a dispute resolution process. Given the above points, we consider that an ombudsman/regulator would bring no extra benefits in addition to or instead of this, especially bearing in mind the cost and bureaucracy implied by such a regime. HM Treasury's Hampton review envisaged a consolidation and reduction in regulatory activity to improve co-ordination – and having another ombudsman/regulator would not be consistent with that policy.

25. Moreover, natural justice does not allow findings to be made without both sides being able to put their case. A proper resolution to any Code issue, regardless of who administers the Code, relies on transparency from both sides to a dispute. In the interests of transparency and giving suppliers more assertiveness in their dealings with supermarkets, as well as reducing the potential for conflict, we continue to encourage terms of supply to be agreed in writing. We are always willing to discuss any issue with suppliers in confidence. In fact, the Code has been increasingly being used as a means of resolving disputes.

I hope the above deals adequately with all the issues on which you require comments.

Yours sincerely

John Fingleton
Chief Executive
May 2006

Sarah Boyack MSP
Environment and Rural Development Committee
The Scottish Parliament
Edinburgh
EH99 1SP

Your Ref:
Our Ref: TG/567857

RE: Competition policy and the food supply chain

Thank you for your letter of 2 March, to my predecessor Gerry Sutcliffe, about the inquiry relating to the sustainability of the food supply chain in Scotland conducted by the Environment and Rural Development Committee.

You also wrote in similar terms to John Fingleton at the Office of Fair Trading. I understand that John provided a full and comprehensive reply to the issues around mergers and the supermarket Code of Practice in his letter of 18 April. There is very little I can add to what he has said.

The UK competition framework has established the OFT and the Competition Commission (CC) as independent statutory bodies because the Government wanted to remove politics out of decisions on mergers and broader competition issues allowing expert, independent competition bodies to take decisions based purely on competition grounds.

On a related issue, I am sure that you will be aware that on 9 May, the OFT made its decision to formally refer the grocery market to the Competition Commission. The CC has a statutory maximum of 2 years
to carry out its investigation and publish its final report. The full OFT reasons paper for the referral can be found at http://www.oft.gov.uk/NR/rdonlyres/1A2D7FA2-FEA3-4459-9B25-4A737A20023D/0/of845.pdf

Ian McCartney
SUPPLEMENTARY RESEARCH NOTE FROM SPICE

Market share of multiple retailers in other European countries

The table below has some information on the market share of the main retailers in other European countries.

Table 1 – Market share (%) of top 5 grocery retailers in selected European countries 2005

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Share</th>
<th>Country</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>70.5</td>
<td>Netherlands</td>
<td>38.2</td>
</tr>
<tr>
<td>Denmark</td>
<td>69.6</td>
<td>Czech Republic</td>
<td>38</td>
</tr>
<tr>
<td>Switzerland</td>
<td>66.7</td>
<td>Croatia</td>
<td>33.9</td>
</tr>
<tr>
<td>UK</td>
<td>62.6</td>
<td>Slovakia</td>
<td>31.6</td>
</tr>
<tr>
<td>Norway</td>
<td>58.3</td>
<td>Greece</td>
<td>25.7</td>
</tr>
<tr>
<td>France</td>
<td>54.5</td>
<td>Italy</td>
<td>20.6</td>
</tr>
<tr>
<td>Germany</td>
<td>53.7</td>
<td>Poland</td>
<td>15.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>53.7</td>
<td>Turkey</td>
<td>11.2</td>
</tr>
<tr>
<td>Ireland</td>
<td>50.5</td>
<td>Bulgaria</td>
<td>10.3</td>
</tr>
<tr>
<td>Spain</td>
<td>44.6</td>
<td>Romania</td>
<td>9.7</td>
</tr>
<tr>
<td>Belgium</td>
<td>43.1</td>
<td>Ukraine</td>
<td>3</td>
</tr>
<tr>
<td>Portugal</td>
<td>38.5</td>
<td>Russia</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Source: European Grocery Retailing 2005, IGD Research

Farmgate and retail prices for liquid milk in other European countries

The table below has some information on farmgate and retail prices for liquid milk in other European countries, and the difference between them, called the price spread.

Table 2 - Farmgate and retail price of liquid milk in selected European countries 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>Farmgate price (euro cents/l)</th>
<th>Retail price (euro cents/l)</th>
<th>Price spread (retail price – farmgate price)</th>
<th>Farmgate price as a % of Retail price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>28.2</td>
<td>57.8</td>
<td>29.6</td>
<td>49</td>
</tr>
<tr>
<td>Belgium</td>
<td>28.0</td>
<td>61.8</td>
<td>33.8</td>
<td>46</td>
</tr>
<tr>
<td>France</td>
<td>28.2</td>
<td>62.8</td>
<td>34.6</td>
<td>45</td>
</tr>
<tr>
<td>Finland</td>
<td>34.8</td>
<td>71.0</td>
<td>36.2</td>
<td>49</td>
</tr>
<tr>
<td>Sweden</td>
<td>30.6</td>
<td>76.7</td>
<td>46.1</td>
<td>40</td>
</tr>
<tr>
<td>UK</td>
<td>27.8</td>
<td>71.5</td>
<td>43.7</td>
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<tr>
<td>Netherlands</td>
<td>29.4</td>
<td>77.2</td>
<td>47.8</td>
<td>38</td>
</tr>
<tr>
<td>Ireland</td>
<td>31.1</td>
<td>84.9</td>
<td>53.8</td>
<td>37</td>
</tr>
</tbody>
</table>
Source – Dairy Supply Chain Margins 2004-05, Milk Development Council Note: The German, Belgian and French
liquid milk markets are highly influenced by sales of UHT milk

Tom Edwards
SPICe
22/5/06