

# Canadian Dairy Exports: The Knowns, Unknowns, and Uncertainties



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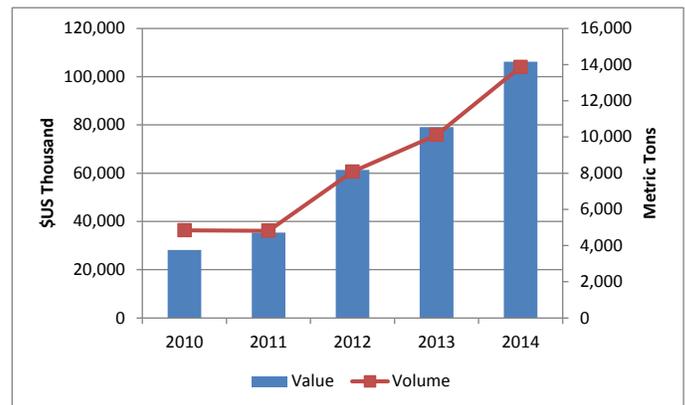
## The Issue

Canada's trade deficit in dairy products is growing. This is a function of restricted exports but increasing imports, especially of milk proteins and other non-fat milk solids. The purpose of this policy note is to examine the issues, prospects, and needs for clarification and action regarding Canadian dairy export expansion, as Canada's dairy imports continue to increase.

The growth in imports of products not subject to tariff has been especially strong; this will increase when the Canada-EU Comprehensive Economic and Trade Agreement (CETA) agreement comes into force, and potentially further still under a Trans-Pacific Partnership (TPP) agreement. Figure 1 provides some context. Canadian imports of milk protein substances (Milk Protein Isolates, or MPI's, composed of at least 85% milk proteins) from the US increased markedly in the last number of years, representing about 60% of the value and about 70% of the volume in HS 3504. In the first quarter of 2015, HS 3504 imports from the US are up 64% (in volume) versus first quarter 2014. Thus, imports from Canada's largest import supplier of milk proteins are increasing rapidly, and Canada has no WTO compliant mechanism at its disposal rules to control these imports.

As a consequence, domestic non-fat milk solids are increasingly in surplus as skim milk powder, and present a domestic disposal problem that is costly to producers. Figure 2 shows the significance of milk marketed in surplus Class 4(m), mostly as livestock feed. Class 4(m) volume has been at or even exceeded milk marketed in Class 2 (ice cream, yogurt, etc.) in volume, but at much lower value. In the current dairy year up to March, Class 4(m) volume is well ahead of Class 2.

**Figure 1 Canadian Imports of Milk Protein Substances from the USA, HS 3504**



Source: USDA-FAS GATS

**Figure 2 Volume and Prices, Milk Marketed in Class 4(m) vs. Class 2**



Source: Canadian Dairy Information Centre

It is natural then that the dairy industry would renew its interest in exports, and how growth in dairy product exports can be engaged given Canada's WTO limits. Indeed, in the face of growing imports, increasing exports will be necessary in order to avoid shrinkage in the Canadian dairy industry, especially in non-fat milk solids and proteins that are in surplus in a domestic (and

limited export) market that balances disappearance through a quota on butterfat. The Dairy Ingredient Strategy proposed by producers, which promotes pricing to compete with milk protein imports and facilitate exports, is consistent with this. However, the manner in which Canada proceeds with dairy export initiatives is critical and urgent, and there are important complexities and unknowns.

## How We Got Here

There have been five watershed events framing the current Canadian dairy export and trade situation (1) the 1995 WTO Agreement on Agriculture, (2) 1998-2003 WTO challenge by the USA and New Zealand on Canadian dairy exports, (3) 2003-04 Canadian International Trade Tribunal (CITT) case on tariff classification for milk protein isolates and concentrates, (4) 2008 Compositional Standards for Cheese, and (5) the coming into force of CETA between Canada and the EU. Two other watersheds lie ahead: the Trans-Pacific Partnership, and the WTO Doha Round of negotiations.

As part of Canada's commitment under the WTO Agreement on Agriculture, Canada agreed to limit subsidized exports of selected dairy products. All countries agreed to not introduce new export subsidies. This, in effect, defined countries' caps on export subsidies, as well as future entitlements for subsidized exports.

The WTO dairy export challenge in the late 1990's was taken against Canada by the USA and New Zealand. The case dealt with the use of special class pricing for milk used in products contingent on export. Canada was found to be in violation of subsidized export rules; specifically, Article 9 (1c) of the Agreement on Agriculture<sup>1</sup>. The case was ultimately resolved by Canada agreeing to abide by the caps on exports of each of butter, skim milk powder, cheese, other milk products and incorporated products, and by terminating the use of

special class pricing for designated exports; these caps remain in place today<sup>2</sup>. The caps are presented in Table 1.

**Table 1 Canadian Dairy Export Caps**

Product	Relevant HS Codes	WTO Commitment Level, Tonnes	WTO Commitment \$ Thousand
Butter	0405.10, 0405.90	3,500	11,025
Skim Milk Powder	0402.10	44,953	31,149
Cheese	0406.10, 4606.20, 4602.30, 0406.40, 0406.90	9,076	16,228
Other milk products	0401.10, 0401.20, 0401.30, 0402.21, 0402.29, 0402.91, 0402.99, 0403.10, 0403.90, 0404.90, 2105.00	30,282	22,505
Incorporated Products	1806.90, 1901.20, 1901.90, 2106.90, 2202.90, 2309.90		20,276

Source: WTO

The CITT case on milk protein isolates (MPI's) and milk protein concentrates (MPC's) related to the appropriate tariff classification for these products, as they were relatively new products at that time. The decision of the CITT was that it was most appropriate to classify MPI's as protein substances in HS Chapter 35, rather than as a dairy product in HS Chapter 4. The result of the decision was that products with 85% or more milk protein were placed in HS 3504- duty-free at that time, having been in tariff line HS 3502 (which was also duty-free from December 1999 until the CITT ruling in March 2005).

<sup>1</sup> Al Mussell and Larry Martin (2000). *The Future of Canadian Dairy Exports and the WTO Appellate Decision: Dairy and Trade Policy at a Crossroads*. George Morris Centre Special Report February 2000.

<sup>2</sup> World Trade Organization (May 2003). *Canada – Measures Affecting The Importation Of Milk And The Exportation Of Dairy Products: Notification of Mutually Agreed Solution WT/DS103/33*.

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Products with less than 85% protein were placed in HS 0409.90, subject to a tariff-rate quota (TRQ) and a 270% tariff for over access commitment.

Compositional standards for cheese were established in 2008. These served to limit the extent of MPI use in cheese manufacturing in Canada, as use of these products increased rapidly in the mid-2000's (consistent with the CITT ruling and with improved processing technology), displacing domestic-origin dairy ingredients. In implementing compositional standards for cheese, Canada requested and received approval to establish tariff lines HS 3504.00.11 (within access commitment of 10 million kilograms), and HS 3504.00.12 (over access commitment) subject to a 270% *ad valorem* tariff. Exemptions were granted to NAFTA countries, Chile, Costa Rica, and Israel under existing trade agreements. Thus, the USA has free access to the Canadian market in MPI's, and Canada has reciprocal access to the USA.

CETA allows for open access to the Canadian market in MPI's for EU countries. The agreement allows reciprocal access for Canada to the EU market in MPI's. CETA is expected to come into force in 2017.

The TPP negotiations appear to be nearing completion. The dairy industry in Canada should expect that a further increase in import access for dairy products will be sought in these negotiations, and yield increases in market access that in all likelihood will be larger than the concessions given by Canada in the CETA. A TPP agreement thus stands to exacerbate Canada's dairy trade deficit and further pressure the system. Secondly, the two complainants in the WTO dairy export case against Canada, the US and New Zealand, are members of the TPP. The TPP negotiations may thus also present a forum for engagement on Canada's subsidized dairy export caps and potential relief, consistent with the process established in the GATT/WTO<sup>3</sup>.

The 1995 WTO agreement called for agriculture negotiations to restart by 2000, with the objective of progressive reduction and eventual phase out of trade restrictions, including export subsidies. Even though the Doha Round negotiations have stalled, it is important to note that the draft modalities established in 2008 called for the elimination of all export subsidies by developed countries by 2013. Given the broad support for elimination of export subsidies, attempts to sharply reduce or eliminate export subsidies over time on trade within the TPP membership may be expected, depending in part on how robust and aggressive the eventual deal will be.

This acknowledgement would appear to bring into question the prospects for *all* Canadian dairy exports, at least in the long term. But what about others? Due to the trade challenge and scrutiny Canada is under, there are policy measures or instruments that it has or might employ in dairy exports that would be immediately challenged by other countries, when those same or similar instruments undertaken by another country might not be challenged. Or, conversely, it would entail a much greater effort to challenge these instruments in other countries because they lack the same dairy export policy "baseline" that Canada had defined for it under the dairy export case.

Thus, Canada has export caps in place for a range of dairy products, and the broad direction of trade policy discussions on export subsidies may make retaining even these difficult in the future. Canada has controlled dairy market access for the imports of a broad range of dairy products including MPI, but has also established reciprocal open access on MPI, notably under NAFTA and CETA. Canada's border controls have been relatively effective barriers to butterfat imports; its barriers on non-fat milk solids are becoming increasingly porous. Coupled with disposition balanced on butterfat, surplus non-fat solids are a clear implication, and will continue to increase due to increasing imports.

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<sup>3</sup> As per GATT Article 22 and WTO Dispute Settlement Understanding Article 4  
[https://www.wto.org/ENGLISH/res\\_e/booksp\\_e/analytic\\_index\\_e/dsu\\_02\\_e.htm#article4](https://www.wto.org/ENGLISH/res_e/booksp_e/analytic_index_e/dsu_02_e.htm#article4)

## Export Market Access

Given this background and current situation, what can be said regarding export market access for Canadian dairy products?

- Canada should expect that it can export any dairy product on an unlimited basis, provided that it does not increase the value or volume of subsidized exports beyond Canada's entitlement. If this view is correct, then increased exports under milk supply management could occur, provided that they are not subsidized. Another possibility of achieving this would be to establish a parallel marketing system for milk product exports, such that producer and processor prices reflect international levels without any export subsidy involved, either directly or indirectly from government action. Returns to producers for milk used to produce products for these exports could not be pooled with the current system.
- What remains unclear is whether there can be a pathway to growing exports from within the supply management system. Potentially, Canada could seek additional dairy exports through the WTO by buying the export access with concessions in other industries or sectors, but this would surely face opposition from the affected industries/sectors. But are there other ways?
- The coupling of subsidized exports to export market access is quite limiting for Canada. Canada's exports were qualified as subsidized in the dairy export case based on the differential between domestic and world prices. But Canada faces both volume and value limits on subsidized exports, and there is no correspondence between the level of subsidy and export access, until the level of subsidy reaches zero- at which point the export caps disappear. Exports are viewed as either being subsidized, or they are not, period.

In other words, even if Canada undertook to significantly reduce its milk prices under supply management relative to the world price, reducing the calculated subsidy, it should not expect to obtain greater export market access- unless it was prepared to reduce prices to world price levels- at which point producers would presumably see little advantage from observing quotas to restrict the supply.

- Moreover, even if Canada was prepared to reduce its domestic milk prices to, or close to, world price, it is somewhat unclear how expansion in export access would actually occur. Canada has a classified end-use pricing system, in which Class 1 (fluid milk) is the highest priced class. Could a premium be retained for Class 1 over manufacturing milk classes priced at world price levels? If so, the resulting blend price would be above world price, potentially conflicting with the definition of an export subsidy clarified in the WTO case. However, virtually all developed countries have a form of classified end-use pooled pricing system that prices fluid milk at a premium to other classes.

Products not identified in the subsidized export caps from the WTO dairy export case in Table 1 would appear to present some exceptions or nuances to the discussion above; importantly this includes MPI as HS 3504 does not appear in the table listing the "Other Dairy Products". For such products, Canada has neither subsidized export caps nor entitlements to subsidized exports, which effectively means that its exports of product that are subsidized is zero. The following are some apparent implications:

- The challenge facing MPI exported from within the supply management system is to develop a mechanism in which it is not viewed as a subsidized export. From the dairy export decision, two criteria regarding subsidized exports were clarified (1) pricing contingent on export, and (2) cross-subsidization from higher-

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priced domestic milk classes/components to facilitate lower-priced exports.

- The second of these two criteria would seem the more problematic in a multiple component, classified pricing system with pooling, and based on cost of production. As noted by the WTO appeal panel in the dairy export case, the cost of production (COP), as implemented in Canada, has been a significant departure from the world price<sup>4</sup>. This COP is the basis for support prices and class prices and their associated border protection measures, with the designed intent that the class prices, when blended together, will meet or exceed the COP. Classified pricing has some prices that are relatively high (e.g., fluid milk) and others are broadly lower (e.g., milk used to produce butter/skim milk powder, as well as MPI/MPC), and pooling of revenue across classes cushions the effect of the lower-priced classes. So somehow the differential between Canadian cost of production and the world price needs to be bridged without having the higher-priced classes (or components) appear to cross-subsidize classes and components priced at a level feasible to export.

Exports could occur from a marketing system run in parallel to milk supply management. However, it would need to be determined how it would interact with the supply-managed system.

## Conclusion

The issues raised here, rather than comprising an assessment, raise critical questions and highlight the urgent need for clarification and more focused attention.

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<sup>4</sup> World Trade Organization (December 2002). Canada – Measures Affecting the Importation of Milk and The Exportation Of Dairy Products-Second Recourse to Article 21.5 of the DSU by New Zealand and the United States. AB-2002-6

As Canadian imports of dairy proteins continue to mount, effective means are required to compete with the imports in the domestic market. However, even if successful, competition with imports is not market growth; it is only market retention, and existing processing capacity appears to be stretched in this retention function. The only prospect for significant market growth of the sort that would induce material new investment in increased processing capacity is in export. Thus export growth, at a time of increasing competition from imports- some known, some anticipated- is crucial.

Ironically, an important test of this may occur in relation to butterfat. Butter is recently being viewed more positively from a health perspective, and the combination of increased consumer demand for butter and a drawdown of butter storage stocks is a source of growth and optimism in the Canadian dairy industry. This is tangible for dairy producers as they have seen increases in quota and additional incentive production days. The challenge is that increased butterfat production to meet even modest increases in butterfat demand will be coupled with increased production of non-fat solids, and the Canadian market and marketing system is approaching its limit to process MPI's, and non-fat solids in general. The possibility exists that butter may actually need to be imported to close this gap, and that the increased quotas may prove unsustainable in the future, unless domestic markets for non-fat solids can be retained and/or growth occurs through exports.

Canada's dairy industry thus finds itself in a very difficult and awkward position. The prospects for increased exports of dairy products from supply management are dependent on them being interpreted as non-subsidized, or alternatively through a parallel marketing system, yet to be developed. Either way, exports would need to begin before the subsidy status of the exports becomes truly known. This will require new investment in processing facilities that immediately face risky prospects from the potential threat of a trade challenge. Moreover, even though Canada has negotiated reciprocal market access for MPI's with NAFTA countries and the EU, the nature of our effective dairy

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export access will determine whether these opportunities are real.

The pathway to increased export for Canada is not clear and as it stands today, the costs of its subsidized export limits within current arrangements could become onerous. But this is an unacceptable situation as Canada's import barriers and domestic market share shrink.

Moreover, other countries may have exceeded subsidy commitments in dairy, as their programs have not faced the same challenge and scrutiny under the definitions established under the WTO dairy export case that Canada has. Other countries have regulated dairy marketing systems as well as export and production subsidies and have expanded their dairy exports. Indeed, much has changed since the dairy export case:

- Development and wide adoption of MPI's in dairy processing
- Significant and growing penetration of Canadian dairy imports free of tariff
- The emergence of the US as a major dairy exporter, and the development of new and varied US support programs in dairy
- Easing and recent elimination of EU milk quotas, with ongoing support programs
- Emergence of Fonterra as a dominant international dairy export organization

As such, the situation regarding Canada's dairy export access and prospects needs to be better understood. Canada's dairy market access barriers are known targets for some TPP members in the negotiations. TPP could also be a key opportunity to re-engage the US and New Zealand on relaxing Canada's dairy export caps. Preparing for these pressures can help shape Canada's domestic policy arrangements to enable unsubsidized exports to ease the pressures as additional import access from Europe and the TPP comes into force. Failing to position itself on this would appear to lead Canada toward a stark future of increasing dairy imports with no option for offsetting increases in exports, leading to a shrink and decline in its dairy industry.

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