Canadian Dairy in the Trans-Pacific Partnership[1]

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A Trans-Pacific Partnership (TPP) agreement was completed by Canada and eleven other nations, after marathon negotiations, on October 5th, 2015. Going into the TPP negotiations, Canada's agenda on dairy was essentially defensive. Within the framework of providing as little increased access to the Canadian dairy market as possible in a TPP agreement, key aspects of the Canadian position were to defend the Canadian compositional standards for cheese, and maintain or improve the balance of butterfat and skim milk solids in the Canadian market. What emerged was a remarkable success for the Canadian dairy industry- Canada conceded only 3.25% dairy market access to its TPP partners through increased quotas on tariff-free imports, the compositional standards for cheese were maintained, and new programs valued at over $4 billion were announced in compensation for losses in dairy and poultry industries. Canada even got increased market access into the protected US dairy market.

The view that is emerging as more detail becomes available is a little more complicated, however. What Canada obtained or conceded in dairy markets under TPP should be understood in the context within which milk supply management operates in Canada. The Canadian dairy market balances through quotas on the butterfat portion of the milk; the skim portion is in surplus. This has long been the case, and the situation was manageable. However, two critical factors changed over time. First, in the early 2000's Canada lost a World Trade Organization case, which effectively capped Canadian dairy exports, including products made from skim milk. Whereas in the past surplus skim could be exported through dairy products made from skim milk, this is now sharply limited. Secondly, in the mid-2000's imports of a new product- milk protein isolate (MPI)- were classified in the Canadian tariff schedule as a "protein" rather than as a dairy product. This opened up a potential breach in the tariff wall protecting milk supply management; it was quickly filled by establishing quotas for tariff-free imports of these products, with very high over quota tariffs. However, under NAFTA, the US and Mexico were exempt, and left with open access to the Canadian market on MPI. Over time, the US has grown into this market- between 2007 and 2014, imports of MPI increased by 76%, and are up dramatically in 2015.

This leaves Canada with burdensome surpluses of skim milk solids, only limited access to exports to relieve the pressure, and with increasing imports of MPI (make entirely of skim) that make the situation even worse. In this environment, processors have had difficulty finding the business case to invest processing facilities, and the capacity to process skim milk in Canada is limiting- some has even been dumped as waste.

Enter into this dynamic the TPP agreement. Late last week, guidance documents issued by the US, Australia, and New Zealand indicated that under TPP, Canada had agreed to eliminate its tariff on MPI, and to phase out tariffs on dried whey. Canada had also agreed to eliminate tariffs on MPI imports from the EU under the trade agreement finalized last year. The effect of these tariff eliminations are above and beyond the 3.25% reported in Canadian guidance documents last week; their effect will only be bounded by supply and demand, not based on volume limits as percentages of the Canadian market. It extends the

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opportunity for major dairy exporters- New Zealand, Australia in TPP, as well as the EU, to enter in a more fulsome way the Canadian MPI market, currently dominated by the US.

This sets the stage for significant reforms to milk supply management. In the last year, Canadian milk prices at the farm were down by about 10%, in part due to the pressure from increased imports. Dairy farmers have proposed policy changes that would significantly reduce prices of skim milk in certain uses to better compete with imports and facilitate exports. With TPP allowing for increased import penetration of certain skim milk products tariff-free, it escalates the pressure to push forward these reforms. The best evidence of the urgency of the situation was the announcement earlier this week by the Dairy Farmers of Ontario that they were preparing to unilaterally proceed with a program offering world pricing on skim milk in specific uses, not contingent on export, with dairy processors committed to processing the milk.

Rather than simply being a speed bump of 3.25% increased dairy market access, with disproportionate compensation of billions of dollars, TPP is a portent for far-reaching changes in milk supply management. It can lead to instruments and pricing adjustments that address the long run struggle with surplus skim milk in Canada. It can facilitate mechanisms for increased dairy exports above levels that were capped 12 years ago. It can put in place the positive environment for investment in dairy manufacturing that has been lacking since the export restraints came on.

This will come at a cost and some difficult adjustment. Farm milk prices will decline significantly, but not precipitously. Farmers' quota values will soften concomitantly. But these shifts will forestall otherwise more catastrophic changes that would logically have occurred under our existing direction, in which the system would eventually collapse under the ever-increasing weight of surplus skim milk, with no ability to offset imports and domestic skim surpluses with increased exports, and insufficient dairy processing capacity, with no economic rationale to expand it.