The WTO Dairy Export Decision:
What Next For Growth in the Canadian Dairy Industry?

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SPECIAL REPORT

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Introduction

The Canadian dairy industry received the most unwanted of all presents just prior to Christmas 2002- a clear loss on the dairy export issue upon final WTO appeal. This leaves the Canadian dairy industry with protracted challenges if it is to grow in the future. It appears to be the final chapter in the long running WTO-Canadian dairy export saga, which we first analyzed in a George Morris Centre Special Report about 3 years ago[1]. Now the challenges associated with the implications of the WTO decision must be faced.

The purpose of this paper is to outline the basic points advanced by Canada, and by New Zealand and the US in the WTO appeal, and to illustrate the importance of the WTO decision in the context of growth in the Canadian dairy industry. Finally, the apparent challenges laid down by the WTO decision are analyzed in the context of needs for new marketing research to reform the milk marketing system.

The WTO Dairy Export Case: How We Got Here

The WTO case against Canadian dairy exports goes back at least four years. New Zealand and the US complained that Canadian dairy exports sold through the "special export milk classes" (specifically, milk pricing classes 5 (d) and (e)) were implicitly export subsidies, and that Canada had exceeded its allowed levels of subsidized dairy exports under the WTO Agreement on Agriculture. In May, 1999, the panel convened to hear the case under the WTO dispute settlement body found in favour of the complainants (New Zealand and the US)[2]. Canada appealed the decision, and lost on appeal in a decision by a WTO appellate body in December, 1999[3]. Subsequent to the appeal loss, the Canadian dairy export system was reformed. New

[1] Al Mussell and Larry Martin. *Canadian Dairy Export Subsidies and the WTO Appellate Decision: Dairy Market Expansion in Limbo,* George Morris Centre Special Report. February, 2000

[2] *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products Report of the Panel WT/DS103/R*. Geneva: World Trade Organization. May, 1999. www.wto.org

[3] *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products: Recourse To Article 21.5 of the DSU by New Zealand and the United States AB-2001-6. Report of the Appellate Body* WT/DS103/AB/RW, WT/DS113/AB/RW. Geneva: World Trade Organization. December, 1999.

Zealand and the US challenged the compliance of the Canadian dairy export system to the WTO. In July, 2001, a WTO panel found that the new Canadian dairy export system constituted an export subsidy[4]. Canada appealed that decision, and in December 2001, the WTO appellate body supported the Canadian position and found that the reformed Canadian dairy export system was not an export subsidy[5].

In late 2001, the US and New Zealand requested that the original panel investigate the WTO legality of the reformed Canadian dairy export system[6]. The original panel ruled that the reformed Canadian export milk system constituted an export subsidy, and that Canada had violated its subsidized export levels under the Agreement on Agriculture. It is the appeal of this decision that was released in December, 2002[7]

The December 2002 WTO Decision

The WTO appellate panel that released its decision in December 2002 clarified two crucial issues in the dairy export case against Canada. The first relates to the benchmark used to establish whether a two-price system is truly in place. Canada had successfully argued earlier in the debate that production cost could be used as a yardstick against which to measure export prices, rather than the domestic price. In other words, Canada conceded that Canadian export prices were lower than domestic milk prices, but argued they were not below the production cost of exporting producers. The US and New Zealand argued that the appropriate measure of production costs had to be an industry average, and that it must include returns to invested capital and owners' unpaid labour. Canada argued that only the production costs of producers that actually export were relevant, and that non-cash overhead costs (such as return to invested capital and owners' unpaid labour) should be excluded.

The panel rejected the Canadian argument that only the costs of exporting producers mattered; they determined that industry average costs were the relevant benchmark. Rather than address the issue of overhead costs directly, the panel chose to compare actual export prices received by Canadian producers with production costs as proposed under the Canadian argument. The observation the panel made was that export prices were lower than the *Canadian* proposal for production costs. Thus, given that export sales were made at a loss relative to the lower of the

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[4] ***Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*** *Recourse to Article 21.5 of the DSU by New Zealand and the United States Report of the Panel* WT/DS103/RW, WT/DS113/RW. Geneva: World Trade Organization. July 2001

[5] ***Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*** *Recourse to Article 21.5 of the DSU by New Zealand and the United States AB-2001-6 Report of the Appellate Body* WT/DS103/AB/RW, WT/DS113/AB/RW. Geneva: World Trade Organization. December, 2001.

[6] ***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: Report of the Panel* WT/DS103/RW2 WT/DS113/RW2. Geneva: World Trade Organization. 26 July 2002

[7] **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 *Report of the Appellate Body* WT/DS103/AB/RW2 WT/DS113/AB/RW2. Geneva: World Trade Organization. December 20, 2002

two production cost benchmark proposals, the panel reasoned that the export sales must have been financed from elsewhere- i.e. from domestic sales.

Secondly, the panel was very clear about the relationship between government intervention, domestic milk pricing, and the financing exports. The panel found the Canadian Dairy Commission, as an instrument of government, set minimum domestic prices for butter and skim milk powder, which effectively determined the domestic milk price. Since under either of the Canadian or US/New Zealand production cost proposals, export milk was produced at a loss, the loss must be financed (or pooled against) milk sold profitably in the domestic market. Thus, since domestic sales are required to finance export sales, and domestic prices are due to government intervention, then effectively exports occur due to government intervention.

Implications for the Canadian Dairy Industry

On the surface, it may appear that this decision is not a big deal. The WTO decision will prevent Canada from exporting above WTO subsidized export levels fixed in the Agreement on Agriculture in 1994. Since the panel demonstrated that under either conception of production costs presented, export sales occur at a loss, then the decision prevents Canadian farmers from incurring further self-injury by exporting at a loss. If this were true, Canada should be thanking the US and New Zealand for bringing this to our attention. However, dairy exports actually occur at marginal cost, with overhead costs typically covered through domestic milk sales, so exports can be marginally profitable for farmers.

At a broader level, this dairy export decision presents a crucial challenge to the Canadian dairy industry. This is due to the following:

- Increases in dairy exports have vaulted Canada well ahead of the levels agreed to in WTO for subsidized exports. This is shown in Table 1. The Canadian dairy industry appears to have adapted itself to growth through cheese and "other product" exports at well above WTO authorized levels. Canadian exports are currently around 200% of committed levels in cheese and other products. This trend is less consistent in butter and skim milk powder; however, Canada has periodically exceeded subsidized export levels in these products by a significant margin as well. As a result of the WTO decision, export volumes must fall to the subsidized export levels defined in Table 1, which will amount to a loss of half the export volume in cheese and other products.
- The budget for milk procurement on behalf of processors comes from product sales and earnings. This is true regardless of the structure of regulated prices that occur under supply management. For many plants, the dramatic reduction in dairy exports that could occur as a result of the WTO decision will reduce plant volumes which will, in turn, reduce processor sales and profits[8]. The ultimate result will be a decreased incentive to invest (or reinvest) in dairy processing, plant consolidation and rationalization, and a decreased willingness to

[8] This is an important issue in cheese and "other product" processing (see Table 1 below), because these are the products in which export volumes must fall, and in which there are no support prices. In butter and skim milk powder processing, a manufacturing cost allowance is included in the support price value, which provides some protection for a processor's margin.

Table 1 WTO Subsidized Export Commitments and Actual Exports

		Commited Quantity (Tonnes)	Actual Quantity (Tonnes)	Actual/Commited (%)
Butter				
	95/96	9,464	13,956	147.5
	96/97	8,271	10,987	132.8
	97/98	7,079	10,894	153.9
	98/99	5,886	4,327	73.5
	99/00	4,693	1,803	38.4
	00/01	3,500	808	23.1
	01/02	3,500	1,501	42.9
Cheese				
	95/96	12,448	13,751	110.5
	96/97	11,773	20,409	173.4
	97/98	11,099	27,397	246.8
	98/99	10,424	26,027	249.7
	99/00	9,750	20,480	210.1
	00/01	9,076	17,945	197.7
	01/02	9,076	14,445	159.2
SMP				
	95/96	54,910	35,252	64.2
	96/97	52,919	24,888	47.0
	97/98	50,927	29,886	58.7
	98/99	48,936	40,728	83.2
	99/00	46,944	39,061	83.2
	00/01	44,953	41,197	91.6
	01/02	44,953	52,294	116.3
Other Milk Products				
	95/96	36,990	37,573	101.6
	96/97	35,649	62,146	174.3
	97/98	34,307	71,023	207.0
	98/99	32,966	46,630	141.4
	99/00*	31,624	57,058	180.4
	00/01*	30,282	63,794	210.7
	01/02*	30,282	60,721	200.5

Source: WTO Agreement on Agriculture and Statistics Canada, Agriculture Division, Livestock Section, Dairy/Food Unit

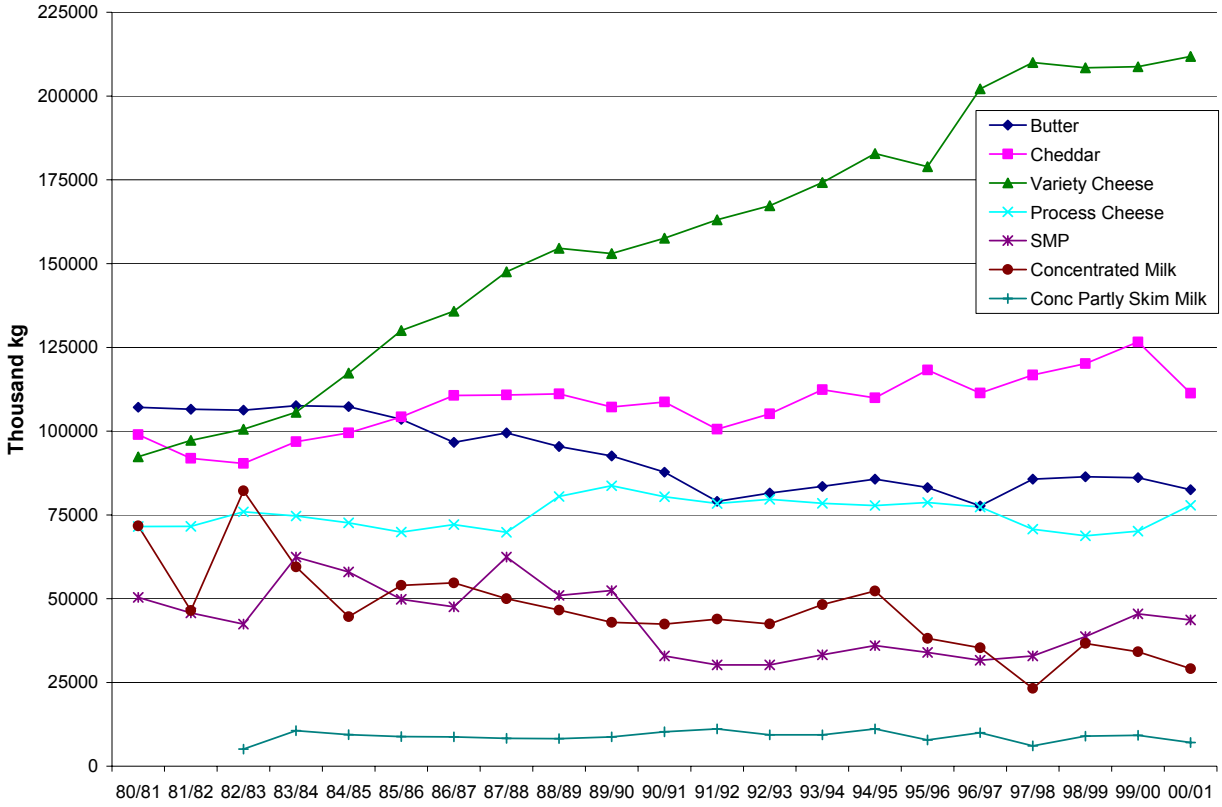
purchase milk at regulated prices. Either way, the demand for *within-quota* milk (as well as export milk) is apt to decrease. As this occurs, over time, there will be a greater resistance to milk price increases, and it may become difficult to retain historic milk price levels. The logical result of long-run weakened processor demand is that farm milk prices must fall, or the commitment to support prices will have to be increased.

- Market growth is a difficult challenge for supply management. Some even view market growth as being in conflict with the concept of supply management. However, in any industry, there are fundamental reasons why growth is critical:
    - Assets employed in the industry tend to be priced (capitalized) given current and future expectations of gross margins.
    - Because expected returns effectively determine the price of assets, in order to generate a profitable return on them, growth in gross margins is required
    - To induce new investment, returns on investment in dairy assets must be competitive with those in other farm and non-farm enterprises.
- Milk price increases provide growth for the farm sector, but it must be shared through increases in processor revenue if growth is to be sustainable. Also, price increases are transparent, and thus are readily capitalized into higher quota values. .
- Decreases in unit production cost create growth, but without the ability to expand volume, they too tend also to be readily capitalized into quota values.
- Meaningful growth occurs with increases in volume at stable or only slightly decreasing prices. Such growth has no obvious bias on quota values, and allows farmers and processors to leverage the scale economies evident in the dairy industry.

Growth in volume and sales will drive profitability and new investment in the dairy industry; however:

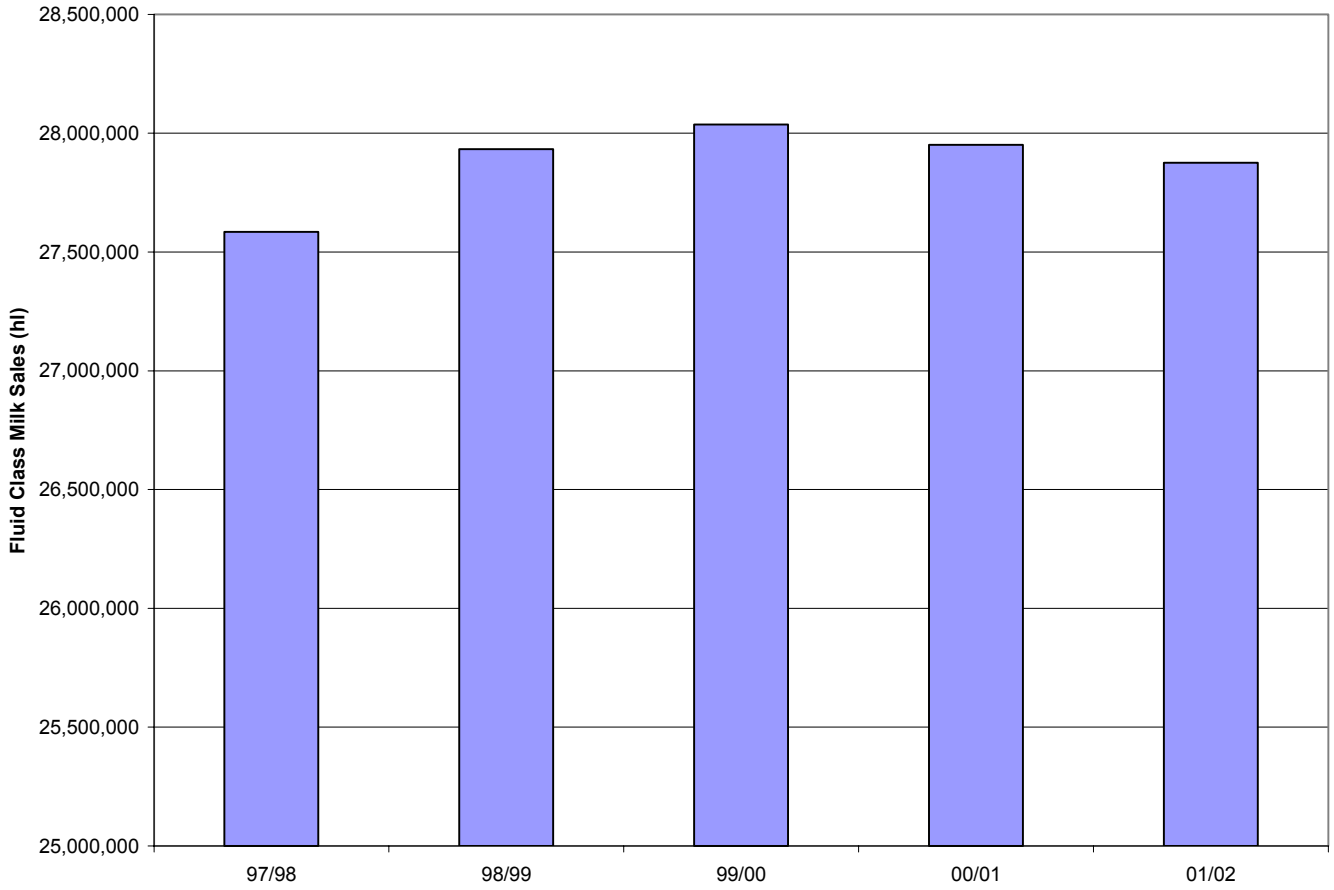
- The domestic market for dairy products in Canada is largely mature. This is demonstrated in Figure 1 below. The only significant source of growth in the industry has been in variety and cheddar cheeses. In recent years, even its growth has slowed, making manufactured dairy products a mature market.
- The market for fluid milk is also largely mature. Figure 2 shows that while there has been some growth in the fluid milk market since 1997/98, it has been at best slow. In all likelihood, future growth in the fluid market will be limited to increases in the Canadian population.
- At the same time, there has been a significant increase in the production of milk for export. This has occurred despite the interruptions that occurred in response to the WTO rulings. To illustrate, Figure 3 presents the volumes of total milk production sold for export relative to total milk production (export and domestic) for Ontario. For the early part of the period, the export volumes shown are the volumes shipped under Class 5 (d) and (e) relative to total production in the supply management system; from August 2000 onward, they reflect volumes in Class 5(d) plus the volume sold through the export contract exchange relative to total production within the supply management system plus the volume moved through the export contract system. The figure shows a steady increase in milk volumes, despite a high degree of seasonality. What is surprising is that in Ontario, exports have grown to be commonly 10% of total milk production, and periodically 15% or more of total production.

Figure 1 Domestic Disappearance of Manufactured Dairy Products in Canada



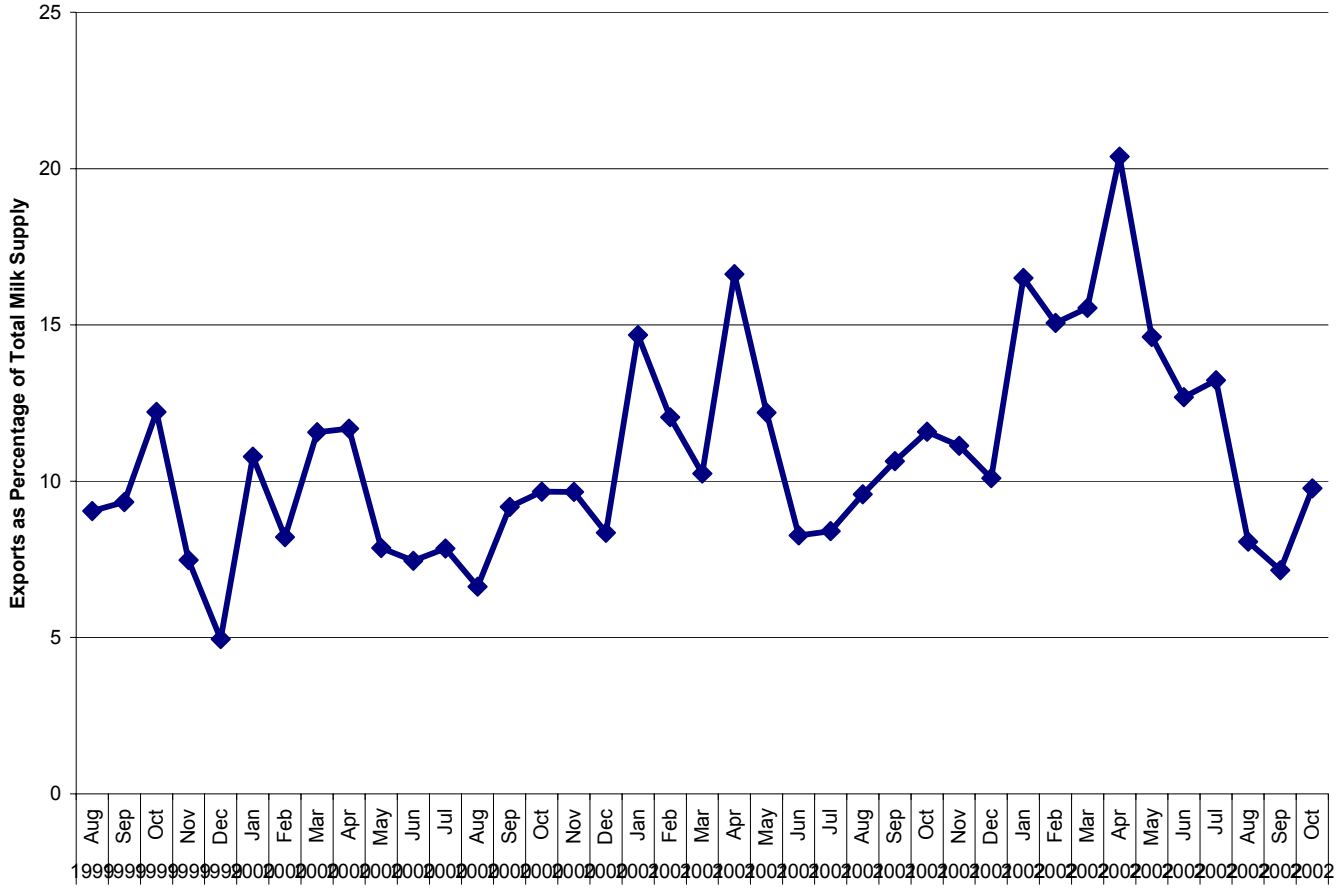
Source: Statistics Canada

Figure 2 Canadian Fluid Milk Shipments



Source: Canadian Dairy Commission, milk volumes in Classes 1(a), (b), (c), and (d)

Figure 3 Percentage of Ontario Milk Shipments Exported, Aug. 1999-Oct. 2002



Thus, based on the foregoing, the prospects for meaningful growth in the domestic dairy market are dubious. However, Canada has been successful in achieving growth through exports. The loss of export growth thus stifles the most promising source of growth to attract new capital into the dairy industry. Export sales have expanded to the point that if we must now backslide on exports down to WTO subsidized export levels, the Canadian dairy industry will shrink.

Canada's Options for Reform

What appears clear is that exports have been critical to dairy industry growth. What is less clear is what Canada must do to bring the milk marketing system into final compliance with the WTO decision so that exports can resume. The following themes mentioned in the most recent and previous panel decisions appear to make the job of redesigning dairy supply management difficult:

- The WTO panels have made clear that government "payments" that facilitate separate domestic and export prices need not occur in the form of cash. Apparently, delegation of regulatory authority to implement a two-price system, or foregoing domestic revenue in favour of export sales through regulatory measures can constitute a government payment.
- Total cost of production has been established as the relevant benchmark in evaluating the legality of a two-price domestic-export marketing system. Allocation of production costs toward the higher of the two prices in order to cross-subsidize the lower one can be regarded as an export subsidy, if the two-price system is maintained by statute (and it literally always is).
- The WTO panels have devoted significant attention to whether processors would otherwise have access to milk competitively priced on the world market *but for* government action. If product is priced *contingent on* export, this criterion is clearly met. However, one can only speculate that managing the domestic supply would be extremely difficult if product priced for the export market were not contingent on export and could flow back into the domestic market.

Conclusion and Implications

The implications of WTO dairy decision may not be limited to the Canadian dairy industry. Other products in Canada, and many agricultural marketing systems around the world, use two-price systems in which the domestic market is priced higher than the export market, with provisions to prevent low-priced exports from flowing back into the domestic market. In all likelihood, the complainants that brought about the challenge against Canada (the US and New Zealand) have programs with these characteristics themselves. If so, their efforts in the dairy case may backfire, and Canada would be justified in highlighting and prosecuting cases against products marketed under these systems to their fullest extent under WTO. Alternatively, Canada can make the case that the existing definition of export subsidies is simply unworkable given the apparent broad implications of the dairy export ruling, and that it must be renegotiated in the Doha Round.

Canada has a tremendous vested interest in protecting supply management in the dairy industry. Literally billions of dollars in quota and farm equity are at stake. At the same time, the Canadian dairy industry must be able to grow or it will shrink, its productive assets will be deteriorated,

and it will eventually implode. This is the same conclusion we reached in our analysis of the dairy export issue three years ago.

In order to avoid a conflict between supply management and growth through exports, Canada needs to fundamentally rethink the milk pricing system within supply management. Research is now urgently needed which can address the following marketing challenges:

- The apparent need to minimize or eliminate government action (as defined under the WTO decision) in domestic price determination
- The apparent need to maintain domestic market revenue as separate and independent from export revenue (i.e. prevention of pooling and cross-subsidization)
- The need to export in the absence of a pricing system that gives export prices as contingent upon export, while maintaining a higher domestic price.

The Canadian dairy industry faces protracted challenges if it is to continue to grow through exports. Given the constraints imposed by the WTO decision, the entire pricing and marketing system will probably need to be reconsidered, along with a broad discussion of how supply management can be maintained and facilitate growth and exports. The evidence presented above says that intensive effort and a willingness to place everything up for analysis is warranted to solve this problem. This will likely prove to be the greatest challenge faced by dairy supply management in the last thirty years.

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