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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the flax and hemp sector

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1. INTRODUCTION

Article 15(3) of Council Regulation (EC) No 1673/2000 on the common organisation of the markets in flax and hemp requires the Commission to submit a report, and if necessary proposals, to the European Parliament and the Council. The report "*shall assess the impact of processing aid on producers, the processing industry and the market for textile fibres. It shall examine the possibility of extending processing aid for short flax fibre and hemp fibre and the additional aid beyond the 2007/2008 marketing year as well as the possibility of integrating this aid scheme in the general framework of support for farmers under the common agricultural policy laid down by Regulation (EC) No 1782/2003*".

For this report the Commission took into account an external evaluation report on the flax and hemp sector[1], statistical data for which were updated in 2007. The figures referred to in the text are to be found in the accompanying Commission staff working document.

The flax and hemp sector in the EU

In the EU-27, 105 025 ha of **flax** was grown in 2006, making up 20% of world flax area. For climatic reasons, flax is grown in the temperate coastal regions of northern France (72%), Belgium (15%) and the Netherlands (4%), and to a lesser extent in Poland (2.6%), the Czech Republic (2.5%) and the Baltic States (2.4%).

Production: flax, generally grown on farms producing the principal arable crops, is more labour- and capital-intensive than cereals, and requires a rotation of 5 to 7 years. In addition, the retting process separating fibres from the harvested plant in the field adds considerable risk to production. Agricultural practices are also more complex than those for cereals.

Processing: in the EU-27 around 140 processing plants transform (scutch) 635 589 tonnes of flax straw (2006) into long fibres (112 914 tonne) and short fibres (61 775 tonne). This equals 53% of world production of flax fibres.

Use: long flax fibres are used in the textile industry. Some 80% of EU output is exported, mainly to China. Short flax fibres are used for composite material, textiles and paper (new outlets are developing following novel demand). Further income is derived from the sale of linseed and shives.

The 14 577 ha of **hemp for fibre** grown in the EU-27 in 2006 equals around 9% of world area under hemp. Production is concentrated in France (55%), the UK (11%), Romania (10%), Germany (8%), the Czech Republic (7%), and Poland (5%).

[1] http://ec.europa.eu/agriculture/eval/reports/lin/index_fr.htm.

Production and processing: hemp is grown on larger arable farms in the vicinity of a small number of major processing industries. No specific agronomic or climatic conditions are required. In 2006, 86 685 tonnes of hemp straw was processed into an estimated 22 863 tonnes of hemp fibre.

Use: hemp fibres are mainly used in the special paper industry (75%), with additional outlets for composite materials and insulation material ("novel" demand). By-products (shives for the equestrian sector) provide additional income.

The EU is part of the global market. Both hemp and flax fibre are exempt from import tariffs and no export refunds apply. For hemp, specific import rules apply, partly to offer guarantees regarding *tetrahydrocannabinol* (THC) values.

2. DEVELOPMENTS IN THE FLAX AND HEMP SECTOR

2.1. Evolution of the current scheme

The aid scheme for processors of flax and hemp has been prolonged twice, to allow its review to coincide with the overall 2008 "Health Check" on the CAP[2]. As early as in 2000 the Council decided to stop granting aid for short flax and hemp fibre as from the 2006/07 marketing year (after a transitional period). Both extensions of the scheme have confirmed this policy, which provides for aid to long flax fibres only.

The aid granted to authorised primary processors is based on the quantity of specific fibres actually obtained over a 22-month period from straw covered by a sale/purchase contract. The amount of the aid is:

– for long flax fibre:
  – EUR 160 per tonne for the 2002/2003 to 2008/2009 marketing years,
  – EUR 200 per tonne from the 2009/2010 marketing year onwards;
– for short flax and hemp fibre (containing not more than 7.5% impurities and shives):
  – EUR 90 per tonne from the 2001/2002 to 2008/2009 marketing years.

Member States are also allowed to grant aid for short flax fibres containing between 7.5% and 15% of impurities and shives and for hemp fibres containing between 7.5% and 25% of impurities.

The processing aid is granted up to a maximum guaranteed quantity (MGQ) per marketing year of 80 878 tonnes for long flax fibre and 147 265 tonnes for short flax and hemp fibres. These amounts are apportioned between the Member States as national guaranteed quantities (NGQ). Transfers of quotas between long flax fibres and short fibres are allowed, applying a coefficient of equivalence that keeps the operation budget-neutral.

[2] Communication from the Commission to the Council and the European Parliament 'Preparing for the "Health Check" of the CAP reform' - COM(2007) 722, 20.11.2007.

In order to support traditional long flax fibre production in certain areas of the Netherlands, Belgium and France, additional transitional processing aid is granted to authorised primary processors until 2008/2009.

The current budget for processing aid totals about EUR 21 million for the EU-27. While the scheme has provided for stable budgetary development and averted the speculative behaviour observed in the 1990s, its administrative and control requirements are relatively complex[3] and could be simplified.

In addition, part of the previous support to producers of flax and hemp has been decoupled and included in the Single Payment Scheme. Coupled aid is granted to farmers for basic or certified flax or hemp seed[4].

2.2. Flax: processing industry and market trends

A long-term increase can be observed with regard to flax straw production in the EU (figures 1 to 9). A total of around 140 processing plants continue to operate in the EU-27. With total turnover of **long flax fibre** processing estimated at around EUR 235 million and short flax fibre processing at around EUR 32 million (2005), the average size of processing companies remains small, with the exception of some French processors. Most processors, some of which are cooperatives, have strong links to the local economy and tend to be highly specialised and sometimes integrated upstream (seed production, participation in flax production) or downstream (second level processing).

Further transformation of flax fibres is largely located outside the EU. In 2006, more than 80% of European long flax fibres, mainly used in the textile industry, were exported — 82% of this to China. In addition almost 40% of short flax fibres are exported, 91% of this to China. As the largest producer of flax fibres in the world, EU fibres have been in great demand as a result of the strong and quick expansion of the Chinese spinning industry. Exports to China almost tripled between 1999 and 2006.

Despite this strong export demand, the price for long flax fibres decreased from EUR 2 340/tonne in 2000/2001 to EUR 1 511/tonne in the 2006/2007 marketing year. This trend is mostly a consequence of the strong appreciation of the Euro vs. the US dollar: in dollar terms, the prices for long fibres only decreased by 10% from 2001 to 2006.

Short flax fibres are quite exclusively the co-product of long flax fibre production. Hence, few processing plants in the EU are dedicated to first-processing of flax "technical fibres". Nevertheless, considerable employment is observed in second processing of short flax fibres and companies trading in by-products.

Technical applications absorbed 38% of short flax fibre production in 2005 (up from 9% in 1999). Use of short flax fibre for textiles (30%) is growing, mainly in China. The share of the paper industry decreased from 45% to 32%, declining marginally in terms of volume. Despite some competition from wood and other natural fibres, the paper outlet remained attractive as it can absorb large volumes and does not demand high quality.

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[3] See Figure 10 in the working document: Assessment of the administrative cost of processing aid for flax and hemp fibres.

[4] €28.38/100 kg for fibre flax seed, €22.46/100 kg for linseed and €20.53/100 kg for hemp seed.

New technical applications for short flax fibres have increased both in volume and in share of short flax fibres. Production of composite materials for the car industry is the most advanced new market, using 18 300 tonnes (27% of all short flax fibres). Nevertheless, this market remains dependant on prices of substitutes and the ability to guarantee a regular supply of fibres.

Prices of short flax fibres, generally a co-product of long fibre production, are very variable, and range from around EUR 300/tonne for the special paper industry, through EUR 350-650/tonne for textile fibres, to EUR 500-600/tonne for composite materials (2005).

2.3. Hemp: processing industry and market trends

The joint working document shows the decline of the hemp area to less than 15 000 ha, while straw production remains relatively stable. The main scutching capacity for hemp straw is situated in around 10 sites in France, UK, Germany, Poland (wood and flax fibres for insulation materials) and the Czech Republic (fibres for paper industry). In 2006, these plants processed 86 685 tonnes of hemp straw into 22 865 tonnes of fibre, of which around 75% is used in the paper industry. This traditional market is mature and looks relatively stable in the long run.

Composite materials (20%) and insulation material (5%) represent a growing outlet. Hemp fibre has qualitative advantages over fibreglass, but production is not high or stable enough to make it a major player in the sector. While other new applications have been developed for hemp shives (cosmetics, omega-rich oil) and for the whole plant (concrete, biomass), these projects remain small, often lack competitiveness and currently remain dependent on public support.

There are considerable differences between the prices of fibres used in the special paper industry (average of EUR 360/tonne in 2006/2007) and those for technical applications (EUR 500/tonne for non-woven materials and EUR 600/tonne for plastic compounds). In the long run the competition from three to four times cheaper wood fibres could seriously affect the special papers market.

2.4. Environmental impact of the flax and hemp sectors

Reviewing the environmental impact of flax and hemp cultures, the evaluation study underlines that flax and hemp cultures show considerably lower consumption of synthetic fertilisers and pesticides than do alternative crops. In addition, flax and hemp cultures have positive effects on diversity in agro-ecosystems and landscapes. Flax, and to a lesser extent hemp, cultures are located in some of the most intensively farmed areas of the EU where the current trend is in favour of simplifying rotation (and increasing use of chemicals in case of replacing flax and hemp by cereals). In this context, fibre crops provide an “environmental break” beneficial to soil quality, biodiversity and landscapes.

3. ASSESSMENT OF THE PROCESSING AID

3.1. Impact of the processing aid for long flax fibres

3.1.1. Impact on producers

Processors need to ensure a sustainable supply of flax straw by offering a price generating a gross margin for flax that is competitive with alternative crops. While flax production generally provides good margins, its relative competitiveness has deteriorated with the recent surge in cereal prices. Gross margins for cereals exceeded those of flax in 2007, whose processors were mostly not able to compensate through higher straw prices. Moreover, as a result of the heavier and more complex workload, investment needs and the greater weather-related risks of flax production, even gross margins equal to those of cereal crops may lead farmers, especially in the traditional regions, to abandon the crop and to simplify their production system.

3.1.2. Impact of additional transitional aid for traditional areas

The additional transitional aid to processors of long flax fibres for flax grown in certain areas of the Netherlands, Belgium and France, in order to take account of the special status of traditional flax in these areas, would have been based on the higher level of support in these regions under the previous scheme, until 2000. Originally provided for until 2005/2006, it was extended in order to enable farm structures to gradually adapt to the new market conditions.

The evaluation study concludes that the *additional aid of EUR 120 per ha* for traditional production regions in the Netherlands and Belgium has been important in maintaining production in these areas. Removal of this additional aid would, according to the evaluation study, result in a very significant reduction in, or disappearance of, the area under flax in these regions. On the other hand, the study considers the influence of the *additional aid of EUR 50 per ha* for certain areas in France and in Belgium to be limited. Removal of this additional aid (while maintaining the regular aid) would not hamper the continuation of the production of flax.

3.1.3. Impact on processors and employment

The flax processing industry has become increasingly dependant on demand from China. Although declining flax fibre prices (mainly as a result of the appreciation euro/US dollar) were partly compensated by increase in volume, there is considerable pressure on the market, partly resulting from decreasing margins in the Chinese textile industry.

The evaluation study, on the basis of data supplied by the processing industry itself, estimates that for a majority of (larger) French and Belgian processors aid accounted for around 35% of gross margins in the years 2002 to 2005 and that an absence of aid would require some measure of restructuring and reorganisation. However, for a considerable number of smaller enterprises, aid exceeds gross margins. Although the evaluators estimate that an absence of aid may cause around half of these processing plants to disappear, a restructuring process would allow much of this capacity to be consolidated.

Locally, this could have a serious impact on employment. The aid regime has contributed to maintaining the level of activity and employment in the traditional production areas (northern France, Belgium and the Netherlands) and has allowed the emergence of new industries in some others, including new Members States (Poland and the Czech Republic). The evaluation report estimates that of total estimated employment of over 4 050 full-time equivalents (FTE), around 2 000 FTE may be lost in the short run, in the absence of specific Community aid for fibre crops, specifically as these jobs are generally located in rural areas where agriculture and processing are major employers.

Granting processing aid to primary processors has no significant impact on the profitability of European downstream industries (spinning, clothing, etc.), which have delocalised to South East Asia in the past decade.

Table: Estimated employment in the flax and hemp sector (in FTE)

	Flax and hemp
Agriculture	850
First processing	2 000
External inputs first processing	200
Second processing	> 1 000
TOTAL	> 4 050

Source: AND International

3.2. The impact of aid for short fibres

Hectares intended specifically for **short flax fibre** production are marginal. And as major producing Member States (France and Belgium) have converted considerable quota for aid to short fibres into long flax fibre quota, the impact of the aid for short flax fibres must be analysed in combination with aid for long fibres. As few specialised primary processors of short flax exist, removing the aid would directly affect only a number of small specialised processing units.

The use of short flax fibres has only slightly increased since 1999. Besides the traditional outlet for specialty papers, only use as composite material in the car industry shows significant growth.

Comparing the gross margins for **hemp production** with those for alternative crops shows that without aid for short fibre, margins would be narrower, specifically taking into account that hemp production is more labour intensive than alternative crops. This may lead to some reduction in the area under hemp.

But the major market for hemp fibres, the specialised paper industry, is considered stable. This industry offset the decrease in aid in 2001 with an increase in the price paid for fibres. Although it remains to be seen whether a similar increase may be expected if the aid is abolished, an economic perspective without processing aid does exist for hemp processors focusing on the paper industry. Nevertheless, considering the weak financial situation of some processors, abolishing aid could affect their continuity.

The small number of processors focusing solely on the use of fibre for new industrial applications could see development potential and their survival threatened in the absence of aid. The evaluation study shows that public support continues to determine a large part of their profits.

4. ISSUES AT STAKE

The 2003 reform continued the shift from product to producer support through the introduction of a decoupled Single Payment Scheme. This was done in order to encourage competitiveness and market orientation and at the same time increase the transfer efficiency of income payments. The Health Check review poses the question whether coupled support, despite the overall orientation towards full decoupling, is still pertinent.

The **additional processing aid** for processors of flax grown in traditional areas was introduced by the Council as a transitional measure, and is scheduled to be abolished. The aid has contributed to competitiveness of flax cultivation in these regions (in particular in Belgium and the Netherlands), but it should not be continued from the 2009/2010 marketing year in view of its transitional character (to allow for gradual adjustment of the sector) and its application in three Member States only.

The objective of the temporary processing aid for **short flax and hemp fibres** is to encourage the development of new (industrial) products and potential outlets. In view of the above analysis, one must ask whether years of support for short fibres have been most effective in encouraging such development. The Council decided in 2000 to phase out the aid for short fibres, which has been extended for three additional years only to allow an assessment in the context of the overall Health Check review. Project support through Rural Development or research programmes may be a more cost efficient way to stimulate development of competitive renewable products. On the basis of these developments and considerations, the specific processing aid for short fibres should not be continued from the 2009/2010 marketing year.

Continuing processing aid for **long flax fibres** could contribute to maintaining employment and economic activity in production regions. However, maintaining processing aid is not in accordance with the principles of the 2003 CAP reform. In addition, continued high cereal prices would most likely entail a reduction in production and a loss of environmental benefits and employment, which, despite this specific aid, raises questions regarding its effectiveness.

Therefore full decoupling and integration of the aid in the Single Payment Scheme appears to be the best solution[5]. Similar to the earlier integration of support for hemp and flax growers in the Single Payment Scheme, decoupling would integrate the processing aid budget into this system. This option would allow for considerable simplification compared to the relatively complex current regime.

[5] See the Impact Assessment for the Health Check proposal.

Decoupling introduces flexibility in choice for producers. Farmers will continue to produce where it is profitable, and adapt their production to the market or change to alternative products where it is adequate, while they are still obliged to keep land in good agricultural and environmental condition, in line with cross-compliance rules. Overall, decoupling leaves the producer at least as well off as before, and most likely better off as a result of production flexibility and market orientation.

In view of the gross margins of alternative crops and the higher costs and risks of flax production, it is estimated that the area under flax will decrease. And without processing aid the smaller processors especially would face serious difficulties, specifically in the traditional production regions. For this reason, gradually phasing out processing aid for long flax fibres, together with the possibility to apply Article 69 of Regulation (EC) No 1782/2003, seem appropriate to allow restructuring and modernisation of the industry.