

Australian Dairy Industry Submission to the Australia China Free Trade Agreement Feasibility Study.

June 2004

The Australian Department of Foreign Affairs and Trade has called for submissions on issues of interest to industry in the negotiation of a free trade agreement with China.

- The terms of reference for the joint FTA feasibility study, as set out in Annex II of the Trade and Economic Framework between Australia and the People's Republic of China, are as follows:
 1. to provide an overview of recent trends in bilateral trade and economic relations;
 2. to assess recent international trade policy developments and the possible implications for Australia-China trade and investment;
 3. to identify and describe existing barriers to trade and investment flows, covering goods, services and investment and other issues that might be addressed in a free trade agreement;
 4. to identify possible cooperation measures to promote trade and investment liberalisation and facilitation between Australia and China;
 5. to assess the impact of the removal and/or reduction of existing barriers to goods and services trade and investment; and
 6. make conclusions and recommendations as regards options for future action.

This submission has been prepared by Dairy Australia in consultation with the Australian Dairy Industry Council, the Australian Dairy Products Federation, Australian Dairy Farmers Ltd and major Australian dairy manufacturers.

The submission is in two parts. It firstly addresses each of these terms of reference as they apply to the export of Australian dairy products to China. Part 2 of this submission addresses the terms of reference as they apply to the export of dairy cattle genetics to China.

The main recommendations of this submission are.

For dairy products, as set out in Section 1.6 of this submission:

- Immediate removal of all tariffs on all dairy product lines (in HSCC chapters 04, 17, 18, 19, 21 and 35). If this is not feasible, a maximum of three years to phase the tariffs to zero.
- There should be no special treatment for particular dairy products.
- No special safe guards or quotas should apply to any dairy lines
- An understanding on the use of safe guards

- An understanding on the implementation of customs valuation and on customs procedures or a joint commission on customs procedures
- Specific and detailed harmonization/homologation provisions on dairy SPS, animal welfare and residue levels for food imports
- An undertaking that Australia will have no worse treatment for dairy imports than is negotiated between China and any other country (particularly New Zealand)
- Other provisions of importance to dairy:
 - o Standard rules of origin for dairy products
 - o Investment guarantees (including establishment rights, arbitration and dispute settlement, including investor-state procedures)
 - o Secure, nation-wide rights for wholly-owned foreign firms to market and distribute goods
 - o A time-table for achieving on-line customs administration and financial settlements
 - o Agreement on IP protection for Australian food technology
 - o An understanding on the limits of Geographical Indications as they apply to food products (other than wines and spirits)

For dairy cattle genetics as set out in section 2.6 of this submission:

- Regular meetings with the Chinese authorities should include discussions of ways to enhance the trade in dairy cattle genetics.
- Steps be taken for Chinese authorities to formally recognize regulatory environment for semen and embryos the quality assurance programs in place at Australian artificial breeding centres.
- The Chinese Government be requested to recognize the Australian vector line for blue tongue.

In addition, it would be useful if there were memoranda of understanding associated with the FTA which:

- recognizes the Australian dairy industry's food safety system including AQIS competence in certifying dairy exports
- formalizes regular Government to Government talks (to include industry representatives) on dairy issues (including both products and genetic material).

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PART 1. Export of Dairy Products to China

1.1. Overview Of Recent Trends In Bilateral Trade

In 2002 China imported 291,991 tonnes of dairy products valued at \$US336 million (approx \$A450 million). Australia supplied about one quarter of this product.

The value of Australian exports of dairy products to China grew from just \$A2 million in 1993 to \$A118 million in 2002.

Recent work commissioned for Dairy Australia estimates that the Chinese market for imported dairy products will continue to grow by 5% (for products such as condensed milk) to 15% (for items such as cheese) per year for the next 10 years. There is, therefore, considerable potential for Australian exporters to take advantage of this market growth.

A more detailed overview of recent trends in the bilateral dairy product trade is attached.

1.2. Implications Of Recent International Trade Policy Developments

China's accession to the WTO saw the removal of all quantitative restrictions on dairy trade and considerable reductions in tariffs on all dairy lines. Today most dairy products enter China on payment of tariffs of less than 15%. The exception is ice cream which has a bound tariff rate of 19%.

The reduction in tariffs since 2000 has seen an expansion in China's food processing sector and dairy consumption in general. The main growth areas have been SMP and WMP (supplied primarily by Australia and New Zealand) and whey powder (supplied primarily by EU and US). Recent years have also seen an increase in the sale of some retail dairy items (such as ice cream) and specialty dairy ingredients such as casein and lactose.

WTO accession also saw a centralisation of Chinese dairy import licensing requirements. This led to some uncertainties during the initial period as authority was moved from the provinces to Beijing. It has, however, resulted in a more transparent national system which currently operates reasonably well.

1.3. Existing Barriers To Trade And Other Issues For A FTA

The Chinese tariffs applying to dairy imports are the rates negotiated as part of China's WTO accession package. China's applied rates for dairy are those required by WTO accession agreements. By 2006 the phase in period will be over and the bound rates will be the rates that apply.

One of the Dairy industry's objectives is to eliminate the remaining tariffs on dairy products. Although none of the bound tariffs are prohibitive, they are sufficient to suppress demand in this very price sensitive market. This is evidenced by the strong growth in consumption of dairy products when tariffs were reduced following WTO accession. Further tariff reductions are likely to see a similar increase in demand.

As such the removal of these tariffs would see a direct benefit to dairy product exporters through higher returns (as at least part of the cost of the tariff is retained in export prices) and increased volumes (as demand responds to lower prices).

In seeking the removal of dairy tariffs, particular attention will need to be taken to ensure that finished products such as yogurt (0403.1), processed cheese (0406.3) and ice cream (2105) are not the subject of slower tariff removal. Given the rate of growth of China's dairy manufacturing industry there would be no justification for this kind of tariff escalation should it be proposed.

While immediate removal of all tariffs on dairy products would be the preferred outcome, China may prefer a phase in period. In this regard it should be noted that the tariffs have been phasing down since China's accession to the WTO in 2001. A continuation of the current rate of reduction would see all dairy tariffs reduced to zero within three years.

It should be noted that milk production in China is expanding at the rate of 20% per year. This has continued, indeed accelerated, even after accession to the WTO saw dairy tariffs reduced by about half in most cases. Moreover Chinese dairy farming growth has continued even while the tariffs have been brought down to the bound rates. This suggests that China's dairy farmers do not need tariff protection to ensure their survival. On the contrary, the availability of high quality foreign product has not only helped grow the overall dairy market but has also been an impetus to improved quality of local milk which is increasingly competitive (on both cost and quality terms) against imported product. There should be no reason, therefore, to countenance any suggestion of a need for special safeguards or quotas on dairy items to protect local dairy farmers.

Increased sophistication, wealth and awareness of contaminated food incidents have heightened Chinese regulation of food products. This has manifested itself in more stringent inspection, increased assurances required at a commercial level and new food safety regulations.

China is implementing a number of food standards for specific dairy products and other associated areas such as food labelling. The process for development and implementation of these standards has generally been cooperative with good consultation with the Australian Government. This has resulted in standards which are usually in line with international practice. There are, however, some exceptions to this. For example the current draft storage standard for butter if applied would effectively prohibit the import of butter other than in frozen form. The pre-market labelling approval requirements, if applied fully, would also make imports of retail food products virtually impossible. It is important, therefore, to work with the Chinese authorities to remove these anomalies which could severely impede our ability to export dairy products.

It is important that Australian authorities keep close contact with Chinese authorities on these issues to ensure that Chinese requirements are transparent in the sense of the WTO provisions on SPS and TBT transparency (notified, published), in keeping with existing

international standards and proportionate to the assessed risks. On those occasions where regulations and other requirements are unreasonable we need a fast track mechanism to get them changed to suit commercial reality.

With the increase in regulation of food, though compositional, labelling and food safety requirements, there is a danger that regulations could be tightened for political purposes – for example to reduce the competitiveness of imports and so support local industries. Health inspection for liquid milk and cream, for example, has occasionally resulted in difficulties for exporters. While these problems have generally been resolved satisfactorily in the past it is an area of risk to the trade.

To facilitate swift resolution of quarantine and food safety related problems it would be helpful to establish formal recognition by the Chinese authorities of the effectiveness of Australia's dairy food safety system. This includes farm, factory, State and Commonwealth regulations and ultimately AQIS certification for exports of dairy products to China. This could be recognized in the form of a MOU between the two countries associated with the FTA.

Exporters to China report problems with the Chinese customs valuation method. In many cases Chinese Customs do not accept the declared value but instead assign values based on Chinese Customs' estimation of the market value of the product. This often leads to the levying of higher tariffs than would usually be the case.

It would be useful if the FTA could include an agreement on Customs valuation to overcome problems with overvaluation of imports for the purpose of import tariffs. In the first instance valuation should be on the basis of declared value. Where Customs authorities have reason to doubt the truth of declared values, alternate values should only be assigned following consultation with the Australian Government and the industry affected. Any such agreement would need to include provisions to ensure that product is not held up while negotiations take place. An option could be the payment of provisional duties to clear product while the actual value is determined.

We note that the Chinese Government has already embarked on FTA negotiations with a number of our competitors in the international dairy market and that negotiations with New Zealand in particular seem to be further advanced than the Australian negotiations. Australia and New Zealand compete very closely in similar parts of the dairy market. As such any tariff advantage New Zealand gains over Australia will translate directly into either loss of market share or lower prices for Australian product. It would, therefore, be extremely damaging to Australian dairy exports to China if our strongest competitor were able to achieve tariff reductions in advance of Australia.

1.4. Possible Cooperation Measures

The Australian dairy industry has been working closely with the Chinese dairy industry for a number of years. Dairy Australia manages an information exchange and scholarship program which have built a close relationship between Australian and Chinese dairy

companies and industry bodies. As important ingredient suppliers we have been an integral part of the development of China's dairy manufacturing sector.

Dairy Australia, together with Murray Goulburn Cooperative, worked closely with the Chinese Government in a pilot school milk program and nutrition study which demonstrated the importance of milk in the physical development of children. The pilot study concluded early in 2004.

The close relationship at the commercial level has been enhanced by a close relationship that has been established over the past 7 years between Dairy Australia and the China Dairy Industry Association (representing Chinese dairy manufacturers). Since 2003 Dairy Australia has been working to broaden this network to include the Dairy Association of China – a body representing dairy farmers as well as some manufacturers, the DAC is also closely linked to the Chinese Ministry of Agriculture.

As noted above, the Chinese Government is actively working to expand its dairy farming sector. This has seen Chinese milk production increase by 10-20% per annum in recent years. Moreover, improvements in milk quality have increased consumer confidence in and acceptability of locally produced milk. As dairy farming increases in economic importance, it will be important to ensure that the Chinese Government is not able to easily succumb to the temptation to put up safeguard or non tariff trade barriers to protect the sector.

To this end it will be important that any safeguard mechanisms included in the agreement do not provide the Chinese authorities with opportunities to raise unreasonable barriers to trade. Specifically there is no justification for special safe guards on any dairy product lines and where safeguards are contemplated the usual requirements for demonstration of damage etc should be required before any anti-dumping or countervailing action is taken.

The Australian Government Department of Agriculture Forestry and Fisheries has made preliminary overtures to the Chinese Government to establish a regular dialogue on dairy issues – commencing with a proposal for a meeting in China in September 2004. We understand that should this meeting proceed it would include both Government and industry participation. It would be helpful if the FTA includes provision for meetings of the kind being sought by DAFF for a regular exchange of information on dairy industry developments. Such an arrangement could usefully be formalised in a side letter or MOU associated with the FTA.

1.5. Impact Of The Removal And/Or Reduction Of Existing Barriers To Trade

2002 Australian dairy exports to China would have attracted tariffs at WTO bound rates of approximately \$A12 million (actual tariff levied was a little higher as some tariff rates were still phasing down to final WTO bound levels). With the removal of these tariffs it is reasonable to expect that some of this would be retained by Australian exporters in the form of higher returns. If half of this is retained, the value to the Australian dairy industry would be \$A6 million per annum.

In addition the increase in demand for Australian products at the preferential tariff rate would see an increase in trade in these products. If this saw a doubling in the volume of trade then increased returns to Australian exporters (from tariffs not paid on the increased trade) would be an additional \$A6 million per annum bringing the value of the tariff cuts to a total \$A12 million per annum.

If, on the other hand, our largest competitor New Zealand negotiated an FTA and Australia did not, we would have to discount our exports by some \$12 million to keep our market share or suffer loss of market share to avoid arbitrage of lower prices into other markets.

None of the above takes account of savings from improved customs valuation and smoother quarantine operations. In addition anticipated growth in cheese and other dairy segments when realized should see a considerable increase in the above estimates. It is estimated that this would be worth at least \$A3 million per annum.

As such an FTA with China would be worth at least \$A15 million per annum initially and considerably more as the market develops. Given the huge potential for growth in this market the industry anticipates that actual returns from an FTA would be considerably greater than this.

1.6. Conclusions And Recommendations For Future Action

A FTA with China would see at least an additional \$15 million per year in premiums not otherwise obtainable. By including provisions for increased consultation on quarantine, food standards and other issues affecting dairy trade the FTA could also play an important role in securing our position in this rapidly growing dairy market.

With this in mind the Australian dairy industry recommends that the FTA include:

- Immediate removal of all tariffs on all dairy product lines (in HSCC chapters 04, 17, 18, 19, 21 and 35). If this is not feasible, a maximum of three years to phase the tariffs to zero.
- There should be no special treatment for particular dairy products.
- No special safe guards or quotas should apply to any dairy lines
- An understanding on the use of safe guards
- An understanding on the implementation of customs valuation and on customs procedures or a joint commission on customs procedures
- Specific and detailed harmonization/homologation provisions on dairy SPS, animal welfare and residue levels for food imports
- An undertaking that Australia will have no worse treatment for dairy imports than is negotiated between China and any other country (particularly New Zealand)
- Other provisions of importance to dairy:
 - o Standard rules of origin for dairy products

- Investment guarantees (including establishment rights, arbitration and dispute settlement, including investor-state procedures)
- Secure, nation-wide rights for wholly-owned foreign firms to market and distribute goods
- A time-table for achieving on-line customs administration and financial settlements
- Agreement on IP protection for Australian food technology
- An understanding on the limits of Geographical Indications as they apply to food products (other than wines and spirits)

In addition, it would be useful if there were memoranda of understanding associated with the FTA which:

- recognizes the Australian dairy industry's food safety system including AQIS competence in certifying dairy exports
- formalizes regular Government to Government talks (to include industry representatives) on dairy issues.

PART 2: Export of Dairy Cattle Genetics to China

2.1. Overview Of Recent Trends In Bilateral Trade

In 2002/03 Australia exported 50,000 head of dairy cattle to China worth about \$A75 million. This is a significant market that needs to be considered in the context of an FTA with China.

The Australian Dairy Herd Improvement Scheme (ADHIS) produces breeding values on Australian and international dairy cattle and this objectively shows that Australia has some of the best dairy cattle genetics (semen and embryos) in the world. While trade with China in this kind of genetic material is relatively light, there is enormous capacity to grow this business via Australian artificial breeding centres.

In addition, Australian dairy genetics expertise and herd improvement expertise can be a growth industry for trade with China.

2.2. Implications Of Recent International Trade Policy Developments

With WTO accession both Australia and China are bound by the provisions of the SPS agreement which will support future trade. There are, however, on going problems with Chinese recognition of Australia's systems for control of disease.

2.3. Existing Barriers To Trade And Other Issues For A FTA

There are two significant barriers to this trade:

- . the vector line for blue tongue
- . the Chinese requirement for a Chinese veterinarian to be present during semen collections.

Currently China recognizes the Murray River as the vector line for blue tongue. This means that any cattle from States north of Victoria are ineligible for trade. We understand that the Australian Government recognizes a vector line which is further north. Recognition of this zone by China would allow export from many NSW dairy areas. Within Australia the animal health quarantine and movement of animals regulations are governed by rigorous state laws with significant infrastructure to ensure their integrity. For example there are a large number of State Government veterinarians constantly monitoring animal health and there are severe penalties for breaching regulations relating to the movement of cattle. This is not well recognized by the Chinese Government.

The requirement that Chinese veterinarians be present for semen collection is costly and would be unnecessary if the Chinese recognized Australian artificial breeding (AB) centres' quality assurance systems and Australia's regulatory environment for the management of AB centres as well as semen and embryo collection and processing. The Australian dairy industry requests that formal procedures be put in place for the recognition of Australian AB centres.

As with the trade in products it is important that Australian authorities keep close contact with Chinese authorities on quarantine issues to ensure that Chinese requirements are transparent in the sense of the WTO provisions on SPS and TBT transparency (notified, published), in keeping with existing international standards and proportionate to the assessed risks. On those occasions where regulations and other requirements are unreasonable we need a fast track mechanism to get them changed to suit commercial reality.

2.4. Possible Cooperation Measures

The Australian and Chinese dairy industries are unusual in that they both operate in a range of environments from cold temperate climates through to the tropics. We are, therefore, well placed to exchange technology and cooperate in farm research and development which can benefit both countries.

Such cooperation could be discussed within the context of the Australia China Agricultural Cooperation Agreement or in the context of regular Government/industry dairy talks of the kind proposed in section 1.4 above.

2.5. Impact Of The Removal And/Or Reduction Of Existing Barriers To Trade

The trade in live dairy cattle, embryos and semen has developed very rapidly in recent years. It is, however, opportunistic rather than strategic. The dairy industry would like to change this situation and develop long term trading relationships based on recognition of Australia's quality assurance, quarantine and regulatory environment. While it is possible that the recent growth in the live animal trade may slow in coming years, there is enormous opportunity to grow trade in semen and embryos. Formal recognition of Australia's regulatory environment and quality assurance systems would facilitate longer term business partnerships between Australian and Chinese companies.

2.6. Conclusions And Recommendations For Future Action

To facilitate the development of a strategic long term trading relationship the Australian dairy industry recommends that:

- . regular meetings with the Chinese authorities include discussions of ways to enhance the trade in dairy cattle genetics
- . steps be taken for Chinese authorities to formally recognize the quality assurance programs in place at Australian artificial insemination centres
- . the Chinese Government be requested to recognize the Australian vector line for blue tongue which includes parts of NSW.

Recent Trends In Australian Exports Of Dairy Products To China

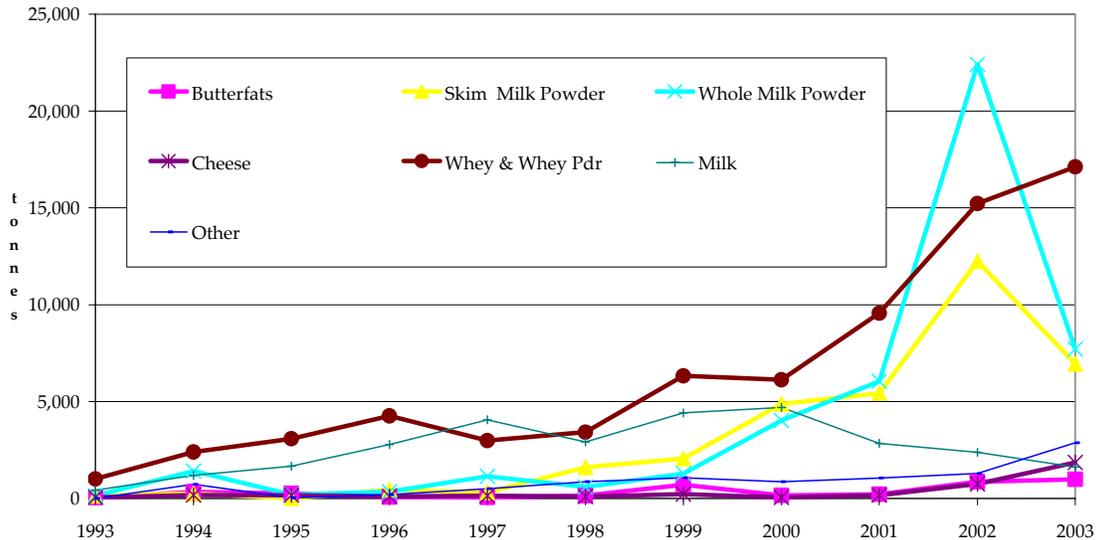
In 2002 China imported 291,991 tonnes of dairy products valued at \$US336 million (approx \$A450 million). Australia supplied about one quarter of this product.

The value of Australian exports of dairy products to China grew from just \$A2 million in 1993 to \$A118 million in 2002. This fell off again in 2003 to just \$A70 million as the drought in Australia saw Australian product replaced by product from other countries while at the same time low world dairy commodity prices and the high value of the Australian dollar reduced the returns in Australian dollar terms.

As the following graph shows, most of the trade to date has been in whey powder, skim milk powder and whole milk powder. With the reduction in milk availability in 2002 and 2003, Australian national production of skim and whole milk powder has been cut back considerably. This has seen the surge in exports in 2002 cut back to the previous growth line.

Although shortages of supply have reduced Australian sales, demand for milk powders in China continues to grow with increasing requirements for the rapidly expanding food processing sector and increasing requirements for high quality milk powders for children and infant formula.

Australian Dairy Exports to China



Whey powder, on the other hand, as a bi-product of more profitable cheese production has continued to be manufactured in increasing quantities and Australian exporters have

been able to take advantage of this growing market. Although it is expected that growth in this segment will continue, it is probable that current applications for whey powder will be replaced with other more specialized milk powders as incomes rise and consumers become increasingly sophisticated. This trend may, however, be reversed if the relative price of skim and whole milk powder continues to increase compared to the cheaper whey powder available from the US and EU.

Exports of liquid milk exceeded 4,000 tonnes per annum between 1997 and 2000. This too has fallen away a little in recent years as demand for liquid milk has increasingly been met by local fresh milk or recombined milk made from imported SMP and butter oil. In addition, liquid milk imports have been the subject of particularly tight quarantine inspections which has made this trade difficult.

The Chinese cheese market is still at a very early stage of development. Although some ethnic groups have traditionally consumed sheep and goats cheese, cheese made from cows milk is still new to the market. Most older Chinese still find the taste and smell of cheese offensive. Consumption of cows' cheese is currently estimated to be 5,000 to 10,000 tonnes per annum. This is mostly made up of imported mozzarella cheese for pizzas, cheese for processing or processed cheese (primarily consumed on hamburgers). The remainder is sold direct to consumers (mostly as processed cheese slices) or to the food processing or food service industries.

Previous experience in other North Asian countries (Japan, Korea, Taiwan and Hong Kong) suggests that Chinese cheese consumption will grow in line with increased disposable income and westernization of the diet.

A study of the China dairy market undertaken for Dairy Australia by Stanton Emms and Sia in March 2004 estimates that the Chinese market for imported dairy products will continue to grow by 5% (for products such as condensed milk) to 15% (for items such as cheese) per year for the next 10 years. There is, therefore, considerable potential for Australian exporters to take advantage of this market growth – particularly if the returns in China are improved due to lower tariffs and higher consumer sophistication.