Milk Supply Management After CUSMA: An Economic Policy Analysis

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Take Home Messages

- CUSMA provides for significant access to the Canadian dairy market. This stacks up with access provided under the Canada-EU CETA, and CPTPP. This will be blunted somewhat by anticipated Canadian dairy market growth. The provisions of CUSMA allowing for US dairy market access for Canada are unlikely to result in significant increases in market for Canadian dairy producers.
- There remains significant ambiguity regarding how milk classes that are not contingent on export will be treated. Canada committed to removing Milk Classes 6 and 7in CUSMA, but the thresholds for exports of skim milk powder and milk protein concentrate, which exceed applicable WTO caps for subsidized exports, imply that the US acknowledged that Canada can have non-contingent price classes.
- Canada committed to enhanced notification, disclosure, and consultation on changes to milk marketing and pooing, on a reciprocal basis with the US. This will provide the US (and others) with greater information on classified pricing and pooling in Canada, but does not extend authority to the US for approval of changes.
- It would appear that ratification of CUSMA in the US could occur, at the earliest, in the summer of 2019. With changes to Class 7 not required until 6 months following ratification, it means that existing dairy policy in Canada will be largely unaffected until 2020.
- The best understanding of CUSMA is that with non-subsidized exports of milk powders retained, the essential mechanics of the milk supply management system are retained. With some time anticipated prior to US ratification and the removal of Class 7, Canada has the opportunity to determine the losses to the dairy industry due to CUSMA, consider and develop appropriate policy alternatives in response, and then consider how compensation could facilitate desired adjustment.

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Introduction

The Canada-U.S.-Mexico Agreement (CUSMA) was signed by member countries on November 30, 2018. The negotiations and ultimate agreement on September 30, 2018 that brought Canada into a trade agreement initially reached by the U.S. and Mexico in August 2018 featured Canadian dairy policy prominently. The demands of the U.S. government and dairy industry along with concerns of the Canadian dairy industry also figured prominently in the agreement's outcome. The path from November 2018 to the ultimate ratification and implementation is complex, and many uncertainties remain. The purpose of this paper is to describe, place in context, and provide initial analysis on the CUSMA and its potential impact on the Canadian dairy industry.

Market Access Under CUSMA

In the Annexes to CUSMA Chapter 2, the text sets out market access to the Canadian dairy market granted to the U.S., and access to the U.S. dairy market granted to Canada. These concessions were made in the form of tariff-rate quotas (TRQ). A TRQ establishes a fixed volume within which exemptions to tariffs are given; in excess of the TRQ volume, there are no exemptions and the full applicable tariff is charged. In the case of Canadian dairy products, under the CUSMA, imports within TRQ volume from the U.S. will enter at zero tariff; in excess of the TRQ, volume imports are levied tariffs that differ by product, ranging between around 250 and 300%.

U.S. Access to the Canadian Dairy Market

Under the CUSMA, Canada provided the U.S. access to the Canadian market in the form of TRQ for dairy products. The milk equivalent of this access was announced at about 3.6% of the domestic market; however, industry estimates have pegged it at closer to 3.9%. Broadly speaking, the access resembles the structure of TRQ provided for the U.S. under the original Trans-Pacific Partnership (TPP) Agreement in 2015. The notable difference is that under CUSMA, Canada allowed for much higher TRQ levels for bulk cream.

The access levels in CUSMA stack up with market access TRQ provided in previous trade agreements. These are summarized in Table 1, which is formatted mostly using the categories from the CUSMA but with some redundancy to accommodate categories in previous trade agreements. For selected products, the approximate share of consumption allocated to imports through TRQ's is estimated. The table shows that, for the most part, the CUSMA access is similar to that under the TPP (now Comprehensive and Progressive Agreement for Trans-Pacific Partnership, or CPTPP). In a

number of cases the access levels are identical. When the access allowed under each of the trade agreements is combined and taken as a share of Canadian consumption, the estimated significance of the market access allowed can be seen; for example, the combined access allowed for cheese under CUSMA, CPTPP, the Comprehensive Economic and Trade Agreement with the EU (CETA) and existing market access arrangements under the World Trade Organization is an estimated 9% of consumption.

The access presented in the table requires some additional context. First, while it is reasonable to expect that the access granted to the U.S. under the CUSMA will be filled, this is not as clear under CPTPP. For example, the access granted for fluid milk would need to be filled by New Zealand, Australia, Mexico, or another of the Asian or South American CPTPP members; this seems unlikely. Secondly, the significant volume of bulk cream granted to the U.S. in CUSMA is consistent with Canada's structural surplus of cream. Canada has the incentive to offer access on products that represent the highest levels of embodied butterfat and relatively less embodied skim.

Canadian Access to the U.S. Dairy Market

Canada was also given TRQ access to the U.S. dairy market under the terms of the CUSMA. This is summarized in Table 2, with comparisons to access granted to Canada under the TPP agreement. Canada obtained access to the U.S. over a narrower range of products compared with U.S. access to Canada. Understanding the significance of this access requires further elaboration, as Canada faces constraints in accessing it. The first hurdle that Canadian exports to the U.S. face is the higher price point on raw milk in Canada vs. that in the U.S. an effect largely intended by milk supply management. Secondly, Canada's dairy exports are deemed subsidized according to the resolution of the WTO dairy export decision in 2003; under the Canada-U.S. Trade Agreement of 1989 and succeeding agreements, there are no subsidized exports between member countries. Finally, many of the products listed in Table 2 are subject to the U.S. Pasteurized Milk Ordinance, (PMO) the regulation establishing Grade A milk standard in the U.S. The U.S. has not established equivalency agreements with others to satisfy the PMO. The experience of Canada and other countries is that compliance with the U.S. PMO is costly and practically difficult for the Canadian dairy supply chain to comply with, and as such, the PMO represents a non-tariff trade barrier to the U.S. dairy market.

Table 1. Market access concessions by Canada according to trade agreements, six years into implementation period.

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	
Skim Milk Powder	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	16,000	3,625	19,612	45,487	8.9%
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: CUSMA Text, Trade Agreements, Statistics Canada Food Survey

Table 2. Market access concessions by the U.S. to Canada according to trade agreements, six years into implementation period.

	CUSMA	TPP
Fluid Cream, Sour Cream, Ice Cream, and Milk Beverages	10.5 ML	8.5 ML
Skim Milk Powder	7,500	12,000
Butter	4,500	4,500
Cheese	12,500	18,000
Whole Milk Replacer	690	4,000
Dried Yogurt, Sour Cream, Whey, and Products of Milk Constituents	11,030	12,500
Concentrated Milk	1,380	2,000
Other Dairy	1,900	7,500

Source: CUSMA Text, Trade Agreements

■ Adjustments to Class 7

This section provides some background to the situation leading up to the development of milk Class 7, and the manner in which Class 7 was addressed in the CUSMA.

Prelude to Milk Class 7

The Canadian dairy industry has struggled with surplus skim in the milk market; meeting butterfat demand with a quota generates a structural surplus of skim, which has only worsened as milk quotas expanded to meet growing butterfat demand. Canada has difficultly managing this surplus. In resolving the WTO dairy export dispute in 2003, Canada agreed to the WTO panel criteria defining its dairy exports as subsidized and agreed to limit these exports to WTO caps- on both volume and "outlay" amounts. Under the WTO Nairobi Declaration of December 2015, subsidized exports must be completely eliminated as of 2021.

This limited export market access situation has generated protracted problems clearing the Canadian skim market. The structural surplus and sharply limited export market access have eroded the incentive to invest in skim processing capacity, even as skim availability has grown. This has pushed Canada toward other means of skim surplus removal within the domestic market, such as the marketing of skim milk into the feed market in Class 4m (at exceptionally low prices), and periodic waste dumping of surplus product with no market. In effect, prior to the establishment of Class 7, Canada was effectively operating under what amounts to a skim quota, with limited ability to meet butterfat demand without importing.

Class 7 was established as a mechanism to allow the Canadian skim market to clear, by providing for pricing at a competitive world price, in either domestic or export markets. Consistent with the WTO definition of export subsidy clarified in the dairy export dispute, exports based on Class 7 are not notified to WTO as subsidized. With Class 7 priced competitively for domestic use or in export, it provides an incentive for renewal of skim processing investments, and investment in dairy processing in Canada has recently occurred.

Without this mechanism, the structural surplus of skim had reached the point that it risked overwhelming the system. Milk supply management has evolved to a point at which, absent Class 7, it is effectively bound by skim production, not butterfat; in turn, balancing domestic skim supply and demand ends up driving the adjustment in butterfat quota, more so than actual demand in butter and cream markets. Without Class 7, increases in butterfat demand in Canada would need to be served by imports, because additional production under quota would exceed the feasible limits to market skim.

In its communications prior to and during the negotiations leading to the CUSMA, the U.S. dairy industry and later the U.S. Trade Representative (USTR) enunciated concerns with Class 7 and made elimination of Class 7 a part of the U.S. negotiating position. The U.S. view of Class 7 is seen in connection with losses of Canadian export markets, notably in diafiltered milk

and milk protein isolate. The U.S. has also expressed concerns over increased exports of skim milk powder (SMP) from Canada and the competition with the U.S. in third country markets. The U.S. concerns are supported by actual trade data. In particular, in the 2017/18 dairy year Canadian SMP exports increased to over 70,000 tonnes, compared with WTO subsidized export cap levels that had previously limited SMP exports to around 8,000–15,000 tonnes, based on outlay, and current volume limits under the Nairobi protocol of about 19,000 tonnes.

However, Class 7 is much more than a trade irritant identified by the U.S. that could be closed off through a trade concession, with the system re-setting back to pre-Class 7 levels. Without Class 7 there is no path that would allow the system to revert to a stable past. A major reduction in production quota and complete loss of any access to exports (as of 2021) would immediately sour the climate for dairy processing investment, and strand assets recently invested in dairy processing. Producer pricing of skim would further deteriorate. At current levels of butterfat demand, the removal of Class 7 would begin a process of sequential butterfat quota reductions, sharply reducing domestic milk production and increasing dependence on butterfat imports that could lead to collapse in the supply management system.

At the same time, Class 7 is unpopular with many producers who have seen the blend price they receive for their milk decline, and who have been unable to expand their herds in response to the additional milk quota introduced into the system. Class 7 also has differential effects on processors depending on the extent to which they manufacture products that can use Class 7 pricing. However, since the type of pricing presented in Class 7 is so critical to the operation of milk supply management, Canada faces the question: if not milk supply management, then what? Dairy markets are some of the most distorted markets in agriculture, and alternative policy approaches used elsewhere, intended to stabilize the dairy industry, appear not to be working. Dairy industry news throughout 2017–18 has reported the ongoing malaise in the dairy industries in the U.S., EU, New Zealand, and Australia, with many producers struggling financially, or even exiting the industry. In some regions of the U.S., the dairy industry is at risk of collapsing under low prices and surplus milk production. These are not Canadian issues, and Canada is hesitant to abandon its supply management policy and risk exposing its dairy industry.

CUSMA and Treatment of Milk Class 7

One of the challenges with the interpretation of the CUSMA text is that portions of it are ambiguous, creating difficulty determining specific implications. With this caveat acknowledged, the CUSMA text states the following:

- Canada agreed to eliminate Class 7 and Class 6 (still on the books in some provinces) within six months of ratification and to reclassify components previously marketed in these classes in their appropriate end-use class.
- Canada agreed to a price mechanism for SMP, milk protein concentrate (MPC) and infant formula using the U.S. wholesale price as a reference, with adjustments for Canadian product yields and manufacturing costs.
- Canada agreed to export volume thresholds for SMP and MPC (55,000 tonnes in year one, 35,000 tonnes in year two, and then increasing by 1% per year). Beyond the export thresholds, a surcharge of $540/tonne will apply.
- Analogous thresholds will apply to infant formula (13,333 tonnes in year one, 40,000 tonnes in year two, and then increasing by 1% per year) with a surcharge over the threshold volume of $4250/tonne.
- The text contains paragraphs that commit Canada to enhanced notification, information disclosure, and consultation with the U.S. on any changes to milk classification and pricing.

The potential implications of these elements can only be inferred because the text itself does not provide statements of intent. Moreover, there are implied inconsistencies. Canada agreed to eliminate Class 7; however, the agreement contains threshold volumes for SMP and MPC that exceed Canada's subsidized export caps for these products. This, in turn, implies acknowledgement by the U.S. that Canada can have non-contingent price classes, such as Class 7. The implication would seem to be that Canada can have non-subsidized exports of SMP, MPC, and infant formula, a point recently observed by Professor Andy Novakovic of Cornell University, an influential expert on U.S. dairy policy[1].

The specifics around the surcharge over the threshold volumes for SMP, MPC, and infant formula are unclear—points such as how the surcharge will be implemented (an export tax?), who will implement, and whether it will play the role of an export cap. However, it is clear that with the same surcharge on SMP and MPC, the implications will be more significant for SMP than for MPC. With SMP at a 34% protein specification, and the most common MPC meeting a 70% protein standard, the percentage tax will be lower for MPC than for SMP.

In late November 2018, the implications of the provisions for notification, disclosure, and consultation remained a source of very active discussion.

[1] https://business.financialpost.com/commodities/agriculture/trump-extracted-another-major-concession-on-canadian-dairy-restrictions-on-our-skim-milk-exports

According to media reports, Canadian officials have indicated that this wording was not agreed to. The Canadian dairy industry has advocated aggressively for its removal. The concern is that it commits Canada to asking permission of the U.S. to make changes in its dairy policy. If that is the correct interpretation, it is extraordinary, and it is unlikely that this provision can survive.

CUSMA Timing

The U.S. has a strict timeline requiring a study of economic impacts and a period in which members of congress can review the signed agreement in the process of a strict up or down vote. The U.S. Senate leadership has indicated that the congressional process of review and hearing will not occur until the new session of congress in 2019. The mid-term election results, which provided for control of the House of Representatives by Democrats—some of whom have expressed concerns about aspects of the CUSMA—will not speed the process of ratification in the U.S.

The implication for the Canadian dairy industry is that from the period of signing, it should be expected that the U.S. will not ratify CUSMA for at least seven to eight months. From the timing of ratification, Canada has six months before it must eliminate Class 7 and go through whatever process of policy adjustments that may entail. This means no change until at least the 2019–2020 dairy year, and perhaps well into the next dairy year. This timing will allow for Canada to evaluate alternatives and make policy adjustments in anticipation of CUSMA.

Conclusions

The market access granted by Canada to the U.S., likely about 3.9% on a milk equivalent basis, piles on market access granted under CPTPP (3.25%) and CETA (2%). This entails significant market access opened by the Canadian dairy industry, and it can be expected that the access established under CUSMA will certainly be filled. Growth in the Canadian dairy market may help blunt some of the increased market access, but it will hurt. While Canada also obtained market access to the U.S. dairy market, for the most part this access will be subject to non-tariff barriers that will sharply limit its benefit.

Important questions remain, even with the agreement signed. The provisions dealing with Class 7 are ambiguous and subject to interpretation. The text dealing with notification and consultations on milk pricing differs from what Canada believes it agreed to. However, what does appear clear is that through the CUSMA the U.S. confirmed that, in some way, Canada can have some non-subsidized dairy exports, presumably through non-contingent milk

price classes. This is a key victory for Canada in the CUSMA, and with this in place, the fundamentals of milk supply management can be retained.

The time expected prior to ratification and committed changes can be used by the Canadian dairy industry to consider prospective policy changes, and where compensation could potentially fit in obtaining desired change. It will be important to first measure the damage from the CUSMA to Canadian dairy, develop and design policy changes to mitigate and evolve, and only then get into the serious dialogue on compensation. In so doing, it will be important for the dairy industry—producers, processors, provinces, and stakeholders—to work collaboratively toward solutions. Disruptive forces such as trade agreements can inspire fear and worry and drive participants into specific camps; this would be very costly. A renewed focus on working together on common objectives will be critical.