

CANADIAN
INTERNATIONAL
TRADE TRIBUNAL



AN INQUIRY INTO THE
IMPORTATION OF DAIRY
PRODUCT BLENDS
OUTSIDE THE COVERAGE
OF CANADA'S
TARIFF-RATE QUOTAS

June 1998

REFERENCE NO. GC-97-001

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IMPORTATION OF
DAIRY PRODUCT BLENDS
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Canadian International Trade Tribunal

The Canadian International Trade Tribunal is an administrative tribunal operating within Canada's trade remedies system. It is an independent quasi-judicial body that carries out its statutory responsibilities in an autonomous and impartial manner and reports to Parliament through the Minister of Finance. The main legislation governing the work of the Tribunal is the *Canadian International Trade Tribunal Act*, the *Canadian International Trade Tribunal Regulations*, the Tribunal's Rules of Procedure, the *Special Import Measures Act*, the *Customs Act* and the *Excise Tax Act*. The Tribunal's primary mandate is to: conduct inquiries into whether dumped or subsidized imports have caused, or are threatening to cause, material injury to a domestic industry; hear appeals of decisions of the Department of National Revenue made under the *Customs Act*, the *Excise Tax Act* and the *Special Import Measures Act*; conduct investigations into requests from Canadian producers for tariff relief on imported textile inputs that they use in their production operations; conduct inquiries into complaints by potential suppliers concerning procurement by the federal government that is covered by *North American Free Trade Agreement*, the *Agreement on Internal Trade* and the *Agreement on Government Procurement*; conduct safeguard inquiries into complaints by domestic producers that increased imports are causing, or threatening to cause, serious injury to domestic producers; and conduct inquiries and provide advice on such economic, trade and tariff issues as are referred to the Tribunal by the Governor in Council or the Minister of Finance.

For further information, write to the Secretary of the Tribunal, 333 Laurier Avenue West, Ottawa, Ontario K1A 0G7.

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Catalogue No. F42-11/1998E

ISBN 0-662-26926-X

Accessible on the Tribunal's Web site at: www.citt.gc.ca

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FOREWORD

This report completes an inquiry by the Canadian International Trade Tribunal (the Tribunal) into the importation of dairy product blends outside the coverage of Canada's tariff-rate quotas. The inquiry was referred to the Tribunal on December 17, 1997, by the Governor in Council on the recommendation of the Minister of Finance, the Minister of Agriculture and Agri-food and the Minister for International Trade.

The Tribunal was asked to examine the domestic market for imports of dairy product blends, as well as their impact on the Canadian dairy industry and their potential impact if they continued to increase. It was also asked to review the legal, technical, regulatory and commercial considerations relevant to these imports. Finally, the terms of reference required the Tribunal to identify options for addressing any problems raised by imports of dairy product blends in the context of Canada's domestic and international rights and obligations.

There was a time when governments had considerably more flexibility with respect to import barriers in agricultural trade. Over the last 10 years, however, there have been fundamental changes in the international regime for trade in agricultural products. Beginning with the *Canada-United States Free Trade Agreement* and then the *North American Free Trade Agreement*, and now with the conclusion of the *World Trade Organization Agreement on Agriculture*, trade in agricultural products, including trade in supply-managed sectors such as the dairy sector, has moved into the realm of rules-based trade.

A rules-based trading system is particularly beneficial to smaller players in the international marketplace, but it obliges all governments to deal with problems that may arise within the established rules. Canada has been an active participant in the formulation of these rules and an advocate of a dispute resolution system grounded in law rather than in bargaining power. These agreed rules apply equally to all Members of the World Trade Organization.

The Tribunal's inquiry process provided a public forum for interested parties to express their concerns and present the options that they favoured and believed viable to deal with any problems raised by imports of dairy product blends. The inquiry process also allowed other interested parties to test those options against the framework of our domestic and international rights and obligations.

The Tribunal has come to the conclusion that the options available for addressing any problems raised by this issue are not without cost to the dairy farmers and/or the Government of Canada. The dilemma is that there are economic consequences for the dairy farmers from imports of butteroil blends, and yet the international rules limit the types of action now available. It is equally true that these same rules provide the dairy farmers with the benefits of increased certainty and protection.

Within the rules-based system, moreover, there are avenues available to the dairy farmers to seek relief from the effects of imports of butteroil blends. As well, the dairy farmers manage the supply of domestic dairy products and have the ability to moderate the effects of these imports on their industry.

The Tribunal wishes to thank the firms, industry associations and government departments that assisted it with this reference. Almost 90 firms completed questionnaires. In seven days of public hearings, the Tribunal heard from 35 witnesses, including 23 from the private sector and 12 from the government.

The inquiry into imports of dairy product blends was an exceptional challenge for the Tribunal. We were honoured to have been asked to take on this important task.

Arthur B. Trudeau

Arthur B. Trudeau
Presiding Member

Pierre Gosselin

Pierre Gosselin
Member

Patricia M. Close

Patricia M. Close
Member

EXECUTIVE SUMMARY

On December 17, 1997, the Governor in Council directed the Canadian International Trade Tribunal (the Tribunal) to inquire into the importation of dairy product blends outside the coverage of Canada's tariff-rate quotas. Imports of dairy product blends, particularly butteroil/sugar blends, were a matter of increasing concern to Canadian dairy farmers. Their representatives requested that the Government of Canada address concerns relating to their importation. The Government considered that the economic impact of such imports and the implications under domestic law and international trade agreements of possible courses of action needed to be thoroughly evaluated.

The terms of reference for the inquiry directed the Tribunal: (a) to examine the factors influencing the domestic market for imports of dairy product blends and the implications of these imports for the Canadian dairy producing and processing industry and other segments of the Canadian food processing industry, including production and revenue levels; (b) to review the legal, technical, regulatory and commercial considerations relevant to the treatment of imports of these products, as well as Canada's international trade rights and obligations under the *North American Free Trade Agreement* (NAFTA) and the World Trade Organization (WTO) Agreement; and (c) to identify options for addressing any problems raised by this issue in a manner consistent with Canada's domestic and international rights and obligations. The Tribunal was asked to hold a public hearing with respect to the inquiry and to report to the Governor in Council by July 1, 1998.

Dairy Product Blends

The Tribunal surveyed importers to identify the range of dairy product blends being imported into Canada outside the coverage of Canada's tariff-rate quotas. The survey identified imports of butteroil blends. It also showed that most of the other products entering under the identified tariff items without tariff-rate quotas were either products for sale at the retail level, such as chocolates, candies, prepared puddings and baby food, or products imported for further use, such as chocolate products, cocoa paste and cheese flavourings.

The Dairy Farmers of Canada did not indicate that any of the products entering under the tariff items examined, other than butteroil blends, were of concern to its members. Of concern to the Dairy Farmers of Canada were imports of butteroil blends and other dairy product blends that could be used as replacements for raw milk, fresh cream or any type of butterfat used in the production of traditional dairy products, such as ice cream and cheese, that benefit from import protection.

The Tribunal is, therefore, satisfied that the products that are relevant to this inquiry are the butteroil blends identified, that is (1) blends of butteroil and sugar, (2) blends of butteroil and glucose, and (3) blends of butteroil and processing solids, such as emulsifying salts. These blends are used in the production of ice cream and processed cheese.

Factors Influencing the Demand for Imported Butteroil Blends

There are a number of factors that influence the demand for imported butteroil blends in the domestic market. The factors include the cost savings on butterfat, the security of supply, the extent of competition in the ice cream market and certain technical benefits, such as the longer shelf life of butteroil blends.

The single most important factor is the cost saving on butterfat that manufacturers of ice cream and processed cheese realize by using imported butteroil blends. The average cost to the processors of the butterfat in the butteroil blends imported and used in 1997 was about \$5.20/kg. Had these processors purchased this butterfat domestically, it would have cost them approximately \$6.25/kg. The use of the imported butteroil blends resulted in a weighted average saving of about \$1.05/kg for the butterfat content replaced in ice cream and processed cheese.

Closely linked to the issue of the price of domestic butterfat is the issue of the supply of domestic butterfat for ice cream processors. Ice cream processors testified that the milk supply management system has been slow to respond to the new realities in ice cream production, specifically the shift of ice cream production from integrated dairies to single-purpose plants. Single-purpose ice cream plants in Ontario can access only half of their butterfat requirements from raw milk supply. The rest must be obtained from the secondary market, which is both a more expensive and a less secure source of supply. In Quebec, a new single-purpose ice cream operation has access to only a small quantity of raw milk and, accordingly, is required to use butter as its source of domestic butterfat.

Implications of Imports of Butteroil Blends for Domestic Industries

Ice cream manufacturers have been importing dairy product blends since the early 1980s and butteroil/sugar blends since the late 1980s. The use of butteroil blends increased rapidly in the period from 1994 to 1996 and then almost doubled in 1997. In 1997, about 6.3 million kilograms of butteroil blends were used in ice cream and processed cheese production. This represented about 12 percent of the total butterfat in ice cream and the replaceable butterfat in processed cheese.

In reaction to this displacement of domestic butterfat, the dairy farmers, in the first part of 1997, exported the butterfat that they otherwise would have sold in the domestic market. On August 1, 1997, the dairy farmers reduced production, in part, in response to imports of butteroil blends. Estimated revenues forgone from the lost domestic sales of butterfat ranged between \$12.8 million (if production were maintained and surplus butterfat exported for the entire year) and \$30.9 million (if production were reduced for the entire year). The total revenues of the dairy farmers in 1997 was \$3.8 billion. In comparison, ice cream and processed cheese manufacturers reduced their costs of butterfat by approximately \$3.2 million in 1997 by using butteroil blends.

The Tribunal expects that the use of butteroil blends will increase in the years ahead, although at a slower pace than in recent years. Some firms have decided not to use the blends for reasons of suitability in their recipes, marketing or economics. Other firms have decided to use the blends. After a period of working with these blends, these firms have strongly held views on the extent to which the blends can be used in their different recipes. Compared to a current penetration level of 12 percent, the Tribunal considers that up to 25 percent of the butterfat in ice cream and the replaceable butterfat in processed cheese could be supplied by the butterfat in imported butteroil blends.

International and Domestic Framework

Over the last 10 years, there have been fundamental changes in the international regime for trade in agricultural products generally and, in particular, for supply-managed products. Beginning with the *Canada-United States Free Trade Agreement* and then NAFTA, and now with the conclusion of the *WTO Agreement on Agriculture*, trade in agricultural products has moved into the realm of rules-based trade. These rules are clearer and more transparent and can be enforced.

In general terms, this means that, where disputes arise with respect to agricultural trade, WTO Members may seek recourse through a dispute settlement system that, unlike that under GATT, cannot be effectively “blocked.” The same is true of disputes arising under NAFTA between Canada, the United States and/or Mexico. That the dispute resolution procedures under these agreements are of benefit, particularly to the smaller players in the international context, is amply demonstrated by the NAFTA panel’s decision upholding Canada’s right to apply tariff-rate quotas to imports of certain US agricultural products, including dairy products.

As part of the *Agreement on Agriculture*, all countries agreed to convert non-tariff barriers, such as import quotas, into tariff equivalents. They also agreed not to revert to such barriers in the future as a means of protecting agricultural production. Canada was thus required to convert the import quotas on dairy products into tariff lines. In consultation with the dairy industry, virtually all blends identified as potential problems at that time were tariffed. However, butteroil blends were not identified as a problem and were not tariffed. Once the tariff lines were incorporated into Canada’s tariff offer, they became part of Canada’s obligations under the WTO.

Options for Addressing Any Problems Raised by this Issue in a Manner Consistent with Canada’s Domestic and International Rights and Obligations

The Tribunal has identified a number of options which are consistent with Canada’s domestic and international rights and obligations. Maintaining the status quo is an option. There are, in addition, a number of options that could lessen the consequences of the imports of butteroil blends on the dairy farmers. Some options require action by the dairy farmers, others by the Government. These options include:

- an appeal to the Tribunal by the dairy farmers of the classification of butteroil blends;

- a safeguard inquiry by the Tribunal pursuant to a complaint by the dairy farmers or a government reference;
- a special class price for butterfat for ice cream and processed cheese;
- a special class price for butterfat for domestic butteroil blends;
- compensation of the dairy farmers for their income losses; and
- a new tariff item for butteroil blends with a different tariff treatment.

It is clear to the Tribunal that there is no option available that comes without a cost to one or more of the stakeholders. The dilemma is that there are economic consequences for the dairy farmers from imports of butteroil blends, and yet the international rules limit the types of action now available. Within the rules-based system, there are avenues available to the dairy farmers to seek relief from the effects of the imports. As well, the dairy farmers manage the supply of domestic dairy products and have the ability to moderate the effects of these imports on their industry.

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CHAPTER I

INTRODUCTION

1. Terms of Reference

This report completes an inquiry by the Canadian International Trade Tribunal (the Tribunal) into the importation of dairy product blends outside the coverage of Canada's tariff-rate quotas (TRQs). The inquiry was referred to the Tribunal on December 17, 1997, by the Governor in Council on the recommendation of the Minister of Finance, the Minister of Agriculture and Agri-Food and the Minister for International Trade.

Pursuant to section 18 of the *Canadian International Trade Tribunal Act*¹ (the CITT Act), the Governor in Council directed the Tribunal:

- (a) to inquire into the matter of the importation of dairy product blends outside the coverage of Canada's TRQs by:
 - (i) examining the factors influencing the domestic market for such imports and the implications of these imports for the Canadian dairy producing and processing industry and other segments of the Canadian food processing industry, including production and revenue levels;
 - (ii) reviewing the legal, technical, regulatory and commercial considerations relevant to the treatment of imports of these products, as well as Canada's international trade rights and obligations under the *North American Free Trade Agreement*² (NAFTA) and the World Trade Organization (WTO) Agreement;
 - (iii) identifying options for addressing any problems raised by this issue in a manner consistent with Canada's domestic and international rights and obligations; and
- (b) to hold a public hearing with respect to the inquiry and to report to the Governor in Council by July 1, 1998.³

The preamble to the terms of reference states that the importation of blends of dairy products is becoming a matter of increasing concern to the Canadian dairy industry; that representatives of Canadian dairy producers have requested that the Government of Canada address concerns relating to the importation of certain of these products, in particular, butteroil/sugar blends; and that the economic impact of this importation and the implications under domestic law and international trade agreements of possible courses of action need to be thoroughly evaluated.

1. R.S.C. 1985, c. 47 (4th Supp.).

2. *Canada Treaty Series*, 1994, No. 2 (C.T.S.), signed on December 17, 1992.

3. The Order in Council, P.C. 1997-1868, is reproduced in Appendix I.

It is important to note that the terms of reference directed the Tribunal to conduct a broad economic inquiry in which the interests of several sectors within the Canadian economy are at issue. The Tribunal was not called upon to adjudicate upon a private dispute between two litigants, as would be the case, for example, in a tariff classification appeal. In this regard, the terms of reference directed the Tribunal to examine “the implications of these imports for the Canadian dairy producing and processing industry and other segments of the Canadian food processing industry” and to identify “options,” as opposed to making a definitive decision or providing recommendations. The conduct of the inquiry in this matter and the nature of this report flow directly from the Tribunal’s mandate under the terms of reference.

2. Conduct of the Inquiry

The inquiry was organized in a manner which provided interested parties with maximum access to the inquiry process. To notify interested parties about the inquiry, the Tribunal issued a press release on January 7, 1998.⁴ In addition, a notice of inquiry,⁵ dated January 7, 1998, was mailed to over 200 interested persons and was published in the January 17, 1998, edition of the *Canada Gazette*, Part I.⁶

The press release and notice invited parties to make preliminary submissions concerning the issues that should be addressed in the course of the inquiry, the scope of the inquiry, the methodology to be used and the possible options. To allow parties to present their views to the Tribunal, a pre-hearing conference was held in Ottawa, Ontario, on January 30, 1998.⁷

As part of this inquiry, an extensive program of research was carried out by the Tribunal’s research and legal staff and consultants engaged by the Tribunal.⁸ The Tribunal staff prepared the following five reports:

- *The International and Domestic Legal Framework*
- *Profile of the Canadian Dairy Industry*
- *Import Regimes for Dairy Products*
- *Possible Reactions of Dairy Producers to Imports of Butteroil/Sugar Blends: Four Scenarios*

4. Tribunal Exhibit GC-97-001-3, Administrative Record, Vol. 1 at 18.

5. Tribunal Exhibit GC-97-001-4, Administrative Record, Vol. 1 at 21.

6. Vol. 132, No. 3 at 94.

7. Appendix II lists the participants at the pre-hearing conference. It also lists the witnesses who appeared at the hearing and their counsel or representatives.

8. The reports prepared by the Tribunal staff and the consultants engaged by the Tribunal are available on the Tribunal’s Web site until July 1, 1999. After that date, the reports can be obtained by contacting the Secretary of the Tribunal. These reports do not necessarily represent the views of the Tribunal, but may be consulted by readers who would like to have more detailed information than is contained in this report.

- *Data Tabulation* — The data tabulation report compiled the data received in over 90 questionnaire responses.⁹ Questionnaires were sent to the Dairy Farmers of Canada (DFC), dairy processors, importers and foreign governments.

Two additional reports were commissioned by the Tribunal for this inquiry. They are:

- *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Treloar Product Development International Inc. and International Food Focus Limited
- *The Impact of Imports of Butteroil/Sugar Blends on the Canadian Dairy Industry - An Economic Analysis using the FARM Model*, Economic and Policy Analysis Directorate, Policy Branch, Department of Agriculture and Agri-Food

Parties were asked to provide written submissions to the Tribunal prior to the public hearing in April. These submissions provided the evidence of parties, their comments on the reports prepared by the staff and consultants, and their views on issues and options relevant to the inquiry. Parties were provided an opportunity to comment on the submissions of other parties in advance of the hearing.

The hearing for this inquiry, including public and *in camera* sessions, was held in Ottawa from April 6 to 9 and from April 14 to 16, 1998. This hearing provided an opportunity for parties to test the evidence on the record, to introduce additional evidence and to submit their final arguments. Arguments were received in written form, and parties were provided an opportunity to respond to the arguments of other parties. In total, 35 witnesses appeared before the Tribunal, including 23 from the private sector and 12 from the government.

Following the hearing, the panel reviewed the evidence and arguments provided by parties who attended the hearing, the submissions and questionnaire responses from other companies and organizations and the reports prepared by the staff and the consultants engaged by the Tribunal. The panel deliberated, made its assessment and prepared this report.

3. Organization of the Report

This report is divided into six chapters, including this introductory chapter. Chapter II discusses the products under inquiry and provides background information on the dairy farmers and the dairy processing industry.

Chapter III examines the factors influencing the domestic market for imported butteroil blends.

Chapter IV examines the implications of the imports of butteroil blends for the Canadian dairy farmers, the Canadian dairy processing industry and other segments of the Canadian food processing industry.

9. Appendix III lists the parties that filed submissions and questionnaire responses, but that did not appear before the Tribunal.

Chapter V reviews the legal, technical, regulatory and commercial considerations relevant to the treatment of imports, as well as Canada's international trade rights and obligations under NAFTA and the WTO Agreement.

Chapter VI identifies options considered by the Tribunal for addressing any problems raised by the issue in a manner consistent with Canada's domestic and international rights and obligations. This chapter addresses options considered by the Tribunal, those set aside and those retained.

Appendix V includes a glossary of terms used in this report.

CHAPTER II

PRODUCT DESCRIPTION AND INDUSTRY PROFILES

1. Product Description

The Tribunal was asked to inquire into the importation of dairy product blends outside the coverage of Canada's TRQs. There are two key phrases relating to the product description, that is, "dairy product blends" and "outside the coverage of Canada's tariff-rate quotas."

a) Dairy Product Blends

For the definition of dairy product blends, the Tribunal looked, first, to the Order in Council, the Government's news release and the backgrounder to it for guidance. The Order in Council uses the phrase "blends of dairy products" and makes a reference to "in particular butteroil/sugar blends."¹⁰ The Government's news release refers to "imports of product mixtures containing dairy blends, including butteroil/sugar blends, that are not covered by tariff-rate quotas,"¹¹ while the backgrounder¹² attached to the news release uses the wording "imports of dairy blends." The backgrounder is the first document in which "dairy blends" is defined. The following definition is given:

Dairy blends are mixtures of dairy products and other food substances for use in the preparation of products such as ice cream, confectionery and bakery goods. In the context of imports into Canada, dairy blends are often created in a manner intended to avoid entering under tariff-rate quota descriptions covering the importation of most dairy products.

The imported dairy product blends normally have a minor weight content¹³ of dairy ingredients. The backgrounder refers to a "specific mixture containing roughly 49% butteroil and 51% sugar that is not subject to tariff-rate quotas."

In the absence of a widely accepted standard definition pertaining to dairy product blends, the Tribunal decided to look at the products in question in the broadest sense possible under the terms of reference so as not to restrict the discussion in the early stages of the inquiry. For this reason, in its questionnaires and throughout its research program, the Tribunal defined the goods subject to this inquiry as:

Dairy product blends outside the coverage of Canada's tariff-rate quotas. Dairy product blends include but are not limited to butteroil/sugar blends. Dairy product blends are mixtures of dairy products and other food substances for use in the preparation of products such as ice cream, confectionery and bakery goods.

10. Tribunal Exhibit GC-97-001-1, Administrative Record, Vol. 1 at 2.

11. Tribunal Exhibit GC-97-001-2, Administrative Record, Vol. 1 at 9.

12. Tribunal Exhibit GC-97-001-2, Administrative Record, Vol. 1 at 11.

13. Blends with less than 50 percent by weight of dairy content.

As part of its research, the Tribunal staff surveyed importers to identify dairy product blends outside the coverage of Canada's TRQs being imported into Canada. Research showed that there were a number of tariff items under which dairy product blends could be imported.¹⁴

The survey identified three types of butteroil blends: blends of butteroil and sugar,¹⁵ blends of butteroil and glucose and blends of butteroil and processing solids. The expression butteroil blends is used in this report to refer to these three blends.

The survey showed that most of the other products entering under the identified tariff items were either finished products for final sale at the retail level, such as finished chocolates, candies, confectionery items, prepared puddings and baby food, or products imported for further use, such as chocolate products, cocoa paste and cheese flavourings.¹⁶ The survey also indicated that a product known as chocolate crumb¹⁷ or milk crumb was being imported under these tariff items outside of the TRQs.¹⁸

In its submissions and testimony, the DFC¹⁹ did not indicate that any of the products surveyed by the Tribunal staff, entering under the tariff items not covered by Canada's TRQs, other than butteroil blends, were of concern to its members. Of concern to the DFC were imports of butteroil blends and other dairy product blends that could be used as replacements for raw milk, fresh cream or any type of butterfat used in the production of traditional dairy products. The DFC "would be concerned if a blend was coming in with any type of butterfat, whether it was butteroil with milk fat or whether it was butter, in the proportion we're talking about, particularly when mixed with sugar, that could be used directly to replace the domestic supply of fat, or solids non-fat."²⁰ Of particular concern was the use of dairy product blends in products, such as ice cream and cheese, that benefit from import protection.²¹

The Tribunal is, therefore, satisfied that the products that are relevant to this inquiry are the butteroil blends identified, that is, blends of butteroil and sugar, blends of butteroil and glucose, and blends of butteroil and processing solids.

Blends of butteroil and sugar are a combination of butteroil and sugar that is melted to form a homogenous suspension suitable for pumping and packaging. Because there is virtually no moisture content in butteroil, the sugar is not in solution in the butteroil, but rather the sugar crystals are suspended in the butteroil. The degree of suspension depends on the temperature of

14. The Tribunal sent questionnaires to importers of products entering Canada under classification No. 1704.90.90.90 and tariff item Nos. 1806.20.90, 1806.90.90, 1901.90.39, 1901.90.40, 1901.90.59 and 2106.90.95.

15. These products were referred to as butteroil/sucrose blends by some parties.

16. *Data Tabulation*, Tribunal Exhibit GC-97-001-80, Administrative Record, Vol. 1E at 16 and 17.

17. Preparation containing dairy products, sugar and chocolate liquor or cocoa in about equal parts.

18. Evidence was presented by processors and users of chocolate crumb to the effect that it was not a dairy product blend according to the Tribunal's definition, but a finished product used in the production of chocolate and confectionery. Participant's Exhibit B-16, Administrative Record, Vol. 15.1.

19. References to the DFC include the Dairy Farmers of Ontario and the Fédération des producteurs de lait du Québec.

20. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 124-25.

21. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 134.

the mixture. The product may be homogenized by some processors to assist in maintaining the suspension. The product is cooled after being put into a bag-in-box package. It is shipped and stored refrigerated or frozen to assure shelf life, as well as suspension of the sugar in the butteroil.²²

Butteroil/sugar blends are of most interest to manufacturers of products containing butterfat and sugar that are looking for a product with a longer shelf life than cream or butter. In these products, subject to formula requirements, the blend can be directly substituted for the equivalent amounts of butterfat and sugar.²³ Typically, a butteroil blend will replace only a part of the butterfat and the sugar in an ice cream formula.

Blends of butteroil and glucose are used as ingredients in the production of processed cheese. The butteroil/glucose blends provide a sweetener that is more conducive to processed cheese.²⁴

Blends of butteroil and processing solids are also used in the production of processed cheese. These blends are described as consisting of 49 percent butteroil and 51 percent of a mixture of food chemicals,²⁵ such as emulsifying salts,²⁶ used in the manufacture of processed cheese.

b) Outside the Coverage of Canada's TRQs

The goods subject to this reference are defined as "dairy product blends outside the coverage of Canada's tariff-rate quotas." A TRQ is a limitation placed on the quantity of imported goods entitled to a specific rate of duty. Under a TRQ, imports up to a certain quantity are, for a specified period of time, admitted duty-free or at a relatively low rate of duty.²⁷ Imports above the in-quota quantity are subject to a higher rate of duty. In the Uruguay Round, the most recent round of multilateral trade negotiations under the *General Agreement on Tariffs and Trade*²⁸ (GATT), Canada and all other contracting parties agreed to convert various non-tariff barriers (NTBs) applicable to agricultural products, such as quotas, into TRQs.

22. *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 12 and 13.

23. *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 13.

24. *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 14.

25. Tribunal Exhibit GC-97-001-12.4, Administrative Record, Vol. 5 at 81.

26. *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 14.

27. For example, the tariff item for "[m]ilk, cream or butter substitutes" provides, in part, as follows:

	---Milk, cream or butter substitutes and preparations suitable for use as butter substitutes:	[MFN Tariff]
2106.90.31	----Milk, cream or butter substitutes, containing 50% or more by weight of dairy content, within access commitment	7.5%
2106.90.32	----Milk, cream or butter substitutes, containing 50% or more by weight of dairy content, over access commitment	224% but not less than \$2.23/kg

28. Geneva, March 1969, GATT BISD, Vol. IV.

The butteroil blends at issue have been classified by the Department of National Revenue (Revenue Canada) under tariff item No. 2106.90.95²⁹ of the schedule to the *Customs Tariff*³⁰ as “[o]ther preparations, containing in the dry state, over 10% by weight of milk solids but less than 50% by weight of dairy content.”³¹ That tariff item is not subject to a TRQ. For a detailed discussion of the classification of these blends, please see Chapter V of this report.

2. Industry Profiles

a) Dairy Farmers

The Canadian dairy farming sector³² is the third most important agricultural sector in terms of farm cash receipts, after the grains and red meat sectors. Revenue to the dairy farming sector from milk sales in Canada, plus the federal dairy subsidy of \$145 million, totalled \$3.8 billion³³ in the 1996-97 dairy year.³⁴

There are two markets for milk in Canada: the fluid milk market for table milk and fresh cream and the industrial milk market for manufactured dairy products, such as butter, cheese, ice cream and yogurt. Total milk production in the 1996-97 dairy year was 72.7 million hectolitres. The fluid milk market accounted for 38 percent of milk production, or 27.4 million hectolitres, and the industrial milk market accounted for 62 percent, or 45.3 million hectolitres of milk. Quebec is the largest producer of milk in Canada, with 38.1 percent of the national production, followed by Ontario with 33.4 percent and Alberta with 8.3 percent. The average herd size in Ontario is 43 cows per farm. In Quebec, the average herd size is 40 cows per farm. There are about 24,000 dairy farms in Canada.

Milk is priced using a multiple component pricing system. Dairy farmers are paid on the quantities of butterfat, protein (mainly casein) and other solids (lactose and minerals) in the milk shipped.³⁵ The prices that processors pay for components vary according to a milk classification system, which is made up of five classes. Products that benefit from TRQs, such as ice cream and cheese, have a higher price for their dairy components than do products, such as confectionery and bakery products, that do not benefit from TRQs.

Marketing boards and/or agencies in most provinces purchase raw milk from dairy farmers and sell it to processors for the manufacture of dairy products. The milk is shipped directly from farms to processing plants. The marketing boards and/or agencies use a plant allocation system to direct milk to processing plants. Processors pay the appropriate price for

29. This tariff item came into force on January 1, 1995, as a result of *WTO Technical Amendments Order, No. 2*, SOR/95-20, December 20, 1994, *Canada Gazette* Part II, Vol. 129, No. 1 at 53.

30. R.S.C. 1985, c. 41 (3rd Supp.).

31. As of January 1, 1998, the tariff rate under this tariff item for imports from the United States or Mexico is zero. The MFN rate is 9.5 percent.

32. *Profile of the Canadian Dairy Industry*, Tribunal Exhibit GC-97-001-78, Administrative Record, Vol. 1D at 18, 23 and 24.

33. Tribunal Exhibit GC-97-001-60, Administrative Record, Vol. 17A at 259.

34. The Canadian dairy industry operates on a dairy year which runs from August 1 to July 31.

35. Tribunal Exhibit GC-97-001-104A (protected), Administrative Record, Vol. 2A at 5.

the components of raw milk to the marketing boards and/or agencies, which pool the revenues and distribute them to the dairy farmers according to their production.

b) Milk Processors

Milk processors³⁶ include processors of such dairy products as table milk, cream, butter, cheese, ice cream and yogurt. In 1996, dairy products were manufactured and shipped from an estimated 285 processing plants located across Canada. These products were valued at \$7.8 billion and represented 14 percent of all Canadian food and beverage production.

The processing industry is heavily concentrated in Ontario and Quebec, which account for 71 percent of output. Quebec is the dominant producer of industrial milk and is the country's leading producer of butter, cheese, milk powders and yogurt, while Ontario is the major ice cream producer. There is no production of butteroil blends in Canada and only limited production and use of butteroil.

There has been a trend toward consolidation in the Canadian dairy processing industry. Industry ownership has become highly concentrated. Three organizations have annual dairy product sales of more than \$1 billion, and five organizations control 50 percent of the industry's plants, accounting for more than 60 percent of production.³⁷

Among the dairy processors, it is the ice cream manufacturers and the processed cheese manufacturers that are of principal interest in this inquiry. In the ice cream industry, three major processors, Good Humor-Breyers, Nestlé Canada Inc. (Nestlé) and David Chapman's Ice Cream Limited (Chapman's), account for the majority of the ice cream market in Canada.

Good Humor-Breyers is a division of UL Canada Inc., which is a wholly owned subsidiary of Unilever Canada Limited.³⁸ There have been a number of acquisitions by the Unilever group of companies, including the Dickie Dee ice cream business in 1992, the Popsicle and Klondike businesses in 1993, the ice cream, frozen yogurt and frozen novelties business from Beatrice Foods in 1994, and the ice cream, frozen yogurt, frozen novelties and frozen dessert business from Natrel Inc. in 1995.

In 1997, Nestlé acquired the assets of Ault's Frozen Products Division and purchased Dairyworld Foods' Ice Cream Products Group. Other prominent firms in the ice cream business include Agropur, Baskin Robbins Canada and Lucerne Foods.

36. *Profile of the Canadian Dairy Industry*, Tribunal Exhibit GC-97-001-78, Administrative Record, Vol. 1D at 24 and 25.

37. Tribunal Exhibit GC-97-001-60 (single copy), Administrative Record, Vol. 17A at 121; and Tribunal Exhibit GC-97-001-53, Administrative Record, Vol. 1B at 160.

38. Unilever Canada Limited is a wholly owned subsidiary of Unilever PLC.

In the processed cheese industry, three major processors, Kraft Canada Inc., Parmalat Canada and Saputo Group Inc., account for most of the market.³⁹ Parmalat Canada entered the Canadian market in 1997 by acquiring Beatrice Foods and part of Ault Foods Limited.⁴⁰

For the calendar years 1992 to 1996, the production of ice cream mix⁴¹ in Canada averaged 181.9⁴² million kilograms annually. For the dairy years 1991-92 to 1996-97, the production of processed cheese averaged 76.2 million kilograms annually.⁴³ Over the same time periods, the ice cream industry utilized, on average annually, approximately 21.8 million kilograms of butterfat from domestic and import sources,⁴⁴ and the processed cheese industry utilized, on average annually, approximately 17.5 million kilograms of butterfat from domestic and import sources.⁴⁵ In 1997, 283.8 million kilograms of butterfat were used in the fluid and industrial milk markets in Canada.⁴⁶

39. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 446.

40. Ault Foods Limited retained the trade of cheese and milk powders. Tribunal Exhibit GC-97-001-53, Administrative Record, Vol. 1B at 162.

41. Ice cream mix is the industrial product from which ice cream is made. It typically contains between 10 and 12 percent butterfat by volume.

42. Participant's Exhibit L-5A, Scenario 1, Administrative Record, Vol. 15C.

43. Participant's Exhibit L-5A, Scenario 2, Administrative Record, Vol. 15C.

44. Participant's Exhibit L-5A, Scenario 1, Administrative Record, Vol. 15C.

45. Participant's Exhibit L-5A, Scenario 2, Administrative Record, Vol. 15C.

46. Tribunal Exhibit GC-97-001-85.4 (single copy), Administrative Record, Vol. 17C at 85.

CHAPTER III

FACTORS INFLUENCING THE DOMESTIC MARKET FOR IMPORTED BUTTEROIL BLENDS

There are a number of factors that influence the domestic demand for imported butteroil blends. First and foremost is the cost saving realized by manufacturers of ice cream and processed cheese that use imported butteroil blends. Other factors include supply issues facing certain manufacturers of ice cream in Ontario and Quebec, the competition in the ice cream industry and certain technical benefits derived from the use of butteroil blends. The following sections discuss the main factors identified by the Tribunal during this inquiry.

1. Cost Savings

The lower cost of butterfat from imported butteroil blends compared to the cost of butterfat from domestic ingredients provides an economic incentive for certain manufacturers of ice cream and processed cheese to use imported butteroil blends.

The cost incentive to use imported butteroil blends does not extend to all processors that use dairy ingredients. Some processors, such as those in the confectionery and baking industries, have access to lower-priced domestic milk ingredients through special class prices. For other processors, such as the higher-quality niche players, a butteroil blend is not a suitable ingredient in their product recipes.⁴⁷ For others still, such as smaller integrated and local dairies that produce smaller volumes of ice cream, the cost savings associated with imported butteroil blends may not be worth the additional investment and labour required to use butteroil blends.⁴⁸

With respect to the sugar component of butteroil/sugar blends, the evidence indicates that the price of sugar in Canada is competitive with the world price of sugar.⁴⁹ A major importer, International Dairy Ingredients Inc. (IDI), appeared before the Tribunal and stated that the price of sugar in butteroil/sugar blends is essentially the same as the price that Canadian customers currently pay. Moreover, none of the users of the butteroil/sugar blends indicated that the blends were being used to reduce their sugar costs. For these reasons, the Tribunal considers that butteroil/sugar blends are purchased for the savings on the butterfat component of the blends.

47. Tribunal Exhibit GC-97-001-18.18, Administrative Record, Vol. 9A at 174. Schwan's Canada, Ltd. submitted that it has not considered sourcing blends because its philosophy is to use the freshest available source of supply of milk fat possible.

48. Tribunal Exhibit GC-97-001-26.2, Administrative Record, Vol. 1 at 99. Reid's Dairy Products submitted that, in light of its limited ice cream volume, it cannot justify the equipment required to liquefy butteroil blends.

49. *The Impact of Imports of Butteroil/Sugar Blends on the Canadian Dairy Industry - An Economic Analysis using the FARM Model*, Tribunal Exhibit GC-97-001-83, Administrative Record, Vol. 1G at 12; Tribunal Exhibit GC-97-001-70, Administrative Record, Vol. 1C at 19-21; and *Data Tabulation*, Tribunal Exhibit GC-97-001-80, Administrative Record, Vol. 1E at 56.

a) Prices of Domestic Butterfat

Milk is priced in Canada on a component basis. When purchasing raw milk, a processor pays for the components of milk, specifically, butterfat, protein and other solids. Currently, milk produced in Canada is sold to processors through a common classification system for the manufacture of products according to the following classes.⁵⁰ The processors pay the appropriate class price for the components of raw milk to the marketing boards and/or agencies that pool the revenues and distribute them to the dairy farmers according to their production.

- Class 1
 - a) fluid milk
 - b) fluid cream
 - c) milk-based beverages
 - d) fluid milk for the Yukon and Northwest Territories (Alberta only)
- Class 2 yogurt and ice cream
- Class 3
 - a) specialty cheeses
 - b) cheddar cheese
- Class 4
 - a) butter, milk powders and condensed milk for ingredient purposes
 - b) condensed milk for retail
 - c) new products for the domestic market
 - d) animal feed and unclassified products
- Class 5
 - Classes 5a), b) and c) are essentially for the domestic market:
 - a) cheese ingredients for further processing, e.g. dry and canned sauces and macaroni and cheese dinner
 - b) all other dairy products for further processing
 - c) confectionery
 - Classes 5d) and e) are for the export market only:
 - d) specific negotiated exports for dairy products (fixed volumes)
 - e) surplus removal (based on milk production not needed for the domestic market)

On the basis of this milk classification system, processors pay different prices for milk components depending on the end use of the products. The prices in Classes 1 to 4 are relatively stable and higher than the prices in Class 5. Table 1 illustrates the range of prices observed in the various classes. It provides a comparison of the end products in various classes and the related average prices paid to the dairy farmers for the first six months of 1997 on a component basis. These prices represent an average for all of Canada.

50. Tribunal Exhibit GC-97-001-85.5 (single copy), Administrative Record, Vol. 17C at 87.

Table 1

**AVERAGE SELECTED MILK COMPONENT PRICES BY CLASS AND PRODUCT
JANUARY TO JUNE 1997**

Class	Product	Component Prices (\$/kg)			\$/hl
		BF	Protein	OS	Total
1a)	Fluid Milk	5.46	6.56	3.70	61.61
1b)	Table Cream	5.43	5.22	3.58	56.62
2)	Yogurt and Ice Cream	5.43	4.00	3.89	54.37
3a)	Specialty Cheeses	5.47	9.04	0.58	51.78
3b)	Cheddar Cheese	5.48	8.59	0.58	50.40
4a)	Butter, Ingredients	5.45	3.51	3.51	50.82
4b)	Condensed Milk	5.44	3.62	3.62	51.71
Classes 5a), b) and c) are essentially for the domestic market					
5a)	Specialty Cheeses	2.99	7.01	0.57	36.37
5a)	Cheddar Cheese	3.05	7.01	0.57	36.55
5b)	Fluid Milk	3.08	2.92	2.92	37.00
5b)	Creams	3.05	2.92	2.92	36.89
5b)	Yogurt	3.05	2.92	2.92	36.91
5b)	Butter, Ingredients	2.98	2.91	2.94	36.75
5c)	Milk products for Confectionery	2.64	2.59	2.59	32.51
Classes 5d) and e) are for the export market only					
5d)	Milk	2.18	2.18	2.12	27.28
5d)	Cream	2.46	2.46	2.46	30.69
5d)	Yogurt	2.57	2.57	2.57	32.06
5d)	Specialty Cheeses	1.94	4.87	0.51	25.37
5d)	Cheddar Cheese	3.97	6.72	0.51	38.56
5d)	Butter	1.83	1.83	1.83	24.91
5e)	Milk	2.15	2.15	2.15	26.87
5e)	Cream	2.20	2.20	2.20	27.47
5e)	Specialty Cheeses	1.50	4.54	0.51	22.75
5e)	Cheddar Cheese	1.86	4.92	0.51	25.23
5e)	Butter	1.28	1.28	1.28	15.98

Notes: BF = butterfat, hl = 100 litres, OS = other solids.

One hectolitre of milk = approximately 3.6 kg of butterfat, 3.2 kg of protein and 5.7 kg of other solids.

Source: Canadian Dairy Commission.

Ice cream manufacturers obtain their butterfat requirements at the Class 2 price, and processed cheese manufacturers obtain their butterfat requirements at the Class 3b) price. In September 1997, the price of butterfat sold into Classes 2 and 3 was \$5.49/kg.⁵¹ This was the price paid by ice cream and processed cheese manufacturers that were able to purchase their butterfat requirements in the form of raw milk.⁵² However, it does not include the cost to separate the butterfat from the rest of the components of the milk.⁵³ The Class 2 price of butterfat can vary among provinces. Ice cream manufacturers mentioned that Alberta has the lowest Class 2 price in Canada.⁵⁴

Since 1992, single-purpose ice cream processors in Ontario have been unable to purchase more than 50 percent of their butterfat requirements at the Class 2 price. Their remaining butterfat requirements must be obtained from other sources, typically from the skim-off⁵⁵ market where it is more expensive because additional processing costs and profits of the intermediate processors are included. The price of butterfat from the skim-off market is a market price. It can vary depending on the competing demands of different users for butterfat during the year. In 1997, Ontario ice cream manufacturers paid up to \$6.80/kg and higher⁵⁶ for butterfat purchased from the skim-off market. Chapman's indicated that the price of butterfat from the skim-off market had increased by 13 percent since 1994.⁵⁷

The prices paid for butterfat from domestic sources by the ice cream and processed cheese industries are considerably higher than the prices paid for butterfat by the confectionery and bakery industries. Ice cream and processed cheese are protected from import competition, whereas confectionery and bakery products are not. In this respect, Classes 5a), b) and c) milk is available to manufacturers of confectionery and bakery products and other manufacturers, allowing them to compete in the domestic market with imports.

b) Prices of Butterfat in Butteroil Blends

Ice cream manufacturers indicated in their responses to the Tribunal's questionnaire that, in order to reduce the cost of butterfat used in the production of frozen dairy products, they looked to other sources and began to purchase imported dairy product blends in the early 1980s.⁵⁸ A similar long-term history of using imported dairy product blends has not been identified for processed cheese manufacturers.

51. Tribunal Exhibit GC-97-001-105B, Administrative Record, Vol. 1C at 214.8.

52. Participant's Exhibit L-5A, Scenario 2, Administrative Record, Vol. 15C.

53. There is a cost associated with skimming off the butterfat/cream. This cost may be offset by the processors by selling the protein and other solids non-fat on the secondary market. *Transcript of In Camera Hearing*, Vol. 2, April 7, 1998, at 95.

54. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 552.

55. Skim-off is the excess butterfat, in the form of cream, that is extracted from raw milk.

56. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 624.

57. Closing argument on behalf of Chapman's and Good Humor-Breyers at 16, Administrative Record, Vol. 29.

58. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 688.

Questionnaire replies were used to quantify the savings, in terms of butterfat costs, to the ice cream and processed cheese manufacturers from using butteroil blends.⁵⁹ The weighted average cost of the butterfat contained in the imported butteroil blends used in 1997 was about \$5.20/kg. If processors had purchased this butterfat domestically, it would have cost them approximately \$6.25/kg. The use of the imported butteroil blends resulted in a weighted average saving of about \$1.05/kg for the butterfat content replaced in ice cream and processed cheese.

Ice cream manufacturers noted that incorporating butteroil blends or butter into the production process is more labour intensive than incorporating liquid ingredients and that there are extra labour costs associated with it.⁶⁰ Nonetheless, one witness stated that the cost advantages of using butteroil/sugar blends offset the additional labour costs and potential additional capital that may be required.⁶¹

In assessing the factors that influence the demand in the domestic market for butteroil blends, the Tribunal considered the relative importance of the cost savings compared to the supply issues. In this regard, the Tribunal finds the evidence respecting production of ice cream in Alberta to be instructive. The evidence indicates that, in Alberta, there are no issues relating to the domestic supply of butterfat to ice cream manufacturers.⁶² Despite this, imported butteroil/sugar blends are being used in Alberta to produce ice cream. Evidence regarding the use of butteroil/sugar blends by processors in Alberta suggests that price is the primary reason for using the imported blends.

In the Tribunal's view, the price advantage of the butterfat in the imported butteroil blends is the most important factor influencing the demand in the domestic market for butteroil blends.

2. Supply Issues Regarding Domestic Butterfat

Closely linked to the issue of the price of domestic butterfat is the issue of the supply of domestic butterfat for ice cream processors. Ice cream processors can obtain butterfat for the production of ice cream from several sources: cream which is approximately 40 percent butterfat; raw milk which is close to 3.9 percent butterfat; butter which is about 80 percent butterfat; butteroil which is 99.3 percent butterfat; or, for certain applications, they can use an imported butteroil/sugar blend which has a butterfat content of just under 49 percent,⁶³ as will

59. For each individual processor, the cost savings were calculated as its domestic cost of butterfat replaced per kilogram less the cost of the butterfat per kilogram in the butteroil blend. The butterfat cost in the imported blend was calculated as the cost per kilogram that the processor paid for the blend less the cost per kilogram that the processor paid for its domestic sugar/sweetener ingredients.

60. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 97.

61. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 100.

62. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 553.

63. To convert the butteroil content of the blend to butterfat: 49 percent butteroil times 99.3 percent butterfat content = 48.65 percent butterfat in the blend.

be discussed later. In terms of the taste qualities of the final product, the preferred source of butterfat for ice cream is fresh cream.⁶⁴

Traditionally, ice cream production was part of an integrated dairy with a fluid milk plant. In a fluid milk plant, raw milk is processed into table milk and cream for the consumer market. Since raw milk typically contains more butterfat than table milk, some butterfat in the form of cream is “skimmed off” the raw milk to produce the table milk with the desired lower fat content. This cream or “skim-off” can be sent from the fluid operation to ice cream processing. As a result, the integrated dairies have a ready supply of cream for use in ice cream production. Recently, however, there has been a trend towards single-purpose ice cream plants which do not have this ready supply of cream.

Ice cream processors testified that the milk supply management system has been slow to respond to the new realities in ice cream production, specifically the shift of ice cream production from integrated dairies to single-purpose plants. The following sections describe how ice cream plants are supplied with butterfat in Ontario and Quebec and some of the concerns regarding milk supply that have been expressed by the ice cream manufacturers. These sections focus on production in Ontario and Quebec, which represent approximately 67 percent of the production of ice cream in Canada.⁶⁵

a) Current Supply Issues in Ontario

In Ontario, the Dairy Farmers of Ontario’s (DFO) Plant Supply Quota Policy⁶⁶ provides for the ice cream plant milk entitlement quota (MEQ). The MEQ policy states that a single-purpose ice cream plant shall be limited to sourcing no more than 50 percent of its butterfat requirements from raw milk.⁶⁷ As a result of this restriction on the access to raw milk, the remainder of its butterfat requirements are obtained, typically in the form of skim-off, from the secondary market. As discussed in the preceding section, butterfat from the secondary market comes at a higher price than butterfat from raw milk.

In addition, according to the ice cream processors, the secondary market for butterfat is a less secure source of supply. They argued, for example, that some dairies that manufacture butter would rather process cream into butter than sell cream on the secondary market. These butter manufacturers will satisfy internal production demands first.⁶⁸ As a result, during the summer of 1997, the available supply of surplus cream was substantially reduced.

Good Humor-Breyers observed that the ice cream season partly overlaps with the berry season, during which time the demand for cream is very high. Shipments of cream to the

64. Participant’s Exhibit D-1 at 3, Administrative Record, Vol. 15A.

65. *Profile of the Canadian Dairy Industry*, Tribunal Exhibit GC-97-001-78, Administrative Record, Vol. 1D at 27-28.

66. Participant’s Exhibit D-1, Administrative Record, Vol. 15A.

67. The MEQ is fixed and allotted for the quota supply period, which is the dairy year. The amount of milk delivered by the DFO to a plant, in any one month, equals that plant’s previous month’s utilization. Variations in monthly demand are to be reported to the DFO.

68. Participant’s Exhibit D-1, Administrative Record, Vol. 15A.

ice cream plant may be diverted to other end uses. As a result, alternate sources of butterfat must be found.⁶⁹ Good Humor-Breyers stated that, during the 1996 ice cream season, it had to juggle production schedules because of the short supply of cream from skim-off. As well, it, like other single-purpose ice cream manufacturers in Ontario, has its MEQ milk sent to a dairy for separation of the components. At times, the dairies are too busy to handle the ice cream processors' raw milk. Although there is no shortage of raw milk, the ice cream manufacturers are forced to purchase skim-off from the marketplace.⁷⁰

Chapman's indicated that the ice cream industry's busiest season is from April to August and that it experiences serious supply problems during that period each year.⁷¹ Chapman's feels that, since it competes against ice cream products of fully integrated dairies, its requirements are at the bottom of the list in terms of being supplied with cream.

The processors argued that, in order to avoid these tight supply situations, they hold inventories of imported butteroil blends to help smooth out the production schedule during the busy summer months,⁷² a time during which they cannot afford to be without input ingredients.

In response, the DFO indicated that the MEQ has a back-up policy to guarantee the supply of butterfat to ice cream processors. If an ice cream company can prove that it cannot source skim-off for the other 50 percent of its butterfat requirements, then the DFO will attempt to find it and, if it cannot find any, additional raw milk will be provided above the 50 percent MEQ volume.⁷³

The Tribunal agrees that there are unique supply issues facing single-purpose ice cream plants. The uncertainties inherent in sourcing butterfat from the skim-off market cause very real concerns to the single-purpose ice cream processors, even if it can be argued that there never have been situations where they were actually left without a source of butterfat. To ensure a secure supply of butterfat, the single-purpose ice cream processors have imported butteroil/sugar blends. The relatively long shelf life of these blends in inventory makes them ideal to help mitigate supply uncertainties.

b) Supply Issues in Quebec

The milk allocation system in Quebec is governed by the milk marketing agreement.⁷⁴ Under this agreement, milk allocation to existing operations is based on milk purchases in the previous dairy year, plus a provision for increased use of up to 5 percent. For new operations with no historical volumes, only a share of a 5 million litre pool of milk is available, subject to

69. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 626.

70. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 636.

71. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 689.

72. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 632.

73. Participant's Exhibit D-1, Appendix 3 at 13, Administrative Record, Vol. 15A.

74. The agreement is signed by the Fédération des producteurs de lait du Québec which represents the producers, the Lactel group which represents the co-operatives, Agropur which is a co-operative and The Quebec Dairy Council which represents private processing companies.

an application to the Fédération des producteurs de lait du Québec. In subsequent years, this share can be increased by 5 percent.

Good Humor-Breyers purchased a plant in Quebec in 1995 to manufacture frozen dairy products for the foodservice sector and for retail sale. When Good Humor-Breyers purchased this plant from Natrel Inc., it lost its historical standing and was considered to be a new operation in Quebec. As a result, Good Humor-Breyers' new Montréal plant had no historical volume of milk allocated to it. Good Humor-Breyers estimated that the total volume in the pool of milk available for all new operations from the milk allocation system of 5 million litres is less than 10 percent of its milk requirements for that plant.⁷⁵ Therefore, a share of that available milk supply is simply not a viable source of butterfat for Good Humor-Breyers. As a result, Good Humor-Breyers is forced⁷⁶ to use butter as a source of domestic butterfat for its ice cream operation in Quebec.⁷⁷

In the Tribunal's view, the fact that Good Humor-Breyers must use butter as its source of domestic butterfat for ice cream production in Quebec influences its demand for butteroil/sugar blends in that province. Testimony indicated that there is a preference to use cream in ice cream production so as to give the ice cream a fresher taste. When there is access to cream, there is a price and quality trade-off between using domestic cream for a fresher taste and an imported butteroil/sugar blend, a less expensive ingredient. However, when the domestic ingredient is butter, this quality consideration is no longer a factor in the purchase of butteroil blends.

3. Increased Competition in the Ice Cream Industry

As part of the supply-managed dairy industry, ice cream production is sheltered from import competition by TRQs. Notwithstanding the limited import competition, the evidence reveals a competitive marketplace for ice cream products.

For a number of reasons, the ice cream market is currently a buyer's market. First, there is the influence of the consumer. Ice cream is perceived as a commodity product by consumers,⁷⁸ making it difficult for retailers and manufacturers to raise prices, particularly at the lower end of the market. In addition, evidence suggests that, if the ice cream manufacturers do not keep prices competitive, the retailers and consumers will turn to other desserts, such as pies or pastries. Second, there is the buying power of the large grocery chains.⁷⁹ Their negotiating power keeps the wholesale prices of ice cream low, especially for the high-volume, lower-priced, economy ice cream. Third, there is the excess production capacity of approximately 40 percent⁸⁰ in the ice cream industry, which gives an incentive to firms to hold

75. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 647-48.

76. Participant's Exhibit D-2, Administrative Record, Vol. 15A.

77. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 627.

78. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 196.

79. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 501-2.

80. *Data Tabulation*, Tribunal Exhibit GC-97-001-80, Administrative Record, Vol. 1E at 42.

on to contracts even at low prices. Finally, there is a high degree of competition between two global competitors, Unilever Canada Limited and Nestlé.⁸¹

These pressures have made it difficult for domestic ice cream processors to raise prices at a time when the cost of butterfat on the open market and other ingredients and the cost of packaging are increasing.⁸² For example, one ice cream processor testified that the last time that his company was able to take a price increase was three years ago and that was the first price increase in 10 years.⁸³ Another ice cream processor spoke of rebates and discounts to retailers and promotions necessary to stay competitive in the marketplace. The pressure for low prices, the cost increases and the overcapacity in ice cream production have resulted in a margin squeeze that has had a negative effect on the financial performance of the ice cream industry.

In the Tribunal's view, the ice cream processors have looked to less expensive ingredients, such as butteroil/sugar blends, to help meet the low prices demanded in the marketplace, to help offset cost increases in other ingredients and packaging and to help improve financial performance.

4. Technical Benefits of Using Butteroil Blends

While recognizing that the main reasons for using butteroil blends are cost savings and, to a lesser extent, supply considerations, processors explained that some technical advantages were derived from using the blends in the production of ice cream.

The ice cream processors stated that butteroil/sugar blends can be stored at room temperature for up to two months, and much longer if frozen. This long shelf life allows production flexibility and helps stretch the supply of fresh dairy products over the peak production period. Also, butteroil/sugar blends are said to be easier to melt than butter.

Good Humor-Breyers and Chapman's argued that the negligible moisture content of the blends compared to butter means fewer problems with the stability, quality and flavour of the final product.⁸⁴

Nestlé said that it is possible to reformulate existing ice cream mixes and to restandardize mixes using butteroil/sugar blends because the two prime components of the blends are key factors in measuring the quality of a batch of ice cream mix.⁸⁵

81. Tribunal Exhibit GC-97-001-18.12, Administrative Record, Vol. 9A at 27.

82. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 550.

83. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 695.

84. Closing argument on behalf of Chapman's and Good Humor-Breyers at 18, Administrative Record, Vol. 29.

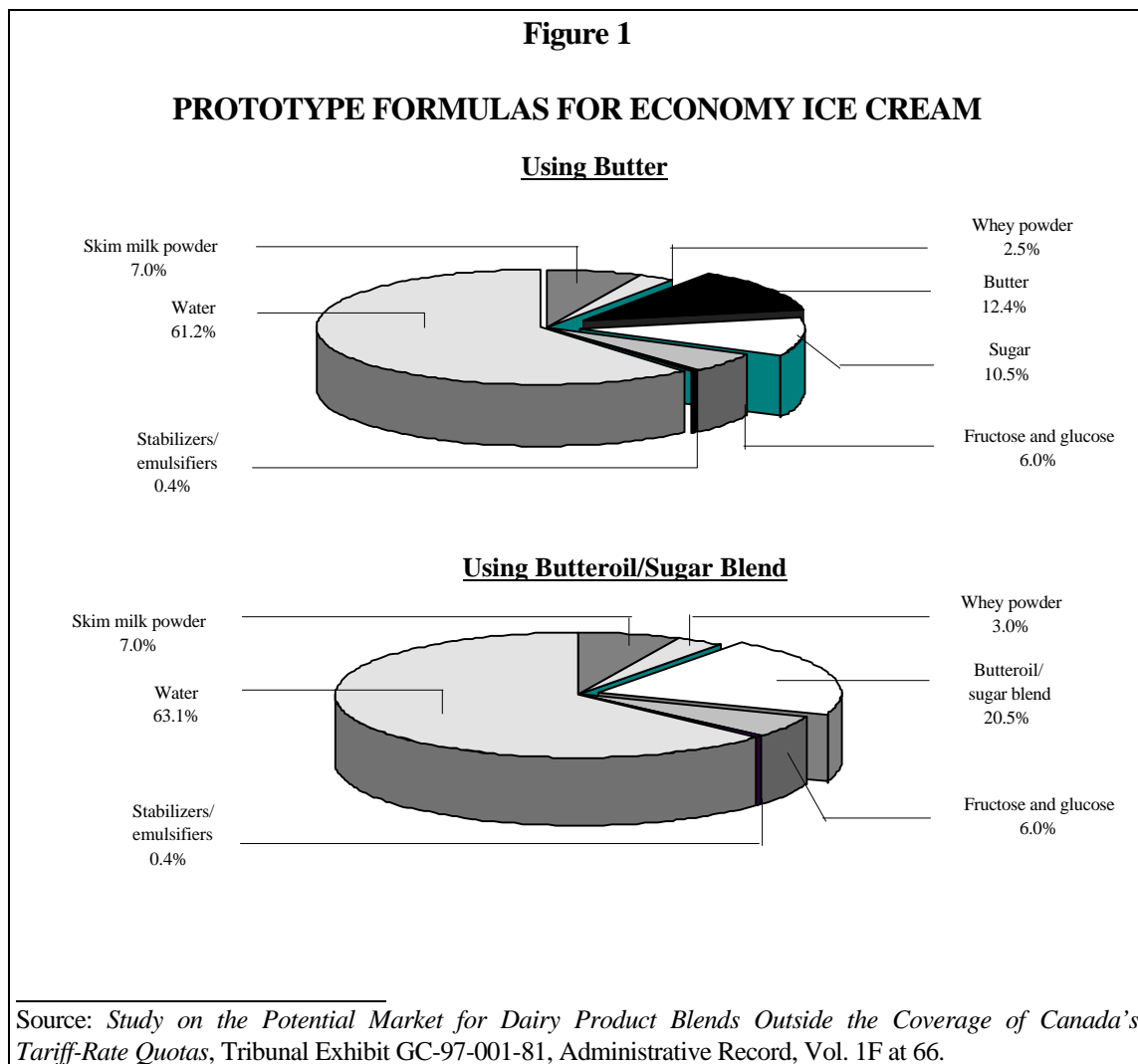
85. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 509 and 510.

5. Suitability for Certain Recipes

a) Ice Cream

Ice cream processors testified that butteroil/sugar blends are limited in their use in the production of ice cream due to the flavour imparted to the ice cream.⁸⁶ In this regard, evidence and testimony presented during the hearing demonstrate that imported butteroil/sugar blends are used mainly in the manufacture of economy ice cream and, to a lesser extent, of standard/premium ice cream.

Butteroil/sugar blends are of particular interest to ice cream processors because they contain both butterfat and sugar in sufficient quantities and proportions that make them readily adaptable to use with the basic ice cream formulas. Figure 1 shows two prototype formulas for economy ice cream, the first one uses butter as the source of butterfat and the second uses a butteroil/sugar blend.



86. Tribunal Exhibit GC-97-001-18.9, Administrative Record, Vol. 9 at 212.

The butteroil/sugar blend is directly substituted for the equivalent amounts of butterfat and sugar in the preparation of ice cream, although the formula is adjusted to accommodate the lower moisture content of the blend. Both formulas contain approximately the same amount of water, skim milk powder, whey powder and stabilizers/emulsifiers. The first formula includes 12.4 percent butter (for a total butterfat content of 10 percent) and 10.5 percent sugar plus other sweeteners.

Typically, when using a butteroil/sugar blend, ice cream manufacturers replace only a portion of the fat and sugar requirements. This proportion varies depending on the type of ice cream. For example, Good Humor-Breyers' economy brands, which are its most price sensitive, contain larger portions of the blend than do its premium brands. Good Humor-Breyers stated that, because of the nature of the product formulation and higher-end target market, certain premium, value-added products, such as "Breyers All Natural" ice cream, will never contain butteroil/sugar blends or other dairy product blends.⁸⁷

The witness for Dairyworld Foods' Ice Cream Products Group stated that, in the past, when it was experimenting with blends, it chose to use butteroil/sugar blends only in its economy ice cream mixes, high overrun⁸⁸ ice cream and ice cream with strong flavour additives in an effort to mask any flavour that is associated with the butteroil/sugar blends.⁸⁹

Nestlé described to the Tribunal the technical taste and texture qualities of ice cream made from butteroil/sugar blends.⁹⁰ It stated that, as a number of its brands are sold in various categories from economy to super premium and because it is known for its quality, Nestlé is very careful not to change the value perceived with those brands. Therefore, it is careful in terms of how much butteroil/sugar blend is used in any given recipe for ice cream.

Finally, Chapman's testified that it uses butteroil/sugar blends mostly in its economy brands.⁹¹

b) Processed Cheese

The following discussion of the use of butteroil blends in processed cheese production is based on the best information available to the Tribunal. The public information available regarding processed cheese is limited. However, the Tribunal is of the view that the information in the public record is not inconsistent with that reported in the confidential record.

87. Tribunal Exhibit GC-97-001-18.12, Administrative Record, Vol. 9A at 30-32.

88. While the ice cream is being frozen, blades in the freezer, or "dashers," whip and aerate the mix. Without this aeration, the finished product would be an inedible, solidly frozen mass of cream, milk, sugar and flavouring. This aeration is called "overrun." Generally, "overrun" may be between two and three times the total solids of the mix. A usual overrun for packaged ice cream is 80 percent; for soft ice cream, it is from 40 to 80 percent; and for bulk ice cream, the overrun could go from 80 to 100 percent, and it may even reach 150 percent. If, for example, there is 100 percent overrun, one gallon of ice cream mix makes about two gallons of finished ice cream.

89. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 101.

90. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 506.

91. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 694.

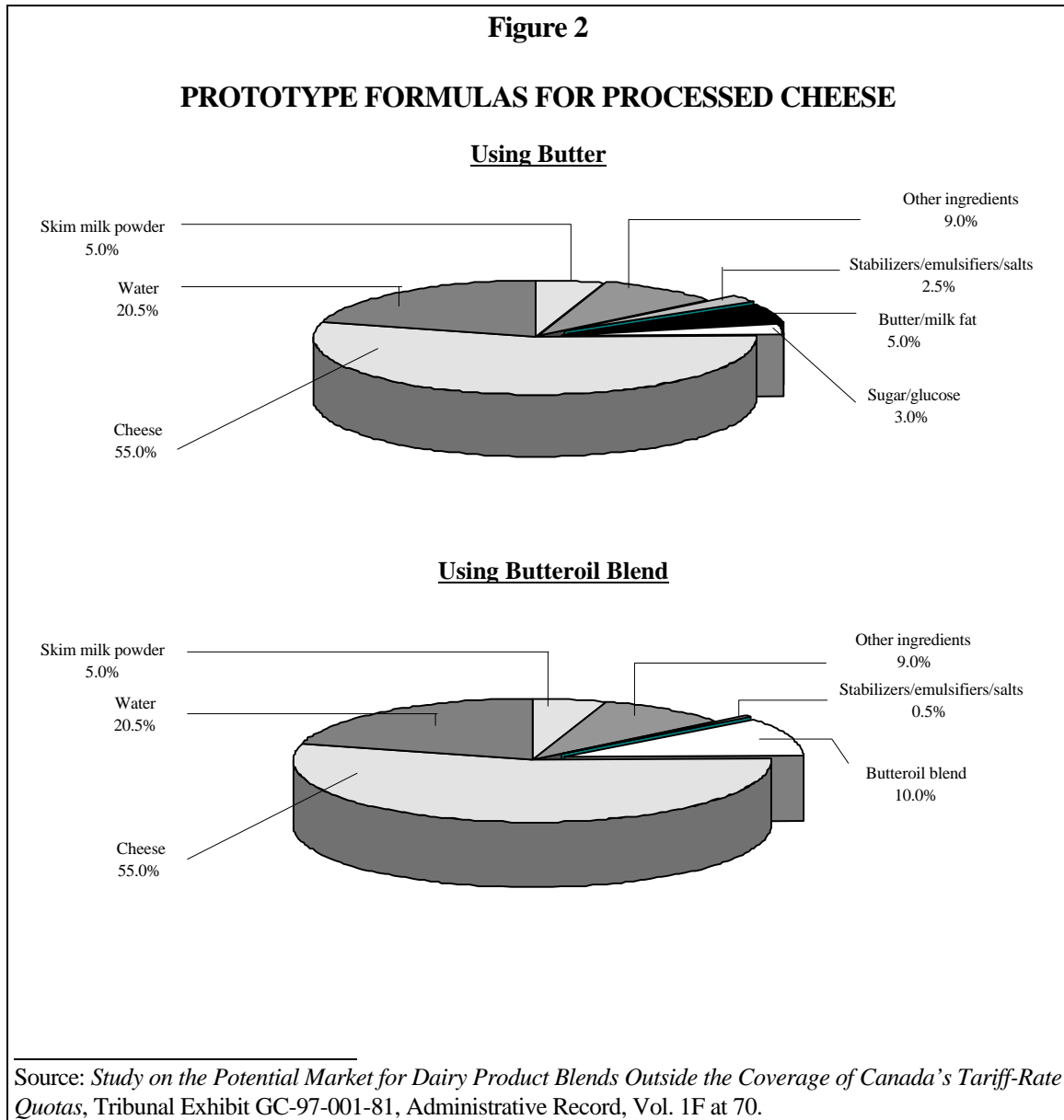
While processed cheese does not contain large amounts of sugar or other sweeteners, there is a potential to use specially designed dairy product blends. These blends would likely contain the maximum allowable butteroil content, certain sweeteners that are more conducive to processed cheese, such as glucose and dextrose, and emulsifying salts commonly used in processed cheese production.⁹²

The Treloar/Culhane report described a prototype formula for processed cheese which shows that processed cheese contains, by weight, 55 percent cheese, 5 percent butter/milk fat, in addition to other ingredients. In this prototype formula, it is the butterfat in the 5 percent butter/milk fat ingredient, the “free standing fat,”⁹³ that is available for replacement by fat from a butteroil blend. Specifically, it is the butterfat which is over and above the butterfat contained in the cheese ingredient of the recipe. Figure 2 shows two prototype formulas for the production of processed cheese, the first one uses butter/milk fat as the source of the replaceable butterfat. The second formula uses a butteroil blend as the butterfat source for the replaceable butterfat.

The pie chart shows that, in the prototype formulas, cheese accounts for about 55 percent of the ingredients in the production of processed cheese. In both recipes, water, skim milk powder and other ingredients (milk protein, acids and seasonings) are used in the same proportions. When using a butteroil blend instead of butter/milk fat for the 5 percent replaceable butterfat content, the sugar/glucose portion, as well as stabilizers, emulsifiers and salts, are partially replaced.

92. *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 14.

93. *Transcript of Public Hearing*, Vol. 6, April 15, 1998, at 1199.



6. Conclusion

The evidence before the Tribunal demonstrates that there are a number of factors that influence the demand for imported dairy product blends in the domestic market. The Tribunal is of the view that the single most important of these factors is the cost saving, in terms of butterfat content, that producers of ice cream and processed cheese realize by using imported butteroil blends. The Tribunal believes that the other factors, such as security of supply, competition in the ice cream industry and certain technical benefits, such as the longer shelf life of butteroil blends, have also influenced the demand for such blends.

CHAPTER IV

IMPLICATIONS OF IMPORTS OF BUTTEROIL BLENDS
FOR DOMESTIC INDUSTRIES

In this chapter, the Tribunal assesses the economic implications of imports of butteroil blends for dairy farmers, dairy processors and other segments of the Canadian food processing industry. The assessment includes a review of the volume of imports and of the use of butteroil blends, the displacement of domestic butterfat by butterfat imported in the blends, and the economic implications, in terms of production and revenue levels, for affected domestic industries. In the final section, the Tribunal assesses the potential use of butteroil blends in the ice cream and processed cheese industries.

1. Imports and Use of Dairy Product Blends**a) Historical Context**

The Tribunal considers that it is useful to position the current level of imports of butteroil blends in a broader historical context. In this regard, the Tribunal heard testimony that a number of dairy product blends were imported into Canada and used by the dairy processing industry in the 1980s.⁹⁴

Evidence was presented regarding a number of dry dairy blends, such as a beverage mix consisting of 94 percent skim milk powder, with some lactose, and 5 percent sugar. This particular dairy blend was imported as early as 1984 and was being used as a milk replacement in the bakery industry and in ice cream production.⁹⁵ In 1986, a blend containing 51 percent sugar and 49 percent dried skim milk powder, known as confectionery mix,⁹⁶ was imported and being used in further processing into confectionery items. In 1987, a blend consisting of skim milk powder and rock salt was imported. The salt component was separated and then the milk powder was used as a milk replacement in the production of cheese and ice cream, among other products.⁹⁷ This product was found to have been designed to circumvent import controls and its importation was stopped.⁹⁸

Other imported blends included a preparation referred to as C-70. This particular dairy blend consisted of 49 percent spray-dried cream and 51 percent sugar,⁹⁹ also known as sugar/high-fat milk,¹⁰⁰ and was imported into Canada from 1992 until mid-1995. This product

94. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 688.

95. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 28.

96. Participant's Exhibit A-7, Administrative Record, Vol. 15.

97. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 30.

98. *Champlain Industries Ltd. v. Canada (Minister of National Revenue - M.N.R.)*, Federal Court of Canada, File No. T-652-88, June 19, 1995.

99. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 439.

100. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 490-91.

was used by the ice cream industry during this period.¹⁰¹ Other blends used in further processing were identified, including a blend consisting of 49 percent dry whole milk and 51 percent sugar and a milk protein concentrate blend.¹⁰²

The degree to which a mixture of dairy and other products would be considered a dairy blend, and thus covered by the then existing *Import Control List* (ICL),¹⁰³ was a heavily debated issue in the mid-1980s. Products listed on the ICL required special permits in order to be imported into the country and were subject to quantitative limits. In 1988, the Government made it clear that blends with 50 percent or more of dairy content would be covered by the ICL.¹⁰⁴ Minor weight dairy blends continued to be imported.

In 1995, following WTO negotiations, the ICL was replaced by TRQs.¹⁰⁵ The application of high tariffs to imports in excess of TRQs resulted in the various dairy blends becoming uneconomical to import into Canada.

The ICL served as the guidepost in deciding which products were to be tariffed. If a product was on the ICL, it was tariffed. However, there were some products that were not on the ICL but which were, nevertheless, accepted by Canada's Uruguay Round negotiating partners as being subject to tariffication. The importer's testimony identified two such products: the blend known as C-70, 49 percent spray-dried cream and 51 percent sugar, and a blend of 49 percent liquid cream and 51 percent sucrose.¹⁰⁶

Virtually all of the dairy blends that had been identified as potential problems in January and February 1994 were tariffed. Butteroil/sugar blends were, at that time, not identified as a problem.¹⁰⁷

Evidence pertaining to butteroil/sugar blends shows that these blends have been imported since the late 1980s¹⁰⁸ for use in further processing, especially in the production of ice

101. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 463. The DFC testimony refers to a cream powder sugar blend, used in the production of ice cream, as a source of butterfat. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 32.

102. Participant's Exhibit A-7, Administrative Record, Vol. 15.

103. The *Export and Import Permits Act* provided authority for the establishment of controls on imports of designated goods, such as certain supply-managed agricultural products, by the addition of items to the ICL. Goods on the ICL could only be imported under the authority of individual import permits, which were obtained through the Department of Foreign Affairs and International Trade. Over-quota imports were imported under a general import permit.

104. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 29; and *Import Control List, amendment*, SOR/88-117, January 28, 1988, *Canada Gazette* Part II, Vol. 122, No. 4 at 1134, item 21.

105. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 588.

106. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 441.

107. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1280-81.

108. Participant's Exhibit A-7, Administrative Record, Vol. 15.

cream. Limited evidence was presented on the level of imports of butteroil/sugar blends in the early 1990s.¹⁰⁹

b) Imports for the 1994-97 Period

Table 2 shows the apparent imports and use of butteroil blends from 1994¹¹⁰ to 1997. Over this period, imports of the blends increased from 1.7 million kilograms in 1994 to 3.4 million kilograms in 1996, before climbing sharply to 8.8 million kilograms in 1997. The pattern of increase in the imports from 1994 to 1996 reflected the apparent use; however, the increase from 1996 to 1997 did not, since 2.4 million kilograms of imports remained in inventory at the end of 1997.

In 1996, imports of butteroil blends were principally from the United States. This changed in 1997 when New Zealand became the major source of imports of butteroil blends (47 percent)¹¹¹, followed by Mexico (32 percent), the European Union and then the United States.

APPARENT IMPORTS AND USE OF BUTTEROIL BLENDS				
(million kilograms)				
	1994	1995	1996	1997
Apparent Imports of Butteroil Blends	1.735 ¹	1.167 ²	3.404	8.752
Net Change in Inventories ³	<u>0.0</u>	<u>0.040</u>	<u>0.006</u>	<u>2.409</u>
Apparent Use of Butteroil Blends	1.735	1.127	3.398	6.343

1. Includes the C-70 blend which is composed of 49 percent spray-dried cream (70 percent butterfat) and 51 percent sugar. Ice cream processors reported the use of C-70 and butteroil/sugar blends in 1994.

2. Understated. Imports of Champlain Industries and/or IDI were not reported.

3. For ice cream production only.

Source: Tribunal Exhibit GC-97-001-80A (protected), Administrative Record, Vol. 2 at 32 and 59; Participant's Exhibit E-2, Administrative Record, Vol. 15A; and Participant's Exhibit D-1, Administrative Record, Vol. 15A.

109. In a letter dated August 1994 to the DFC (Participant's Exhibit A-6, Administrative Record, Vol. 15), counsel for the importer attempted to identify the volume of all dairy blends imported into Canada in 1993. While it was acknowledged that it was impossible to know the exact volume of dairy blend imports, it was determined that they were not insignificant.

110. Imports in 1994 include the C-70 blend.

111. Tribunal Exhibit GC-97-001-83, Administrative Record, Vol. 1G at 42.

After reviewing the evidence, the Tribunal is of the opinion that butteroil blends are only one type of blend in a range of blends which have been available and used in the food processing industry for a number of years. Certain sectors of the domestic dairy processing industry have a history of using imported blends to supplement domestic dairy ingredients. The current use of butteroil blends continues that historical use. As circumstances and conditions changed, so did the composition of the blends.

On the other hand, the Tribunal acknowledges that the DFC has been consistent in opposing the importation of dairy product blends as a replacement for raw milk supply, fresh cream or any type of butterfat in making traditional dairy products. In the view of the DFC, such importation undermines the integrity of the milk supply management system. The dairy farmers believed that the tariffication exercise that was part of the WTO negotiations effectively blocked the border to the type of dairy product blends that were of concern to them.¹¹²

c) Supply of Butterfat by Imports of Butteroil Blends

Table 3 shows the penetration levels of the imported butteroil blends from 1994 to 1997. The use of butterfat from butteroil blends increased rapidly between 1994 and 1996, and then almost doubled in 1997. In 1997, ice cream and processed cheese manufacturers used 6.3 million kilograms of butteroil blends, which corresponds to approximately 3.1 million kilograms of butterfat. Of the total butterfat used in 1997 by ice cream processors (see Chapter III, section 5a) and of the total replaceable butterfat used in 1997 by processed cheese manufacturers (see Chapter III, section 5b), 12 percent was supplied by butterfat from imported butteroil blends.

112. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 226.

Table 3

**APPARENT USE OF IMPORTED DAIRY PRODUCT BLENDS
IN THE PRODUCTION OF ICE CREAM MIX AND PROCESSED CHEESE**

(million kilograms)

	1994	1995	1996	1997
Production				
Ice Cream Mix ¹	193.137	189.306	181.569	181.940 ²
Processed Cheese	74.765	76.422	75.827	76.200 ³
Butterfat Requirement	26.915	26.538	25.580	25.639
Ice Cream Mix (12% butterfat)	23.176	22.717	21.788	21.833
Processed Cheese (5% replaceable butterfat)	3.738	3.821	3.791	3.807
Apparent Use of Dairy Blends	1.735	1.127 ⁴	3.398	6.343
Butterfat Equivalent⁵	0.844	0.548 ⁴	1.653	3.086
Penetration Level⁶ (%)	3.1	2.1	6.5	12.0

Note: Numbers may not add up due to rounding.

1. One litre of ice cream mix weighs approximately 1.1 kg.
2. 1992 to 1996 average (DFC Scenario 1). Calendar year.
3. 1991-92 to 1996-97 average (DFC Scenario 2). Dairy Year.
4. Understated. Imports of Champlain Industries and/or IDI were not reported.
5. 49 percent of the blends times 99.3 percent, to derive the butterfat content of butteroil.
6. Percentage share of butterfat requirement accounted for by butterfat from dairy product blends.

Source: Tribunal Exhibit GC-97-001-78, Administrative Record, Vol. 1D at 44 and 47; and Participant's Exhibit L-5A, Administrative Record, Vol. 15C.

2. Implication for Dairy Farmers

This section provides the Tribunal's estimate of the impact that imported butteroil blends had on the dairy farmers in 1997.

a) Revenues

There was considerable evidence on the implications of imported butteroil blends for the revenues of the dairy farmers in 1997. Estimates were provided by the DFC, ice cream processors and the Tribunal staff.¹¹³ The estimates ranged from \$8.9 million¹¹⁴ to \$67.9 million.¹¹⁵ The major reasons for the wide range of estimates were the various assumptions regarding the use levels of butteroil blends in 1997, the prices of exported butterfat and the way in which dairy farmers respond to imports of butteroil blends.

113. Staff of the Department of Agriculture and Agri-Food provided estimates for the period 1998-2002. *The Impact of Imports of Butteroil/Sugar Blends on the Canadian Dairy Industry - An Economic Analysis using the FARM Model*, Tribunal Exhibit GC-97-001-83, Administrative Record, Vol. 1G at 1-46.

114. Closing argument on behalf of Chapman's and Good Humor-Breyers at 3.2, Administrative Record, Vol. 29.

115. Tribunal Exhibit GC-97-001-84, Administrative Record, Vol. 1H at 13.

In assessing the impact of the imports of butteroil blends on the dairy farmers in 1997, the Tribunal considered the evidence of the dairy farmers. During the first part of 1997, the dairy farmers reacted to the imports of butteroil blends by maintaining domestic milk production and exporting the surplus production of butterfat. In August 1997, however, the level of the national production quota for industrial milk, the market sharing quota (MSQ), was reduced, in part, to respond to the displacement of domestic butterfat with the butterfat from imported butteroil blends.

The implications of the imports of butteroil blends for the revenues of the dairy farmers must, thus, be assessed under each of these two reactions. In its assessment, the Tribunal used the methodology of the dairy farmers and the domestic and export prices as reported in their evidence. In determining the volume of domestic butterfat displaced by butteroil blends, the Tribunal used the evidence on the record relating to the import level of butteroil blends adjusted by the changes in the inventory levels.

Table 4 provides the estimates for the revenues forgone by the dairy farmers under each of their reactions to the imports of butteroil blends. In estimating the revenue impact of the imports of butteroil blends in 1997, the Tribunal has taken, as its base, a situation where there are no imports of the blends.

For the first part of 1997, the dairy farmers maintained the production of milk and exported the surplus butterfat. Under this alternative, the revenues forgone by the farmers correspond to the difference between the return to the farmers from selling butterfat domestically to the ice cream and processed cheese industries and the return from selling it in the international marketplace. There were no revenues forgone for protein and other solids since, with or without the imports of butteroil blends, these products were already in surplus production and were already being exported. The level of the national MSQ is set on the basis of domestic butterfat requirements. Producing to butterfat requirements results in surplus protein and other solids.

For the latter part of 1997, the dairy farmers cut the production of butterfat partly in response to the imports of butteroil blends. However, the only way to cut butterfat production is to cut milk production, meaning that the production of protein and other solids is also cut. Under this alternative, the revenues forgone are the reduction in revenues from butterfat that otherwise would have been sold on the domestic market to the ice cream and processed cheese manufacturers and the reduction in revenues from protein and other solids that otherwise would have been sold on the international market.

As shown in Table 4, had the dairy farmers maintained the same level of milk production and exported the surplus butterfat throughout 1997, they would have forgone about \$12.8 million in revenue. On the other hand, had dairy farmers reduced the production of milk for the entire year, they would have forgone \$30.9 million in revenue. The actual value of the revenues forgone was likely between these two numbers. Putting these revenues in perspective, they represent between 0.3 percent and 0.8 percent of the dairy farmers' total revenues of \$3.8 billion in 1997.

Table 4

ESTIMATED REVENUES FORGONE BY DAIRY FARMERS, 1997**(Compared to a Situation of no Imports of Butteroil Blends)**

	\$/kg	Quantity (million kilograms)	Revenues Forgone/Year (\$ million)
Maintain Production of Milk and Export Surplus Butterfat			
Butterfat	4.15 ¹	3.086 ³	12.81
Protein	1.76 ²	0 ⁴	0
Other Solids	1.87 ²	0 ⁴	<u>0</u>
			12.81
Reduce Production of Milk			
Butterfat	5.49 ⁵	3.086 ³	16.94
Protein	1.76 ²	2.743 ⁶	4.83
Other Solids	1.87 ²	4.886 ⁷	<u>9.14</u>
			30.91

Assumptions:

1. The loss on export sales of butterfat compared to domestic sales is based on the September 1997 world price of butterfat at \$1.34/kg.
2. The value of protein and other solids is based on the September 1997 world price taken from the DFC submission that estimates the impact on farmers if they reduced production. These are export prices.
3. An estimated 6.343 million kilograms of imported butteroil blends were used in 1997 by the ice cream and processed cheese manufacturers. This is equivalent to 3.086 million kilograms of butterfat. The volume of butterfat used in 1997 is the actual volume of imports adjusted for inventories.
4. The quantity of affected protein and other solids is zero under this scenario. These surplus products are exported in the same quantity and at the same price as under the no imports scenario.
5. Class 2 domestic price for butterfat of \$5.49/kg (September 1997).
6. & 7. A normalized hectolitre of milk contains 3.6 kg of butterfat, 3.2 kg of protein and 5.7 kg of other solids. Therefore, to determine the amount of protein and other solids forgone, the Tribunal determined the amount of milk that it takes to produce 3.086 million kilograms of butterfat and calculated the amount of protein and solids in that volume of industrial milk:
for protein: $3.086/3.6 \times 3.2 = 2.743$
for other solids: $3.086/3.6 \times 5.7 = 4.886$

Note: The method of calculating these estimates is based on the submissions made by the DFC. See Participant's Exhibit L-5A, Administrative Record, Vol. 15C.

In estimating the revenue effect of the imports of butteroil blends in 1997, the Tribunal has taken, as its base, a situation where there are no imports of the blends. Another base would be the historical level of imports of blends. In this regard, the best evidence before the Tribunal is that for 1994, when 1.7 million kilograms of the blends, representing about 0.8 million kilograms of butterfat, were imported. Using this alternative base, the estimated revenues forgone by dairy farmers would be approximately 25 percent less, between \$9.5 million and \$22.9 million.

The Tribunal notes that gross revenue has been used as a base to assess the revenue implications for the dairy farmers resulting from the imports of butteroil blends. Another approach, and one used in the study by the Department of Agriculture and Agri-Food, is to take a net income approach, which takes into consideration the dairy farmers' incremental cost to produce additional hectolitres of milk. Evidence before the Tribunal suggests that there are variability and reliability issues in measuring these costs.¹¹⁶ Given these issues, the Tribunal chose to focus on assessing the revenue implications, rather than the net income implications, for the dairy farmers of the imports of butteroil blends. In this regard, the Tribunal also notes that the terms of reference directed it specifically to consider revenue and production levels.

b) Production

The Canadian Milk Supply Management Committee sets the annual national production quota for industrial milk, the MSQ,¹¹⁷ measured in terms of butterfat. It represents the total butterfat requirement for the production of dairy products such as butter, cheese, ice cream and yogurt.

The DFC submitted that imported butteroil blends have displaced demand for domestic butterfat and that, as a result, there was a reduction in the level of domestic production. The industry experienced an MSQ reduction of 3 percent in August 1997, which, the DFC claims, is largely attributable to the imported butteroil blends.¹¹⁸

The Tribunal accepts that the imports of butteroil blends could have influenced, to some degree, the cut in the MSQ. In 1997, the 3.1 million kilograms of butterfat from imported butteroil blends were equivalent to approximately 2 percent of the MSQ of 157.9 million kilograms on July 31, 1997. Expressed as a percentage of overall milk production in Canada in 1997, the imports were equivalent to approximately 1.1 percent of the 283.8 million kilograms of butterfat for both the fluid milk market and the industrial milk market.

The Tribunal recognizes that there are other factors that affect the level of production of industrial milk in Canada. Some of these factors include a growing trend in milk consumption away from whole milk and 2 percent milk toward 1 percent milk and skim milk, general consumer trends toward low-fat products, changing demographics and butter

116. The DFC suggested that the marginal cost is different for every farmer and that the only estimate that it has is \$30 per hectolitre. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 286. There were discussions on whether the average marginal cost of production is constant, increasing or decreasing. *Transcript of Public Hearing*, Vol. 4, April 9, 1998, at 816. As well, the DFC argued that, while the variable costs would have been reduced when the MSQ was cut in August 1997, it may not be reasonable to assume that the fixed costs would have been reduced proportionately. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 78 and 80.

117. The MSQ is closely watched by dairy farmers because it is the basis for their industrial milk production. On August 1, the beginning of each new dairy year, the Canadian Dairy Commission calculates the MSQ based on demand forecasts for butterfat. The MSQ is monitored throughout the year and adjusted when necessary by the Canadian Milk Supply Management Committee. Any change in the MSQ is reflected at the farm level in changed production. Because of changes in domestic demand for dairy products, the MSQ can show significant variability over time.

118. Participant's Exhibit L-1, Administrative Record, Vol. 15C.

imports.¹¹⁹ All these factors, which have affected the market for some time, tend to put downward pressure on the volume of industrial milk production.

c) Quota Values

In its analysis of the economic impacts resulting from the importation of butteroil blends, the DFC calculated the loss in quota value under certain scenarios. The DFC assumed that this quota value equalled \$16,500 for the right to produce one kilogram of butterfat per day.¹²⁰

The issue of quota value was not discussed extensively during the public hearing. Based on limited testimony, it is not clear whether the reduction in the MSQ on August 1, 1997, resulted in an increase or decrease in quota value.¹²¹ In most provinces, quota values are determined by supply and demand at quota exchanges. As production quota is cut, it is suggested that producers may try to recover the lost quota which may, in turn, bid up the prices of available quota. As a result, the net worth of dairy farmers, in terms of quota value, may remain unchanged or change for the better. Other reasons for the increase in quota value are expansion of production by some dairy farmers and purchase of quota by new farmers.

From a historical context, it was also suggested that, while the MSQ declined through the 1980s and into the 1990s, due to a host of factors identified in the previous section, the quota value went up during the same period.¹²² To counter this assertion, the DFC cautioned that there was also a variety of other factors.

In light of the insufficient and sometimes contradictory evidence on quota values, the Tribunal makes no assessment of the DFC's calculations regarding the impact on dairy farmers in terms of quota values. Moreover, the Tribunal was not expressly asked by the Government to examine the question of quota values in its reference.

3. Implications for Ice Cream and Processed Cheese Manufacturers

In 1997, the total butterfat used by ice cream manufacturers and the replaceable butterfat used by processed cheese manufacturers amounted to approximately 25.6 million kilograms. Of this total butterfat requirement, approximately 3.1 million kilograms of butterfat was sourced from imported butteroil blends, representing about 12 percent of the total butterfat requirement for ice cream and the replaceable butterfat for processed cheese (see Table 3).

Using imported butteroil blends resulted in an estimated average saving to the ice cream and processed cheese manufacturers of approximately \$1.05/kg on the cost of domestic butterfat in 1997. Based on the use of butteroil blends in the ice cream and processed cheese industries in 1997, those savings reduced ingredient costs by an estimated \$3.2 million.

119. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 189.

120. Participant's Exhibit L-8, Administrative Record, Vol. 15C.

121. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 160-61.

122. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 250.

4. Implications for Other Segments of the Food Processing Industry

There is no evidence on the record to suggest that butteroil blends are currently being used by other segments of the food processing industry. During the early stages of this inquiry, the Tribunal staff met with a number of association representatives from various food sectors. These associations included the Food & Consumer Products Manufacturers of Canada, the Association of Canadian Biscuit Manufacturers and the Confectionery Manufacturers' Association of Canada. These associations did not raise any concerns with respect to the importation or use of dairy blends by their members. Confectionery and bakery industries have access to Class 5 prices, in addition to the ability to use vegetable oil as a replacement for much of their fat requirements.

Representatives from Good Humor-Breyers testified that the foodservice sector and certain institutional customers to whom it sells ice cream products benefit from its use of butteroil blends in the production of low-priced ice cream.¹²³ Some institutional groups, for example, purchase the small, individual ice cream sundae cups which are made using a butteroil/sugar blend. This allows the manufacturer to supply these products at lower prices compared to the price that it would have to charge if the butteroil/sugar blend were not available.

5. Maximum Penetration of Butteroil/Sugar Blends into Ice Cream

a) Review of the Evidence

The commissioned reports, the submissions of parties and the testimony presented at the hearing provided a range of views regarding the maximum potential use of butteroil/sugar blends in ice cream. Estimates of the maximum potential proportion of domestic butterfat that could be replaced by the butterfat in butteroil/sugar blends ranged widely.

The Treloar/Culhane report suggested that butterfat from imported butteroil/sugar blends could replace up to 60 percent of the total butterfat used in the production of ice cream.¹²⁴ This estimate was based on the strong and continuing economic incentive for ice cream manufacturers to use butteroil/sugar blends and the technical feasibility of using the blends in the formulas for ice cream. The growth in the imports of butteroil/sugar blends and their equally fast adoption by the ice cream industry indicated to the authors that there were low barriers to their use in that industry. The DFC subscribed to this view.¹²⁵ In her testimony before the Tribunal, Dr. Treloar acknowledged that, because of the taste factor,¹²⁶ the necessity to preserve brand signature and technical incompatibility, butteroil/sugar blends may not be appropriate for use in premium brand ice cream. Further, Dr. Treloar acknowledged that, although she initially planned to do so, because of limited cooperation, she did not consult ice

123. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 635.

124. *Study on the Potential Market for Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 7.

125. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 238.

126. *Transcript of Public Hearing*, Vol. 6, April 15, 1998, at 1106-7.

cream processors on their potential use of butteroil/sugar blends in the preparation of the report.¹²⁷

The study prepared for the Tribunal using the food and agriculture regional model (FARM) of the Department of Agriculture and Agri-Food assumed, as a starting point, the estimate that butteroil/sugar blend imports could supply up to 40 percent of the butterfat in ice cream by the year 2000. The study suggested that the future use of blends is influenced by the skim-off rule in Ontario and the use of blends by co-operatives. In the long run, other ice cream processors may adopt the use of butteroil/sugar blends because of the competitive pressures from current users. Over time, the study estimated that the majority of ice cream would be produced using butteroil/sugar blends.

Ice cream processors maintained that the maximum potential penetration level is no more than 25 percent.^{128,129} The major reason presented for this position is one of taste consideration from the consumer's perspective. They noted that, while the penetration level may go up to 75 percent for specific brands of economy ice cream, the overall average use would be no more than 25 percent of all ice cream produced. The ice cream processors testified that dairy blends have been used in the production of ice cream for several years. Yet, they observed that the importance of these dairy blends in the production of ice cream has remained unchanged and is, therefore, not expected to substantially increase in the near future.¹³⁰

The importer, IDI, contended that, for individual ice cream manufacturers, 25 percent of their butterfat requirement could be supplied by butteroil/sugar blends. However, based on its sales efforts and understanding of the marketplace, it estimated that firms accounting for about 30 percent of ice cream production would not use imported butteroil/sugar blends to secure lower-priced butterfat.¹³¹ Many of these firms are farmer co-operatives, ice cream processors related to local dairies, or ice cream processors with premium product lines or too small to benefit from the investment required. Therefore, in the importer's view, the maximum penetration was 25 percent of 70 percent of the industry, for an overall penetration level of 17.5 percent.

b) Tribunal's View

In considering the potential use of butteroil/sugar blends in ice cream production, the Tribunal looked first to the historical and current use of such blends. It notes that there has been a history of importing dairy product blends for ice cream production which extends back into the 1980s. Butteroil/sugar blends have been imported since at least the late 1980s. The use of imported blends in domestic dairy processing increased rapidly from 1994 to 1996 and then almost doubled in 1997.

127. *Transcript of Public Hearing*, Vol. 6, April 15, 1998, at 1087.

128. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 644.

129. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 693-94.

130. *Transcript of Public Hearing*, Vol. 6, April 15, 1998, at 1194.

131. *Transcript of Public Hearing*, Vol. 2, April 17, 1998, at 494.

In analyzing the trend in the use of butteroil/sugar blends in ice cream production, the Tribunal considered whether or not it expects this rapid growth in use to continue or to moderate. For a number of reasons, the Tribunal is of the view that the rate of growth in the use of butteroil/sugar blends in ice cream production will moderate.

First, the competition for sales among the importers has assured that the market is well aware of the availability of butteroil/sugar blends and the cost savings from using the blends.¹³² Some firms have decided not to use the blends,¹³³ while other firms have decided to use them. After a period of developing recipes and procedures for incorporating butteroil/sugar blends into their manufacturing processes, these latter firms have strongly held views on the extent to which they can use these blends.

Second, butteroil/sugar blends have been offered at very competitive prices in recent years. Because the prices were low and because there was an expectation of rising world prices for butter, positions were taken in the marketplace resulting in a build-up of inventories.¹³⁴

Looking ahead to 1998, growth in imports is expected, at best, to be limited. This conclusion is based on the large inventory of butteroil/sugar blends carried over from 1997, the expectation of the importer at the hearing and the testimony of a major ice cream processor stating that its use of butteroil/sugar blends is expected to remain stable in 1998, compared to 1997. The conclusion is also consistent with interim 1998 import data from Revenue Canada.¹³⁵

Although the Tribunal does not consider that the use of butteroil/sugar blends will continue to grow at the pace of recent years, it is of the view that the use could increase. In the Tribunal's view, that use could increase to no more than 25 percent of the overall butterfat requirement for ice cream. The Tribunal bases that view on several considerations.

The large processors testified that, across their entire product range of ice cream, the maximum overall use could reach about 25 percent. This maximum use reflects the fact that, in economy products and in products with strong flavour, a high proportion of the butterfat requirements can be supplied by butteroil/sugar blends.¹³⁶ It also reflects the fact that, for other products, butterfat from the blends can only be used in limited amounts and that, for other products again, butterfat from butteroil/sugar blends cannot be used at all. The processors told the Tribunal of their taste testing of individual products and brands and of their unwillingness to affect the target taste characteristics by using too much butterfat from butteroil/sugar blends. The Tribunal is convinced that there is a strong incentive for ice cream processors to limit the

132. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 457.

133. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 494.

134. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 469.

135. Tribunal Exhibit GC-97-001-89A, Administrative Record, Vol. 1C at 153.3.

136. *Transcript of Public Hearing*, Vol. 6, April 15, 1998, at 1192.

use of butteroil/sugar blends so as not to affect the “brand equity”¹³⁷ that they have in individual products.

The Tribunal notes that, to reach a 25 percent penetration rate, the current penetration rate would have to more than double. This is, in the Tribunal’s view, an outside estimate. The smaller processors, those accounting for approximately 30 percent of the industry, are expected to make less use of butteroil/sugar blends than the large processors. Some of these processors produce only premium ice cream for which butteroil/sugar blends would not be suitable ingredients. Other processors are part of dairy co-operatives, and it is unlikely that these firms will use butteroil/sugar blends extensively. Finally, there are many small local niche ice cream manufacturers for whom the economics of using butteroil/sugar blends may not be present¹³⁸ or for whom the marketing of their product may not accord with the use of butteroil/sugar blends.¹³⁹

In the foreseeable future, the Tribunal believes that there is a limited possibility that technology could alter the taste of butteroil/sugar blends sufficiently to encourage higher use or that consumer tastes will change.

6. Maximum Penetration of Butteroil Blends into Processed Cheese

a) Review of the Evidence

There is only limited information on the record regarding the potential use of butteroil blends in processed cheese. Processed cheese is, by weight, 23 percent butterfat. However, the evidence before the Tribunal suggests that only 5 percent of the weight of processed cheese could possibly be replaced by butterfat from butteroil blends.

In the Treloar/Culhane report, the prototype formula identified two sources of butterfat in processed cheese. These are bulk cheese and butter/milk fat. The butterfat from butter/milk fat, which is about 5 percent by weight of processed cheese, could be replaced by butterfat from butteroil blends. The report estimated that, currently, butteroil blends supply between 5 and 15 percent of the replaceable butterfat. The report suggested that the penetration level could rise to 25 percent due to the technical feasibility and commercial likelihood of blends replacing butterfat in processed cheese.¹⁴⁰

IDI presented a different perspective, estimating that the ceiling on the use of butterfat from butteroil blends is based on the maximum use of sweeteners and emulsifiers in processed cheese. Because the butterfat and the processing solids are present in about equivalent proportions in the blends, their use is limited by the least used ingredient in the formula. IDI noted that a large processed cheese manufacturer¹⁴¹ submitted that it would not use the

137. “Brand equity” refers to the value perceived by consumers of each of the individual brands. *Transcript of Public Hearing*, Vol. 2, April 7, 1998, at 507.

138. Tribunal Exhibit GC-97-001-26.2, Administrative Record, Vol. 1 at 99.

139. Tribunal Exhibit GC-97-001-18.18, Administrative Record, Vol. 9A at 174.

140. Tribunal Exhibit GC-97-001-81, Administrative Record, Vol. 1F at 48.

141. Tribunal Exhibit GC-97-001-26.5, Administrative Record, Vol. 1 at 108.

product and that processed cheddar cheese did not permit the use of butterfat from blends because of regulations.

b) Tribunal's View

After reviewing the evidence, the Tribunal is of the view that the maximum penetration level of butteroil blends for use in processed cheese could be as high as 25 percent of the replaceable butterfat. It is recognized that a large processed cheese manufacturer is on record stating that it is neither a current user nor a future user of butteroil blends. Again, as in the case for ice cream, compared with a penetration level of between 5 and 15 percent, the Tribunal emphasizes that the 25 percent penetration ratio for the processed cheese industry is an outside limit estimate. In a highly competitive environment, the switchover to using butteroil blends by the industry, one would expect, would have been largely completed by now.

Table 5 shows the amount of butterfat that would be displaced in ice cream and processed cheese production by the butterfat in the butteroil blends if the 25 percent penetration level were reached. The actual amount of butterfat displaced in 1997 is presented for comparison purposes.

BUTTERFAT DISPLACED BY IMPORTS OF BUTTEROIL BLENDS		
(million kilograms)		
	Penetration Level¹ Actual 1997	Estimated Maximum Penetration Level¹
	<u>12%</u>	<u>25%</u>
Butterfat Displaced by Imports	3.086	6.410
Butterfat Requirement	25.639	25.639

1. Penetration level expressed as a percentage of total butterfat requirements for ice cream and replaceable butterfat in processed cheese.

7. Conclusion

This chapter has considered the implications for dairy farmers and dairy processors of imports of butteroil blends. The use of butteroil blends increased rapidly from 1994 to 1996 and then almost doubled in 1997. In 1997, about 3.1 million kilograms of the butterfat used in the manufacture of ice cream and processed cheese was supplied by 6.3 million kilograms of butteroil blends.

In reaction to this displacement of domestic butterfat, the dairy farmers, in the first part of 1997, exported the butterfat that they otherwise would have sold in the domestic market. On August 1, 1997, the dairy farmers reduced production, in part, in response to imports of butteroil blends. Estimated revenues forgone from the lost domestic sales of butterfat ranged

between \$12.8 million (if production were maintained and surplus butterfat exported for the entire year) and \$30.9 million (if production were reduced for the entire year). Putting these losses in perspective, the total revenues of the dairy farmers was \$3.8 billion in 1997. In comparison, ice cream and processed cheese manufacturers reduced their costs of butterfat by approximately \$3.2 million in 1997.

The Tribunal expects that the use of butteroil blends will increase in the years ahead, although at a slower pace than in recent years. Compared to the current penetration level of 12 percent, the Tribunal considers that up to 25 percent of the butterfat in ice cream and the replaceable butterfat in processed cheese could be supplied by the butterfat from butteroil blends.

CHAPTER V

INTERNATIONAL AND DOMESTIC FRAMEWORK

The terms of reference direct the Tribunal to, among other things, review the legal, technical and regulatory considerations relevant to the treatment of imports of dairy product blends outside the coverage of Canada's TRQs.

This chapter sets out the international and domestic legal and regulatory framework applicable to trade in agricultural products. Much of the chapter is devoted to describing certain of the changes in that framework brought about by the conclusion and implementation of the *WTO Agreement on Agriculture*.¹⁴² Many of the matters addressed in this chapter are broadly applicable to international trade in agricultural products and are, thus, relevant to more than one of the options discussed in the final chapter.

1. WTO Agreement,¹⁴³ GATT and NAFTA

On April 15, 1994, the Uruguay Round of multilateral trade negotiations was concluded with the signing of the WTO Agreement in Marrakesh. That agreement established the WTO, which provides an organizational framework within which Members can pursue their international trading rights and obligations. The WTO Agreement contains 14 multilateral agreements, including the *General Agreement on Tariffs and Trade 1994*¹⁴⁴ (GATT 1994),^{145,146} to which are attached Members' schedules of tariff concessions, the *Agreement on Agriculture* and the *Agreement on Safeguards*.¹⁴⁷ Canada's implementing legislation, the *World Trade Organization Agreement Implementation Act*¹⁴⁸ (the WTO Act), entered into force on January 1, 1995.

Prior to January 1, 1989, when the *Canada-United States Free Trade Agreement*¹⁴⁹ (the FTA) came into force, Canada's international rights and obligations with respect to trade in agricultural products were governed primarily by GATT 1947. Though, in theory, GATT 1947 applied to all trade, countries on accession to GATT could reserve rights for

142. Signed at Marrakesh on April 15, 1994.

143. *Agreement Establishing the World Trade Organization*, signed at Marrakesh on April 15, 1994.

144. Signed at Marrakesh on April 15, 1994.

145. The *General Agreement on Tariffs and Trade* (GATT 1947) (Geneva, March 1969, GATT BISD, Vol. IV) is incorporated into the WTO Agreement. Together with the provisions of certain legal instruments that entered into force under GATT 1947, as well as a number of understandings on the interpretation of certain GATT provisions and the Uruguay Round protocol adopted in Marrakesh, GATT 1947 is now referred to as GATT 1994. In the event of a conflict between a provision of GATT 1994 and a provision of an agreement in Annex 1A, the provision of the agreement prevails to the extent of the conflict (general interpretative note to Annex 1A of the WTO Agreement).

146. Unless a distinction needs to be made between GATT 1947 and GATT 1994, this report simply refers to "GATT."

147. Signed at Marrakesh on April 15, 1994.

148. S.C. 1994, c. 47.

149. *Canada Treaty Series*, 1989, No. 3 (C.T.S.).

particular products.¹⁵⁰ Moreover, there were special rules under GATT with respect to trade in agricultural products. For example, subject to certain exceptions, Article XI:1 prohibited contracting parties from imposing quantitative restrictions on imports from other contracting parties. However, Article XI:2(c) provided that the prohibition did not apply to “[i]mport restrictions on any agricultural ... product,” if certain conditions were met. Pursuant to Article XI:2(c)(i), Canada and a number of other contracting parties established supply management regimes for dairy, poultry and certain agricultural products.

It has also been suggested that two other events served to take agricultural trade outside the normal disciplines of GATT.¹⁵¹ The first of these events is the waiver obtained by the United States of its GATT obligations under Article XXV which allowed it to apply quantitative restrictions on imports of certain agricultural products that would not have otherwise been GATT consistent.¹⁵² The second is the implementation by the European Economic Community (EC) of a Common Agricultural Policy in 1958, following which the EC renegotiated its GATT tariff commitments so as to eliminate tariff bindings on certain agricultural products. The EC, thereafter, charged “prohibitive levies, which were varied to ensure that foreign agricultural products would not be able to compete with EC products on price terms so long as EC products could satisfy EC demand.¹⁵³” In the words of Professor Davey:

The net result [of these events] is that significant barriers to the import of many agricultural products existed in the United States and the EC almost from the beginning of GATT’s existence. While other countries generally did not benefit from a waiver like that obtained by the United States or from the sort of renegotiation undertaken by the EC, many felt that they should not be bound by GATT rules in the agricultural sector if the US and EC were not effectively bound by those rules.¹⁵⁴

2. *Agreement on Agriculture*

The *Agreement on Agriculture* brings trade in agricultural products¹⁵⁵ more squarely into the realm of rules-based trade. While certain provisions of the *Agreement on Agriculture* of particular relevance to this report are discussed in greater detail below, in summary, under

150. Paragraph 1(b) of the *Protocol of Provisional Application of the General Agreement on Tariffs and Trade*, October 30, 1947.

151. J. H. Jackson, W. J. Davey and A.O. Sykes, Jr., *Legal Problems of International Economic Relations, Cases, Materials and Text on the National and International Regulation of Transnational Economic Relations*, 3rd ed. (St. Paul: West Publishing, 1995) at 1161-62.

152. BISD 3rd Supp. 32 (1955).

153. J. H. Jackson, W. J. Davey and A.O. Sykes, Jr., *Legal Problems of International Economic Relations, Cases, Materials and Text on the National and International Regulation of Transnational Economic Relations*, 3rd ed. (St. Paul: West Publishing, 1995) at 1162.

154. *Ibid.*

155. The *Agreement on Agriculture* applies to products classified in Chapters 1 to 24 of the *Harmonized Commodity Description and Coding System*, as well as to products classified in various headings and under tariff items of Chapters 29, 33, 38, 42, 43 and 50 through 53.

the *Agreement on Agriculture*, WTO Members¹⁵⁶ agreed to the long-term objective of reforming trade in agriculture by establishing a fair and market-oriented agricultural trading system through the establishment of strengthened and more operationally effective GATT rules and disciplines. As to immediate reforms, WTO Members agreed:

- to limit the amount of domestic support which they provide to their agricultural industries;¹⁵⁷
- to limit the amount and type of export subsidies which they provide to their agricultural industries;¹⁵⁸
- to provide “minimum access” on agricultural products, including those which were formerly controlled or prohibited;¹⁵⁹
- to tariffify all existing NTBs and not to revert to such barriers in the future as a means of protecting agricultural production;¹⁶⁰ and
- that disputes arising under the *Agreement on Agriculture* would be governed by Articles XXII and XXIII of GATT 1994, as elaborated in the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU) in Annex 2 to the WTO Agreement.¹⁶¹

a) **Tariffs, NTBs and Tariffication**

One major change in international agricultural trade brought about by the *Agreement on Agriculture* was Members’ conversion of their NTBs to a system of tariff barriers. Tariff barriers, unlike the NTBs that they replaced, are transparent and rules-based and could be subject to further liberalization in successive multilateral negotiation rounds.

i) **Tariffs and Tariff Bindings**

Tariffs are the most common import restraints permitted under GATT. A tariff is a tax or customs duty imposed at the border on imported goods. Tariff rates can be found in each Members’ tariff schedule. Most of these rates are “bound” as the result of access concessions agreed to in the successive rounds of multilateral trade negotiations that have occurred since the formation of GATT in 1947. Rates are bound at the MFN level. The MFN tariff is the highest tariff that can be applied to WTO Members. The binding of rates provides certainty to international trade because, unlike the unbound rates that a Member is free to raise at any time, bound tariff lines are subject to the disciplines of GATT, in particular, Articles II, XXIII and XXVIII. In general terms, these articles: prohibit a Member from imposing tariffs in excess of those committed to by that Member; allow a Member that considers that a benefit accruing to it has been “nullified or impaired” to take, in appropriate circumstances, retaliatory action;

156. The WTO Agreement was open for signature to all governments and the European Union which participated in the Uruguay Round negotiations and which were contracting parties to GATT 1947. Those contracting parties which signed the WTO Agreement became WTO “Members.”

157. Articles 6 and 7 of the *Agreement on Agriculture*.

158. Articles 8 and 9 of the *Agreement on Agriculture*.

159. Articles 3 and 4 of the *Agreement on Agriculture*.

160. Article 4 of the *Agreement on Agriculture*.

161. Article 19 of the *Agreement on Agriculture*.

and permit a Member to enter into negotiations to modify any concession, including a tariff concession.

ii) NTBs

NTBs include all other forms of import restraints. Quotas or quantitative restrictions are the most common form of NTBs. A quota specifies the quantity of a particular product that a country will allow to be imported during a specified period of time. A quota may be global, in the sense that it expresses the total amount that can be imported from all sources, or it may be divided into country quotas that provide limits on the volume of goods from certain countries. Once these limits have been attained, no more imports of the particular product covered by the quota are permitted for the period.

iii) Tariffication

Under the *Agreement on Agriculture*, Members agreed to convert existing NTBs on agricultural imports into customs duties set at levels which broadly reflected the difference between the domestic and world prices of those goods (tariff equivalents). Members also agreed to no longer “maintain, resort or revert” to these measures. The conversion of agricultural NTBs into tariff equivalents is known as “tariffication” and resulted in the creation of TRQs on a number of agricultural products. As noted earlier,¹⁶² a TRQ is a limitation placed on the quantity of goods, entitled to a specific tariff treatment, which may be imported during a given period of time. Imports in excess of the specific quantity receive a higher tariff rate.

Under the *Agreement on Agriculture*, Members also agreed that, where they had restricted or prohibited the importation of agricultural goods, imports of those goods would be permitted at low rates of duty in amounts equal, overall, to at least 3 percent of the domestic consumption.¹⁶³

For agricultural goods subject to tariffication, the WTO Act amendments to the schedule to the *Customs Tariff* implemented the tariff equivalents of NTBs on agricultural products, as well as the agreed-upon phased reductions to the within and over-quota tariff rates applicable to these goods. The over-quota or tariff equivalent rates for dairy products subject to a TRQ range from 200 to 300 percent in terms of final *ad valorem* rates.¹⁶⁴

The butteroil blends at issue in this inquiry have been classified by Revenue Canada under tariff item No. 2106.90.95¹⁶⁵ of the *Customs Tariff* as “[o]ther preparations, containing, in the dry state, over 10% by weight of milk solids but less than 50% by weight of dairy content.” That tariff item is not subject to a TRQ.

162. See section 1b) of Chapter II.

163. As part of the Uruguay Round, Canada agreed that its “minimum access commitments” with respect to dairy products would be provided for under TRQs for fluid milk, butterfat, cheese and butter/butteroil blends. For the other “dairy” tariff lines subject to TRQs, there is zero access for imports.

164. The Uruguay Round schedules contained a current applied rate and a final bound rate pursuant to which WTO Members agreed to reduce tariffs to within an agreed period of time.

165. This tariff item came into force on January 1, 1995, as a result of *WTO Technical Amendments Order, No. 2, SOR/95-20, December 20, 1994, Canada Gazette Part II, Vol. 129, No. 1* at 53.

The WTO Act also amended various provisions of the *Export and Import Permits Act*¹⁶⁶ (EIPA) to facilitate the implementation of Canada's access commitments under the *Agreement on Agriculture*. Section 5.3 was added to the EIPA, providing the Governor in Council the authority to place agricultural products which were tariffed on the ICL. Goods on the ICL may only be imported under the authority of individual import permits, which are obtainable through the Department of Foreign Affairs and International Trade. Over-quota imports are freely imported under a general import permit.

iv) Certain Exceptions to Tariff Bindings

Certain GATT provisions enable tariff concessions or bindings to be suspended temporarily. For example, Article XIX of GATT, together with the *Agreement on Safeguards*, allows WTO Members, in appropriate circumstances, to temporarily modify tariff concessions. Article XIX is referred to as an "escape clause" because it allows Members to temporarily escape from their obligations and provides domestic producers with a window within which to adjust to increased levels of imports.

The *Agreement on Safeguards* provides that, subject to certain exceptions, a safeguard measure may only be applied following an "investigation" by the "competent authorities."¹⁶⁷ However, the *Agreement on Safeguards* provides that measures may be applied prior to an investigation by a competent authority in "critical circumstances where delay would cause damage which ... would be difficult to repair."

The object of a safeguard inquiry is to determine whether imports of a given product from all sources are entering Canada in such increased quantities and under such conditions as to be a "principal" cause of serious injury or threat of injury to domestic producers of like or directly competitive goods.

Tariff concessions may also be permanently altered through renegotiation under Article XXVIII of GATT. Article XXVIII provides that a Member may enter into negotiations with other Members to modify or withdraw tariff concessions. The withdrawing Member must, however, negotiate and agree on "compensatory adjustment" with the Members that have a substantial interest.¹⁶⁸

The parties to an Article XXVIII negotiation endeavour to maintain the general level of tariff concessions provided in GATT. If agreement cannot be reached, then the withdrawing Member may go ahead with its modification or withdrawal. Then, the other non-agreeing Members may, upon 30 days' written notice, withdraw substantially equivalent concessions initially negotiated with the withdrawing Member.

166. R.S.C. 1985, c. E-19. The EIPA provides authority for the establishment of controls on imports of designated goods, such as certain supply-managed agricultural products (for example, dairy products) by the addition of items to the ICL.

167. Article 3(1) of the *Agreement on Safeguards* and Article 803(2) of NAFTA.

168. See notes 4 to 7 of paragraph 1 of the Notes and Supplementary Provisions to Article XXVIII of Annex I of GATT; and *Understanding on the Interpretation of Article XXVIII of the GATT 1994* in Annex 1A to the WTO Agreement.

b) Dispute Resolution under the *Agreement on Agriculture*

Article 19 of the *Agreement on Agriculture* provides that disputes arising under that agreement are to be resolved in accordance with the regime established under the DSU.¹⁶⁹ Dispute resolution under the DSU is, in several important respects, different from the way it was under GATT, as illustrated by the following examples.

Establishment of panel - If consultations fail to resolve a dispute, the DSU provides for recourse to a dispute settlement panel. Unlike the GATT system, the establishment of a panel is automatic, unless the Dispute Settlement Body decides by consensus against it.¹⁷⁰ Once the panel is established, it is generally required to issue its report within six months.

Panel report - Adoption of the panel's report is automatic unless the Dispute Settlement Body decides by consensus to reject it or a party decides to appeal it.¹⁷¹ Under GATT, before a report could take effect, all contracting parties had to agree to adopt it. This requirement often resulted in the non-conforming party to the dispute blocking the adoption of the report. That is no longer possible.

Enforcement - The DSU provides for both monitoring and enforcement of Panel and Appellate Body decisions.¹⁷² Where a party fails to implement recommendations and rulings within a reasonable period of time, the prevailing party may seek from it mutually satisfactory compensation, failing which, the prevailing party may, with the authorization of the Dispute Settlement Body, suspend the application of concessions or obligations to the non-conforming party.

3. NAFTA

The FTA created a free trade area between Canada and the United States, which came into being on January 1, 1989. In accordance with the FTA, tariffs on almost all originating goods were to be eliminated as of January 1, 1998.¹⁷³ Under the FTA, Canada and the United States also agreed that neither Party would increase existing or introduce new customs duties on such goods.¹⁷⁴

The FTA was suspended when NAFTA came into force on January 1, 1994. Some parts of the FTA were incorporated into NAFTA. For instance, as between Canada and the United States, Annex 302.2 of NAFTA incorporates the FTA tariff schedules for tariff elimination purposes. In addition, Article 710 of the FTA provided that the Parties preserved their rights under Article XI:2(c)(i) of GATT. This allowed Canada to maintain its import restrictions in respect of its supply-managed products. Tariff schedules as between Canada and Mexico provide for the elimination of tariffs on most goods within 10 years (i.e. as of

169. Article 19 of the *Agreement on Agriculture*.

170. Article 6(1) of the DSU.

171. Article 16(4) of the DSU.

172. Article 21 of the DSU.

173. Article 401(2) of the FTA.

174. *Ibid.*

January 1, 2003). Under NAFTA, Canada and Mexico exempted certain sectors from tariff elimination. Dairy was one such sector. As a result, originating dairy products exported from Mexico to Canada normally receive the MFN rate.

Canada's import restrictions, including prohibitions and quotas, on supply-managed products remained in place after the FTA and NAFTA came into force between Canada and its North American trading partners. With the implementation of the WTO, Canada converted its NTBs under supply management into tariff equivalents, with no distinction being made for its NAFTA trading partners. These tariff equivalents would be reduced at the same rate for the United States and Mexico as for the rest of the WTO Members. The within access quota rates, however, continued to be reduced at the scheduled FTA rate for the United States. Mexico normally receives the MFN rate for both in-quota and over-quota imports.¹⁷⁵

The tariffication of NTBs on Canadian agricultural products resulting from the *Agreement on Agriculture* was the subject of a complaint by the United States to a Panel under Chapter 20 of NAFTA.¹⁷⁶ The United States claimed that, by applying such tariff equivalents to US agricultural products, Canada had acted contrary to NAFTA (i.e. its commitments not to raise tariffs, not to impose new tariffs and to phase out all tariffs). In reply, Canada argued that tariffication was consistent with NAFTA in view of Article 4 of the *Agreement on Agriculture*. The Panel ruled in Canada's favour.

Like GATT and the WTO, NAFTA also provides for safeguard action. The object of a bilateral safeguard inquiry conducted under NAFTA is to determine whether, as a result of the tariff reductions provided for in that agreement, a particular product is being imported from the United States or Mexico in such increased quantities and under such conditions as to alone constitute a principal cause of serious injury to domestic producers of like or directly competitive goods. Certain of the key features of Canada's safeguard regime are further discussed in the following chapter.

The dispute settlement provisions in Chapter 20 of NAFTA, in many respects, parallel those of the DSU. Like the DSU, Chapter 20 of NAFTA encourages parties to consult with a view to resolving their disputes. However, if a matter cannot be resolved, the parties can request a meeting of the Free Trade Commission.¹⁷⁷ Ultimately, the parties may request the establishment of a panel.¹⁷⁸

4. Customs Classification

Because tariff rates vary from tariff line to tariff line, imported goods must be located (i.e. classified) under the correct tariff line. Each country is responsible for the administration of its import classification system and customs laws.

175. Some dairy substitutes in Chapter 21 of the schedule to the *Customs Tariff* do have Mexico Tariff rates for within access imports, e.g. tariff item No. 2106.90.33. Tariff item No. 2106.90.35 also has a Mexico Tariff rate.

176. *Ibid.*

177. Article 2007 of NAFTA. The Free Trade Commission is comprised of cabinet-level representatives of each NAFTA Party or their designees, pursuant to Article 2001 of NAFTA.

178. Article 2008 of NAFTA.

The Customs Co-operation Council (CCC), established in 1950, now called the World Customs Organization (WCO), was given the mandate to create a universal customs classification system. The result of the CCC's work, the *Harmonized Commodity Description and Coding System*¹⁷⁹ (the Harmonized System), was implemented by all CCC members.¹⁸⁰ The *General Rules for the Interpretation of the Harmonized System*¹⁸¹ (the General Rules) were adopted by the CCC and its members. The basic premise underpinning the Harmonized System is that all products, even new products which did not exist when the Harmonized System was first created, can be classified somewhere within the Harmonized System.

The Harmonized System Committee of the WCO meets regularly to consider classification issues among members and to update the Harmonized System and the *Explanatory Notes to the Harmonized Commodity Description and Coding System*¹⁸² (the Explanatory Notes). The WCO also issues classification opinions, which are published in the *Compendium of Classification Opinions to the Harmonized Commodity Description and Coding System*¹⁸³ (the Classification Opinions).

The Harmonized System became law in Canada on January 1, 1988, when the schedules to the *Customs Tariff* were rewritten in order to adopt the new system. Tariff rates are set out, and goods are described in the schedule to the *Customs Tariff*. It should be noted that, once a product is classified in the schedule, the applicable tariff rate can vary depending upon the product's country of origin.¹⁸⁴

Section 10 of the *Customs Tariff* provides that the classification of goods imported into Canada must be determined in accordance with the General Rules and the *Canadian Rules*.¹⁸⁵ Section 11 of the *Customs Tariff* provides that, in interpreting the headings and subheadings in the schedule to the *Customs Tariff*, regard shall be had to the Classification Opinions and the Explanatory Notes, as amended from time to time, published by the WCO.

The procedure to be followed in classifying imported goods is set out in the *Customs Act*¹⁸⁶ and in the *Customs Tariff*. Sections 58 through 63 of the *Customs Act* allow importers to seek re-determinations and further re-determinations of the classification of imported goods. At the departmental level, this process culminates with a re-determination by the Deputy Minister of National Revenue (the Deputy Minister).¹⁸⁷ Pursuant to section 67 of the *Customs*

179. Customs Co-operation Council, 1st ed., Brussels, 1987.

180. Customs Co-operation Council, Nomenclature Committee, 38th Session, Brussels, February 18, 1977.

181. The schedule to the *Customs Tariff*.

182. Customs Co-operation Council, 1st ed., Brussels, 1986.

183. Customs Co-operation Council, 1st ed., Brussels, 1987.

184. There is: (1) the MFN Tariff for Members of the WTO; (2) the United States Tariff; (3) the Mexico Tariff; (4) the Mexico-United States Tariff; (5) the General Tariff for non-WTO Members; (6) the Commonwealth Caribbean Countries Tariff; (7) the Australia Tariff; (8) the New Zealand Tariff; (9) the General Preferential Tariff and the Least Developed Country Tariff for some developing countries; (10) the Chile Tariff; and (11) the Canada-Israel Agreement Tariff.

185. The schedule to the *Customs Tariff*.

186. R.S.C. 1985, c. 1 (2nd Supp.).

187. Under section 64 of the *Customs Act*, the Deputy Minister may elect to re-determine tariff classifications on his own initiative.

Act, a person “aggrieved” by a tariff classification determination of the Deputy Minister may appeal to the Tribunal. Decisions of the Tribunal can be appealed to the Federal Court of Appeal under section 68 of the *Customs Act*.

5. Conclusion

Over the last 10 years, there have been fundamental changes in the international regime for trade in agricultural products generally and, in particular, for supply-managed sectors such as the dairy sector. The thrust of these changes has been toward trade liberalization and greater transparency. These changes have been reflected in Canada’s import regime. Beginning with the FTA and then NAFTA, and now with the conclusion of the *Agreement on Agriculture*, trade in agricultural products has moved into the realm of rules-based trade.

In general terms, this means that, where disputes arise with respect to agricultural trade, WTO Members may seek recourse under the DSU. Unlike under GATT, Panel or Appellate Body decisions cannot be effectively “blocked” by the offending party. The same is true of agricultural disputes arising under NAFTA between Canada, the United States and/or Mexico. That the dispute resolution procedures under the WTO and NAFTA are of benefit, particularly to the smaller players in the international context, is amply demonstrated by the NAFTA panel’s decision upholding Canada’s right to apply TRQs to imports of certain US agricultural products, including dairy products.

With respect to dairy products, the changes brought about by the FTA, NAFTA and, particularly, the *Agreement on Agriculture* are evident. Whereas, prior to the conclusion of the *Agreement on Agriculture*, the importation into Canada of certain dairy products was prohibited, now Canada is bound to permit at least some overall, minimum level of such imports. The NTBs applicable to dairy product imports into Canada have now been converted into tariff equivalents or have been tariffied. As such, the previous domestically controlled barriers to agricultural imports have now been converted into tariffs which are transparent, subject to the international disciplines of the WTO, and open to further liberalization through future tariff negotiations. It is important to note that all WTO Members have undertaken this tariffication process. Moreover, all WTO Members have agreed to reduce the tariffs on most agricultural tariff lines, including those subject to TRQs, by the year 2000.

The net result of these changes is an international marketplace governed by established rules, with the likelihood of ever-increasing levels of trade.

CHAPTER VI

CONSIDERATION OF THE OPTIONS

The terms of reference direct the Tribunal to identify options for addressing “any problems raised” by the importation of dairy product blends outside the coverage of Canada’s TRQs. Prior to the hearing, several options were raised in the work done by the Tribunal staff and by the independent consultants. In addition, parties and counsel to the inquiry identified a number of options in their written submissions, which were elaborated upon and refined during the course of the hearing. Finally, prior to argument, the Tribunal tabled a list of options which it requested counsel to address in their final argument. That list included all of the options that had, to that point, been canvassed in the inquiry, as well as several new options.

In this chapter, the Tribunal discusses the options in two groups. The first group contains the options that the Tribunal considered and set aside either because they are inconsistent with Canada’s domestic or international rights and obligations or because they do not represent a viable option. The following options are included in this group:

- reclassification by the Government;
- imposition of an excise tax;
- bilateral negotiations with New Zealand;
- removal of anti-dumping and countervailing duties on refined sugar;
- increase in milk prices; and
- change in labelling requirements.

The second group identifies a number of options which are consistent with Canada’s domestic and international rights and obligations. Maintaining the status quo is an option. There are, in addition, a number of options that could lessen the consequences of the imports of butteroil blends on the dairy farmers. Some options require action by the dairy farmers, others by the Government. The following options are included in this group:

- appeal to the Tribunal by the dairy farmers of the classification of butteroil blends;
- safeguard inquiry by the Tribunal pursuant to a complaint by the dairy farmers or a government reference;
- special class price for butterfat for ice cream and processed cheese;
- special class price for butterfat for domestic butteroil blends;
- compensation of the dairy farmers for their income losses; and
- new tariff item for butteroil blends with a different tariff treatment.

1. Options Considered and Set Aside

This first group of options includes those considered by the Tribunal, but set aside because they are inconsistent with Canada's domestic or international rights and obligations or because they do not represent a viable means of addressing "any problems raised."

a) Reclassification by the Government

Option: *that the Government of Canada request the Deputy Minister to "look into" reclassifying butteroil blends under tariff item No. 2106.90.33, 2106.90.34, 0404.90.10 or 0404.90.20*

The DFC supported this option on the grounds that reclassification would provide the dairy farmers with immediate relief from the "surge" in butteroil blend imports and would pose no complications in terms of Canada's international obligations, as reclassification would simply serve to correct an error that has persisted since the implementation of the WTO Agreement. Moreover, in the DFC's submission, Revenue Canada's position with respect to the classification of the blends is based on a flawed assumption (i.e. that a "butter substitute" must be a substitute for butter in most or all butter applications.). The DFC also suggested that the Government could direct the Deputy Minister to simply reclassify butteroil blends.

Other parties to the inquiry generally opposed this option. They submitted that the butteroil blends currently being imported into Canada are correctly classified. In addition, the reclassification of the blends would be inconsistent with Canada's international obligations, in that, from 1991 through the conclusion of the Uruguay Round, the blends were classified by Revenue Canada in a consistent manner and, therefore, Canada's trading partners have a "legitimate expectation" that the blends will continue to be classified in that manner.

In light of the fact that Revenue Canada has already considered the question of the classification of butteroil/sugar blends on four previous occasions,¹⁸⁸ the Tribunal considers that it would be fruitless for the Government to direct Revenue Canada to "look into" that same question a fifth time.

Regarding the DFC's suggestion that the Government direct the Deputy Minister to reclassify butteroil blends, the Tribunal is of the view that such action would be inconsistent with Canada's obligations under Article X:3 of GATT. That article provides, in part, that each Member shall administer its laws, decisions and rulings with respect to, among other things, customs classification, in a "uniform, impartial and reasonable manner." Article X:3 also requires Members to maintain an independent body to undertake, where appropriate, the "prompt review and correction of administrative action relating to customs matters."

188. Participant's Exhibit A-1, par. 8, Administrative Record, Vol. 15.

In addition, Canada is a signatory to the WCO “convention¹⁸⁹” and is “expected” to apply the decisions of the WCO “Council.¹⁹⁰” Canada’s commitments under the WCO “convention” are reflected in Canadian law. Specifically, the *Customs Tariff* requires that the classification of imported goods be determined in accordance with the General Rules and the *Canadian Rules* and having regard to any relevant Classification Opinions and Explanatory Notes.¹⁹¹ These are the considerations that, as a matter of law, Canadian customs authorities can take into account in deciding upon the correct classification of any product. For the Deputy Minister to reclassify butteroil blends on the basis of a direction from the Government would, therefore, be inconsistent with Canadian law.¹⁹²

With respect to “legitimate expectations,” the Tribunal notes that a number of witnesses testified that, if the Government directed the Deputy Minister to reclassify butteroil blends under a tariff line which had a higher rate or which was subject to a TRQ, Canada’s trading partners would likely claim that benefits accruing to them under the Uruguay Round had been nullified and impaired. They testified that such a claim could, in part, be based on those partners’ expectations as to the treatment of butteroil blends following the conclusion of the Uruguay Round.¹⁹³

In light of the testimony received by the Tribunal at the hearing¹⁹⁴ and the fact that, prior to and after the conclusion of the Uruguay Round, Revenue Canada issued classification opinions regarding the blends, the Tribunal is of the view that, if the Government of Canada were to reclassify the butteroil blends under a tariff item subject to a TRQ, such action could frustrate the reasonable expectations of Canada’s trading partners and, as a result, be subject to the process of negotiation under Article II:5 of GATT.

b) Imposition of an Excise Tax

Option: *that, subject to Article III:2 of GATT, the Government of Canada impose an excise tax on butteroil blends*

All parties opposed this option on the basis that it would be inconsistent with Canada’s international obligations.

Article III of GATT provides that imported products shall not be subject, directly or indirectly, to internal taxes or other internal charges in excess of those applied to like domestic products. It also provides that internal taxes must not be applied to imported products in a manner which would “afford protection to domestic production.”

189. *Transcript of Public Hearing*, Vol. 5, April 14, 1998, at 940.

190. *Transcript of Public Hearing*, Vol. 5, April 14, 1998, at 940.

191. Sections 10 and 11 of the *Customs Tariff*.

192. Tribunal Exhibit GC-97-001-72, Administrative Record, Vol. 1C at 31; and *Transcript of Public Hearing*, Vol. 5, April 14, 1998, at 917-18.

193. *Transcript of Public Hearing*, Vol. 4, April 9, 1998, at 749-50, Vol. 5, April 14, 1998, at 910 and 988, and Vol. 7, April 15, 1998, at 1357-58.

194. *Transcript of Public Hearing*, Vol. 5, April 14, 1998, at 910, and Vol. 6, April 15, 1998, at 1357-58.

The Tribunal is of the view that, if, as a means of addressing “any problems” associated with imports of butteroil blends, the Government were to impose an excise tax that served to substantially limit or eliminate such imports, it would run afoul of Article III of GATT because the tax would have been imposed to protect the domestic industry. Such a tax would, therefore, be inconsistent with Canada’s international obligations.

c) Bilateral Negotiations with New Zealand

Option: *that the Government of Canada enter into negotiations with the Government of New Zealand under their bilateral Agreement on Trade and Economic Cooperation to restrict access for imports of butteroil blends*

This option was opposed by all parties. The DFC maintained that negotiating with New Zealand would result in Canada having to “pay again” for a concession already obtained under the Uruguay Round. It also noted that negotiations tend to involve a protracted process. All parties noted that, even if an agreement could be reached with New Zealand, it would not address imports of butteroil blends from other sources.

The Tribunal notes that, in the *Agreement on Trade and Economic Cooperation between the Government of Canada and the Government of New Zealand*¹⁹⁵ (TEC), pursuant to Article VII:2(a) which pertains to agricultural, horticultural and fishery products, Canada agrees “to turn to New Zealand as among preferred suppliers when Canada has an import requirement for butter.” To single out New Zealand for discriminatory treatment on the import of the blends might well, therefore, be problematic within the context of the TEC.¹⁹⁶

Furthermore, although New Zealand is currently the major source of imports of butteroil blends, the evidence before the Tribunal indicates that butteroil blends have been imported into Canada at various times from the United States, Mexico and the European Union. Moreover, given the relatively simple process involved in manufacturing the blends, it would be possible to produce the blends in a country other than those mentioned and export that production to Canada.

In light of the foregoing, the Tribunal is of the view that a solution which addresses imports from only one source does not represent a viable option.

195. *Canada Treaty Series*, 1982, No. 17 (C.T.S.), September 25, 1981.

196. Under the TEC, there was a preferential rate for tariff item No. 2106.90.99, where imports of New Zealand butteroil/sugar blends were classified. However, in 1995, when imports of butteroil/sugar blends were reclassified under tariff item No. 2106.90.95, there was no longer a preferential rate. However, the tariff rate under that tariff item is lower than the preferential rate under tariff item No. 2106.90.99.

d) Removal of Anti-Dumping and Countervailing Duties on Refined Sugar

Option: *that anti-dumping and countervailing duties on refined sugar be removed for sugar to be used in ice cream*

This option was put forth by the National Dairy Council of Canada (NDC). The NDC is a non-profit association of Canadian manufacturers and marketers of dairy products. The NDC maintained that removing the anti-dumping and countervailing duties on refined sugar¹⁹⁷ would make the use of domestic ingredients more attractive to processors and would lead to lower sugar prices in Canada, which would, in turn, permit greater flexibility to allow higher input cost prices for dairy ingredients.

No other party supported this option. The DFC opposed this option because, in its view, butteroil blends are being imported into Canada for the cost savings on the butterfat component, not sugar. Therefore, the option would fail to address the economic driver behind butteroil blend imports. The Canadian Federation of Agriculture opposed the option on the basis that the removal of duties would unjustly deprive the Canadian sugar industry and, in particular, sugar beet producers, of protection from dumped and subsidized imports. The remaining parties to the inquiry opposed the option on the grounds that the current inquiry is not the appropriate proceeding to entertain this question. They also submitted that it would not be appropriate to sacrifice interests of one sector of the Canadian economy (i.e. the sugar producers) for the benefit of another.

The Tribunal is of the view that the removal of the anti-dumping and countervailing duties on refined sugar does not pose any problems in terms of Canada's international rights and obligations. However, the Tribunal agrees with the DFC that, in economic terms, the butteroil blends are being imported largely for the savings associated with the butterfat component of the blends. Therefore, removing the anti-dumping and countervailing duties on sugar would do little, if anything, to address imports of butteroil blends.

e) Increase in Milk Prices

Option: *that prices of other domestic milk products (such as fluid and/or industrial milk) be raised to offset lower returns from sales of milk products to the ice cream and processed cheese industries*

The DFC opposed this option. It argued that increasing milk prices to offset lower returns from milk sales to the ice cream and processed cheese industries would run directly counter to the principles underpinning domestic pricing arrangements; encourage greater use of butteroil blends to rebalance overall costs; apply pressure on other dairy processors to absorb increased input costs or to pass them along to the consumers; and decrease consumption of

197. See *The Dumping in Canada of Refined Sugar Originating in or Exported from the United States of America, Denmark, the Federal Republic of Germany, the Netherlands, the United Kingdom and the Republic of Korea, and the Subsidizing of Refined Sugar Originating in or Exported from the European Union*, Canadian International Trade Tribunal, Inquiry No. NQ-95-002, *Findings*, November 6, 1995, *Statement of Reasons*, November 21, 1995.

dairy products. The NDC, IDI and the Director of Investigation and Research, Competition Bureau (the Director), also opposed this option. Counsel for Good Humor-Breyers and Chapman's observed that this option is always available to the dairy farmers. Whenever there is a cost of production increase, there is an opportunity for dairy farmers to raise milk prices in order to avoid losses.

The Tribunal does not consider a general increase in milk prices to be a viable option to address problems resulting from imports of butteroil blends. The Tribunal accepts that such a price increase would put unnecessary cost pressures on other domestic processors and could possibly decrease the consumption of domestic dairy products.

f) Change in Labelling Requirements

Option: *that the Government of Canada change the labelling requirements to require that butteroil blends be identified as ingredients in final dairy products such as ice cream and processed cheese*

The Director was the only party to support this option. The Director submitted that requiring butteroil blends to be identified on packaging would provide consumers with information that would permit them to make informed choices about which products to purchase and would, therefore, assist in developing and maintaining a competitive market.

Parties opposing this option submitted that changing the labelling requirements for ice cream and other products to address increasing blend imports would not be consistent with Canada's international rights and obligations. They also noted that, while the *Food and Drugs Act*¹⁹⁸ prohibits the labelling of any food in a manner that would mislead or deceive consumers as to its character, value, composition or safety, there is no evidence to suggest that the butteroil blends are inferior or unsafe products or that they are mislabelled. Finally, they questioned whether such a measure would have any material impact on blend imports.

In considering this option, the Tribunal notes that Canada is a party to the *Agreement on Technical Barriers to Trade*.¹⁹⁹ Pursuant to Article 2.2 of that agreement, Members agreed not to apply "technical regulations"²⁰⁰ with a view to or with the effect of creating unnecessary obstacles to international trade. Article 2.2 also provides that any technical regulation applied is to be no more trade restrictive than necessary to fulfil a "legitimate objective." Legitimate objectives include such things as "national security," "the prevention of deceptive practices" and the "protection of human health or safety."

There is no evidence before the Tribunal to suggest that a labelling requirement such as is contemplated under this option is necessary to fulfil any legitimate objective of the type provided for in Article 2.2. In the absence of such evidence, it is the Tribunal's view that such a

198. R.S.C. 1985, c. F-27.

199. Signed at Marrakesh on April 15, 1994.

200. Article 1 of Annex 1 of the *Agreement on Technical Barriers to Trade* provides that technical regulations "may also include or deal exclusively with terminology, symbols, packaging, marking or labelling requirements as they apply to a product, process or production method." (Emphasis added)

requirement, if implemented, would likely be construed as an attempt to create an obstacle to trade in butteroil blends outside the scope of Canada's TRQs and, thus, contrary to the *Agreement on Technical Barriers to Trade*.

In addition, the Tribunal notes that Canadian legislation pertaining to labelling generally reflects the approach espoused in the *Agreement on Technical Barriers to Trade*, in that it focuses on health, safety and deceptive practice concerns. Therefore, absent some compelling concern regarding butteroil blends, to require the blends to be specifically identified on product labels would arguably be inconsistent with the prevailing Canadian approach with respect to product labelling. For example, in ice cream, the butteroil/sugar blends are currently identified as milk ingredients and sugar.

2. Options Considered and Retained

This section identifies a number of options which are consistent with Canada's domestic and international rights and obligations. Maintaining the status quo is an option. There are, in addition, a number of options that could lessen the consequences of imports of butteroil blends on the dairy farmers. Some options require action by the dairy farmers, others by the Government.

a) Maintaining the Status Quo

Option: *that the Government of Canada take no unilateral action to affect the access conditions of imports of butteroil blends*

i) Position of Parties

The DFC argued that maintaining the status quo is not an option. Such an approach would not lessen the impact of the large and increasing dairy blend imports. The DFC stated that leaving the concerns that gave rise to the reference unchecked would amount to a refusal of jurisdiction by the Tribunal to address the central question of the inquiry.

The DFC believed that, in order to be meaningful, options proposed by the Tribunal must address the economic impact on dairy farmers of the imported blends. These options must also be reasonable to administer, and they must not present or threaten to cause economic harm that is substantially similar to or greater than the butteroil blend imports themselves.

The DFC argued that the Government of Canada, by keeping the border open to the importation of butteroil blends under the current import regime, failed to honour its domestic obligation to support the integrity of the domestic milk supply management system. The status quo option, the dairy farmers argued, places in jeopardy one of the pillars of the supply management system,²⁰¹ that is, the Government's commitment to retain import controls or

201. *Transcript of Public Hearing*, Vol. 1, April 6, 1998, at 25 and 26. According to the DFC, the other two pillars are a commitment from the dairy farmers to plan, produce and take responsibility for surplus production and a commitment by the Government of Canada to ensure that dairy farmers receive a price that reflects, for efficient producers, production costs and a reasonable return on equity.

border protection, to allow a higher price for domestic products reflecting actual costs of production.

Finally, the DFC was of the opinion that the injury calculations put forward by the processors understated the injury caused to the dairy farmers by the imported blends. Their calculations did not recognize that the injury will continue indefinitely and that the loss of quota value was a legitimate consideration in the injury assessment.

IDI maintained that the status quo is the best option available, when the effects on all Canadians are taken into account. The effect of the current and expected volume of imports on the dairy farmers' income is minimal, when compared to the total dairy farmers' revenues of \$3.8 billion, and any losses experienced by the dairy farmers are not net losses to the Canadian economy. Imports of dairy product blends provide many benefits to the processing sector that are passed on to the larger Canadian economy. The imports also address serious problems of shortages of butterfat supplies to single-purpose ice cream processors.

The NDC favoured the status quo option. It noted that this option is consistent with Canada's international obligations and poses no risks of an international challenge. The NDC further considered that the status quo option would allow legitimate businesses to continue to operate; enhance the welfare of many sectors of the Canadian economy; and promote a competitive environment in Canada's dairy industry, which would help to prepare it for the liberalization of trade in agricultural products under the next WTO negotiations.

Good Humor-Breyers and Chapman's supported the status quo option. These ice cream processors stated that the use of dairy product blends was well established historically and that the current and projected use of imported butteroil blends by ice cream processors was relatively small in terms of ice cream use. As single-purpose ice cream processors, they favoured the status quo option because they believe that the dairy farmers, under the current supply management system, do not supply dairy products in an adequate manner. Imports of butteroil blends allowed processors to address that uncertainty of supply.

The International Dairy Foods Association (IDFA), which, at the hearing, represented the US dairy processing industry, maintained that the status quo option would be the most acceptable to its members and most consistent with Canada's international obligations in the near term. It argued that any modification to the current import regime would necessitate a bilateral or multilateral agreement.²⁰²

ii) Canada's Domestic and International Rights and Obligations

In the Tribunal's view, a decision by the Government to maintain current access conditions for imports of butteroil blends does not suggest any change in the Government's commitment to supply management.

Prior to the signing of the Marrakesh agreements in April 1994, Canadian government officials and industry representatives were given the challenge of converting from a system of

202. *Transcript of Public Hearing*, Vol. 4, April 9, 1998, at 775-76.

import permit controls that were administered on the basis of product description to a system of tariff protection that was based on tariff classification.²⁰³

A witness for the Government indicated that, whenever possible, the Government drew a line that was favourable to the domestic dairy industry.²⁰⁴ As part of the conversion exercise, virtually all of the dairy product blends that had been identified as potential problems in January and February 1994 were tariffed.²⁰⁵ The witness for the Government expressed the opinion that the representatives from the DFC and the NDC involved in the conversion exercise were reasonably satisfied with the efforts of the Government to address the problems identified.²⁰⁶ Moreover, the witness for the NDC stated that the group of individuals involved in the conversion exercise were aware that they may not be covering all dairy blends.²⁰⁷ Butteroil blends were not, at that time, identified as a problem by the Government, the DFC or the NDC.²⁰⁸ As well, there were no assurances given to the dairy industry as to how the Government would handle new blends. That promise would have been impossible to make.²⁰⁹ In brief, the Government did what it was able to do. It addressed the problems that were before it, and it dealt with them in a manner favourable to the dairy industry.

The Tribunal believes that the status quo option does not raise any issues in terms of Canada's obligations in international trade.

iii) Tribunal Assessment

The status quo option implies that imports of butteroil blends will continue to enter the country under the present import regime. As discussed in Chapter IV of this report, the Tribunal is of the view that the penetration level of butteroil blends could reach as high as 25 percent of the butterfat for ice cream and of the replaceable butterfat portion of processed cheese. The Tribunal considers this to be the maximum estimate of the potential level of penetration.

Table 6 shows the estimated maximum annual cost to dairy farmers in terms of revenues forgone, if the penetration level were to reach this upper limit of 25 percent.²¹⁰ As shown in the following table, 6.4 million kilograms of butterfat could come from imported butteroil blends in this scenario. Based on this amount of imported butterfat, compared to a situation of no imports, dairy farmers would forgo \$26.6 million of revenue each year if they were to maintain milk production and export the surplus butterfat. By comparison, the annual revenue forgone could reach \$64.2 million per year, if the dairy farmers were to reduce milk production. Putting these revenues in perspective, they represent between 0.7 and 1.7 percent of dairy farmers' total revenues of \$3.8 billion.

203. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1279.

204. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1310.

205. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1280.

206. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1290.

207. *Transcript of Public Hearing*, Vol. 3, April 8, 1998, at 566.

208. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1310.

209. *Transcript of Public Hearing*, Vol. 7, April 15, 1998, at 1331.

210. See section 2 of Chapter IV of this report for the methodology used in the calculations.

Table 6

**ESTIMATED ANNUAL REVENUES FORGONE BY DAIRY FARMERS
(Compared to a Situation of no Imports of Butteroil Blends)**

	Actual Imports 1997	Maximum Potential Penetration 25%¹
	3.086 million kg²	6.410 million kg²
Farmers' Response	Revenue Forgone/Year (\$ million)	
(1) Maintain Production of Milk and Export Surplus Butterfat	12.81	26.60
(2) Reduce Production of Milk	30.91	64.20

1. Maximum potential penetration expressed as a percentage of total butterfat requirements for ice cream and replaceable butterfat in processed cheese.

2. Butterfat content of butteroil blend imports.

Domestic manufacturers of ice cream and processed cheese would continue to benefit from lower-priced butterfat from imports of butteroil blends. The Tribunal has determined that processors save, on average, approximately \$1.05/kg on butterfat when using imported blends, compared to using domestic inputs. At the maximum penetration level of 25 percent, this translates into annual savings of \$6.7 million on ingredient costs.

b) Classification Appeal to the Tribunal

Option: *that the DFC file an appeal of the tariff classification of butteroil blends under tariff item No. 2106.90.95 with the Tribunal pursuant to section 67 of the Customs Act*

i) Position of Parties

The DFC indicated that it did not support this option, largely because of the protracted nature of the appeal process. The DFC indicated that it understood that, if it were successful in having the butteroil blends reclassified pursuant to an appeal to the Tribunal, the importers and processors would appeal that decision to the Federal Court of Canada and, if necessary, the Supreme Court of Canada. The DFC stated that it anticipated that the appeal process could take a number of years. Moreover, the DFC indicated that it understood that, even if it were successful on appeal at the Tribunal level, Revenue Canada would not apply the Tribunal's decision to future imports of butteroil blends until the appeal process had been exhausted. Until that time, the blends would continue to enter Canada unabated. Finally, the DFC submitted that

a successful appeal with respect to butteroil blends would do nothing to address other possible dairy blend formulations which could, in the future, find their way into the Canadian market.

Other parties to the inquiry submitted that butteroil blends have been correctly classified by Revenue Canada. They also submitted that, if the DFC were successful in an appeal to the Tribunal and the blends were thereafter classified under tariff item Nos. 2106.90.33 and 2106.90.34, Canada's trading partners would take "trade action" based on their "legitimate expectation" that the blends would, following the conclusion of the Uruguay Round, continue to be classified under a tariff item not subject to a TRQ.

ii) Canada's Domestic and International Rights and Obligations

Article X:1 of GATT provides, in part, that laws, judicial decisions and administrative rulings of a Member, pertaining to classification of products for customs purposes, shall be published so as to enable governments and traders to become acquainted with them. As noted earlier, Article X:3 provides that Members shall administer their laws with respect to customs classification in a "uniform, impartial and reasonable manner." Article X:3 also requires Members to maintain an independent body to undertake, in appropriate circumstances, the prompt review and correction of administrative action relating to customs matters.

Section 16 of the CITT Act, together with section 67 of the *Customs Act*, provides the Tribunal with jurisdiction to hear appeals with respect to, among other things, classification decisions of the Deputy Minister. As part of its mandate, the Tribunal regularly hears classification appeals and, not infrequently, overturns the Deputy Minister's determinations. The *Customs Tariff* requires the Tribunal to determine the classification of goods imported into Canada in accordance with the General Rules and the *Canadian Rules*,²¹¹ and having regard to any relevant Classification Opinions and Explanatory Notes.²¹² These are the considerations that, as a matter of law, the Tribunal takes into account in deciding upon the correct classification of any product. Consequently, the Tribunal decides upon the appropriate classification of a product without regard to whether its decision will result in a higher or lower rate of duty being applied to that product or whether its decision may have trade repercussions in some other forum.

Section 67 of the *Customs Act* permits any person "who deems himself aggrieved" by a classification decision of the Deputy Minister to file an appeal with the Tribunal. In the normal course of events, it is the importer of a given product that initiates the appeal. In addition, under subsection 70(1), the Deputy Minister may refer to the Tribunal for its opinion any questions relating to the tariff classification of any goods or class of goods. Sections 67 and 68 apply in respect of such a reference, as if it were an appeal under section 67.

211. Section 10 of the *Customs Tariff*.

212. Section 11 of the *Customs Tariff*.

iii) Tribunal's Assessment

In the Tribunal's view, based on the relevant international agreements and conventions, as implemented into law in Canada, the filing of an appeal with the Tribunal by the DFC²¹³ regarding the classification of butteroil blends or, for that matter, a reference to the Tribunal by the Deputy Minister concerning that same question would be consistent with Canada's domestic and international rights and obligations. Moreover, it would be consistent with Canada's domestic and international rights and obligations for the Tribunal to issue a decision classifying butteroil blends within the schedule to the *Customs Tariff* on the basis of the General Rules, the applicable rules, the Explanatory Notes and the Classification Opinions.

Regarding the DFC's submission that, if its appeal to the Tribunal were successful, Revenue Canada would not apply that decision until the appeal process was exhausted, the Tribunal notes that section 64 of the *Customs Act* provides the Deputy Minister with the discretion to re-determine the tariff classification of goods to give effect to Tribunal decisions. If the DFC were successful on appeal, it would, therefore, be open for the Deputy Minister to implement the Tribunal's decision forthwith.

c) Safeguard Inquiry Pursuant to a Complaint Filed by the Industry

There are two possible alternatives with respect to safeguard action.

Option: *that the DFC file a safeguard complaint with the Tribunal, or that the Government of Canada direct the Tribunal to conduct a safeguard inquiry*

i) Position of Parties

The DFC submitted that producer-initiated safeguard proceedings under section 23 of the CITT Act would entail unacceptable delays. Unlike a government-initiated safeguard inquiry, there is no provision within the *Customs Tariff* for immediate provisional relief from imports. Moreover, periods for preparation and filing of a complaint and initiation of an inquiry would aggravate the injury already caused by butteroil blend imports and would permit large inventories to be imported, pending the resolution of the matter. The DFC suggested that this situation would be exacerbated if the Governor in Council directed the Tribunal to provide a further report on the appropriate remedy.

The DFC submitted that a government-initiated safeguard action under section 20 of the CITT Act is a viable option for relief from injury due to imports of butteroil blends. The DFC argued that the rapid increase in import volumes of butteroil blends, the clearly

213. To file an appeal, the DFC would have to be "[a] person who deems himself aggrieved." To accomplish this, it could import a small quantity of a butteroil blend and then appeal the Deputy Minister's classification decision regarding the blend to the Tribunal. Alternatively, it could argue, on the basis of the impact which, for example, the butteroil/sugar blend has had on the dairy industry, that it is already a person aggrieved by a decision of the Deputy Minister. If the DFC elected to follow the latter route, as a preliminary question, the Tribunal would have to decide whether, under section 67 of the *Customs Act*, someone other than an importer can deem himself to be a person aggrieved.

established price undercutting at which these imports gained a foothold in the Canadian market, the negative impact on dairy farmers' revenues, the diversity of import sources and the direct displacement of domestic production which they cause all point to the appropriateness of a safeguard remedy. The DFC also notes that, pursuant to subsection 55(1) of the *Customs Tariff*, if critical circumstances exist, immediate relief could be provided for dairy farmers while the Tribunal conducts the safeguard inquiry.

IDI submitted that a separate investigation and record must be developed in order to make a determination that the necessary conditions exist to support a safeguard action. It submitted, however, that the evidence on record does not support the view that the importation of butteroil blends into Canada is a principal cause of serious injury or threat of serious injury to domestic producers of like or competitive goods.

IDI argued that, even if it were assumed that dairy farmers are producers of like or directly competitive goods, any realistic assessment of injury to producers would show that the injury is minimal when considered in the context of the \$3.8 billion industry. IDI noted that, if a safeguard inquiry were conducted, under certain provisions in NAFTA, imports from the United States and Mexico would only be subject to safeguard measures if they were a "major contributor to the problem."

The NDC stated that any industry in Canada can seek relief from imports which are causing or threatening to cause serious injury, as contemplated by Article XIX of GATT and the *Agreement on Safeguards*. However, the NDC submitted that, if the government were to act on a Tribunal recommendation, there could be demands for dispute settlement on the question of whether or not dairy farmers are producers of like or directly competitive products to the imported butteroil blends.

Good Humor-Breyers and Chapman's opposed this option and argued that there is no basis for a safeguard action because the loss of revenue from butterfat displacement, at less than 0.3 percent of Canadian dairy farmers' overall revenues, is relatively insignificant. In addition, the consumer trend to lower-fat dairy products, such as skim milk, 1 percent milk and 2 percent milk, has been the principal cause for the reduction in quota and sales, not imports of blends.

ii) Canada's Domestic and International Rights and Obligations

Article XIX of GATT and the *Agreement on Safeguards* provide that, if a Member's "competent authority" determines that, as a result of tariff concessions or other trade liberalizing concessions, imports of a particular product have increased so as to cause serious injury or threat thereof to domestic producers of like or directly competitive goods, that Member may apply a safeguard measure. Such measures may include a surtax on imports or import quotas. Chapter Eight of NAFTA provides for a comparable, if not identical, bilateral safeguard remedy.

Both the *Agreement on Safeguards* and NAFTA provide that, subject to certain exceptions, a safeguard measure may only be applied following an "investigation" by a

“competent authority.”²¹⁴ Article 6 of the *Agreement on Safeguards* provides, in part, that measures may be applied prior to an investigation by a competent authority in “critical circumstances where delay would cause damage which it would be difficult to repair.”

Article 7 of the *Agreement on Safeguards* provides that a safeguard measure shall only be applied for such period of time as is necessary to prevent or remedy serious injury and to facilitate adjustment. That period is not to exceed four years unless it is extended in accordance with Article 7(2), in which case it may be applied for an additional four years.

Finally, Article 8 of the *Agreement on Safeguards* provides that a Member applying a safeguard measure shall “endeavour to maintain a substantially equivalent level of concessions” between it and the exporting Members affected by a measure. To that end, the Members may agree to “trade compensation” for the adverse effects of a safeguard measure. If agreement cannot be reached, subject to certain conditions, the exporting Members may suspend the application of substantially equivalent concessions against the trade of the Member that applied the safeguard measure. However, the right of suspension may generally not be exercised for the first three years during which a safeguard measure is in effect.

Canada has implemented its rights and obligations under Article XIX of GATT, the *Agreement on Safeguards* and NAFTA in the CITT Act, the *Customs Tariff* and the EIPA. The CITT Act provides the Tribunal with the jurisdiction to conduct safeguard investigations, which are called “inquiries.” A safeguard inquiry may be initiated on the basis of a complaint by domestic producers or pursuant to a reference by the Governor in Council.

Before initiating an inquiry based on a complaint filed by domestic producers, the Tribunal must be satisfied that the complaint discloses a reasonable indication that the imports in question are entering the domestic market in such increased quantities and under such conditions as to cause or threaten to cause serious injury and that the complaint is made by or on behalf of domestic manufacturers that produce a major proportion of domestic like or directly competitive goods.²¹⁵

Once an inquiry is initiated, whether pursuant to a complaint by producers or a reference by the Governor in Council, the process and applicable principles are the same.

A threshold issue which the Tribunal must resolve in all safeguard inquiries is what Canadian goods are “like or directly competitive” to the imported goods said to be causing serious injury or threat thereof. This is an important issue because it, in effect, serves to identify the Canadian producers that are relevant for purposes of the Tribunal’s injury or threat of injury determination.

As noted above, in certain circumstances, safeguard measures may be applied on a provisional basis. Specifically, subsection 55(1) of the *Customs Tariff* provides that provisional safeguard measures can only be applied prior to the Tribunal conducting a safeguard inquiry, if the Minister of Finance reports to the Governor in Council that “critical circumstances” exist. If

214. Article 3(1) of the *Agreement on Safeguards* and Article 803(2) of NAFTA.

215. Subsection 26(1) of the CITT Act.

this occurs, the Governor in Council must immediately refer the matter to the Tribunal for a safeguard inquiry.

Safeguard measures may be applied to goods from a free trade partner,²¹⁶ if the Governor in Council is satisfied that the quantity of goods from that partner represents a substantial share²¹⁷ of total imports of goods of the same kind and that the imports from a NAFTA country, or from any other free trade partner, contribute importantly to the serious injury or threat of serious injury to domestic producers of like or directly competitive goods.²¹⁸

iii) Tribunal Assessment

The Tribunal is of the view that, based on the relevant international agreements, as implemented into Canadian law, the filing of a safeguard complaint with the Tribunal by the DFC or, for that matter, a safeguard reference to the Tribunal from the Governor in Council would be consistent with Canada's domestic and international rights.

The outcome of an inquiry regarding imports of, for example, butteroil blends is a matter beyond the scope of this report. However, if the Tribunal were to conduct an inquiry and make a serious injury or threat of injury determination concerning butteroil blends, it would be consistent with Canada's domestic and international rights for the Government to apply safeguard measures on such imports.

Finally, provided the necessary conditions existed, the application of a provisional measure with respect to butteroil blends would be consistent with Canada's domestic and international rights.

d) Special Class Price for Butterfat for Ice Cream and Processed Cheese

Option: *that a special class price be created for butterfat for use in the production of all ice cream and processed cheese*

i) Position of Parties

The DFC is opposed to the creation of special classes and has stated that it is not willing to service the domestic butterfat market at world prices. It argued that, because of the direct competition from butteroil blends, this option would immediately lower butterfat prices made available to the ice cream and processed cheese industries to world prices. Special class pricing arrangements for Classes 5a), b) and c) are established on the basis of industry consensus and for Classes 5d) and e) through producer-processor negotiations. In this regard, the DFC pointed out that special class prices are outside the control of government.

216. Subsection 2(1) of the *Customs Tariff* provides that a "free trade partner" means a NAFTA country, Chile or Israel or another *Canada-Israel Free Trade Agreement* beneficiary.

217. Article 802(2)(a) of NAFTA provides that imports from a NAFTA partner "normally shall not be considered to account for a substantial share of total imports if the Party is not among the top five suppliers" of the given product over the most recent three-year period.

218. Subsection 59(1) of the *Customs Tariff*.

In the view of the DFC, special class pricing for butterfat would exacerbate the injury sustained by dairy farmers from imports of butteroil blends. A special class price would have to be extended to all the butterfat used in the ice cream and processed cheese sectors, not just the butterfat currently being replaced by imports. Moreover, there would be no reason, in principle, to distinguish between the ice cream and processed cheese industries and other industries that could potentially use butteroil blends in other products.

The DFC argued that the institution of special class pricing would, to the extent that it was effective in regaining butterfat sales, increase the likelihood of a challenge by other WTO Members. Since most existing special classes for domestic consumption relate to tariffed inputs, they cannot be said to be designed to replace imports of milk components.

IDI did not support the option of special class milk, as special class milk would compete with its imports of blends and this option would only address the pricing concerns of the dairy processors and not their supply problems. Unless supply problems were resolved, processors would continue to have an incentive to use the blends during their peak ice cream season. IDI also noted that the concept of special classes has been challenged by Canada's trading partners at the WTO and that it would seem only prudent not to institute further special classes until the status of these programs has been confirmed by the WTO.

The NDC considered that any adverse impact on Canadian dairy farmers of maintaining the status quo would be alleviated by the creation of a special class of dairy input for use in the manufacture of dairy products currently using the imported blends. The NDC argued that it should be no more difficult to define the end use for new special class prices than it was to define the end use for existing special class prices. While sharing concerns about the challenge at the WTO on special classes, the NDC noted that the focus of the dispute is on exports produced using special class prices.

Good Humor-Breyers and Chapman's opposed the creation of another special class for butterfat for ice cream, as the existing ice cream milk class pricing system does not work. New single-purpose ice cream processors in Quebec have virtually no access to raw milk, and, in Ontario, they have access to only 50 percent of their butterfat requirements from raw milk. If ice cream processors could purchase all of their butterfat from raw milk at the existing Class 2 price, one of the main reasons for using imported butteroil blends would disappear. They argued that, since the impact on dairy farmers is relatively small and there was no evidence of a future increase in the importation of butteroil/sugar blends, there is no need for special class prices.

The Director argued that the better options were those permitting a competitive response to imports of dairy product blends while, at the same time, facilitating a gradual transition to a fully competitive market for the supply of dairy products in Canada. In the Director's view, special class pricing is a form of price discrimination, which, in general, is welfare-enhancing in a monopoly situation because it increases output. It allows consumers and processors the benefits of import competition. Assuming competition continued to exist, special class pricing would minimize the loss of production and revenues for dairy farmers. This is consistent with a gradual transition to a competitive market.

The IDFA, of the United States, testified that it does not support the use of a special class price to recapture the butterfat lost to imported blends. It noted that, to the extent that a special class is designed to displace imports, it may be just as trade-distorting as a tariff or a TRQ. Any new barriers to trade, direct or indirect, would be opposed by the IDFA.

ii) Canada's Domestic and International Rights and Obligations

A special class pricing program exists in Canada for dairy ingredients. This program was created by the dairy industry. The Canadian Milk Supply Management Committee directed its implementation in 1995 and instructed the Canadian Dairy Commission to administer this program.²¹⁹ If the dairy industry is prepared to amend the current special class pricing system, the Tribunal believes that there is no other impediment to doing so. The fact that a special class pricing system currently exists suggests to the Tribunal that this option is not inconsistent with the Government's policy of supply management.

iii) Tribunal's Assessment

The Tribunal is of the opinion that, in order to compete, in terms of price, with the imported butteroil blends in 1997, the return to dairy farmers for the butterfat sold to ice cream and processed cheese manufacturers would have had to be between \$3.89/kg²²⁰ and \$4.44/kg.²²¹ This would cost dairy farmers between \$41 million and \$27 million per year,²²² based on butterfat utilization in ice cream and processed cheese of 25.6²²³ million kilograms. The impact on dairy farmers under this scenario would not change under different import penetration assumptions, since all butterfat going into ice cream and the replaceable butterfat in processed cheese would be at this lower price.

Canadian manufacturers of ice cream and processed cheese would, however, be better off than in the present situation because, currently, when using imported butteroil blends, only that part of their business that uses the blends has a cost advantage. This option thus affords a windfall gain to the processors, because the special price is for all butterfat used in ice cream and all the replaceable butterfat for processed cheese. The Tribunal believes that a smaller reduction in the price of butterfat could be negotiated between the dairy farmers and the processors to encourage the processors to buy their butterfat domestically. A negotiated price could reduce the revenues forgone by the dairy farmers and maintain the current level of cost savings to the ice cream and processed cheese manufacturers. As just one example, a smaller

219. *Transcript of Public Hearing*, Vol. 6, April 15, 1998, at 1231.

220. The highest price for skim-off butterfat in 1997 (\$6.80/kg) less the average cost of the butterfat contained in the imported butteroil blends used in 1997 (\$5.20/kg) is \$1.60/kg. To match this saving to processors, Class 2 butterfat would have to be offered at \$3.89/kg, compared to the September 1997, Class 2 price of \$5.49/kg.

221. Based on the weighted average saving of \$1.05/kg of butterfat, i.e. the Class 2 price of \$5.49/kg less the average saving of \$1.05/kg equals \$4.44/kg.

222. Participant's Exhibit L-5A, Administrative Record, Vol. 15C. The DFC's estimate of this scenario differs from that of the Tribunal. The DFC estimates a revenue loss to producers of \$84 million for ice cream and \$67 million for processed cheese. It assumes that a world price of \$1.65/kg of butterfat would have to be paid to producers in order to compete with the imported blends. It further assumes that all butterfat in processed cheese would be affected, whereas the Tribunal assumes that only the replaceable butterfat would be affected.

223. See Table 3 of this report.

price reduction could be negotiated for butterfat being made available from raw milk, as its price is closer to the price of the butterfat in the imported butteroil blends.

In putting forward special class prices as a possible option, the Tribunal notes a couple of considerations. First, the international price of butterfat and exchange rate fluctuations would need to be reflected in the special class price calculations if producers wanted to match the imported price of the blends. Adjusting for price volatility is already a feature of certain of the existing special class prices. Alternatively, it is possible that a more stable price could be negotiated between the dairy farmers and the processors.

Second, the Tribunal has also considered the argument that there may be other industries that could use dairy product blends to which the farmers would have to extend the special class price. During the hearing, however, no such industries were identified. Those industries that could use the blends, such as the bakery and confectionery industries, already have access to special class prices for milk ingredients.

Establishing a special class for ice cream and processed cheese will not, on its own, solve the supply difficulties that some processors, in particular, the single-purpose ice cream manufacturers, have experienced. In the Tribunal's view, these supply problems should be examined and dealt with through negotiations between the milk marketing boards and the processors, regardless of which option is considered. In this regard, the Tribunal notes that the issues of the supply of domestic butterfat to the ice cream industry, the pricing of domestic butterfat and the use of imported butteroil blends are closely linked. Certain ice cream processors testified that, if they were able to purchase 100 percent of their butterfat in the form of raw milk at the existing Class 2 price (5.49/kg in 1997), one of the main reasons for using imported butteroil blends would disappear.

e) Special Class Price for Butterfat for Domestic Butteroil Blends

Option: *that a special class price be created for butterfat for use in the production of domestic butteroil blends for use only in the production of ice cream and processed cheese*

i) Position of Parties

The DFC suggested that a special class price for butterfat for use in the production of domestic butteroil blends, while intended to limit the price injury across all butterfat, would increase the use of blends in domestic processing. Price competition with imported blends would force prices down to the world level, at which point the incentive to use blends would increase. Moreover, to the extent that the current penetration was limited by variations in the taste of imported blends compared to Canadian butterfat, domestic butteroil blends may be substitutable at higher rates than imported blends. Additional costs of production, record keeping and auditing were also cited as concerns.

Good Humor-Breyers and Chapman's argued that, if a special class price for butterfat for use in making a butteroil/sugar blend for use in producing ice cream is recommended as an option, ice cream processors should be free to continue to import, in case the DFC is not able to supply the butterfat for this special class.

The Director argued that it was in the interests of dairy farmers to limit the special class price for butterfat to only the volume that faces competition from imports of butteroil blends. This would be the rational, profit-maximizing response to imports of butteroil/sugar blends.

ii) Tribunal's Assessment

The Tribunal is of the opinion that, in order to compete in terms of price with the imported butteroil blends in 1997, the dairy farmers would have had to price the butterfat available to a manufacturer of a butteroil blend for use in the production of ice cream and processed cheese at about \$3.00/kg.²²⁴

Compared to the previous option, dairy farmers would receive less per kilogram of butterfat because of the additional processing cost that is involved. On the other hand, the volumes of butterfat sold at this special class price would be less, since only a maximum amount of 25 percent of the butterfat in ice cream and processed cheese would be affected, rather than all butterfat in these categories, as was the case under the previous option.

This option would have a smaller impact on dairy farmers' revenues than a special class price for all butterfat used in ice cream and processed cheese. In 1997, this option would have cost dairy farmers about \$7.5 million in revenues forgone based on 3.1 million kilograms of butterfat at the special class price. It is estimated that the maximum loss of revenue to dairy farmers, at the 25 percent penetration level (6.4 million kilograms of butterfat), would be approximately \$15.8 million annually.

This option compares favourably with the status quo, where the revenue implications for dairy farmers could range from \$27 million to \$64 million depending on their reaction to the imports at the estimated maximum 25 percent penetration level. As with the earlier option on special class prices, the impact would change with world prices for butterfat and the exchange rate.

Canadian dairy processors would not be greatly affected, provided all the required butterfat can be made available at the right price. They would merely replace a foreign supply with a domestic supply. It is possible, however, that a more stable price could be negotiated between dairy farmers and processors which might benefit the processors. The dairy processors making the butteroil and/or the butteroil blends would benefit from this option in terms of a new value-added product.

224. This price takes into account the cost of sugar at \$0.50/kg, an estimated processing cost for the butteroil/sugar blend calculated by the Tribunal staff to be \$0.78/kg and the landed duty-paid cost of the imported butteroil blend of about \$2.51/kg. Tribunal Exhibit GC-97-001-84, Administrative Record, Vol. 1H at 7; *Transcript of In Camera Hearing*, Vol. 2, April 7, 1998, at 35 and 91-95; and Tribunal Exhibit GC-97-001-118A (protected), Administrative Record, Vol. 2A at 47 and 48.

f) Compensation for the Dairy Farmers for Income Losses

Option: *that the Government of Canada provide support to compensate dairy farmers for income losses*

i) Position of Parties

The DFC's primary argument is that butteroil blends were intended to be covered by TRQs. However, it submitted that, if the Government were unwilling to reclassify butteroil blends under a tariff item covered by a TRQ or, because of inadvertence, the blends were not included in Canada's "final offer of tariffication in Uruguay Round," any injury suffered by farmers which is attributable to imports of blends would warrant the payment of compensation. The Victoria County Dairy Committee supported this option.

Other parties submitted that the decision on whether or not to provide compensation was a policy question for the Government. The NDC submitted that compensation for trade-related adjustments is not normally provided by governments in Canada.

ii) Canada's Domestic and International Rights and Obligations

In terms of Canada's international rights and obligations, the Tribunal notes that, pursuant to the *Agreement on Agriculture*, Members agreed to certain limits to the support that they can provide to their agricultural industries. The *Agreement on Agriculture* uses the concept of "Total Aggregate Measurement of Support" or "Total AMS." In simple terms, Total AMS is the sum of all support provided by a given Member to its agricultural industry. Under the *Agreement on Agriculture*, developed country Members, such as Canada, agreed that, in the six years beginning in 1995, they would reduce their Total AMS by 20 percent from what it was in the 1986-88 base period.

In response to questions, a witness for the Government indicated that Canada has already reduced its Total AMS well in excess of the 20 percent required under the *Agreement on Agriculture*, providing some "room" in the event that the Government wished to pay compensation.

iii) Tribunal's Assessment

Based on the foregoing, the Tribunal is of the view that it would be possible for the Government to provide compensation to the dairy farmers without violating Canada's international rights and obligations.

It has not generally been Canadian government practice to provide compensation for losses occasioned by trade liberalization. The Tribunal notes that assistance was provided by the Government of Canada to Canadian grape growers to assist them to adjust to trade impacts associated with the FTA. With respect to the Government's decision to provide that assistance, a witness for the Government testified that "there was a general recognition that of all the agricultural subsectors that were going to be potentially affected by the [FTA], that the [grape] wine sector would suffer the most severe dislocation, and as a consequence there was a

federal-provincial agreement ... to provide financial assistance [to that sector in Ontario and British Columbia].²²⁵ In addition, the Tribunal notes that the Government negotiated Chapter 8 of the FTA, which substantially liberalized trade in wine and distilled spirits and resulted in significantly greater access to the Canadian market.

By contrast, the evidence before the Tribunal indicates that, in the Uruguay Round, the Government of Canada took no concerted action to increase access for imports of butteroil blends. In fact, just the opposite is true. Many imports of blends and similar products have less rather than more access to the Canadian market following the Uruguay Round. For butteroil blends, the access conditions to the market following the conclusion of the Uruguay Round remains unchanged from what they were prior to that time.

g) More Restrictive Tariff Treatment

Option: *subject to Article XXVIII of GATT, that the Government of Canada create a new tariff line for butteroil blends with a more restrictive tariff*

This option contemplates the creation of a new tariff line for butteroil blends and either applying a higher tariff rate or making it subject to a TRQ. A new tariff line would have to be created, otherwise other products, such as some baby foods, which also enter Canada under tariff item No. 2106.90.95, would be caught in the increased rate.

i) Position of Parties

The DFC opposed this option. It argued that butteroil blends are already entitled to TRQ treatment, as those matters were negotiated during the Uruguay Round. In the DFC's view, three years of misclassification does not alter that entitlement. It noted that negotiations under Article XXVIII of GATT, and any additional compensation, would amount to double payment for a concession already negotiated and agreed to. The DFC referred to the testimony of a government official to the effect that negotiations under Article XXVIII of GATT would not apply to Canada's NAFTA partners. Therefore, this option would not address any problems caused by imports of butteroil blends from the United States and Mexico.

IDI agreed that the Government of Canada may take steps to increase the restrictions upon a bound tariff item, either by imposing a TRQ or by increasing the rate of duty applicable to a certain tariff item. However, IDI argued that such action would impair the rights of Canada's trading partners and would attract trade retaliation, regardless of Canada's rationale for acting. IDI referred to the evidence on the record which suggested that the request for compensation could be substantial.

Good Humor-Breyers and Chapman's also opposed this option, as it contravenes NAFTA and, as such, could not be implemented in relation to Mexico and the United States. They noted that it would require compensation to be paid to New Zealand, while imports would continue to enter duty-free from Mexico and the United States. In their view, this option would cost Canada millions of dollars.

225. *Transcript of Public Hearing*, Vol. 7, April 16, 1998, at 1304.

The NDC also opposed this option. It argued that, if implemented, this option would increase costs to Canadian users of butteroil blends. It also argued that, because tariff item No. 2106.90.95 is bound under both the WTO and NAFTA, the implementation of this option would breach Articles II and XI of GATT. Furthermore, any restrictive change in the tariff rate or TRQ status of this tariff item would require notification under Article XXVIII of GATT and trigger negotiations with Canada's trading partners, which would entail a cost to Canada. The NDC submitted that Canada's trading partners have a "legitimate expectation" that benefits accruing to them under the WTO or NAFTA will not be nullified or impaired. The NDC also noted that there is no counterpart provision in NAFTA to Article XXVIII of GATT.

ii) Canada's Domestic and International Rights and Obligations

A tariff line must have a bound MFN tariff rate in order to be subject to GATT disciplines. Tariff rates are bound through concessions made by countries during multilateral trade negotiations. Tariff item No. 2106.90.95, under which Revenue Canada now classifies butteroil blends, was not included in Canada's Uruguay Round Offer.²²⁶ It was also not included in Canada's implementing legislation, in either Part D IV of Schedule I of the WTO Act, which lists the TRQs, or Part D II, which lists the MFN tariff concessions on agricultural products.

Tariff item No. 2106.90.95 was only added to Schedule I to the *Customs Tariff* by *WTO Technical Amendments Order, No. 2*, dated December 20, 1994, which came into effect on January 1, 1995. This technical amendments order renumbered and amended certain tariff items in Schedule I, which were created pursuant to the WTO Act to accommodate certain NAFTA Rules of Origin.²²⁷

Nevertheless, at the conclusion of the Uruguay Round, butteroil blends were entering Canada under residual tariff item No. 2106.90.99, which had a bound tariff rate.²²⁸ This tariff line was not tariffied in the Uruguay Round.²²⁹ When butteroil blends were reclassified in 1995 by Revenue Canada under tariff item No. 2106.90.95, there were no adverse trade implications because the new tariff item had a lower rate (i.e. 12.5 percent) and was also not subject to a TRQ.

226. Participant's Exhibit L-3, Tab 11, Administrative Record, Vol. 15C.1.

227. Tariff item No. 2106.90.95 was created to ensure that, when goods falling in either Chapter 4 or 19 of the *Customs Tariff* are imported into a NAFTA country and combined to make a product which falls in Chapter 21, that product will not be considered a NAFTA-originating product. This NAFTA rule of origin was covered between January 1, 1994, and January 1, 1995, by tariff item No. 2106.90.32, which read as follows: "Preparations containing, in the dry state, over 10% by weight of milk solids." Tariff item No. 2106.90.32 had a rate of 12.5 percent in 1994.

228. *Transcript of Public Hearing*, Vol. 5, April 14, 1998, at 1023-24.

229. Tariff item No. 2106.90.99 had a 1995 tariff rate of 17.1 percent, which was bound in the Uruguay Round at a final rate of 10.9 percent.

iii) Tribunal's Assessment

In the Tribunal's view, because butteroil blends were being imported at the conclusion of the Uruguay Round under a bound tariff item (No. 2106.90.99), the GATT disciplines of binding apply. If a product was receiving a certain bound treatment and unfettered access at the conclusion of the Uruguay Round and had continued to be imported following the Uruguay Round at an even lower rate of duty, then, under GATT rules, an exporting Member can negotiate for compensation if that product receives an increased rate of duty or reduced access after the Uruguay Round.

If the Government were to decide to raise the tariff rate to a "dairy" tariff equivalent level and/or create a TRQ covering butteroil blends, it would have to notify that intention to its trading partners and effect that modification through negotiations under Article XXVIII of GATT.²³⁰ Such a notification involves a process that could well lead to compensation having to be paid, possibly in excess of the amount of trade actually affected.²³¹

There is no counterpart to Article XXVIII of GATT in NAFTA and, thus, no ability to raise a tariff rate and pay compensation. Therefore, even if the MFN rate on butteroil blends could be increased or if they could be made subject to a TRQ, this would do nothing to address imports from the United States and Mexico, the source of a fair amount of imports in the past. The United States and Mexico, having preferential duty-free access under both tariff item Nos. 2106.90.95 and 2106.90.99, would not be subject to any changes in concessions applicable to the MFN rate.

An alternative to negotiations under Article XXVIII of GATT would be to include the issue of butteroil blends or tariff item No. 2106.90.95 in the agricultural negotiations to begin in 1999, in accordance with Article 20 of the *Agreement on Agriculture*.

230. It should be noted, however, that, because the bound rate of butteroil blends, under tariff item No. 2106.90.99, is higher than the base rate provided under tariff item No. 2106.90.95, the Government has some flexibility in raising the applied rate without necessitating a negotiation under Article XXVIII of GATT. The MFN tariff rate for butteroil blends could be raised from the current rate of 9.5 to 13 percent, the rate which now applies to tariff item No. 2106.90.99.

231. Paragraph 6 of the *Understanding on the Interpretation of Article XXVIII of the General Agreement on Tariffs and Trade 1994* provides that, when an unlimited tariff concession is replaced by a TRQ, the amount of compensation provided should exceed the amount of trade "actually affected" by the modification of the concession. That understanding also provides the basis for the calculation of compensation.

3. Conclusion

The Tribunal has identified a number of options which are consistent with Canada's domestic and international rights and obligations. Maintaining the status quo is an option. There are, in addition, a number of options which could lessen the consequences of the imports of butteroil blends on the dairy farmers. Some options require action by the dairy farmers, others by the Government. These options include:

- an appeal to the Tribunal by the dairy farmers of the classification of butteroil blends;
- a safeguard inquiry by the Tribunal pursuant to a complaint by the dairy farmers or a government reference;
- a special class price for butterfat for ice cream and processed cheese;
- a special class price for butterfat for domestic butteroil blends;
- compensation of the dairy farmers for their income losses; and
- a new tariff item for butteroil blends with a different tariff treatment.

It is clear to the Tribunal that there is no option available that comes without a cost to one or more of the stakeholders. The dilemma is that there are economic consequences for the dairy farmers from imports of butteroil blends, and yet the international rules limit the types of action now available. Within the rules-based system, there are avenues available to the dairy farmers to seek relief from the effects of the imports. As well, the dairy farmers manage the supply of domestic dairy products and have the ability to moderate the effects of the imports of butteroil blends on their industry.

APPENDIX I

ORDER IN COUNCIL

P.C. 1997-1868
December 16, 1997

Whereas the importation of blends of dairy products is becoming a matter of increasing concern to the Canadian dairy industry;

Whereas representatives of Canadian dairy producers have requested that the Government of Canada address concerns related to the importation of certain of these products, in particular butteroil/sugar blends;

And Whereas the economic impact of this importation and the implications under domestic law and international trade agreements of possible courses of action need to be thoroughly evaluated;

Therefore, His Excellency the Governor General in Council, on the recommendation of the Minister of Finance, the Minister of Agriculture and Agri-Food and the Minister for International Trade, pursuant to section 18 of the *Canadian International Trade Tribunal Act*, hereby:

- (a) directs the Canadian International Trade Tribunal to forthwith inquire into the matter of the importation of dairy product blends outside the coverage of Canada's tariff-rate quotas by:
- (i) examining the factors influencing the domestic market for such imports, and the implications of these imports for the Canadian dairy producing and processing industry and other segments of the Canadian food processing industry, including production and revenue levels,
 - (ii) reviewing the legal, technical, regulatory and commercial considerations relevant to the treatment of imports of these products, as well as Canada's international trade rights and obligations under the North American Free Trade Agreement and the World Trade Organization Agreement, and
 - (iii) identifying options for addressing any problems raised by this issue in a manner consistent with Canada's domestic and international rights and obligations; and
- (b) directs the Canadian International Trade Tribunal to hold public hearings with respect to the inquiry and to report to the Governor in Council by July 1, 1998.

APPENDIX II

LIST OF PARTICIPANTS/WITNESSES

1. Pre-Hearing Conference - January 30, 1998

Company/Association	Counsel/Representative
International Dairy Ingredients Inc.	Donald Kubesh and Justine Whitehead
National Dairy Council of Canada	Peter Clark, Sean Kirby and Alia Tayyeb
David Chapman's Ice Cream Limited	Michael A. Kelen
Good Humor-Breyers	Michael A. Kelen
Ministère de l'Agriculture, des Pêcheries et de l'Alimentation du Québec	Raymond Tremblay
Ontario Ministry of Agriculture, Food and Rural Affairs	Sid Friesen

2. Hearing - April 6-9 and 14-16, 1998

Participant/Witness	Counsel/Representative
Dairy Farmers of Canada	Gregory Somers and Benjamin Bédard
Dairy Farmers of Ontario	
Fédération des producteurs de lait du Québec	
Richard Doyle	
Rick Phillips	
Barron Blois	
John Core	
Jean Norbert	
Ron Pelzer	
The Canadian Federation of Agriculture	
Donald Knoerr	
Victoria County Dairy Committee	
Bill Denby	
International Dairy Ingredients Inc.	Donald Kubesh and Justine Whitehead
Douglas McEwen	
National Dairy Council of Canada	Peter Clark, Sean Kirby, Chris Hines
Kempton Matte	Yannick Beauvalet and Alia Tayyeb

Participant/Witness	Counsel/Representative
Nestlé Canada Inc. Kathryn Rowan Martin Crumplen Domenic Della Penna	Peter Clark, Sean Kirby, Chris Hines Yannick Beauvalet and Alia Tayyeb
Parmalat Canada Bert Lear	Peter Clark, Sean Kirby, Chris Hines Yannick Beauvalet and Alia Tayyeb
David Chapman's Ice Cream Limited David Chapman	Michael A. Kelen
Good Humor-Breyers Brad Allender James Summers Tom Prychitka	Michael A. Kelen
Ministère de l'Agriculture, des Pêcheries et de l'Alimentation du Québec	Raymond Tremblay
Director of Investigation and Research, Competition Bureau Robert Lancop	James Sutton and Duane Schippers
International Dairy Foods Association Janet Nuzum	

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International Trade

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Department of Finance

Darwin Satherstrom

Paul Robichaud

Department of National Revenue

Phil McLester

Department of Agriculture and Agri-Food

Michael Gifford

Thomas Barton

Sanderson Graham and John Clifford

Sanderson Graham and John Clifford

Sanderson Graham and John Clifford

Sanderson Graham and John Clifford

APPENDIX III**PARTIES FILING SUBMISSIONS AND QUESTIONNAIRE RESPONSES BUT
NOT APPEARING BEFORE THE TRIBUNAL****SUBMISSIONS BY PARTIES NOT PARTICIPATING IN THE PRE-HEARING
CONFERENCE**

Canadian Restaurant and Foodservices Association
Island Farms Dairies Co-op Association
Mainland Dairymen's Association
National Milk Producers Federation, U.S. Dairy Export Council and International Dairy
Foods Association (joint submission)
New Brunswick Ministry of Agriculture and Rural Development
New Zealand High Commission
Office of the United States Trade Representative
Pascobel Inc.

SUBMISSIONS BY PARTIES NOT PARTICIPATING IN THE FINAL HEARING

British Columbia Milk Marketing Board
Canadian Restaurant and Foodservices Association
Saskatchewan Ministry of Agriculture and Food
Hershey Canada Inc.
Kraft Canada Inc.
Reid's Dairy Products

QUESTIONNAIRE RESPONSES

292806 Ontario Ltd., o/a Bright Cheese House	Belser Holdings Inc.
655537 Ontario Limited, o/a The Candy Factory	Bond Foods Ltd.
Abbott Laboratories Limited	Braxco Ltd., Scotsburn Co-operative Services Limited and Brookfield Dairy Group
ADM Cocoa Ltd.	Brum's Dairy Ltd.
Agropur	Burns Philip Food Limited
Aliments Ultima inc.	Burt Lewis Inc.
AM Ingredients Corp.	Cadbury Beverages Canada, Inc.
Amalgamated Dairies Limited	Calico Cottage, Inc.
Andrew Janssens Enterprises Ltd., o/a Andea Chocolate & Supplies	Canada Safeway Limited
Arthur Roger & Assoc. Inc.	Central Smith Creamery
Ashley-Koffman Foods	Chocolat Chocolat Inc.
Barry Callebaut Canada Inc.	Chocolate Masters Inc.
Baskin Robbins Canada	Dalimpex Ltd.
Batory Industries Ltd.	Dealers Dairy Canada Ltd.
	Dorsey Marketing Inc.

Effem Foods Limited
European Union Delegation of the
European Commission in Canada
Federated Co-operatives Ltd.
Ferrero Canada Ltd.
Foothills Creamery Ltd.
Fromagerie Bergeron
G. Van Kam Trading Company Ltd.
Gay Lea Foods Co-Operative Limited
General Mills Inc.
Gourmet Qzina International Inc.,
o/a Qzina Specialty Foods Inc.
Hershey Canada Inc.
Hung Gay Enterprises Ltd.
Hunt-Wesson Canada
J.M. Smucker (Canada), Inc.
Jennings & Associates Sales and
Marketing Company Ltd.
K.M.L. Food & Confectionery
Kouri Foods Inc.
Kozy Schack, Inc.
Kraft Canada Inc.
Laiterie de la baie Ltée
Laurentian View Dairy Ltd.
Les Desserts Congelés Ltée
Lindt & Sprungli (Canada) Inc.
MacKay's Cochrane Ice Cream Ltd.
Major Smith, Inc.
Malcolm Ingredient Innovations, Inc.
McCormick Canada Inc.
Morris National Inc.
Nabisco Ltd.
National Importers Ltd.
Neilson Dairy
New Zealand Dairy Board
New Zealand High Commission
Pillsbury Canada Limited
Preisco Foods Ltd.
Principal Marques
Priority Brands, A Division of
Nasmark Inc.
Purdy's Chocolate Ltd.
Real Fresh, Inc.
Robin Marketing Corporation
Roger's Chocolates Ltd.
Russell Stover Candies
S&F Food Importers
Schwan's Canada, Ltd.
Soluble Products Co., L.P.
Splendid Chocolates Ltd.
Tootsie Roll of Canada, Ltd.
Trebor Allan Inc.
Triple C Inc.
United States Department of Agriculture
Vacationland Dairy Co-op Ltd.
Walter E. Jacques & Sons Ltd.
Western Grocers, Division of
Westfair Foods Ltd.
William M. Dunne & Associates Ltd.
World's Finest Chocolate Canada Ltd.

APPENDIX IV

TRIBUNAL STAFF INVOLVED IN THE INQUIRY

I RESEARCH BRANCH

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Assisting Research Staff

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APPENDIX V

GLOSSARY

- Butter:** creamy fat food product obtained from the churning of cream from milk. It contains not less than 80 percent milk fat and may contain milk solids, bacterial cultures, salt and permitted food colour.
- Butteroil (clarified butter):** product prepared from butter or cream and resulting from the removal of most of the water and solids non-fat which contains not less than 99.3 percent milk fat and not more than 0.5 percent water.
- Cheddar Cheese:** product made by coagulating milk, milk products or a combination thereof with the aid of bacteria to form a curd and subjecting the curd to the cheddar process or any other process other than the cheddar process that produces a cheese having the same physical, chemical and organoleptic properties as those of cheese produced by the cheddar process. It contains not more than 39 percent moisture and not less than 31 percent milk fat and may contain salt, bacterial cultures to aid in the further ripening, colour and other permitted agents. Cheddar is the principal cheese used to make processed cheese.
- Dairy Year:** August 1 to July 31 inclusive.
- Fluid Milk:** milk used for the production of liquid dairy products such as skim milk, 2 percent milk, 1 percent milk, homogenized milk (3.25 percent fat) and long-life ultra high temperature milk, as well as products such as table cream and whipping cream.
- Fluid Milk Market:** milk that will be sold as fluid milk (see above definition).
- Ice Cream Mix:** unfrozen pasteurized combination of cream, milk or other products, sweetened with permitted sweetening agents and does not contain less than 36 percent total solids, of which 8 percent is milk fat.
- Ice Cream:** food made from the whipping and freezing of ice cream mix. The product contains not less than 36 percent solids, of which 10 percent is milk fat or, where cocoa or chocolate syrup, fruits, nuts or confectionery items have been added, 8 percent milk fat. Ice cream contains at least 180 grams of solids per litre, of which amount not less than 50 grams is milk fat or, where cocoa or chocolate syrup, fruits, nuts or confectionery items have been added, 180 grams of solids per litre, of which amount not less than 40 grams is milk fat.

Import Control List:	The <i>Export and Import Permits Act</i> provided authority for the establishment of controls on imports of designated goods, such as certain supply-managed agricultural products, by the addition of items to the <i>Import Control List</i> . Goods on the <i>Import Control List</i> could only be imported under authority of individual import permits, which were obtainable through the Department of Foreign Affairs and International Trade. Over-quota imports were freely imported under a general import permit.
Industrial Milk:	milk used for the production of milk dairy products such as cheese, butter and ice cream.
Industrial Milk Market:	milk that will be sold as industrial milk (see above definition).
Market Sharing Quota (MSQ):	quota that is held by a dairy farmer that is part of the total Canadian industrial milk quota. The MSQ gives dairy farmers the right to produce a certain volume of milk every year. Milk produced under this quota is used for processed dairy products.
Milk Classification System:	milk produced in Canada is sold to processors through a common classification system for the manufacture of products according to classes 1 to 5. Dairy farmers receive different prices for milk components depending on the end use of the products. They receive the highest return per hectolitre for milk produced for the domestic market allocated to classes 1 to 4.
Milk Entitlement Quota:	means the allocation of milk supply to a single-purpose ice cream plant by the Dairy Farmers of Ontario.
Overrun:	while the ice cream is being frozen, blades in the freezer, or “dashers,” whip and aerate the mix. This aeration is called “overrun.” Generally, “overrun” may be between two to three times the total solids of the mix. A usual overrun for packaged ice cream is 80 percent; for soft ice cream, it is from 40 to 80 percent; and for bulk ice cream, the overrun could go from 80 to 100 percent, and it may even reach 150 percent. If, for example, there is 100 percent overrun, one gallon of ice cream mix makes about two gallons of finished ice cream.
Pooling:	pooling in the context of dairy policy refers to pooling of producers’ revenues.
Processed Cheese:	processed cheese or processed cheese spreads are made by grinding, mixing, melting and emulsifying, with the aid of heat and emulsifying agents, of one or more varieties of cheese with a selection of ingredients or additives.
Raw Milk:	milk that is shipped from the farm to the processing plant.
Single-Purpose Ice Cream Plant:	plant that, during the immediately preceding calendar year, produced frozen dairy products exclusively.

- Skim-Off (fluid skim-off):** milk fat (butterfat) that remains after the production of milk destined for the fluid milk market (i.e. homogenized, 2 percent, 1 percent, skim milk and cream). Skim-off is used to produce dairy products, mainly ice cream and butter.
- Table Cream:** usually refers to cream that has a butterfat content of 18 percent.
- Tariff-Rate Quota (TRQ):** limitation placed on the quantity of imported goods entitled to a specific rate of duty. Under a TRQ, imports up to a certain quantity are, for a specified period of time, admitted duty-free or at a relatively low rate of duty. Imports above the in-quota quantity are subject to a higher rate of duty. In the Uruguay Round, the most recent round of multilateral trade negotiations under GATT, Canada and all other contracting parties agreed to convert various non-tariff barriers applicable to agricultural products, such as quotas, into TRQs.
- Whole Milk:** homogenized milk which contains 3.25 percent milk fat (butterfat).