MARKET IMPACT OF EU REGULATIONS ON GROUP HOUSING OF SOWS – UPDATE REPORT

1. Introduction

New regulations on pig welfare come into force on 1 January 2013. The most significant element of these is the requirement that for most of their gestation period, sows are kept in social groups rather than in individual stalls. The regulations also cover other issues such as the amount of floor space and pen dimensions, width of slats and slots on slatted floors, access to manipulable materials and availability of sufficient feed.

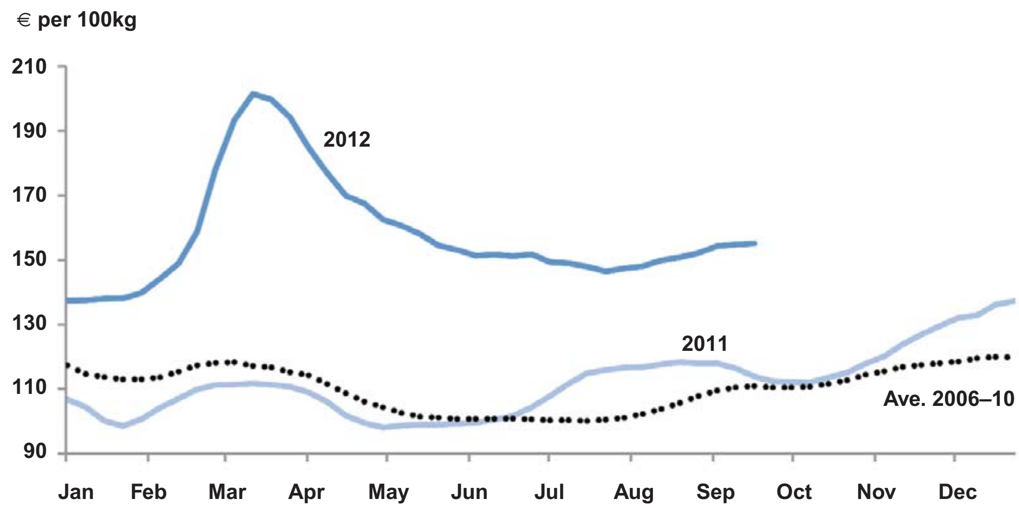
This report is an update on progress since the BPEX report *Market Impact of EU Regulations on Group Housing of Sows*, published in April 2012. It collates the latest available information on implementation and enforcement of the regulations. It then reassesses the possible impact of the regulations on the pig market, in light of this progress and other developments in the market since the original report was published.

As with the original report, this update has incorporated information provided by expert economists from across most of the major pig producing Member States in Europe. It also incorporates information from published sources, including announcements from the EU Commission and national governments.

Experience of the laying hen sector

In the original report we considered the experience of the laying hen sector, which faced the introduction of similar changes on 1 January 2012. At that time, 13 Member States had failed to comply with the regulations and this led to a sharp spike in the price of shell eggs; in mid March prices were over 80 per cent higher than they had been a year earlier. Since then prices have subsided somewhat but remain much higher than a year earlier, having stabilised at around €150 per 100kg. To put that in context, the highest price recorded before this year was €147 per 100kg and the average price over the last five years was €114.

Figure 1 EU average market price for shell eggs for consumption



Source: EU Commission

On 21 June 2012, the EU Commission announced that it had sent reasoned opinions to ten Member States who had still failed to comply with the Welfare of Laying Hens Directive (WLHD). They had two months to comply or the Commission could take the case to the European Court of Justice. Non-compliant states are also being targeted by FVO missions, although not all will be covered by the end of 2012.

Experience of the laying hen sector *(cont'd)*

The EU Commission responded to non-compliance by first sending formal infraction letters and by a monthly review of Member States' action plans. They also made a 'gentleman's agreement' with the Member States not to export non-compliant eggs, although this does not include manufactured products, such as pasta. There are concerns about some Member States not complying with the gentleman's agreement and exporting non-compliant shell eggs. However, for various reasons it is unlikely that there will be a similar intra-community trade ban on pig meat from illegal production systems.

2. Progress towards implementation

In mid-June, the EU Commission announced that 18 Member States had confirmed that they expected all of their remaining pig breeders to be compliant with the new regulations by 1 January 2013. The Member States involved were: Belgium, Bulgaria, Czech Republic, Denmark, Estonia, Germany, Hungary, Ireland, Latvia, Lithuania, Luxembourg, Netherlands, Malta, Romania, Slovakia, Spain, Sweden and the UK. Although many of these Member States are already close to full compliance, some will need to make rapid progress to meet their commitment without losing a large proportion of production.

Of the remaining nine Member States, five are expecting to be over 90 per cent compliant by the end of the year. These are Austria, Finland, Greece, Poland and Slovenia. Of the remainder, Cyprus and Portugal will have lower compliance rates, while France has not yet provided data to the Commission and Italy has provided data but has requested that the Commission do not publish it because of the way it was collected.

Brief information on the latest progress in each Member State[1] is provided below. This information, in common with the figures from the Commission quoted above, largely pre-dates the recent rise in feed prices which has had a major impact on the profitability of the sector. This may have a significant effect on progress towards compliance and is dealt with in more detail in section 4.

Austria: Progress towards compliance was delayed during 2011 as Austrian politicians debated stronger pig welfare regulations. This produced considerable uncertainty among producers and made them reluctant to invest until the requirements were clarified. This situation has now been resolved and investment has begun again. However, the delay means that an estimated five per cent of producers will not have converted by the end of 2012. Nevertheless, the Austrian government expects full conversion to be completed by early 2013. Some producers, perhaps up to 10 per cent, will leave the industry or stop breeding instead of converting.

Belgium: During the summer of 2012, the Belgian government carried out a survey to establish the latest position on compliance, plans for conversion and reasons for non-conversion. According this survey, 63 percent of producers were already converted and 93 per cent planned to be by the end of the year.

Denmark: Danish pig producers are expected to be fully compliant by the end of the year. Significant progress has been made during the year and remaining producers have plans in place. A few producers will choose to leave the industry, with estimates that this could amount to a loss of about five per cent of total sow numbers. This should be partly offset by expansion of remaining producers, although this will depend on the development of feed and pig prices.

[1] With the exception of Sweden and the UK which implemented national legislation requiring group housing of sows more than a decade ago and Luxembourg which has been fully compliant since 2010.

Progress towards implementation *(cont'd)*

Finland: Virtually all of the larger pig farms in Finland are expected to have complied with the regulations by the end of the year but some smaller producers may not have done so. It is thought that the rules on slatted floors may be causing difficulties as well as group housing. Finland is also debating stronger welfare rules, requiring more space than EU regulations, which are likely to be decided later in the year.

France: The French government is believed to be the only one which has been unable to provide any estimates of likely compliance to the EU Commission. A study by the French government suggested that only 30 per cent of producers were compliant in April and almost half did not expect to be compliant by the end of 2012. Around 30 per cent planned to convert during 2013, with most of the remaining 17 per cent planning to stop breeding. This suggests that there may be a significant fall in production during 2013 and 2014 and that much of what is produced during the year could be from non-compliant systems. This might have a major impact on the market, since France is the third largest producer in the EU.

Germany: A recent survey has suggested that only around half of German pig breeding farms had converted to group housing, with another 30 per cent planning to do so by the end of the year. It is likely that most of the remainder is made up of smaller farms and some of these will leave the industry or switch to finishing. The German government has confirmed that they expect all producers to be compliant by the end of the year but has not published any plans for how this will be achieved, given the significant number of producers who have not yet converted.

Ireland: Latest information from Ireland suggests that less than 30 per cent of sows were not in group housing by the middle of 2012. Financing problems are limiting progress towards conversion, despite the availability of government funding. Further progress is expected during the remainder of 2012 but some existing producers will not be able to comply in time. The Irish government has indicated that it will enforce the regulations, which could lead to producers having to cease breeding, temporarily at least. A fall in production is likely to result, although this may be partly mitigated by some remaining producers expanding.

Italy: There are no published official figures on levels of compliance in Italy. A survey undertaken by ANAS, the Association of Pig Breeders, in April suggested that around half of producers were compliant, with a further 17 per cent planning to convert by the end of the year. This leaves over a third of Italian producers with no plans to convert before the deadline. It is not yet clear what the response of the government will be to this situation.

Netherlands: It is thought that around 80 per cent of Dutch pig breeders were keeping sows in group housing in the middle of 2012, with that proportion likely to rise to over 90 per cent by the end of the year. In a survey conducted in the summer of 2011, around 10 per cent of producers said that they expected to stop breeding by the start of 2013. However, it was expected that this would be partly offset by some expansion among remaining producers, although rising feed prices may affect this. The government has plans to enforce the regulations, having drawn up an inventory of non-compliant farms.

Poland: Use of sow stalls has been less prevalent in Poland than in many other Member States, so there has been less of an issue with conversion. Most large-scale producers are already using group housing or have plans in place to convert by the end of the year. Some smaller farms may be unable to convert but they are likely to cease breeding, particularly given that the industry has been struggling financially for some years and that situation has been made worse by recent feed price increases.

Progress towards implementation *(cont'd)*

Romania: The Romanian pig industry is one of the few which is expanding at present. This is largely the result of significant foreign investment and the confirmation that the country is free of classical swine fever, allowing it to recommence exporting pig meat to other Member States. Most large operations are thought to be compliant already but little is known about the situation for the many smaller producers.

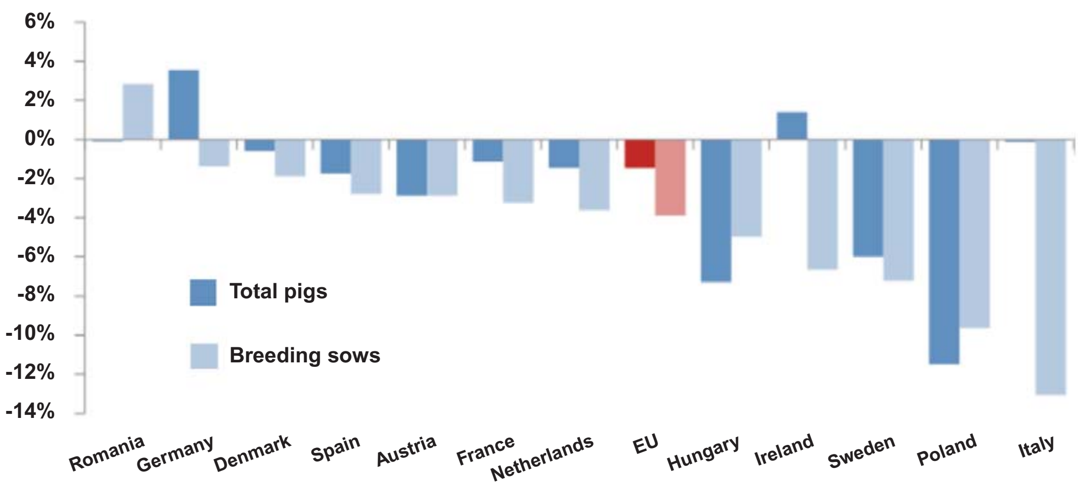
Spain: Significant efforts have been made in Spain to ensure that all producers are compliant or cease production by the end of 2012, including provision of finance, communication and training. The government has required producers to submit plans for adaptation or stopping production. It is believed that most of the larger commercial producers have already converted or have plans in place to comply by the end of the year. However, compliance is currently lower among smaller producers and some reports suggest that a large proportion of these may leave the industry or convert to finishing. If this turns out to be the case then it could lead to a sizeable fall in production.

Other Member States: In many smaller Eastern Member States, including Bulgaria, Czech Republic, the Baltic States, Hungary, Slovakia and Slovenia, compliance is not considered a major issue as they have few large-scale producers and many of them did not use stalls anyway. Therefore, most expect to be fully compliant or close to it, without a significant fall in production as a result (although production may fall for other reasons).

In some smaller Member States in the south, including Cyprus, Greece, Malta and Portugal, the economic situation has made it very difficult for producers to access the finance required for investment. This means that significant numbers of producers in some of these countries will be unable to convert to group housing by the end of the year. Some will leave the industry, particularly as the financial position of producers has worsened lately but some may continue in the short-term. How governments will respond to this is not yet clear.

Provisional results of pig censuses from various Member States show that the EU pig herd and, in particular, the breeding herd declined over the year to May/June 2012. This came despite feed prices during the year being lower than they were in the periods immediately before and after. Census results are now available from most major producers, representing over 80 per cent of the EU pig herd. Overall, pig numbers across these countries were down by 1.5 per cent, while sow numbers were down by nearly four per cent. All of the countries except for Romania recorded a fall in their breeding herds.

Figure 2 Annual change in pig and sow numbers May/June 2011–2012



Source: Eurostat

3. Enforcement

Information is beginning to emerge about how the EU Commission plans to enforce the pig welfare regulations. In general, it is planning to be more proactive than was the case with the Welfare of Laying Hens Directive (WLHD) last year. As well as collecting data and action plans at an earlier stage, the Commission is also increasing communication, planning FVO missions, training veterinarians and preparing to launch infringement procedures from 1 January 2013.

If by autumn 2012 Member States are not implementing the Directive, they will receive a letter to which they have ten weeks to reply. This will allow the Commission to be ready to start infringement proceedings by 1 January 2013. This begins with a warning letter and could potentially end with fines.

In June 2012, the European Parliament's Committee on Agricultural and Rural Development passed a non-binding resolution which called for a single set of EU-wide rules for enforcing animal welfare legislation. They want member states to employ more inspectors and for the FVO to have increased powers to penalise breaches. To prevent the same situation that happened with the WLHD, the committee wants the Commission to employ an early intervention system and to check regularly on the progress of Member States. They would also like new labelling rules on farming methods and animal welfare and to ensure that imports meet the same welfare criteria as EU member states.

Most Member States have enacted national legislation incorporating the regulations into national law. This forms the basis of enforcement action by national governments. The approach to enforcement will vary and details are not always available. However, there are a number of common elements which have been identified.

The first stage of enforcement is to gather information about which producers are compliant with the regulations, which have plans to convert and which do not. Most governments have already collected this information or are in the process of doing so. This is often being done through surveys of producers but this is typically being audited, at least for a proportion of producers, for example through routine visits by veterinarians. In some cases, such visits are being used as the means for collecting information in the first place.

Several Member States are planning to place restrictions on non-compliant producers in advance of the deadline of 1 January 2013. This includes prohibitions on serving sows which would farrow beyond the turn of the year. In some cases there will also be restriction on the movement of gilts onto non-compliant farms.

After the 1 January 2013, several governments plan to force depopulation of non-compliant units, typically involving culling any remaining sows and gilts, although any non-breeding pigs will normally be allowed to remain on farm. In other cases, licenses will be removed, effectively preventing producers from operating.

In addition to taking action to prevent production using non-compliant systems, most Member States plan to prosecute non-compliant producers, typically leading to significant fines. However, some expect to take a more lenient approach to those producers who have conversion plans in place, with only small fines likely.

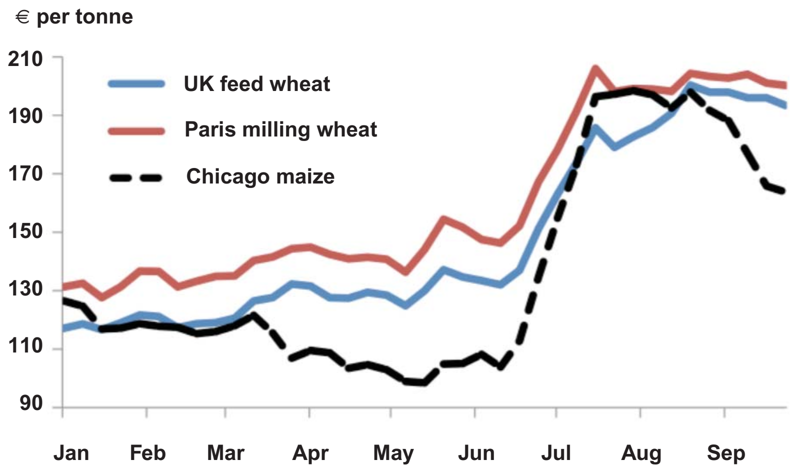
Any enforcement action by governments will be supplemented by industry-led approaches such as the use of quality assurance schemes and the requirements of processors, retailers and foodservice providers. These will vary between Member States, partly in response to consumer attitudes. In general, consumers in northern Europe are more concerned about animal welfare issues than those elsewhere and provide a key driver towards compliance in those countries.

4. Feed price rises

It is clear from the information in section 2 that many producers had made plans to convert from stalls to group housing during the second half of 2012. For most, this conversion would require significant capital investment. Raising finance for this investment has been a challenge for many, given the prevailing economic climate and the poor profitability that the industry has suffered for much of the last decade.

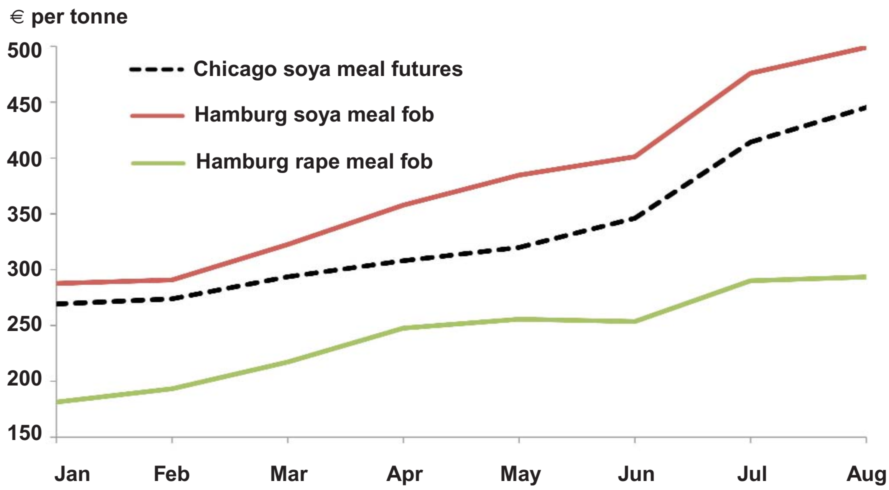
However, since the start of July the financial situation of the industry has deteriorated further. This is the result of a rapid rise in feed prices, largely due to adverse weather conditions in several key global crop growing regions, notably the US. Prices have risen for both cereals and oilseed meals, the two major components of most pig rations, leaving them at or close to record highs.

Figure 3 International Grain Futures Prices (post-harvest delivery), 2012



Source: HGCA

Figure 4 International Oilseed Meal Prices, 2012



Source: HGCA

Feed typically makes up around 60 per cent of the cost of producing pigs and rising prices have added more than ten per cent to the cost of production since the start of the year. This has left most pig producers in a loss-making position, with many facing substantial losses. Furthermore, feed prices are unlikely to fall markedly during the remainder of 2012 and subsequent price movements will depend on the outcome of future harvests.

Feed price rises *(cont'd)*

With global supplies of cereals and oilseeds tight, volatility is likely to remain a feature of markets in the future, making it difficult for pig producers to budget and secure finance. Regardless of the introduction of the new welfare regulations, this situation might be expected to lead to some pig producers choosing to leave the industry rather than face mounting debts. Although this could lead to higher pig prices in due course, the length of the production cycle means that they would come too late for many producers. If sustained, the rise in pig prices experienced across much of the EU during the summer of 2012 may mitigate the effect of the high feed costs to some extent.

Higher feed costs and increased market volatility may also lead to many producers reconsidering investment plans for conversion to group housing. For some, making an investment on this scale will no longer be viable given the financial situation facing the industry and the uncertainty about future profitability. This will probably mean that some producers who had planned to convert will choose not to. At this stage, it is too early to accurately assess the extent of this or to judge whether these producers will leave the industry or carry on producing without complying. Either way, the rise in feed prices will have a significant impact on how the pig market develops both before and after 1 January 2013.

Higher costs may have an even greater impact on producers in other parts of the world, potentially leading to shortages of pig meat on the global market. In the US, sow slaughterings have already increased considerably and this is likely to continue as market commentators indicate that producers are heading for record losses that could be as much as US$60 per pig by the autumn. The situation in Canada is similar, with two of the largest producers already in receivership.

In Brazil, the Government is giving support to pig farmers to counteract the weak finished pig market and the escalating feed costs, with producers losing between US$30-50 per pig in recent months, although prices have started to move up recently. In China, pig producers are expected to be in a loss-making situation in the coming months. Past experience suggests this will lead many to stop producing, leading to shortages of pigs and higher prices next year.

5. Market impact

Our original report on the market impact of the new pig welfare regulations identified three scenarios for how the market might develop:

1 The most likely situation was a fall in pig meat production of around five per cent from 2011 levels, leading to price increases but with fairly rapid recovery as productivity improved

2 Rigorous enforcement of the regulations leading to a sharper fall in production, shortages of pig meat and substantial price increases, resulting in pressure for political intervention

3 Realignment of production so that breeding is concentrated in North West Europe and finishing in Eastern and Southern Europe, reducing overall production costs.

Treating the welfare regulations in isolation, relatively little has changed since the publication of the first report. The situation in a number of countries has become clearer but an overall reduction in pig meat production of around five per cent still seems realistic. However, the timing of the reduction is now clearer.

Scenario 1 of the original report envisaged a gradual reduction in the size of the breeding herd during 2012 as producers converted to group housing, switched to finishing or left the industry. Some acceleration in the rate

Market impact *(cont'd)*

of decline was expected at the end of the year and into 2013. The latest census results suggest that this decline has already begun but the most significant decline is still likely to take place during the remainder of this year and early 2013.

This would mean that the main fall in production will begin during 2013, given that it takes six months or more to raise a pig to slaughter weight. As a result, there would only be a modest decline in 2012 and the first half of 2013, accelerating in the second half of the latter. The timing may also be affected by the extent of non-compliant production continuing into 2013 and how quickly it is ended. Although the overall fall in production may be similar to the estimates in the original report, the reduction in production would be phased, with perhaps a one per cent decline in 2012, two to three per cent in 2013 and a further one to two per cent in 2014, with a recovery thereafter.

The impact on the market would still be broadly as described in the original report, under this revised scenario. However, the effects might take longer to become apparent. For example, by the end of the period in mid 2014, prices would still be higher than they might otherwise have been but the rise would be more gradual. This might make it harder to isolate the impact of the welfare regulations from other factors affecting pig prices. Nevertheless, past experience suggests that production declines on this scale normally lead to an increase in prices of at least ten per cent.

To some extent, similar comments apply to Scenario 2, although in this case a rapid fall in the breeding herd could be expected early in 2013, leading to a sharper fall in production later in the year and in early 2014. Scenario 3 would be less affected since this is a longer-term development anyway.

However, the welfare changes are not happening in isolation. As outlined in the previous chapter, they are happening at a time when pig producers are under considerable financial pressure due to high feed costs. The bulk of the impact of increased costs has fallen on breeders, since weaner prices have been dropping while finished pig prices have been rising. This has left most producers, and particularly breeders, in a loss-making position. The situation is not likely to improve markedly in the immediate future, unless recent pig price rises are sustained, since feed prices are expected to remain high.

There have been two recent periods when feed prices have risen rapidly, in 2007/08 and 2010/11. On those occasions, the number of breeding sows across the EU fell by four to six per cent in a year. In most other years, the fall was around one or two per cent, suggesting that the impact of feed prices reduced numbers by around three per cent. On those occasions, only prices for cereals were highly inflated; this year, prices for both cereals and oilseeds are close to record levels. Therefore, the impact could be higher than the previous price spikes, leading to a fall in sow numbers three to five per cent greater than would have happened otherwise. These falls could be mitigated if pig prices are sustained at or above the levels seen over the summer.

From the analysis above, it is clear that both the welfare regulations and the feed price rises could have a significant impact on the pig market, if they were happening separately. However, they are happening together, so the question is what the combined effect might be.

From chapter 2, it is clear that a significant number of producers had already decided to leave the industry or switch to finishing rather than convert to group housing. For some of these, the decision was a financial one, due to the investment required to convert. It is likely that the financial situation of many of these producers would have meant that they would have made a similar decision in the face of rising feed costs. This may mean

Market impact *(cont'd)*

that the combined impact of the two issues would be less than the sum of the two.

However, there is another group of producers who were waiting until the last minute to convert to group housing. Although most of them will have already secured funding for the required investment, some may now decide not to go ahead, given the lower returns they might expect, in the short-term at least. Those who have not yet secured funding may find it more difficult to do so, for the same reason. This will probably mean that some producers who would otherwise have survived either of the two issues will be forced out of the industry by the combination of the two.

Overall, there are probably more producers in the first category than the second because financially vulnerable producers would be less likely to have chosen to convert. This means that the combined effect of the welfare regulations and feed crisis may be less than the sum of the two individual impacts. Nevertheless, the timing may mean that the overall fall in the EU pig breeding herd over the next year will be between five and ten per cent. This decline could be mitigated to some extent if pig price rises are sustained, reducing or eliminating the financial losses experienced by producers.

In this situation, pig meat production could fall five per cent or more in 2013, with further declines the following year. This would be likely to lead to substantial price increases and some supply shortages. Any resulting further rise in pig prices could encourage expansion but this wouldn't feed through into production until 2014, at the earliest. In any case, financing may be challenging if feed prices remain high and volatile.

A fall on this scale is close to the one envisaged in Scenario 2 of the original report and the impacts may be similar to those described there. However, the option to open the EU market to imports from elsewhere may not be effective, given that global pig meat supplies are likely to be much tighter, at least in the short term. Indeed, export demand for EU pig meat will probably be high as a result of shortages elsewhere, providing further support to prices.

Scenario 3 in the original report set out the possibility of a fundamental realignment of production. This would see breeding increasingly concentrated in North West Europe, where productivity is highest, with weaners then moved to finishers in Eastern and Southern Europe, where costs are lower and there are fewer environmental constraints. This possibility still remains but the impact of recent developments on the likelihood and timing of any change is unclear. Rising feed prices should increase the focus on reducing overall costs, one of the main drivers of the realignment. They will probably also increase the number of producers hoping to switch from breeding to finishing. However, counteracting this, higher feed costs may limit expansion among breeding producers in North West Europe, partly because it will make it harder to obtain finance and partly because it will reduce expected returns on any investment.

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