Evolution in Canadian Dairy Policy: Interpreting the Known-Known's

Independent Agri-Food Policy Note- January 2016
Douglas Hedley and Al Mussell

Introduction

The year 2015 was a dramatic one for Canadian dairy policy. After protracted preliminary discussions, representatives of producers and processors began formal negotiations on a national Ingredient Strategy; these proceeded through the fall and are ongoing as of January 2016. In early October 2015, an agreement was reached on the Trans-Pacific Partnership (TPP). The TPP allows for significant new access to the Canadian dairy market, and was accompanied by the announcement of new programming assistance for supply managed industries by the former federal government; this is now under review. Shortly after the TPP agreement, the Dairy Farmers of Ontario announced the initiation of a new Class 6 milk pricing program, with processors secured to process milk solids-not-fat (SNF) priced at world price levels.

In mid-December 2015, the Canadian Dairy Commission announced a 5% increase in the butter support price and a 30% decrease in the support price for skim milk powder. However, the means of applying the support prices was changed, leading to a 2.2% increase in the blended milk price. It was also announced that future skim milk powder support prices would be decoupled from SNF prices in all but one of the industrial milk price classes, and that pending the outcome of producer-processor negotiations, further CDC action on surplus removals and processor manufacturing cost allowances could occur. Finally, in late December 2015 a WTO Ministerial Decision was released announcing an agreement to eliminate all export subsidies and some activities of state trading enterprises.

Each of these events are significant in framing the evolution of Canadian dairy policy and milk supply management going forward. In particular, with the outcome of key elements of trade policy now established, the external unknowns frustrating the development of expectations, planning and analysis of Canadian dairy policy and milk supply management are now known. The purpose of this policy note is to briefly review the factors placing stress on the milk supply management system, and to provide a succinct analysis of the events of 2015 and what this means for Canadian dairy policy in the future.

The Issue

Current dairy policy in Canada is facing considerable stress in meeting growing consumer demand for butterfat while generating surplus non-fat milk solids that exceed current consumption and use, and that cannot be exported beyond levels established under the limits on subsidized exports Canada has agreed to in the WTO. The export subsidies are measured as the difference in price between domestic and international prices for these products. These limits have been established for virtually all dairy products in Canada with the exception of milk protein isolates (MPIs). Canada has maintained tariff rate quotas (TRQs) for nearly all imports of dairy products, with low in-quota tariffs and much higher over-quota tariffs, again with the exception of MPI imports. These import arrangements have worked well to limit imports of butterfat but have become increasingly porous for non-fat milk solids. In particular, MPI imports have been growing very rapidly over the past few years. The milk proteins imported into Canada are exacerbating the surplus of non-fat milk solids within the current dairy policy for which there is a limited domestic food market, forcing surplus milk solids into animal feed or even waste, creating added costs to the industry.

The TPP agreement and the Comprehensive Economic and Trade Agreement (CETA) with the European Union have extended the unrestricted entry of MPIs into Canada from Europe and the TPP members, and could exacerbate this situation. The CETA agreement increased the TRQ for cheese substantially, and the TPP has further increased the TRQ for cheese.

Indeed, the TPP increased the TRQs across nearly all dairy products. Even though the phase-in periods range from 10 to 19 years across the range of dairy products, the schedule for increased TRQs indicate the vast majority of additional access is front-end loaded over the first six years. In the case of whey powder, the TRQ will be entirely removed in the 11th year.

One can hypothesize that the CETA and TPP will come into effect following ratification, probably sometime in 2017 or 2018. Given that existing TRQs on dairy products are filled to a large extent, further expansion in TRQs is likely to decrease the price of existing imports as well as increase import volumes, creating cost competitiveness pressure for processors.

Detail on both the CETA and TPP agreements can be found in "Toward a Pathway for Renewed Canadian Dairy Exports", available at http://www.agrifoodecon.ca/uploads/userfiles/files/the%20dairy%20ingredient%20strategy%20revisited-%2020%20october%202015(1).pdf

Nairobi WTO Agreement

Because the Nairobi agreement is very recent, it requires a more detailed discussion than the TPP and CETA. In the WTO Draft Modalities under the Doha round of the WTO trade negotiations, members, including Canada, agreed to reduce and eliminate export subsidies. This occurred in 2008, and was consistent with discussions among members that occurred early in the Doha Round. While the negotiations have broadly languished, these provisions have never come into effect.

At the WTO's Tenth Ministerial Conference, held in Nairobi, Kenya, from 15 to 19 December 2015, members agreed to dismantle export subsidies in agriculture. In effect, the agreement indicated that:

- Developed country Members shall immediately eliminate their remaining scheduled export subsidy entitlements as of the date of adoption of this Decision, effective 1 January 2016.
- Developing country Members shall eliminate their export subsidy entitlements by the end of 2018.

However, the agreement also allows a developed country that (1) agrees to eliminate all export subsidies for exports to least developed nations by 1 January 2016, and (2) has notified export subsidies to the WTO in at least one of the last three years in which notifications have been made, to maintain quantity commitments attracting export subsidies at the actual average of subsidized export quantities made in the years 2003-2005.[1] It is expected that Canada can meet these conditions and as a result, can delay until January 2021 the elimination of exports contingent on export subsidies.

Nonetheless, only a part of the current export subsidy volume commitments can be maintained until 1 January 2021. The reason is that the outlays (monetary value of the export subsidies) for the three year period 2003-2005 were the criteria limiting exports for these three years, not the export volumes themselves. As a result, the volume limits on exports for the next five years will be set at substantially lower levels than the current export quantity commitment.

This outcome from Nairobi will not add further pressure on the non-fat milk solid surplus however, because export outlay commitments were also binding in recent years, and export volumes have also been lower in recent years than the new commitment based on the average volumes based on 2003-2005 dairy years. The

[1] Footnote 4 in the Nairobi text on export competition reads as follows: "For these products, scheduled export subsidies shall be eliminated by the end of 2020, and quantity commitment levels shall be applied as a standstill until the end of 2020 at the **actual average of quantity levels** of the 2003-05 base period.

limitation on exports of incorporated products is based only on outlay commitments, and has been filled almost entirely in both the base years 2003-2005 as well as the most recent five years. There is no mention of relaxing Canada's outlay commitments in the Nairobi agreement, so one must assume they are still in place. Some very limited additional space for exports in the short term may have been achieved, based on the low prices for milk solids in the current world market[2]. However, paragraph 10 of the Nairobi agreement says that "members shall not raise export subsidies above the average of the last five years, on a product basis", so we must assume that even under very low prices in the current period, Canadian dairy exports declared as subsidized between now and 2021 could not increase much, if at all.

Table 1 below shows the current volume commitments, the average exports contingent on subsidies for the dairy years 2003-2005 and the average exports for the dairy years 2009-2013[3].

Table 1 Canadian Subsidized Export Limits and Actual Reported Subsidized Exports

Products	Current Volume Commitment	Average Exports/yr 2003-05 Dairy Years	Average Exports/yr 2009-13 Dairy Years
	Tonnes		
Butter	3,500	774	162
Cheese	9,076	4,003	4,970
Skim Milk Powder	44,953	6,970	11,305
Other Milk Products	30,282	10,598	6,733

Source: Canada's WTO Notifications

With the agreement in Nairobi on subsidized exports, nearly all of the unknowns regarding the Canadian dairy policy scenario for the next several years are known, barring any further international agreements or challenges under the various trade agreements. Although TRQs have expanded, the tariffs on over-quota levels remain unchanged and there have been minor reductions in the within-quota tariffs. The one remaining unknown is what the federal government will decide to do with the election commitment by the previous government of $4.3 billion in support of quota value, producer revenue, assistance for processor expansion, and marketing in supply managed industries.

Looking Ahead

Canada now faces the elimination of export subsidies on dairy products no later than 1 January 2021, five years from now. By the end of 2020, it is expected that the impacts of TPP and CETA will be well underway enabling additional access to imports, with nearly half of all additional access offered in TPP available for imports within the TRQs. One can look at this scenario in several different ways.

First, five years is a long time in the trade and domestic policy world, so some may want to maintain business as usual over the next five years with cut backs in industrial milk quota to account for the likely expansion of imports and eventual elimination of subsidized exports. One difficulty is that with the effective barriers on butterfat/butter imports, and the increasingly porous nature of the barriers to the imports of non-fat solids, the growing surpluses of non-fat milk solids in Canada will have two effects. The basis for the national quota will necessarily shift *de facto* from butterfat to non-fat milk solids, to forestall the growing non-fat milk solids surpluses. This in turn implies increased imports of butter. The overall effect could be a continuous reduction in the national industrial milk production quota.

[2] Canada's outlay commitment includes a dollar value of "incorporated products" of $ 20.276 million but no volume limitation. This export limitation has not been reduced

[3] It is understood that the subsidized exports are made from milk components marketed in Class 5(d)

Another difficulty with this approach is that lenders and others will immediately factor in the substantial changes that must occur by 2021 in lending on quota purchases, other farm assets, and production credit. Processors will begin re-shaping their businesses to meet the new arrangements required after 2020. In fact, even with the five year grace on subsidized exports, there really is no "business as usual" scenario available. Markets will begin the making the transition to the post-2020 world regardless of whether the existing pricing and marketing structure in Canada is maintained.

Canada has been given a grace period to modify its trade arrangements for dairy products. The Canadian Dairy Commission has already signaled that pricing arrangements for non-fat milk solids will begin to change as early as 1 February 2016. The Dairy Farmers of Ontario has already indicated its intention to move toward world prices for non-fat milk solids in a new class, and negotiations with other provincial dairy farm agencies and processors are ongoing to see if they can find a nation-wide agreement on a way forward.

Regardless of whether the approaches of the CDC or the producer-processor negotiations outcome becomes the way forward, several other parties are necessarily involved. The federal government will need to decide whether to follow through on the commitment by the previous government to provide transition funding, both in amount and its distribution, for the changes that may occur. Clearly, the use of any federal funding would need to complement the choice of transition pathway. Indeed, the federal government will need to assist in designing the transition path for the industry to assure the best possible use of the funds for the long run health and viability of the dairy industry.

Additionally, the transition to removal of export subsidies will need to be undertaken with an eye on the trade and potential trade challenges that may occur during the transition and following 2020. The business risk management programs may need to change as the dairy industry moves to world pricing for some milk components and end-use classes. The Agri-Stability program in particular may need to be more inclusive in its treatment of the dairy industry, raising the costs of the program over time. Finally, the role and operations of the CDC itself will need to change.

The P-5 and Western Pool arrangements will come under increasing pressure to maintain unanimity in their approaches to pricing and quota allocation. Either of the approaches represented by CDC and producer-processor negotiations will effectively sever the linkage between the cost of production pricing and support prices for butterfat and non-fat milk solids in industrial milk. The role of the CDC's surplus removal program will likely diminish over time, consistent with the elimination of subsidized exports. This will force provinces into exploring whether the provincial industrial milk quota allocations can be maintained as some provinces look for expansion in jobs and investment in industrial milk processing in a more open export market, while others prefer industry contraction in an attempt to salvage as much as possible of the status quo.

All of these factors indicate quite considerable stress on all of the components and players in the months ahead. All of the players will need to be involved to determine the optimal pathways for the dairy industry in Canada. In fact, all of the players cannot avoid being involved.

Conclusion

The year 2015 saw the beginning of wrenching changes in the relatively stable field of Canadian dairy policy. The events influencing these changes, still in evolving in early 2016, are apt to elicit angst by many within the producer segment of the dairy industry. It is a sobering reality that the future will be unlike the recent past, particularly in terms of milk price levels that can be maintained in milk supply management going forward.

With this important acknowledgment, as these events unfold, a certain optimism should be observed- for a number of reasons. The major unknowns that have dogged Canadian dairy policy development for years have now been revealed, and their implications are not what many would have feared. The protection of high over-quota tariffs on Canadian dairy products was essentially retained, with the exception of dried whey in TPP. Tariff-rate quotas were expanded under both CETA and TPP, but not to the extent that Canada will be placed under siege by dairy imports. The prospect of significant compensation for farm operating and quota value losses, as well as investment capital for dairy processing, has been established, with agreement from trading partners under TPP- subject to review by the new federal government. An international agreement to eliminate export subsidies- an expected development since at least 2008- can be deferred by five years for Canadian dairy. Thus, we now know the major outcomes of trade liberalization, and the time frames in which they will apply.

With the benefit of greater certainty on these issues, changes to Canadian dairy policy and milk supply management can now be pursued with greater clarity as an issue of economic design. Within this context, the likelihood exists that Canada should be able to retain a significant blended milk price premium over world prices. This is due to the prospect of future increases in fluid milk pricing essentially unimpeded by trade liberalization (and to which demand has been quite insensitive), and the reality of high over-quota tariffs still in place that can protect domestic pricing at well above world price levels.

The challenge remains to design dairy export mechanisms compliant with the elimination of subsidized exports, and this has been an element of the Ingredient Strategy and its ongoing discussions. World pricing on non-fat milk solids in certain classes stands to allow better competition with imports and facilitate exports- leading to long sought after dairy market growth.

Thus, the prospect exists that much of the current pricing environment and new market growth could be retained through pragmatic and careful economic design, with the assistance of support programs to implement, along the lines previously proposed and agreed to under TPP.

The principal threats to this prospect are (1) complacency with respect to the five year grace period on subsidized exports, and (2) conflict among producers and stakeholders.

The temptation will exist among producers and governments to kick forward the implication of the subsidized export elimination five years into the future; this would be a mistake. The corresponding adjustments in quota markets will occur well in advance of the actual subsidized export elimination, and we must assume that increased imports under CETA and TPP will occur prior to then as intervening factors. It will not be clear sailing for the next five years, even if the deferred adjustment on subsidized exports would suggest this.

Milk supply management is essentially a federated provincial policy, in which the federal government is responsible for international trade policies but most of the real authority is at the provincial level. Conflict between producers in different provinces would undermine what could be accomplished, given the trade policy established at the national level. Ultimately, the future prospects for milk supply management hinge on provinces', producers', processors' and Ottawa's willingness to work together, and make compromises to support broadly held objectives and the realities of markets, technology, and foreign policy.

This coalition of stakeholders, if allowed to fray, could easily devolve or even dissolve the system as a whole, making the economic design prospects contemplated above unachievable. Conversely, federal and provincial governments will need to be involved with producers and processors in future dairy policy development. Regardless of the political perils, all stakeholders will simply need to participate.