

CUSMA panel issues decision on Canada's interpretation of dairy tariff rate quotas under Agreement

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The regulation of Canada's dairy industry has long been a source of tension between Canada and the U.S., its largest trading partner. On January 4, 2022, the first dispute resolution panel (the Panel) convened under the Canada-United States-Mexico Agreement (CUSMA) made public its decision, which will shape trading relations between the two countries moving forward. In its report, the Panel concluded that certain practices of the Canadian government relating to the dairy industry violate the government's commitments under CUSMA.

Background

The dispute arose as a result of the "supply management"^[1] system used to regulate Canada's dairy industry. Supply management allows specific commodity sectors — including dairy — to limit the supply of products to amounts Canadians are expected to consume in order to ensure predictable, stable prices. The system is comprised of three pillars:

- [Controlled production](#): a national marketing agency determines production amounts for each commodity, and then sets production quotas for each province. Farmers are assigned a quota.
- [Pricing mechanisms](#): Farmers are guaranteed a minimum price for their products. Farmers negotiate minimum prices with processors, through provincial marketing boards. Processors then manufacture the product for sale to consumers.
- [Controlled imports](#): Canada sets tariff rate quotas (TRQs) through free trade agreements to limit the volume of foreign dairy products entering the Canadian market. It is this third pillar that was the subject of the Panel's review.

TRQs establish a limit on the quantity of a product that may be imported at a lower rate of duty, and apply a preferential rate of duty to the "in-quota" quantity of imports of a certain product or category of products. Though the TRQ does not impose a limit of the amount of a product that may be imported, a different (higher) tariff rate is applied to imports beyond that "in-quota" quantity. As part of its tariff commitments set out in the CUSMA Chapter 2, Canada maintains TRQs in 14 different categories of dairy products.

The dispute arose as the U.S. challenged Canada's allocation of dairy TRQs.

Canada's chosen allocation mechanism for the 14 dairy TRQs involved the establishment of "pools" — reserved amounts of each TRQ — for processors. These pools of processors were provided with access to between 85% and 100% of each TRQ. Other eligible TRQ applicants could then apply within their respective pools for the remaining amounts — up to 15% under

each TRQ.

The U.S. challenged Canada's practice of reserving 85–100% of the TRQs exclusively for processors. It took the position that these measures deny the ability of U.S. dairy farmers, workers and exporters to utilize the TRQs and realize the full benefit of the CUSMA. Where a U.S. dairy importer cannot utilize a TRQ, it will likely be subject to prohibitive over-quota tariff rates. Depending on the product, these rates can be up to 313.5%, or perhaps higher in certain instances.^[2]

On December 9, 2020, pursuant to CUSMA, the U.S. requested consultations with Canada concerning this practice. Consultations were held on December 21, 2020, but the Parties failed to reach a mutually satisfactory resolution. In May 2021, the U.S. advanced the first state-to-state dispute under CUSMA when it called for the establishment of a dispute panel to review Canada's practice of reserving TRQs for processors.

The basis of the dispute and the panel's decision

The Panel was specifically asked to determine whether Canada's practice of reserving TRQs for processors is inconsistent with the following obligations under CUSMA:

- Its commitment in Article 3.A.2.11(b) not to "limit access to an allocation to processors" when administering an allocated TRQ;
- Its commitment in Article 3.A.2.11(c) to ensure that in administering an allocated TRQ, "each allocation is made...to the maximum extent possible, in the quantities that the TRQ applicant requests";
- Its commitment in Articles 3.A.2.4(b) and 3.A.2.11(e) to provide "fair" and "equitable" procedures and methods for administering its TRQs; and
- Its commitment in Article 3.A.2.6(a) (together with its Schedule to Annex 2-B, Appendix 2, Section A, paragraph 3(c)) to not "introduce a new or additional condition, limit, or eligibility requirement on the utilization of a TRQ...beyond those set out in [Canada's] Schedule to Annex 2-B."

The central issue for interpretation was whether Canada's allocation mechanism (reserving 85–100% of TRQs for processors) violated Article 3.A.2.11(b). The U.S. argued the term "allocation" in Article 3.A.2.11(b) refers to a portion of the TRQ. It maintained that Canada had "limited access to an allocation" to processors, both because the initial 85% to 100% set aside is an "allocation" limited to processors, and because access was limited to each specific allocation made from the reserved pools.^[3] Conversely, Canada argued the TRQ should be viewed as a whole — with the term "allocation" referring to the entire TRQ — such that its policy was not an allocation within the meaning of CUSMA as it had allowed access for at least one non-processor to at least one allocation, and the creation of "pools" for processors falls short of being "allocations," as they are not granted to specific recipients.^[4]

In a [decision made public](#) [PDF] on January 4, 2022, the CUSMA Panel determined that Canada was in breach of its commitments under CUSMA by reserving TRQs for the exclusive use of processors. More specifically, the Panel found this practice of limiting access to an allocation to processors for 85–100% of 14 dairy TRQs is inconsistent with the treaty.

The governments of Canada and the U.S. now have until February 3, 2022 (45 days from the final report's date of December 20, 2021) to endeavour to agree on a resolution of the dispute.

Key takeaways

The governments of both countries have released statements emphasizing that, in certain respects, the Panel's decision is a "win" for their respective interests.

The Office of the United States Trade Representative released a [statement](#) emphasizing that the United States "has prevailed" in the first dispute settlement proceeding brought under CUSMA, and that the "historic win will help eliminate unjustified trade restrictions on American dairy products, and will ensure that the U.S. dairy industry and its workers get the full benefit of the [CUSMA] to market and sell U.S. products to Canadian consumers."

Minister of International Trade, Export Promotion, Small Business and Economic Development, Mary Ng, and Minister of Agriculture and Agri-Food, Marie-Claude Bibeau, released a similarly positive statement on behalf of the Canadian government, emphasizing the Panel's "express recogni[tion]...of the legitimacy of Canada's supply management system" and that "Canada has the discretion to manage its TRQ allocation policies under CUSMA in a manner that supports Canada's supply management system."

While Canada's practice of reserving TRQs/TRQ pools for the use of dairy processors has been found to be in violation of Canada's obligations under CUSMA, it remains to be seen exactly how the resolution will take shape and what the impact will be on Canada's dairy industry.

The dispute was the first state-to-state dispute under CUSMA since its coming into force on July 1, 2020. As we wrote about in our [Year in Review](#), the most significant change between CUSMA and its predecessor agreement, the North American Free Trade Agreement (NAFTA), was the abolishment of the dispute provisions under NAFTA's Chapter 11. As a result, only state-to-state disputes are permitted under CUSMA.^[5]

Conclusion

This is the first decision of a dispute panel convened under CUSMA. While these disputes will be determined on a case-by-case basis, it provides insight into the new dispute resolution process. Investors should expect for future disputes to be resolved in a similar manner, and for disputes to be impacted by various political objectives. Both investors and governments will continue to adapt and interpret the agreement as time goes on.

Osler's International Trade and Investment Law team has experience in various forms of trade and investment disputes, as well as matters relating to international trade regulations, government measures, and actions and policies that impede access to Canadian and foreign markets. The International Trade and Investment team works hand-in-hand with Osler's [Agribusiness experts](#), who understand the unique nuances of agribusiness. Consisting of lawyers drawn from practice areas across the firm, Osler's Agribusiness team provides technical legal advice and practice business guidance on the multi-faceted Agribusiness, Ag Inputs, and Agtech sectors. Together, our interdisciplinary team is well positioned to give expert advice on how best to navigate these challenges presented by this evolving landscape.

[1] For more information on supply management in the Canadian dairy industry, see

"Canada's dairy industry at a glance" on the Government of Canada's website.

[2] See e.g., *Customs Tariff* (2022), tariff line 0405.90.20 00, "Butter and other fats and oils derived from milk; dairy spreads – other" which establishes a tariff of "313.5% but not less than \$5.12/kg".

[3] Canada – Dairy TRQ Allocation Measures (CDA-USA-2021-31-010), Final Panel Report, December 20, 2021, at para 63.

[4] Canada – Dairy TRQ Allocation Measures (CDA-USA-2021-31-010), Final Panel Report, December 20, 2021, at para 64.

[5] Private investors can bring NAFTA legacy disputes for a three-year period, which began to run when CUSMA came into force on July 1, 2020. Private citizens will continue to have rights under foreign investment treaties and private contracts (i.e., arbitration clauses).