

**The Canadian Dairy Sector in Relation to the Canada-US-Mexico
Agreement and Comprehensive and Progressive Agreement for Trans-
Pacific Partnership**



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February, 2019

Background

Canada has a dairy policy that employs mechanisms of milk supply management, administered milk pricing, and import controls to support and stabilize producer returns. The raw milk supply is managed through producer quotas that match production with Canada's butterfat requirements. Milk pricing is established to cover producer costs of production. Pricing is also fragmented into classes based on end-use, with pooling of revenue across end-use classes. Imports are controlled via tariff-rate quotas (TRQ's) and over-quota tariffs, generally at levels that are prohibitive to imports in excess of TRQ. Management of dairy product inventories is facilitated by the Canadian Dairy Commission, which acts as the first receiver of butter imports, regulates butter and skim milk powder storage stocks, and establishes processor margins to cover the costs of processing these products.

Under this system, producer returns have been broadly positive and stable. Processors have also been profitable operating in this environment. It is not clear that relatively high milk prices have parleyed into high retail dairy product prices, despite ongoing and long-running analyses and debate. The situation in Canada is in notable contrast to other developed county dairy industries- notably the US, EU, Australia, and New Zealand- which are suffering through multi-year downturns in world dairy prices. The situation is especially dire in the US, with record stocks of cheese held in storage, and the dairy industry in some regions of the US is in danger of collapse due to chronic surplus production, low prices and poor producer profitability.

At the same, Canadian dairy policy has had to evolve due to a number of difficulties. Under a butterfat quota, the associated production of skim milk structurally exceeds domestic demand. The persistent problem of domestic skim surpluses, coupled with limits on subsidized exports (and elimination of subsidized exports by January 2021) has generated protracted problems in the past in getting the market to clear in skim milk. Canada faces binding caps on its dairy exports, established in the settlement of a WTO trade dispute in 2003. The constraint of these caps has been particularly limiting on exports of skim milk powder. This has pushed Canada toward other means of skim surplus removal, such as the marketing of skim milk powder in the domestic feed market at well below world prices, and periodic waste dumping of surplus product that had no market.

More generally, world dairy markets are some of the most distorted markets in agricultural trade. All major exporters of milk powders and some other dairy products are suffering from over production, with very large stocks in the EU (powders, cheese) only recently being drawn down, and record US stocks of cheese. A recent EU Parliamentary study¹ shows that 70 percent or more of the income for EU dairy farmers comes from the "whole farm payment", not from dairy farming, allowing exports at far below remunerative prices for dairy producers. New Zealand pricing and exports are controlled almost entirely by Fonterra. The issue of Fonterra acting as a *de facto* state

¹ [http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_STU\(2017\)585911](http://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_STU(2017)585911)

trading enterprise is an issue raised by the US, and likely others, and a source of regulatory review in New Zealand².

Significant Policy Developments

The Nairobi Declaration, made as part of the WTO-Doha Round in late 2015, commits countries to eliminate subsidized exports. As a signatory, Canada was given a reprieve to fully comply, with certain conditions, until 2021. However, as of January 1, 2021 Canada will be entirely out of the market for dairy exports, with the exception of products it declares as free of subsidy.

Milk Class 7 was established as a mechanism to allow the skim market in Canada to clear, by providing for pricing at a competitive world price, in either domestic or export markets. Consistent with principles clarified in the settlement of the 2003 WTO dairy export, Canada views exports of skim products made from Class 7 as non-subsidized and hence outside the WTO limitation on subsidized exports. Under the Class 7 environment, the Canadian Dairy Commission has generally decreased its skim milk powder stockholding activities.

With the development of Class 7, Canadian dairy policy has increasingly evolved toward US dairy policy:

- Both Canada and the US operate end-use classified pricing systems.
- Both Canada and the US have mandatory price/revenue pooling across the end use classes.
- Both Canada and the US employ a markup on fluid end-use classes which has the effect of supporting the blend price paid to farmers relative to the class prices for milk used in dairy manufacturing. In both countries, the fluid milk market is essentially mature, but also highly price inelastic- meaning that fluid milk price increases do not reduce volume demanded by much but add significant revenues to the pool.
- Both Canada and the US maintain significant barriers to imports. Canada uses a combination of tariff-rate quotas (TRQs) and very high over-quota *ad valorem* (percentage) tariffs. The US employs a mix of fixed per unit tariffs and *ad valorem* tariffs, in combination with special safeguards. While the matter is complex, measured on an equivalent *ad valorem* basis, it would appear that US tariffs protecting dairy products are lower than Canada's- but still high enough to be largely effective in keeping imports out.

The major differentiating points of Canadian and US dairy policy are:

- Canada limits the milk supply (and the supply response to pooling) with quotas.
- Canada is bound by subsidized export caps- with subsidized exports soon to be eliminated entirely.

² <https://www.mpi.govt.nz/law-and-policy/legal-overviews/primary-production/dairy-industry-restructuring-act/>

Media outlets reported on requests that the US had made of Canada with respect to dairy under NAFTA renegotiation in mid-October 2017. The requests made of Canada reported at that time were the following:

- Increased transparency regarding the operation of milk supply management
- Elimination of milk Class 3(d), Class 5, and Class 7
- US prior agreement to any changes in milk supply management
- A phase-out of supply management through elimination of supply control/quotas in dairy, poultry, and eggs within 10 years
- Increased dairy market access of 5% per year leading to open access for the US within 10 years

While the more extreme among these requests were rejected by Canada, it is understood that they remained part of the US position until the late stages of the negotiations that resulted in CUSMA. In its rejection of certain of these demands, Canada acknowledged that granting these requests would move it toward a dairy policy even more like the US. However, left without effective supply controls, periodic and persistent milk surpluses and lower prices could be expected in Canada, requiring deficiency payments or some other form of stabilization assistance to address the situation, as has occurred consistently in the other major exporting countries. If this were to occur, in turn Canada could expect the immediate threat of countervail or other trade action from the US (and perhaps others) in response. Thus, in the US request for Canada to conform with even more of a US-style dairy policy, Canada could expect malaise in its dairy sector, coupled with the threat of trade action from the US.

Moreover, elimination of production quotas that support milk supply management would destroy an immense amount of policy-created asset that would result in massive compensation demands from producers and seriously financially weaken the dairy sector, some lenders, and probably some input suppliers. The implication is that there is no reasonable alternative that involves a wholesale jettisoning of the existing dairy policy. Rather the issue is refinements, perhaps bold, within the essentials of the existing dairy policy framework of supply management.

Dairy in the Canada-US-Mexico Agreement (CUSMA)

In CUSMA, Canada agreed that Classes 6 and 7³, must be terminated no later than six months following the coming into force of this agreement. Furthermore, Canada accepted two constraints on exports of skim milk powder and milk protein concentrates taken together, and infant formula. First was the minimum pricing formula for milk to make these products marketed in domestic and export markets based on USDA reported prices in commercial US markets. Second was volume constraints on exports within this pricing structure for the three commodities. Exports beyond the export thresholds would face a significant surcharge.

³ Class 6 was established in Ontario and later expanded to Manitoba. In essence, Class 7 expanded Class 6 to a national basis. Its reference in CUSMA is a formality as certain provinces may still retain mention of Class 6 in regulations

The CUSMA Agreement also indicated that “products and ingredients formerly classified under milk classes 6 and 7 are reclassified and that their associated milk class prices are established appropriately based on end use”. Any reasonable interpretation of this condition indicates that Canada cannot simply create a new class that mirrors the pricing and use currently within Class 7. Clearly, Canada will have to create sub-classes to comply with CUSMA in each of three products with price and export constraints. This may result in additional sub-classes for milk products outside of the product and pricing arrangements for the three commodities under the agreement. The CUSMA contains other clauses that increased the volumes of milk, cream and dairy products available for US exports to Canada under tariff rate quotas. The additional access in CUSMA for the most part reflected the increased access to Canada in the draft Trans Pacific Partnership (TPP) from which the US withdrew in 2016. A significant difference was the TRQ for cream with greater than six percent butterfat in CUSMA, providing a several fold increase from the levels proposed in the TPP draft. The high level of butterfat in this TRQ can displace domestically produced butterfat but will also reduce the surplus of skim in Canada. Conversely, the larger TRQs for other dairy products can exacerbate the surplus of skim in Canada; examples are the TRQ for increased imports of skim milk powder, milk protein concentrates, whey powder and the like.

CUSMA also contains provisions providing access for Canada to the US dairy market. These include fluid milk, butter, skim milk powder, cheese, yogurt, and other dairy products. However, there are reasons to expect that this access will actually be of only modest benefit to Canada. First, there is a ban on subsidized exports among CUSMA members and, broadly speaking, Canada’s dairy exports from most of the sub-classes are deemed subsidized. Second, Canada’s milk prices at the farm are higher than those in the US (by design) so it makes it difficult to be price-competitive with US product in the US market. Finally, most dairy products fall under the Pasteurized Milk Ordinance⁴, a long-time trade irritant between Canada and the US that prescribes necessary conditions for Grade A milk status in the US. It requires that the supply chain for imports is inspected for and satisfies US Grade A status; no other country has successfully concluded an equivalency agreement with the US to satisfy this requirement. As a result, the scope for Canadian exports to the US to occur based on the full extent of the Canadian dairy supply chain is strictly limited.

While the three countries signed the CUSMA the end of September 2018, the timing for the agreement to come into force remains unclear. The continuing dysfunction in the US Administration and Congress along with the legal requirements for reports on the effects of the new agreement on the US economy by the International Trade Commission and other offices make it impossible to predict with any precision how soon ratification can take place. There are several reports indicating that the Congress would like additions or changes to the agreement on labour standards, environment, immigration and human resources (among others) prior to accepting the deal. As well, the US President has threatened to announce withdrawal from NAFTA, so that after six months the US would be able leave the NAFTA agreement, putting pressure on the US Congress to work toward a timely ratification of CUSMA. This threat, if carried out, is likely to cause the Congress to seek redress through US courts.

⁴ The notable dairy product exceptions not requiring US Grade A status are cheese, butter, and ice cream

A possible scenario would be that US ratification could take place late in 2019 or early 2020. This timing places the termination of Classes 6 and 7 into mid-2020, six months or so before the Nairobi Agreement denies use of export subsidies for dairy products from Canada. There is also the possibility that the agreement will not be ratified by the US, and that the current NAFTA remains in place.

Comprehensive Economic and Trade Agreement (CETA)

The CETA came into force in September-October 2017. The principal result for the dairy industry in Canada was the creation of tariff rate quotas available to the EU for cheese. These quota levels are being phased in linearly over six years going from 2,667 tonnes of cheese in year 1 to 16,000 tonnes in year 6. For industrial cheese, year 1 quota was 283 tonnes rising to 1700 tonnes after six years. There was also a permanent annual allocation of 800 tonnes for the EU from the WTO-Global TRQ of 20,411.9 tonnes.

Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)

This agreement covers eleven nations on the Pacific rim. Six nations ratified the agreement in late 2018, bringing it into force for those nations on 30 December 2018. A seventh country, Vietnam, has since ratified the agreement. For dairy, the TRQ structure is very similar to that of the CUSMA. With the exception of cream, the CPTPP gives members greater long-term access than that accorded the US. The TRQ for fluid milk is identical in the two agreements. The TRQs for dairy in the CPTPP are virtually the same as those in the draft TPP that initially included the US.

Only the US has a realistic capability to export fluid milk and cream to Canada. Although both Australia and New Zealand have the capacity to do so, the transportation distances are too great for these products.

Table 1 below attempts to group and interpret dairy market access according to trade agreements. This should be interpreted as a general characterization, as the groupings of products vary somewhat across agreements. The share of domestic disappearance assumes that all access is filled; only a subset of products is estimated for market access. The table provides volumes, in tonnes, assuming year 6 of implementation for each, summed across agreements as though they were implemented at the same time (for simplicity).

The table shows that the dairy market access granted under CUSMA is material, and differs from the general structure of CPTPP in terms of much greater access for cream. CETA focuses on cheese, and builds on the existing 66 percent share of the WTO-Global cheese quota allocated to the EU. The estimated market shares for imports under concluded trade agreements is estimated at about 9 percent for cheese, and higher levels for concentrated milk and powdered buttermilk.

What is clear from the table is that the access expanded by Canada to dairy imports is material. For example, with cheese, 9 percent of a large number is itself a large number. The allocation of the TRQ to non-traditional parties under CETA exacerbates the market disruption of the increased cheese access, with adjustments to increased imports occurring for Canadian cheeses and brands for some time to come. At the same time, the market access obtained by Canada to the US market in a range of dairy products is unlikely to be of major value, and certainly the net effect of CUSMA will be a significant increase in net imports of dairy products from the US- in addition to the increased imports from the EU and CPTPP countries. This is consistent with a significant loss to the Canadian dairy industry.

This anticipated loss needs to be placed in context. The Canadian dairy market has been growing. This is illustrated in Figure 1 below, based on total butterfat marketed. The last several years have seen significant growth; 2017-18 saw slowing growth but some growth in the dairy market can be expected to continue. In the face of increased import competition, it is likely that policy shifts can be made to enhance the competitiveness of the Canadian dairy industry. Class 7 represents a past example of an important dairy policy shift made to adjust to market conditions.

When the combined effects of increased market access, domestic market growth, and policy shifts made to adjust to increased market access are better understood, then the role of compensation to the dairy industry can be better understood. This could include the addressing of residual losses to producers and/or processors, the use of compensation as a component of implementing policy change, or both. We are not currently at this point as the industry loss has not been determined or measured, none of the three agreements is fully in force yet, and the policy options to mitigate their effects not yet determined or fleshed out.

Finally, the discussion of policy adjustment and compensation should encompass the full range of issues Canada can expect to face. In this regard, the effects of CUSMA, CPTPP, and CETA are not the endgame. The policy space within which Canadian dairy policy will need to operate will be heavily dictated by the coming full implementation of the WTO Nairobi Declaration, banning subsidized exports in 2021. The nature of biological fluctuations in the milk supply and fluctuations in dairy product demand by consumers are such that it is practically difficult to operate milk supply management without *any* export access. Equally, export market access will be critical to expanding or even retaining processing and milk production investments in Canada, due to limited growth within the Canadian market. This represents a near term threat that the industry and governments should take the opportunity to address within the broader discussion brought about by CUSMA, CPTPP, and CETA.

Table 1 Dairy Market Access and Potential Share of Canadian Market Access

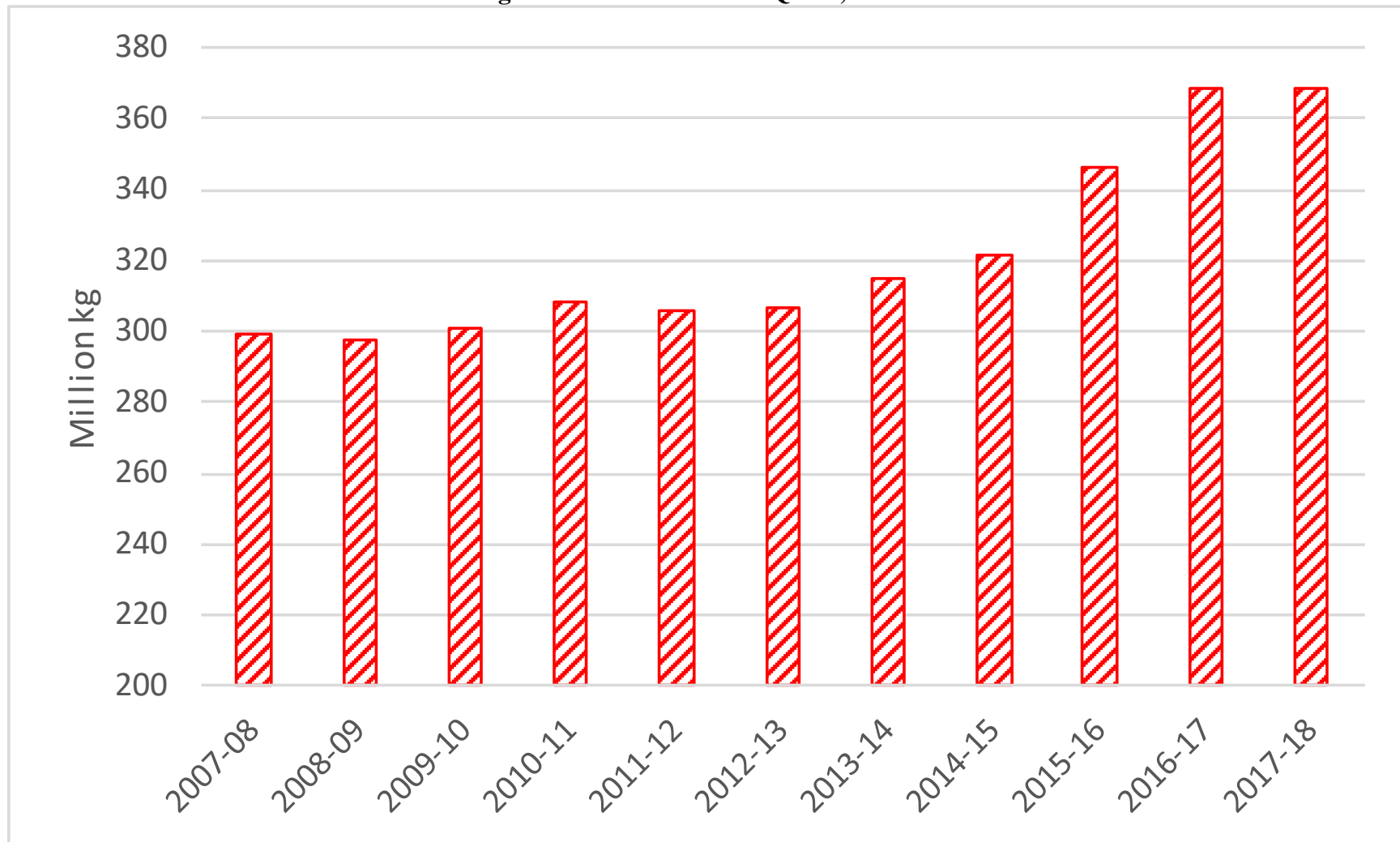
As of 2024:						
	CUSMA	CETA	CPTPP	WTO-Global	Total	Share of Can Disappearance
	Tonnes					
Milk	50,000		50,000	64,500	164,500	
Cream	10,500		580	394	11,474	
SMP	7,500		7,500		15,000	
Butter +Cream Powder	4,500				4,500	
Industrial Cheese	6,250	1,700	7,975		15,925	
Cheese all types	6,250	16,600	3,625	19,612	46,087	9.0%
Yogurt and Buttermilk	4,135		6,000	332	10,467	2.6%
Whey Powder	4,135		6,000	3,198	13,333	
Concentrated Milk	1,380		2,000	12	3,392	14.3%
Milk Powders	690		1,051		1,741	
Powdered Buttermilk	520		828	908	2,256	12.1%
Products of Natural Milk Constituents	2,760		4,000	4,345	11,105	
Ice Cream and Ice Cream Mixes	690		1,051	347	2,088	1.4%
Other Dairy	690		1,051		1,741	
Butter			4,500	1,964	6,464	
Cream Powder			105		105	
Mozzarella Cheese			2,900		2,900	

Source: Trade Agreements, Export-Import Permits Act Annual Reports

Note: WTO-Global TRQ for cheese is adjusted for reallocation of Global TRQ to CETA in consideration of Croatia's accession to the EU. CETA allowed for 800 tonnes of cheese reclassified from global quota to the EU, in addition to 16,000 tonnes of new market access. Prior to CETA, the WTO-Global TRQ for Cheese all types was 20,412 tonnes.

Note that the WTO Global Quota for fluid milk is taken up by cross border shopping and not available to the US.

Figure 1 Total Production Quota, Canada



Source: CDC Total Quota by month summarized by dairy year