The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
http://ageconsearch.umn.edu
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

No endorsement of AgEcon Search or its fundraising activities by the author(s) of the following work or their employer(s) is intended or implied.

At Odds With Stated Objectives: Increasing Industrial Milk Prices in Canada

Al Mussell[1] and Ted Bilyea[2]

SPECIAL REPORT

July 16th, 2008

[1] Senior Research Associate, George Morris Centre
[2] Research Fellow, George Morris Centre, and past Chair, Dairy Industry Working Group

Introduction

The Dairy Farmers of Canada (DFC) recently advocated an emergency industrial milk price increase of $3.50/HL. On July 11th, the Canadian Dairy Commission (CDC) announced it was increasing industrial milk prices by $1.45/HL, effective September 1, by raising support prices for butter and skim milk powder (SMP). Additional support price increases will be considered in the normal operating cycle in December, to become effective February, 2009.

The rationale for the price increase is probably well-founded, based on the increased costs faced by farmers for energy and feed since the last industrial milk price increase in February, 2008. However, increasing industrial milk prices is in direct violation of some of the key strategic objectives articulated by dairy industry leaders.

First, a stated objective of at least some provincial milk marketing boards is to seek market expansion. Second, the industry is seeking a smooth transition to new compositional standards for cheese, but has lacked a pricing plan for implementation. Third, some in the dairy industry have proposed advanced preparedness for a WTO agreement and the anticipated increase in market access; increasing prices is counter to competing for domestic market share. Finally, provincial boards have grappled with policies to suppress escalating quota values, and milk pricing has a central role to play in driving those quota values.

In this special report, we describe the contradictory nature of an industrial milk increase, and provide suggestions for an alternative.

Market Expansion

Sluggish or negative growth in dairy markets is a concern for provincial marketing boards, and the boards have enunciated measures to address growth. For example, the Dairy Farmers of Ontario has championed initiatives to expand its sales to ice cream processors. Among the causes of slow growth in Canadian dairy markets are substitution of imports for domestic dairy ingredients, substitution of non-dairy ingredients for dairy ingredients, and price sensitivity of dairy product demand. All of the above have the effect of mitigating growth or, indeed, reducing the market for farmers' milk.

Evidence of this is updated below, as of the last dairy year. Figure 1 shows that growth has been slow in major dairy product categories in Canada. Variety cheese, which includes mozzarella, has been a growth category, and the 2006-07 data suggests that cheddar cheese disappearance has experienced some recent growth. SMP disappearance is up significantly, but much of this is consumption as livestock feed at very low prices. Most other categories are simply flat, and have been for some time. Admittedly, the figure does not present yogurt as a category, and yogurt has shown impressive growth. But the predominant trend illustrated by the figure is extraordinarily slow or even

stagnant growth. Figure 2 presents volumes of milk marketed in fluid milk classes. Its trend in volume is simply flat. With the exceptions described above, it mirrors the broad trend dairy product disappearance.

Figure 1 Manufactured Dairy Product Disappearance in Canada

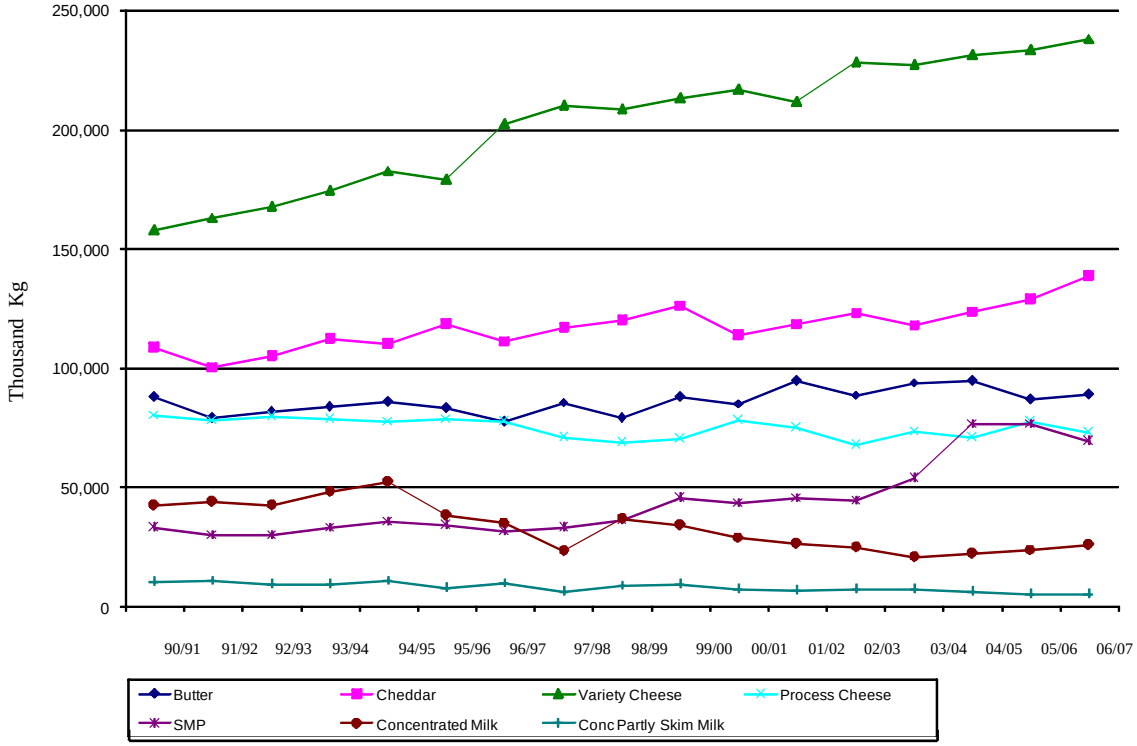
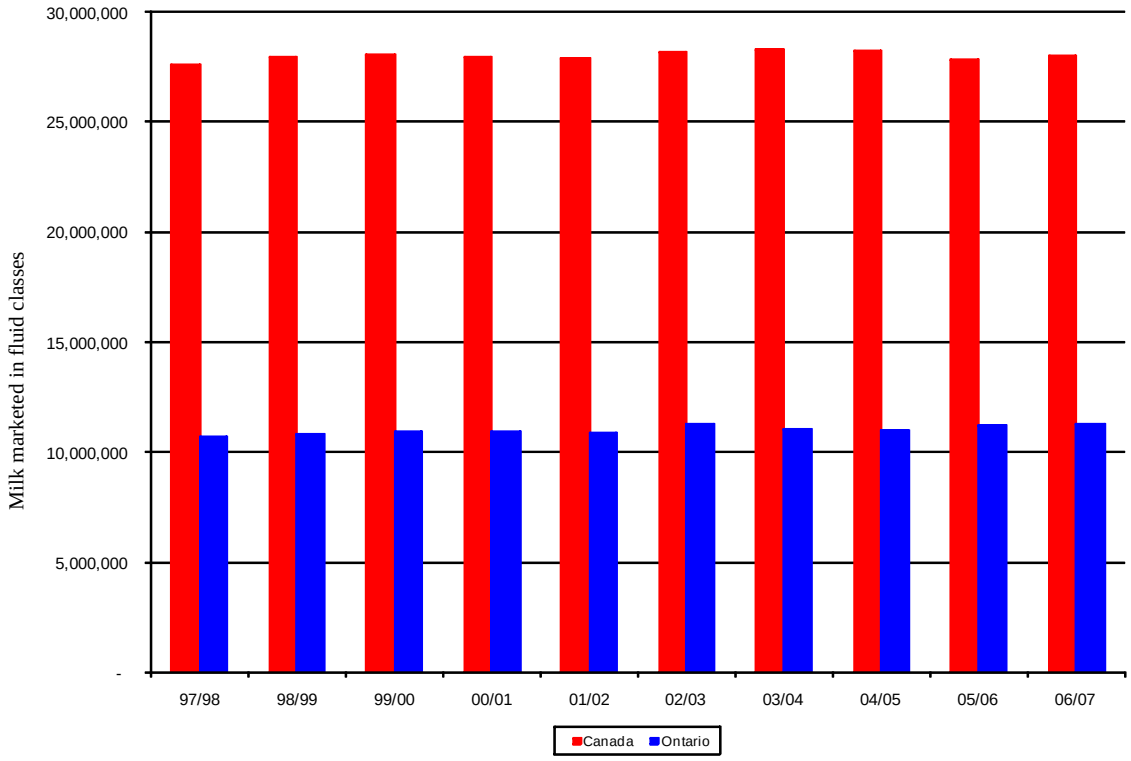


Figure 2 Milk Marketed in Fluid Classes, Canada and Ontario



Sluggish growth in the domestic market is occurring in what is now an inflationary environment for consumers, as well as for input costs faced by Canadian dairy producers. Indeed, inflation of dairy input cost items in many other jurisdictions, such as China, far outstrips inflation observed here. Interestingly, in rapidly growing economies such as China and India, dairy production is struggling to expand fast enough to keep up with demand. It, therefore, seems odd that we would choose this particular time to increase support prices that can only induce a reduction in dairy output.

Implementing Cheese Compositional Standards

Compositional standards for cheese, released just over one year ago, limit the use of non-traditional dairy ingredients in cheese products. The standards were controversial, especially among processors, because they will impose the use of domestic dairy ingredients in place of functional dairy ingredients only recently developed, such as milk protein isolates. Much of the functional dairy ingredient use was imported at a lower price compared with traditional dairy ingredients procured domestically.

Part of the controversy around compositional standards has been compliance. There are concerns that the standards will be difficult to enforce, because processors use different technologies and recipes for products, and have a proprietary interest in not disclosing ingredient use. Alternatively, processors may choose to continue use of functional

ingredients, rather than comply with the compositional standards, and simply stop referring to their products as "cheese" (similar to the advent of "frozen dessert" in place of "ice cream"). Ambiguities in compliance with the regulations could prove dangerous for both producers and processors.

Reducing milk pricing in cheese classes would have the effect of improving incentives for processors to comply with the standards. At the margin, pricing milk in these classes at a price equal to the new, functional ingredients would make processors indifferent between the new ingredients and traditional ones. That no pricing changes have been made thus far in consideration of the new compositional standards for cheese is unfortunate, and probably undermines some processors' willingness to comply. By increasing support prices just as the compositional standards are coming into force, thereby increasing prices in cheese milk classes, the opportunity cost borne by processors will increase and will only exacerbate the potential compliance problems.

WTO Preparedness

Supply management agencies have followed the WTO-Doha Round negotiations very closely, and have offered their input to Canadian trade negotiators. However, if concluded today, a WTO agreement would consist of elements that are clearly negative for the dairy industry under its existing marketing structure. These include the following:

- Elimination of export subsidies. Canadian dairy exports are deemed subsidized, based on the difference between Canadian and world prices for products. Elimination of export subsidies will thus curtail exports and require supply management to be operated under exceptionally tight production discipline
- Reduction in aggregate and product-specific income support. Income support is deemed based on the difference between Canadian and world prices. Reduction in support will limit the extent to which support prices can be held above world price levels by regulation under supply management.
- Increased market access. Tariffs on dairy products range well above 75%, which, under the most recent modalities, would be subject to reductions of 70%, or 23-24% if they are regarded as "sensitive products" (Gifford and Dymond). It is entirely likely that dairy products would be treated as sensitive. In addition, a base increase in tariff-rate quota (TRQ) of 4-6% of domestic consumption will apply, subject to several qualifications. Gifford and Dymond anticipate an increase in TRQ of 5%, assuming Canada applies all dairy products as sensitive.

The domestic milk price is a critical factor in each of the above aspects of WTO compliance and, even with existing support prices, Canada risks being out of compliance and/or out of synch with the direction established in the Doha Round. Figures 3 and 4 below provide some context. Figure 3 presents US SMP prices relative to the CDC support price (pre-July 11th). Even with historically high US prices in 2007 (which effectively formed the world price) Canada's support price is already very high. If world prices were to fall back to levels between the recent highs and previous lows, current Canadian support price levels would appear even higher. At the price spread indicated by

Canadian support prices and historic US prices, even small reductions in tariffs would invite import penetration. Figure 4 presents similar information on Canada/US butter pricing, and similar observations apply.

Figure 3 Canadian Support and US Cash SMP Prices

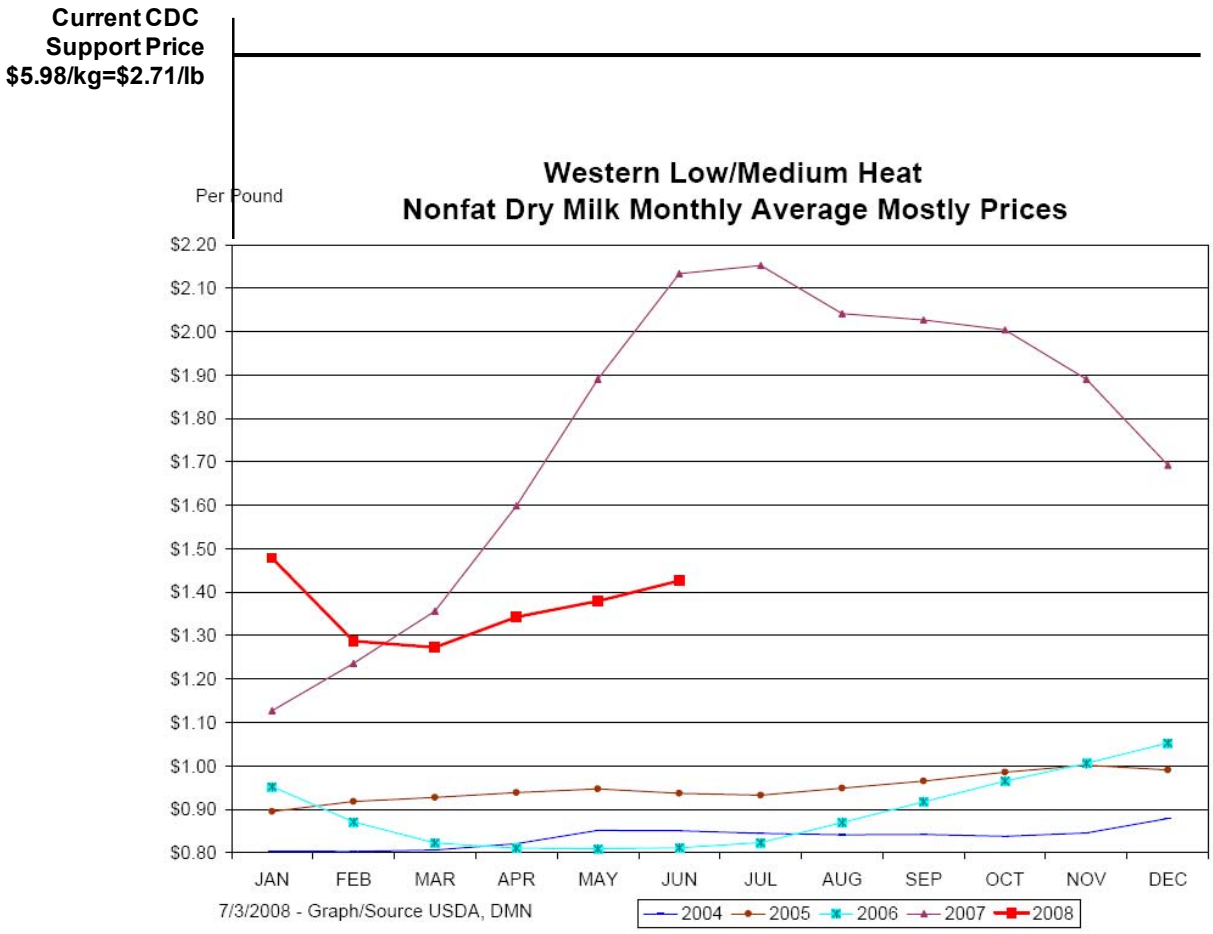
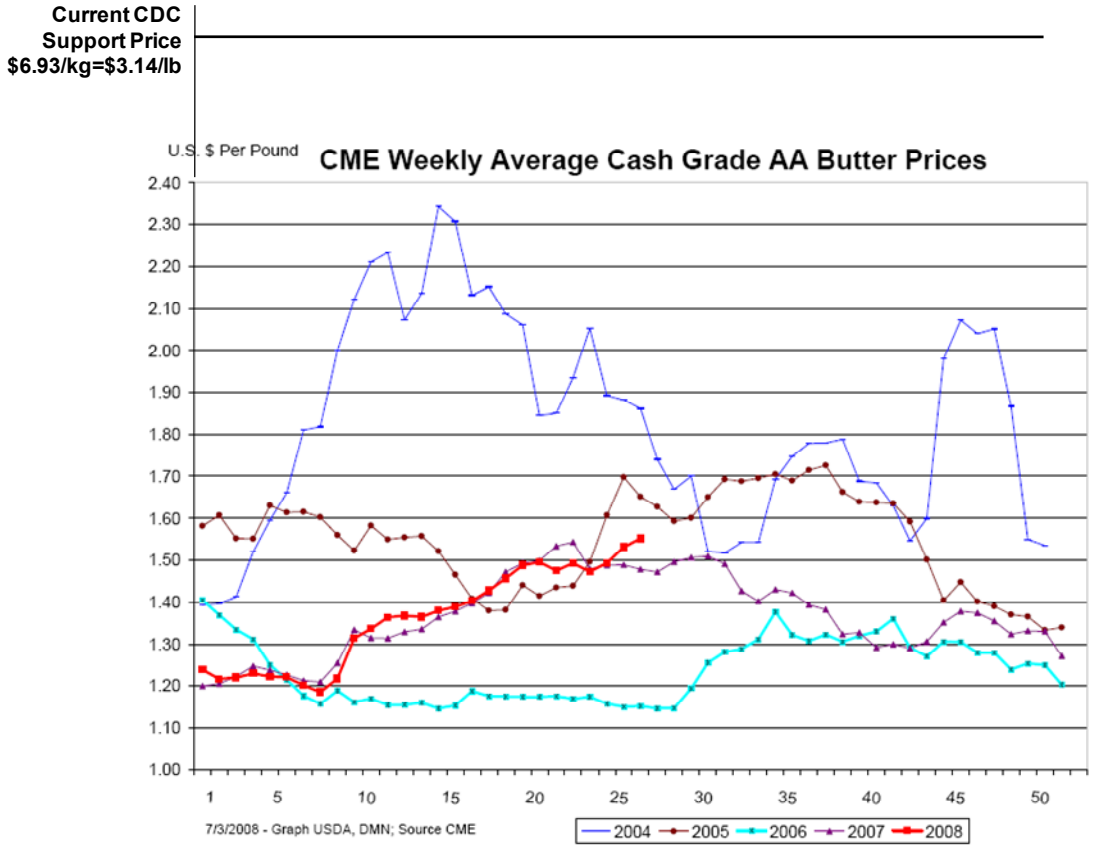


Figure 4 Canadian Support and US Cash Butter Prices



Quota Values

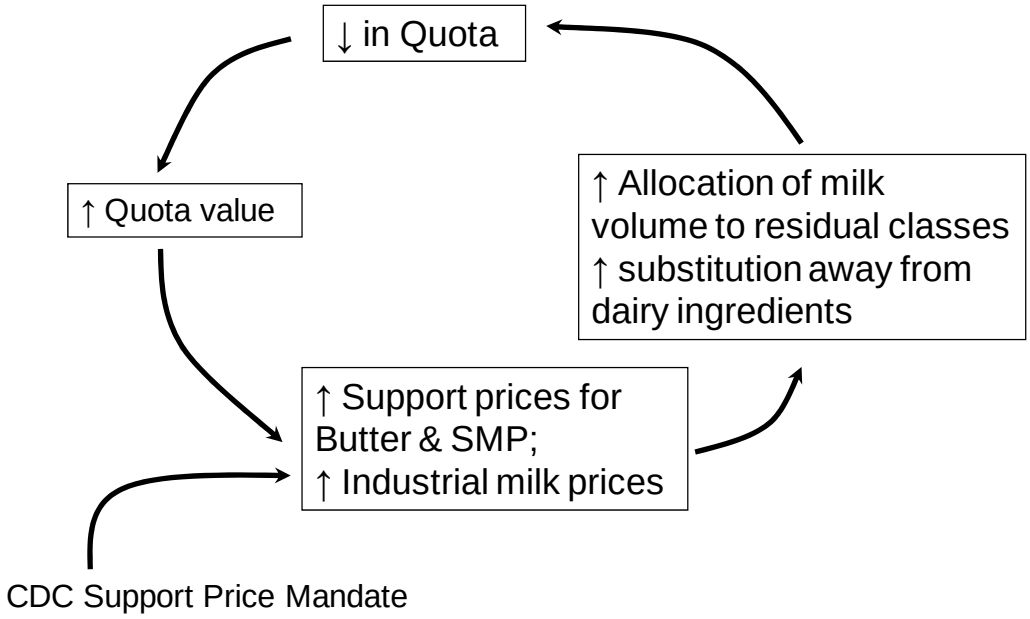
High and increasing quota values have been a source of ongoing concern for provincial milk boards, and most have enacted measures specifically designed to reduce milk quota values. Some provinces have enacted an assessment scheme to effectively freeze quota values at a target level; others have imposed a range of different caps in quota prices. These schemes have generally ignored the central role that milk pricing has in generating observed quota values.

A representation of the economic mechanism is summarized as the "treadmill" in Figure 5 below. The process starts in the bottom left hand corner with price increases implemented by the CDC raising support prices for butter and SMP. The increase in support prices for butter and SMP is applied to butterfat and non-fat solids prices across industrial milk price classes. However, this price increase is met by demand resistance from processors in the form of reduced demand, substitution with imports, and substitution with non-dairy ingredients. Consequently, more milk must be diverted into residual (lower priced) milk classes. This shift in utilization would otherwise cause the blend price to fall, so the quota must be reduced to compensate and restore the blend price to a level proportional to the support price increase. This, finally, puts upward

pressure on quota values. Because CDC support price-setting activity is essentially disengaged from the process, it continues unmitigated, allowing the ironic result of a slow-growing or shrinking dairy market, but with quota values rapidly increasing.

Thus, increasing milk prices will act against the stated objective of provincial boards to mitigate quota price inflation and reduce quota values. Indeed, it could have the perverse effect of ushering in even harsher auxiliary rules to dampen quota values, because the primary driver of quota price inflation is being ratcheted upward.

Figure 5 Milk and Milk Quota Price Treadmill



Conclusion

The Canadian dairy industry entered a transitory phase in 2006 with the formation of the Dairy Industry Working Group and the fulfillment of the CDC's mandate to meet 50% of producers' costs of production. The question is 'transition toward what?' Some provinces, notably Ontario and some western provinces, have advocated a controlled expansion of dairy markets. Among the key aspects of such a strategy is pricing that is competitive with imports and dairy substitutes. It is unclear that this vision is shared universally across provinces. At the same time, with the fulfillment of its mandate, the CDC is searching for a new rationale and mandate for dairy support prices. It is also unclear how the CDC support price mandate is connected to the visions of provincial marketing boards regarding market growth.

Having a CDC support price function working independently of provincial marketing board strategies is dangerous, and risks obviating any expansionary provincial board strategies. With this in mind, the CDC should be directed to freeze support prices at current levels, and conduct a process, coordinated with provincial initiatives and broader

dairy industry strategies, to determine an appropriate role and mechanism for CDC support prices. This should include the potential for suspension of CDC support price-setting authority, with that function effectively devolved to provincial boards and regional pools, or a replacement mechanism developed, which squarely puts pricing authority in the hands of the authorities that sell milk.

For dairy farmers, the current spike in production costs is testing the mettle of latent industry strategies for growth and WTO preparedness. The material reduction in price required as part of these strategies will never come at an easy time, and there will be some pain to adjustment. But responding to the narrow and immediate term context of increasing costs with a price increase removes any pretext of a long-term strategy to strengthen the Canadian dairy industry. Short-term pain with the benefit of longer term gain is what the industry has said it wants, at least as stated by the proponents of controlled growth. It should stay this course and reject a support price increase, particularly in an environment in which consumers are challenged by steep inflation in other consumer goods. There are many ways to mitigate income shortfall of small dairy herd operators in a price reduction strategy, which would be far more strategically beneficial than following the path of price increase and volume reductions. However, these alternatives will never be given the thought deserved as long as the industry can simply raise price in the short term.

References

Gifford, Mike and Bill Dymond. *The Doha Round of WTO Negotiations: Implications For The Canadian Dairy Processing Sector*. Centre for Trade Policy and Law, Carleton University. May, 2008.