Canadian Dairy in the Trans-Pacific Partnership: A Preliminary Analysis

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AGRI-FOOD ECONOMIC SYSTEMS

The Issue

A Trans-Pacific Partnership (TPP) agreement was completed by Canada and eleven other nations, after marathon negotiations, on October 5th, 2015. The prospect of a TPP agreement was viewed with significant trepidation by the Canadian dairy industry. Most recently, in the Canada-EU Comprehensive Economic and Trade Agreement (CETA), Canada allowed for phased-in cheese market access from the EU through tariff rate quotas (TRQ) totaling just over 18,000 tonnes, and tariff-free access for milk protein isolates (MPI) upon the coming into force of the agreement.

At the same time, Canadian imports of MPI have been increasing, especially from the US. The effect has been to increase the problems associated with the structural surplus of skim milk powder (SMP). Given Canada's limitations on dairy exports, the influx of MPI imports has required displaced SMP to be increasingly disposed of domestically at very low prices, or even dealt with as a waste stream[1]. Canadian dairy exports are generally at WTO limits on exports. Trying to expand Canada's export limits in some way is a needed release valve even without pending CETA or TPP agreements.

It is in this context that dairy producers developed an Ingredient Strategy, with the intent of better competing with imports and facilitating exports by providing competitive, non-contingent pricing of skim milk solids. Negotiations between producers and processors on the Ingredient Strategy began in the summer of 2015. These negotiations were bracketed by the ongoing TPP discussions.

The purpose of this policy note is to explore the situation facing Canadian dairy policy, given an agreement in principle among members of the TPP.

Canadian Dairy in the TPP

Going into the TPP negotiations, Canada's agenda on dairy was largely defensive. Within the broad 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 compositional standards for cheese, and maintain or improve the balance of butterfat and solids not fat (SNF) in the Canadian market.

In the communique of October 5th, the federal government provided the following summary of results of the TPP agreement on dairy[2]:

- Increased access amounting to 3.25% of annual production, (with a significant majority of the additional milk and butter being directed to value-added processing), phased-in over five years
- Canadian cheese compositional standards were maintained
- Tariff elimination for specialty and artisanal cheeses exported to the United States, apparently to be phased-in
- Information was provided on new programs that will be enacted in conjunction with TPP:
    - A new Income Guarantee Program will provide income protection for ten years from TPP coming into force, with support continued on a tapered basis for an additional

[1] For more detail on the interface between MPI imports and pressure on subsidized export caps, see http://www.agrifoodecon.ca/uploads/userfiles/files/dairy%20export%20briefing%20note%20june-15.pdf

[2] http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/tpp-ptp/benefits-avantages/sectors-secteurs/01-AgriSector.aspx?lang=eng

five years. Total budget for the program is $2.4 billion.
    - A new Quota Value Guarantee Program will be implemented to protect producers from reduction in quota value when quota is sold following the implementation of TPP. The budget for the program is $1.5 billion over 10 years.
    - A new Processor Modernization Program will be developed to provide processors with support to further advance their competitiveness and growth. The budget for this program is $450 million.
    - A new Market Development Initiative will assist in promoting and marketing of supply managed products. The budget will be $15 million, added to the existing AgriMarketing Program.

As can be expected immediately following the announcement, in-depth detail was not provided regarding the specific tariff lines that will be affected under increased access, and how these new programs will work.

On October 8th, additional information on the TPP was released by the USDA[3], by the Australian Department of Foreign Affairs and Trade [4], and by the New Zealand Ministry of Foreign Affairs and Trade[5]. In each case, these documents provided detail on each of these countries' market access and concessions under TPP.

- The USDA indicated that Canada would eliminate its tariff on milk protein substances upon entry into force of TPP, and that tariffs on whey powder would be eliminated over 10 years, with a duty-free TRQ during the transition. For all other dairy products, Canada will establish new TRQ's, which will grow for an additional 13 years after they reach agreed-upon quantities.
- According to DFAT Australia, under TPP there will be "Preferential access into the highly protected Canadian market with new quotas for dairy products including, cheese, milk powders and butter. Tariffs on milk protein concentrates will be eliminated on entry into force".
- The document from New Zealand MFAT states that "A number of [dairy] protein products have tariffs eliminated in Japan, US and Canada, most at entry into force", and "Tariffs on infant formula will be eliminated in the US, Canada and Mexico".

This indicates that in addition to market access concessions using TRQ's, which are bounded and can be calculated as percentages of domestic production, TPP also includes elimination of tariffs for specific dairy products. The impact of reduction or elimination of tariffs is not bounded, and as such not amenable to estimates of percentage access. However, the impacts of import increases due to reduced tariffs could be quite significant. Moreover, it appears that there will be growth in market access over time following the increased volume adjustment in TRQ's.

Potential Implications

Greater information and detail will be required before a fulsome analysis of the implications of TPP can occur. Some of the *dimensions* of impact can be identified, however. One is the proportion of existing trade and production represented by imports upon full implementation. Another is to understand the product yield and milk equivalent implied by product imports; in general, the impact is largest for relatively low yield dairy products as these represent the largest volume of milk equivalent at the farm. A related dimension is the ratio of butterfat/SNF embodied in imported dairy products. Canada's milk marketing system balances on the basis of butterfat and is in significant surplus in SNF.

[3] http://www.fas.usda.gov/sites/default/files/2015-10/tpp_ag_overview_-_long_10-08-15_1.pdf
[4] http://dfat.gov.au/trade/agreements/tpp/outcomes-documents/Pages/outcomes-goods-market-access.aspx
[5] http://www.tpp.mfat.govt.nz/assets/docs/TPP_factsheet_Goods-Market-Access.pdf

Imported products with higher content of SNF are more problematic in terms of required domestic realignment.

The specific HS codes in which TRQ's have been granted and the codes in which tariffs will be eliminated have not yet been made public. However, with respect to the tariff eliminations, these can be inferred based on verbal descriptions by the US, Australia, and New Zealand. Milk protein substances identified by the US fall under HS 3504. In this set of codes, the US is exempt of tariff, and New Zealand and Australia are subject to TRQ's, with an over-quota tariff of 270%.

Whey falls under several prospective codes. HS 3502.20 and HS 3502.90 is milk albumin, including concentrates of two or more whey proteins. These are subject to a tariff 6.5%, not subject to TRQ. HS 04 includes a number of tariff lines with whey. Powdered whey is in HS 0404.10.21 and 0404.10.22. Both are subject to TRQ's and tariffs of $3320/tonne, and of 208% but not less than $2070/tonne, respectively. However, for HS 0404.10.21, powdered whey imports from the US within the current access commitment are duty free already. HS 0404.10.90 contains condensed, evaporated and modified whey with an 11% tariff and no TRQ, although already duty free for the US. HS 0404.90 contains various formulations of whey, with SMP, or blended dairy powder with a TRQ and within-quota tariff of 3% (duty free for the US) and an over quota tariff of 270% but not less than $3150/tonne.

The following can be inferred. NAFTA countries already have tariff-free access to the Canadian market for MPI's under HS 3504 and parts of 0404, so there is some logic in having this access extended to TPP countries- as occurred under CETA. This is consistent with the US description of Canada opening tariff-free access to milk protein substances under TPP. Although the terminology is slightly different, it is also consistent with the Australia identifying Canada as eliminating tariffs on "milk protein concentrates".

The US discussion of Canada having eliminated tariffs on whey powder with a transitional TRQ appears more consistent with HS 0404 than 3502, as no TRQ's currently exist on 3502. The tariffs under 0404 are much more material, and thus represent a greater gain to TPP countries from their removal. The implication is that the TRQ for whey powder under HS 0404.10.21 and HS 0404.10.22 would be phased out over ten years with a new TRQ established for TPP members during the transition period. This will need to be confirmed as soon as the details of tariff line by tariff line changes are made public.

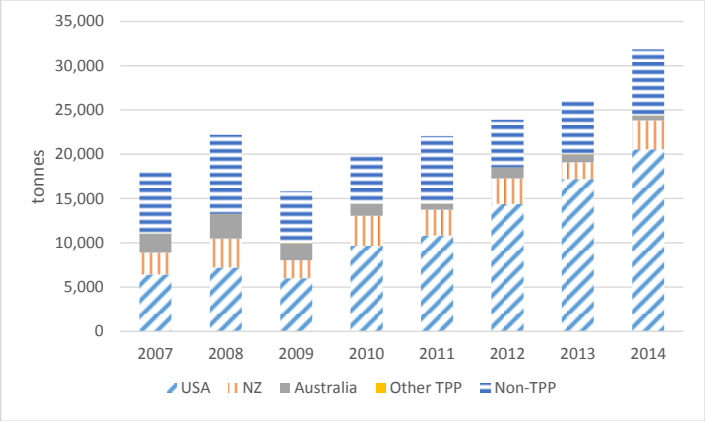
Figure 1 below presents Canadian imports under HS 3504[6] which include MPI, from the US, New Zealand, Australia, other TPP countries and elsewhere. Imports have increased very significantly over time, by about 76% between 2007 and 2014. However, virtually the entire growth over the period can be attributed to increases in US exports- consistent with US exports being exempt to tariff under HS 3504, while others were subject to TRQ and over-quota tariff.

Under tariff elimination actual imports will be based upon supply and demand. The current market environment is such that the US holds a commanding position as an MPI supplier to Canada with a wet-based product made possible by geographic proximity, which is experiencing remarkable growth. Others- including the EU, New Zealand, and Australia- have been stagnant or even declining as MPI suppliers, and have not filled available TRQ recently. New Zealand and Australia have not been major exporters of MPI; they have been more oriented to milk protein concentrate (MPC) exports, which it appears will remain subject to TRQ in Canada under TPP. Finally, there will ultimately be physical limits to Canadian demand for MPI, although these limits are not known.

But, acknowledging the above, one would expect that relief from tariffs of up to 270% would surely elicit some response from large dairy exporting countries, even if it occurs on a deferred basis. The EU is a major producer/exporter of MPI. Facilities used to make MPC in New Zealand and Australia can be converted to make MPI. Australia is reporting that the US will remove its

[6] HS 350400- "Peptones & derivatives; other protein substances & derivatives, nes; hide powder " from Canada customs basis, 6-digit commodity level

Figure 1 Canadian Imports under HS 3504



Source: Statistics Canada

tariffs on "milk powders" in TPP. If this includes MPI, it could be sufficient to induce New Zealand and/or Australia to shift its export mix away from MPC toward MPI to take advantage. Perhaps more fundamentally, it will leave Canada fully exposed to imports of MPI from the top four global dairy exporters and the capacity of their respective dairy supply chains to shift or gear up for the Canadian market. The evidence from the observed growth in US exports of MPI and the gaps created in the tariff wall protecting milk supply management is ominous in this regard.

Conclusion

The recent announcement of a TPP agreement, and the forthcoming details will facilitate an extensive analysis of impacts and adjustments for the Canadian dairy industry. However, policy adjustments are already in motion through the producer Ingredient Strategy and the negotiations between producers and processors. With the TPP complete, domestic dairy policy reforms can now be resumed with greater focus.

In this context, the following is evident. First, the Canadian compositional standards for cheese were retained in the TPP. As this was a core element of the Ingredient Strategy, the uncertainty surrounding its status it is now removed.

Secondly, policy initiatives to support income and quota value losses will be put in place that could generate greater confidence among producers to make major dairy policy changes. Funding to support processing plant capacity is consistent with the intent of the Ingredient Strategy to create incentives for dairy processing investment, particularly to process SNF and export MPI.

Third, Canada will obtain some specific access under TRQ to the US market. It remains to be seen how significant this access truly is, and how this will mesh with Canada's subsidized export caps under WTO. Canada already has a large proportion of its dairy exports to the US, and if this new export access falls under WTO subsidized export caps (as would be expected) then this access could allow for a change in the mix of products Canada exports to the US, but not much change in overall volume.

Fourth, it appears evident that Canada will face increased pressure from imports under TPP. This was expected, and the opening of 3.25% dairy market access quoted remains to be interpreted in terms of its content of butterfat and SNF, with an understanding of the Canadian dairy industry's sensitivity to increases in embodied SNF in imports. It appears that this access will grow over time beyond the volumetric schedule of increased TRQ's.

Moreover, as it becomes evident that there will also be tariff eliminations, the true extent of increased dairy import penetration under TPP remains to be seen. It could be much more than 3.25%- an estimate that must be based solely upon the TRQ concessions. As tariffs of up to 270% are eliminated for TPP countries for milk protein substances and dried whey, the prospect exists for increases in Canadian imports of these SNF-dense products.

As is currently the case with imports of MPI from the US, there will be no volumetric controls on these imports, and imports will be a function of price, supply, and demand. This will place further pressure on the supply management system to effectively deal with SNF surpluses. This, in turn, should escalate the pressure on producers and processors to get to an agreement that will

provide for non-contingent pricing of SNF for processors, with the prospect of export outside of subsidized export caps.

Assistance for new plant capital could help facilitate this agreement. But the threat of unregulated imports of MPI and dried whey from the US, New Zealand, Australia, as well as MPI from the EU under CETA, and its potential to swamp Canada's ability to cope with the burgeoning SNF glut, should create the urgency and impetus for significant shifts in dairy policy within supply management.

The best illustration of this urgency is the October 13th, 2015 announcement by the Dairy Farmers of Ontario[7] that Ontario is prepared to press forward unilaterally with an Ontario ingredients strategy. It includes world pricing on SNF in a new pricing class not contingent on exports, with Ontario processors prepared to process the milk. The announcement indicates that Ontario will continue to press for, and be part of, a broader national ingredient strategy.

Understanding the implications of TPP in the context of Canada's SNF difficulties also sheds light on the programs to compensate losses and protect quota values. The immediate, conventional reaction has been that the billions set aside for the prospective relief of revenue losses and decreases in quota values (for dairy, poultry, and eggs) is remarkable (or disproportionate) compensation for just 3.25% market access granted in dairy, and around 2% in poultry and eggs. It is possible that the primary motivation was to carve out the entitlement for this level of compensation with TPP partners, who might otherwise object later to such levels of subsidy directed to specific commodities. However, it may also be an indication of an expectation that large compensation will be needed, consistent with the possibility of major increases in imports of SNF-dense products from a wider range of sources, as tariffs are removed and domestic milk prices are pressured down.

At this point, many important questions remain regarding the true implications of TPP for the Canadian dairy industry, such as the specific tariff lines for products that will see increased market access under TRQ and their embodied milk and butterfat/SNF content, how increased export access to the US will work with respect to existing WTO disciplines on Canadian dairy exports, and how the TRQ's themselves will be allocated.

However, the biggest issue remains the burgeoning SNF surplus in Canada, increasing imports of MPI and other dairy products and their embodied SNF, with no offsetting increase in export market access-let alone adequate domestic processing capacity- to relieve the pressure. These issues, along with competitive, non-contingent SNF pricing to facilitate increased exports, frame the negotiation between producers and processors currently occurring.

With these considerations in mind, it appears at this early point that the TPP agreement could actually have a more profound impact on the Canadian dairy industry than that suggested by the apparently benign 3.25% increase in dairy market access. The impact of TPP should be interpreted in the context of the ongoing struggle for improved balance of butterfat and SNF in the Canadian dairy market. TPP will leave Canada further exposed to the prospect of material increases in embodied SNF imports, pressing the need for further reforms within milk supply management.

[7] https://www.milk.org/Corporate/News/NewsItem.aspx?id=6561