REPORT OF THE 2008

DAIRY QUOTA REVIEW PANEL

on

Administrative arrangements

for

EU and USA DAIRY QUOTAS

managed by Australia

Report to the Minister for Agriculture, Fisheries and Forestry

June 2008

Dairy Quota Review Panel

John McQueen   Sandra Welsman   David Harris

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Meat, Wool & Dairy
Australian Government Department of Agriculture, Fisheries & Forestry
GPO Box 858
Canberra ACT 2601

Foreword

This report details the process, background, outcomes and recommendations of a review undertaken by the Dairy Quota Review Panel into the operations of current WTO and AUSFTA dairy tariff rate quotas (TRQs) to the European Union and USA.

The report provides a detailed description of a recommended new model for dairy TRQ management now and into the future. The Panel sought widespread consultation with all sectors of the dairy industry and relevant government authorities in developing the model and preparing this review report.

We particularly wish to thank those people who gave their time and energy to prepare submissions and meet with the Panel to discuss the issues considered in this report. This has provided the opportunity for the Panel to gain an understanding of the views of industry and government and the need for change from the current management system for dairy TRQs.

The Panel, comprising Dr Sandra Welsman, Mr David Harris and myself, believes it has developed a robust model for TRQ management that will serve the dairy industry well into the future.

We also believe this dairy model could act as a template for any future TRQ that the Australian government may negotiate through WTO or bilateral free trade agreements for any Australian product access to other countries.

The Panel has developed this model with a view to ensuring the recommendations align with a range of government policies and directions including: streamlining regulation; National Competition Policy; and, cost recovery and user pays. The Panel considered issues such as improving international competitiveness, optimising the commercial value of TRQ, minimising government intervention in the market, minimising barriers to exports, and administering quota in a consistent, transparent and efficient way, while considering commercial arrangements.

The Panel has been very well served by the expertise, dedication and professionalism of a Secretariat led by Ms Auli Uotila. Auli and her team of Tim Nicholas, Tim Lewer and Rebecca Phillips have provided the Panel with strong assistance and background information that is vital to ensuring a sound outcome of the review process. They have also worked long hours including weekends to assist the Panel to complete the report in a timely manner.

John McQueen
Chair
Dairy Quota Review Panel

6 June 2008

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Report summary

Dairy product tariff rate quotas (TRQs) allocated to Australia allow for the export of specified quantities of particular dairy products at concessional or zero tariffs. DAFF manages two TRQs for cheese to the European Union (EU) and sixteen dairy TRQs to the United States of America (USA). These TRQs were negotiated by the Australian Government and obtained under World Trade Organisation (WTO) agreements and the Australia-United States Free Trade Agreement (AUSFTA).

WTO TRQ management arrangements were put in place by the Australian Dairy Corporation (ADC) and Australian Dairy Industry Council (ADIC) after the General Agreement on Tariffs and Trade (GATT) Tokyo Round of multilateral trade talks (1979) and the WTO Uruguay Round (1994). In 2003, DAFF assumed responsibility for TRQ management. AUSFTA TRQ regulations are based on an industry approach negotiated with government in 2004. This included agreement for formal review after three years.

On 2 April 2008, the Minister for Agriculture, Fisheries and Forestry, the Hon. Tony Burke MP, announced an independent review of AUSFTA and WTO dairy TRQ management, and released the Terms of Reference (appendix 1). The Panel was asked to examine arrangements for all dairy TRQs from the EU and the USA managed by Australia, and to identify improvements. Panel membership and the review process including consultation arrangements and industry contact are set out in chapter 1.

Panel Principles for Quota Management – chapter 2

Dairy TRQs are an outcome of government to government market access negotiations and are a public asset. The management of these quotas should be based on public policy principles that can achieve the best outcomes for the dairy industry and the broader Australian community.

Such public policy objectives include promoting economic prosperity by increasing the competitiveness of Australian dairy industry and consideration of social, environmental, access and regional issues. TRQ management is not intended to create property assets for individual companies.

In addition, successive Australian governments, through COAG, have reinforced their commitment to comprehensive reform of business regulations and at meetings during 2007 and 2008. The national reform agenda objectives include removing regulation not providing public benefit, and to:

- accelerate and broaden the regulation reduction agenda;
- improve processes for regulation making and review; and
- deliver significant improvements in Australia’s competition, productivity performance and international competitiveness.

Against this background, the Panel agreed on five principles to guide deliberations in evaluating appropriateness, effectiveness and efficiency of current quota management arrangements and options under the Terms of Reference.

1. Optimise the TRQs commercial value to Australia
The most favourable economic outcomes for Australia from TRQs are more likely to be achieved where company decision making is focused on optimising commercial returns from all markets rather than meeting conditions established by quota arrangements. TRQ management should not seek full utilisation of TRQs where such outcomes are contrary to market signals and potentially reduce overall value of Australian dairy exports.

2. Minimise government intervention in the marketplace
The TRQ will be utilised most effectively by Australian exporters where market forces are allowed to operate to the greatest extent possible, with individual firms able to make decisions in response to domestic, EU, USA and global market signals. However, market forces relating to Australian dairy exports to the EU and USA can be affected by the TRQ when it is filled or if fill is anticipated.

3. Administer consistently, transparently and efficiently
Any administrative system should seek to be efficiently managed and transparent to all segments of the industry and other observers. This provides the optimal basis for business planning and commercial decision making. In particular, it should seek to minimise the use of discretionary decisions or arbitrary changes to quota rules.

4. Minimise barriers to exporting
Management should minimise barriers to TRQ use by companies willing to compete in the marketplace. The TRQ value will be enhanced by a competitive, innovative and profitable Australian dairy production, processing and exporting industry. If a system creates undue barriers to companies entering the market or to company expansion, less efficient firms may retain quota and possibly utilise it in a sub-optimal manner.

5. Consider commercial arrangements
Changes to existing TRQ management need to consider production, processing and exporting investments, existing commercial relationships, and how affected businesses might make adjustments.

Market dynamics and outlook for dairy exports – chapter 3

Advice received from ABARE and Dairy Australia confirmed there have been valuable premiums for Australia dairy products exported under TRQ to both the USA and EU. However, due to significant rises in world market prices for dairy products the premiums in the USA have eroded in recent years which has influenced use of TRQ in that market. While premiums have reduced in the EU it continues to be a good returning market for Australian exporters which has ensured the TRQs have been fully utilised.

In this context, the Panel considers that a flexible TRQ management model responsive to performance by companies in these changing export marketplaces is needed – not a system locked into historical arrangements. In addition, such a model needs to be flexible and robust to cater for expansions to TRQ through trade negotiations over, say, a five year period.

History and current arrangements for dairy TRQs – chapter 4

The background, legislative basis and current allocation arrangements for each of the EU and USA TRQs are outlined in this chapter. Each TRQ has particular characteristics that are taken into account in developing a TRQ management model in chapter 6.

Industry perspectives on dairy TRQ management – chapter 5

Submissions received from industry associations and companies presented a range of perspectives, concerns and priorities. These are summarised in chapter 5 and have been taken into account by the Panel in developing the Model recommended in chapter 6.

Management options and development of a model – chapter 6

The Panel evaluated a number of options for TRQ management in the context of the principles, policy directions and industry perspectives [see 6.1]. These included:

- current arrangements including fixed allocations for all EU and the main USA TRQs
- no quota allocation - 'first-come-first-served' (FCFS) until each TRQ is filled
- annual allocation of all TRQs
- auction of each TRQ

Through considerable discussion, reference to market and industry information and testing of scenarios, the Panel has developed a recommended model TRQ management. This Model is framed to be robust in variable global marketplace conditions and to be applicable across expansions in dairy TRQ through trade negotiations.

Key elements of the Model and recommendations explained in 6.2 are summarised below.

► ***Eligibility for quota allocation, transfer or access to a FCFS pool***

- Eligibility for TRQ allocations is currently restricted to dairy manufacturers. The Panel recognises the evolution of business structures and recommends that the Regulations be refined. Eligibility for allocation should include persons or groups with ownership of milk or dairy produce who undertake sub-contract processing or transformation through a plant they do not own.
- Exporters or traders that do not own and manufacture dairy products should continue to be excluded from TRQ allocations.
- There should be no restrictions on the transfer or sale of allocated quota. This is the most efficient way to facilitate redistribution. Similarly, where a TRQ is unallocated, or quota is returned, there should be no restriction on access by any person or company to the FCFS pool.

► ***Applications for an allocation of quota from a TRQ and decision to allocate***

An application-based process should be adopted for the management of all EU and USA dairy TRQs including to gauge need for a TRQ to be allocated in the forthcoming year. The application process can be utilised as a market demand indicator and a mechanism for switching between allocated and unallocated TRQs.

Key features of the application process in the first week of October each year include:

- DAFF calling for applications for volumes in kilograms from each EU and USA TRQ
- applications to be accompanied by a flat fee for each request for quota from each TRQ
- a closing date for applications that provides sufficient time for processing by DAFF with non-applicants excluded from allocations for the coming 12 months

- companies apply for the use of particular TRQs and will only be able to receive an allocation from those TRQs. No companies or persons are excluded from using quota in FCFS pools.
- the quota volume applied for from a TRQ will be the maximum quantity an applicant can receive if that TRQ is allocated.

The decision to allocate or not allocate a particular TRQ should be based on the total requests (demand) for allocation of quota from that TRQ. If applications in total are less than 100% of the amount of the TRQ, that TRQ will be unallocated in the forthcoming year. That TRQ becomes a 'first-come-first-serve' (FCFS) pool.

If total requests are greater than or equal to volume available it becomes an allocated TRQ.

Applicants will be advised of outcomes of the application process as close as possible to 1 November. Where a TRQ is to be allocated, main allocations will also be advised to enable shipments to start. Final allocations will be advised by the end of November and will redistribute quota not taken up from the main allocation.

► ***Framework for management of allocated TRQ including return and reclaim of TRQ***

To maximise the value of the dairy TRQs for the Australian economy it is important that the management system ensures the annual quota access is 'mobile'. Allocation decisions should reflect changing market circumstances. They should also contain an element of reward for active, expanding manufacturer-exporters.

Accordingly, the Panel recommends all calculations for allocation should be determined by:

- a three year moving average of performance based on exports of the product category covered by the TRQ, with
- an equal weighting applied to global exports and exports to the TRQ market, and
- global exports to include shipments to the TRQ market (EU or USA) as the small TRQ volumes will not make a significant difference to the allocation outcomes.

Where a TRQ is allocated, a mechanism for early return of unused quota is important. The reclaiming process would be similar to current procedures. Quota holders should be advised that unused quota will be automatically reclaimed on 15 June if there is no response to the DAFF communication, or if documentary evidence of intended use is considered to be insufficient.

To ensure the effectiveness of these provisions a penalty will apply to all quota that remains with a company after 15 June but is unused by the end of the quota year. This penalty will be a kilogram for kilogram reduction in a company's allocation the next time the company applies for and receives an allocated share of the same TRQ.

- A company's allocation of quota from a particular TRQ is deemed to be fully used if at least 98% of the company allocation has been shipped (for TRQs less than 3000 tonnes) or 99% of allocation has been shipped for TRQs of 3000 tonnes or above.
- The penalty provisions will not apply to returns that occur before or as a result of the reclaiming process that is completed by 15 June.

- The transfer of unused quota allocations will mean the potential penalty liability will move to the quota recipient. However, penalties could be avoided by transfer to an entity ineligible for allocation (eg. a trader). A rule for the penalty to remain with the transferring entity if the recipient is ineligible to participate in allocations will prevent this possibility.

After considering the various aspects of this issue the Panel does not consider a minimum allocation is appropriate or necessary in this model.

► ***Allocated TRQs - small and new entrant set-aside provisions***

The Panel agrees provision should be made for small operators and new entrants (SNE). Where a TRQ is to be allocated, those companies with an allocation below a threshold of 10 tonnes (including new entrants) should be able to share in a small amount of additional quota set-aside for this purpose.

- SNE companies will be subject to the same performance based criteria including all application, allocation, usage, return, reclaim and penalty provisions.

- SNEs will receive their performance-based allocation plus an equal share of the set-aside amount. Final allocation will be no higher than 10 tonnes or quantity requested.

The amount of the set-aside for each allocated TRQ will be based on the absolute size of that TRQ and should be 2% of the TRQ for TRQs less than 3000 tonnes, or 1% for TRQs greater than or equal to 3000 tonnes. If new quotas arise that are substantially larger, then a lower set-aside percentage should be considered.

The set-aside will only operate if (i) a TRQ is allocated, and (ii) one or more eligible SNE applicants would be allocated less than 10 tonnes of quota for that TRQ:

- If there are no such applicants, the full amount of the set-aside will be included in the final allocation process for that TRQ to all non-SNE applicants

- Any residual set-aside amount not allocated to SNE applicants will also be distributed in the final allocation to all non-SNEs

- This minimises the risk of losing TRQ value through inactivity in the first six months of the shipping year – the TRQ will be fully allocated at the start of each quota year.

For most TRQs, applications for quota by small operators are unlikely to occur. Nevertheless, the Panel considers this opportunity should be generally available for TRQs.

► ***Framework for administering unallocated TRQs.***

The current approach to managing FCFS by issuing quota certificates on request shortly before a planned export of a specified quantity under a specified TRQ should continue.

This is the most efficient and effective way of managing a FCFS quota pool and should apply to quotas where a decision to allocate has not been triggered by the application provisions. It will also apply to each FCFS pool arising from voluntary quota return or the use-it-or-lose-it provisions at any time.

- There will be no quota ‘reserving’ mechanism.

- There will be no eligibility restrictions on the use of quota from any FCFS pool.

- Quantities will be provided as requested until the TRQ is fully used, with no minimum or cap on individual applications to use the FCFS quota.

Quota certification will be provided by DAFF in the order requests are received:

- if an export shipment does not proceed after the issuing of a quota certificate, the quota certificate will automatically lapse usually within a week
- at that time the quota will immediately return to the FCFS pool and become available
- hence, quota return provisions and use-it-or-lose-it penalties cannot apply for FCFS shipments that do not proceed.

Administration of an FCFS pool by DAFF will involve monitoring of accumulated use of the TRQ and providing regular usage updates to the industry.

► ***Implementation of the model for EU and USA TRQs***

The recommended TRQ Management Model is framed to be robust in variable global market conditions and to be applicable across any expansions in dairy TRQ achieved through international or bilateral trade negotiations.

The Panel recommends that this TRQ Management Model be implemented with the objective of the new system operating from the 2009 quota shipping year. The review has been intensive and stakeholders would reasonably anticipate timely outcomes.

In developing the recommended Model, the Panel has identified a need for some variations where particular features of a TRQ granted to Australia restrict the application of the full Model. The recommended application of the Model for dairy TRQ management, and variations for some current TRQs are set out in 6.3. In summary:

- The TRQ Management Model should be fully applied to all the EU TRQs.
- The TRQ Management Model should be applied to all AUSFTA TRQs, with the only exception that there be no SNE provision for the tiny Skim Milk Powder TRQ.
- The Panel recommends that historical USA cheese TRQs cease to be managed by Australia. Historical TRQ is best operated as an unallocated FCFS system managed solely by the USA with no intervention by the Australian Government. This would not reduce ability of USA importers to source product from any Australian supplier.
- USA supplementary cheese TRQs require a degree of different treatment because of the USA requirements for identification of USA importers before the start of each quota year. The Model should be adjusted to require importer information during the application process. There should be a minimum allocation of 10 tonnes as an interim measure. The Australian Government should seek to negotiate changes in these particular importing conditions imposed by the USA.

TRQ administration by DAFF – chapter 7

Australia’s WTO TRQs to the EU and the USA plus those under the AUSFTA were achieved through government negotiations to benefit the Australian economy. Quotas are not commercial assets of industries or companies. TRQ allocation systems are legislated arrangements with regulatory effect on trade, even where the aim is to minimise regulation and enable market operation, as in recommendations above.

The Panel considers it is both appropriate and necessary that:

- government, through DAFF, continue to manage TRQ distribution, usage monitoring, availability certification and reporting
- ongoing costs of dairy TRQ administration continue to be recovered from users of all aspects of this service – there is no justification for taxpayers to cover these costs.

In developing a TRQ administration framework the Panel considered concerns and proposals put forward by industry, as well as the submission from DAFF. Responses are set out in 7.1.

TRQ management operations are multi-faceted, and the full costs of all aspects of these operations need to be recovered whether some TRQs are fully utilised or otherwise. Companies benefit from the existence of the TRQs and their administration by DAFF proportionately to the quantity of quota they access by allocation and/or by request from the pool. The value of the quota accrues on a volume basis and it is appropriate that there is a volume based charge.

The recommended framework is structured to support the principles and objectives of the TRQ Management Model, taking into account government principles of full cost recovery, transparency and orientation to user-pays in line with equity and policy aims. Key elements of the administration framework set out in 7.2 include:

- continuation of a per kilogram charge for quota allocated or issued from a FCFS pool.
- initial application fees for each TRQ for each applicant. DAFF will need to calculate fee levels, interacting with industry on market/TRQ use outlook and any system changes, with the aim of cost recovery each year.
- for 2009, a fee of $200 is suggested for each application for each type of TRQ to accompany each company’s application. Applications without payment will not be processed. Application fees will apply whether the TRQ is eventually allocated or not.
- there will be no refunds for unused allocated or FCFS pool quota.
- there will be no charge for quota transfer, or for ultimate issue of certifications.

To facilitate communication and consultation, DAFF should prepare and distribute a short Annual Statement in October before each quota year, showing (a) finalisation of income and outgoings for the previous quota year (b) income and outgoings for the current year including estimates for the final months and (c) calculations of projected total costs for the next year and income from applications and allocations.

- The Dairy Australia Trade Reference Group would be an appropriate forum for discussion of the Annual Statement and regular administration issues.

The TRQ administration system should have the flexibility to adjust the per unit fee on an annual basis to reflect the projected net financial position of the Quota Unit cost recovery. The annual statement would form the basis of this decision after consultation with industry.

Implementing the Panel’s recommendation mainly through Orders rather than Regulations should facilitate this. The Panel notes that regulations in any form, including Orders, are subject to the requirement for regulatory impact assessment where changes will directly affect business, or have a significant indirect effect on business, or restrict competition.

Abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ADC	Australian Dairy Corporation
ADIC	Australian Dairy Industry Council
ADF	Australian Dairy Farmers Limited
ADPF	Australian Dairy Products Federation
AQIS	Australian Quarantine and Inspection Service
AUSFTA	Australia United States Free Trade Agreement
CIE	Centre for International Economics
COAG	Council of Australian Governments
DA	Dairy Australia
DAFF	Australian Government Department of Agriculture, Fisheries and Forestry
DQR	Dairy Quota Review 2008
EU	European Union
EXDOC	Export Documentation system operated by AQIS
FCFS	First-come first-served
GATT	General Agreement on Tariffs and Trade
NSPF	Other cheese Not Specifically Provided For
NZ	New Zealand
OECD	Organisation for Economic Co-operation and Development
Quota Unit	DAFF Quota Administration Unit
Quota	Allocations of TRQ to individual companies
SMP	Skim Milk Powder
SNE	Small and New Entrants
TRQ	Tariff Rate Quota
UK	United Kingdom
USA	United States of America
USDA	United States Department of Agriculture
WC&B	Warrnambool Cheese and Butter Co. Ltd.
WMP	Whole Milk Powder
WTO	World Trade Organisation

1. Review Terms of Reference and process

On 2 April 2008 the Minister announced an independent review of AUSFTA and WTO dairy TRQ arrangements, and released the Terms of Reference. The Minister asked the Panel to examine management arrangements for all Australian dairy TRQs from the EU and the USA managed by Australia, and to identify improvements. TRQ quantities are fixed by WTO and AUSFTA agreements and are outside the scope of the review.

Précis of Terms of Reference [see appendix 1]

The Quota Review Panel should examine and report on the appropriateness, effectiveness and efficiency of the current TRQ management arrangements.

The Panel should identify areas where improvements to TRQ management arrangements could be made, including in the areas of:

- options for the management of TRQ categories
- where TRQs are allocated, options for the allocation of quota
- minimum allocations, having regard to commercial practices
- provision for access to the TRQs for new entrants
- quota transfer arrangements
- measures to deal with unused quota, including incentives and/or penalties if applicable, to maximise commercial use of Australia's in-quota access to the relevant dairy market
- the legislative framework underpinning TRQ management
- cost recovery arrangements
- transitional arrangements from the current procedures to those recommended by the Quota Review Panel
- any other area related to TRQ management that the Panel considers is relevant, and
- The implications of the provisions of the Australia-USA Free Trade agreement on the management of these dairy TRQs in 2008 and subsequent years.

1.1 Panel Members

The Dairy Quota Review 2008 is an independent panel review. Candidates were identified through industry nominations, the DAFF Balance database, which is open to all interested applicants, and experienced personnel known to the Department of Agriculture, Fisheries and Forestry (DAFF). Mr John McQueen was appointed as Chair, and Dr Sandra Welsman and Mr David Harris as members.

John McQueen – Chair
Mr McQueen was previously Chief Executive Officer of Australian Dairy Farmers (ADF), retiring at the end of 2007 after 25 years with ADF. As first Chief Executive Officer of the Australian Dairy Herd Improvement Service, he was instrumental in introducing and communicating need for Australian Breeding Values. Mr McQueen was closely involved in developing options for the $1.9 billion dairy industry assistance package to assist farmers adjust to a deregulated market milk environment. He was also the driver for ADF obtaining authorisation under the *Trade Practices Act 1974* to allow farmers to collectively bargain terms and conditions of supply. He is experienced with multilateral and bilateral trade negotiations since the Uruguay Round. He was instrumental in the development of the model for Animal Health Australia and chaired its industry forum from 2004 to 2007.

Dr Sandra Welsman – Member
Dr Welsman is a public policy and regulation specialist and principal of Frontiers Insight Pty Ltd. Dr Welsman's career has included senior roles in the wool, meat and Australian resources industries. In 2003, Dr Welsman was Founding Director of the Australian Centre for Agriculture and Law at the University of New England. In 2005, she was a member of the Beef Quota Review Panel. Dr Welsman has conducted extensive planning, review and development work for government, agricultural industries and the education sector, including development of the first Dairy Australia Strategic Plan 2004-2009.

David Harris – Member
Mr Harris is a senior agricultural economic consultant, with expertise in trade policy analysis, economic advice and econometric modelling. Mr Harris is currently managing director of DN Harris and Associates, an economic consulting business. He was involved in developing options for deregulation of the Australian milk market and has prepared a number of economic reports on agricultural trade and market issues. Previous senior positions have been with Bonlac Foods Ltd, the Centre for International Economics (CIE), the OECD Secretariat and the Australian Bureau of Agriculture and Resource Economics (ABARE).

The Review Panel has been supported by a Secretariat provided by DAFF. The Panel met five times in Canberra and twice in Melbourne from March to early June 2008.

1.2 Consultation and Information

The Panel consulted as widely as possible in its deliberations. The public and interested parties were invited to lodge submissions on the appropriateness, effectiveness and efficiency of the current arrangements for WTO and AUSFTA TRQs, and any changes that may serve to improve existing processes. The Panel invited parties making submissions to also meet with the panel.

Submissions were sought in March 2008 through advertisements in major national and rural newspapers. The DAFF website (www.daff.gov.au/quota) provided further information on the review. All registered exporters of dairy products were contacted directly by facsimile. The panel also sought the assistance of the Australian Dairy Products Federation (ADPF) and Dairy Australia (DA) in circulating notices. In addition, the Panel chair actively contacted several organisations, including the Australian Speciality Cheese Association and individual business entities to confirm they did not wish to provide a separate written submission or to meet with the Panel to discuss the issues.

Submissions were received from dairy manufacturing companies, industry organisations, DAFF and a USA trading company (chapter 5). ADIC noted its "Submission incorporates the views of key milk processing companies and traders who have been involved in exporting dairy products to the USA and the EU since 1 January 2005. In addition the views of industry associations were sought including ADPF, ADF and the Australian Speciality Cheese Association and the industry services organisation, Dairy Australia".

The Panel offered to hold meetings if required in all capital cities in Australia on an individual and confidential basis to ensure an open dialogue. Ultimately, the Panel met with all interested parties in Melbourne. The Panel sought information on markets, past TRQ management arrangements and other background from a broad range of sources. Briefings were provided by senior staff from the DAFF Meat, Wool and Dairy Branch and the Multilateral Trade Branch, and the Quota Administration Unit (Quota Unit). The panel also obtained briefings from Dairy Australia (DA) and ABARE.

2. Principles for dairy TRQ management

Australia's WTO tariff rate quotas (TRQs) to the EU and the USA and the TRQs under AUSFTA were achieved through government to government market access negotiations for the benefit of the Australian economy.

In the Panel's assessment the primary objective for management should be to optimise the TRQs commercial value to Australia. TRQ management is not intended as a mechanism for creating property assets for individual companies.

2.1 Public policy and regulatory contexts

The Panel considers the TRQ should be administered to achieve sound public policy outcomes for the Australian community. Such public policy objectives include promoting economic prosperity by increasing the competitiveness of Australian industry and consideration of social, environmental, equity and regional development needs.

The Coalition of Australian Governments (COAG) has developed principles to underpin effective regulations and review of those regulations and have agreed to comprehensive reform of regulations. At meetings on 20th December 2007 and 26 March 2008, Australian Governments, through COAG, reaffirmed their recorded commitments to the national reform agenda objectives,[1] including to :

- accelerate and broaden the regulation reduction agenda
- improve processes for regulation making and review, and
- deliver significant improvements in Australia's competition, productivity and international competitiveness.

As part of this commitment to maximise the efficiency of new and amended regulation and avoid unnecessary compliance costs or restrictions on competition, COAG has agreed the following principles for minimum effective regulation and good regulatory practice:

1. establish a case for action before addressing a problem

2. consider a range of feasible policy options, including self-regulatory, co-regulatory and non-regulatory approaches, and their benefits and costs

3. adopt the option that generates the greatest net benefit for the community

4. in accordance with the Competition Principles Agreement, legislation should not restrict competition unless it can be demonstrated benefits of the restrictions to the community as a whole outweigh the costs and objectives of the regulation can only be achieved by restricting competition

5. providing effective guidance to relevant regulators and regulated parties in order to ensure the policy intent and expected compliance requirements of the regulation are clear

[1] COAG Meeting 10 February 2006 Communiqué and COAG National Reform Agenda, plus the *COAG Regulatory Reform Plan,* April 2007. COAG endorsed eight principles for 'Maximising the Efficiency of Regulation'. These add to the *Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies*, and the National Competition Policy Principles of 1995.

6. ensuring that regulation remains relevant and effective over time

7. consulting effectively with affected key stakeholders at all stages of the regulatory cycle, and

8. government action should be effective and proportional to the issue being addressed.

COAG principles include objectives that decision makers should consider in proposing and structuring regulation arrangements,[2] including:

- *Minimising the impact of regulation*: the overall goal of regulation should be effective enforcement of stated objectives.
- *Minimising the impact on competition*: regulations should have minimal impact on competition, except where the public interest is served, or where the only means of achieving regulation is through restricting competition.
- *Predictability of outcomes:* regulation should have clearly defined outcomes.
- *Regulations should not restrict international trade:* regulations should not be applied in a way that creates unnecessary obstacles to international trade.
- *Flexibility of standards and regulations:* regulations should be capable of being adapted to changing circumstances.
- *The exercise of bureaucratic discretion:* good regulation should attempt to standardise the exercise of bureaucratic discretion. This should not preclude an appropriate degree of flexibility to permit regulators to deal quickly with exceptional or changing circumstances or to recognise individual needs. Nor should it avoid the danger of administrative action effectively constituting regulation and thus avoiding the disciplines of regulatory review.

Review Principles

Against the above background, the Panel has identified a set of principles to guide its deliberations in evaluating the *appropriateness, effectiveness and efficiency* of the current TRQ management arrangements and options as per its Terms of Reference.

Principle 1: Optimise the TRQs commercial value to Australia

A TRQ's value is derived from the difference between the landed price of the TRQ import (including any within-quota tariff) and the price that product can be sold for in the importing country. Therefore the value of TRQ access varies according to changes in the landed price and the price it is sold for in the importing country. Best economic outcomes for Australia associated with the TRQ are more likely to be achieved where individual company decision making is focused on optimising commercial returns from all markets – domestic and export - rather than strategic behaviour affected by TRQ management rules.

TRQ management schemes can distort company behaviour by influencing decisions:

- to enter or exit markets, or to invest or not invest in productive capacity or supply systems

[2] COAG Principles and Guidelines for National Standard Setting and Regulatory Action by Ministerial Councils and Standard-Setting Bodies, 1995 as amended, at April 2008.

- to decide on export action to maintain or enhance quota allocations in future years or
- to set-up particular choose a business arrangements.

TRQ management should not seek to promote full utilisation of TRQ where such outcomes are contrary to market signals and potentially reduce the overall value of Australian dairy exports. For instance, some forms of TRQ management may encourage exports at discounted prices to increase sales into a TRQ market to protect future allocations, but at the expense of sales into other important markets where higher returns are available.

Principal 2: Minimise government intervention

The Panel considers the EU and USA TRQ will be utilised most effectively by Australian exporters where market forces are allowed to operate to the greatest extent possible, with individual firms being able to make decisions in response to domestic, EU, USA and global market signals. However, as the TRQ is approaching fill or it is anticipated to be filled there can be effects on decisions relating to Australian participation in these markets.

In such a scenario, under a 'first-come-first-served' (FCFS) scheme, companies could engage in discounting to gain access to remaining TRQ. In these circumstances, a managed TRQ allocation system would increase the value of the TRQ being optimised for the Australian industry and economy.

Where projections of TRQ fill are low or uncertain from year to year, assessment of the need for government intervention should consider likely net gains from regulation. If an allocation scheme is applied but TRQ fill occurs only rarely, intervention is likely to be of no benefit because of added costs, possible distortions by sales at lower prices to maintain allocations, and limitations on other companies developing markets by selling product within the TRQ.

Principle 3: Administer consistently, transparently and efficiently

Any administrative system should seek to be efficiently managed and transparent to all segments of the industry and other observers. This provides an optimal basis for business planning and commercial decision making. In particular, it should seek to minimise the use of discretionary decisions or arbitrary changes to TRQ allocations or administration. Frequent use of discretion can signal that the regulatory system needs revisiting.

More complex TRQ management usually means higher costs for government (which are passed to industry through cost recovery) plus higher monitoring and compliance costs for individual companies. The objectives noted here are important but they alone should not determine the form of TRQ management, especially where an approach offers greater economic benefits with only marginal cost increases in management, which is a small component of overall trade value to the EU and USA.

Principle 4: Minimise barriers to exporting

TRQ management should minimise barriers to TRQ use by companies willing to compete in the marketplace. TRQ value will be enhanced by a competitive, innovative and profitable Australian dairy production, processing and exporting industry.

Factors likely to influence the capacity of companies to access TRQ include:

- eligibility criteria for participation in any TRQ allocation arrangements

- new entrant and expansion provisions
- allocation formula and minimum allocations
- reclaimed and distributing unused quota
- tradability of quota if allocated.

If a TRQ management system creates undue barriers to new companies entering the market or to company expansion, then incumbents may retain quota and possibly utilise it in a sub-optimal manner. New businesses can bring innovative technologies and market development practices to an industry.

Tradability of allocated quota is a key to facilitating optimal use of and returns of quota. However, the TRQ trading rules and environment can restrict the ability of companies to obtain quota. For instance, permanent allocations lock other companies out. Further, annual TRQ allocations alone could build an anti-competitive incentive for some companies to retain allocated quota for as long as possible into the year, even if it will not be used by them.

Rules should not operate to preclude the TRQ being optimally utilised. TRQ should be accessible to the widest range of companies able to make use of it in supplying and developing export markets. This should optimise returns to dairy farmers and supply chain participants and the economy.

Principle 5: Consider commercial arrangements

In changing TRQ management there is a need to consider current production, processing and exporting investments, existing commercial relationships and how affected businesses might make adjustments. Some commercial arrangements may have been influenced by the rules of the TRQ system which itself may not optimise use of the TRQ.

3. Market dynamics and outlook for dairy exports

Dairy marketplace dynamics affect the commercial value of the TRQs for Australia. A TRQ management system is not dependent on the market forecast, however, a management model needs to be responsive to changing market conditions.

The USA and EU are generally high-return markets for Australian dairy products so access to TRQ is attractive to many companies. Although the fixed TRQ quantities are small relative to Australia's overall dairy product exports (on average less than 4% of annual exports) the historic price premium makes these important markets to companies and the industry. However, world dairy trade and prices are also influential, as is being seen in 2007 and 2008.

As part of the review process, the Panel received briefings on the domestic and global dairy market situation and outlook from ABARE and Dairy Australia, in particular the supply and demand situation for Australian TRQ products into the USA and the EU in the context of world dairy market trends. The Panel also discussed Australian objectives in international trade negotiations with government officers.

3.1 Recent market patterns

The USA and the EU are moderate size but generally high-value dairy markets for Australia. In 2006-07, the USA was Australia's 10th largest dairy market taking 29,000 tonnes. The gross value of all dairy product exported to the USA was $125 million [see table below].

Figure 1. Top 10 Australian export destinations, 2006/07

Country	Volume-Tonnes	% Total	Country	Value-A$ million	% Total
Japan	137,698	16%	Japan	493	19%
Singapore	84,621	10%	Singapore	192	8%
Malaysia	64,382	8%	Malaysia	187	7%
Indonesia	63,656	8%	Indonesia	182	7%
Philippines	45,606	5%	Saudi Arabia	140	6%
Thailand	41,265	5%	United States	125	5%
Saudi Arabia	37,818	4%	Thailand	111	4%
Hong Kong	32,932	4%	Philippines	104	4%
New Zealand	31,768	4%	New Zealand	86	3%
United States	28,995	3%	Korea, Republic of	84	3%

Source: Dairy Australia

In 2006, the USA produced 82,462,000 tonnes of milk making it the second largest milk producer with approximately 15% global cow milk production. The USA share of world trade in dairy products was 6% in 2006 (milk equivalents). In 2006, the USA manufactured 657,000 tonnes of butter, exported 11,000 tonnes and imported 32,000 tonnes of butter including 7541 tonnes from Australia. The figures for cheese were 4,325,000 tonnes produced, 71,000 tonnes exported and 178,000 tonnes imported including 13,000 tonnes from Australia.

Australia's TRQ access to the USA for all dairy products under the AUSFTA for 2007 was 30,203 tonnes (of which 12856 tonnes was used). Australia's access under the WTO was 7000 tonnes (of which 4881 tonnes was used). The major products exported to the

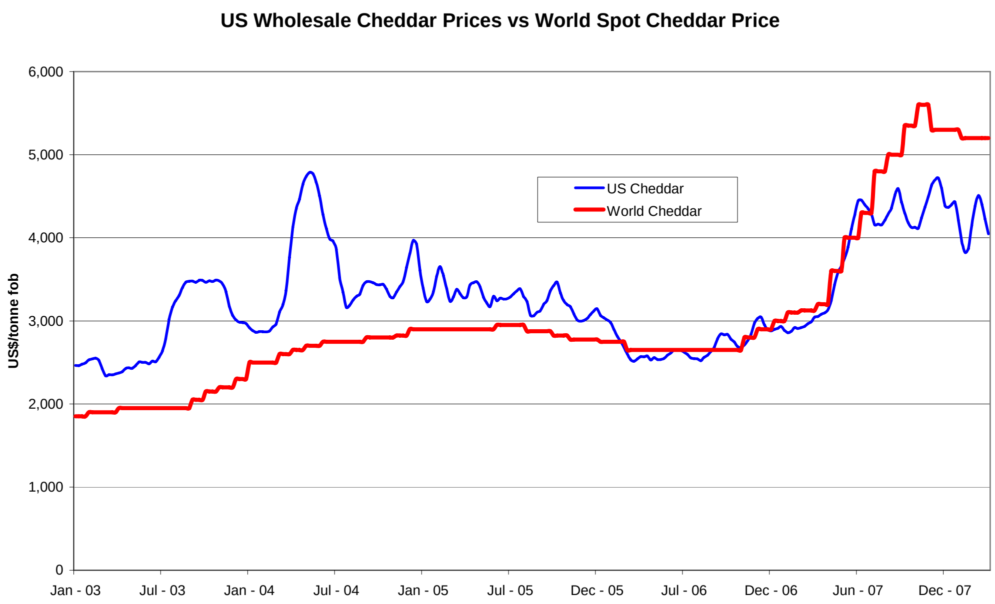
USA in 2007 were Cheese, Whole Milk Powder (WMP) and Butter, all with TRQ access and a zero in-quota tariff. Cheese exported to the USA without quota coverage incurs a tariff between US$1055 and US$2269 per tonne. There have been minimal 'outside quota' exports of these products to the USA because tariffs are very high.

In 2006, the EU produced 141,628 thousand tonnes of milk or 26% of global cow milk production making it the single largest producer in the world. The EU was the second largest dairy exporter in 2006 (after New Zealand) with 30% of the world trade. In 2006, for example, the EU produced 7,732,000 tonnes of cheese, exported 580,000 tonnes, and imported 107,000 tonnes of cheese including 13,000 tonnes from Australia.

In 2006-07, 11136 tonnes of Australian cheese was exported to the EU. Australia's annual cheese TRQs to the EU totalled 4211 tonnes (3211 tonnes for Table Cheddar Cheese, 500 tonnes and Cheese for Processing), which was fully utilised in 2007, as it has been in years past. Exports 'outside-quota' incur a tariff of €1,671 per tonne compared to €170.6/tonne if the product is certified as in-quota. In 2007, Australia shipped 10,959 tonnes of Table Cheddar and 500 tonnes of Cheese for Processing to the EU, of which 7,255 tonnes of cheese was shipped outside of Australia's TRQ.

In recent years, the world dairy market has been characterised by rising prices reflecting shifts in production, export supply and demand patterns. These dynamics are crystallised in world market prices. Figure 2 usefully shows actual world spot market prices for cheddar cheese over 2003 to 2007, compared to USA market prices.

Figure 2



Source: Dairy Australia

Key points of Dairy Australia's June 2008 projections, and ABARE's March 2008 Outlook forecast, plus briefings provided by DA are summarised below for reference. These points, as worded, were confirmed with both ABARE and DA in early June 2008.

3.2 Dairy Australia – Situation and Outlook report, June 2008

World market remains strong for dairy *DA Situation and Outlook, June 2008*

Rising incomes, population growth and pressures on the limited availability of agricultural land and products are sustaining higher world food prices. Dairy should remain a beneficiary of these trends at least in the foreseeable future.

The world market for dairy products has fundamentally changed in the past two years as demand and supply have significantly tightened, and export subsidies have been removed. Commodity prices have been sustained well beyond traditional "ceilings" and possibly are reaching new sustainable levels above USA$3,500/t. Lower supplies from traditional exporting regions have pushed up the value of products to historically high levels, while demand has proved resilient despite higher prices.

A strong global economy has underpinned demand in importing countries. Growing consumption in large milk producing countries such as Brazil, Russia and China has kept them as net importers of dairy.

The fundamentals of demand for dairy in developing markets have not been undone by moderately higher prices to consumers. In many of these countries, expanding middle classes are unlikely to stop consuming dairy, as income growth is helping to offset the higher costs. The improving perceptions of the nutrition, convenience and taste benefits of dairy have seen it become a more staple part of diets which is sustaining consumer demand.

As dairy prices rise, ingredient buyers traditionally consider substituting lower priced vegetable-based substitutes. But the world market for dairy commodities has been aided by increased prices for a number of competing and alternative food groups.

Shortages in grain commodities available for food – due to the combined effects of production shortages and demand from biofuels production in the USA, Brazil and the EU – has increased the costs of feed grains and vegetable oils on world markets. Higher costs are being passed through the supply chain by feed users in meat production.

The rising prices for alternatives, and volatility in most food commodity groups has limited the scope for substitution away from dairy as an ingredient. In addition, dairy's functionality limits the potential for end users to further dilute dairy content in ingredient formulations, with buyers preferring to absorb or pass on higher costs.

World Supply

Growth in world dairy product supply is likely to be in line with, or below, demand growth in the medium term. However, supply in some major regions, such as the EU and USA, may affect export pricing.

Australian supply has been reduced by drought and a reduced dairy herd, with limited prospects for expansion at least in the short-term. Other dairy exporters have also struggled to fill the international trade gap.

The EU has continued with reforms to its Common Agricultural Policy. Export subsidies on all products have been set at zero for most of the 2007/08 year. The EU has increased production quotas by 2% in 2008/09 and plans further increases totalling 4% over the period to 2014, yet the European Commission's own analysis indicates that production output will remain within these limits due to cost pressures and farmer demographics.

The EU dairy sector is also benefiting from increased consumption within the expanded EU – now comprising 27 member states. Increased internal cheese demand has seen a significant shift in EU product mix away from butter and powders which are less-attractive to manufacturers without the market support regime of the past.

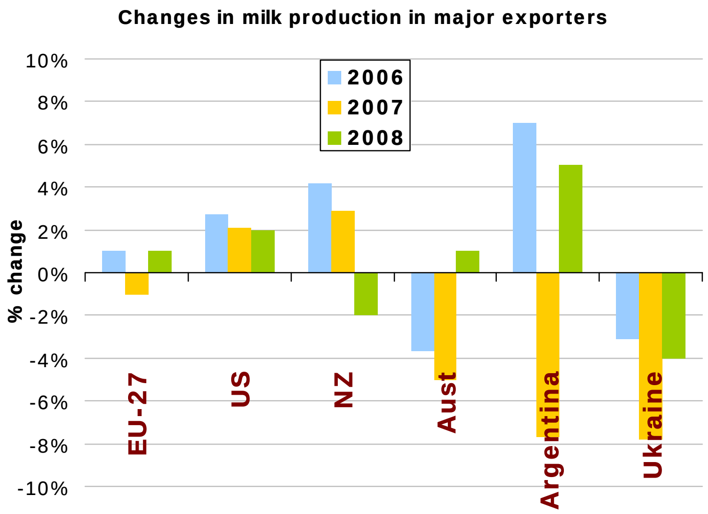
The growth in milk supplies as the EU expands its production quota may not increase the volume of exports but may mean lower internal market prices and subsequently lower export prices onto the world market.

USA production growth remains steady at around 2% reflecting relatively high milk prices despite rising feed grain prices which have limited farmer cash margins. The USA looks capable of being a larger supplier of skim milk powder to world markets, although issues relating to quality and marketing may allow world prices to remain ahead of USA internal market settings.

In New Zealand, production growth has been adversely affected by drought in the first quarter of 2008 which will cause a 3-4% decline in 2007/08 milk production and limit recovery in 2008/09. High milk prices are encouraging significant amounts of investment in farm conversions and expansions, yet the high land values and increasing environmental constraints may curtail long-term growth potential.

India, Argentina and Brazil are likely to increase milk supply, however, local consumption, government policy and competition from other sectors will limit export viability from these regions.

Figure 3



Dairy Australia, 2008

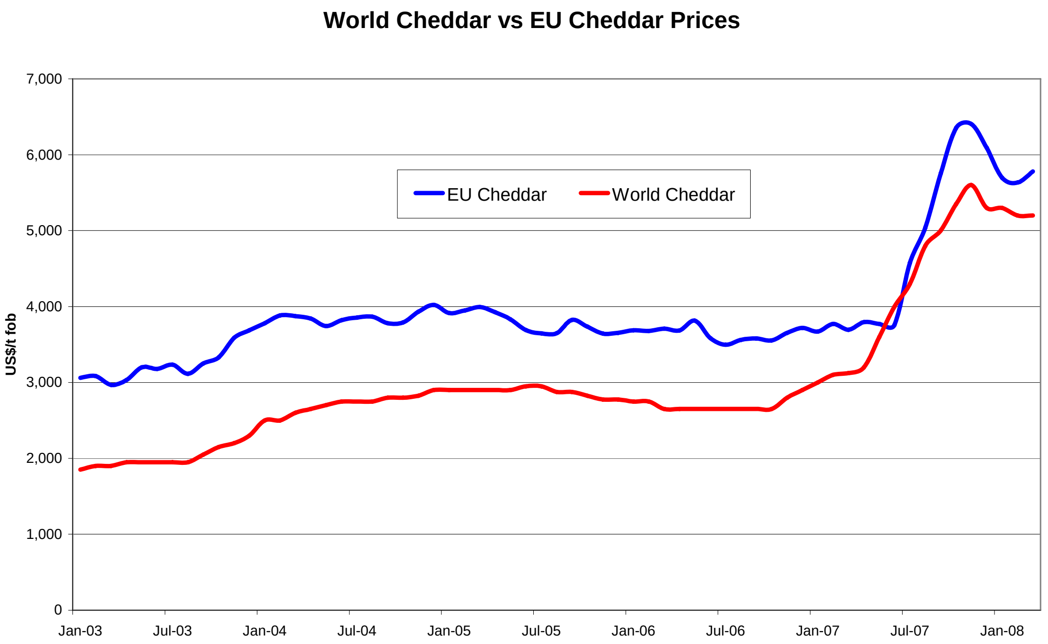
United States and European Union markets

DA’s briefing to the Panel included a series of points regarding USA and EU markets:

- The USA domestic market price and the world market prices have converged. Due to this, there is currently no premium in quota products and current quota fill rates are more about sustaining trade relationships than above normal profit margins.
- The USA is now a net exporter of dairy products. The USA exports 8% of what it produces; up from 5% a few years ago.
- Historically the USA market was very attractive to import quota holders, however with the world price rising above the US price this situation has altered [see figure 2]. The USA is now a large exporter of skim milk powder (SMP) and a growing exporter of butter and cheese because world prices have risen so sharply.
- The USDA has forecast that USA cheese imports are expected to slip by 3% to 190,000 tons in 2008 which would represent the fifth consecutive year of declining imports. As in 2007, the higher world cheese prices compared to US wholesale prices is expected to see the attractiveness of the market being eroded when compared to other markets.
- Production of dairy product in the EU has remained stable over the last 5-10 years, with domestic EU prices rising steadily over the same period, seeing an extraordinary year in 2007 consistent with world prices [see figure 4].
- Traditionally the EU has been the price setter in the world market because of the past operation of export subsidies (the EU’s export subsidies have been set to zero since 14 June 2007).
- The USA has always been a high premium market because they have barriers on the market that insulate them from the world market.
- The EU permitted a 2% (2.8 bn litres) increase in the EU milk production quota from 1 April 2008. Depending on the level of take-up by farmers, which DA forecasts to be around half the 2%, the additional production is likely to be directed to cheese and whole milk powder production. This will result in a lower EU wholesale dairy prices for cheese.

- The take-up of the expanded production quotas is expected to differ between individual EU members. The EU market is likely to become more volatile with reform to its Common Agricultural Policy and these reforms will determine the EU production. Increased production may drive down prices and therefore affect quota premiums and quota fill rates.
- The low in-quota tariff rates mean that at present there is still money to be made for Australian quota holders in the EU market. The country specific cheese quota still has a premium compared to other cheese quotas.
- There will be diminishing premiums for sales into the EU under Australia's WTO quota over the next 5-10 years as the gap between internal EU and world prices continues to narrow.

Figure 4



Source: Dairy Australia

3.3 ABARE forecast 2008 to 2013

ABARE's Outlook analysis,[3] plus its briefing to the Panel, include the following points:

- A recovery in dairy herd numbers in Australia to be constrained by relatively higher feed costs and the lead times involved in rebuilding. Australian milk production will recover slowly over the medium term as a result of an assumed improvement in water allocations, rising cow numbers and steady increases in average milk yields per cow.
- Some decline in world prices for dairy products is forecast in 2008-09, but prices to remain relatively high over the outlook period to 2012-13 [see figure 5].
- Future growth in world dairy product trade to be relatively slow, reflecting production constraints in the major exporting countries, particularly Australia and the European Union, despite strong world prices. High prices and a lower US dollar are expected to provide price incentives for more USA exports, with growth in exports also expected from South America. New Zealand will try to expand production and exports, but has some constraints (land availability, effluent disposal and lead times in herd building) [ABARE 2008 and USDA 2007, Commission of the European Communities 2007].
- Total value of Australian dairy exports is expected to continue to rise to 2013 reflecting rising Australian production, increasing exports and relatively high world prices.

Figure 5

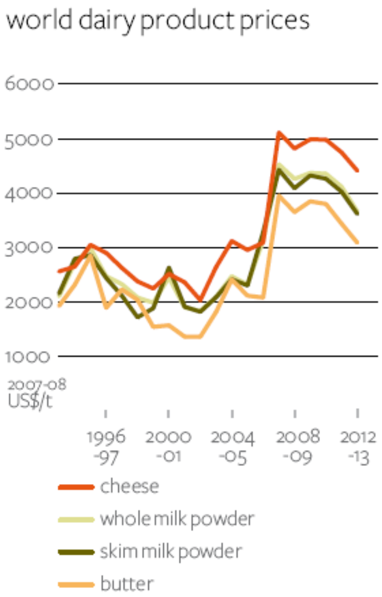
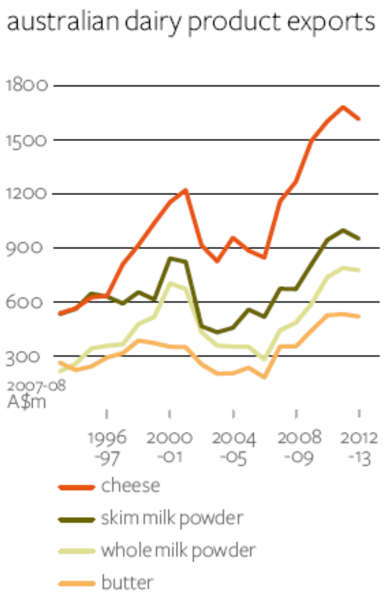


Figure 6



Source: Australian Commodities March Quarter 08.1

[3]ABARE, Australian Commodities, Outlook 2008 Conference, March Quarter, 08.1 Canberra

USA and EU markets

In written and oral briefings, ABARE provided the following insights on these markets:

- The 2007-08 rise in world dairy prices to above USA domestic prices and a higher Australian dollar exchange rate, has meant declining incentive for Australian exporters to sell into that market. In addition, an assumed lower USA dollar is expected to make USA dairy exports more price competitive on world markets.
- The very large USA dairy industry has typically been focussed on its domestic market with subsidies and import barriers leading to domestic prices that were higher than world prices. This situation changed somewhat with higher world dairy prices and a lower US dollar that have provided strong incentives for US dairy producers to increase their exports. A lower US dollar and lower domestic prices (compared to world prices) makes US dairy product much more price competitive on world markets.
- ABARE does not forecast USA dairy prices, however, considers that (in the absence of agricultural reforms) USA dairy prices will rise because of a number of factors:

  - Feed grain prices are expected to remain high over the outlook period to 2013 due to competition in consumption by the biofuels industry.

  - High fuel prices are inputs into production of most commodities, indirectly through feed grains and directly through other dairy costs. In addition, higher fuel prices are driving up the value of vegetable fats and proteins (increasingly used as inputs to the manufacture of biofuels) and are substitutes for dairy products in some processed foods.

  - A lower US dollar suggests (in the absence of further subsidies and price distorting policies) that world prices might be more of an influence on USA dairy prices than they have been in the past. (ie. some degree of price convergence).

Figure 7

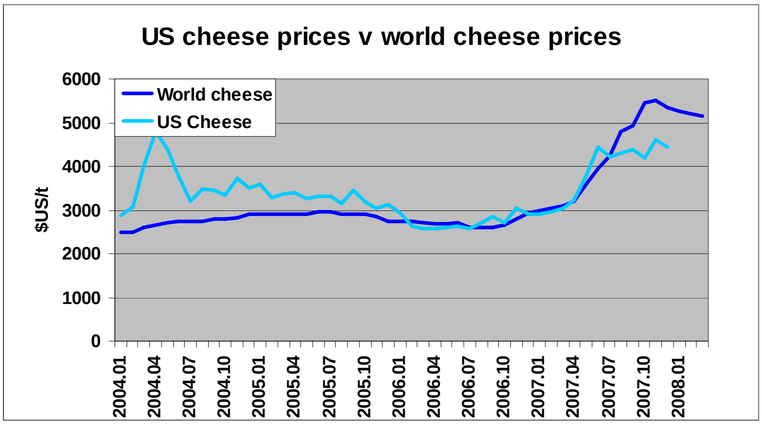
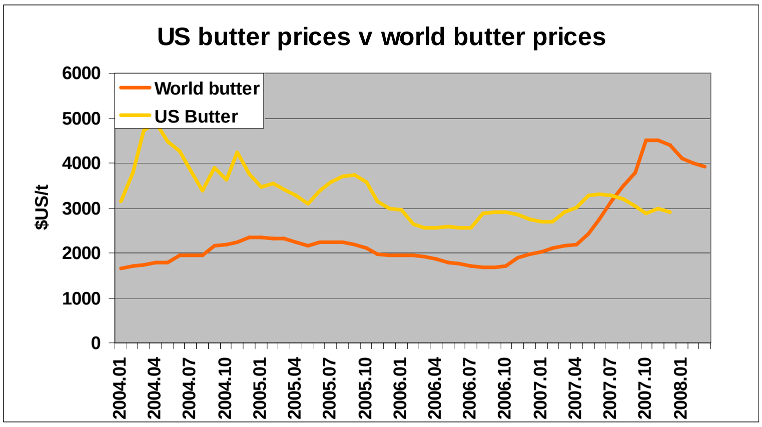


Figure 8



- A US recession may mean reduced consumption of processed foods which contain dairy products as an input. This might cause more exports of US dairy products onto world markets, particularly SMP, but also some cheese and butter.
- A falling US dollar will reduce the price competitiveness of dairy products imported by the US, while making US exports cheaper on world markets.
- The EU market is still providing a price premium for Australia quota holders. At April 2008 comparable domestic EU cheddar was selling at $450/tonne above the world price. Australian dairy produce is of high quality and does attract a premium – also quota rents. However, it is difficult to quantify this as it is difficult to compare some prices due to different products on offer. We would expect the current situation to continue, as Australian processors have developed their particular niche in the market place.
- A future growth in global cheese consumption will be linked strongly to rising consumer incomes and an upward trend toward more western style diets in major developing countries of Asia, Eastern Europe and in new member states of the EU.
- The EU has traditionally been the largest dairy product exporter (New Zealand recently became the largest dairy exporter) while the US is focussed on its domestic market, with little product exported.
- As a result, EU exports have been one of the major drivers of the world price for many years – remember that the EU was trying to dispose of subsidised product at below the actual cost of production and this drove the price of traded dairy products down. The US, with its domestic focus (and import quotas) was able to maintain higher prices in their domestic market than prevailed in world markets because they weren't trading very much with the rest of the world. But this is now changing, because of high world prices and a lower US dollar – and, to a lesser extent, ongoing efforts at trade liberalisation.
- The change in the mix of dairy products produced in the EU probably won't change the relative prices of dairy products too much. The changes in product mix reflect consumer demand. It is only likely to change the relative prices of individual products if more is produced, relative to demand, as a result of changes to the Common Agricultural Policy.
- Each EU member state has a certain milk production quota (largely based on historical production). The EU quota will largely determine how much milk (in total) is produced by the EU, but individual countries within the EU may not produce their full quota as each has different comparative advantage in milk production and some countries (such as the UK) are going through industry restructure and will come in below quota for some years to come. Increased price volatility (if it occurs) will be a result of changes in supply conditions (droughts, floods etc and changes to the Common Agricultural Policy and trade barriers) while the exhaustion of intervention stocks (which used to act as a buffer) can no longer help to reduce volatility.

3.4 Market outlook and this TRQ management review

ABARE advice indicates that expanding milk production quotas in the EU may reduce the value of TRQ rents to Australia.[4] More production in the EU and product availability may reduce the price received by EU producers for their product. DA advice also suggests that premiums in these markets may diminish. On the other hand, market conditions could change and the value of the premium could rise.

The Panel notes that while premiums are currently lower than a few years ago, analysts and industry generally agree the EU should continue to be a valuable TRQ market and a TRQ allocation system will probably be needed in forthcoming years.

These markets and outlook assessments show how the value of the TRQ can fluctuate with changes in market conditions. They also suggest there could be more volatility and unpredictability in global, EU and USA dairy product markets.

In this context, the Panel considers that a flexible TRQ management model that has the capacity to switch between allocation and FCFS is important. In addition, the model needs to be more responsive to performance by companies in changing export market conditions – not a system locked into historical arrangements.

The TRQ management model developed in chapter 6 reflects this assessed need for flexibility and robustness to cater for changing market conditions and possible expansion to bilateral TRQs through trade negotiations.

[4] The concept of 'quota rent' arises often in discussion of quota management schemes. Quota rent can be described as the price premium that companies can obtain by being able to access a particular marketplace at a low in-quota tariff while the price in the market is higher [see appendix 2].

4. History and current arrangements for dairy TRQs

Tariff rate quotas (TRQs), are fixed amounts of specified products that can be imported by one country from another at a reduced tariff rate. TRQs are widely used to limit trade around the world. There are over 1400 TRQs in 45 World Trade Organisation (WTO) member countries covering (according to the OECD) almost 30% of global agricultural production. Most TRQs are administered by the importing country and TRQ rents are retained by that country. Only country-specific TRQs, where management rights have been granted to the exporting country allows the capture of rent by the exporter.

In relation to dairy products, Australia has access rights to country-specific and global TRQs in a number of countries but the Australian Government is only involved in managing some of the country-specific TRQs with the United States of America (USA) and the European Union (EU). These TRQs were negotiated with the EU and the USA through the Tokyo round of the General Agreement on Trade and Tariffs (GATT) in 1979 and subsequent Uruguay Round of WTO agreements 1994 as well as through the 2004 Australia United States Free Trade Agreement (AUSFTA).

Until 2003, these TRQs were managed by the ADC, a statutory authority responsible for provision of services to the dairy industry. The ADC's export control powers derived from the *Dairy Produce Act 1986* and previous equivalent legislation. These Acts allowed the ADC to: define "controlled dairy products"; prohibit the export of controlled dairy products except by firms that the ADC licensed; issue directions to licensees imposing conditions on the quality or volumes of product they could send to all (or specific) export destinations; and cancel or suspend licenses for failure to comply with directions.

Following dissolution of the ADC as a statutory authority from 1 July 2003 and formation of the industry-owned company Dairy Australia Ltd, DAFF assumed responsibility for administering exports of Australian dairy products to regulated markets. The *Dairy Produce Act 1986* (the Act) was amended to provide that specified dairy produce may be declared regulated dairy produce and specified dairy markets may be declared regulated dairy markets in respect of that produce. The Act prohibits export of regulated dairy produce to a regulated market without approval.

4.1 EU WTO TRQs

Basis for Australia's EU TRQ

Australia has TRQ access rights to the EU for 4211 tonnes of cheese as shown in figure 9:

Figure 9

Customs Tariff Code	Product	Access Amount	In-Quota Import Duty	Out-of-Quota Import Duty
0406 90 21	Table Cheddar Cheese	3,711 tonnes	€17.06/100kg	€167.1/100kg
0406 90 01	Cheese for Processing	500 tonnes	€17.06/100kg	€167.1/100kg

Australia's EU WTO TRQs were granted mainly in two separate multilateral trade negotiations: 3000 tonnes in 1979 under the GATT Tokyo Round agreement and 750 tonnes in 1994 under the WTO Uruguay Round agreement. This was divided into 3250 tonnes of cheddar and 500 tonnes of processing cheese. In April 2006, the EU increased Australia's cheddar TRQ by 461 tonnes to 3711 tonnes, to compensate for loss of open-access markets due to expansion of the EU from 15 to 25 countries in 2004.

The in-quota tariff of 170.6 euros per tonne is significantly lower than the out-of-quota tariff of 1671.0 euros per tonne.

EU TRQ management history in Australia

Until 2003, EU cheese TRQs were managed by the ADC. In 1980, after discussion with industry, the ADC allocated the EU cheese TRQ across local manufacturers according to their respective shares of global exports of cheddar cheese in previous financial years, with a minimum allocation understood to be 20 tonnes. Allocations were granted free of charge to firms.

When the new EU TRQ of 750 tonnes became available in 1994, the ADC again allocated new quota across firms according to their share of recent global exports of cheddar cheese. Allocations for individual firms were adjusted in line with a theoretical measure of a full container load. Firms whose export record led to an allocation of less than 20 tonnes were excluded from the final allocation. The 1980 quota allocations remained with their original recipients who had developed appropriate matured cheddar lines for the EU. These TRQ arrangements have remained in force to 2008 with minor adjustments to take account of company amalgamations and consolidation.

In April 2006, the EU increased Australia's table cheddar TRQ by 461 tonnes to 3711 tonnes to compensate for the expansion of the EU from 15 to 25 countries in 2004. Industry proposed, and it was agreed by the Australian government, that those companies that had exported product previously to the new member countries of the EU should be beneficiaries of the extra TRQ. Exporters' allocations of the new TRQ quantity were apparently calculated as a proportion of all exports to new member countries, averaged over 2002 and 2003 with a minimum allocation of one tonne.

Legislative basis

In 2003, the Dairy Produce Regulations 1986 were amended to declare the EU as a regulated dairy market in respect of regulated dairy produce. A Schedule to the Regulations specifies the cheeses in Table 3 above as regulated dairy produce for the EU.

The Regulations also provide for the Secretary of DAFF to manage the TRQs in accordance with rules set out in the Regulations.

Current management and usage of EU TRQs

An EU certificate, known as an IMA-1, is required by the EU for dairy produce imported into the EU at a reduced tariff rate. The Australian Quarantine and Inspection Service (AQIS) within DAFF is recognised by the EU as the official Australian government issuing authority for IMA-1 certificates. AQIS issues this certificate at the request of the DAFF Quota Unit (QU) for exports falling into the above cheese TRQ categories.

There are currently seven manufacturing companies allocated EU cheese quota for bulk table cheddar and one company holding the allocation of the EU processing cheese TRQ.

Key features of TRQ management rules and administration operation are -

- In practice, allocations are formally made in October/November each year in time for the shipping year which commences on 1 November prior to the quota year.
- The amount each company is allocated is static unless they have formally transferred quota to another entity or are in breach of the usage rules.
- Quota allocations are only made to dairy manufacturers but are transferable to any other entity.
- A quota recipient will lose quota allocation in a subsequent year if they have shipped zero quota product in the two previous years or if all allocations are transferred for two consecutive years to other entities.
- On 23 August each year unused quota is withdrawn from quota holders for the remainder of the quota year unless the company advises that the quota will be used. This quota may then be allocated by the Secretary to other companies for the remainder of the shipping year.
- New entrants can only obtain quota through a transfer from existing quota holders or after August 23 each year from DAFF if an allocation of quota has lapsed or been withdrawn under the provisions outlined above. In practice this has not occurred.

The EU cheese TRQs have always been fully utilised by the seven companies with historically fixed allocations. Figure 10 shows usage for the past four years.

Figure 10

EU Table Cheddar			EU Cheese for Processing		
Year	**Annual TRQ (kgs)**	**Shipped (kgs)**	**Year**	**Annual TRQ (kgs)**	**Shipped (Kgs)**
2004	3,250,000	3,249,960	2004	500,000	500,000
2005	3,250,000	3,249,840	2005	500,000	499,820
2006	3,711,000	3,701,000	2006	500,000	495,580
2007	3,711,000	3,704,000	2007	500,000	500,000

4.2 USA WTO TRQs

Australia has WTO country quota rights for a total of 10765 tonnes of dairy products to the USA (Figure 11).

Figure 11 **WTO Tariff Rate TRQs - USA**

PRODUCT	Amount
Condensed Milk	92 t
NDM or Skim Milk Powder	600 t
Whole Milk Powder/BMP/Feeds	57 t
Other Dairy	1016 t
Chocolate crumb	2000 t
Cheddar cheese	**2450 t**
American (or Granular) cheese	**1000 t**
Swiss cheese	**500 t**
NSPF (other) cheese	**3050 t**
Total	10765 t

The Australian Government only has a role in managing the four WTO cheese TRQs, amounting to 7000 tonnes. All of Australia's other WTO dairy TRQs are managed by the United States Department of Agriculture (USDA) and Australia is not able to monitor the rate at which the TRQs are used or by which importing companies in the USA.

Australia's USA WTO cheese TRQs were granted in two separate trade negotiations: 4000 tonnes in 1979 under the Tokyo Round of the GATT and 3000 tonnes in 1994 under the WTO Uruguay Round agreement. Following the commencement of the AUSFTA in 2005, tariffs on all of the in-quota cheeses (which had ranged between 10% and 20% of the landed price) were reduced to zero. Out-of-quota tariffs on the TRQ-type cheeses remain at prohibitively high levels ranging from US$1055 per tonne to US$1877 per tonne. By comparison, USA prices for cheddar currently range between US$4000-4500 per tonne, with world prices currently over US$5000 per tonne.

WTO TRQ allocation and management mechanisms in the USA

The USDA allocates Australia's cheese TRQ import rights to licensed USA importers. Australian exporters can only sell cheese under the WTO TRQs to these licensed importers. USA import licences are issued as either *historical* TRQ licences (2616 tonnes) or *supplementary* TRQ licences (4385 tonnes). Each receives different treatment:

- For *historical* TRQ, the USDA issues import licences to USA importers on the basis of the importers' historical trade. The historical licences were confirmed in the Tokyo Round trade negotiations. Australia has no influence on the distribution of these licences. Imports under these licences are monitored by the USA Department of Customs and Australia has no recognised management rights.
- *Supplementary* licences derive from both Tokyo and Uruguay Round trade negotiations. Supplementary TRQ is structured differently in that the USDA issues import licences to USA importers who are nominated annually by the Australian Government, provided they meet eligibility criteria. Currently the Australian Government nominates importers based on advice from dairy companies allocated quota. Imports under supplementary licences are monitored by the USDA.

The amounts of historical and supplementary TRQ are shown in Figure 12.

Figure 12 Supplementary and historical TRQ amounts

TRQ	Historical	Supplementary	Total TRQ
Cheddar	984,500	1,465,500	2,450,000
Granular	881,000	119,000	1,000,000
Swiss	209,700	290,300	500,000
NSPF	541,200	2,508,800	3,050,000
Total	2,616,400	4,384,600	7,000,000

History of USA WTO TRQ management in Australia

Until 2003, USA cheese TRQs were managed by the ADC. In December 1979, after dairy companies had failed to reach a consensus, the ADC allocated USA cheese TRQ from the Tokyo GATT Round to local manufacturers on the basis of each company's share of export sales to the USA in 1977, 1978 and 1979. These allocations were comprised of both historical and supplementary TRQ types. This allocation carried through until the Uruguay Round settlement in 1994 (with company allocations being amended to take account of mergers and takeovers in that period).

Following the Uruguay Round, the ADIC and the ADC agreed that all Tokyo Round cheese allocations should be held on an ongoing basis (rather than being re-issued each year) but could be transferred by the holder.

The ADC allocated Australia's Uruguay Round entitlements, all of which were supplementary-type TRQ, to manufacturers based on their exports of non-quota cheddar and NSPF category cheeses in the previous financial year (1993-94). Companies were given the right to swap any new allocations of cheddar and NSPF among themselves on a temporary or permanent basis. At the same time, provision was allowed for firms to permanently transfer any of their quota allocations to other firms including trading/ exporting houses.

A key condition was that if firms did not ship any product against their quota for two years, the ADC would remove their allocation and redistribute this across industry on the basis of trade shares in the most recently completed financial year. Firms could plead special circumstances to the ADC regarding non-shipment. If the ADC accepted their argument, then it would not reassign quota.

Legislative basis

The Dairy Produce Regulations 1986 were amended in 2003 to declare the USA as a regulated dairy market in respect of regulated dairy produce. A Schedule to the Regulations specifies the cheeses in Table 1 above as regulated dairy produce for the USA. The Regulations also provide for the Secretary of DAFF to manage the TRQs in accordance with rules set out in the Regulations.

Current allocation arrangements for USA WTO TRQs

At present a total of six Australian firms hold USA quota allocations across the four WTO cheese TRQs. As noted above, the TRQs were granted to Australia as either historical or supplementary TRQ and allocations to companies were made on the same basis. Most firms therefore hold a fixed proportion of each cheese TRQ as historical TRQ and the remainder as supplementary. Those companies that only received allocations from the Uruguay Round hold only supplementary quota. For supplementary TRQs, the department is required annually to obtain advice from Australian exporters on their preferred importer, and to advise the USDA.

The management of Australia's 2616 tonnes of *historical* cheese TRQs is problematic for both exporters and administrators. The Australian Government has no capacity to effectively control these TRQs or monitor their usage. This is because the USA does not recognise Australia's quota documentation. In 2003, following an agreement with industry to continue previous arrangements, the government introduced legislation that prevented exporters from shipping any product of these TRQ types without approval (*DPA* 1986 s.53). As the USA does not recognise Australian allocations of TRQ, shipments cannot be accurately matched with the licenses provided by USDA to USA importers. There is no guaranteed way to protect the allocations to Australian exporters.

- for example, a shipment of cheese may be approved by DAFF on the basis of exporter assurances that it is not intended to enter the USA under Australia's TRQ. It may nevertheless end up being treated as Australian TRQ cheese by USA Customs (if it is imported by a licensed USA importer whose amounts have not yet been filled

- further supporting evidence for the lack of monitoring and control over these TRQs is apparent in the discrepancy between USDA entry statistics for TRQ product and DAFF records of TRQ usage.

Historical TRQs also provide exporters with limited market power. Licenses are issued to USA importers on the basis of historical performance – importers have essentially inherited quota allocations and hold them in perpetuity although nominally subject to usage rules. Australian exporters can only sell to these licensed importers. Most cheese categories are controlled by restricted numbers of importers leaving Australian exporters with minimal access to quota rents [see appendix 2]. If an Australian exporter with historical quota allocations cannot come to a commercial arrangement with an importer, that quota remains unused.

Supplementary TRQ (4384.6 tonnes) allows Australian exporters some flexibility in choosing buyers and therefore potentially capturing some of the quota rents. This is because the USA Government issues licences for *supplementary* WTO TRQ on the basis of advice from the Australian Government. DAFF obtains this information from quota recipients. Recipients generally nominate importers with whom they have relationships.

These importers are then issued licenses by the USA Government to import a specified amount of product. This feature enables Australian exporters to capture a portion of the quota rents because they have some control over the selection of a buyer. It also enhances Australia's control and enforcement processes compared to historical quota because quota product can only be sold to an importer designated by Australia.

Current Allocation Rules

- TRQ quantities are formally allocated to companies in October each year by the Secretary of the DAFF in time for the commencement of the shipping year on 1 November. The amount each company receives is static. Companies have retained the quantities they were first allocated in 1979 and 1994 unless they have formally transferred quota to another entity or have been in breach of the usage rules.

- Quota allocations are transferable to other entities with no restriction on type of entity. A quota recipient will lose quota allocation in a subsequent year only if the company has shipped zero quota product in the two previous years or if all allocations are transferred for two consecutive years to other entities.

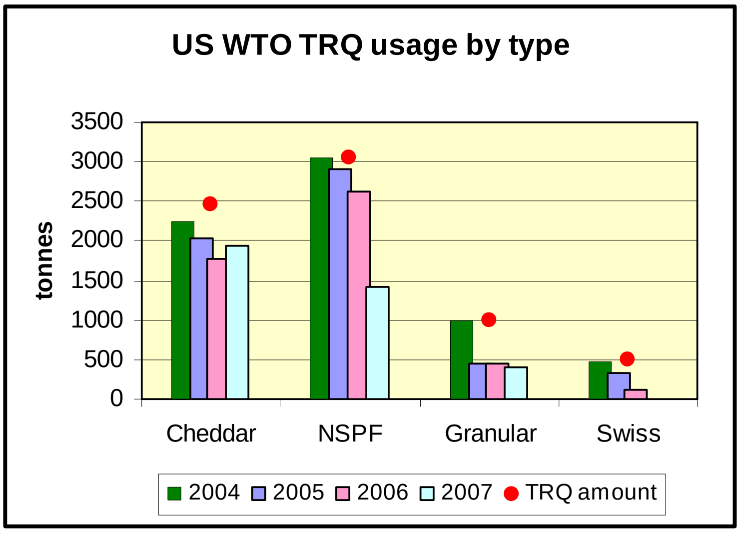
- On 23 August each year unused quota may be withdrawn from quota holders for the remainder of the quota year unless the holder advises that the quota will be used. This uncommitted quota may then be distributed by DAFF to any other companies during the remainder of the shipping year. A potentially complicating factor in distributing uncommitted WTO quota is the need to identify returned quota amounts by type (ie. historical or supplementary) and for the receiving company to ship appropriate amounts to the relevant licensed importer. Effectively, any returns are difficult for other companies to utilise within a relatively short time-frame because amounts are attached to specific historical license holders and/or importers nominated by the original quota recipient. No returned WTO quota has been accessed by other companies since the department began TRQ management activities in 2003.

- New entrants can only obtain quota through transfers, lapsed or withdrawn quota.

Usage rates

Aggregate WTO cheese TRQ shipments to the USA and TRQ usage are shown in figure 13.

Figure 13



4.3 AUSFTA dairy TRQs

Basis for Australia's TRQ rights

The AUSFTA was negotiated in 2004 and provided Australia with tariff-free access for specified annual quantities of dairy products in twelve broad categories (ie. 12 TRQs) as set out in figure 14. Access commenced on 1 January 2005 and the amount of access for each TRQ grows annually by an agreed factor. Under the AUSFTA, products entering the USA in any of the TRQs must be accompanied by a quota certificate specifying the amount of product and the USA Harmonised Tariff Schedule product code. All quota certificates for each TRQ must be issued by the Australian government. The certificate is recognised by the USA government as a condition of import for tariff-free entry.

Figure 14. Initial access amounts, annual growth percentages and 2008 access amounts.

PRODUCT	INITIAL 2005 TRQ AMOUNT	ANNUAL GROWTH	2008 AMOUNT
Milk/Cream/Ice Cream	7.5 m litres	6%	8.9 m litres
Condensed Milk	3,000 t	6%	3,573 t
Butter/Butterfat	1,500 t	3%	1,639 t
Non-fat Dried Milk Powder / Skim Milk Powder	100 t	3%	109 t
Other Milk Powder	4,000 t	4%	4,499 t
Other Dairy Products*	1,500 t	6%	1787 t
Cheddar Cheese	750 t	3%	820 t
American Cheese – Granular?	500 t	3%	546 t
Swiss Cheese	500 t	5%	579 t
European Cheese	2,000 t	5%	2,315 t
Goya Cheese	2,500 t	5%	2,894 t
Other Cheese	3,500 t	5%	4,052 t

The AUSFTA negotiations agreed the TRQ amounts and annual growth rates, and provided Australia with the rights to distribute and manage the TRQs. The current arrangements for managing AUSFTA TRQs were initially developed by the dairy industry and negotiated with government in 2004 The agreed rules were given effect through amendment of the Dairy Produce Regulations 1986.

Legislative framework

Division 2.3A of the Dairy Produce Regulations 1986 (the Regulations) provides that the USA is a regulated dairy market in respect of regulated dairy produce under the AUSFTA. A Schedule to the Regulations provides definitions of dairy produce declared as regulated dairy produce for the USA. The Regulations also set out the detailed rules and formulas for distribution and management of the TRQs and provide for the Secretary of DAFF to manage the TRQs.

Current management of AUSFTA quotas

Each TRQ covers a range of specific product codes contained in the USA Harmonised Tariff Schedule. The exporter is responsible for ensuring that the product for which quota is sought does, in fact, meet the Schedule's description for this code. Exporters may seek advice from customs agents or obtain a ruling from the USA authorities. DAFF provides some guidance on its website on the USA Harmonized Tariff Schedule product codes through an Australian product equivalence schedule.

Eleven of the 12 AUSFTA categories are managed as 'allocated' TRQs. The category Other Dairy Products is 'unallocated'. This category is subdivided into sub-categories A and B, of which sub-category B is for chocolate-type dairy products. The category of Milk/Cream/Ice Cream is subdivided into sub-categories, of which Ice Cream is unallocated.

- 'Allocated' categories are those where dairy manufacturers are issued quota allocations that can be used throughout the year to ship product, or can be transferred to other exporters (temporarily or permanently).
- 'Unallocated' categories are those for which applications for export approvals can be made by any person throughout the quota year until the TRQ is fully utilised. The unallocated categories are also referred to as FCFS.

Current rules for allocated categories

Eligibility: Since 2005 eligibility has been restricted to dairy manufacturers. A dairy manufacturer is a person who collects milk from farms and processes it into dairy products or purchases dairy produce and subjects it to a process that changes it from one kind of dairy produce to another.

Transfers: Once an allocation of quota has been made it may be transferred to another party, including non-manufacturers, on a temporary or permanent basis by notifying DAFF.

Year One allocation: In 2005, the preliminary allocation for each TRQ category was calculated on the basis of a company's pro-rata shares of 2002 and 2003 total exports (less quota exports) and their total manufactured production for that category. The weighting given to exports was twice that given to production.

There was also a provision for applicants disadvantaged by significant events in one of the two base years. Applicants considered to have been disadvantaged in one of the two years were able to use data from one year only, which was then doubled. This provision was applied to a few companies.

Once the preliminary allocation was calculated, the amounts were rounded up by a factor of either 10 or 20 tonnes (see figure 15). All applicants on or above the minimum quantity for the category, as shown in Table M, received a primary allocation. The amount of set-aside for each TRQ as listed was shared equally by all applicants whose preliminary allocation fell below the minimum threshold.

Figure 15. Allocated Categories: Total and minimum amounts, rounding factors and set-asides

FTA Category	Total TRQ amount for allocation 2005	Minimum Allocation	Rounding Factor	Set-Aside Amount	
Milk and Cream & Ice Cream*	5,000,000 litres	20,000 litres	20,000	5%	250,000 litres
Condensed Milk	3,000 tonnes	20 tonnes	20	5%	150 t
Butter/Butterfat	1,500 tonnes	20 tonnes	20	5%	45 t
Non-Fat Dried Milk Powder & Skim Milk Powder	100 tonnes	20 tonnes	20	0%	0
Other Milk Powders	4,000 tonnes	20 tonnes	20	5%	200 t
Cheddar Cheese	750 tonnes	20 tonnes	20	5%	37.5 t
American Cheese	500 tonnes	20 tonnes	20	5%	25 t
Swiss Cheese	500 tonnes	10 tonnes	10	5%	25 t
European Cheese	2,000 tonnes	10 tonnes	10	5%	100 t
Goya Cheeses	2,500 tonnes	20 tonnes	20	5%	125 t
Other Cheese	3,500 tonnes	10 tonnes	10	5%	175 t

* Ice-cream is an unallocated sub-category, therefore not shown in this table. Total Ice-cream access amount is 2.5m litres.

Subsequent allocations from 2005: TRQs are formally allocated to companies in October each year by the Secretary of DAFF (or delegate). Although the quota applies to a calendar year, the “shipping year” is considered to begin on 1 November to allow exporters to have product in the USA from 1 January.

Companies that received a quantity of quota in 2005 retain the allocation for subsequent years subject to any permanent transfers or forfeits [see below]. They were also eligible to receive annual increases in allocation because the total TRQ quantities grow each year in accordance with the percentages set out in figure 15. The available TRQ amounts from 2005 to 2008 are set out in Figure 16.

Figure 16. Total TRQ access amounts 2005-2008 (tonnes except Milk/Cream/Ice cream in kilolitres)

TRQ category	2005	2006	2007	2008
Milk/Cream/Ice cream	7,500	7,950	8,427	8,933
** of which: Icecream*	*2,500*	*2,650*	*2,809*	*2,978*
Condensed milk	3,000	3,180	3,371	3,573
Butter	1,500	1,545	1,591	1,639
Skim Milk Powder	100	103	106	109
Other milk powder	4,000	4,160	4,326	4,499
* Other dairy products	1,500	1,590	1,685	1,787
Cheddar Cheese	750	773	796	820
American Cheese	500	515	530	546
Swiss Cheese	500	525	551	579
European Cheese	2,000	2,100	2,205	2,315
Goya Cheese	2,500	2,625	2,756	2,894
Other Cheese	3,500	3,675	3,859	4,052
TOTAL	29,850	31,391	33,013	34,724

* Unallocated TRQ categories

Forfeits of quota – the ‘use it or lose it’ provision: Quota allocation is forfeited if it has been temporarily transferred in two consecutive years (not including 2005). Where a quota holder ships less than 95% of allocation for two consecutive years (not including 2005), the average of unused quota over the period is forfeited. Forfeited quota becomes part of the total amount for allocation in the subsequent year.

Distribution of annual TRQ growth and forfeits: Half of the annual growth amount (together with forfeited quota as noted above) is distributed *proportionately* to all primary and secondary quota holders in the previous year (a primary quota holder is one that holds more than 4 times the minimum allocation quantity for the category, or 5% of the 2005 quota amount, whichever is greater) - the remainder are secondary quota holders. The other half of the annual growth amount is distributed *equally* to all secondary quota holders and new applicants.

Management of unused quota: All quota holders with unused allocation in any category must advise DAFF by 23 August each year how their remaining allocated quota will be used. Any amounts not advised by 23 August are withdrawn and made available for re-distribution in the current quota year. Companies unable to use their available quota in any year may request DAFF to withdraw quota at any time.

New applicants: A dairy manufacturer without previous TRQ allocation in a category can apply to the Secretary of DAFF for an allocation of quota in that category by 15 October each year. All new applicants and secondary quota holders will share half the annual TRQ growth amount for the category.

Unallocated quotas

The Milk/Cream/Ice Cream TRQ is managed as two sub-categories: two-thirds is assigned to Milk/Cream and is managed as an 'allocated' quota, and one-third of the total annual access amount is assigned to the Ice Cream sub-category which is unallocated. The Other Dairy Products TRQ is also unallocated.

Annual TRQ amounts from 2005-2008 are shown in figure 16.

Persons wanting to ship FCFS products in a calendar quota year can apply for approvals on or after 1 November of the year prior to the quota year. Multiple shipments throughout the quota year require separate applications for each shipment. Applications are not restricted to dairy manufacturers. General requirements for an application are:

- No applicant will be approved for a cumulative amount greater than one-third of the total quota for the relevant quota year.
- Each application must include information on the amount of quota sought and the USA Harmonized Tariff code under which the product will enter the USA.
- Each application must include the date of proposed export.
- Each application must include evidence that the products will be imported into the USA.
- Fees relating to applications need to be paid prior to quota certificates being issued.

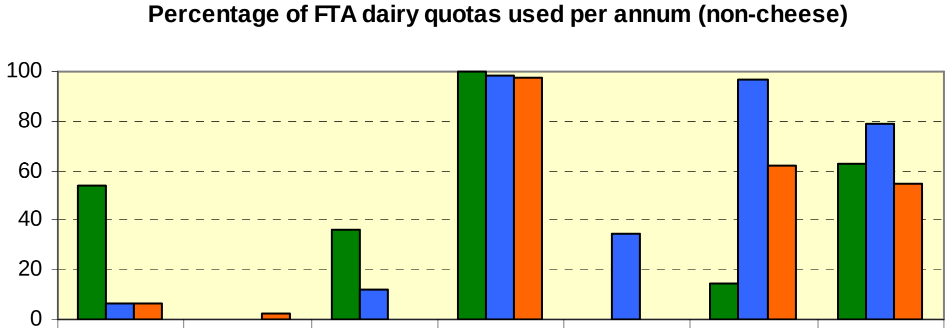
All requests for approval are dealt with on a FCFS basis. If applications on 1 November are over-subscribed, then all applicants on that day share the TRQ equally, provided no applicant receives more than one-third of the TRQ or more than they requested.

Approvals to export may be withdrawn by DAFF if the holder of the approval fails to export at least 95% of the specified amount by the date specified in the application for approval or, where delays are beyond the control of the holder, within 28 days of the specified date.

Usage rates

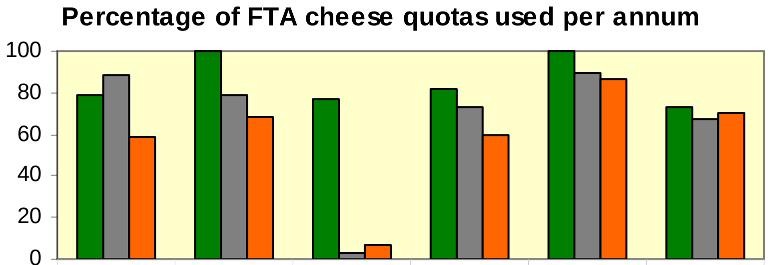
Fill rates for AUSFTA TRQ have declined in most categories since 2005 (figures 17, 18).

Figure 17



	Cream	Icecream	Condensed Milk	Butter	Skim milk powder	Other Milk Powder	Other Dairy
2005	54	0	36	100	0	15	63
2006	7	0	12	98	35	97	79
2007	6	2	0	98	0	62	55

Figure 18



	Cheddar Cheese	American Cheese	Swiss Cheese	European Cheese	Goya	Other Cheeses
2005	79	100	77	82	100	73
2006	88	78	3	73	89	67
2007	59	69	7	60	86	70

5. Industry perspectives on dairy TRQ management

The Panel consulted as widely as possible in its deliberations. Submissions were sought in March 2008 through advertisements in major national and rural newspapers. The Panel invited parties making submissions to also meet with the panel.

The panel also sought the assistance of the ADPF and Dairy Australia in circulating notices. In addition, the Panel chair contacted several organisations, including the Australian Speciality Cheese Association and individual business entities to confirm they did not wish to provide a separate written submission or to meet with the Panel to discuss the issues.

The Review received submissions from several organizations and companies including:

- Trugman-Nash Inc.
- Warrnambool Cheese and Butter Co. Ltd.
- Fonterra Australia Pty Ltd
- Australian Dairy Industry Council Inc.
- Australian Government Department of Agriculture, Fisheries and Forestry
- Australian Dairy Farmers Ltd.
- K L Ballantyne

The following is a brief summary of the issues raised in the various submissions.

5.1 Trugman-Nash Inc.

This is a United States of America trading company trading in dairy products. Its submission summarised the company's involvement in cheese imports to USA from the 1930's and up to 1953 when the USA applied import TRQs for cheese. At that time the company was issued with cheese import licences for historical WTO TRQ allocated by the USA to Australia.

From that time Trugman-Nash argued they had worked to develop the market in USA for Australian cheeses which had been a basis for expansion of cheese TRQ to Australia under subsequent WTO and FTA trade agreements.

This submission also argued that due to the current USA dairy product prices being well below world market prices, Australia's 2008 TRQs will not be filled. However, the company argued that this situation would not always be the case and that the review should be mindful of those Australian companies that have successfully penetrated the USA market.

5.2 Warrnambool Cheese and Butter Co. Ltd.

AUSFTA Dairy TRQs

WC&B commented that it supports the current AUSFTA dairy TRQ arrangements as they provide equitable allocation of quota including a provision for new entrants and they provide for reallocation of under-utilised quota.

They believe there should be a minimum allocation of a container load of product and there is no need for additional provisions for incentives or penalties for quota utilisation.

In addition, WC&B believe there should be a test on commercial incentives from the USA market compared to world markets and where the USA market prices are not competitive a penalty for under-utilisation or non-use of quota should not apply.

WTO TRQ to European Union

WC&B argued that the current EU cheese TRQs have been in place for some 30 years and suggested the "review presents an important opportunity to improve the rationale for EU quota allocations, better reflecting developments in industry since these allocations were originally made."

They also argued, as with the AUSFTA dairy TRQ, Australia 'owns' the entitlement to the EU TRQ access and is in a position to extract better margins.

They also argued that the principles for TRQ management adopted for the AUSFTA TRQ be adopted for the EU market, including:

- available to a broad range of industry participants under consistent eligibility criteria;
- equitable across firms recognising the current nature of industry and trade;
- allow local industry to capture the economic benefits;
- provide security of access to quota holders;
- that there be provision for new entrants by setting aside 5% of the quota;
- allocations should be based on a base period of 2 years to June 2008 with a weighting of two-thirds exports to one third Australian production;
- that there are provisions to deal with unused quota; and
- efficient, cost-effective management.

The company argued that changing the EU TRQ management arrangements would allow a consistent approach by industry and government to all Australian dairy TRQs instead of the four methodologies currently in place.

Cheese and other products to the USA

WC&B argued that all other USA TRQs should be brought into line with arrangements under the AUSFTA.

DAFF Quota Administration Fees

WC&B commented that "the DAFF administrative charges seem excessive given the nature and extent of services provided". They asked for a thorough review of the "rationale for and justification of the charges" by the Panel with suggestions from the Review on how fees might be reduced.

5.3 Fonterra Australia Pty Ltd

Fonterra provided a summary of their perspective on quota allocations to Australia in the past. They also commented that over the past five years the dairy industry has been impacted by a range of significant domestic and international events, including severe droughts, increases in costs of production and more recently a dramatic increase in the global price of dairy products. Due to these circumstances Fonterra have prioritised local milk production for the domestic market which, in their view, has moderated price increases for Fonterra products in the Australian market.

AUSFTA Arrangements

Fonterra said "it should be noted that at present dairy export trade to the USA (mainly cheddar cheese) is not profitable. Nonetheless Fonterra values the USA dairy quota and the future trade opportunities with the USA." They argued that due to these market conditions "the current application of the 'use it or lose it' penalties should only apply if trade is commercially profitable in the 6 months preceding the cut-off date."

They argued they "would support a mechanism being developed which recognises the commercial situation of better returns being made in other markets (USA wholesale prices are below prevailing commodity FOBs in 2007/2008) and the strong domestic demand for milk which has meant the filling of quota can be a challenge and at time not commercially viable." Fonterra suggested that to avoid penalties a company should be able to export 75% of its quota rather than the current minimum of 95%.

WTO TRQ for EU

Fonterra stated that they are "supportive of the existing (status quo) EU dairy export quota and administration system". They also felt that combining the AUSFTA and WTO quota management "would not necessarily improve transparency, cost effectiveness and market access."

DAFF Management Fees

Fonterra suggested that DAFF fees should be based on certificates issued rather than tonnes of product shipped as is current practice.

5.4 Australian Dairy Industry Council Inc (ADIC)

ADIC provided a comprehensive submission which reported on outcomes of a widespread consultation process of dairy companies and traders who have been involved in exporting dairy products to USA and the EU since 1 January 2005. A range of industry associations were also consulted. These included Australian Dairy Products Federation, Australian Dairy Farmers Ltd, the Australia Specialty Cheese Manufacturers Association, and the dairy industry services organization, Dairy Australia.

The following is a summary of the views expressed in the submission on a range of issues arising from the terms of reference for the review:

- retention of the current management within DAFF is appropriate subject to meeting certain industry concerns;
- all dairy product TRQs should be allocated, ie. abolish first come first served;
- for ingredient and commodity processors a minimum allocation of one full container should be applied;
- company viewpoints diverged over access to existing TRQs for established and new entrants with some companies supporting the status quo while others argued that quota allocations should be based on more recent export performance – these concerns related primarily to trade in cheese to the EU and USA;
- support for new entrants but with provision for a mechanism to minimise allocations to companies in a speculative (quota rent seeking) manner;
- support for the flexibility of the current quota transfer provisions but with a change to the quota usage cut off date of 23rd August to an earlier date – this would provide more time for another company to make effective use of any unused quota;
- support for penalties to be applied for non-use of quota but with a mechanism developed to apply a commercial test to the 'use it or lose it' penalty to ensure "companies are not put in a position of having to fill quota to retain quota in the knowledge that returns are (substantially) higher in other export markets.";
- that the legislative framework for administering quota be changed "from a time consuming 'regulation' approach requiring up to four months hiatus to the administratively speedier 'order' system.";
- addressing the current fee arrangements with ADIC believing the current "charge is excessive and DAFF needs to justify, in detail, the costs of administering quota and outline plans to adopt and keep abreast of best commercial practice so as to keep the cost low."; and
- the panel should recommend transition arrangements to accommodate a major policy change in view of the relatively short time between the report to the Minister and the start of a new quota year.

ADIC Recommendations

AUSFTA TRQ

That the principles that were originally agreed in 2004 for the management of AUSFTA quota be retained but with the following changes:

- the 'use it or lose it' provision should only apply if, from 1st January of the quota year, export trade to the USA is commercially viable and profitable relative to other markets – if the trade is not commercially viable then the penalty should not be applied (the industry provided detail of commercial benchmarks that could be used to apply this test);
- to avoid non-performance penalties, a company must export 75% of its quota rather than the current minimum of 95%;

- the cut-off date for return of uncommitted quota should be brought forward from 23rd August to 23rd June to allow sufficient commercial time for unfilled quota to be taken up by other exporters;
- the "Other Dairy Products Category" should be treated the same as other TRQ categories (ie. allocated); and
- all currently unallocated dairy categories should be allocated.

EU WTO TRQ

"Some companies desire no changes to existing arrangements, while others would like there to be an allocation of the two EU product categories (cheddar and cheese for processing) based on market performance."

DAFF Management and Fees

- Dairy TRQ administration should be quite separate to meat quota administration.
- The administration of dairy quota to the USA could be significantly streamlined by using electronic certification similar to but less complicated than that used by AQIS to manage exports to Europe.
- Fees be based on a charge per certificate rather than on a per tonne shipped basis.
- There should be an additional registration fee per company to be eligible to participate in the quota allocations.
- Administration of dairy quota could be more efficiently performed by AQIS under the EXDOC scheme (i.e. no DAFF involvement).

Additional Industry Information Sought by the Panel

Following a meeting with the ADIC, the Panel sought additional comment from industry on a range of issues and the ADPF provided a response that is summarised as follows:

- Following a review of the DAFF submission to the Review, ADPF provided detailed comment on their concerns with the high costs of quota management.
- They provided the Panel with three suggested definitions of a manufacturer. These were a firm that:

  - collects milk off farm and processes it into finished product;

  - purchases milk/cream from other firms and processes it into finished products; or,

  - purchases dairy products from a dairy manufacturer and then undertakes reprocessing that substantially transforms the purchased input before resale.

- Provided more detail on mechanisms that could be applied to a 'commercial reality' test for addressing the industry request to suspend the 'use it or lose it' rule in times of poor returns from a TRQ market.
- There is no good reason for Australia continuing to allocate historical USA (cheese) TRQ as this policy is implemented by the USDA for the benefit of their dairy importers.

- For consistency purposes, the ‘use it or lose it’ rule should apply to the EU WTO TRQs along the same lines that the ADIC submission outlined for USA TRQs including reducing the fill rate to 75% and the application of the ‘commercial reality’ test.

5.5 Department of Agriculture, Fisheries and Forestry

Dairy Product TRQs Held by Australia

The DAFF submission to the review provided a detailed and comprehensive outline of the background to the WTO and AUSFTA TRQs for Australian exports of dairy products to the EU and the USA.

Cost Recovery for TRQ Administration

The Quota Unit of DAFF is operated on a cost-recovery basis with approximately 28% of the costs of the Unit in 2006/2007 being applied to administration of dairy quota to the EU and USA. The cost of administering dairy quota in that year was $282,567, while $280,815 was cost recovered from the dairy industry.

DAFF have developed a draft stakeholder report for 2006/2007 which was attached to their submission. The intention of this report was to set out the costs and charges associated with administering TRQs and DAFF were seeking feedback from stakeholders on the merits of this approach to improving communications with stakeholders annually.

A large part of the costs ($194,007 or 69%) incurred by DAFF administering dairy TRQs in 2006/07 were related to Information Technology which the Department argued was an integral component of the Quota Unit operations and the maintenance of this equipment is the major expense of managing both the meat and dairy TRQs.

DAFF commented that they are developing a new IT management system “for the management of dairy quotas, building on work undertaken for the meat quotas, with the considerable development savings this will incur. The new dairy quota management system is scheduled to be operational by July 2008.”

The Quota Unit requires the equivalent of 3.5 full time employees with the dairy TRQ management requiring the equivalent of one full time employee. Staff costs represent 20% of the dairy TRQ administrative costs. The balance of costs for managing the dairy TRQs are incurred on overheads and other administrative charges.

DAFF argued that there is an impact on revenue in 2007/2008 due to lower demand for dairy quota in the year because of the “combination of supply constraints due to poor seasonal conditions in Australia and less attractive market conditions in the USA.”

Electronic Certification

DAFF recently engaged the USA authorities to undertake a trial of an electronic certification system for dairy product entering the USA under Australian TRQs. DAFF have been advised by USA Customs that the trial was a success with the result that the need for paper quota certificates was removed from 7th April 2008.

5.6 Australian Dairy Farmers Limited (ADF)

Australian Dairy Farmers Ltd provided a brief submission to the Review outlining the following set of principles the Panel might like to consider when completing the review:

- There are different allocations of quota, some of which have been in place for 30 years. Their value must be maximised for the benefit of the Australian economy, the broader community, but also importantly the dairy farmers of Australia who have invested over time in the development of this access to markets.
- During these thirty years the dairy industry has changed markedly and is now totally different in structure with very different channels to market. The review should take account of these changes.
- Dairy farmers want the TRQ values maximised and therefore believe there needs to be a balance in the ability of everyone to have an opportunity and the need for commercial shipments, which are necessary if trade is to take place.
- Critical to dairy farmers is that the management cost of securing trade through these TRQs is efficient and the costs are minimised and reflect fairness and equity.

5.7 K L Ballantyne

K L Ballantyne provided a brief written submission following a face to face meeting with the Panel. It asked that the submission be treated as confidential.

6. Management options and development of a model

The Panel examined the current dairy TRQ management arrangements using the principles developed in chapter 2: to optimise the commercial value of TRQ to Australia, minimise government intervention and barriers to exports, and administer transparently and efficiently, with consideration of commercial arrangements. These principles provided guidance for the Panel on options for appropriate, effective and efficient TRQ management.

6.1 Options considered

The Panel initially evaluated a number of options for TRQ management utilised in varying circumstances, in the context of the principles, policy directions and industry perspectives. TRQ management options looking forward five years could include:

i) continuation of current arrangements [chapter 4], including fixed allocations for all the EU and the main USA TRQs.

- The Panel assessed that current arrangements, with elements established at various stages over the past decades do not, today, accord with the principles of optimising commercial value of TRQs to Australia in variable market conditions, minimisation of government intervention and minimisation of barriers to export. While TRQ quantities are small, the EU and USA can be valuable markets and should be generally accessible to dairy product exporters. In addition, industry was divided on this option, with some wanting the status quo while a number of participants sought a quota allocation system that would better reflect more recent export performance. All these factors indicated that a new dairy TRQ management model should be developed.

ii) no quota allocation (‘first-come-first-served’ until each TRQ is filled).

- The Panel considers the EU and USA TRQ will be utilised most effectively by Australian exporters where market forces are allowed to operate to the greatest extent possible, with individual firms being able to make decisions in response to domestic, EU, USA and global market signals. However, anticipation of full use of a TRQ could engender ‘strategic’ rather than commercial export decisions, including a rapid fill of small TRQ quantities by large exporters. In accord with Principles 1, 2 and 3, the Panel assessed that a ‘first-come-first-served’ (FCFS) system should operate unless there are firm indicators that the demand for access to a particular TRQ will exceed the available TRQ quantity in the forthcoming year.

iii) annual allocation of all TRQs

- The Panel could not establish a need for advance allocation of all TRQs, nor any administrative advantage. A number of TRQs in the USA have not been filled or near-filled in recent years and market circumstances indicate this will continue in 2008. A flexible system is needed to determine if allocation is required each year. Where a TRQ is allocated, a mechanism for early return of unused quota will be important.

iv) auction of each TRQ

- The Panel discussed the concept of auctioning Australia's dairy TRQs. An auction mechanism, in theory, would be capable of distributing the TRQ quantity in an economically efficient manner to maximise any benefit flowing to the Australian community. Auctioning TRQ can lead to government retaining the quota rents. The Panel believes it is more appropriate for the rents to flow to industry as this is more likely to benefit regional communities and economies. Auctioning dairy quota has no precedent nor support from industry and has not been considered further.

6.2 A model for dairy quota management

The general approach was to identify areas where the current arrangements could be improved. This provides a basis for establishing a set of procedures that should be applied on a consistent basis across all dairy TRQs. These procedures may be described as a 'model' for dairy TRQ management which should also apply to any country specific dairy TRQs that may arise from future trade negotiations – including the Doha Round and bilateral free trade agreements.

The Panel is conscious of the need for TRQ management rules to provide a straightforward and transparent process for distributing dairy quota. Minimising costs is also important. Government and commercial transaction costs in allocating, transferring and using the quota reduces the economic return from the TRQ. Therefore a dairy TRQ management system should aim to distribute quota in a timely, efficient and equitable manner.

The following development of the TRQ management model recognises the need to allow for allocated and unallocated TRQs. As a matter of principle TRQ allocation should only be imposed when the demand for quota exceeds the supply and can create conditions where the value of the quota is reduced [chapter 2, 6.1]. Allocation increases transaction costs but this is a necessary trade-off to ensure the value of a TRQ is not eroded.

The following discussion sets out the recommended model TRQ management in sections:

- Eligibility for quota allocation, transfer or access to a FCFS pool
- Applications for an allocation of quota from a TRQ and decision to allocate
- Framework for management of allocated TRQs including for small/new entities
- Framework for administering unallocated TRQs.

Eligibility and transfer provisions

Eligibility for TRQ allocations is currently restricted to dairy manufacturers. The definition of a manufacturer in the Regulations is a person who, for commercial purposes, collects milk from farms and processes it, plus companies engaged in further processing or repackaging of dairy produce. The Panel recognises the evolution of business structures and recommends that the Regulations be refined. Eligibility for allocation should include persons or groups with ownership of milk or dairy produce who undertake sub-contract processing or transformation through a plant they do not own.

The aim of the eligibility conditions is to have the benefits of the TRQ – the price premium earned on in-quota sales – transferred back to the industry and the community. In general, the market for purchasing raw milk is competitive. The presence of processors in regional areas works to pass the value of the TRQ back to farmers through farm gate prices for milk and to the community through regional employment. The current industry structure includes major co-operatives that aim to maximise farm-gate prices. Other manufacturers, including public companies, have to match the offer prices of competitors to secure milk supplies.

Exporters or traders that do not own and manufacture dairy products should continue to be excluded from TRQ allocations. These private or public companies generally aim to source material for export at the lowest available price. Much of the premium they would receive on sales under a TRQ is likely to be retained as their profit.

There are currently no restrictions on the transfer or sale of allocated quota. Manufacturers and traders can purchase or lease quota allocations from others. This is the most efficient way to facilitate redistribution because it reflects market signals. Sales or transfers of quota will mean some of the value of the TRQ allocation is realised by the initial quota recipient ie. manufacturers and their suppliers. Similarly, where a TRQ is unallocated, or quota is returned, there should be no restriction on access by any person or company to the FCFS pool.

Application for quota

The current process for an initial allocation of TRQ involves an application for quota. This is because the aim of TRQ management is to direct the quota to those who will be active market participants. In reality, in many TRQ categories applications are deemed to occur each year unless the company opts out ie. allocations have been 'automatic' [chapter 4].

An automatic allocation is not a suitable approach to adopt for TRQ management. It is not conducive to maximising the value of the TRQ. Distributing quota to those who do not plan to use it will increase the risk of the quota remaining dormant or under-utilised.

However, an initial application step can be a crucial aspect of effective and efficient management of TRQs where market conditions and likely usage will vary. An annual application process is an appropriate time to gauge the need for a TRQ to be allocated in the forthcoming year. If market conditions are such that the TRQ will be under-utilised, an allocation mechanism is not required. It would add unnecessary administration costs and is not conducive to maximising the value of the TRQ.

The application process can be utilised as a market demand indicator and a mechanism for switching between allocated and unallocated TRQs. It provides flexibility in quota management which is more responsive to market dynamics than making a set decision on which TRQs should or should not be allocated. Market and commercial circumstance can and will change over time as has been witnessed in recent years [chapter 3].

Key features of the application process in the first week of October each year should include:

- DAFF to call for applications for quota from each EU and USA TRQ managed by DAFF and to request a quota volume in kilograms as per the TRQ.[5] This is an effective way of gaining an indication of the strength of demand for each TRQ for the forthcoming year. Current provisions for a deemed application based on activity in the previous year must be removed;

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[5] Allocation to the nearest kilogram is appropriate in general, as data shows shipments are often in uneven kilograms, and imports are measured by the EU and USA in kilograms.

- Applications to be accompanied by a flat fee for each request for quota from each TRQ. This should act as a deterrent for frivolous applications to notionally 'reserve' an allocation and/or reduce the incentive for speculative activity [see chapter 7 for associated recommendations on the quota fee and administration system]
- A closing date for applications that provides sufficient time for processing by DAFF. Non-applicants to be excluded from allocations for the coming 12 months. Companies apply for the use of particular TRQs and will only be able to receive an allocation from those TRQs – they are excluded from other TRQ allocations for the coming 12 months. No companies or persons are excluded from using quota in FCFS pools
- The quota volume applied for from a TRQ will be the maximum quantity an applicant can receive if that TRQ is allocated [see below on allocation mechanism].

The decision to allocate or not allocate a particular TRQ should be based on the total requests (demand) for allocation of quota from that TRQ. If applications in total are less than 100% of the amount of the TRQ, that TRQ will be unallocated in the forthcoming year. That TRQ becomes a 'first-come-first-serve' (FCFS) pool [see below]. If total quota requests are greater than or equal to the volume of a TRQ it becomes an allocated TRQ.

All applicants will be advised of outcomes of the application process as close as possible to 1 November. Where a TRQ is to be allocated they will be advised of their main quota allocations to enable shipments to start from 1 November. Final allocations will be advised by the end of November [see below].

If a TRQ is identified for allocation the aim is to fully distribute the available quota to those who have applied. Applicants will be advised of their main allocation and given the option of accepting the offered amount. This main allocation will incorporate any adjustment for carry-over penalties that may be applicable. Non-acceptances will be redistributed as part of a final determination of allocations, along with any unused quota set-aside for small operators or new entrants [see below].

An advantage of this approach is that it requires eligible applicants to actively assess their future intentions on utilising a TRQ. In circumstances where commercial strategies change or market conditions have diminished the value of the TRQ (ie. the price premium is small) then quota requests will fall. This provides a mechanism to reveal applicants' intentions. This process is preferable to automatic allocation approaches because:

- it removes the possible anomaly of quota being automatically allocated to those who are uninterested in using that TRQ
- it reduces the potential for allocations above planned requirements – the amount that is not required is directed to those who can use the quota from the start of the year
- both these circumstances increase administration transaction costs and are not conducive to maximising the value of the TRQ.

The Panel recommends the adoption of this application process for the management of all EU and USA dairy TRQs. It is an effective and efficient way of managing the process for allocating a TRQ, in the event that it is required.

However, some commercial operators may choose to use these provisions as a quota reserving mechanism and this could affect the capacity of the management arrangements to maximise the value of the TRQs. For these reasons, provisions to 'claw back' unused allocated quota are required to limit the potential for this to occur.

Distribution of allocated TRQs

Allocation of quota is a fundamental aspect of TRQ management. TRQ allocation is valuable because there is a price premium on quota sales relative to sales outside the TRQ. Allocation of the quota among eligible companies is equivalent to sharing a 'windfall gain'. But the per unit value of the windfall gain is not the same for each quota recipient. Companies have different commercial strategies and trading relationships that affect the value that can be extracted from access to quota for a particular product.

To maximise the value of the dairy TRQs for the Australian economy it is important for the management system ensures the annual quota access is 'mobile'. Allocation decisions should be adjusted to reflect changing market circumstances. They should also contain an element of reward for commercial entities who are active, expanding exporters.

Restricting the distribution of quota will not increase the value of TRQ to the Australian economy. A fixed allocation system relies on voluntary returns, temporary transfers and non-performance penalties for adjusting quota distribution as commercial activity changes. Long term fixed allocation of TRQ does not reward gains in competitiveness or commercial innovation in the use of the quota and more generally in global trading performance.

An allocation mechanism that allows for a wide distribution of quota among manufacturers engaged in the export trade will enhance the value of the dairy TRQs. A mechanism that allows for regular annual adjustments based on performance will have a similar effect on the value of a TRQ. It increases the prospects of maximising the per unit value of quota and the TRQ fill rate under different market conditions.

Current allocations are mainly based on a fixed performance criteria of export sales. In some cases the performance is based on a time period that bears little relationship to current market circumstances.

- For instance, EU cheese quota allocations from the Tokyo Round were apparently based on global export sales of cheddar cheese in 1980, whereas USA cheese from the Tokyo Round was allocated on the basis of US sales over three years. USA cheese quota allocations from the Uruguay Round were based on export sales of non-quota cheddar and NSPF (other cheese) categories in financial year 1993-94. These essentially fixed allocations continue under current arrangements [see chapter 4].

A fully allocated TRQ based on a fixed performance criterion severely restricts the ability of new entrants to gain access to a share of the TRQ. It also locks up the TRQ and fails to adequately allow for changes in the commercial activity of those who hold the quota. A moving average of an appropriate performance criterion is a more efficient approach.

The performance criteria for allocation should be linked to the past trade in the product category covered by each TRQ.[6] Entities trading in the particular TRQ product are in the best position to optimise the value of the TRQ based on their commercial experiences. There should also be an element of future reward for entities who are active, expanding exporters to the TRQ market and other dairy markets.

[6] Inclusion of dairy products outside each TRQ category in export performance calculations for a TRQ could distort allocation decisions in unintended ways and reduce the value of the TRQ.

It is also important to recognise the efforts of quota holders, both now and in the future. Previous users of a TRQ may have invested in product development, marketing and establishing relationships with distributors. Some exporters may also be selling product without the benefit of Australia's TRQ. This should be recognised by including an element of the performance in delivering the TRQ product to the particular TRQ country (EU or USA) in calculations for allocation of that TRQ.

In weighing up these considerations a performance mechanism with equal weighting to global exports of the TRQ product and to exports of the product to the TRQ market would be appropriate.

However, using a variable allocation mechanism based on past performance can create the potential for strategic behaviour to secure a larger share of the TRQ. To minimise the potential for strategic behaviour that could reduce the overall value of the TRQ to Australia, a moving average of past performance should be used:

- the more years included in the moving average the smaller the incentive for strategic behaviour in the current trading year;
- the greater the weighting on exports to the TRQ market, the greater the incentive for strategic behaviour in the current trading year.

Fixed allocations give an element of certainty to quota recipients that can be useful for export planning. But marketplace uncertainty is a normal aspect of the dairy manufacturing business and certainty is not a reason for retaining fixed allocations of a windfall gain. Variable allocation mechanisms are used for other agricultural products (eg. beef). As long as the annual change in allocations does not lead to a loss of TRQ value to Australia, a variable approach is more appropriate.

A moving average has the advantage of smoothing the fluctuations in trade that can occur from time to time. It helps to remove effects of an unexpected disruption to trade which could unfairly penalise the allocation to an individual operator. To minimise potential for strategic shipping behaviour, a three year moving average of performance would be an appropriate basis for allocations. In practice, as notification of allocations needs to occur prior to the start if a quota year, there will be a one year lag in performance calculation.[7] This will further reduce any incentive for strategic behaviour just to 'keep quota'.

The Panel considered a range of alternatives in the number of years and the weightings between global and TRQ markets. The recommended approach needs to provide a balance between rewarding export performance and discouraging strategic behaviour.

Accordingly, the Panel recommends all dairy TRQ allocations should be determined by:

- a three year moving average of performance based on exports of the product category covered by the TRQ; and
- an equal weighting applied to global exports and exports to the TRQ market.
- global exports to include shipments to the TRQ market (EU or USA) as the small TRQ volumes will not make a significant difference to the allocation outcomes.

[7] For example, allocations for the 2008 quota year would use a three year average of performance in 2004, 2005 and 2006.

Quota return and Use-it-or-Lose-it provisions

To maximise the value of each TRQ it is important to ensure management arrangements do not unintentionally restrict use of the quota. If commercial circumstances change, quota allocations may be under-utilised. Quota return and use-it-or-lose-it provisions are essential to ensure there is opportunity for the total of each TRQ to be used by year end.

Current use-it-or-lose-it arrangements involve a request for companies to satisfy DAFF that unused quota will be used before the end of the year [chapter 4]. This can yield voluntary returns. If there is no response or insufficient evidence the unused quota is automatically reclaimed and made available to others on a FCFS basis. If the unused quota is retained but remains unused there is no immediate penalty.

Under the fixed allocation system there is no change in quota distribution in the following year. For most TRQs, there are provisions that involve an enforced loss of some quota allocation if a portion remains unused for two consecutive years. These provisions aim to redistribute persistently under-utilised quota but may not be effective if over-written by private arrangements.

Effective rules to reclaim unused quota allocations should rely on voluntary returns backed by the threat of an appropriate penalty. The process of gathering unused quota needs to occur on a timely basis. Users of returned quota need sufficient time to make commercial arrangements before the end of the quota year. The industry and companies, in submissions [chapter 5], indicated that current arrangements for reclaiming unreturned quota in August do not allow enough time for this.

A more effective set of provisions would begin the reclaiming process in late May after seven months of the shipping year. Voluntary returns would be possible and should be encouraged prior to this time. They should be immediately made available to others through an FCFS pool for that TRQ. Returns received after the reclaiming process has been completed on 15 June should also be immediately available from the FCFS pool.

This is an appropriate and effective approach to managing under-utilised quota allocations for the dairy industry. It minimises intervention and administration and makes the unused quota available on a timely basis. In effect the dairy TRQ management would be initially a process of allocation, if needed, followed by an unallocated FCFS availability of quota to ensure returned and reclaimed amounts can be used before the end of the year:

- if a TRQ is large (eg the USA beef TRQ) quota management could operate in reverse – initially a FCFS pool followed by managed allocations of reserved quantities if the TRQ is being rapidly utilised that year;
- however, the dairy TRQ quantities are small and cannot be managed this way – there is a high risk that TRQ would be rapidly used and strategic behaviour could lead to a loss of value.

The reclaiming process from May would be similar to current procedures. DAFF should communicate with companies with unused quota to ask about their intentions for the remainder of the quota year. Quota holders should be advised that unused quota will be automatically reclaimed on 15 June if :

- there is no response to the DAFF communication
- documentary evidence of intended use is considered to be insufficient.

To ensure the effectiveness of these provisions a penalty will apply to all quota that remains with a company after 15 June but is unused by the end of the quota (calendar) year. This penalty will be a 1 kilogram for 1 kilogram reduction in company's allocation the next time the company applies for and receives an allocated share of the same TRQ. The penalty should be deducted from the initial performance based calculation and distributed to other eligible applicants in their main allocation.

Penalty assessments for unused quota allocations need to be made on 30 October. This will allow penalties to apply in the following year if allocation is triggered by the forth-coming application provisions. For penalty calculations:

- All unused quota allocations without an export certificate issued by 30 October will be automatically assessed as a penalty.
- This penalty will apply only in the company's next allocation year for that TRQ.
- A company's allocation of quota from a particular TRQ is deemed to be fully used if at least 98% of the company allocation has been shipped (for TRQs less than 3000 tonnes) or 99% of allocation has been shipped for TRQs of 3000 tonnes or above.
- Special consideration to the automatic triggering of penalties on 30 October will be given only where a company presents a case with documentary evidence that shows export of product under the unused quota will occur between 1 November and 31 December that year.[8]

The penalty provisions will not apply to returns that occur before or as a result of the reclaiming process that is completed by 15 June. The aim of the strengthened penalties is to sharpen the focus of quota recipients on their future intentions. This will enhance the 'mobility' of unused allocated quota at the mid-point of the shipping year.

Strengthening the incentive for returns at an earlier date (by June 15) will help to maximise the value of the TRQ to the Australian economy. It opens up the TRQ to other entities that may be able to utilise the quota that becomes available in the FCFS pool for that TRQ.

This approach also reduces the burden on DAFF to assess evidence presented by quota recipients on their intentions to export. These strengthened penalty provisions are essential for variable allocation mechanisms to operate effectively and maximise the value of each TRQ allocated. Each year, new performance-based calculations are made for allocation. Without a penalty there is no disincentive or deterrent to letting quota sit unused rather than being returned to the FCFS pool.

These penalty provisions should encourage voluntary returns if there are significant commercial uncertainties or when the value of the TRQ is limited due to market conditions. In most situations these provisions will not be onerous. All companies can access the FCFS pools that will develop as a result of this process. There is nothing to prevent companies from voluntarily returning unused allocations by 15 June and seeking access from the same TRQ FCFS pool at a later date [see below].

[8] The shipping year for sea freight shipments of quota products in the USA and the EU generally ends on 30 October. The special consideration conditions allow for the possibility of air freight shipments. However, if the intended exports do not occur the penalty will apply at the time of the next allocation of the same TRQ.

The transfer of unused quota allocations will mean the potential penalty liability will move to the quota recipient. However, penalties could be avoided by transfer to an entity ineligible for allocation (eg. a trader). A rule for the penalty to remain with the transferring entity if the recipient is ineligible to participate in allocations will prevent this possibility.

The panel recommends the adoption of these quota return and use-it-or-lose-it provisions for all allocated TRQs within the management arrangements.

Small and new entrant set-aside provisions

The use of a performance mechanism to allocate TRQ raises the issue of minimum quota allocations. When a TRQ is to be allocated, the performance based calculation applied to the small dairy TRQs [chapter 4] could lead to very small allocations to some operators.

The dairy industry has a few large manufacturers who will dominate allocations based on performance. In general these companies have a substantial export trade and most are participants in current TRQ distributions.

There are some medium and small sized manufacturers with a limited export performance. Currently most but not all of these operators are speciality cheese manufacturers. The export performance of small operators can be tiny compared to the large trading volumes of the major dairy manufacturers.

A TRQ could be allocated down to the lowest practical measurement point – a kilogram. However, commercial aspects of exporting very small amounts warrant consideration. For the importer, small quantities can increase transaction costs, distribution costs and influence continuity of supply.

There can be similar problems for exporters when the quota allocation is very small. Together, these practicalities provide an argument against very small allocations.[9] A quota allocation of less than 10, or even 20, tonnes might seem to some to be commercially unviable for developing a market opportunity over a 12 month period.

On the other hand, opportunities may arise at times for proactive small operators to develop niche markets, facilitated by applying for and making use of a small TRQ volume. It is not appropriate for the TRQ management system to attempt to identify where opportunities for use of very small allocations are a viable proposition or where they could undermine the value of a TRQ.

After considering the various aspects of this issue the Panel does not consider a minimum allocation is appropriate or necessary in this model.

The Panel acknowledges provision should be made for small operators and new entrants. While commercial realities in a market based economy indicate there are no grounds for a TRQ management system that unduly favours small-scale exporters, Government policies encouraging food product innovation and exporting are recognised. Industry also generally sees the need for small and new entrant (SNE) arrangements.

[9] Minimum quota allocations have been used in most prior arrangements [chapter 4]. Minimums have ranged from zero (EU cheese from Uruguay Round and USA cheese TRQ from the Tokyo Round) to 1 tonne (EU expansion TRQ) to 10 and 20 tonnes (USA FTA TRQs) and 20 tonnes (EU cheese from the Tokyo Round).

Therefore the Panel recommends that, where a TRQ is to be allocated, those companies with an allocation below a threshold of 10 tonnes (including new entrants) should be able to share in a small amount of additional quota set-aside for this purpose.

- SNE companies will be subject to the same performance based criteria including all application, allocation, usage, return, reclaim and penalty provisions.
- SNEs will receive their performance-based allocation plus an equal share of the set-aside amount.
- Their final allocation will be no higher than 10 tonnes or the quantity they request.

The amount of the set-aside for each allocated TRQ will be based on the absolute size of that TRQ.

- Two percent of the TRQ for TRQs less than 3000 tonnes, or
- One percent of the TRQ for TRQs greater than or equal to 3000 tonnes, and
- If new quotas arise that are substantially larger, then a lower set-aside percentage should be considered.

The set-aside will only operate if (i) a TRQ is allocated, and (ii) one or more eligible SNE applicants would be allocated less than 10 tonnes of quota for that TRQ by the DAFF performance-based calculation.

- If there are no such applicants, the full amount of the set-aside will be included in the final allocation process for that TRQ to all non-SNE applicants
- Any residual set-aside amount not allocated to SNE applicants will also be distributed in the final allocation to all non-SNEs
- This minimises the risk of losing TRQ value through inactivity in the first six months of the shipping year – the TRQ will be fully allocated at the start of each quota year.

For most TRQs, applications for quota by small operators are unlikely to occur. Nevertheless, the Panel considers this opportunity should be available for both EU and USA TRQs.

FCFS administration provisions

The current approach to managing FCFS is to issue quota certificates on request shortly before the planned export of a specified quantity under a specified TRQ. The quota should be issued in the order that requests are received until the TRQ quantity is fully used. There is no cap on individual applications to use the FCFS quota.

This is the most efficient and effective way of managing an FCFS quota pool.

The panel recommends that this approach be applied to all FCFS dairy quotas to ensure there is consistency and clarity in administration. It should apply to quotas where a decision to allocate has not been triggered by the application provisions [see above]. It will also apply to each FCFS pool arising from voluntary quota return or the use-it-or-lose-it provisions at any time:

- There will be no quota ‘reserving’ mechanism.

There will be no eligibility restrictions on the use of quota from any FCFS pool. All persons will be eligible to request FCFS quota subject to supplying information on export arrangements. Exporters and traders excluded from quota allocation will be eligible along with dairy manufacturers. Quantities will be provided as requested until the TRQ is fully used, with no minimum quantity.

Quota certification will be provided by DAFF in the order requests are received.

- if an export shipment does not proceed after the issuing of a quota certificate, the quota certificate will automatically lapse usually within a week
- at that time the quota will immediately return to the FCFS pool and become available
- hence, quota return provisions and use-it-or-lose-it penalties cannot apply for FCFS shipments that do not proceed.

Administration of an FCFS pool by DAFF will involve monitoring of accumulated use of the TRQ and providing regular usage updates to the industry. The DAFF web site would be a suitable vehicle for this. As explained in chapter 7, an administration fee should apply for FCFS quota issued, at the same per kilogram rate as charged for allocated quota.

6.3 Implementation of the model for EU and USA TRQs

The recommended TRQ Model is framed to be robust in variable global market conditions and to be applicable across any expansions in dairy TRQ achieved through international or bilateral trade negotiations.

The Panel recommends that this TRQ Management Model be implemented with the objective of the new system operating from the 2009 quota shipping year. The review has been intensive and stakeholders would reasonably anticipate timely outcomes.

In developing the recommended Model, the Panel has identified a need for some variations where particular features of a TRQ granted to Australia restrict the application of the full Model.

The recommended application of the Model for dairy TRQ management, and variations for some current TRQs are set out below.

Application of the Model to European Union TRQs

The history and current allocation and administration arrangements for EU WTO TRQs are outlined in chapter 4. The model developed by the Panel and discussed in chapter 6.2 should be fully applied for the management of all the EU TRQs.

Application to United States TRQs under the AUSFTA agreement

The history and current allocation and administration arrangements for AUSFTA TRQs are described in chapter 4. The model developed by the Panel and discussed in chapter 6.2 should be applied for the management of all AUSFTA TRQs.

- the only exception is there will be no SNE provision for Skim Milk Powder TRQ which is currently 109 tonnes. A set aside is impractical for this tiny amount of TRQ.

During implementation, the current separation of Other Dairy Products into sub-categories A and B should be removed. Sub-category B has never been utilised.

Application to USA historical cheese TRQs

The history and current allocation and administration arrangements for USA WTO TRQs are described in chapter 4. The management of these TRQs is the responsibility of USA authorities. This contrasts with the management of AUSFTA TRQs for which Australia has management authority.

In relation to the 2626 tonnes of historical WTO cheese TRQs, the Australian Government has no capacity to effectively allocate quota or monitor its usage. The TRQs are allocated by the USA as licences to its importers. The USA does not recognise Australia's quota documentation or any quota holdings by Australian exporters, so any allocation to Australian exporters is therefore only weakly enforceable.

The concentration of these licences in the hands of a few USA importers also removes the possibility of Australian exporters capturing quota rents. The Australian Government has never had a role in managing any other dairy TRQs that are allocated to USA importers on the basis of historical licences eg. skim milk powder.

The Panel considers it is unnecessary to manage any historical TRQs. The ADPF concurs that there is not a good reason to continue to manage the historical cheese TRQs.

Therefore the Panel recommends that historical USA cheese TRQs cease to be managed by Australia. Historical TRQ is best operated as an unallocated FCFS system managed solely by the USA with no intervention by the Australian Government. This would not change the ability of the USA importer to source product from any Australian supplier.

Australia has several other WTO TRQs with the USA such as condensed milk, milk powders and chocolate products that operate without Australian Government involvement. Australia has no rights to administer these TRQs. They have been operating as FCFS and monitored by US authorities and are outside the Terms of Reference for this review.

The Panel notes that the recommendation to remove management of USA historical cheese TRQs brings this in line with how these other USA historical TRQs have operated.

Application to US supplementary cheese TRQs

As discussed in chapter 4, the management of 4385 tonnes of WTO supplementary cheese is mainly the responsibility of USA authorities. However, Australia has some control over the management of these TRQs. The Australian Government is required to advise the USA authorities of specified importers for these products in advance of the quota shipping year.

The Australian Government has no commercially sensible way of establishing this list for notification without first obtaining advice from exporters. It therefore appears that the USA WTO supplementary cheese TRQs cannot be managed as FCFS.

The requirement to advise USA authorities of the specified importers of these products for the entire quota year and before the start of the shipping year is a highly restrictive condition. It ties a specific amount of quota to a specified importer which can not be altered:

- this undermines the 'mobility' of quota access;
- it prevents Australian exporters from responding to changes in market conditions throughout the year.

If the TRQ were to operate as FCFS, these conditions of entry could lead to a reduction in the value of the TRQ to Australia. The balance of negotiating power would shift to USA importers. The USA importer is likely to capture most of the rent associated with the TRQ. When market conditions limit the size of the price premium, use of the TRQ would rely on USA importers proactively seeking Australian export partners in advance of the shipping year. This may lead to less of the TRQ being utilised than would be the case if the Australian Government had clear allocation rights.

The panel recommends the Australian Government seek to negotiate with the USA Government to adjust the conditions for supplementary cheese TRQs. Australia should seek the removal of the requirement to nominate importers 12 months in advance.

The Australian Government should have the capacity to specify a USA importer at any time throughout the year. If this variation could be negotiated the recommended TRQ Management Model could be fully applied to USA supplementary TRQs. This would result in gains in the value of rents associated with these TRQs and reductions in commercial transaction costs.

However, given the current circumstances some variations in the Model are required if it is to be applied. First, the quota application process should not allow for the option of switching between FCFS and allocation. Irrespective of quota demand and supply, the Panel considers that the most appropriate mechanism for managing supplementary TRQs is through allocation.

The allocation process for these TRQs must ensure the entire TRQ amount is ‘live’ at the start of the quota year. In other words each kilogram of the TRQ has to be attached to a USA importer irrespective of the final acceptance of allocation offers by Australian exporters. If this does not occur, a portion of the TRQ will be ‘dead’ for the entire year because there is no importer attached to the amount.

Therefore a second variation is that the application process will include a requirement for applicants to specify US importers before the final allocations are made. This is because if a portion of the final quota allocations is not accepted it needs to be tagged to become ‘live’ in an FCFS pool at the start of the quota year. This will ensure the full TRQ amount will be potentially available for use through the shipping year. This is essentially equivalent to the way the supplementary TRQs are currently operating:

- The requirement to specify importers means the process of seeking applications will need to commence a little earlier

Unfortunately the attractiveness of TRQ product available under these conditions is greatly diminished to an alternative user – the product is ‘tagged’ to a single importer. The commercial compatibility of one importer’s product requirements and the business operations of an alternative TRQ exporter is a major impediment to using FCFS quota:

An administration process that potentially increases the amount of quota being pushed into this pool would work against maximising the value of the TRQ. Very small FCFS quantities tagged to a single importer are especially unappealing to a potential alternative exporter. It is highly unlikely that tiny quantities of cheese quota that can only be sold to a single nominated importer will be snapped up. If larger tagged quantities were to become available there is more chance they could be utilised. An allocation process that potentially increases the commercial unattractiveness of using returned quota will not maximise the value of the TRQ:

- for example, ten individual lots of 1 tonne tagged to 10 different importers is more difficult to make use of commercially than a 10 tonne parcel tagged to one importer;
- the more small parcels of individually tagged quota, the greater the potential risk of eroding the value of the TRQ.

This would suggest that a minimum allocation should be imposed as an interim measure until the Australian Government can negotiate changes in the importing conditions imposed by the USA authorities. Eligible companies excluded because of the allocation threshold will still be able to utilise the FCFS pool at any time. Amounts of any size can be claimed from the pool – large parcels of tagged quota can be broken down into smaller lots.

After careful consideration of this issue the Panel recommends a 10 tonne minimum allocation until the Supplementary TRQ conditions can be renegotiated. No allocation of less than 10 tonnes will be made. All other aspects of the recommended TRQ Management Model will apply to the USA Supplementary TRQs.

The Panel recommends that this interim measure be removed if the Australian Government is successful in achieving the required change in USA access conditions for WTO Supplementary cheese quotas. The ability of the TRQ application process to switch between FCFS and allocation would be reinstated and the application process would be realigned with the standard approach specified in the recommended TRQ Management Model.

7. TRQ Administration by DAFF

Australia's WTO TRQs to the EU and the USA and those under the AUSFTA were achieved through government negotiations to the benefit of the Australian economy. Quotas are not commercial assets of industries or companies.

TRQ allocation systems are legislated arrangements [see chapter 4] with regulatory effect on trade, even where the aim is to minimise regulation and enable market operation, as in recommendations above. Under National Competition Policy and associated reviews, agricultural industry marketing and research has progressively shifted from statutory authorities to industry owned companies. Regulatory functions have returned to government, mainly now the Department of Agriculture, Forestry and Fisheries (DAFF).

The Panel considers it is both appropriate and necessary that –

- DAFF continue to manage TRQ distribution, usage monitoring, availability certification and reporting
- Ongoing costs of dairy TRQ administration continue to be recovered from users of all aspects of this service – there is no justification for taxpayers to cover these costs.

However, a number of submissions from DAFF and industry associations and participants raised questions about the effectiveness and efficiency of current TRQ administration. It appears communication with the dairy industry around the mechanics and costings of dairy TRQ administration could be clearer and more frequent.

The Panel has evaluated these and other concerns. The Panel identified a need for some adjustments to administrative procedures to reflect the principles, the model and recommendations for each TRQ.

Quota administration costs are a loss of economic value of the TRQ to Australia. Seeking the most efficient set of arrangements is appropriate for maximising the value of the TRQ.

Recommended changes to key elements of dairy TRQ administration are outlined in chapter 6. Overall, the Panel considers the procedural detail to implement the recommendations should be discussed by DAFF with dairy industry stakeholders.

7.1 Current operations and concerns

The legislative regime includes the *Dairy Produce Act* 1986 (as amended to 23 April 2004, and current), the *Dairy Produce Regulations* 1986 (amended to 25 October 2005) . The Regulations provide for the Secretary of DAFF to manage the TRQs in accordance with rules set out in the Regulations.

Dairy and beef TRQs are managed by the Quota Unit of DAFF. The proportion of beef and dairy activity is measured by DAFF and reflected in cost recovery. As advised in the DAFF submission, "during 2006/07 the Quota Unit received $1,002,815 in total revenue, of which $280,815 was received from dairy charges. The cost of administering the dairy TRQs in 2006/07 was $282,567".

- The Panel noted that the dairy TRQ administration is a small proportion of the overall cost of running the Quota Unit.

Arrangements for the current 18 dairy TRQs vary [chapter 4] and this in itself needs to be managed by the Quota Unit. DAFF reports that in 2006/07, the Quota Unit dealt with at least 53 companies for issuing certificates or approvals. More received allocations under the AUSFTA TRQ allocation system put forward by the industry in 2004. Features common to most dairy TRQs include:

- calculating allocations and application approvals, reallocation of quota not taken up
- receiving quota requests, checking availability (allocated or pool), providing certification
- monitoring usage by each company, checking intentions, reclaiming/redistributing unused quota
- producing and publishing statistical reports for AUSFTA dairy quota use about once a week
- answering queries from company personnel, addressing documentation and other problems (numerous phone calls a day varying across the year, in addition to e-mail interactions)
- maintaining records, sending accounts, collecting fees
- processing requests for quota transfers (agency, temporary, permanent – 250 in 2006/07), and
- development and maintenance of a computer based system for timely handling of these actions for current TRQ and potential future TRQs under trade negotiations.

Quota Unit dairy-related costs are currently recovered through a set fee for allocated or approved dairy TRQ products which is 0.7 cents per kilogram ($7 per tonne). The fee is designed to provide cost recovery for the administration of all Australia’s managed dairy TRQs. For allocated TRQs, the fees (calculated on kilograms of allocated quota) are advised to quota recipients at the time of the allocation advice and collected before any quota certificates or transfers are processed. For unallocated TRQs, the fee is based on approvals granted and must be paid before a quota certificate is provided.

Issues raised by industry participants during this review can be summarised using Australian Dairy Farmers Ltd words: “Critical to dairy farmers is that the administration cost of securing trade through these quotas is efficient and the costs are minimised and reflect fairness and equity.”

Particular concerns and propositions from industry submissions are summarised in chapter 5. These have been considered and Panel responses on six areas follow.

i. Periodic review of burdensome system arrangements to ensure ‘best practice’ is adopted

This should occur at working level through newly established pathways, at least annually during consideration of the recommended Annual Statement. The Panel believes that more detailed arrangements to implement the recommended framework should be determined by DAFF in active consultation with dairy industry stakeholders and participants. A number of the issues raised suggest that communication has been limited and where it has occurred, has not been relayed across the industry. However, the Panel notes that during the development and implementation of the AUSFTA arrangements, there was extensive consultation with industry.

There are avenues for industry consultation that may not have been utilised including the Trade Reference Group convened by DA and AQIS technical committees. The AQIS committees are not necessarily appropriate for policy discussions and while these may be practical for technical issues, outcomes would depend on discussions being recorded and promulgated at multiple levels.

ii) The current charge of $7 per tonne

DAFF reports that day-to-day operation of the Quota Unit requires 3.5 full time equivalent (FTE) employees with salary and usual superannuation and leave expenses. Of these, 2.5 FTE are allocated to meat TRQ administration and one FTE employee is nominally allocated to dairy. DAFF does not charge for senior staff involvement from outside the Quota Unit. Computer services and licensing are major parts of the overall cost.

Most of the 2006/07 total cost of $282567 is related to information technology costs ($194007) which are particularly high due to the operation of an out-dated system that has only one service provider. A new IT system has been under development and is expected to go on-stream from July 2008. This new system is expected to generate cost savings in the order of 10 percent of total costs over the next five years. There are expected to be further IT savings after five years when the costs of the development of the new system have been fully recovered but IT costs are expected to continue as a significant component in TRQ management.

DAFF should work through these in detail with the industry through a newly defined consultation pathway including any implementation costs arising from a new model being adopted. It appears unlikely that industry or a private entity could supply the scope of Quota Unit services for dairy at lower cost. However, DAFF should continue to seek and negotiate efficiencies.

iii) Reimbursement of fees paid where allocated or pool quota is not used

In deciding to take up allocations applied for, or quota issued from a pool, companies need to recognise that the fees are calculated to achieve cost recovery across all elements of the quota operations and services used by the industry. Administration costs continue to be incurred whether or not products are shipped under a dairy TRQ. The Panel recommends there should be no refunds.

iv) Charging per Certificate issued

Companies benefit from the existence of the TRQs and their administration by DAFF proportionately to the quantity of quota they access by allocation and/or by request from the pool. Further, the great majority of TRQ administration costs continue even if TRQ product is not shipped in a particular year. Therefore charging on a per certificate basis would be inappropriate and unworkable.

v) Dairy TRQ operations should be separate and could be performed by AQIS under EXDOC

Combining of the beef and dairy TRQ administration into one unit allows economies of scale including higher level staff and back-up across staff that would not be achievable if dairy TRQ were managed separately by DAFF (or any organisation). The Panel investigated whether additional economies of scale could be achieved through incorporating other managed TRQs but were advised that no other similar TRQ administration is undertaken by government at this point. Whether the EXDOC system could be modified to provide services for dairy companies should be discussed at DAFF/Industry meetings. It is not clear that this would result in any cost savings.

vi) Lack of consultation.

The Panel is recommending increased consultation between industry and DAFF during implementation of changes to current systems and then ongoing to coincide at a minimum with the release of the Annual Statement.

7.2 Recommended framework for Dairy TRQ administration

The following framework is structured to support the principles and objectives of the TRQ Management Model set out and explained in chapter 6, taking into account government principles of full cost recovery, transparency and orientation to user-pays in line with equity and policy aims.

TRQ management operations are multi-faceted, and the full costs of all aspects of these operations need to be recovered whether some TRQs are fully utilised or otherwise.

Companies benefit from the existence of the TRQs and their administration by DAFF proportionately to the quantity of quota they access by allocation and/or by request from the pool. The value of the quota accrues on a volume basis and it is appropriate that there is a volume based charge.

Accordingly, the Panel recommends continuation of a per kilogram charge for quota allocated or issued from a FCFS pool. The Panel also recommends initial application fees for each TRQ for each applicant. DAFF will need to calculate fee levels, interacting with industry on market / TRQ use outlook and any system changes, with the aim of near cost recovery each year (adjusted as needed the next year).

Applications for Allocation of Quota from a TRQ

- A fee should be charged by DAFF for all applications for allocation of each type of TRQ in October each year.
- This fee should be set at a level that would dissuade speculative or off-hand applications without being onerous to small, serious exporters.
- For 2009, a fee of $200 is suggested for each application for each type of TRQ to accompany each company’s application. Applications without payment will not be processed.
- DAFF could utilise applicant generated tax invoice forms to reduce administration costs.
- Application fees will apply whether the TRQ is eventually allocated or not, with no refunds.

Quota Allocation under the recommended TRQ Management Model

- The main allocation on 1 November will be accompanied by an account for fees on a cents per kilogram basis. If payment is not received in three weeks (21 Nov) the quota amount will be taken back before the final allocation for redistribution. A final invoice will be issued with the final allocation.

- A company requesting quota from any FCFS pool will be charged on a cents per kilogram basis for issuing of quota, to be paid on receipt of monthly accounts from DAFF. This will apply for all quota in any FCFS pool including that returned or reclaimed from companies during the year.
- There will be no refunds for unused allocated or FCFS pool quota.
- There will be no charge for quota transfer, or for ultimate issue of certifications.

Non-payment of fees

The Department will not issue quota certificates or transfer quota while any type of fee or account is beyond the due payment date.

Communication – Annual Statement to Industry

DAFF will prepare and distribute a short Annual Statement in October before each quota year, showing (a) finalisation of income and outgoings for the previous quota year (b) income and outgoings for the current year including estimates for the final months and (c) calculations of projected total costs for the next year and fees income from applications and allocations.

The Dairy Australia Trade Reference Group would be an appropriate forum for discussion of the Annual Statement and regular administration issues.

Flexibility of quota administration

DAFF and industry submissions raised the issue of greater flexibility and responsiveness in adjusting regulatory instruments for matters such as fees. The Panel has considered the issue of timeliness in adjusting fees and other mechanical aspects of the recommended Dairy TRQ Management Model, while conscious of the need for accord with principles for minimisation of regulation and administrative discretion. Regulatory instruments are structured in a hierarchy to reflect degrees of power and levels of Parliamentary scrutiny.

The panel recommends that the administration system have the flexibility to adjust the per unit fee on an annual basis to reflect the projected net financial position of the Quota Unit cost recovery. The annual statement would form the basis of this decision after consultation with industry.

The Panel considers that implementing the Panel's recommendation mainly through Orders rather than Regulations should facilitate this. The Panel notes that regulations in any form, including Orders, are subject to the requirement for Regulatory Impact Assessment where changes will directly affect business, or have a significant indirect effect on business, or restrict competition [see Federal Office of Best Practice Regulation]

Appendix 1

TERMS OF REFERENCE

WTO DAIRY QUOTA REVIEW - 2008

The Hon Tony Burke MP, Minister for Agriculture, Fisheries and Forestry, has decided that dairy quotas obtained under the Australia United States Free Trade Agreement will be reviewed in early 2008 and that WTO quotas will be reviewed at the same time. Any changes resulting from the review are expected to be implemented by the start of shipping for the 2009 quota year ie. 1 November 2008.

The Review will be undertaken by an independent Quota Review Panel (QRP) with secretariat assistance to be provided by the Australian Government Department of Agriculture, Fisheries and Forestry.

Terms of Reference

The QRP will examine and report on:

1. The appropriateness, effectiveness and efficiency of the current quota arrangements.
2. Identify areas where improvements to the quota management arrangements could be made, including in the areas of:
    - options for the management of quota categories;
    - options for the allocation of quota entitlement;
    - minimum allocations, having regard to commercial practices;
    - provision for access to WTO quotas for new entrants;
    - quota transfer arrangements;
    - measures to deal with unused quota, including incentives and/or penalties if applicable, that will maximise the commercial use of Australia’s WTO quota access to the EU and USA cheese markets;
    - the legislative framework underpinning quota management;
    - cost recovery arrangements;
    - transitional arrangements from the current procedures to those recommended by the QRP; and
    - any other area related to quota management that the QRP considers is relevant.

Considerations

In undertaking the review, the QRP should have regard to quota fill outcomes, cost and responsiveness of quota administration, and commercial requirements of individual quota holders.

The Panel should take into account the views of industry representatives and individual exporters and processors.

Timing

The QRP should provide its report to the Minister not later than 30 May 2008.

TERMS OF REFERENCE

AUSFTA DAIRY QUOTA REVIEW - 2008

Background

The Australia USA Free Trade Agreement (AUSFTA) dairy quota arrangements were negotiated with the dairy industry on the basis that a formal review of the quota arrangements would be undertaken after three years' operation.

The quota arrangements commenced operation in January 2005 and the Hon Tony Burke MP, Minister for Agriculture, Fisheries and Forestry, has agreed to the review being conducted in early 2008. Any changes resulting from the review are to be implemented by the start of shipping for the 2009 quota year ie. by 1 November 2008.

The Minister has determined that the 2008 review be undertaken by an independent Quota Review Panel (QRP) with secretariat assistance to be provided by the Australian Government Department of Agriculture, Fisheries and Forestry.

Terms of Reference

The QRP will examine and report on:

1. The appropriateness, effectiveness and efficiency of the current quota management arrangements.
2. Identify areas where improvements to the quota management arrangements could be made, including in the areas of:
   - options for the management of quota categories;
   - options for the allocation of quota entitlement;
   - minimum allocations, having regard to commercial practices;
   - provision for access to the AUSFTA quota for new entrants;
   - quota transfer arrangements;
   - measures to deal with unused quota, including incentives and/or penalties if applicable, that will maximise the commercial use of Australia's in-quota access to the US dairy market;
   - the legislative framework underpinning quota management;
   - cost recovery arrangements;
   - transitional arrangements from the current procedures to those recommended by the QRP; and
   - any other area related to quota management that the QRP considers is relevant.
3. The implications of the provisions of the AUSFTA on the administration of the dairy quota in 2008 and subsequent years.

Considerations

In undertaking the review, the QRP should have regard to quota fill outcomes, the cost and responsiveness of quota administration, and the commercial requirements of individual quota holders.

The Panel should take into account the views of industry representatives and individual exporters and processors.

Timing

The QRP should provide its report to the Minister not later than 30 May 2008.

Appendix 2: Quota rent

The concept of 'quota rent' arises often in discussion of TRQ administration schemes. Quota rent can be described as the price premium that companies can obtain by being able to access a particular marketplace at a low in-quota tariff while the price in the market is higher.

Australia's beef trade with the United States provides an example that demonstrates the concept. Quota rent from the beef TRQ is available only when US import demand is sufficiently strong that the desired volume of exports from Australia will exceed the TRQ. Faced with restricted supply, buyers in the US will be prepared to bid up prices to secure product.

Under the TRQ, Australian beef exporters benefit from having access to the preferential tariff rate and, under certain market conditions, from the potential to obtain quota rent. These benefits are identified for three particular market cases:

- the quota is not binding;
- the quota is binding; and
- imports exceed the quota

Quota is not binding
In Figure A the import demand schedule for Australian beef in the USA is represented by DD. The quota is denoted by the fixed volume of imports, Quota, and the landed price of imported product is P (the preferential access tariff under the Australia-United States FTA is zero). In this case the USA imports the quantity OM at import price P. In the absence of the TRQ, the import price would be Pto because the MFN tariff rate (out-of-quota tariff) would apply. At that price imports would be OQ1, much less than under the tariff quota. While importers in the United States would pay Pto, Australian exporters would receive the price, P. Therefore, having access to the preferential tariff means that Australian exporters benefit from being able to export an additional quantity Q1M at price P. In this situation import demand is not strong enough to fill the quota and no quota rents are available.

Benefit

- *Rent*: none
- *Increased exports*: Q1 to M

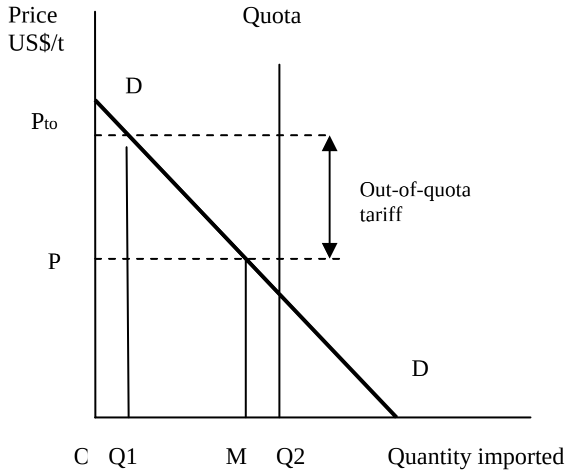

Figure A: Potential for rent where quota is not filled

The quota is binding
For the market situation where the quota is binding (Figure B) Australian exporters can potentially capture quota rent as well as gaining the benefit of having access to the preferential tariff. Demand is sufficiently strong so that the desired volume of imports exceeds the quota constraint. At the landed import price, P, consumer demand for imports is OQ3, a quantity that exceeds the TRQ volume. The TRQ acts to limit supply in the domestic market and, as a result, buyers in that market bid up prices to secure product. Imports fill the TRQ volume, OM, and the price consumers are willing to pay is Pq. The quota rent that potentially can be captured is the difference between Pq and the landed price for the imported product multiplied by the TRQ quantity (indicated by the shaded area).

Without the TRQ, exporters would face the MFN tariff rate (over-quota tariff) and the import volume would be OQ1. In this case, the preferential access tariff confers a benefit to exporters by allowing additional exports, Q1M.

Benefit

- *Rent*: (Pq-P)*OM
- *Increased exports*: Q1 to M

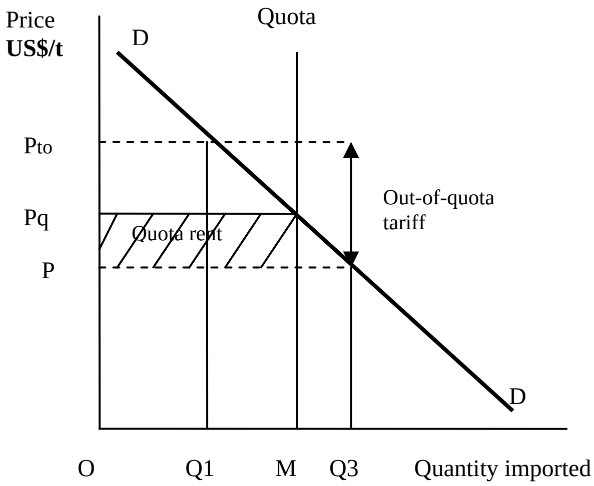

Figure B: Potential for rent where quota is filled

Imports exceed the quota
When import demand is strong enough, product is imported at the out-of-quota tariff rate and imports exceed the TRQ. In this case imports are OM and the price consumers pay Pto, the landed price of imports plus the out-of-quota tariff. Imports of beef above the TRQ volume that attract the out-of-quota tariff rate are Q2M.

The price premium that can be captured by imports within the quota OQ2, will be the difference between the MFN tariff rate and the in-quota tariff rate (Pto minus P). The potential quota rent obtained in this case is indicated by the shaded area in Figure C. In this case having access to the preferential tariff confers no additional benefit to exporters.

Benefit

- *Rent:* (Pto-P)*OQ2
- *Increased exports:* none

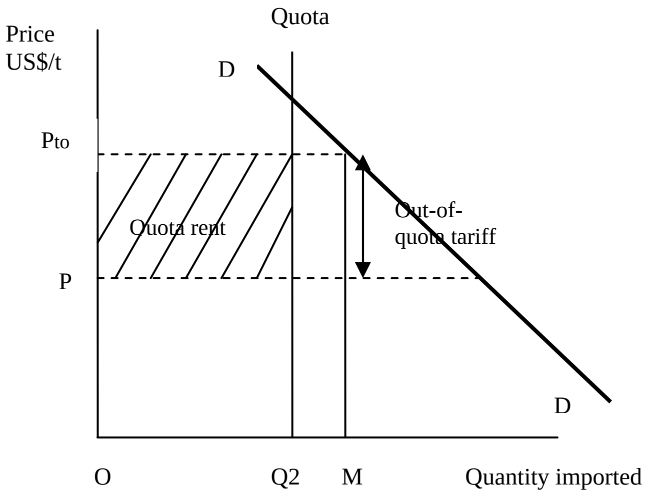

Figure C: Potential for rent where imports exceed the quota

Appendix 2 supplied by ABARE to the Beef Quota Review in 2005.