Dairy Farmers of Canada

Submission on the renegotiation of the NAFTA

July 18th, 2017

Dairy Farmers of Canada (DFC) appreciates the opportunity to present comments regarding objectives for the renegotiations of the North American Free Trade Agreement (NAFTA).

DFC is the national policy, lobbying and promotional organization representing Canada's farmers living on approximately 11,000 dairy farms. DFC strives to create stable conditions for the Canadian dairy industry, today and in the future, and works to maintain policies that foster the viability of Canadian dairy farmers, and promote dairy products and their health benefits.

Summary

Despite concentrating our efforts on serving the domestic market, international trade talks are an important consideration when it comes to maintaining the integrity of the Canadian supply managed dairy system. Supply management continues to be *critical* to the viability and sustainability of Canada's dairy industry, and, as a system, it relies heavily on import management. Under supply management, Canadian dairy farmers collectively manage their production to meet market requirements, enabling them to avoid producing surplus milk at dumping prices (unlike in some other jurisdictions). Trade talks, whether at the WTO or bilateral level, have the potential to affect import management measures, which are critical to planning production.

The Canadian dairy sector was deliberately excluded, by the Canadian government, under the original NAFTA agreement, and, as such, was exempt from opening its market. The agreement ensured Canada was able to maintain its obligations under the GATT/WTO, allowing Canada to legally implement and maintain a series of Tariff Rate Quotas (TRQ), as negotiated and approved in the Uruguay Round Agreement. **As such, DFC asserts that the Canadian dairy industry must continue to be excluded from negotiations on the so-called modernization of NAFTA.** More specifically, as outlined in a SM5 joint letter addressed to Ministers Freeland, Champagne and MacAuley on February 10th, 2017, DFC insists that the Canadian government reject any discussion regarding the size of TRQs and the level of over-quota tariffs for dairy products as part of the re-negotiation of NAFTA.

DFC does not oppose Canada entering into bilateral, plurilateral or multilateral negotiations, provided that there is no negative impact on the Canadian dairy industry. Opening the Canadian dairy market to the U.S. would be costly for the Canadian economy in terms of loss to GDP, jobs, lower returns to producers, and would bring no benefits to Canada (i.e. lower prices for consumers, etc.).

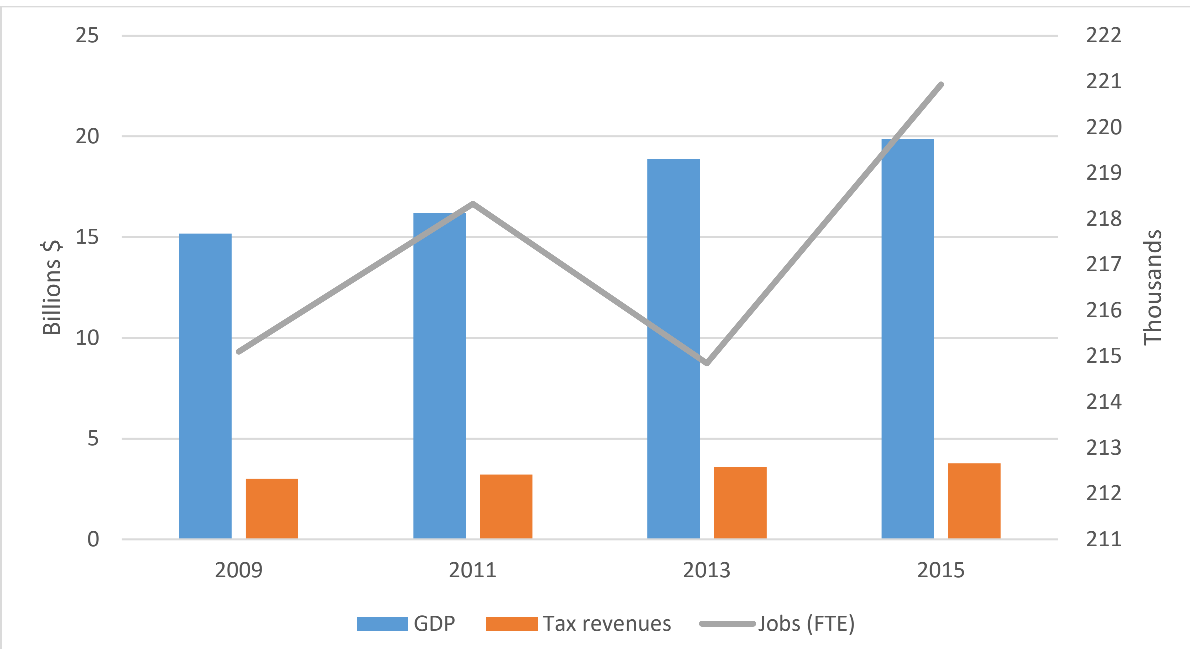
DFC appreciates the continued support of the Canadian government, and looks forward to working together to explore ways to maintain the integrity of the supply managed system in the face of U.S. demands to re-negotiate NAFTA.

<u>The Canadian dairy sector: a significant contributor to the Canadian economy</u>

The dairy sector is a consistent positive contributor to the economic stability of the Canadian economy. In 2015, the sector's economic contributions amounted to $19.9 billion towards Canada's GDP, and $3.8 billion in tax revenues. In addition, the dairy sector sustains approximately 221,000 jobs[1] in Canada, while providing Canadians with fresh, high quality and nutritious products without any of the direct government subsidies provided in other jurisdictions.

As shown in Chart 1 below, based on the results of economic impact studies conducted by ÉcoRessources Consulting, the dairy industry remains a dynamic contributor to the Canadian economy: between 2009 and 2015, the number of jobs increased by 3%, contribution to tax revenues increased by 25% and contribution to GDP by 31%.

Chart 1. Economic impact of the Canadian dairy industry



Under supply management, farmers focus primarily on producing milk to meet domestic demand; however, Canadian dairy farmers remain open to exploring export market opportunities, providing they are profitable and such exports respect Canada's international trade obligations. Furthermore, the relative stability offered under supply management creates a positive and predictable environment, conducive to investment and growth. In fact, based on the results of the 2016 Census of Agriculture, Statistics Canada noted that the increased efficiency of the dairy industry is attributed to "improvements in feed quality and management, genetics and advancements in technology, including the use of robotic

[1] Source: ÉcoRessources

milking." (Census of Agriculture 2017, *Production efficiency and prices drive trends in livestock*). Without the stability offered by supply management, the significant and ongoing investments required to achieve this increased efficiency might not be possible.

In Canada, our farmers derive their returns from the market, without any direct government subsidies. Conversely, in the U.S., the government provides massive support to farmers and the agri-food sector, in the form of direct and indirect subsidies. A 2009 study by Grey, Clark and Shih concluded that the U.S. dairy industry benefitted from a total of $31/HL in direct and indirect subsidies funded through taxpayer dollars[2]. The subsidies are administered through programs run by Federal and State Departments of Agriculture, as well as U.S. irrigation programs, which constitute an important component of the total level of support. By contrast, in Canada, dairy farmers do not receive a single dollar of direct government subsidies.

Furthermore, according to a 2015 study by the Boston Consulting Group, commissioned by Agropur, dismantling the supply management system in the Canadian dairy industry would result in:

- A decrease of $2.1B to $3.5B to GDP;
- A loss of 24,000 direct jobs;
- Up to 40% to 50% of farms being unable to cover their cash costs.

The Boston Consulting Group study (2015) also concluded that despite lower farm gate prices, deregulation in other countries has actually *reduced* dairy processing margins. Moreover, the decrease in farm prices has not necessarily been passed on to consumers. For example, in Australia following deregulation, from 2004 to 2011, retail prices for butter and cheese increased annually by 4% and 7% respectively, much higher than the Australian inflation rate over the same period (2.9% annually).

Moreover, in the current context of over-saturated world dairy markets, which have led to low prices at the farm-gate and a lower price received by processors, supply management is a breath of fresh air. Supply management, by its nature, ensures overproduction is largely avoided, and the system significantly reduces the impact of devastating market fluctuations, which have negatively impacted milk prices in other countries. When too much milk is produced, prices crash, and there is no incentive to invest in increased processing capacities. The end result is job loss, loss of income for farmers, and in some cases, farmers being forced to shut down their operations. According to a study by the International Farm Comparison Network (IFCN), in 2015, given a global average price of US 29$/100 kg of Energy Corrected Milk (ECM)[3], less than 10% of the world's milk production was sold at a level covering the costs of production! Fortunately, the situation has since improved, but current prices only cover 50% of the world's cost of production for milk.

Not only does supply management work for Canadian farmers and the Canadian economy, it also benefits Canadians consumers. While comparing the retail prices of dairy products between Canada and the U.S., it is clear that dairy products in Canada are not necessarily more expensive than in the U.S. In fact, table 1 below clearly demonstrates that for some products, Canadian prices are lower than those in the U.S. For example, for the 52-week period ending May 27th, 2017, Canadian consumers paid an average of $9.34/kg for butter and $13.90/kg for Cheddar compared to $10.71/kg and $14.87/kg respectively in the United States.

[2] The study is currently under review, an updated version will be available shortly.

[3] ECM refers to standardized milk at 4% butterfat and 3.3% protein

Table 1. Retail prices for some dairy products

CDN$/kg	Canada	U.S.
Milk	$1.51/litre	$1.27/litre
Milk (rbST free)*	$1.51	$1.63
Butter	$9.34	$10.71
Cheddar	$13.90	$14.87
Mozzarella	$13.65	$14.38
Yogourt	$4.98	$6.57

Source: Nielsen, 52 weeks ending May 27th, 2017. Exchange rate @ 1.32
*All Canadian milk is rBST-free

By and large, the Canadian public also supports the supply management system, and the dairy industry. On May 26th, 2017, Campaign Research published the results of a poll asking Canadians whether or not they approve or disapprove of supply management. The results are both clear, and unequivocal: 75% of Canadians approve of supply management. This poll comes on the heels of a separate poll published earlier in May by Abacus Data which found that 92% of Canadians are happy with the range and quality of dairy products available in Canada, and 77% are satisfied with Canadian dairy policy.

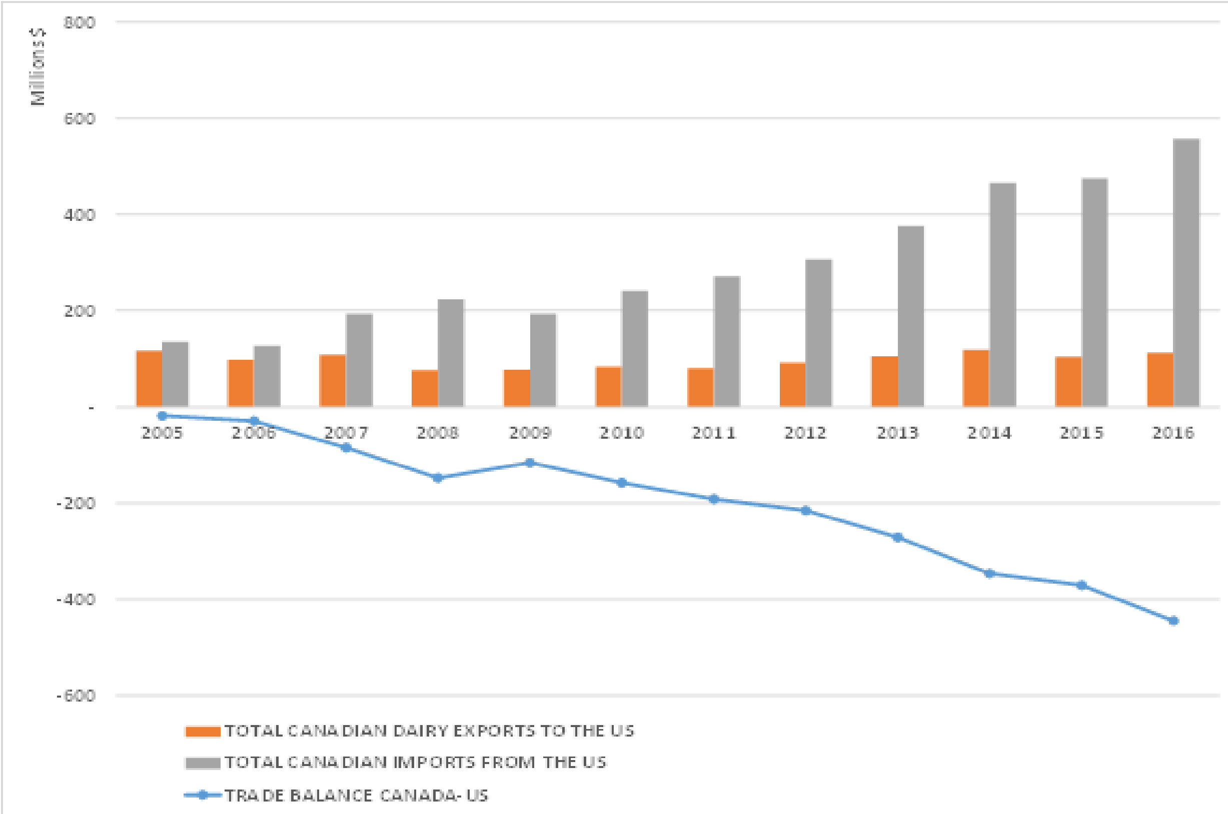
To quote Prime Minister Justin Trudeau, "the supply management system works for farmers, it works for our agricultural industry and it works for Canadians."

Canada – U.S. Dairy Trade

Under the supply management system, the Canadian dairy industry focuses on production to meet domestic demand requirements. As such, Canadian dairy policies have been introduced in order to respond to domestic needs and market evolutions. Conversely, the U.S. dairy industry is heavily reliant on export markets, with exports representing 14% of U.S. milk production in 2016. The U.S. is increasingly using the export market to dispose of surplus solids non-fat (SNF).

As shown in chart 2 below, the U.S. enjoys a favourable dairy trade balance with Canada. In 2016, the U.S.' trade surplus with Canada was the largest it has been in over the past 10 years. Today, Canada is the second largest export market for U.S. dairy products; surpassed only by Mexico.

Chart 2. Canada - U.S. dairy trade balance (CDN)



Source: Canadian Dairy Information Centre (AAFC)

The strong demand for butterfat in the U.S. has resulted in surplus skim milk powder (SMP) (also known as solids non-fat (SNF)), a by-product in butter production. As such, the focus of U.S. dairy export strategies is centered on the export of this surplus solids non-fat (SNF), including the export of diafiltered milk to Canada. The over-supply of SNF dumped onto the export market has resulted in a global over supply, causing significant negative impacts to farmers around the world.

It is also important to keep in mind that the value of the U.S. dollar has not generally been favourable for exports. Despite an over 30% increase in the exchange rate, placing the Canadian dollar at approximately $1.30 per U.S. dollar, the trade balance continues to increase in favour of the U.S. In fact, as we saw in Chart 2, in 2016, the U.S. enjoyed an over $400 million CDN dairy trade surplus with Canada.
U.S. dairy exports to Canada originate primarily from five states, which account for 64% of all U.S. exports to Canada. Furthermore, imports from the states of Wisconsin and New York alone (CDN $241M) represent more than Canada's total dairy exports to all countries combined (CDN $235M) (see table 2 below).

Table 2. Top dairy U.S. states exporting to Canada in 2016

	Canadian Dairy Imports 2016 (CDN $)	% of Total Imports from U.S.	Most Imported Product(s)
Wisconsin	$155.4 M	27.9%	Whey, MPC, butter, cheese
New York	$85.5 M	15.3%	MPC, MPI, butter, whey
Idaho	$47.5 M	8.5%	Whey products, MPI, cream, MPC
California	$40.4 M	7.2%	Whey, milk protein substances
Minnesota	$28.1 M	5.0%	Whey, WMP, MPI, butter
5-state total	**$356.9 M**	**64.0%**	

Finally, in the U.S., dairy exports are also supported by programs such as Cooperatives Working Together (CWT), introduced in 2004, coinciding with the rapid rise of U.S. exports. According to CWT, the program involves a “voluntary” levy collected by co-ops (although co-op members do not seem to have the ability to opt out[4]) to support the export of U.S. dairy products on the world market. In other words, CWT is a way to subsidize the export of U.S. dairy products.

Supply management is not a barrier to trade

As stated above, the trade balance in dairy trade is indeed very beneficial to the U.S. It is worth noting that currently, approximately 10% of Canadian demand is met through imported dairy products, much of which is being dumped on the Canadian market from the U.S. In comparison, in the U.S., only 3 to 4% of domestic demand is filled by imports from all countries.

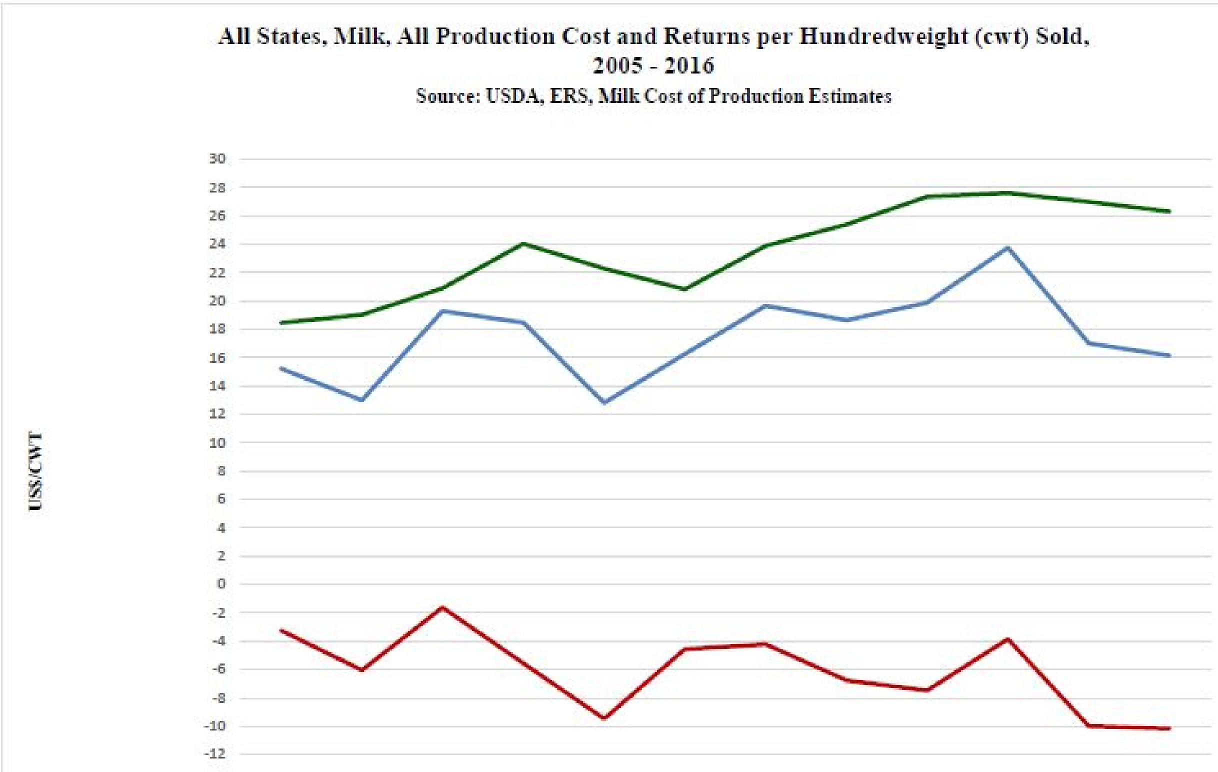
Not only does Canada respect its international trade commitments, it allows heavily subsidized American products to enter the Canadian market and compete with our domestic production. When U.S. politicians refer to “reliable, open and fair trade”, it is according to their own unique interpretation of “reliable”, “open” and “fair”. Fair trade implies a level playing field. The amount of support provided to U.S. agriculture through direct and indirect government subsidies clearly precludes a level playing field, and is not likely to change any time soon. The last two agreements negotiated by Canada, CETA and TPP, were qualified as comprehensive, but the reality is, as comprehensive as they may be, domestic support to agriculture was excluded from these agreements. Both the U.S. and the European Union argue that domestic support can only be addressed at the WTO level. Moreover, the disengagement of the U.S. from the multilateral process, notably at the WTO, suggests that further discipline on the use of domestic

[4] **CWT withdrawal conditions**: Unless otherwise approved by the CWT Committee, a CWT Member may only terminate its CWT Membership during any one-year term upon the discontinuance of the CWT Program, except that an Independent Producer may also terminate its CWT Membership during such one-year term if such Independent Producer sells its entire herd of dairy cows during such term. Permission to withdraw may be granted or denied by the CWT Committee, in its discretion, and may be subject to such terms and conditions as the CWT Committee may prescribe.
(CWT 2017, http://www.cwt.coop/about-us/by-laws/)

support may be postponed indefinitely. It is therefore critical to address this question as part of the NAFTA re-negotiations in order to ensure a level playing field between Canada and the U.S.

Finally, as shown in Chart 3, data from the U.S Department of Agriculture (USDA) demonstrates that the price of milk paid to farmers is not sufficient to cover U.S. dairy farmers' cost of production in the absence of subsidies. The data raises serious questions about the evolution of the U.S. dairy industry and its dependence on government support.

Chart 3. U.S. Milk, All States Production Cost and Returns per cwt



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Farm Gate Price	15.23	12.99	19.28	18.48	12.81	16.26	19.67	18.64	19.88	23.76	17.02	16.15
Cost of Production (cwt)	18.46	19.03	20.90	24.04	22.28	20.82	23.88	25.39	27.36	27.61	27.00	26.31
Loss (cwt)	-3.23	-6.04	-1.62	-5.56	-9.47	-4.56	-4.21	-6.75	-7.48	-3.85	-9.98	-10.16

U.S. Protectionism

Notwithstanding that Canada's supply management systems depends on the need to manage imports, in order to adequately fulfill all domestic demand while limiting surplus production, it is worth noting that the U.S. also limits its imports of milk through Tariff Rate Quotas (TRQ), making it just as protective, if not more, of its dairy industry than Canada. The U.S. has a total of 24 TRQs for dairy, compared to 12 for

Canada. Both countries have retained their rights to apply WTO Special Safeguard Mechanisms (SSGs)[5]. However, unlike the U.S., which regularly invokes the use of SSGs, Canada has never invoked an SSG. When discussing allegations of Canadian protectionism, one must not forget that similar, and in some cases even more stringent policies are in place for sensitive U.S. industries, including dairy and sugar, among others.

Moreover, ongoing legislative changes continue to add levels of protection to a number of U.S. industries. The Buy American/Hire American Presidential Executive Order is only the most recent example of this. Another longstanding protective legislation is the Jones Act/1920 Maritime Transportation Act, which stipulates that only American built ships are permitted to transport goods within U.S. coastal areas. Finally, The U.S. has a myriad of policies and subsidies in place to stimulate exports. Examples include CWT, and heavy subsidies to the agricultural, manufacturing and energy sectors. Similarly, a number of policies exist to inhibit imports. These include protectionist policies that act as non-tariff barriers. Examples include the Buy American Act, recent tariffs on Canadian softwood lumber, proposed taxes on imported products from China, and so-called National Security measures, which could affect global trade in steel and aluminium products.

These examples highlight some of the significant protectionist measures taken by the U.S. to protect its own domestic markets. These measures are in addition to significant government support to the agricultural industry vis-à-vis the Farm Bill, totalling well over U.S. $100 billion per year, excluding irrigation subsidies. Each of these represents a defensive use of domestic policy and legislation to destabilize trade and undermine market access.

Playing by the rules

Some have suggested that Canada has not played by the rules by adopting policies that, allegedly, impede trade. Dairy Farmers of Canada consider the Canadian dairy system to be dynamic and responsive; the dairy industry continuously responds to changes to the domestic market environment. Any new policy is created in order to respond to these changes. The agreement in principle between producers and processors for a national ingredient strategy, including the Class 7, isn't any different. The introduction of Class 7 fosters innovation, which will result in the growth of the Canadian dairy industry. The purpose of the strategy is to upgrade our capacity, provide an array of products for use in foods and non-food applications, simplify supply chain management, and increase flexibility in order to meet market demand in a more timely and efficient manner - all while adding value to domestically produced protein in the Canadian market. Once again, the Canadian system is concerned about meeting the needs of the domestic market, and is not export-focused like the U.S. industry.

Another example is the Canadian Cheese Compositional Standards. These standards were put in place to provide clarity and reduce confusion for domestic cheese consumers. Prior to the introduction of the Standards, cheese products were being sold under two sets of regulations: the Food and Drug Act and the Canada Agricultural Product Act for dairy products. The U.S. also has a set of cheese standards, through the Standards of Identity, which are far more stringent than Canadian standards such as prohibiting the

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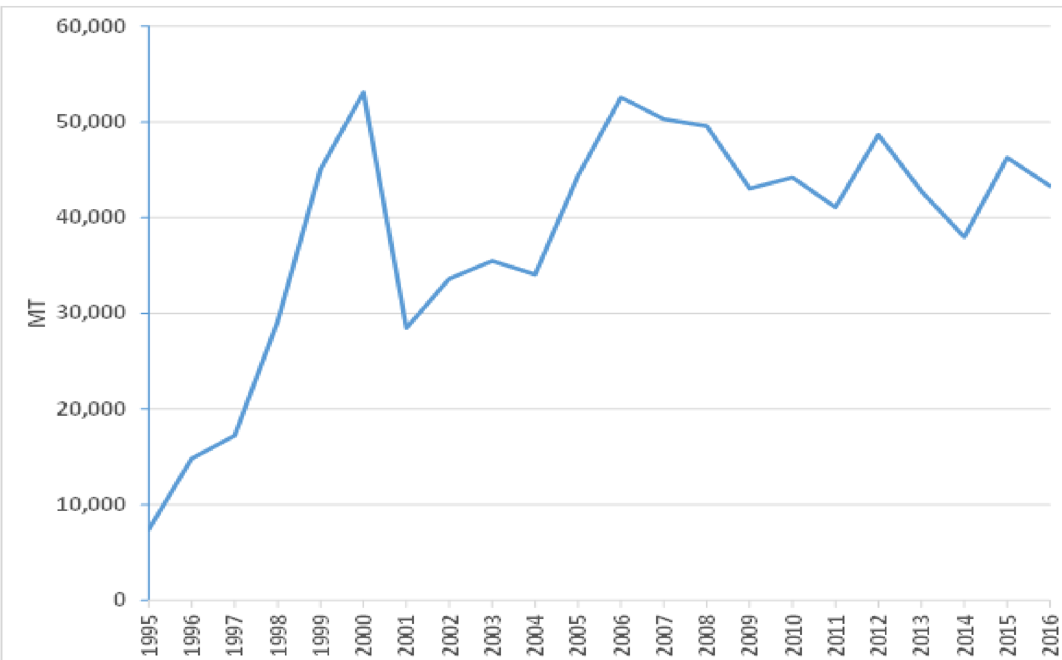
[5] SSGs refer to a contingency restriction on imports implemented temporarily in order to address specific circumstances resulting in a surge in imports. SSGs on agriculture cannot be used within TRQs, and can only be applied to products that have been tariffed. Provisions on the use of SSGs are outlined under Article 5 of the WTO Agriculture Agreement. 39 countries reserve the right to use SSGs, including Canada and the U.S.
(WTO 2017)

use of Milk Protein Concentrates (MPCs) and diafiltered milk in cheese making. Ironically, diafiltered milk is exported by the U.S. to Canada.

While Canada's focus is on addressing domestic market changes, the U.S. has also undertaken studies of market deficiencies and implemented associated policies. For example, the 2004 study conducted on the competiveness of the U.S. dairy ingredient industry identified deficiencies in the U.S. dairy market. This report resulted in a process through which the U.S. reinvested in their processing capacity, which ended in stabilizing the imports of Milk Protein Concentrates (MPCs) from New Zealand, whose have increased tremendously in the previous years. As shown in Chart 4 below, U.S. imports of MPCs from New Zealand boomed in the late nineties. In 2004, the U.S. implemented a program to produce domestic MPCs, using money it would normally use to buy surplus milk powder. The program supported the development of the U.S. MPC/casein industry.

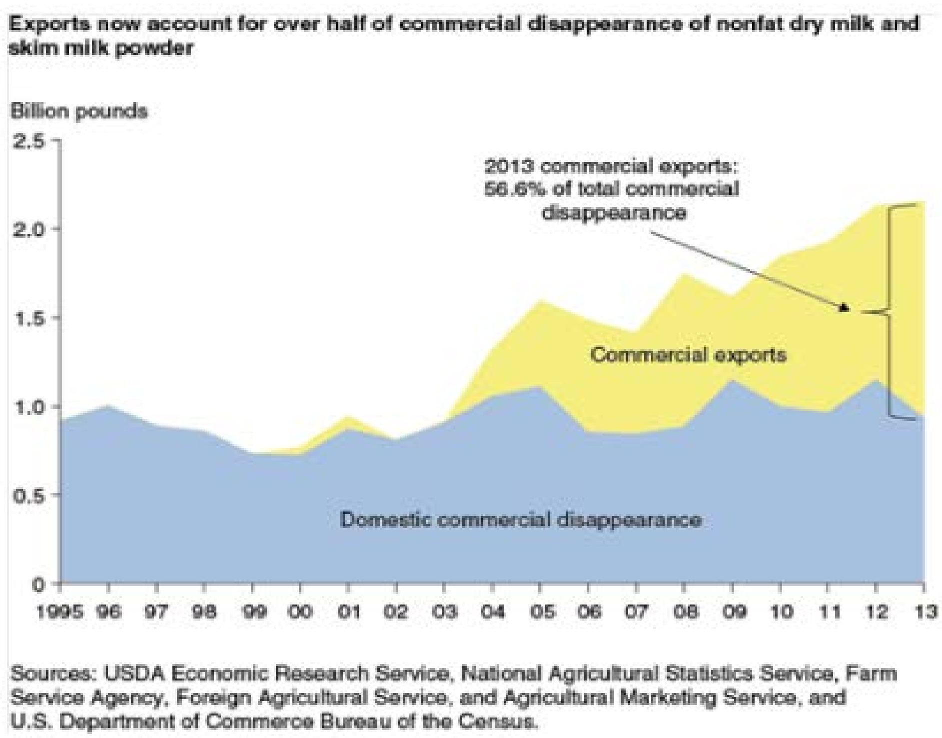
Chart 4. U.S. imports of MPC from New Zealand



Source: USDA/FAS (Foreign Agricultural Service)

In addition to the program to develop the MPC/casein industry, the U.S. tilted the support purchase price of butter and non-fat dry milk (NFDM) powder. In order to balance the markets for butter and NFDM, the Commodity Credit Corporation (CCC) increased the price it pays for butter, and decreased its purchase price for NFDM. To offset the impact of the tilt, the USDA also announced its allocation of an additional 55 million pounds of NFDM powder to export under the Dairy Export Incentive Program (DEIP). The tilt policy, in allowing a subsidized price for NFDM and SMP, resulted in a corresponding boom of U.S. exports of these products (see Chart 5 below). This is a clear case of a program designed to address a deteriorating domestic market in the U.S.

Chart 5. Exports of non-fat dry milk (NFDM) and skim milk powder (SMP)



Furthermore, on several occasions, the U.S. has circumvented trade regulations in its trade with Canada. For example, the U.S. developed a product rarely used domestically (diafiltered milk), specifically in an attempt to take advantage of loopholes in existing trade agreements and undercut the Canadian dairy market. Canadian dairy producers have lost approximately $230 million annually since 2015 as a result of the importation of diafiltered milk directly displacing Canadian domestic production.

Additional examples of products imported from the U.S. in an attempt to circumvent Canadian TRQs and classification systems include: pizza toppings (Appeal No. AP-2015-011), salted cream and other food preparations.

The Canadian dairy industry has respected and will continue to respect existing international trade agreements and their associated regulations. The same cannot be said for the U.S. dairy industry, which, time and again, has proven that they are not willing to play by the rules of international trade.

Conclusion

As mentioned, supply management works for Canada by promoting job creation, fostering innovation, and contributing heavily to Canada's GDP and tax revenues. Based on all available data, it is inarguable that:

1. Canada has a trade deficit with the U.S. in dairy products;
2. Canadian milk production focuses on the domestic market with the intention of fulfilling domestic demand and;
3. The Canadian dairy industry respects and has every intention to continue to respect existing international trade agreements and their associated regulations.

Furthermore, a closer look at the economic context that led Canada to adopt supply management for dairy 50 years ago suggests that when it comes to the dairy market, things remain similar in 2017:

1. Small number of buyers;
2. Large number of sellers;
3. Highly volatile world markets largely due to an imbalance between supply and demand;
4. Highly subsidized/supported dairy industries around the world.

The introduction of supply management fostered the creation of a very stable market environment in Canada – the creation of a stable market environment is an objective pursued by policy makers around the world. Canada's dairy sector has accomplished something that the world envies – particularly in the current context of an extremely volatile global dairy market. The government's ongoing support is critical in maintaining the integrity of the supply managed sectors, should demands for greater access to our market be made amidst the potential re-negotiation of NAFTA. Consistent with our mandate to maintain a strong and united support for a national system of supply management, the delegates attending the 2017 DFC Annual Policy Conference unanimously confirmed that they do not oppose Canada entering into bilateral, plurilateral or multilateral negotiations, providing that any Agreements come with no negative impact to our industry. More specifically, the delegates unanimously endorsed that the Canadian government must not engage in any discussion regarding the size of TRQs and the level of over-quota tariffs for dairy within the context of the re-negotiation of NAFTA.