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Dairy Sector Faces New Challenges

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Report Highlights:
Bulgarian dairy sector faces an important year which will likely represent a turning point for its future development. In 2013 all cattle dairy farms should meet EU milk quality requirements. 27,000 farms may have to close if operational procedures are not upgraded. The new Veterinary Medical Law shifts mandatory veterinary prophylactics and animal waste disposal services to producers from the Government. Cabinet-approved changes to the milk market should bring it into conformance with EU requirements. And finally, in January 2013, the Ministry of Agriculture introduced a regulation to limit production of dairy products containing vegetable oils (palm oil) ingredients. This policy would likely affect dairy market competition and trade.

General Information:
<u>Dairy Voluntary Report 2013</u>

Bulgarian dairy sector faces an important year which will likely represent a turning point for its future development. Several key developments are expected to occur in 2013, as follows:

- In 2013, all cattle dairy farms should meet EU milk quality requirements as the second EU derogation for Bulgaria will expire by the end of the year. 27,000 small dairy farms are under threat to be closed if they do not upgrade their operational procedures.

- In January 2013, the Parliament approved a new Veterinary Medical Law according to which mandatory veterinary prophylactics will no longer be subsidized by the Government. The government will discontinue its subsidized animal waste disposal forcing farmers to pay incinerators for such service. The Cabinet approved changes to the organization of the milk market to bring it into conformance with latest changes at the EU level. Smaller farms will be affected more than larger operations.

- In January 2013, the Ministry of Agriculture introduced a regulation to limit production of dairy products containing vegetable oils (palm oil) ingredients. This policy would likely affect dairy market competition and trade. 60 smaller dairies declared that they may not be able to observe the new rules and be forced out of the market.

These changes, along with continued economic struggles, and declining consumer demand are expected to result in accelerated consolidation and acquisition processes both at the farm level and at the processing level. Expiration of EU milk compliance derogation is likely to have serious political, economic, and social effects, along with the snort-term negative effects on the dairy market. Most likely, smaller dairy farms and processing units will be the ones to pay the price of austerity measures and milk derogations. Rural regions, especially in the mountains, will likely suffer from increased unemployment and higher social burden.

On the other hand, the above regulations will play a positive role for the support of more efficient dairy farming, and demand for U.S. genetics will likely increase. Dairy production is projected to become more commercialized and more professional, as more investments are likely to flow into the sector. These trends have already started in 2011/2012 with increased vertical integration and acquisitions. Competition for consumer spending will intensify and stimulate healthier growth in the dairy sector.

<u>Milk Quality Compliance Derogation</u>

More than 27,000 small dairy farms are threatened with closure as the milk they produce does not meet EU standards (Regulation 853/2004). Farmers have until the end of this year to address the problem but if they do not meet EU requirements by then, the authorities will be forced to close them down. The milk can be still produced but not to be sold on the market.

The sector has been restructuring slowly since EU accession as defined by the share of compliant to total cow milk produced annually. The share of compliant production stood at 35 percent (in 2007), then rising to 44 percent (2009), then 50 percent (2010), to 60 percent (2012). In volume terms, the Ministry of Agriculture reported as of January 2013, compliant milk produced in the country totaled 507,000 MT.

During 2011 and 2012 negative trends in the dairy sector leveled off with the first signs of recovery emerging. Declines in number of cattle dairy farms slowed to a modest 2.5 rate. For a second year in a row growth occurred in the total cattle inventory, at a modest 2.5 percent level, while the number of dairy cows stabilized.

By farm category, between 2010-2012 smaller farms (3-9 animals) show the largest reduction in numbers Meanwhile medium farms (10-20 animals) a trended upward in terms of number of dairy livestock. Farms holding 10-20 dairy cows increased in number by 9.5 percent while the number of dairy cows on farms of this size increased by 10.7 percent. Larger farms (above 20 dairy cows) continued to account for 47 percent of all dairy cows, a figure that increased to 62 percent when medium farms are added. Smaller farms account for 38 percent of dairy cows. However, smaller or subsistence farms with less than 5 dairy cows accounted for 29.6 percent of all dairy cows inventory. As of early 2012, small farms with 1-2 dairy cows represented 78 percent of all farms but accounted for 23.5 percent of all dairy cows.

Table 1. Dairy cattle farms and dairy herd, 2010 and 2011

Changes in the number of dairy cattle farms and dairy herd, 2010 vs. 2011				
Dairy cows per farm (Range)	Farms as of 12/31/2011	Percent Change between 2010-2011	Dairy cows (1,000 head)	Percent Change between 2010 - 2011
1-2	58,629	2.0	72.3	2.4
3-9	9,946	-7.7	45.7	-3.2
10-19	3,430	9.5	44.5	10.7
20 and more	2,829	-14.1	144.3	-3.9
Total	74 834	0.2	306.8	-0.5
Source: Statistical Office, Ministry of Agriculture, Bulletin 186, April 2012				

As of January 2, 2013, 3,078 dairy farms fully comply with EU requirements, representing 35 percent of the national dairy cattle inventory, and about 50 percent of the national milk quota. Dairy farms which only partially meet EU requirements total 484.

Dairy farms which do not meet EU standards total 27,718 (as per MinAg records and official statements of January 2013). Out of this category, some farms are commercially oriented and have the chance to upgrade until the end of 2013 using private funds or EU-Rural Development Program (RDP) subsidized investment projects (so called measure 121). About 100 farms are currently using this instrument to modernize. However, the remaining farms are very unlikely to upgrade and will be shut down at the end of 2013. In most cases, these are small farms with up to 5 milking cows. According to the Ministry of Agriculture, these farms supply 34 percent of country's cow's milk production.
The Ministry of Agriculture estimates that farms which have 5 or more milking cows have a chance to

meet the EU hygiene and safety requirements if they organize and manage their farms more professionally. Ministry estimates show that small farms have to invest 1,400 Euro per an animal head (or 7,000 Euro for a 5 cow farm) to upgrade and meet the EU milk quality standard- an investment which is unaffordable for most small farmers. Commercial banks usually consider such loans risky and do not provide credit; therefore, small farmers have to work with EU-RDP projects.

Thus, by the end of 2013, FAS Sofia estimates that not more than 15,000 dairy cattle farms will remain operational and will raise 280,000-300,000 dairy cows.

Expected effects on dairy market and milk processing

Currently, non-compliant milk is processed using different technological lines at dairy plants, mainly for cheeses with longer aging period, and under a special label for sale on the local market only. Larger dairies which work on the local and EU market buy only compliant milk and compensate raw milk deficit by importing raw, condensed or powder milk.

After years of decline, growth in total milk production re-emerged in 2010 (+3.7 percent), 2011 and 2012 (modestly). Prior to 2010 cow milk supply was stable while its share of total milk output remained flat at 88 percent. The increase in total production resulted from productivity grains generated by improved genetics and changes in feeding and management practices, mainly at larger farms.

However, although total milk supply was little higher in 2011/12, milk deliveries dropped by 3.6 percent (following an 8.2 percent drop in 2010) for two main reasons related to non-compliant milk and cost competition. Processors began finding it more cost efficient to import raw or powder milk from Central or South East European countries rather than increase their collection of local milk. For this reason, milk deliveries, especially of non-compliant milk, have dropped and imports increased.

Table 2. Milk production, 2003-2011, MT

Milk production by animal origin, 2003-2011, MT					
Years	Dairy Cow	Buffalo	Sheep	Goat	Total
2003	1,308,525	5,276	88,679	101,530	1,504,010
2004	1,344,750	6,229	117,682	129,381	1,598,042
2005	1,286,909	6,989	105,057	109,114	1,508,069
2006	1,298,709	7,132	107,535	102,297	1,515,673
2007	1,148,328	7,052	84,907	87,174	1,327,461
2008	1,143,190	7,173	88,243	77,465	1,316,071
2009	1,073,401	7,022	87,247	64,090	1,231,760
2010	1,124,360	7,933	85,001	60,410	1,277,704
2011	1,125,824	8,868	89,543	61,543	1,285,531
Percent Change between 2010 - 2011	0.1	11.8	5.1	1.9	0.6
Source: Source: Statistical Office, Ministry of Agriculture					

Germany, Hungary, Greece, Romania, Poland, and France are leading suppliers of raw milk (HS0401) to Bulgaria. Over the last several years imports increased, especially in 2010 when the annual growth vs. 2009 was 230 percent, but as of September 2012 (World Trade Atlas data) it dropped by 35 percent to 17,000 MT compared to a year before. Similarly, imports of powder milk under HS0402 for the same period were 11 percent down to 29,000 MT.

By the end of 2013, as a result of expiring derogation, processors may be forced to compensate the milk deficit with higher milk imports. Related, in the near term imports of dairy products may grow as well. Farmers forced out due to non-compliant operations will likely slaughter or sell dairy cows; and/or export live animals to neighboring markets.

Compliant dairy operations will have an excellent opportunity to expand and improve their financial position. Since 2007 these dairies had to compete with products from non-compliant farms thus were unable to receive any premium for producing EU quality milk.

Economic and social effects

Shutting down of a large number of small dairy farms will have a social and economic consequence. Such farms provide employment to rural families, on average 4-5 jobs per farm. Often these farms have little own land, therefore, little option to switch to crop production. Expectation is that many small farmers will sell-off their equipment and livestock with many leaving the rural area in search for employment in towns.

New Veterinary Rules

In early January 2013, the Parliament approved the new Veterinary Medical Law.

To date, dairy and livestock prophylactics, animal identification, and mandatory disease program are paid by the Government. Payments are transferred to private veterinarians under annual contract set within the general framework contract existing between the Ministry of Agriculture and the Veterinary Doctors Union. The Law just approved by Parliament, to be signed by the President still, will require farmers participate in the mandatory veterinary program, close contracts with private veterinarians, and pay for veterinary services and for veterinary medicines directly. The government will continue to pay for laboratory tests related to the mandatory veterinary program.

While this Law will provide cost relief to the national budget, it will place a significant cost burden on dairy and livestock farmers, especially for small and even medium-sized farms. Concerns in the industry are that farmers may decide to terminate certain veterinary care practices placing the overall epizootic situation at greater risk. This, in turn, would require larger farms to implement more stringent bio-security programs and incur more veterinary expenses verifying the safeness of their operation.

The Law would also discontinue subsidized disposal and destruction of animal waste from farms (dead animals) and slaughterhouses. To date the subsidies are paid mainly with the goal to compensate incinerator operations for costs associated to process and dispose the waste with no return. The two incinerators in the country that have been funded via this mechanism have had difficulty staying open. Under the new legislation, farmers and slaughterhouses will pay incinerator operations directly for services.

This latter change is the subject of much criticism and even strikes by veterinarians in several regions in 2012. Many veterinarians express concern that the new rules would result with thousands of dead animals being improperly disposed by smaller farmers without the required bio-security measures and under no veterinary control in order to avoid having to pay an incinerator for services. The epizootic risks would be high.

New Common Market Regulations

On January 9, 2013 the Cabinet approved new regulations related to the milk market.

Buyers of raw milk will not be mandated to provide a bank guarantee in favor of the Paying Agency as has been required to date. In addition, the new regulation made written contracts between suppliers/farmers and buyers' compulsory, as the contracts should be registered and controlled. Dairy farmers are encouraged to establish producer organizations for negotiations with milk buyers.

New Regulations for Dairy Products

In 2011-2012 the Ministry of Agriculture undertook massive public campaigns against dairy products containing vegetable oils. Since the beginning of the economic crisis in 2009/2010, many dairies began to substitute a portion of milk in products, especially in cheese, with vegetable oils, mainly palm oil. This practice was born as a response to: declining consumer spending and demand for less expensive products, increasing prices for raw milk, along with fluctuating milk quality and milk supply.

Initially, the Ministry of Agriculture banned labeling of such products as dairy products and mandated suppliers place labels without "misleading" language, such as dairy, milk, etc. including pictures of dairy animals, or milk.

As a second step, the Food Safety Agency required separation of "pure milk" products from "products with vegetable oils or imitation product" at the retail level on different shelves. At all times, these policies were accompanied by a campaign against palm oil as harmful to human health, and with the purpose to provide precise and non- misleading information to consumers. At the end of December 2012, the Agriculture Minister issued public statements that imitation products should be labeled in the same way as cigarettes "harmful to your health."

In mid-late 2012 the Ministry of Agriculture developed a national regulation which prohibits processors to produce simultaneously "pure milk" products and "products with vegetable oils" at the same time and at the same facility. Companies have to choose which type of product to produce and notify such to the government. Companies can change their decision but no earlier than 6 months after the last decision and they must notify authorities in advance of any change. At the retail level, traders have to observe the new rules and name the shelves for dairy products with vegetable oils "imitation product, containing milk."

The regulation was to enter into force in October 2012. However, the Association of Dairy Processors protested the decision and asked for notification to the EC. Over 100 processors were against the 6 month period which would mean that they could produce using vegetable oils only half the year while so far they could produce either product depending on the market demand. Traders, especially of smaller retail outlets, were also against the regulation due to limited shelving space available.

On January 4, 2013 the regulation was finally approved and published in the Official Gazette #1.

At the EU level, several member states including Germany, Austria, France, Slovakia and Spain, as well as the EC, submitted comment and/or some extent of disagreement with the proposed rule. Today, dairy processors still hope that they can challenge the regulation in the court.

To date, 76 dairies produce both dairy and imitation products. As of mid-January, 29 dairies out of 208 or 14 percent declared their desire to produce dairy products with vegetable oils.

Meanwhile about 60 dairies have indicated expectation of significant financial difficulty complying with new requirements. These dairies usually produce pure milk products for exports and imitation products for the local market. Dairies state that the empty market niche will be quickly filled by larger companies which have more than one facility/plant and can afford production of both types of products.

Currently, three dairies have already gone on the market for sale and this number will likely increase along with other new acquisitions and mergers.