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## CONTENT

1	General review.....	4
1.1	Major agricultural market developments in 2005.....	4
1.2	Agricultural and rural policy developments.....	4
1.3	Issues related to the enlargement.....	6
2	Assessment and outlook: market integration in the cereal sector.....	7
2.1	Introduction.....	7
2.2	Storage capacity and transportation.....	8
2.3	Quality.....	8
2.4	Possible or existing market distortion.....	8
2.5	Assessment of the market integration.....	9

## **1 General review**

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### **1.1 Major agricultural market developments in 2005**

In 2005 there were no major changes on the agricultural market. The volume of production remained close to the 2004 level, which was the highest so far. The downward trend in the farm-gate prices of agricultural products continued, but it was less intensive than in previous years. In 2005 prices dropped by 1.1% in real terms (in 2004 by 4.6%). Prices of cereals, sugar beet, potatoes and poultry meat dropped the most, whilst prices of beef and pig meat, vegetables and vine rose. On the input side, 2005 was marked by an increase of the prices of oil and gas, but on the other hand, prices for animal feed dropped. The input prices of goods and services for agricultural production at the aggregate level dropped by 2.4% in real terms, so the terms of trade for agriculture improved slightly. Trends in production and prices along with a rise in direct support for agriculture (see 1.2) indicate that the agricultural income should remain relatively high in 2005, among the highest in the last decade.

The situation in 2005 was thus little changed for producers, and it remains relatively favourable for agriculture in general. The trends from the past have continued, meaning also a continuation of changes in the economic positions among production activities. The situation in the beef and dairy sector has improved, as these two sectors benefit from direct selling of intermediate products to the neighbouring countries (the export of raw milk to Italy and of cattle to Austria increased significantly). On the other hand, the situation in the majority of the crop sectors has deteriorated. The farmers, especially the most advanced and prosperous have responded to the changed economic conditions by further accelerating technological progress and increasing their farm size.

The year was again very negative for the food industry, as input prices generally increased and the output prices decreased. Some food sectors, such as dairy and meat suffered from the loss of previously favourable conditions for exports to the Western Balkans, where they used to sell the surplus products before the Accession, with significant assistance from the state.

Beside a downward trend in agricultural prices, declining consumer prices for food and beverages also continued. In 2005 these prices dropped by 3.2% in real terms, which is the largest drop so far. Consumers gained through the enlargement and increasingly competitive relations in the retailing sector. Also this is only a continuation of the past trends, reflecting also long-term changes in the consumer habits.

### **1.2 Agricultural and rural policy developments**

2005 was marked by an increase in the level of CAP direct payments, which are implemented in Slovenia according to the pre-reform Agenda 2000 arrangements. These payments rose in 2005 (by 6% in euros) to 90% of the comparable (pre-reform) level in the EU-15 and to 95% in 2006. Among other market support measures, export subsidies were the most significant although their level was only a fraction of that before the Accession. Another rather important measure in 2005 was support for restructuring of vineyards, which replaced a similar national measure previously in force.

Regarding the Rural Development Programme, the compensatory allowances for LFA and agricultural environmental payments represented the highest share of funds. The per hectare rate for less-favoured area was raised again (by 8.8% in euros). Among new measures introduced after Accession, the aid for compliance with the EU standards proved to be of most interest for farmers; with around 40% of all farms submitting direct payment applications in 2005 claiming this aid.

The agricultural structural policy measures have largely continued. Gradual switching off of SAPARD programme was more or less replaced by similar measures from new EU co-financed structural policy implemented in the frame of the Single Programming Document (SPD). For all measures included in SPD, new public calls for tenders were published in 2005 to enable the use of all available funds within the current programme period. By the end of 2005, commitments had been made for almost 50% of all SPD funds for agriculture and forestry for the period 2004-2006 and around 20% of available funds had been paid out. The majority of funding was intended for improving processing and marketing of agricultural products, investments in agricultural holdings and diversification of agricultural activities. Beside national funds for complementing CAP measures, some national structural policy measures were still in place (setting-up of young farmers, land management operations, marketing and promotion etc.).

Although in Slovenia the adoption of the CAP on Accession largely meant a continuation of the measures pursued under the national agricultural policy in the pre-Accession period, farmers still face some difficulties in relation to the rules for application for support. In 2005 from 63.329 submitted applications for direct payments, the Agency for agricultural markets and rural development (national paying agency for EU agricultural funds) had to ask for corrections to around 70% of all applications. The most frequent irregularities are data inconsistency and incomplete application forms. The consequences are higher administrative costs and problems with data processing, approving and execution of payments on time.

In 2005, discussions on agricultural policy developments were concentrated mainly on the implementation of 2003 CAP reform of direct payments for Slovenia. According to broadly accepted research study prepared in 2005 (Rednak et al), on the bases of actual data on farms which applied for direct payments in 2004, the immediate introduction of the single payment scheme at regional level could cause severe market distortions in Slovenian agriculture because of distinctive redistribution effects. A decision on how to implement the reform of direct payments has not yet been taken.

After public discussions launched in December 2005, it seems that the maximum possible coupling of payments in all sectors except arable crops will be retained, whilst at least part of the dairy payment will remain based on farms' historical entitlements. In addition, specific payments (from the national reserve) are expected to beef farmers who are in a special situation as a result of the transition to the single payment scheme. The remaining "national envelope" will have the form of single area payments. The reform should be implemented in 2007. If this reform model is accepted, Slovenia will have a very different direct payments policy in comparison with other CEECs, and implementation will be administratively very complex and demanding. The alternative proposal to this static scheme was based on a dynamic introduction of single (regional) area payments. This scheme is less acceptable for the farmers and public administration mainly because it leads to the total decoupling of

payments at the end of the transitional period and cause strong redistributions between the sectors and between the agricultural holdings with different production intensity.

Currently, public attention is focused also on the National strategic plan for rural development, prepared in late 2005/ early 2006 in the framework of the reform of the second pillar of the CAP. This (draft) document changes priorities in the field of rural development policy, as more funds are intended to be used for the economic development of rural areas (competitiveness, quality of life, diversification of activities). It seems that the main concern is attributed to the fact that potentially this means lower funds for second development axes (mainly environmental issues) i.e. for supporting agriculture in less favourable areas (LFA) and agri-environmental programmes. This concern is understandable as within total payments for rural development of around 120 million euros per annum in the years 2004-2006 (and probably the same amount also in the next financial programme); the majority of the funds are spent on environmental and LFA payments. These payments are considered as a kind of historical right and change in the priorities leads to a decrease in such rights. Slovenia will probably be forced to change the criteria and to exclude some measures that are very popular but, from the objective point of view, are questionable.

### **1.3 Issues related to the enlargement**

So far in Slovenia there were no major difficulties in agriculture that could be directly attributed to the EU accession. However, further changes in the economic situation of some agricultural sectors can be expected.

Most uncertainty is situation in the milk sector. For milk producers the most relevant issue is introduction of milk quotas and levy, although so far, there have been no problems in this field. According to actual data on milk sales in the 2005/06 marketing year, the national quota will not be exceeded and some quota remains in the national reserve.

Opening up the market after Accession increased competitive pressure on the dairy industry, which tried to pass it on also to the primary sector. The introduction of dairy premiums was used by the industry to justify cutting milk producers' prices. As a result, some, mainly large, co-operatives signed contracts to sell milk directly to Italian dairies at higher prices than those obtainable in Slovenia. Thus in 2005, more than 10% of the domestic raw milk gradually "leaked" to Italy (expert assessment, detailed data are not available). Domestic dairies, lacking sufficient domestic raw milk, either replaced domestic supplies by imports or reduced production to cope with greater competitive pressures in the dairy market.

The second critical sector is sugar. As a result of the expected fall in the profitability of sugar production after the reform of CMO for sugar, the owners of the sole sugar factory in Slovenia decided to close down sugar mill and thereby end Slovenian sugar beet production. After negotiations, the Ministry for Agriculture, factory owners and sugar beet producers reached an agreement to continue production and processing in the market year 2006/07 and after that reconstruct the factory for production of bio-ethanol. This means that the year 2006 is probably the last one with domestic sugar beet production. Over the next years, a reorientation of sugar beet producers to wheat and maize production is expected. The issue of realisation of these plans, however, remains open as the owners set additional state aids as a precondition for reconstruction. Even if these plans are realised, they will lead to a drop in the

number of employed in the factory and, after the transitional period, probably also to a drop in the farmer's incomes as production of sugar beet was among the most profitable crops.

## **2 Assessment and outlook: market integration in the cereal sector**

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### **2.1 Introduction**

In Slovenia cereals are cultivated on almost 100 thousand ha and account for 20% of utilised agricultural area or 60% of all arable land. Cereals production represents about 8% of the total value of gross agricultural output. The leading grains are maize and common wheat (close to 80% of cereal area and 90% of total grain production); while among other types of grains only barley is cultivated on more than 10 thousand ha. Total production of cereals varies between 400 and 600 thousand tonnes a year, depending mostly on weather conditions (2001-2005 average: 530 thousand tonnes). Domestic consumption with relatively stable level of around 1 million tonnes is almost twice as high as production. Most grains (about 2/3) are used as animal feed. Human consumption of cereals is on the level of 90 kg per capita (in flour equivalent), of which around 75 kg is wheat. In recent years over 500 thousand tonnes of cereals were imported yearly (on average), 80% as raw grains (mostly maize, wheat and barley).

There is generally a noticeable difference in markets for grain used for animal feed and for food. There is only a negligible quantity of feed grain (mainly maize and barley) produced on individual farms that actually enters commercial market channels. The majority of production is used as an intermediate input directly on farm. However, some agri-food corporations are vertically integrated, with a chain of grain production, feed processing and animal production (poultry or pigs). These corporations, therefore, meet part of their raw material requirements from their own grain production, however, they still import a noticeable part of their total raw materials needs. The only important market grain is common wheat, where normally 50% to 70% of total production is sold, depending on harvest, quality and price.

In the early years after the political and economic changes at the end of 1980's, the government still controlled virtually all purchases of wheat and rye from producers and, on the other hand, supplies to grain millers. The administration was performed by the Agency for Commodity Reserves that was also the sole importer of milling wheat. The purchasing prices of wheat from domestic producers and selling prices to millers were set with the former higher than the latter. The price difference was absorbed through imports at world market prices that reduced the average price charged to food processors. This system provided support to domestic wheat producers, whilst minimising the negative impact on processors.

In 1998 the trade regime for wheat was substantially liberalised (CEFTA Agreement). In the subsequent year the fixed purchasing price was abolished and gradually direct payments per ha were introduced. This was mainly forced by the start of accession negotiations and the reform of national agricultural policy settled in the 1998. Furthermore, basic elements of market intervention system (CAP like) were established in 2001. Since then the wheat price and other commercial matters have been determined by the market.

## **2.2 Storage capacity and transportation**

### Storage

Storage capacities for milling grains are found within the milling enterprises, Agency for Commodity Reserves and some larger cereal producers (agricultural companies). Total storage capacities are estimated to be at about 300 thousand tonnes, of which about 130 thousand tonnes are owned by the milling enterprises and 100 thousand tonnes by the agricultural companies. Estimated capacities of the Agency for Commodity Reserves are about 70 thousand tonnes; however these include only capacities available for commercial storage (without “security reserves”). Almost two-thirds of the total storage capacities at the milling companies are held by the largest enterprise in Slovenia, which is a business group that emerged after a series of mergers and acquisitions within the milling and bakery sector in the recent years. Concentration of storage capacities is rather high, since the second largest owner has about 15%; the third has about 10%, whereas the remaining is distributed among four smaller operations with capacities of less than 10 thousand tonnes.

Although overall storage capacities are sufficient, adequately equipped and suitably located, however they are mainly owned by buyers (millers or bakers) and not by suppliers (producers). Moreover the storage facilities owned by family farms, or their cooperatives, are very limited.

### Transportation

Slovenia has well developed road and railway infrastructure and therefore no major problems are reported regarding transportation of cereals. Despite expected cost advantages, only a small proportion of grain is transported by rail mainly due to the lack of flexibility of rail transport compared with road transport. Despite oil price rises, competition among road hauliers is keeping transport costs down. This is also true in transport of imports into Slovenia which, coupled with more liberal border controls, makes imports very competitive.

## **2.3 Quality**

The quality of Slovenian milling grain is increasing, mainly due to high quality hybrid seeds being used, improvement in production technology and a strict implementation of a quality stimulation pricing system. Most large buyers of wheat offer premiums for higher quality and impose penalties for low quality grain. In 2005, due to bad weather conditions, the quality of milling wheat in general was below average and many producers decided to sell their produce for animal feed.

## **2.4 Possible or existing market distortion**

Cereal production in Slovenia is very small-scaled. Despite the general process of concentration in agriculture, which has been particularly intensive in recent years, the average cereal area is only around 2 ha per holding (FSS 2003), which does not allow high productivity. Small-scale production also means that marketing costs, such as transport and quality analyses are high relative to the value of output. This is one of the reasons for relatively low share of grains entering commercial marketing channels. The existence of

collusion among the major buyers is shown by the fact that in recent years, all the larger buyers (mills) have adopted unified terms of purchase (basic price and quality parameters). On the other hand producers have rather limited negotiating power due to small-scale production and no sufficient storage capacities to allow them to postpone sales to gain a better price.

In 2004 and 2005, prices of cereals fell sharply, with wheat at the lowest level of recent years. The low prices were partly attributed to below-average quality but mostly to a good harvest in the EU as a whole depressing the Slovenian price. Following EU Accession, prices of cereal food products dropped in real terms as well, but much less than the cereal prices. Rising prices of inputs, notably oil and mineral fertilisers, added to the worsening economic conditions for cereal producers.

Although producers had not expected so substantial a drop in prices, the area sown to cereals has not changed substantially and is expected to remain around 100 thousand hectares due to relatively high direct payments and the lack of profitable alternative crops. Indeed the cereals area could expand if the sugar beet mill changes to bio-ethanol production and cereal growers may then switch to higher yielding but lower quality varieties.

## **2.5 Assessment of the market integration**

Slovenia is a traditional importer of cereals with only about half of demand met by domestic production, hence has been integrated into international markets though in the past trade was almost entirely administered through government agencies. Since EU Accession, foreign competition has intensified, but the first wave was triggered already with the CEFTA agreement (1998). Slovenian cereal producers have to compete with low priced imports, especially from Hungary. Accession has meant lower transaction costs for imports from EU member states which has also contributed to lowering the costs of importing.