

# Australian Dairy Industry

## Submission To A Scoping Study For A Japan Australia Free Trade Agreement

August 2005

### 1. Background and Australian Dairy Industry Request

This submission builds on the Australian dairy industry submission of 14 November 2003 to the scoping study for an Australia-Japan Trade and Economic Framework. We note that many of the points raised in that submission, and re-iterated here, were taken up in the final report of that study issued on 20 April 2005.

Japan has been the Australian dairy industry's most valuable overseas market for more than thirty years. During the time that Australian dairy exporters have been exporting to the market, they have developed strong commercial relationships at all levels. This has occurred in the face of Japanese dairy policies which have been severely interventionist aiming at import replacement and control of imported products.

Since the Uruguay Round, the main instruments for controlling dairy imports into Japan have been prohibitive out of quota tariffs and restrictive applications of tariff quotas. This has led to the development of products which meet the requirements so that they can legitimately enter Japan in those few areas (such as cheese and dairy preparations) where tariffs are low enough to allow trade to occur. This in turn has led to the development by the Japanese authorities of unorthodox definitions and unusual tests to provide the authorities with instruments to control the volume and end use of these products.

Accordingly, improved access to this market will need to address both tariff and non-tariff impediments to the export of dairy products to Japan. The following outcomes from a Free Trade Agreement would achieve this.

- Removal of tariffs on dairy product lines.
- The first priorities in this regard would be:
  - Cheese
  - Dairy preparations
  - Butter and milk powders
  - Consumer products such as ice cream.
- If access is in the form of bilateral quotas, these should be administered with the maximum flexibility for exporters and be large enough to allow for considerable growth in the current levels of trade.

- Bilateral accesses should not be subject to special safeguards.
- Imprecise, non-repeatable test methods unique to Japan should not be allowed.
- Provisions ensuring that Prefectural and Local Governments apply regulations to exports in the same way that they apply them to local product.
- Specific and detailed harmonization provisions on dairy food standards, SPS, animal welfare and residue levels for food imports.
- An assurance that Australia will never receive worse treatment than any of our competitors in dairy products (New Zealand, EU, US, Canada, Latin America).
- An understanding on the use of anti-dumping and countervailing safe guards
- Standard rules of origin for dairy products
- An understanding on the limits of Geographical Indications as they apply to dairy products

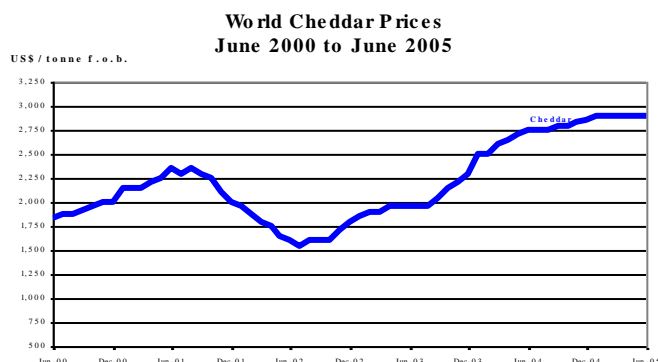
### 3. Tariffs and Quotas

The Australian dairy industry would view a successful FTA with Japan as one which achieves zero tariffs on all dairy imports into Japan. The industry recognizes that from a Japanese perspective dairy may be one of the more politically difficult sectors to liberalize immediately. The following priorities are provided, therefore, as a guide to achieving the ultimate objective of free trade in dairy products with Japan.

#### Cheese (0406)

Cheese has historically been the largest component of Australia's dairy exports to Japan. Exports regularly exceed \$300 million per year. Most of this enters as "other fresh cheese" or "other cheese" attracting a tariff of 29.8%. If the cheese is used by a Japanese company which uses locally produced cheese there is an opportunity for it to enter at zero tariff. This local content scheme is permitted by WTO as the so called "quota" under which product enters at zero is voluntary and not bound in Japan's Uruguay Round schedule. This tariff reduction assists some Japanese cheese manufacturers with little, if any, advantage to exporters. Whether or not they benefit from the local content quota arrangements, all users of imported cheese will, however, benefit from the removal of the tariff on their ingredients. An across the board removal of all cheese tariffs would see the quota become irrelevant which might change some competitive positions amongst Japanese companies (depending on their current use of local product). It would, however, benefit both Australian exporters and Japanese importers alike.

Since mid 1992 there has been a steady increase in the world price of cheddar cheese. The impact of this in Japan has been exacerbated by currency movements. At the retail level (which accounts for about one third of cheese consumption),



this increase has not been able to be passed on to consumers. Manufacturers have responded by maintaining retail prices but reducing the volume of product in each pack. This has effectively reduced Japanese consumption of cheese – including both the domestic and imported component of the product. This could have long term implications for consumer attitudes towards cheese and public health. Japanese processed cheese manufacturers have, therefore, been pushing for a reduction in the landed cost of cheddar cheese. The best way to do this would be to remove the import tariff.

### **Cheese Powder (0406.20)**

A specific problem also exists in respect of cheese powder (0406.20). Cheese powder manufacture requires that emulsifiers be added. As emulsifiers are on the ingredient list, it is classified as 0406.20.100 “cheese powder of processed cheese” (attracting a tariff of 40%) when in fact it should fall under 0406.20.200 and attract the lower tariff of 26.3% as it the product is not heat treated in the way that processed cheese normally is.

The higher tariff on “processed cheese powder” is in place to protect the Japanese processed cheese manufacturers. As the output from processed cheese manufacturers is not used in the manufacture of cheese powder there is no reason to maintain the differential tariff. It would be simpler, therefore, if all cheese powder were treated the same and the tariff on both lines reduced to zero immediately. This would have no adverse impact on any Japanese industry.

### **Milk Powders (0402.1, 0402.2, 0403.9, 0404)**

Access to the Japanese milk powder markets is generally restricted to sales to the state trading body ALIC (Agriculture and Livestock Industries Corporation) specified dairy quotas or through the pooled quota. Out of quota trade is virtually impossible as the trade attracts a tariff equivalent of in excess of 200%. However, as Japanese domestic prices are well above world prices, access to this market would be very valuable.

### **Butter (0405)**

With a tariff equivalent in excess of 350% for out of quota trade, Japan would be a premium market for butter. However, trade is generally restricted to ALIC and the pooled quota. As the tariff is expressed in specific terms, it is possible to make some sales of high value added products (such as individual portions) or under specified quotas. This trade has, however, been reduced in recent years as ALIC imports have caused a “surge” in trade sufficient to trigger the special safe guard.

The specified quota for butter also has limited value as most of it must be either used for recombining in Okinawa (where there are no longer any recombining plants) or for use at trade fairs (where volumes are too small to justify the administrative cost of applying for quotas).

Butter is also imported under the Prepared Edible Fat quota (2106.90.121 and 2106.90.122). This is a quota for a mixture of butter and vegetable oils. New Zealand holds a country specific quota accounting for 60% of the volume. The remainder is available for product from other countries. This quota is usually filled each year.

### **Food Preparations (1806, 1901, 2106)**

Another important avenue for selling milk solids in Japan is in the form of food preparations – in other words milk powders that have been mixed with other ingredients (such as sugar and cocoa) which enables them to enter at tariffs of 20 to 30%. Australian exporters have built up strong commercial relationships on the basis of this trade. Removal of the tariffs on these lines would, therefore, be of considerable benefit to a number of Australian exporters.

### **Consumer Lines – Ice cream (2105), yogurt (0403.10), milk and cream (0401), infant formula (ex 0404.10)**

There is already a small volume in trade in some of these items. Ice cream is traded on tariff only protection of 21 to 28%. Although there are some sales to international airports and within the pooled quota, trade in yogurt is generally prohibited by the high tariff. Milk and cream imports are impossible at the lower tariff levels of 21.3% as heat treatment is not permitted in these lines. Trade can occur at the out of quota rate (including the full specific and ad valorem tariff) but it is stopped early in each financial year with the imposition of a special safe guard. The high out of quota tariff rate on infant formula prohibits trade other than through the pooled quota.

### **ALIC Quotas**

Under the terms of the Uruguay Round the Agriculture and Livestock Industries Corporation (ALIC) is required to import 137,202 tonnes of milk equivalent of “designated dairy products”. In practice this means that ALIC must import approximately 4,000 tonnes of whey powder and either 17,000 tonnes of skim milk powder or 6,000 tonnes of butter or a mixture of this. ALIC purchases at world prices, with virtually all of the premium absorbed in the ALIC mark up. ALIC is also an extremely difficult customer with difficult specifications and high penalties for off spec product. There is no opportunity to develop markets based on sales via ALIC as the relationship between the seller and the customer is broken by ALIC and ALIC determines the timing and content of tenders based on political rather than commercial factors.

Any increase in access in the form of increased ALIC quota volumes would be of minimal value to Australian dairy exporters.

### **Specified Dairy Quotas**

Japan is required to offer a number of quotas for specific products. The nature of these quotas and the fill rates in 2003 are set out below.

Given that the conditions attached to these quotas already lead to low fill rates any increase in the volume of these quotas would be of little value to Australian exporters.

Japan's WTO Notification for 2003. (8 September 2004)

Description of Products	Tariff item number(s) encompassed in product description		Tariff quota quantity for period in question (tonnes)	In-quota imports during period (tonnes)	Comment
Skimmed milk powder for school lunch	0402.10.211	0402.21.211	7,264	2,907	Restricted by end use
Skimmed milk powder for other purposes (most of this is for animal feed)	0402.10.121	0402.21.216	85,878	35,418	Usually fill is better than this for animal feed. Supply is down due to high world prices.
	0402.10.216	0402.21.222			
	0402.10.222	0402.29.220			
Whey and modified whey for feeding purposes	0404.10.131	0404.10.171	45,000	22,774	Restricted by end use
	0404.10.141	0404.10.181			
Prepared whey for infant formula	0404.10.142	0404.90.126	25,000	10,471	No real demand given local whey production and ALIC
	0404.10.182	0404.90.136			
	0404.90.116				
Butter and butteroil	0405.10.121	0405.90.221	1,873	225	End use provisions have made this difficult. Access further reduced by SSG.
	0405.10.221				
Mineral concentrated whey	0404.10.121	0404.10.161	14,000	3,730	Little demand
	0404.10.122	0404.10.162			

The following two quotas are, however, exceptions and as such expansion of these quotas with specific access for Australia would be of some benefit.

Description of Products	Tariff item number(s) encompassed in product description		Tariff quota quantity for period in question (tonnes)	In-quota imports during period (tonnes)	Comment
Evaporated milk	0402.91.121	0402.91.210	1,585	1,461	Generally close to filled
Prepared edible fat	2106.90.121	2106.90.122	18,977	18,909	PEF is filled most years. 60% of the quota is restricted to product from New Zealand.

### **The Pooled Quota**

The remaining dairy quotas are offered in the form of a "pooled quota" covering 32 tariff lines in chapters 04, 18, 19 and 21. Australian exporters are able to sell a variety of products into these quotas which have been achieving close to 100% fill rate in recent years. In spite of the high fill rate as a result of attempts by the Japanese

Government to improve the transparency of these quotas, there continues to be problems as they are issued to a large number of small quota holders which make finding the holders and extracting premiums very difficult.

Any expansion of this quota under a bilateral agreement should be in a form which gives control of allocation to the Australian Government. If expansion is ultimately based on specific end users, it would be more useful if it is allocated to users of those products falling under Chapter 04 (for which out of quota trade is virtually impossible) rather than on the preparations falling in other chapters where trade already takes place out of quota.

### **Special Safe Guard**

Japan has reserved SSG rights on most dairy lines.

It regularly invokes this right on liquid milk imports within the first few weeks of each Japanese financial year. The basis of this is that as soon as imports occur there is a surge and as such the SSG may be applied. This means that trade in liquid milk can only take place for about two weeks each year.

In 2004/05 Japan invoked the SSG on butter. The surge in trade was a result of imports by ALIC. Although ALIC as a State Trading Enterprise which has already imported its quota for the year is not affected by the SSG, its imposition effectively stopped the small but valuable out of quota trade or trade to specified butter quotas for the remainder of the year..

### **Temporary Tariff Rates (Specific & Ad Valorem Rates)**

Under the terms of its Uruguay Round commitment, a number of Japanese dairy tariff lines are expressed as a combination of both a specific and an ad valorem rate. In many cases the applying Customs Schedule only shows the ad valorem rate and none or only part of the specific rate (as a temporary rate). The application of the full specific rate is reserved until trade begins to occur. In this way the Japanese Government effectively uses the mixed rate as a kind of special safeguard. As with other SSG applications, this means that companies find themselves in the position of developing a market on the basis of a temporary applied rate, only to find that trade becomes impossible because of the arbitrary nature of higher tariffs which may apply.

## **4. Non Tariff Barriers To Trade**

The Japanese Government imposes a number of conditions on trade in dairy products other than simple tariff protection.

### **Controls on cheese imports**

Cheese imports may be subject to a “stand up” test, an emulsion test, a coagulation test or a “sharp knife” test. These are all tests which are unique to Japan and tend to be subjective in nature. It is generally understood that the tests are deliberately subjective to enable the Japanese Government a degree of informal influence over the volume, timing and other aspects of the trade which the Government considers it needs to control from time to time to meet domestic supply and demand policy

objectives. Such requirements impose costs on exporters, restrict the development of new market niches and often result in trade being temporarily or permanently halted.

### **Food Sanitation Law**

Imports of dairy products into Japan are subject to the requirements of the Japanese Food Sanitation Law. This is a law which has developed over a number of decades and in many instances is incompatible with international standards (as defined by Codex Alimentarius for example) or Australian standards.

### **Chemical and Pesticide Residues**

In 2006, Japan will be introducing new laws governing residues in food. A pilot version of the law, covering a limited number of products, has been in place since 2004. The new law has been drafted in consultation with Codex and food exporters and as such should not, of itself, create any particular problems for Australian exporters.

However, the interpretation of the law by Prefectural and Local Government authorities is already causing confusion. Authorities at these levels are demanding assurances and test results for imported product which are not made in respect of locally produced dairy products. Compliance would impose considerable cost on imported product. It is important, therefore, that steps be taken to ensure that international trade obligations are understood not only by the central authorities but by all levels of Government in Japan.

## **5. Conclusions**

The Australian dairy industry would benefit considerably from full free trade with Japan in dairy products. Ideally this would remove all tariffs on the bilateral trade. However, experience has shown that this alone would not ensure free trade. There is also a need to ensure that any agreement removes opportunities to bring in barriers in the form of standards, testing requirements and so forth which are often the main hindrances to expanding our exports to this important market.

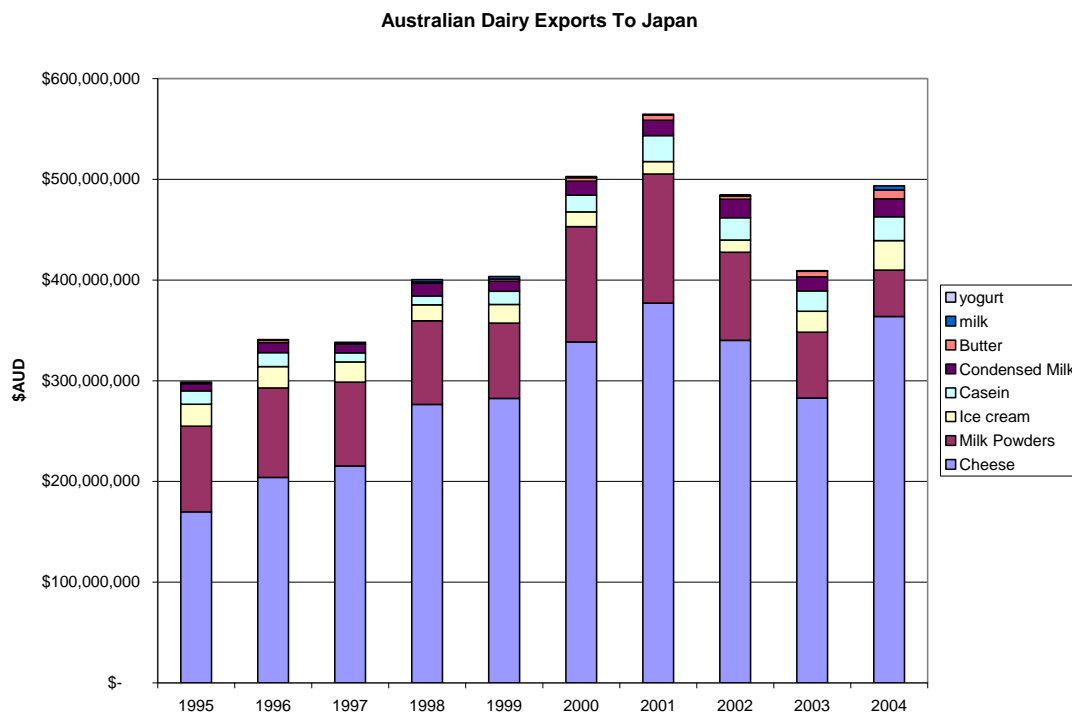
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### Recent Trends In Australian Exports Of Dairy Products To Japan

Japan is the world's third largest dairy import market. Importing more than five hundred thousand tonnes of dairy products each year, Japan accounts for about 5% of the world trade in dairy products. For Australia, Japan is our most valuable dairy market. In 2004, exports worth about \$500 million accounted for nearly 20% of the value of Australia's dairy exports.



The mainstay of Australian dairy exports to Japan has been cheese. This has been primarily used in the processed cheese manufacturing and shred cheese sectors. This sector continues to dominate the trade. Cheese exports to Japan are now worth in excess of \$300 million every year. Australia accounted for nearly half of Japan's cheese imports in 2004. Although the market for Australian cheese is relatively stable, the structure of that market is changing. In addition to the traditional sales of cheese for processing and shredding which accounts for about two thirds of cheese exports, Australia is exporting increasing quantities of specialty fresh cheese for Japan's food processing industry. In recent years there has also been a growth, from a small base, of sales of processed cheese and specialty cheeses for use primarily in Japan's food service sector.

In the past 15 years, the trade in cheese has been supplemented by trade in other products. The main sector of growth other than cheese has been in the area of milk powders. The main stream for milk powder growth has been the area of food preparations. Japanese customers have worked closely with Australian manufacturers to develop carefully tailored products which meet specific end uses in Japan. The trade in preparations alone is worth in excess of \$30 million each year. The value of



milk powder exports can, however, exceed \$100 million in years when ALIC is importing milk powders or when Australia has supplies available for sale under the animal feed quota tenders.

Japanese internal prices for milk powder and butter are currently more than double the level achievable on the international market. As such any increase in trade into these areas will be of considerable benefit to the Australian dairy industry.

The main consumer dairy product export to Japan has been ice cream. The volume and value of ice cream sales has varied from year to year. This reflects complex supply arrangements, many of which have not lasted beyond a few years as well as the difficulties in marketing ice cream in Japan where consumer tastes can change very rapidly. Currently ice cream exports are worth around \$25 million per year.