

***Canada – Measures Affecting the Importation of Milk  
and the Exportation of Dairy Products***

***Report of the Panel***

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## I. INTRODUCTION

1.1 This proceeding has been initiated by two complaining parties, the United States and New Zealand.

1.2 In a communication dated 8 October 1997 (WT/DS103/1), the United States requested consultations with Canada in accordance with Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU"), pursuant to Article XXII:1 of the General Agreement on Tariffs and Trade 1994 ("GATT 1994"), Article 19 of the Agreement on Agriculture, Article 30 of the Agreement on Subsidies and Countervailing Duties ("the SCM Agreement") and Article 6 of the Agreement on Import Licensing Procedures with respect to export subsidies of Canada on dairy products and the administration by Canada of its tariff-rate quota for fluid milk and cream. The United States and Canada held consultations in Geneva on 19 November 1997 but these consultations did not result in a resolution of the dispute.

1.3 On 29 December 1997 New Zealand requested consultations with Canada pursuant to Article 4 of the DSU, under Article 19 of the Agreement on Agriculture and Article XXII:1 of the GATT 1994 with regard to Canada's Special Milk Classes Scheme. New Zealand and Canada held consultations on 28 January 1998 but these consultations did not result in a resolution of the dispute.

1.4 On 2 February 1998, the United States (WT/DS103/4) and on 12 March 1998, New Zealand (WT/DS113/4), each requested the establishment of a panel with standard terms of reference.

1.5 In its request, the United States claims that:

- (a) "The Government of Canada is providing subsidies, and in particular export subsidies, on dairy products through its national and provincial pricing arrangements for milk and other dairy products without regard to the export subsidy reduction and other WTO commitments undertaken by Canada. Specifically, the Government of Canada established and maintains a system of special milk classes through which it maintains high domestic prices, promotes import substitution, and provides export subsidies for dairy products going into world markets. These practices distort markets for dairy products and adversely affect US sales of dairy products."
- (b) "In addition, although Canada committed under the Marrakesh Agreement Establishing the World Trade Organization to permit access to an in-quota quantity of 64,500 tonnes (product weight basis) under a tariff-rate quota for imports of fluid milk and cream, Canada has refused to permit commercial import shipments within the quota. Instead, Canada is administering this tariff-rate quota in a manner that denies market access."
- (c) "These measures appear to be inconsistent with the obligations of Canada under the General Agreement on Tariffs and Trade 1994 (GATT 1994), the Agreement on Agriculture, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Import Licensing Procedures. The measures in question are the Canadian Dairy Commission Act, agreements of the Canadian Dairy Commission, the Interprovincial Comprehensive Agreement on Special Class Pooling (as well as the P-4, P-6, and P-9 interprovincial pooling agreements), the National Milk Marketing Plan (and amendments thereto), operations of the Canadian Milk Supply Management Committee, the Dairy Products Marketing Regulations, and Canada's administration of its tariff-rate quota on fluid milk and cream (as reflected in its implementation of its WTO Schedule of Concessions)."

- (d) "These measures are inconsistent with the obligations of Canada under Articles II, X, XI, and XIII of the GATT 1994; Articles 3, 4, 8, 9, and 10 of the Agreement on Agriculture; Article 3 of the Agreement on Subsidies and Countervailing Measures; and Articles 1, 2 and 3 of the Agreement on Import Licensing Procedures."

1.6 In its request, New Zealand claims that:

- (a) "The Government of Canada is providing export subsidies on dairy products in contravention of its export subsidy reduction and other WTO commitments as encapsulated by the Agreement on Agriculture and the General Agreement on Tariffs and Trade 1994 (GATT 1994). The dairy export subsidy scheme in question is commonly referred to as the "special milk classes" scheme. The background to, and details of, the "special milk classes" scheme is contained, though not necessarily exclusively, in the following documents:
- (i) the Canadian Dairy Commission Act;
  - (ii) the Comprehensive Agreement on Special Class Pooling (the P9 Agreement);
  - (iii) the National Milk Marketing Plan (NMMP);
  - (iv) the Agreement on All Milk Pooling (the P6 Agreement); and
  - (v) the Western Milk Pooling Agreement (the P4 Agreement)."
- (b) "The "special milk classes" scheme referred to above is inconsistent with Canada's obligations under the following provisions:
- (i) Articles 3, 8, 9 and 10 of the Agreement on Agriculture; and
  - (ii) Article X:1 of the GATT 1994."

1.7 The Dispute Settlement Body (DSB) agreed to each of these requests for a panel at its meeting of 25 March 1998 (WT/DSB/M/44). The DSB further agreed that the two panels be consolidated as a single panel pursuant to Article 9.1 of the DSU with the following standard terms of reference:

"To examine, in the light of the relevant provisions of the covered agreements cited by the United States in document WT/DS103/4 and by New Zealand in document WT/DS113/4, the matters referred to the DSB respectively by the United States and New Zealand in these documents, and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements".

1.8 On 12 August 1998, the parties to the dispute agreed on the following composition of the Panel:

Chairman: Professor Tommy Koh  
Members: Mr. Guillermo Aguilar Alvarez  
Professor Ernst-Ulrich Petersmann

1.9 Australia and Japan, and the United States in respect of the New Zealand claims, reserved their rights to participate in the Panel proceedings as third parties.

## II. FACTUAL ASPECTS

### A. THE CANADIAN DAIRY SECTOR

#### 1. General

2.1 In Canada, milk production is divided into two categories: fluid milk and industrial milk. Of all milk deliveries, approximately 40 per cent is processed into table milk and cream (fluid milk); the remaining 60 per cent is processed into dairy products such as butter, cheese, milk powders, ice cream and yoghurt (industrial milk).<sup>1</sup>

2.2 Dairy producers are individual farmers who are licensed to produce milk and sell it, through marketing boards, to dairy processors. The processors are made up of the dairies that process the raw milk for fluid or industrial use, as well as further processors who use the basic dairy components as inputs for other products (such as frozen pizzas, prepared flour mixes, and confectionery). The processors then sell the value-added product on the domestic market or export it on international markets.

2.3 In Canada, there are approximately 23,800 dairy farms which in 1996/97 produced 77.5 million hectolitres of milk, compared to 84,260 dairy farms which produced 75.5 million hectolitres of milk in 1974/75 following the introduction of supply management.<sup>2</sup> Virtually all production of milk comes from farms that produce for both fluid and industrial markets.

2.4 While fluid milk in general is produced and consumed locally within each of Canada's provinces, industrial milk products move in significant volumes across provincial boundaries or are exported from Canada.

2.5 Quebec and Ontario are the most important dairy-producing provinces in Canada. Quebec is the largest producer of industrial milk, retaining close to 50 per cent of the national share of industrial milk, followed by Ontario with approximately 30 per cent. The dairy processing industry is also centred primarily in Quebec and Ontario.

#### 2. Components of the Canadian Dairy Policy

2.6 The basic components of Canada's supply management system for industrial milk are:

- (a) production quotas;
- (b) administered support prices; and
- (c) border protection.

2.7 Regulatory jurisdiction over trade in dairy products is divided between the federal government and the provinces. While the federal government has constitutional authority over inter-provincial and international trade, other aspects of production and sale of milk are under provincial jurisdiction.

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<sup>1</sup> The raw milk provided by the farmer to the processor is usually broken down at the initial stage of processing into its basic "constituents" (cream and skim milk) or into "components" (such as butterfat, protein and other milk solids). The various types of fluid milk (e.g., 3.25 per cent, 2 per cent, 1 per cent) and cream are created by re-blending the cream and skim milk to the desired butterfat content level.

<sup>2</sup> 1996/97 Annual Report of the Canadian Dairy Commission and Agriculture and Agri-Food Canada: "Long Term Dairy Policy Consultation Paper" (May 1996).

2.8 The federal government pays a subsidy of C\$3.04 per hectolitre for industrial milk produced to meet domestic requirements. To this point in time, this subsidy is being phased out with the subsidy reduction being passed on to the marketplace through support price adjustments. The subsidy is expected to be eliminated by February 2002.

2.9 The federal government maintains tariffs and tariff quotas on imported dairy products. The following table summarizes the base and final bound tariffs for selected dairy products as bound in Canada's WTO Schedule:

**Table 1 - Tariff Binding for Selected Dairy Products**

Products	Base Tariff	Final Bound Rate (2000)
Milk	283.8%, minimum \$40.6/hl	241.3%, minimum \$34.5/hl
Cheddar Cheese	289.0%, minimum \$4.15/kg	245.6%, minimum \$3.53/kg
Butter	351.4%, minimum \$4.71/kg	298.7%, minimum \$4.00/kg
Yoghurt	279.5%, minimum \$0.55/kg	237.5%, minimum \$0.47/kg
Ice Cream	326.0%, minimum \$1.36/kg	277.1%, minimum \$1.16/kg
Skim Milk Powder	237.2%, minimum \$2.36/kg	201.6%, minimum \$2.01/kg

2.10 Low-rate tariff quota commitments are applicable to the following products and quantities: fluid milk (64,500 tonnes); cream – not concentrated (394 tonnes); concentrated or condensed milk or cream (11.7 tonnes); butter (1,964 tonnes increasing to 3,274 tonnes); cheese (20,412 tonnes); yoghurt (332 tonnes); powdered buttermilk (908 tonnes); dry whey (3,198 tonnes); other products of milk constituents (4,345 tonnes).

2.11 Canada operates an Import for Re-Export Program under the authority of the Export and Import Permits Act.<sup>3</sup> Under this programme permits to import dairy products on an Import Control List may be issued by the responsible Minister subject to such conditions as are described in the permit or in the regulations. There are no specific policy guidelines or administrative instructions with respect to this programme, which has been in operation for a number of years. Imports under this programme consist of storable and tradeable components of milk, such as skim and whole milk powders and butter. No permits for milk for manufacturing purposes have been requested by Canadian processors under this program, but fluid milk is imported under the program in retail packages for use on, or eventual re-export by, cruise ships passing through Canada.

### **3. The Canadian Dairy Commission (the "CDC")**

2.12 The Canadian Dairy Commission is a Crown corporation established under the Canadian Dairy Commission Act (the "CDC Act").<sup>4</sup> Its mandate is set out in the following way in the text of the CDC Act:

<sup>3</sup> Canada, Exhibit 35.

<sup>4</sup> The abbreviation "CDC Act" refers to the CDC Act as amended.

"The objects of the Commission are to provide efficient producers of milk and cream with the opportunity of obtaining a fair return for their labour and investment and to provide consumers of dairy products with a continuous and adequate supply of dairy products of high quality."<sup>5</sup>

2.13 The powers of the CDC are set out in Article 9.(1) of the CDC Act (Box 1).

<b>Box 1</b>	
"9. (1) The Commission may	
(a)	purchase any dairy product and sell, or otherwise dispose of, any dairy product purchased by it;
(b)	package, process, store, ship, insure, import or export any dairy product purchased by the Commission;
(c)	make payments for the benefit of producers of milk and cream for the purpose of stabilizing the price of those products, which payments may be made on the basis of volume, quantity or on any other basis of volume, quality or on any basis that the Commission deems appropriate;
(d)	make investigations into any matter relating to the production, processing or marketing of any dairy product, including the cost of producing, processing or marketing that product;
(e)	undertake and assist in the promotion of the use of dairy products, the improvement of the quality and variety of and the publication of information in relation to those products;
(f)	establish and operate a pool or pools in respect of the marketing of milk or cream, including
	(i) distributing money to producers of milk or cream received from the marketing on any quantity of milk or cream, or any component, class, variety or grade of milk or cream from the pool or pools;
	(ii) deducting from the money distributed under sub-paragraph (i) any necessary and proper expenses of operating the pool or pools;
(g)	establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream, the basis on which that payment is to be made and the terms and manner of payment that is to be made in respect of the marketing of any quantity of milk or cream, or any component, class, variety or grade of milk or cream;
(h)	collect the price paid or to be paid to the Commission, or to any producer in respect of the marketing of any quantity of milk or cream, or any component, class, variety or grade of milk or cream, or recover that price in a court of competent jurisdiction;
(i)	subject to an agreement entered into under section 9.1, establish and operate a programme in respect of the quantities and prices of milk or cream, or of any component, class, variety or grade of milk or cream, necessary for the competitive international trade in, and the promotion and facilitation of the marketing of, dairy products, including:
	(i) distributing money for the purpose of the equalization of returns to producers in respect of that milk or cream, or that component, class, variety or grade, from which those dairy products are made, and
	(ii) deducting from the money distributed under sub-paragraph (i) any necessary and proper expense of operating the programme; and,
(j)	do all acts and things necessary or incidental to the exercise of any of its powers or the carrying out of any of its functions under this Act."

2.14 The CDC receives its funding from the federal government of Canada as well as from producers and from market transactions.<sup>6</sup> Its members (a Chairman, Vice-Chairman and Commissioner) are appointed by the federal government, and the CDC is accountable to the federal Parliament, reporting to the Minister of Agriculture and Agri-Food.<sup>7</sup>

2.15 The CDC establishes a national target price for industrial milk, which is an amount deemed to be adequate for producers to cover their costs and receive a fair return on their labour and

<sup>5</sup> CDC Act, Section 8.

<sup>6</sup> 1996/1997 Annual Report of the Canadian Dairy Commission, pp. 26 and 28-29.

<sup>7</sup> CDC Act, Section 4, establishes that: The Commission [CDC] is for all purposes of this Act an agent of Her Majesty in right of Canada.

investments. Using the target price as a basis, the CDC also establishes support prices<sup>8</sup> for butter and skim milk powder.<sup>9</sup>

#### **4. Provincial Milk Marketing Boards**

2.16 In each province a milk marketing board exists. The provincial milk marketing boards operate within a framework established under federal and provincial legislation. The CDC Act defines a board as<sup>10</sup>:

"'Board' means a body that is constituted under the laws of a province for the purpose of regulating the production for marketing, or the marketing, in intraprovincial trade of any dairy product".

2.17 The provincial milk marketing boards have all been given general authority by the federal and provincial governments in respect of the issuance and administration of quota, the pooling of returns, pricing, producer records keeping and reporting, inspection, and agreements to cooperate with other provinces and the CDC.

2.18 The membership of the provincial milk marketing boards is made up mostly or exclusively of dairy producers.<sup>11</sup>

2.19 It is prohibited for milk producers to sell any milk individually, without using the provincial milk marketing boards as an intermediary.

2.20 With the exception of 15 producers in Ontario, a producer must have a minimum quota holding to market milk on the domestic or international market.

#### **5. The NMMP**

2.21 At a national level, the provincial marketing boards cooperate under the National Milk Marketing Plan (NMMP). The NMMP is signed by the boards for nine<sup>12</sup> of the ten provinces, some provincial government representatives<sup>13</sup>, and the CDC.

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<sup>8</sup> Currently, support prices are only used by the CDC for programmes to buffer domestic supplies seasonally and, to a very minor extent regionally and between processors. This is done through Plans A and B. Under Plan A, the CDC maintains butter stocks to buffer the domestic market against seasonal supply fluctuations. Sales from stocks acquired under this programme in 1996-97 amounted to less than 1 per cent of butter disappearance. Under Plan B, processors may sell butter to the CDC on condition that they repurchase it within the year. Sales of butter covered by this programme amounted to 18 per cent of domestic disappearance in 1996-97.

<sup>9</sup> 1996/1997 Annual Report of the Canadian Dairy Commission, under "Price Setting".

<sup>10</sup> CDC Act, Section 2 (Definitions).

<sup>11</sup> This is true for Ontario and Quebec and all other provinces except Nova Scotia, Alberta and Saskatchewan. In Nova Scotia, the board members are appointed by the provincial government with one member of five to be a producer. In Alberta and Saskatchewan, the provincial governments also appoint the members but historically producers are well represented on the boards. Currently, each five-member board includes two producers, one consumer representative and one processor representative. Nova Scotia, Alberta and Saskatchewan accounted for 1.91 per cent, 4.77 per cent and 2.51 per cent of domestic production in 1997. (Canada, Exhibit 3)

<sup>12</sup> Newfoundland is not a party to the NMMP (its producers produce almost exclusively for the local fluid milk market and it has not traditionally contributed to the industrial milk supply that was the subject of the NMMP).

<sup>13</sup> Canada, Exhibit 10 contains a full list of signatories.

2.22 The text of the NMMP states that the

"[p]lan is a federal-provincial agreement in respect of the establishment of a National Milk Marketing Plan for the purpose of regulating the marketing of milk and cream products relating to Canadian domestic requirements and for any additional industrial milk requirements in Canada."<sup>14</sup>

2.23 The NMMP sets out the structure for the calculation of an annual national production target for industrial milk - the national Market Sharing Quota (MSQ).

2.24 The NMMP is supplemented by:

- (a) the Comprehensive Agreement on Special Class Pooling , (the "P9") which deals with the pooling of revenues from the Special Classes;
- (b) the Western Milk Pooling Agreement (the "P4"); and
- (c) the Agreement on All Milk Pooling (the "P6").

2.25 The Comprehensive Agreement on Special Class Pooling is an Agreement among the authorities of nine provinces and provincial producer boards that are signatories of the NMMP in respect of pooling of revenues from sales of milk components in special classes of milk used to service domestic and external markets. The Agreement provides for the adoption of the Memorandum of Understanding on Special Class Pooling (MOU) and an Addendum to that Memorandum of Understanding.<sup>15</sup>

2.26 The powers necessary to create the Special Classes and to administer the Special Milk Classes Scheme were conferred on the CDC by amendment to federal legislation (the CDC Act). It is implemented by the Canadian Milk Supply Management Committee (CMSMC).

## **6. The CMSMC and the MSQ.**

2.27 As noted above, the CMSMC, established under the NMMP<sup>16</sup>, is the body that oversees the implementation of the Comprehensive Agreement on Special Class Pooling.<sup>17</sup>

2.28 It is composed of representatives of each provincial marketing board and the respective provincial governments.<sup>18</sup> Representatives of the Dairy Farmers of Canada (the "DFC"), the National Dairy Council (the "NDC") representing the dairy processors/exporters, and the Consumers Association of Canada participate although they do not have voting rights. The CDC acts as chair of the CMSMC.

2.29 Based on production and demand forecasts developed by the CMSMC Secretariat (economists from the CDC, the producer boards, the DFC and the NDC), the CMSMC sets the level of the MSQ. The MSQ is monitored and adjusted periodically to reflect changes in demand. Acting

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<sup>14</sup> NMMP, A. (Introduction).

<sup>15</sup> Comprehensive Agreement on Special Class Pooling, Introduction.

<sup>16</sup> NMMP, Section H.1.

<sup>17</sup> MOU, Schedule I, Section 1.

<sup>18</sup> Newfoundland sits on the CMSMC as an observer.

under the provisions of the NMMP<sup>19</sup>, the CMSMC calculates shares of the MSQ among the provinces.<sup>20</sup>

2.30 In setting the MSQ, the CMSMC takes into consideration:

- (a) the estimate of domestic demand for industrial milk in the coming year;
- (b) the estimated amount of butterfat that will enter the industrial milk system as surplus from fluid milk production, i.e., the "skim-off";
- (c) anticipated imports;
- (d) stocks of dairy products; and
- (e) planned exports.

2.31 Once a national MSQ has been agreed upon by the CMSMC, the next step is to allocate the MSQ between the provinces. This is done essentially on the basis of historical market shares, with some limited latitude for adjustment through transfers of quota within regional arrangements. Since 1995 the MSQ has been established at the following levels (million hectolitres):

Marketing Year	<u>1995/96</u>	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>
MSQ Level	44.2	44.2	43.3	44.7

2.32 Subsequently, the provincial milk marketing board allocates quotas to individual farmers. In most provinces<sup>21</sup>, the board makes a single allocation<sup>22</sup> to each producer, which represents that producer's share of the domestic, and traditional export, milk market. The individual producer's share of the provincial quota, the producer's quota, is determined by the permanent quota rights held by that producer. While quotas were originally allocated on the basis of historic production levels, these quota rights are commercially tradable and, in many cases, have been acquired on a commercial basis.

2.33 In general, CMSMC decisions are taken by consensus. When votes occur, each province that is a member of the NMMP (provincial government representative and producer marketing board representative together) receives one vote. Some votes require a majority while others require unanimous consent. The CDC is empowered to take a decision in the event of a failure by members to agree at two meetings where the question concerns a matter not covered by the Comprehensive Agreement on Special Class Pooling. The Comprehensive Agreement on Special Class Pooling requires unanimity, including on all matters with respect to export trade.

## B. THE CANADIAN SPECIAL MILK CLASSES SCHEME

### 1. Background

2.34 Prior to 1995, the proceeds of levies paid by producers were utilized to fund the CDC's losses in exporting dairy surpluses.

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<sup>19</sup> NMMP, Section I, Quota Allocation.

<sup>20</sup> 1996/1997 Annual Report of the Canadian Dairy Commission, pp. 7-8.

<sup>21</sup> In Alberta, producers receive two quotas, one for fluid milk, expressed in litres per day, and one for industrial milk, expressed in kilograms of butterfat per annum.

<sup>22</sup> This is usually expressed in kilograms of butterfat per day.

2.35 Following the signing of the WTO Agreement in April 1994, the CDC "directed its activities toward developing alternatives to the use of producer levies".<sup>23</sup> With this in mind, a Dairy Industry Strategic Planning Committee was established. The CDC chaired this Committee and provided research and secretariat support for it. In October 1994, the Committee recommended the implementation of a "classified pricing system based on the end use of milk, national pooling of market returns, and coordinated milk allocation mechanisms."<sup>24</sup>

2.36 A Negotiating Subcommittee of the CMSMC was established, with representation from all provinces, to resolve how to implement a "special milk classes" scheme. This subcommittee presented its recommendations to federal and provincial Ministers of Agriculture in December 1994, who agreed that "some form of pooling of milk returns was urgently required to enable the dairy industry to meet Canada's international obligations and changing market conditions."<sup>25</sup> Ministers also agreed that the CDC Act should be amended to allow the CDC to administer the Special Milk Classes permit and national pooling arrangements. These amendments were passed in July 1995.<sup>26</sup>

2.37 The Special Milk Classes Scheme, which replaced the producer-financed levy system eliminated in 1995, is embodied in a Comprehensive Agreement on Special Class Pooling. The CDC, the provincial producer boards and the provinces that participate in the NMMP are the signatories of the Comprehensive Agreement on Special Class Pooling which became effective on 1 August 1995.

## 2. The Special Classes

2.38 The "Special Milk Classes" are the sub-classes of Class 5 milk in the national common classification system, under which the pricing of milk is based upon the end use to which the milk is put by processors. Classes 1 to 4 comprise:

- (a) Class 1: Fluid milk and cream for the domestic market;
- (b) Class 2: Industrial milk for the domestic market: ice cream, yoghurt and sour cream;
- (c) Class 3: Industrial milk for the domestic market: cheese;
- (d) Class 4: Industrial milk for the domestic market: butter, condensed and evaporated milk, milk powders and others.

2.39 The definition of the Special Milk Classes under Class 5 as contained in the Comprehensive Agreement on Special Class Pooling is as follows<sup>27</sup>:

- (a) Class 5(a) Cheese ingredients for further processing for the domestic and export markets.
- (b) Class 5(b) All other dairy products for further processing for the domestic and export markets.
- (c) Class 5(c) Domestic and export activities of the confectionery sector.

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<sup>23</sup> 1994/1995 Annual Report of the Canadian Dairy Commission, page 4.

<sup>24</sup> 1994/1995 Annual Report of the Canadian Dairy Commission, pages 3-4.

<sup>25</sup> *Ibid.*

<sup>26</sup> *Ibid.*

<sup>27</sup> Comprehensive Agreement on Special Class Pooling, Annex A.

- (d) Class 5(d) Specific negotiated exports including cheese under quota destined for United States and United Kingdom markets, evaporated milk, whole milk powder and niche markets.
- (e) Class 5(e) Surplus removal.

2.40 Class 5(e), which is referred to as "surplus removal", is made up of both in-quota and over-quota milk. The over-quota portion of Class 5(e) represents the production that is in excess of the MSQ. The in-quota portion of Class 5(e) exports represents the milk production that is surplus to domestic and planned export needs. This "surplus" may be derived either from the:

- (a) "sleeve"<sup>28</sup>;
- (b) structural surplus of solids non-fat<sup>29</sup> resulting from setting the MSQ at a level that meets demand for butterfat; or
- (c) other in-quota surpluses.<sup>30</sup>

2.41 Table 2 shows Canada's total exports compared to their export volume commitments under the WTO. Canada also provided data on the amount of exports generated through Classes 5(d) and (e) but requested that this data be kept confidential on the ground that the amounts for some entries make identification of individuals possible. The figures provided indicate that the total amount of exports generated through Classes 5(d) and (e) exceeds Canada's export quantity commitment level in respect of all three marketing years and this for all products contained in Table 2 other than skim milk powder (see also paragraph 7.115).

**Table 2**

Product	Marketing year	Export Quantity commitment level	Total exports <sup>31</sup>	Total exports generated through Classes 5(d) and (e) <sup>32</sup>
Butter	1995/1996	9,464	13,956	
	1996/1997	8,271	10,987	
	1997/1998	7,079	10,894	
Cheese	1995/1996	12,448	13,751	
	1996/1997	11,773	20,409	
	1997/1998	11,099	27,397	
Skim milk powder	1995/1996	54,910	35,252	
	1996/1997	52,919	24,888	
	1997/1998	50,927	29,886	
Other milk products	1995/1996	36,990	37,573	
	1996/1997	35,649	62,146	
	1997/1998	34,307	71,023	

<sup>28</sup> The "sleeve" is a safety margin built into the annual estimate of Canadian domestic requirements – its purpose is to cover for any unexpected changes in domestic demand in the course of the dairy year.

<sup>29</sup> This structural surplus, which consists of skim milk powder, had declined in recent years to about 17,800 tonnes of skim milk powder.

<sup>30</sup> Such surpluses could arise where there is a temporary imbalance in supply and demand, such that milk is available in a province which is not needed immediately on the domestic market in that province. This can also be described as seasonal variation in demand through the year.

<sup>31</sup> Data provided in response to Panel Question: Source of Total Exports: Statistics Canada.

<sup>32</sup> The data provided by Canada in response to Panel questions on exports generated through Classes (d) and (e), which is more extensive than that reproduced in paragraph 7.114 below, is on record and is available to the Appellate Body as necessary.

### 3. In-quota milk and over-quota milk

2.42 A national production quota (the national MSQ) for industrial milk is set each year by the CMSMC (paragraph 2.29 and 2.30). Each province is allocated a share of the MSQ which is then allocated among producers within a province by the various provincial milk marketing boards and agencies.

2.43 If a province exceeds its share of the MSQ, the milk that is in excess of the province's share of the MSQ is referred to as "over-quota" milk (further detail in paragraph 2.57). If a province does not exceed its share of the MSQ, all of the province's milk is referred to as "in-quota" milk.

2.44 Prior to 1995, the percentage of farmers producing in excess of 105 per cent<sup>33</sup> of their allocated quota was small. In 1994-95, only 10 per cent of producers were in this group, a figure consistent with levels observed since 1992. A year later, under the new system, 25 per cent of farmers produced over 105 per cent of quota. By 1997-98, 34 per cent of Canadian producers were producing over 105 per cent of their quota.

2.45 In each of the regional pooling arrangements, fluid milk requirements are estimated on a regional basis, based on previous years' consumption. Since fluid milk demand is the highest priority use for milk supplies in the system, the industrial milk system acts as a buffer for any fluctuations in fluid milk demand or supply. In the event of a milk shortage, for instance, milk that would otherwise have found an industrial use is sent into the fluid milk system to cover the shortfall.

2.46 Each province's share of the total in-quota milk market is the sum of its share of the MSQ and the fluid milk market within its regional pooling arrangement.

### 4. The price of milk to the processor

#### (a) Other Classes (Classes 1 – 4)

2.47 The prices in Classes 1-4 reflect the target return for sales on the domestic market. Although the prices for these classes are established independently in each province by the provincial marketing boards, the boards have agreed in the regional pooling arrangements not to have large differences in these prices.

#### (b) Class 5 (Special Classes)

2.48 To obtain dairy products under Class 5, the processors/exporters must apply for a permit from the CDC. A permit holder then presents the permit to the relevant provincial marketing board or marketing agency, which upon acceptance of the recommendation contained therein, provides the milk for export.

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<sup>33</sup> This is based on the assumption that 105 per cent of quota is a level that reflects a deliberate decision to produce for the over-quota market, allowing for other factors such as weather and biological variability in milk production that may cause producers not to meet their quotas exactly.

2.49 The CDC issues two types of permit for Class 5 milk:

- (a) The first type of permit applies to the activities under Classes 5(a), 5(b), and 5(c) and is issued to processors/exporters on an annual basis.
- (b) The second type of permit applies to Classes 5(d) and (e) and is issued to exporters on a transaction-by-transaction basis.

2.50 Prices in Classes 5(a) and (b) are set through a formula negotiated in and decided upon by the CMSMC. This formula links Class 5(a) and (b) prices to US industrial milk prices. The CDC collects the data and does the necessary calculations for the consideration of the CMSMC. The price of milk in Class 5(c) is negotiated between the CMSMC and the confectionery manufacturers.

2.51 Prices for Classes 5(d) and (e) are negotiated and established on a case-by-case basis with the processors/exporters. The CDC conducts these negotiations in accordance with the criteria agreed upon in the CMSMC.

**Table 3 - Average Selected Milk Component Prices by Class and Product  
January to June 1997**

Class	Product	Component Prices (\$/kg.)			\$/hl
		BF	Protein	OS	Total
<b>1a)</b>	Fluid milk	5.46	6.56	3.70	<b>61.61</b>
<b>1b)</b>	Table Cream	5.43	5.22	3.58	<b>56.62</b>
<b>2)</b>	Yoghurt and Ice Cream	5.43	4.00	3.89	<b>54.37</b>
<b>3a)</b>	Specialty Cheeses	5.47	9.04	0.58	<b>51.78</b>
<b>3b)</b>	Cheddar Cheese	5.48	8.59	0.58	<b>50.40</b>
<b>4a)</b>	Butter, Ingredients	5.4	3.51	3.51	<b>50.82</b>
<b>4b)</b>	Condensed Milk	5.44	3.62	3.62	<b>51.71</b>
<b>5a)</b>	Specialty Cheeses	2.99	7.01	0.57	<b>36.37</b>
<b>5a)</b>	Cheddar Cheese	3.05	7.01	0.57	<b>36.55</b>
<b>5b)</b>	Fluid Milk	3.08	2.92	2.92	<b>37.00</b>
<b>5b)</b>	Creams	3.05	2.92	2.92	<b>36.89</b>
<b>5b)</b>	Yoghurt	3.05	2.92	2.92	<b>36.91</b>
<b>5b)</b>	Butter, Ingredients	2.98	2.91	2.94	<b>36.75</b>
<b>5c)</b>	Milk products for Confectionery	2.64	2.59	2.59	<b>32.51</b>
<b>5d)</b>	Milk	2.18	2.18	2.12	<b>27.28</b>
<b>5d)</b>	Cream	2.46	2.46	2.46	<b>30.69</b>
<b>5d)</b>	Yoghurt	2.57	2.57	2.57	<b>32.06</b>
<b>5d)</b>	Specialty Cheeses	1.94	4.87	0.51	<b>25.37</b>
<b>5d)</b>	Cheddar Cheese	3.97	6.72	0.51	<b>38.56</b>
<b>5d)</b>	Butter	1.83	1.83	1.83	<b>24.91</b>
<b>5e)</b>	Milk	2.15	2.15	2.15	<b>26.87</b>
<b>5e)</b>	Cream	2.20	2.20	2.20	<b>27.47</b>
<b>5e)</b>	Specialty Cheeses	1.50	4.54	0.51	<b>22.75</b>
<b>5e)</b>	Cheddar Cheese	1.86	4.92	0.51	<b>25.23</b>
<b>5e)</b>	Butter	1.28	1.28	1.28	<b>15.98</b>

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

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

Source: United States, Exhibit 22, *An Inquiry Into the Importation of Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Report of the Canadian International Trade Tribunal, June 1998 p. 13 (source referred to in United States, Exhibit 22: Canadian Dairy Commission).

## 5. Returns to producers from exports

### (a) General

2.52 Exports of dairy products from Canada fall within two categories, exports that result from:

- (a) milk from in-quota sources such as planned production for exports to traditional markets and the part of the sleeve not used in domestic markets;
- (b) milk that is the result of over-quota production.

### (b) In-quota exports

2.53 In-quota milk for export use consists of milk that falls within the annual MSQ but is not used for the domestic market. It is sourced from a fixed amount set aside for planned export within Class 5(d), as well as MSQ milk surplus to domestic requirements (under Class 5(e)).

2.54 The CMSMC specifies the amount of sales under Class 5(d), currently 1.2 million hectolitres. Exporters with access to these traditional markets approach the CDC with proposals to purchase milk under Class 5(d).<sup>34</sup> Sales of surplus milk (i.e., Class 5(e)) begin with a declaration that milk surplus to domestic requirements is available. The determination whether there is in fact milk available in system surplus to domestic and traditional export market requirements is made by the Surplus Removal Committee, which is formally known as CDC Advisory Group on Preemptive Surplus Removal (hereafter the "SRC") of the CMSMC. If the SRC determines that milk is available<sup>35</sup> and the CDC believes that the proposal should be accepted, it provides a permit to the exporter that is subject to acceptance by the relevant board. This permit carries a recommendation to the board that the required amount of milk should be supplied at the recommended price.

2.55 Once the exporter has agreed on a milk price with the board it may export the resulting processed products. It keeps the export documentation available for examination by the CDC auditors. To allow the CDC to maintain its monitoring programme on behalf of the CMSMC, the exporter is also required to file proof of export with the CDC. All holders of such permits must provide the CDC with regular reports on their dairy ingredient purchases and use.

2.56 The returns to the producer for in-quota milk sold for export use are based on world market conditions, resulting from prices negotiated between the processor/exporter and the CDC. These returns are subject to pooling with domestic market returns before receipt by the individual producers.

### (c) Over-quota exports

2.57 Exports of dairy products produced with over-quota milk may arise in two ways:

- (a) **Over-quota production:** There are production quotas at the individual farm level and at the provincial level. At the provincial level, over-quota production occurs when producers in a province produce milk in excess of their individual quotas and as a result a province as a whole exceeds its share of the national MSQ in a defined period of time. Independent of the level of production in a province as a whole, at the farm level, an individual producer may exceed his individual farm production quota. It is

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<sup>34</sup> These traditional sales are linked to certain trade opportunities, such as TRQs that are traditionally made available to Canadian exporters, as well as sales arising out of long-term trade patterns. The main markets for Class 5(d) transactions are aged cheddar to the U.K, cheese to the United States under Canada-specific tariff quotas, cheese to Mexico, mainly evaporated milk to Libya, skim milk powder and whole milk powder to Algeria and skim milk powder, whole milk powder and evaporated milk to Cuba.

<sup>35</sup> The Comprehensive Agreement on Special Class Pooling states that the CDC will be guided by the decisions of the SRC.

noted that returns to the producer are calculated on the basis of the over-quota production at the individual level.

- (b) Optional Export Program (OEP): The OEP is a programme whereby milk is produced in addition to quotas and sold outside of the classification system to meet a specific marketing need.<sup>36</sup> OEP contracts are negotiated between the producer marketing board and a processor. The board then offers the agreed terms to the producers who can voluntarily accept to produce for the OEP contract.

2.58 The returns to the producer from over-quota production is based on a three month average reflecting actual Class 5(e) prices, as calculated by the CDC. At year's end, returns during the year for over-quota milk are adjusted to reflect actual total returns. Over-quota returns through Class 5(e) sales are not pooled with the domestic market returns before being paid to the individual producer. Returns from sales under the OEP are likewise, not pooled with the domestic market returns before being paid to the individual producer.

## 6. Pooling

2.59 Pooling calculations are made under the Comprehensive Agreement on Special Milk Classes (P9).

2.60 Revenues from all in-quota sales of milk are pooled between provinces in two regional pools (Table 4).

**Table 4**

<b>P6</b> <b>Agreement on All Milk Pooling</b>	<b>P4</b> <b>Western Milk Pooling Agreement</b>
Ontario	British Columbia
Quebec	Alberta
New Brunswick	Saskatchewan
Nova Scotia	
Prince Edward Island	
Manitoba <i>Note: Manitoba currently belongs to both pools. It first pools its revenues under the P4, then under the P6.</i>	
<b>P9</b> <b>Comprehensive Agreement on Special Class Pooling</b> <b>"National Pool"</b> <b>(all 9 provinces)</b>	

<sup>36</sup> This is to be contrasted with over-quota production. Over-quota production is also produced over and above quotas but is not linked to any specific export market need. Producers are paid for OEP milk on the basis of the prior negotiated price, whereas the board pays the producer for over-quota milk on the basis of actual returns on Class 5(e) sales, i.e., returns from sales made in the spot market. The OEP Agreement is Annex C of the Comprehensive Agreement on Special Milk Classes (P9).

2.61 The pooling process is illustrated by way of an example with the following assumptions:

**ASSUMPTIONS**

- Production		P4	P5	P9
	Class 1-4	15 hl	45 hl	
	Class 5 in-quota	2 hl	5 hl	
	Total	17 hl*	50 hl	67 hl
- Actual returns				
	Class 1-4	\$58 / hl	\$55 / hl	
	Class 5	\$21 / hl	\$22 / hl	
<b>- Target return: (Class 1-4): \$54.00 / hl</b>				
* Includes 3 hl from Manitoba.				

2.62 There are four steps in the pooling process:

**STEP 1**

Remove from pooling calculations sales from:

- **Over-quota.**
- **Optional Export Programme.**

**STEP 2**

Pool Class 5 in-quota: at **actual price obtained.**  
 Pool Classes 1-4: at the **target price: \$54.00 / hl.**

Gives: Revenue to be pooled by region.

REGIONS:	P4	P5	P6	P9
Target Revenue @ <b>\$54.00 / hl.</b>				
Class 1-4	\$810	\$2,430		
Class 5 (@ \$21 and \$22 / hl)	\$42	\$110		
Total	<b>\$852</b>	<b>\$2,540</b>		\$3,392

**STEP 3**

Class 5 in-quota is pooled with all Classes. Gives: **Average return, all classes.**  
**Adjustment** between regional pools is calculated

REGIONS:	P4	P5	P6	P9
Class 5 is pooled in all Classes				
\$3,392 / 67 hl				<b>\$50.63 / hl</b>
Revenue at:				
Target return				
total in Step 2	\$852	\$2,540		
Pooled return (all classes)				
@ \$50.63 / hl	\$861	\$2,531		
Difference (Adjustment)	<b>+ \$9</b>	<b>- \$9</b>		

**STEP 4**

Pool the P4 at actual market returns from all milk sales. Apply the adjustment for P9.

Pool P5 at actual market returns from all milk sales.

Manitoba adds revenues from P4 into the P5. **This becomes the P6.**

Pool the P6 at actual returns from all milk sales. Apply the adjustment for P9.

REGIONS:	P4	P5	P6	P9
Actual revenue				
Class 1-4 (@ \$58 and \$55 / hl)	\$870	\$2,475		
Class 5 (@ \$21 and 22 / hl)	\$42	\$110		
Total	\$912	\$2,585		\$3,497
Adjusted revenue	+ \$9	- \$9		
Total	\$921	<b>→</b>	\$2,576	
Quantity (P4)	17 hl		50 hl	
Average Return (P4)	<b>\$54.18 / hl</b>			
+ Manitoba (3hl @ 54.18)			+\$162.5	
Total Return P6			\$2,738.5	
Quantity (P6)			53 hl	
Average Return P6			<b>\$51.67 / hl</b>	

2.63 The result is that each provincial board in a regional pooling arrangement receives:

- (a) a regional average return for all its Class 1-4 sales;
- (b) a national average return for all of its adjusted Class 5 sales derived from in-quota milk; and
- (c) an average world market return for any over-quota shipments.

C. CANADA'S TARIFF-RATE QUOTA ON FLUID MILK AND CREAM

2.64 In Canada's WTO Schedule V, the tariff-rate quota for fluid milk (HS 0401.10.10) is 64,500 tonnes (product weight basis). The following text is contained under "other terms and conditions":

"This quantity represents the estimated annual cross-border purchases imported by Canadian consumers."

2.65 Currently, Canada does not impose any monitoring of cross-border imports of consumer packaged milk (limited to the value of C\$20.00 per entry).

2.66 Canada has applied the over-quota tariff to fluid milk shipments in commercial containers or in bulk. As noted above in paragraph 2.11, no permits have been issued for imports of milk (HS 0401) for industrial use under the Import for Re-Export Program.

### III. CLAIMS OF THE PARTIES

#### A. EXPORTATION OF DAIRY PRODUCTS

##### 1. Product coverage and period of time

3.1 The dairy products and marketing years covered by the claims of **New Zealand** and the **United States** are set out in Table 1 below.

**Table Error! Unknown switch argument. - Products<sup>1</sup> and marketing years<sup>2</sup> subject to the complainants' claims**

	Butter	Cheese	Other Milk Products
New Zealand	1995/96 1996/97	1995/96 1996/97	1996/97
United States	1996/97	1996/97	1996/97

<sup>1</sup> Butter consists of products classified in 0405.10 and 0405.90. Cheese consists of products provided for in 0406.10, 0406.20, 0406.30, 0406.40, and 0406.90. Other Milk Products includes milk and cream in 0401.10, 0401.20, 0401.30; powdered whole milk and cream in 0402.21 and 0402.29; condensed evaporated milk in 0402.91 and 0402.99; buttermilk and yoghurt in 0403.10 and 0403.90; milk protein concentrate, 0404.90; and ice cream, 2105.00. Although the United States understood that Canadian exports of Skim Milk Powder were not in excess of Canada's WTO commitments, the United States considered that all exports under the SMP category that were exported through the Special Milk Classes Scheme should have been notified as subsidies to the WTO.

<sup>2</sup> New Zealand did not refer to the marketing year 1997/98 because official figures for that period were not available. Nevertheless, if those figures were to indicate that Canada's actual exports also for that period exceeded its reduction commitments in respect of the products mentioned in the table, New Zealand would consider that Canada had also breached its WTO obligations in respect of those products for the 1997/98 marketing year. The United States noted that although Canada had not yet reported to the WTO its export quantities for the 1997/98 period, based on preliminary information for that period, the volume of exports appeared to remain at levels exceeding the pertinent reduction commitments. After our first substantive meeting, the figures for marketing year 1997/1998 became available and are incorporated above in Table 2 in para.2.41.

##### 2. Nature of Measure

3.2 **New Zealand** and the **United States** claimed that there was extensive government involvement in all critical aspects of Canada's Special Milk Classes Scheme, from its initiation through to its administration and operation. Canada's Special Milk Classes Scheme was a product of governmental authority and was operated under the auspices of the federal and provincial governments. This government involvement in the scheme was sufficient to constitute government action within the meaning of the jurisprudence developed by GATT and WTO panels.

3.3 **Canada** claimed that the Complainants' assumptions of government control, direction or mandate were without basis in fact and were, therefore unsustainable. Government involvement was limited to providing an appropriate regulatory framework and essentially responsive to the initiatives of the Canadian dairy industry.

### 3. Agreement on Agriculture

(a) Article 1(e)

3.4 Both **New Zealand** and the **United States** claimed that the Special Milk Classes Scheme was an export subsidy in the sense of Article 1(e) of the Agreement on Agriculture.

3.5 **Canada** claimed that as the sales of milk at differing prices under Special Classes 5(d) and (e) did not constitute a "subsidy" pursuant to the definition of the SCM Agreement, it followed that these sales could not constitute a subsidy for the purposes of the Agreement on Agriculture. Therefore, by definition, such sales could not constitute an "export subsidy" within the meaning of the definition in Article 1(e) of the Agreement on Agriculture.

(b) Article 9.1(a) and (c)

3.6 **New Zealand** and the **United States** claimed that the Special Milk Classes Scheme constituted export subsidy practices listed in Article 9.1(a) and (c). As such, these practices were subject to reduction commitments under the Agreement on Agriculture. **Canada** refuted both these claims.

(c) Article 3.3 and Article 8

3.7 **New Zealand** and the **United States** claimed that Canada's provision of export subsidies under Article 9.1(a) and (c) of the Agreement on Agriculture in excess of its scheduled export subsidy commitments was a violation of Article 3.3 of that Agreement. Furthermore, Canada was in violation of its obligation under Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement on Agriculture.

3.8 **Canada** claimed that since the sales of milk at differing prices for domestic and export markets did not constitute an "export subsidy" as that term was defined in Article 1(e) of Agreement on Agriculture, the practice at issue did not fall within the scope of Article 8; that article could therefore not apply.

(d) Article 10

3.9 Alternatively, **New Zealand** and the **United States** claimed that Special Classes 5(d) and (e) of the Special Milk Classes Scheme constituted an export subsidy not listed in Article 9.1 that was being applied in a manner which circumvented or threatened to lead to circumvention of Canada's export subsidy commitments contrary to Article 10.1 and 10.3 of the Agreement on Agriculture.

3.10 **Canada** claimed that Article 10 did not apply in the present case as it could not be established that there existed "export subsidies", including those export subsidies listed in Article 9.1. Nor could it be established that there was actual or threatened circumvention of Canadian export subsidy commitments.

### 4. Agreement on Subsidies and Countervailing Measures ("SCM Agreement")

(a) Article 1 and Paragraph (d) of the Illustrative List of Export Subsidies in Annex I

3.11 **New Zealand** and the **United States** claimed that even on the basis of Canada's own approach to the interpretation of the term "subsidy" Canada had not shown that the Special Milk Classes Scheme fell outside the definition of subsidy under the SCM Agreement. The Scheme constituted a subsidy within the meaning of Article 1 of the SCM Agreement. In addition, that the

Special Milk Classes Scheme constituted the provision of an export subsidy within the meaning of Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement.

3.12 **Canada** claimed that the sale of milk at differing prices did not constitute a "subsidy" within the meaning of Article 1 of the SCM Agreement. Further, Canada claimed that the practices at issue were not "export subsidies" in the sense of Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement.

(b) Article 3

3.13 The **United States** claimed that as Canada's Special Milk Classes Scheme was inconsistent with Canada's obligations under the Agreement on Agriculture it was consequently in violation of Article 3 of the SCM Agreement.

B. IMPORTATION OF MILK

### 1. Article II of GATT 1994 and the Agreement on Import Licensing Procedures

3.14 The **United States** claimed that Canada's administration of its tariff-rate quota on fluid milk<sup>37</sup> which restricted access to the in-quota quantity of its tariff-rate quota for fluid milk to entries that were valued at less than C\$20 and that were for the personal consumption of Canadian residents, was inconsistent with its obligations under Article II:1(b) of GATT 1994 and Article 3 of the Agreement on Import Licensing Procedures.

3.15 **Canada** claimed that its current treatment of fluid milk imports was fully consistent with the terms and conditions of the tariff concession for fluid milk (HS 0401.10.10) in its Schedule. Canada further refuted any alleged violation of the Import Licensing Agreement.

C. RECOMMENDATIONS REQUESTED BY THE PARTIES

3.16 **New Zealand** requested that the Panel, in accordance with Article 19 of the DSU, recommend that Canada bring its measures into conformity with the Agreement on Agriculture.

3.17 The **United States** requested that the Panel find the Canadian Special Milk Classes Scheme and the denial of access to imports under the tariff-rate quota on fluid milk and cream to be inconsistent with Canada's WTO obligations. Accordingly, the Panel should recommend that Canada bring those measures into conformity with its obligations under the GATT 1994, the Agreement on Agriculture, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Import Licensing Procedures. More specifically, the Panel should recommend (i) that Canada either withdraw its export subsidies or reduce the level of its subsidized exports of dairy products to a level commensurate with its reduction commitments and (ii) that such action be taken without delay. In this regard, the United States saw no reason why Canada could not bring its export subsidies into compliance within 30 days of the adoption by the Dispute Settlement Body of recommendations and rulings. With respect to market access, the United States respectfully submitted that the Panel should recommend that Canada not apply its tariff-rate quota in a manner that denies entry at the in-quota rate to any fluid milk imports made within the quantitative limit of the tariff-rate quota.

3.18 **Canada** requested the Panel to find that (i) Canada's Special Milk Classes did not provide an export subsidy and thus did not violate Canada's obligations under Articles 8, 9 or 10 of the

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<sup>37</sup> The specific products subject to this claim were classified in Canada's tariff schedule within tariff item numbers 0401.10 and 0401.20. The US claim relating to Canada's fluid milk tariff-rate quota related to the last three years (1995-1997) as well as the current year (1998).

Agreement on Agriculture nor under Article 3 of the SCM Agreement; and (ii) that Canada's administration of its tariff-rate quota on fluid milk and cream was consistent with Canada's obligations under Article II:1(b) of the GATT 1994 and Article 3 of the Agreement on Import Licensing Procedures. Canada requested the Panel to dismiss all claims brought against Canada in this case by the United States and New Zealand.

#### IV. ARGUMENTS OF THE PARTIES

##### A. EXPORTATION OF DAIRY PRODUCTS

#### 1. Nature of Canada's Special Milk Classes Scheme

##### (a) Outline

4.1 **New Zealand** argued that the government was implicated in all critical aspects of Canada's Special Milk Classes Scheme, from its initiation through to its administration and operation. Likewise, the **United States** claimed that Canada's Special Milk Classes Scheme was a product of governmental authority and was operated under the auspices of the federal and provincial governments. The Complainants claimed that the government involvement in the scheme was sufficient to constitute government action within the meaning of the jurisprudence developed by GATT and WTO panels.

4.2 **Canada** claimed that the Complainants' arguments rested entirely on erroneous descriptions of the Canadian dairy system. This was particularly true of the way that they had attempted to miscast the means by which milk was marketed for export use in Canada. Exports of milk from Canada were controlled and directed by Canadian dairy *producers*, not governments. As such, the assumptions of government control, direction or mandate that premised each of the Complainants' arguments was without basis in fact. Therefore, each of these arguments was unsustainable. Governments did play a role, but it was limited and essentially responsive to the initiatives of the industry.

4.3 Canada emphasized that the objective behind the institution of the Special Milk Classes Scheme had been to provide export opportunities that were consistent with Canada's WTO commitments, while providing reasonable continuity to dairy producers. Canada noted that the current dispute was not about domestic dairy supply management in Canada: it was about the marketing of milk in Special Classes 5(d) and (e). Even if the Canadian domestic supply management regime were found to be governmental, in Canada's view, that would not necessarily imply that the marketing of milk in Special Classes 5(d) and (e) would be governmental as such.

##### (b) The Authority and Role of the Canadian Dairy Commission (CDC)

4.4 **New Zealand** argued that the price that processors paid for milk, both for domestic and export use, was determined by the exercise of governmental authority through the operation of the CDC and provincial marketing boards and agencies. The CDC and the provincial marketing agencies were in effect a part of the executive branch of government. The fact that they were composed largely of producers could not be allowed to disguise that fact. This was evident, in New Zealand's view, from several Canadian sources. The Act establishing the CDC granted it authority to "establish the price, or minimum or maximum price, to be paid ... to producers of milk or cream ..." (paragraph 2.12 and following).<sup>38</sup> The British Columbia Milk Marketing Board, whose members were appointed by the Lieutenant Governor in Council, was "authorised to regulate the marketing of milk in inter-provincial and export trade ...".<sup>39</sup> The CDC's internet website<sup>40</sup>, describing the relationship between the federal and provincial authorities in the marketing of milk stated: "certain marketing activities related to industrial milk are carried out jointly between the federal government and participating provinces". The Annual Report of the CDC for 1996-97 described the Commission as a "crown corporation" and referred to the "framework" provided by the Commission for "the federal/provincial

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<sup>38</sup> Section 9(1)(g) of the CDC Act, New Zealand, Annex 13.

<sup>39</sup> Section 3 of the British Columbia Milk Order, 1994 (SOR/94-511).

<sup>40</sup> <http://www.cdc.ca/shared.html>

participation that is crucial to the success of the dairy sector".<sup>41</sup> It referred to the authority of the CDC "to purchase, store, process or sell dairy products" and "to make payments to milk and cream producers".<sup>42</sup>

4.5 New Zealand noted, in respect of a few key features of the operating procedures of the CMSMC<sup>43</sup>, that it was noteworthy that the CDC, as Chair of the CMSMC, had a de facto veto power over almost all aspects of that Committee's decision-making.<sup>44</sup> In other words, if the CDC disagreed with the rest of the CMSMC, it could then resolve the disagreement by its own unilateral decision. In this and in other respects, the CMSMC was intrinsically linked to the CDC, a Crown agency, and to the federal government.

4.6 The **United States** argued that the Canadian Special Milk Classes Scheme depended for its existence on legislation enacted by the Government of Canada. The Canadian Government's role did not stop with the planning and enactment of the authorizing federal legislation. The CMSMC established and revised the annual national production quota. The CDC established the target prices and Special Milk Class prices. The CDC issued the permits that were required to initiate surplus removal, which was then exported. The CDC, working with the provincial marketing boards (the powers of which were derived from the provincial and federal governments), calculated the sales returns received by the provinces, and adjusted those returns to reflect participation in the Special Milk Classes. The CDC had even financed the Special Class distributions by obtaining a line of credit.<sup>45</sup>

4.7 The United States argued that the Canadian federal and provincial governments had demonstrated the compulsory nature of the dairy regime's production quotas, administered price levels, and revenue pooling; the CDC and the Province of British Columbia, had for over a decade, sought through legal action to prevent producers in that province from shipping milk without the benefit of a quota allotment under the federal/provincial MSQ.<sup>46</sup> Those milk producers had contested the authority of the provincial government to regulate the production and marketing of milk. The reaction of the federal and provincial government was instructive regarding the urgency with which they met this perceived challenge to supply management and the levies which subsidized dairy exports.<sup>47</sup> Following an initial set back in litigation in British Columbia, both the federal government and provincial governments throughout Canada amended the governing legislative authority to address the court's finding that the provincial marketing board in British Columbia possessed only the power to regulate intra-provincial trade and, therefore, could not either regulate production or impose the levies necessary to finance the system relating to industrial milk. In response to the court's decision, the applicable federal legislation was amended to delegate authority to the provinces to

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<sup>41</sup> New Zealand, Annex 7, p.6.

<sup>42</sup> *Ibid.*

<sup>43</sup> National Milk Marketing Plan (the document which constitutes and lays down the operating procedures of the CMSMC), New Zealand, Annex 12.

<sup>44</sup> New Zealand referred, in particular, to Section 3 of the Memorandum of Agreement, November 1982, which forms part of the National Milk Marketing Plan. Section 3 provides that the CDC shall resolve disagreements in cases where unanimity is not required. The only operative requirement for unanimity is in respect of the provincial shares of the production quota (Section 18 of the Memorandum of Agreement).

<sup>45</sup> Canadian Dairy Commission, Annual Report, 1996/97. (United States, Exhibit 8)

<sup>46</sup> British Columbia Milk Marketing Board and Canadian Dairy Commission v. Luigi Aquilini, et al, Supreme Court of British Columbia, No. A950636. (United States, Exhibit 26)

<sup>47</sup> The United States noted that when the CDC Act was amended in 1995 to provide powers to the Commission to create the Special Classes, Canada's Attorney-General was also given authority to seek injunctive relief in actions on behalf of the Canadian Dairy Commission. (United States, Exhibit 5)

regulate inter-provincial and export trade and the provinces then amended their own authority to reflect this delegation of administrative powers from the Government of Canada.<sup>48</sup>

4.8 The United States noted that the Attorney-General for Canada joined the litigation to preserve the authority to collect levies to finance dairy product exports and to dispute the contentions of the unlicensed dairy farmers that the exercise of power by the provincial marketing board and the Canadian Dairy Commission was *ultra vires*.<sup>49</sup> In submissions to the court, the Attorney General stated that "it was intended by Parliament that the Governor in Council delegate to others the administration of such a scheme [administration of a quota based regulatory system] and, in the *Federal Regulations* there was a valid delegation of administrative powers to the Commission [the CDC], the Committee [the CMSMC], and to provincial Boards."<sup>50</sup> Later in the same document, the Attorney General declared that the:

*"Federal Regulations* were passed to provide federal legislative support to the continued regulation of the dairy industry in Canada. At its core, regulation of this industry is accomplished by the joint participation of both federal and provincial authorities. This is reflected in the National Plan and in the marketing scheme created by the *Federal Regulations*".<sup>51</sup>

4.9 The United States noted that the Special Milk Classes Scheme was established through the collaborative efforts of the federal and provincial governments. Specifically, the Special Milk Classes Scheme was created by the Comprehensive Agreement on Special Class Pooling (P9 Agreement, see also paragraph 2.24).<sup>52</sup> That Agreement was an agreement between the federal government in Canada and the provincial governments. The powers necessary to create the Special Classes and to administer the Special Milk Classes Scheme had been conferred on the Canadian Dairy Commission, a Crown corporation, by amendment to federal legislation, the Canadian Dairy Commission Act.<sup>53</sup>

4.10 The United States emphasized that the powers of the Canadian Dairy Commission, as set forth in Section 9 of the CDC Act (paragraph 2.13)<sup>54</sup>, were numerous and broad. The Act conferred the authority to the CDC: (i) to purchase any dairy product and sell, or otherwise dispose of, any dairy product purchased by it; (ii) to establish and operate a pool or pools in respect of the marketing of milk and cream; (iii) to establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream; (iv) to collect the price paid or to be paid to the Commission, or to any producer in respect of the marketing of any quantity of milk or cream; and (v) to do all acts and things necessary or incidental to the exercise of any of its powers or the carrying out

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<sup>48</sup> The Governor in Council's Orders revising the delegation of authority to the provinces of Ontario and Quebec to include administrative powers respecting inter-provincial and export trade are contained in United States, Exhibit 27.

<sup>49</sup> The United States noted that in February 1997, Agriculture Minister Ralph Goodale separately explained the reason for federal intervention in the litigation as follows: "Right now, some Alberta and British Columbia producers are trying to take advantage of supply management by selling milk illegally. The only way to stop it is to bring them in court, which means a lot of expenses. We believe that producers shouldn't be the only ones to pay a bill in which the governments have a responsibility." *The Western Producer*, 6 February 1997 edition, "Ottawa may share B.C. dairy battle legal costs". (United States, Exhibit 28) Notably, one of the regulations that the British Columbia Board and the CDC sought to enforce in the B.C. litigation was the imposition of the levies on producers used to support supply management and to fund export subsidies. The government succeeded in this pursuit when the Supreme Court of British Columbia in a 12 September 1997 opinion ruled that unpaid provincial and federal levies were enforceable debts. "Oral Reasons for Judgment", Mr. Justice Wong, 12 September 1997, p. 6.

<sup>50</sup> "Outline of the Argument of the Attorney General of Canada," filed 24 September 1996, in the Supreme Court of British Columbia in *British Columbia Milk Marketing Board and CDC v. Luigi Aquilini*, p. 8. (United States, Exhibit 29)

<sup>51</sup> United States, Exhibit 29, p.12.

<sup>52</sup> United States, Exhibit 5.

<sup>53</sup> United States, Exhibit 15.

<sup>54</sup> United States, Exhibit 37.

of its functions under the Act. The power to establish a pool, to establish prices, and to collect the price to be paid had all been added in 1995 at the time of the creation of the Special Class system. Furthermore, conspicuous by its absence in the CDC's enumerated powers was any qualification that those powers were subject to the decision of milk producers.

4.11 The United States further noted that the Comprehensive Agreement on Special Class Pooling contained several interrelated elements. First, the Agreement provided for the adoption of both the Memorandum of Understanding on Special Class Pooling ("MOU on Special Classes") and also an Addendum to the Memorandum of Understanding. The MOU on Special Classes provided that the provincial governments would enter into a revenue pooling arrangement for milk in the Special Classes. The MOU directed the CDC to determine the percentage of total production by special class utilization in each province. The MOU also contained an agreement to establish and harmonize prices for Special Classes in the CMSMC. Significantly, section 11 of the MOU stated that a province could join the MOU only by the action of the individual provincial governments, not through the action of the marketing boards, or the decision of milk producers, either individually or collectively. Annex B of the Comprehensive Agreement addressed the question of surplus removal and confirmed the role of the CDC in the operation of surplus removal. The Annex provided that there would be both a CDC-initiated surplus removal plan, as well as provision for processor-initiated surplus removal. Paragraph C(1)(iii) of Annex B provided that the CDC would remove the surplus milk by authorizing dairy processors to acquire milk under Special Class 5(e) and manufacture dairy products for purchase by the CDC for export. Sub-paragraph (vii) stipulated that the processor would receive an assured margin and that the level of the margin would be negotiated by the CDC with the processor. No mention was made at all in this Annex for a decision-making role for milk producers in any of these decisions. Nor were producers given such a role in connection with a decision of processor-initiated surplus removal. While the MOU established an advisory group, consisting of an equal number of processors and milk producers, their role was to advise the CDC on when the CDC-initiated surplus removal should be initiated.

4.12 **Canada** did not deny that the CDC played an important role in the Canadian dairy system but it was not the central directing agency that the Complainants alleged. The CDC acted as a centre of technical expertise that was available to the dairy industry as a whole and to the producer-dominated decision-makers at the CMSMC. It supplied recommendations and data for the consideration of the CMSMC to assist it in deciding on the annual MSQ. It also calculated a "Support Price"<sup>55</sup> used by the producer boards to assist them in negotiating and establishing domestic price levels. Furthermore, the CDC's role as chair of the CMSMC was one of facilitation. The role of the CDC for practical, legal, historical and political reasons, was necessarily that of facilitator and consensus-builder.

4.13 Canada argued that although the CDC did indeed act as the chair of the CMSMC, the CDC did not act in the manner suggested by the Complainants: that of dominant director, telling the industry how they were going to carry out federal government policy. Its role was that of facilitator and technical advisor. Ultimately, the CDC implemented the policies and programmes agreed upon in the CMSMC; it neither dictated nor directed them. Canada argued that the CDC, in its role as the administrator of aspects of the dairy system, operated under the direction and control of the CMSMC and was routinely subject to rigorous scrutiny at each meeting of the CMSMC. The CMSMC, unlike the CDC, was not a governmental body. For example, CDC-initiated surplus removal did not begin with a decision of the CDC. It began with a decision of the Advisory Group on the Surplus Removal Program (known as the SRC, paragraph 2.54 and footnote thereto refers), a body composed of

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<sup>55</sup> Canada stressed that the CDC did not operate a price support system. In the past, it set a "support price" which was in fact applied in operating an open offer to purchase programme. This programme had been terminated, although the CDC still set a misnamed "support price" which, as noted, was used for reference purposes by the producer boards, as well as certain limited domestic seasonality programmes.

producers and processors.<sup>56</sup> Only when the industry representatives on the SRC had decided that the domestic market was being satisfactorily supplied, did it instruct the CDC to open such a programme. Once the CDC-initiated surplus removal programme had been opened, the CDC entertained proposals from private exporters with whom it negotiated on behalf of the producers as agent. Canada rejected the US suggestion that Annex B of the Comprehensive Agreement on Special Class Pooling confirmed the role of the CDC in surplus removal (paragraph 4.11). What the Comprehensive Agreement on Special Class Pooling did was empower the continuation of the CDC role at the direction of the CMSMC. The difference was important because the role of the CDC had changed profoundly in 1995. The old Offer to Purchase Program, under which butter was bought on open offer by the CDC and then sometimes exported, had been eliminated. Instead, the CDC was instructed to be guided by the decisions of the SRC in deciding whether surplus removal activity was required. In other words, the empowerment for any activity was now squarely with the industry, not the CDC.

4.14 Canada emphasized, in respect of the CDC's role as Chair of the CMSMC and its "de facto veto power", as alleged by New Zealand (paragraph 4.5), that the Comprehensive Agreement on Special Class Pooling had now all but superseded the provisions in the NMMP. Pursuant to Article 1 of Schedule I of the Comprehensive Agreement on Special Class Pooling, all decisions relating to matters covered by that Agreement required *unanimity*, including all matters with respect to export trade. Given the breadth of coverage of the Comprehensive Agreement on Special Class Pooling, little of significance was left without a unanimity requirement. Hence, very little scope had been left for the CDC to take a decision where no consensus was reached in the CMSMC. In addition, Canada noted that the Comprehensive Agreement on Special Class Pooling had a formal dispute settlement process to ensure that no "de facto" CDC veto existed. The Complainants would have been better informed if they had taken note of the clear direction given in the Comprehensive Agreement on Special Class Pooling:

"The Canadian Milk Supply Management Committee (CMSMC) will be the supervisory body which will oversee the implementation of this agreement."<sup>57</sup>

4.15 Canada further argued that similarly, the process of negotiation with exporters with respect to the price for Special Class 5(d) and (e) sales was subject to CMSMC control and direction. Even more importantly, the CDC was required under the terms of the Comprehensive Agreement on Special Class Pooling to act in these negotiations as agent. Section 2 of Schedule II of the Agreement stated that the "CDC shall act as agent in carrying out the administrative functions in the operations of the programme".

4.16 Canada emphasized the importance of the character of the Government's participation as it occurred in practice. Canada argued that to suggest that the mere presence of legislative authority under which an industry operated made that business "governmental" in character was untenable. All businesses operated to some degree within legal and regulatory frameworks established by government to ensure that the public interest was protected. If it were true that a legislative framework made business "governmental" then any regulated industry, including banking or utilities, would be deemed to be "governmental" in nature. It would even be possible to argue that private corporations established under corporation law were "governmental". This would be absurd. Obviously, to establish that business was "governmental" in nature, significantly more governmental intervention had to be shown.

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<sup>56</sup> Canada noted that the CDC required under the terms of the Comprehensive Agreement on Special Class Pooling to form the SRC, to be composed of producers and processors. The processors had insisted that they have such a significant role so that their interests would be respected.

<sup>57</sup> The Comprehensive Agreement on Special Class Pooling, the ("P9 Agreement"), Schedule I, Section 1. (Canada, Exhibit 7)

4.17 Canada argued that once established, producer boards were provided with the authority they required to operate their affairs. This was done through enabling legislation.<sup>58</sup> It established the framework for producer board operations and enabled the board to exercise certain functions when and as required. These discretionary functions related to the issuance and administration of quota, the pooling of returns, prices, producer record-keeping and reporting, inspection and the ability to enter into co-operative arrangements with other producer boards and the CDC. The critical point in this regard was that the authority provided to the producer boards was enabling, not mandatory. The producer boards were not directed or obligated by the enabling legislation to carry out certain tasks or functions, as might be the case with mandatory legislation or regulation. The result of establishing producer boards equipped with authority under enabling legislation had to be to allow producers to join together to run their own affairs, subject to a government oversight function to ensure that this authority was used in the public interest. It was absurd to suggest that, where governments had taken steps to enable citizens or industries to govern their own affairs, and withdrawn from or avoided imposing government direction and control, that the resulting self-governing regime was an arm or extension of government.

4.18 Canada noted that the authority provided to the producer boards was now essentially exercised primarily with respect to the domestic market. Producers had to be licensed to participate in the industry either with respect to milk for domestic or export sales. One of the criteria for such licensing was the holding of a minimal amount of marketing quota, quota that could be purchased in the open market. Producer boards only used their pricing authority with respect to the domestic and general use classes (Classes 1 through 5(c)) and, even in those cases, prices were usually the result of negotiations between the producer boards and the processors. More particularly, the pricing authority was not used with respect to the export classes: Special Classes 5(d) and (e). Prices for sale in these classes were the result of transaction by transaction negotiations between the processor/exporter and the CDC, acting as agent for the producers. In addition, the pooling function was not exercised with respect to over-quota sales under Special Class 5(e).

4.19 Canada acknowledged that the CDC was involved in the negotiation with exporters of prices to be paid for the milk for export purposes. However, the CDC was acting under the direction of the CMSMC, whose policies were driven by the producer-run marketing boards. Further, in acting as intermediary with the exporter, the CDC was acting as an agent on behalf of producers and in furtherance of their interests. The CDC was expected to obtain the best possible price for the producers based on prevailing returns in the world market. CDC performance in this regard was carefully monitored by the CMSMC. The producers proceeded on the expectation that the CDC would, in its negotiations, obtain the highest possible return for them. If, on review at the regular meeting of the CMSMC, there was some question that the CDC had not maximised producer returns on the export market, the CMSMC could direct the CDC to abandon the market in question or work to obtain better prices.

4.20 Furthermore, Canada argued that these negotiations were true commercial negotiations. The CDC, acting for the producers, negotiated with competing processors, pressing for the best price for the producers. The exporter sought the lowest price. The competition among exporters coupled with the forces of the international marketplace drove the negotiations. The CDC was in no position to offer, contrary to the interests of the producers, prices lower than those dictated by the world market. Nor could the CDC force an exporter to pay for a particular transaction more than world prices permitted for it to be profitable. The issuance of a "permit" by the CDC was merely a recommendation to the respective board that milk be supplied for a particular proposal. The

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<sup>58</sup> Canada noted that due to the constitutional division of responsibilities in Canada, legislation was required at both the provincial and federal levels. In the case of the dairy industry, enabling authority within the provincial sphere was passed directly to the producer boards through provincial legislation. On the federal side, the required enabling authority was provided initially to the Canadian Dairy Commission, which in turn, pursuant to an agreement, conveyed authority to the provincial producer boards.

producers, through their boards, were under no obligation to accept that recommendation. Nor was the permit recipient required to actually carry out the proposed export. The CDC did not control milk supply. Thus, it was evident that the ultimate control over decisions to produce milk for export and to pursue any particular sale rested with the producers. It was equally evident that control of production and sales relating to exports did not rest with government.

4.21 **New Zealand** noted that Canada did not seek to deny that the CDC and the provincial milk marketing boards and agencies derived their authority from statute. Instead, Canada argued that reference to the statutory basis of these bodies gave a misleading picture because many of the powers that existed in legislation were not used in practice (paragraph 4.16). But this ignored the fact that the statutory powers of a body gave it a status and character that existed regardless of whether all aspects of those powers were exercised in fact. It did not need to exercise every power that it had on every occasion, or at all, in order to maintain the authority that the government had given it. Its governmental authority derived just as much from its residual as from its exercised authority. Thus, describing legislation as "enabling" did not prove anything. The fact that the federal and provincial legislation in question "enabled" the operation of the Special Milk Classes Scheme was not disputed. The question was whether that scheme entailed sufficient government involvement to meet the relevant definition of an export subsidy. In this respect, enabling legislation was an important first step. It "enabled" the construction of the market for milk into two separate markets. It "enabled" the compelling of producers to ship their milk into one or the other of those markets, and it "enabled" the provision of lower-priced milk to exporters, the subsidy that was the subject of this case.

4.22 New Zealand argued that the above could be demonstrated by reference to the authority of the CDC to resolve differences in the Canadian Milk Supply Management Committee (the CMSMC) by its own unilateral decision.<sup>59</sup> The fact that it might not do so in practice, as Canada alleged, was irrelevant. The fact that it had the authority to make such decisions would have a significant impact on the reaching of consensus within the CMSMC. The process of reaching consensus when one party had the ultimate power of decision was fundamentally different from the process of reaching consensus when no one could individually make that decision. Moreover, in this case, the power of decision rested, not just with a private entity, but with an agency vested with all the authority of government.

4.23 Furthermore, Canada had amended the legislation establishing the CDC in order to enable it to implement the Special Milk Classes Scheme. Thus, there was no lack of opportunity for legislative amendment in Canada. If the Canadian Government's argument that the regulation and pricing of milk was not a matter of governmental authority, New Zealand questioned why then it had been necessary to amend both provincial and federal legislation to provide such powers; for example, why had it been necessary to amend the CDC Act to provide that the CDC may "establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream ..."<sup>60</sup>

4.24 New Zealand noted that the process by which milk was accessed for export implicated federal and provincial authorities in an integral way. Exporters had to obtain a permit under Special Class 5(d) or 5(e) from the CDC. That permit was presented to the relevant provincial milk marketing agency in order to obtain milk at the Special Class 5(d) or (e) price. Canada claimed that this permit was "merely a recommendation" (paragraph 4.20). But that was simply a statement about the relationship of the CDC to the provincial marketing agencies, reflecting constitutional authority regarding the setting of prices for milk in a federal system. The exporter had no choice in the matter. The only way to access milk for export in Classes 5(d) and (e) was with a permit. The system was

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<sup>59</sup> New Zealand referred to Section 3 of the Memorandum of Agreement, November 1982, which formed part of the National Milk Marketing Plan (NMMP). (New Zealand, Annex 12)

<sup>60</sup> Section 9(1)(g) of the CDC Act. (New Zealand, Annex 13)

mandatory and the source of that authority was not producer agreement; it was derived from the statutory authority of the CDC and the provincial marketing agencies to compel such behaviour.

4.25 New Zealand argued that Canada's assertion that the CDC operated as a collective bargaining agent for producers, and was controlled by those producers acting through their producer-run marketing boards, equally did not withstand analysis. Canada claimed that the CDC's performance in negotiating prices for exports had to satisfy the boards and the producers or they would require a re-evaluation of CDC practices through the CMSMC (paragraph 4.15). The impression sought to be conveyed was that the CDC was somehow subservient to producers and not exercising government authority. New Zealand claimed that the opposite was the case. The CMSMC could not control the CDC which ultimately had a veto within the CMSMC, whether or not in practice that veto ever needed to be exercised. Naturally, the CDC would want to maximise returns for producers; that was part of its statutory mandate. And, if producers were unhappy with the CDC, political pressure would be brought to bear on it. Yet this was a normal description of how government agencies functioned. It did not demonstrate that somehow the CDC lost its governmental character through participating in the administration of the Special Milk Classes Scheme. New Zealand noted that Canada downplayed the role of the CDC, arguing that it did not exercise the statutory functions that it had in fact been given. Yet, in New Zealand's view, the actual functions exercised by the CDC were more than sufficient to show the necessary government involvement in the administration and operation of the Special Milk Classes Scheme.

4.26 New Zealand noted that Canada also sought to argue that New Zealand had wrongly focused on the CDC when it was the CMSMC which was the key decision-maker in respect of special milk classes. The CMSMC, Canada argued, was not a governmental body (paragraph 4.13). Yet the CMSMC was created under the National Milk Marketing Plan (the NMMP)<sup>61</sup> and the NMMP was described by Canada as a "contractual agreement", hence the CMSMC "is a contractual body not a creation of government".<sup>62</sup> New Zealand agreed that the NMMP was indeed an agreement. Its opening words were "This Plan is a federal-provincial agreement ... ". It was entered into by the CDC, a federal Crown Corporation, and the provinces. In some instances the agreement was signed by the Ministers of Agriculture for the province as well as the representative of the provincial milk marketing board; in other instances it was signed by the milk marketing board for the province. The NMMP was an intergovernmental agreement entered into between the representative of the federal government, the CDC, and the authorised representatives of the provinces who varied province by province. As a result, the CMSMC was a creature of intergovernmental agreement. Thus, to characterise it as a "contractual body not a creature of government" was misleading. The preamble to the Plan recognised that "the participation of the Federal and Provincial authorities is required to assure the adoption and implementation of such Plan".<sup>63</sup>

4.27 New Zealand noted that although Canada did not deny that the CDC was a Crown agency and was the representative of the Government of Canada, it argued that its role on the CMSMC, which it chaired, was not governmental. Canada said that the CDC's role was that of "facilitator and technical adviser," and the CDC "implements the policies and programmes agreed upon in the CMSMC; it neither dictates nor directs them". Such a view ignored the ultimate decision-making powers of the CDC whose influence through research and technical expertise, as well as its authority derived from the fact that it was the representative of the government of Canada, could not be hidden by focusing on a collegial decision-making process within CMSMC meetings. The CDC did not need to "dictate" or "direct" the policies of the CMSMC. The fact that at the end of the day it could do so, gave the

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<sup>61</sup> New Zealand, Annex 12.

<sup>62</sup> New Zealand referred to p. 21 of the text accompanying Canada's audio-visual presentation at the first substantive meeting of the Panel.

<sup>63</sup> New Zealand referred to the fourth preambular paragraph of the NMMP.

CDC *the* central role in the CMSMC. New Zealand noted that in the *Bari* case, the British Columbia Supreme Court had found that the provincial boards and the CMSMC had valid administrative powers – derived from the CDC Act – "to carry out ... the efficient marketing of milk and milk products".<sup>64</sup>

4.28 New Zealand noted that Canada denied that the CDC had a veto power within the CMSMC claiming that the Comprehensive Agreement on Special Class Pooling had "all but superseded" the provisions of the NMMP which grant such authority to the CDC (paragraph 4.14). It was notable that Canada carefully qualified this statement about the redundancy of the NMMP. It was particularly important to do so because what Canada sought to rely on to support its position simply did not prove its point. The "veto power", Canada said, had been replaced by a unanimity rule. But that made New Zealand's point; it did not contradict it. Under a unanimity rule, the CDC would have a "de facto veto power". The Chairman of the CDC, Mr Guy Jacob, when describing the role of the CDC within the CMSMC to the Canadian House of Commons Standing Committee on Agriculture and Agrifood, in March of 1998<sup>65</sup>, said:

"On occasion, the [CDC] Commissioners may take decisions on issues when [the CMSMC] Committee members are not unanimous."

4.29 New Zealand pointed out that in its Annual Report for 1996/97, the CDC stated that it "is largely responsible for the administration of the National Milk Marketing Plan, [and] the federal/provincial agreement governing industrial milk production and management in Canada ...".<sup>66</sup> The reality was that the Special Milk Classes Scheme operated through the combined actions of the CDC, a federal government agency, and provincial milk marketing boards. New Zealand noted that these institutions, acting individually, or collectively within the CMSMC, exercised governmental functions that were essential for the operation of the Special Milk Classes Scheme. They established and administered the quota regime on which the Special Milk Classes Scheme was based. They set prices and determined whether milk was to be sold in domestic or export markets. They prohibited entry by new producers except in accordance with the quota regime. They exercised enforcement authority over both quota holders and those outside the system. In respect of the federal government agency - the CDC - it had specific authority within the framework of the CMSMC when unanimity was not reached. It also issued permits to exporters, which constituted the only way in which access to lower-priced milk could be obtained.

4.30 New Zealand noted that regardless of the *composition* of provincial milk marketing boards, these boards exercised governmental functions - functions that had been expressly mandated by government in the boards' constituent statutes or regulations, or functions that had been delegated to them by the federal government's agency, the CDC. The CDC both functioned independently as a governmental actor under the Special Milk Classes Scheme and was the source of delegated governmental authority exercised by the provincial milk marketing agencies.

4.31 The **United States** stressed that the Special Milk Classes Scheme could not exist without the CDC to oversee its operations. As noted by New Zealand (paragraph 4.23), if this had not been the case, it would have been unnecessary to amend the Canadian Dairy Commission Act to grant specific additional powers to the CDC to supervise establishment of the Special Classes, to empower it to pool revenue from the Special Classes, and to establish the price to be paid.

4.32 In respect of the producers' involvement in the price-setting of milk, the United States argued that while Canada contended that the MOU on Special Class pooling appointed the CDC to negotiate

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<sup>64</sup> British Columbia Milk Marketing Board and the CDC v. Aquilini et al, (Vancouver Registry, No. A950636). para. 31.

<sup>65</sup> Mr. Guy Jacob, President, CDC, p. 2, United States, Exhibit 45.

<sup>66</sup> 1996/1997 Annual Report of the Canadian Dairy Commission, p.5. (New Zealand, Annex 7)

prices with the processors as *agent* for the milk producers, Canada had been unable to point to specific language that established this principal-agent relationship. Canada failed to identify any provision that demonstrated that the CDC negotiated prices as agent for the producers. In fact, Section 4 of the CDC Act specifically stated that the CDC was the agent of the Crown for all purposes of the Act. Indeed, the facts suggested to the contrary that the CDC was primarily negotiating a price for inputs for the exporters that would allow them to be competitive in world markets for processed dairy products. Furthermore, the language of the MOU specifically contradicted Canada's assertion that the producers negotiated the processors' assured margin on the latter's export sales. Paragraph C(1)(vii) of Annex B to the MOU directed that this was the role of the CDC, not the milk producers.<sup>67</sup>

4.33 The United States argued that an examination of the documents that provided the foundation for the Special Milk Classes Scheme revealed that the Canadian argument that producers retained the ultimate decision-making authority was baseless. The United States had already detailed the scope of the powers that Canada's Parliament granted to the CDC to operate the Special Milk Classes Scheme, as well as the authority provided to the CDC to delegate some of its newly-created powers to both the provincial governments and the provincial milk marketing boards – powers which had been provided mainly through amendment of the CDC Act and the Dairy Product Marketing Regulations (paragraph 4.10 and following).<sup>68</sup> The Memorandum of Understanding establishing the Special Classes was an agreement between the provinces and the CDC, a Canadian Crown corporation. Paragraph 11(a) of Schedule I of the MOU stated that "[i]f a Province wishes to become a party to this agreement, its Provincial *Government representative* shall send a note of its intent to the CDC" (emphasis added). The MOU did not state that provinces would join the Special Classes Agreement when the milk producers or the provincial milk marketing boards so decided. The MOU very plainly stated that Provinces joined the Agreement by the action of their Provincial Government representative. While milk marketing boards were also signatories to the Agreement, the dispositive fact for each province was whether its Government representative indicated an intent to join. The United States did not dispute that most Provincial governments conferred with their industry representatives to determine whether the industry supported the Special Classes Agreement. However, government/industry consultations and a government's receptivity to citizen's input did not alter the essential legal fact that the Comprehensive Agreement on Special Class Pooling was first, and foremost, between the Provincial governments and the CDC.

4.34 The terms of the National Milk Marketing Plan, which had long been the centre piece of Canada's dairy supply management, were similar in effect to the Special Class MOU. The opening paragraph of the NMMP stated "[t]his Plan is a federal-provincial agreement in respect of the establishment of a National Milk Marketing Plan ... ". The Preamble, in fact, stated that "the participation of the Federal and Provincial authorities was required to assure the adoption and implementation of the Plan." In contrast, the terms of the Plan made it clear that the participation of milk marketing boards was not essential to the working of either the Plan or the CMSMC. Paragraph H(3) of the Plan provided:

"In the event that there are no Signatories of a province which are producer boards, representatives of producer organizations shall be seated as full participants in the deliberations of the Committee, *except that they shall not have the right to vote.*" (Emphasis added.)

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<sup>67</sup> The United States noted that Annex B of the Comprehensive Agreement addressed the question of surplus removal and confirmed the role of the CDC in the operation of surplus removal. No mention was made at all in this Annex for a decision-making role for milk producers in any of these decisions.

<sup>68</sup> United States, Exhibit 37.

4.35 Moreover, the United States noted that the Governor in Council had delegated some of his powers to the CDC. For example, the Dairy Products Marketing Regulations provided that the CDC shall cause a federal licence to be issued only to a person to whom a share of the portion of the federal quota had been allocated. Moreover, the regulations stipulated that no person should engage in the marketing in inter-provincial or export trade of a dairy product unless the dairy product was, or was made from, milk or cream that was produced by a person who held a federal licence. The CDC, thus, could deny any milk producer that did not possess a federal quota the right to market milk. The regulations were also important in that they provided specifically for the delegation of federal powers to the dairy marketing boards which operated in the various provinces. Thus, when those dairy boards acted with respect to the Special Classes and inter-provincial or export trade, they functioned under powers delegated by the federal government. Hence, the source of the authority for the regulation of the milk marketing in inter-provincial and export trade was federal law and the Canadian Parliament. The entities that had been tasked with performing the functions necessary to implement the legislated regime were also federal and provincial governments, or marketing boards acting with authority delegated from the federal government, not from the Canadian dairy industry. The price the processors paid for milk, both domestically and for export, was determined by the exercise of governmental authority through the operation of the CDC and provincial marketing boards and agencies. The United States noted that Section 3 of Bill C-86, which was the legislation which amended the CDC Act in 1995<sup>69</sup> gave the CDC the authority, with the approval of the Governor in Council, to enter into agreements with a province or a marketing board to set prices, establish pools, and collect prices to be paid.

4.36 The United States noted that Canada had stated that although the CDC issued permits to processors to enable them to purchase milk at reduced prices, such "permits" did not actually require that milk be made available to the processors at such discounted prices. Instead, Canada claimed that the permits were only recommendations, and that the milk boards were not compelled to provide milk to the processors according to the terms of the permit. However, there was no question that the processors could not obtain the milk at the lower price without the permits.<sup>70</sup> In this sense, Canada minimized two equally, if not more, important practical considerations: (i) the milk producers were essentially price takers; and (ii) processors could not access the lower priced Class 5(d) and (e) milk without a permit. Thus, a CDC issued permit was a condition for receipt by the processor of the Special Class 5(d) and (e) milk, and boards possessed few options but to accept the price that was offered.

4.37 **Canada** argued that to the extent that authority in respect of the Special Milk Classes Scheme was conferred on the CDC, this was to assist in the implementation of the decisions taken through the producer-boards and the CMSMC as reflected in the Comprehensive Agreement on Special Class Pooling. Canada stressed that the amendments to the CDC Act were intended to supplement the existing authority of provincial producer boards with the necessary federal enabling authority so that the producer boards could fulfil their tasks effectively. It was not intended by Parliament that the enabling amendments to the Act would result in the CDC directing the producer boards to conduct their functions in a particular way. On the contrary, Section 9.1 of the amended Act contemplated agreements providing for the performance by those very boards of functions otherwise vested in the CDC in respect of inter-provincial and export trade. In the specific case of pricing, Sections 9(1)(g) and 9.1 of the amended Act were together intended to permit the producer boards' pricing functions in respect of Classes 1 – 4 and 5(a), (b) and (c) to be supplemented with the requisite federal authority, thereby filling the legal gap identified in the *Bari II* case. Contrary to what was suggested by the Complainants, the CDC did not, as a result of the inclusion of Section 9(1)(g) in the Act, exercise price-setting powers. Pricing for Classes 1 – 4 and Classes 5(a), (b) and (c) was negotiated and

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<sup>69</sup> United States, Exhibit 15.

<sup>70</sup> The United States referred to the testimony of Mr. Guy Jacob, President, CDC: "In other words in order for an exporter to be able to buy milk at a lower price, he must first obtain a permit from the Canadian Dairy Commission." (United States, Exhibit 45, p. 2)

decided by the provincial boards either directly or through the CMSMC. Pricing for Classes 5(d) and (e) was negotiated on a contract-by-contract basis, with the producer boards exercising ultimate control over the supply of milk at the negotiated price recommended by the CDC. Class 5(d) and Class 5(e) prices were not fixed through the exercise of regulatory powers, whether under Section 9(1)(g) or otherwise, but were established on a commercial basis based on world market conditions.

4.38 In respect of the US assertion that Canada had not identified specific language that established a principle-agent relationship in respect of the CDC's role as agent for the milk producers in price negotiations with processors (paragraph 4.32), Canada drew the Panel's attention to Section 2, Schedule II, Addendum of the Comprehensive Agreement on Special Class Pooling, which stated that: "... that the Canadian Dairy Commission (CDC) shall act as agent in carrying out administrative functions in the operation of the program" and, also, in Section 1, Schedule I to the same Agreement which stated that the CMSMC "... will be the supervisory body which will oversee the implementation of the [Comprehensive Agreement on Special Class Pooling] agreement."

4.39 Canada emphasized that the role of the CDC as a technical advisor and consensus builder – rather than as a decision-maker at the CMSMC – was evident in the setting and allocation of the MSQ. In practice, the CMSMC asked the CMSMC Secretariat to develop estimates of market requirements for Canadian industrial milk (paragraph 2.27 and following refer). The CDC presented the estimates developed by the Secretariat to the CMSMC for consideration in advance of each dairy year. The technical estimates prepared by the Secretariat were then actively debated by the CMSMC. Typically, the market requirements initially calculated by the CMSMC Secretariat were revised on the basis of directions received from the CMSMC. Canada stressed that the CMSMC was in no way bound to accept the figures suggested by the Secretariat. Nor did the CMSMC merely rubber stamp these suggested market requirements. Only after the CMSMC was satisfied with the market requirements estimates was a decision made on the MSQ allocations among the various provinces. Canada reiterated that it was the CMSMC, not the CDC, that decided on the MSQ allocation. Such allocation required unanimity.

4.40 Canada argued that the Complainants had suggested that because many types of discretionary authority had been conferred on the CDC through the CDC Act, this somehow indicated that the CDC carried out all of the things it was empowered to do. This was insupportable both in principle and in fact. First, simply because enabling legislation permitted an entity to carry out certain acts, this did not mean that they would be exercised. The entity could be constrained from acting by other legal obligations, or may simply find that certain actions were not needed in a particular circumstance. Alternatively, it could not be in a political or technical position to undertake the action it was authorized to do. The point was: enabling legislation did not compel any action. In practice, the list of functions actually carried out by the CDC was much more circumscribed than the list of functions in the CDC Act.<sup>71</sup> Further, Canada argued that the Complainants' argumentation ignored the fundamental principle in the WTO and the GATT that obligations were only attached to what a Member actually did, not what they could do. For example, an entity could have all the necessary power to provide subsidies in excess of a Member's obligations, but this was of no consequence unless such subsidies were actually provided.

(c) Government Involvement

4.41 **New Zealand** argued that the Special Milk Classes Scheme was a response to the belief that export subsidies, which existed under the producer levy scheme, would no longer be compatible with Canada's international trading obligations. The fact that Canada had chosen to abandon the producer

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<sup>71</sup> Canada noted that a fuller discussion of the actual activities of the CDC, as opposed to the list put forward in United States, Exhibit 37, was attached as Annex C to its Second Submission.

levy-based subsidies in favour of an alternative scheme made it clear that the reduction and eventual elimination of the incentives provided by those subsidies was not an option Canada was prepared to follow. The Special Milk Classes Scheme was not, as Canada maintained, a response to the fact that as a result of the new WTO Agreements Canada no longer had to limit production of milk. New Zealand argued that the Special Milk Classes Scheme was a substitute for the old producer levy-based subsidy. Moreover, it was a federal government agency, the CDC, that had spearheaded the process that led to the development of the Special Milk Classes Scheme.

4.42 New Zealand noted that the question of the *degree* of governmental involvement necessary for measures to be regarded as government measures had arisen on several occasions under both the GATT 1947 and the WTO. The 1960 GATT Panel studying the obligation on states to notify subsidies financed by a non-governmental levy under GATT Article XVI, spoke of schemes "which are dependent for their enforcement on some form of government action."<sup>72</sup> The Panel on *Japan - Photographic Film* emphasised the fact that where non-binding action of government "creates incentives or disincentives largely dependent on governmental action for private parties to act in a particular manner, it may be considered a governmental measure."<sup>73</sup>

4.43 New Zealand contended that in the present case, an obvious parallel could be drawn with the decision of the Panel in *EEC - Restrictions on Imports of Dessert Apples*.<sup>74</sup> In deciding whether the EEC regime relating to the marketing of apples constituted a governmental measure within the meaning of GATT Article XI:2(c)(i), the Panel noted that:

" ... the EEC internal régime for apples was a hybrid one, which combined elements of public and private responsibility. Legally there were two possible systems, direct buying-in of apples by Member State authorities and withdrawal by producer groups. Under the system of withdrawals by producer groups, which was the EEC's preferred option, the operational involvement by public authorities was indirect. However, the régime as a whole was established by Community regulations which set out its structure. Its operation depended on Community decisions fixing prices, and on public financing; apples withdrawn were disposed of in ways prescribed by regulation. The Panel therefore found that both the buying-in and withdrawal systems established for apples under EEC Regulation 1035/72 (as amended) could be considered to be governmental measures for the purposes of Article XI:2(c)(i)."<sup>75</sup>

4.44 Hence, New Zealand noted that in such a situation, of combined public and private responsibility, the Panel had considered the EEC regime to be governmental in nature - even although the involvement by public authorities was indirect.

4.45 New Zealand contended that the Special Milk Classes Scheme had been initiated with direct government involvement. The CDC, a federal Crown corporation, had identified the need for changes

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<sup>72</sup> Panel Report on *Review Pursuant to Article XVI:5*, adopted 24 May 1960, L/1160, BISD 9S/188, p. 192; Panel Report on *Japan - Trade in Semi-Conductors*, (hereafter "*Japan - Semi-Conductors*"), adopted 4 May 1988, L/6309, BISD 35S/116, pp.154-155.

<sup>73</sup> Panel Report on *Japan - Measures Affecting Consumer Photographic Film and Paper*, (hereafter "*Japan - Photographic Film*"), adopted 22 April 1998, WT/DS44/R, pp. 383-384 (para. 10.45).

<sup>74</sup> Panel Report on *EEC - Restrictions on Imports of Dessert Apples (Complaint by Chile)*, (hereafter "*EEC - Dessert Apples*"), adopted 22 June 1989, BISD 36S/93.

<sup>75</sup> *Ibid*, p. 126 (para. 12.9); *Japan - Photographic Film*, WT/DS44/R, 31 March 1998 at pp. 383-384 (para. 10.45)

to the programmes it offered as early as 1992.<sup>76</sup> It was a participant in the industry Consultation Committee which concluded that export subsidy reduction commitments would "render the use of levies ineffective".<sup>77</sup> A federal-provincial task force was established to review the matter. The CDC chaired the "Dairy Industry Strategic Planning Committee" that recommended a classified pricing system for milk based on end-use and a national pooling system. A negotiating sub-committee of the CMSMC brought those recommendations to federal and provincial Ministers of Agriculture in December 1994. This was the genesis of the government-initiated Special Milk Classes Scheme.

4.46 New Zealand contended that the Special Milk Classes Scheme was implemented through government action. It was embodied in a federal-provincial agreement, the Comprehensive Agreement on Special Class Pooling. The CDC ACT was amended to allow the CDC to administer the Special Milk Class permit system and the pooling arrangements. Under the Comprehensive Agreement on Special Class Pooling the CDC was to "act as agent [of the federal Government] in carrying out administrative functions in the operation of the programme" (Schedule II).

4.47 New Zealand stressed that the scheme required continued government involvement for its operation and enforcement. In order to be effective and to provide the appropriate incentives, the scheme had to be mandatory and new entrants prohibited. This was done through the exercise of statutory authority. Government involvement was therefore essential to the scheme's existence. The mandatory character of pooling, the administrative functions of the CDC and of the provincial milk marketing boards or agencies in the operation of "special milk class" access, pricing and pooling, were all activities of government. Indeed, in *Canada - Import Restrictions on Ice Cream and Yoghurt*<sup>78</sup>, Canada itself had claimed that its milk supply management system constituted governmental measures within the meaning of GATT Article XI:2(c)(i).

4.48 New Zealand claimed that the centrality of governmental involvement in the Special Milk Classes Scheme was readily apparent when the question was asked whether the scheme could continue to operate if the governmental presence were removed. There would be no legislative basis for the operation of the scheme. There would be no NMMP, there would be no Comprehensive Agreement on Special Class Pooling. In the absence of government authority, there would be no mechanism to set prices or to compel compliance except through the agreement of the members of the "producers' club". Nothing could prevent those outside the "club" from marketing milk domestically. There would be no government agency, no CDC, to chair the CMSMC and resolve differences where unanimity could not be reached, and there would be no delegated governmental powers residing in provincial marketing boards. Furthermore, to the extent that some agency was needed to administer a permit system under which access to "special class" milk was provided, it would have to be a private agency established by the producer members themselves. New Zealand argued that the Special Milk Classes Scheme would simply not function if everything was left to private producer agreement. Indeed, any attempt at price setting by private producer agreement would raise questions about compliance with competition laws. It did not do so under Canada's supply management system because of the very involvement of government in the scheme. Hence, government involvement was critical to the functioning of all aspects of the Special Milk Classes Scheme. Canada's argument that the scheme operated through the private activity of producers with only a government oversight function simply was not credible.

4.49 New Zealand recalled that Canada had not argued that there had been any real change to the role of government after the introduction of special milk classes. At no point had Canada sought to

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<sup>76</sup> 1992/1993 *Annual Report of the Canadian Dairy Commission*, p.3. New Zealand recalled that the Dunkel draft was the basis of the Agreement on Agriculture.

<sup>77</sup> Report of the Consultation Committee on the Future of the Dairy Industry, p.12.

<sup>78</sup> Panel Report on *Canada - Import Restrictions on Ice Cream and Yoghurt* (hereafter "*Canada - Yoghurt*"), L/6568, BISD 36S/68, adopted 5 December 1989, p. 73 (paragraph 22).

suggest that special milk classes heralded a shift in the extent of federal and provincial governments' involvement in the dairy marketing system. Instead, the picture Canada painted of government activity within the dairy supply management system was one of continuity. To Canada, it had remained a producer-driven and dominated dairy marketing system (paragraph 4.62). New Zealand argued that, if this were the case, there would not have been sufficient government involvement within Canadian terms under the old producer levy scheme to meet the requirement of government involvement in order to constitute an export subsidy. It would simply have been a system whereby producers within their own organisations - milk marketing agencies and the CMSMC - decided to levy themselves in order to support exports, and government involvement would simply have been to act as the designated agent of the producers to assist in implementing the system. Although this was the consequence of Canada's position, even Canada had admitted that its old producer levy system would have constituted a subsidy under Article 9.1(c) of the Agreement on Agriculture.<sup>79</sup> In New Zealand's view, such an admission undermined Canada's portrayal of government involvement in the Special Milk Classes Scheme.

4.50 New Zealand noted that Canada claimed that the government role was one of oversight only and provincial and federal governments simply provided a framework for the activities of producer-run marketing boards; within the CMSMC, the government's role was to ensure that the system was operated in accordance with the general public interest (paragraph 4.16). Canada sought to equate the role of government in the operation of the Special Milk Classes Scheme, and in dairy supply management more broadly, to that of its role in society generally - to act in the public interest. However, the role of government in the Special Milk Classes Scheme was much more intrusive than the exercise of its general function of oversight in the public interest. Without the active participation of government in the administration and operation of the scheme, including its residual enforcement authority, the system could not work. Instead of describing the nature of the government involvement, Canada had gone to the other extreme and sought to have the government disappear altogether from the Special Milk Classes Scheme.

4.51 New Zealand argued that in the case of non-mandatory measures, the determining factor in deciding whether conduct could be ascribed as resulting from governmental action had been whether there were sufficient incentives or disincentives for the measures to take effect.<sup>80</sup> Most recently, a WTO Panel had noted that "the fact that an action is taken by private parties does not rule out the possibility that it may be deemed to be governmental if there is sufficient government involvement with it".<sup>81</sup> The Panel had gone on to note that it was difficult to establish definitive rules, and that a case-by-case analysis was required.

4.52 New Zealand maintained that under any of these tests the operation of the Special Milk Classes Scheme was a government activity. The scheme derived from the agreement of agencies of the federal and provincial governments created by statute. These agencies administered a supply management scheme that could function only through the interplay of the exercise of federal and provincial authority. The *Bari* litigation demonstrated that provincial authority alone was not sufficient to give effect to a quota regime affecting inter-provincial and export trade. There had to be the joint action of federal and provincial governments to enable the system to function.

4.53 The Special Milk Classes Scheme, as an aspect of Canada's supply management system, was compulsory: essentially, the only way that milk could be sold on the export market was through special milk classes. Producers did not have the option of selling on the export market independently of a government-mandated scheme. The subsidy that exporters received under the Special Milk

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<sup>79</sup> Canada's Second Written Submission, Annex B, pp. 7-9.

<sup>80</sup> Panel Report on *Japan - Semi-Conductors*, *op. cit.*, p. 155.

<sup>81</sup> Panel Report on *Japan - Photographic Film*, *op. cit.*, para.10.56.

Classes Scheme was provided through the cooperative activity of the CDC and the provincial milk marketing agencies. Exporters had to obtain a permit from the CDC and obtain milk through the provincial milk marketing agency. The scheme was thus government-mandated, maintained through the actions of government agencies, and enforced by government authority.

4.54 The **United States** also agreed that milk would not be available to processors of dairy products for export at the indicated prices absent the structure of the dairy regime established by the Canadian federal and provincial governments and which was administered and enforced by those governments. The pervasiveness of the government's role in the Special Milk Classes Scheme was evident from consideration of the legislatively granted authority that those entities possessed and exercised (paragraph 4.4 and following). Despite Canada's claims to the contrary, government action and authority was not transformed into private action simply because private parties, in this case dairy farmer organizations, could approve in specific instances of the actions taken by their government. If this were the case, any action by a government to benefit a portion of its citizenry would be converted into private action. For example, most anti-dumping measures would be "private actions" by definition and the WTO Agreement on Anti-Dumping would be nullified.

4.55 The United States argued that it was sufficient to look to the marketing boards' own statements about the source of their powers to lay to rest Canada's contention that the boards receive their power from the dairy farmers. For example, the British Columbia Milk Marketing Board's Consolidated Order of 1 August 1997, described both its purpose and the basis for the Board's authority. The stated purpose of the Order prominently referenced both the provincial and federal authority that permitted the Board to act.<sup>82</sup> Also, a regulation issued by the Ontario Milk Marketing Board in June 1995 had a similar effect with respect to the powers delegated to it by the federal government as the authority for its control over the marketing of milk produced in the Province of Ontario.<sup>83</sup>

4.56 The United States argued that both the manner of creation of the Special Classes and the actions by the provincial and federal governments following the *Bari II* litigation also refuted Canada's allegations that the Special Milk Classes Scheme represented an agreement between private parties that was simply pursued within an overall legislative and regulatory framework that was government created.<sup>84</sup> Indeed, if the Special Milk Classes Scheme were simply an agreement between the various producer dominated provincial marketing boards, the United States questioned: (i) why any government involvement was required; (ii) why did the Comprehensive Agreement state that it applied only to those provinces whose provincial governments had approved it<sup>85</sup>; (iii) why was it necessary for the Canadian Parliament to amend the CDC Act to provide specific powers to the CDC to operate the Special Classes; and (iv) why such powers could not simply be conferred by the dairy marketing boards in their capacity as representatives of the dairy farmers. Canada had not, in the US view, provided responses to any of these questions. Its only answer was that the provincial marketing

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<sup>82</sup> "The British Columbia Milk Marketing Board (the "Board") has approved this Consolidated Order for the purpose of promoting, controlling and regulating the production, transportation, packing, storing and marketing of milk, fluid milk, and manufactured milk products within British Columbia under provincial authority, and for the purpose of regulating the production for marketing, or the marketing, in inter-provincial trade of milk, fluid milk, and manufactured milk products, under federal authority". The United States noted that then, in the immediately succeeding section of the Order, the Board identified the specific bases for its authority, citing the Natural Products Marketing (B.C.) Act, the British Columbia Milk Marketing Board Regulation, the British Columbia Milk Order - made under the Agricultural Products Marketing Act (federal legislation), and the Dairy Products Marketing Regulations - made under the Canadian Dairy Commission Act (again federal legislation). (United States, Exhibit 43)

<sup>83</sup> "This regulation has been enacted by the Board under its delegated Federal authority to ensure that all milk marketed is covered by the authority of the Ontario Milk Marketing Board. This Regulation makes it clear that the same requirements that exist for producer licenses, license fees, quota, pooling and transportation that apply to local trade apply to any milk attempted to be marketed in inter-provincial or export trade." (United States, Exhibit 44)

<sup>84</sup> The United States noted that Canada's Answer to Question 7 of the Panel also confirmed the necessity of the delegation of additional federal powers to enable the marketing boards to act.

<sup>85</sup> REO Paragraph 11 of the Comprehensive Agreement on Special Class pooling. (United States, Exhibit 5)

boards (which performed most, if not all, of their relevant responsibilities by virtue of powers delegated to them by both the federal and provincial governments) could not remain in office if they did not satisfy the desires of their dairy farmer constituency (paragraph 4.19). The United States argued that if this were the test for determining whether action was governmental or not, any action by a popularly-elected government would be deemed not to be governmental action. Moreover, every time a government agency or legislature took action which benefited a class of individuals, that action would no longer be considered to be governmental in character.

4.57 The United States noted that a body of legal authority had developed in the GATT and WTO that was relevant to the issues before this Panel. Several GATT and WTO panels had considered, primarily in the context of Article XI of the GATT, whether actions by a government that did not impose specific requirements on private parties were, nonetheless, government measures. While this analysis had necessarily to be conducted on a case-by-case basis, the consistent conclusion that each Panel had reached was that action need not be mandated by a government to constitute enforcement of a government measure. This issue was first addressed in *Japan - Restrictions on Imports of Certain Agricultural Products* (hereafter "*Japan - Certain Agricultural Products*").<sup>86</sup> There the Panel had wrestled with the question of whether the Japanese system relating to restrictions on domestic production provided for "enforcement of government measures". The Panel found that the restrictions emanated from the government and that "administrative guidance" from the Government of Japan played an important role in the enforcement of those measures.<sup>87</sup> This principle was taken a step further by the Panel in *Japan - Semiconductors*.<sup>88</sup> In that dispute, the Panel found that "an administrative structure had been created by the Government of Japan which operated to place maximum possible pressure on the private sector to cease exporting at prices below company-specific costs."<sup>89</sup> The Panel concluded that despite the absence of any legally binding obligation, the complex of measures that Japan had adopted operated in a manner equivalent to mandatory requirements.<sup>90</sup>

4.58 Also, the United States claimed that the analysis of the panel which examined *Japan - Photographic Film*<sup>91</sup> demonstrated exactly how schemes such as the Special Milk Classes Scheme fitted within the body of WTO law. The *Photographic Film* panel addressed the related issues of whether certain governmental actions were "measures" for the purposes of the non-violation nullification or impairment remedy under GATT Article XXIII:1(b) and were "laws, regulations or requirements" for the purposes of GATT Article III. Agricultural trade measures of a hybrid nature had been the subject of GATT panel findings. As the *Photographic Film* panel observed, "a 1989 panel on EEC - Restrictions on Imports of Dessert Apples noted that 'the EEC internal regime for apples was a hybrid one, which combined elements of public and private responsibility. Legally there were two possible systems, direct buying-in of apples by Member State authorities and withdrawals by producer groups'. That panel found that both the buying-in and withdrawal systems established for apples under the EEC regulation could be considered to be governmental measures for the purposes of Article XI:2(c)(i)."<sup>92</sup> The rule formulated by the *Photographic Film* panel was that

" ... the fact that an action is taken by private parties does not rule out the possibility that it may be deemed to be governmental if there is sufficient government involvement with it. It is difficult to establish

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<sup>86</sup> Report adopted 22 March 1988, L/6253, BISD 35/163.

<sup>87</sup> *Ibid.*, para. 5.4.1.4.

<sup>88</sup> Report on *Japan - Semi-Conductors*, *op. cit.*

<sup>89</sup> *Ibid.*, para. 117.

<sup>90</sup> *Ibid.*

<sup>91</sup> Panel Report on *Japan - Photographic Film*, *op. cit.*

<sup>92</sup> Panel Report on *EEC - Dessert Apples*, *op. cit.*, p. 126.

bright-line rules in this regard, however. Thus, that possibility will need to be examined on a case-by-case basis."<sup>93</sup>

4.59 The United States noted that the *Photographic Film* panel also examined the Fair Trade Promotion Council's 1984 Self-Regulating Standards. Whereas Japan argued that this Council was a mere private entity, the panel had noted the extensive links between the Council and the Japanese government – "dependence of the Fair Trade Promotion Council on liaison with the JFTC for the establishment of these standards" – and found that these standards were attributable to the Japanese government.<sup>94</sup> The *Photographic Film* panel examined a Retailers Fair Competition Code and its enforcement body, the Retailers Fair Trade Council. Japan argued that this Code was only self-regulation among business entities, and the Council was a voluntary organ to implement this self-regulation. The panel rejected Japan's position:

" ... Viewed in the context of the JFTC having approved the Fair Competition Code and the Retailers Council, and of Article 10(5) appearing to give a governmental exemption from certain provisions of the Antimonopoly Law to actions by the Retailers Council and code members under the code, it is difficult to conclude that investigation, enforcement and governmental liaison actions of the Retailers Council under the code are purely private actions of a private trade association. ... we note that a finding to the contrary would create a risk that WTO obligations could be evaded through a Member's delegation of quasi-governmental authority to private bodies. In respect of obligations concerning state trading, the provisions of GATT explicitly recognize this possibility. In this regard, an interpretative note to Articles XI, XII, XIII, XIV and XVIII states: "Throughout Articles XI, XII, XIII, XIV and XVIII, the terms "import restrictions" or "export restrictions" include restrictions made effective through state-trading operations". The existence of this note demonstrates that the drafters of the General Agreement recognized a need to address explicitly one aspect of the government-delegation-of-authority problem. In our view, it supports our finding that measure for purposes of Article XXIII:1(b) should be interpreted so as to prevent actions by entities with governmental-like powers from nullifying or impairing expected benefits."<sup>95</sup>

4.60 The United States argued that the same dangers that the *Photographic Film* Panel found, also existed in the context of Canada's Special Milk Classes Scheme. Canada was giving disproportionate weight to the involvement of private dairy farmers in the operation of the marketing boards, and would minimize the greater importance of the boards' dependence on powers delegated by the federal and provincial governments in Canada. The United States argued that if the current Panel found that the Special Milk Classes Scheme was outside the WTO Agreements simply because it incorporated some private elements into an essentially government scheme, other countries, led by the United States, would be impelled to similarly rearrange their affairs. The economics of dairy trade provided overwhelming pressure to imitate Canada's regime if it was determined to be WTO consistent, a result which the United States believed would be entirely unjustified.

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<sup>93</sup> Panel Report on *Japan – Photographic Film*, *op. cit.*, para. 10.56.

<sup>94</sup> *Ibid*, para. 10.314.

<sup>95</sup> *Ibid*, para. 10.328.

4.61 The United States emphasized that the Special Class prices for exported milk were determined by the CDC or the provincial marketing boards. This was essentially achieved by the CDC negotiating an assured margin for processors, which was then subtracted with other costs to provide a net return to the milk producers. In cases of exports by the CDC, this was the end of the matter. Where the CDC reached agreement with a processor on a price to be paid to the producers, Canada insisted that the marketing boards then could determine whether to accept the price obtained. Nonetheless, Canada admitted that the boards rarely failed to accept the price. But more importantly, when the boards accepted that price, they were exercising the governmental powers that had been delegated to them. Their actions, therefore, were no less governmental than those of the CDC. It was not an exaggeration that the boards were essentially extensions of the executive branch of the Government of Canada for most purposes relating to regulation of milk marketing and the Special Classes in particular.<sup>96</sup>

4.62 **Canada** argued that governments did play a role, in that they had taken the necessary steps to provide enabling authority to the producers and their organisations to ensure that the system could fulfill its supply management objectives while retaining an oversight function to ensure that such enabling authority was not misused and that the public interest was protected. Subject to this oversight function, governments in Canada had devolved discretionary authority to the dairy industry so it could run its own affairs. This function was diametrically opposed to the fanciful image suggested by the Complainants of coercive government control and direction.

4.63 Canada refuted the US argument that producer boards were essentially extensions of the executive branch of its government (paragraph 4.61). The executive branch of the Government of Canada consisted of officials and departments directed by ministers of the Crown and the principal executive body, the Cabinet, headed by the Prime Minister. Producer-run and producer-controlled provincial marketing boards could in no way be equated with the executive branch of any government, merely because they carried out certain activities pursuant to enabling legislation and were subject to government oversight. Canada rebutted as equally ill-founded the characterization by New Zealand of the producer boards as "government agencies". The hallmark of a government "agency" (referred to in Canadian, and New Zealand, legal parlance as a "Crown agency") was a "body which was subject at every turn in executing its powers to the control of the Crown".<sup>97</sup> The producer boards in the Canadian dairy sector had a vastly greater degree of independence, private accountability and discretion than "government agencies". Hence, far from being government agencies, the producer boards had the character of private agents representing dairy producers. The boards were collective agents for producers as a group. Producers could revoke the agency at any time. However, as was characteristic of a collective agency role performed by trade unions, revocation decisions were made on a collective not an individual basis. Canada argued that the activities carried out by the producer-run boards (the private bodies in question) were necessary for the proper operations of their affairs. The authority provided to them by governments, fell short of the test of being "governmental" in character.<sup>98</sup>

4.64 Canada further refuted the US claim that the recent Panel Report in *Japan – Photographic Film* provided support for the proposition that the Canadian dairy export measures at issue were to be

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<sup>96</sup> The United States referred to Canada's answers to the Panel's Questions 9(a), 8(a) and 7(c).

<sup>97</sup> Canada noted that one of the leading cases on this point in Canada was the Supreme Court of Canada decision in *Westel-Rosco Limited v. Board of Governors of South Saskatchewan Hospital Centre*, [1977] 2 S.C.R. 238 which in turn referred to a decision of the Privy Council, *Metropolitan Meat Industry Board v. Sheedy*, [1927], A.C. 899 holding that an agricultural board which had government-appointed members and was subject to a government veto power on certain matters was nonetheless not a Crown agency.

<sup>98</sup> Canada noted that except for the producer board in the province of British Columbia, which had been given the capacity of natural person, the other provincial milk producer boards had the status of private (i.e., non-governmental) bodies corporate. The *Fédération des producteurs de lait du Québec* was a professional union incorporated under the Professional Syndicates Act (L.R.Q. c. S-40) as recognized by the Farm Producers Act (L.R.Q. c. P-28) and it grouped together 14 regional unions of milk producers. It was charged by producers to act as a marketing board and to administer the collective marketing plan established following a decision of its members.

treated as governmental in character (paragraph 4.58). Canada argued that that panel report did not provide a rule with respect to determining whether or not a measure is governmental:

"These past GATT cases demonstrate the fact that an action taken by private parties does not rule out the *possibility* that it may be deemed to be governmental if there is sufficient government involvement with it. *It is difficult to establish bright line rules in this regard, however. Thus, that possibility will need to be examined on a case by case basis.*"<sup>99</sup> (emphasis added)

4.65 Canada argued that an examination of GATT cases showed, if anything, that the opposite conclusion than that argued by the United States could be drawn. The *Japan – Semi-Conductors* case,<sup>100</sup> involved a situation where the Government of Japan had initiated a policy of its own volition and then sought to impose it on the industry. In the words of the panel in *Japan – Photographic Film*, this policy was "operated to exert maximum possible pressure on the private sector".<sup>101</sup> Thus, this was a clear case of top-down direction from government, through the private sector. By contrast, it was clear that in the present case there was no policy being imposed by governments. In particular, there was no government imposed policy whatsoever on export methods or levels. This was left to the producers and producer boards to determine. Involvement by government had been limited to oversight. The Complainants had referred to the *EEC – Dessert Apples* case (paragraphs 4.43 and 4.58) suggesting that the facts in that case were relevant to the current matter. As in the case of *Japan – Semi-Conductors*, Canada pointed out that the fact was that the measures in question in *EEC – Dessert Apples* represented top-down government direction in a mixed government/private sector environment. In particular, the Panel in *EEC – Dessert Apples* noted:

"The regime as a whole was established by Community regulations which set out its structure. Its operation depended on Community decisions fixing prices, and on public financing; apples withdrawn were disposed of in ways prescribed by regulation."<sup>102</sup>

4.66 Canada argued that the distinction between the *EEC – Dessert Apples* situation, with direct action by government to implement the policy, and the present case where government provided enabling discretionary authority without policy direction was obvious. In sum, the theme through all these cases was one of governments participating in a top-down, policy-directing and initiating role. The Complainants had failed to show any evidence of governments in Canada setting and dictating policies with respect to the operation of the Canadian dairy system and, in particular, the Special Class export practices at issue. Accordingly, this was suggestive that, using the case-by-case approach, the current case fell outside of the type of situation that could be considered to be governmental.

4.67 Canada further refuted the significance attributed by both New Zealand and the United States to the *Bari* case. The *Bari* cases involved a group of non-licensed British Columbia producers and a processor who were custom processing milk for those producers for marketing in inter-provincial trade. The litigation arose well before the Special Milk Classes Scheme was introduced and, more importantly, had nothing whatsoever to do with export trade in milk or milk products. In response to constitutional gaps in the domestic milk marketing regime identified at an earlier stage in the

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<sup>99</sup> Panel Report on *Japan – Photographic Film*, *op. cit.*, para. 10.56.

<sup>100</sup> Panel Report on *Japan – Semi-Conductors*, *op. cit.*

<sup>101</sup> Panel Report on *Japan – Photographic Film*, *op. cit.*, para. 10.54.

<sup>102</sup> Panel Report on *EEC – Dessert Apples*, *op. cit.*, p.126, para. 12.9.

litigation, regulations were established in 1994 pursuant to the CDC Act. The *Bari III* case referred to by New Zealand addressed the validity and applicability of the Regulations in a purely domestic context. The *Bari* litigation had little relevance to the export of products made from milk sold under Special Classes 5(d) and (e).

4.68 Canada also refuted the Complainant's assertion that milk would not be available to producers of dairy products for export at the indicated prices absent the structure of the dairy regime established by the Canadian federal and provincial governments (paragraphs 4.48 and 4.54). Canada argued that the reality was that export milk was sold to processors at prices negotiated in arms-length transactions directly responsive to world market conditions. Canada argued that even if the CDC were to cease to perform the negotiating activities on behalf of producers that it currently performed, the realities of the world market which drove those export prices would still be the same. Indeed, Canada argued that if the CDC were to exit the export pricing negotiations altogether and producers were to negotiate export sales through their producer boards, processors might easily succeed in negotiating a slightly lower price with nine producer boards having less experience than the CDC in world markets. In this context, to assert the existence of a "benefit" to Canadian processors flowing from the negotiating role performed by the CDC was not only counter-intuitive, it was nonsensical.

4.69 Canada cautioned the Panel in respect of New Zealand's arguments relating to the 1960 Working Party Report regarding the notification of export subsidies under Article XVI of GATT 1947 (paragraph 4.41). That Working Party Report occurred in a context in which there was no consensus among GATT Contracting Parties as to what constituted a subsidy. The entire focus of the report was to decide what measures were to be notified. Accordingly, the report advanced the Contracting Parties trade policy objectives by requiring notification of certain matters so that the Contracting Parties could assess the resulting trade impacts. Given that there now existed binding obligations with respect to subsidies, the Panel had to be careful in using that Report for the purpose of reading context into the definition of "subsidy".

4.70 The **United States** noted that Canada argued that the *Bari* case was irrelevant because it allegedly did not address the issue of exports. This was a remarkable statement by Canada in light of the fact that the principal issue was the authority of the provincial boards over export and inter-provincial trade. In addition, the Canadian court specifically addressed the question of the authority to impose a levy on production. That levy, of course, was used to fund exports and to allow exports of dairy products to be competitive on world markets. Those issues appeared to the United States to be relevant to exports despite Canada's protestations to the contrary.

4.71 In respect of the 1960 Panel Report, the United States noted that Canada's argument that the 1960 Panel Report regarding notification of subsidies should not be given weight because it was issued at a time when the current consensus on those subsidies under the current Agreements had not been concluded totally ignored the fact that the view of producer-financed subsidies had not changed in over 30 years since the Report was issued. In fact, relevant language to this dispute first appeared in that Report and now had been incorporated into the SCM Agreement. Those considerations argued for greater not less weight for the 1960 Report.

(d) Producers' Involvement

4.72 **New Zealand** noted that the Canadian arguments focused almost exclusively on the role of producers within the system in order to distract the Panel from the fact that it was exporters, and not producers, who were being subsidized. New Zealand recognized that producers operating individually and collectively were *involved* in the export regime for Canadian milk products. The fact that a body was composed of producer members did not alter the character it had been granted through its statutory mandate (paragraph 4.21). The power "to regulate the marketing of milk in inter-provincial and export trade" - a power possessed, for example, by the British Columbia Milk

Marketing Board<sup>103</sup> - did not cease to be the exercise of a governmental regulatory function in respect of export trade because the Board happens to be composed of producers. New Zealand argued that contrary to the impression conveyed by the Canadian arguments, provincial milk marketing boards were not producer clubs. They had regulatory functions, and their authority to regulate was derived from statute, not from the agreement of producers. Milk producers had to comply with the decisions of the provincial boards. They had no right to produce milk and market it except in accordance with the systems established through the combined actions of the CDC and the provincial marketing boards and agencies. Access to the system could only be gained through the purchase of existing quota.

4.73 New Zealand noted that Canada had also sought to portray the production of milk for export as the result of the individual decisions of producers relying on their own business sense (as argued by Canada in paragraph 4.109). Yet the power of individual producers was largely limited to deciding upon their level of milk production. The revenue they received for that milk did not depend on market forces. The revenue a producer received depended on whether the milk produced was classified as in-quota or over-quota, and whether it was exported or sold on the domestic market. And those decisions were not made by the individual producer. They were made through the interaction of the CDC and the provincial milk marketing boards and agencies, under the auspices of the CMSMC (further argued in paragraph 4.93 and following).

4.74 New Zealand argued that Canada's description of the operation of the Special Milk Classes Scheme as one that was "developed on a bottom-up basis by Canadian producers" where Governments simply implemented what they were directed to do by producers was an implausible explanation of how governments operated. In any event, it did not prevent the conclusion that there was an export subsidy.

4.75 The **United States** noted that Canada argued that the Special Milk Classes Scheme gave milk marketing in Canada a market-orientation that it had lacked under the producer levies that were eliminated during 1995. In particular, Canada contended that whereas the old system was dependent largely on supply management, the new Special Milk Classes Scheme allowed Canada's milk *producers* to price to the various markets available for their products. At the core of Canada's argument was its assertion that the over-quota levy that existed under the pre-1995 system served as a disincentive to production above quota limits.<sup>104</sup> The United States argued that since the Special Class prices were set at approximations of the world market prices, there appeared to be comparatively little difference between the economic treatment of over-quota production under the levy system as contrasted with the present Special Class 5(e), which was applicable to over-quota production. Canada's assertion that the change to the Special Milk Classes Scheme heralded a new day of producer independence was, in the US view, unfounded.

4.76 The United States stressed that producers could not on their own achieve the national coordination of prices and production that was essential to the operation of the Special Milk Classes Scheme. Canada had, in their view, exaggerated the legal basis for the producers' role in the system and particularly their role in decision-making. The United States claimed that Canada ignored two important factors. The part played by producers was permitted by: (i) the delegation of government powers to producer marketing boards; and (ii) the provincial governments' designation of producers as representatives to the CMSMC. In both instances the producers' participation was at the discretion of the governments involved.

4.77 The United States argued that the omission of several critical facts distorted Canada's portrayal of the scope of the legal authority possessed by the milk marketing boards in their role as

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<sup>103</sup> Section 3 of the British Columbia Milk Order, 1994, (SOR/94-511).

<sup>104</sup> The United States referred to Canada's First Submission, para. 42.

*designated* representatives for the Provinces on the CMSMC. While Canada contended that most of the voting representatives participating in the Canadian Milk Supply Management Committee were from producer marketing boards, Canada neglected to give any weight to the most critical fact. The voting representative from each province was selected by the provincial government, the provincial government commission overseeing the industry, and the provincial marketing board.<sup>105</sup> Thus, any *producer* who was a representative of a province at the CMSMC did so by virtue of the decision of three separate entities, two of which were entirely governmental. Therefore, any producer representative designated to sit at the CMSMC table did so at the discretion of the provincial governments. Even were this not the case, the fact that producers sat on the CMSMC, a policy making committee, again did not alter the fact that the CMSMC itself was a creation of a federal-provincial government agreement. Canada, which contended that the CMSMC was run by milk producers and was the decision-maker for dairy policy, also failed to explain why Canada's Attorney-General in the *Bari* litigation described the CMSMC as "a federal body, a federal functionary ...

"In discharging its duties under the *Federal Regulations*, the Committee acts as a federal body, a federal functionary concerned solely with matters related to the federal quota.

This exercise of co-operative federalism, suggested by many judicial decisions as the only practical and effective way to regulate in Canada the marketing of agricultural products under divided jurisdiction, is at the heart of the Governor in Council's recognition of the Committee. The Committee's composition includes, *inter alia*, representatives *appointed* by provincial signatories who are bodies *established under provincial law to exercise statutory powers* in relation to the marketing of dairy products in intraprovincial trade." (Emphasis added.)<sup>106</sup>

4.78 The United States argued that while Canada's portrayal of the provincial milk marketing boards admitted that federal and provincial delegation of powers were essential to their functioning, Canada failed to acknowledge the binding decision-making powers of the provincial government authorities respecting the boards' operations. The CDC's website description of the operation of dairy management in each of the provinces was enlightening for this purpose.<sup>107</sup> In connection with the province of Nova Scotia, the CDC's internet site stated: "The Nova Scotia Dairy Commission is a government agency which controls the province's marketing." In Ontario, according to the same report, "[t]he Farm Products Marketing Commission, a branch of the Ontario Ministry of Agriculture and Food, acts as a supervisory board for the industry." With respect to Quebec, the website stated that: "In all cases of unresolved dispute, the Regie des marches agricoles et alimentaires - a government organization - has the authority to intervene, and will act as a tribunal and hand down a final and binding decision." In New Brunswick, the same report explained that while the milk marketing board possessed the main responsibility for milk marketing, the Farm Products Marketing Commission, a government agency, which administered the Farm Products Marketing Act, oversaw the activities of the milk marketing board. As Canada already admitted that the milk marketing boards in the provinces of Alberta and Saskatchewan were government operated, there was no need to examine them further. Thus, in at least six of the provinces, accounting for an overwhelming majority of milk production, the provincial governments retained ultimate authority respecting the operation of the milk marketing boards. Although the milk producers could choose who sat on the board, it was

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<sup>105</sup> Canada's Second Written Submission, Annex B, footnote 4.

<sup>106</sup> Outline of the Argument of the Attorney General of Canada, paras. 47-48 (United States, Exhibit 29)

<sup>107</sup> United States, Exhibit 54. (This United States Exhibit, in addition to including documents from the CDC's website, includes a chart excerpted from the Report identified in United States, Exhibit 25.)

the provincial and federal governments that determined the respective board's authority, and it was the provincial government that had the final say on the operation of the boards.

4.79 Hence, the United States argued, regardless of the fact that producers had a role in the Special Milk Classes Scheme, which was not denied by United States, the fundamental authority, practices, and operations necessary for the national application of the Special Milk Classes Scheme were governmental. That the governments at both the federal and provincial levels had entrusted certain powers to the milk marketing boards, and thus indirectly to producers, did not alter the fact that the powers exercised by those boards were governmental in origin and that the boards as institutions were ultimately answerable to the overseeing government authorities.

4.80 The United States argued that the Special Milk Classes Scheme, as outlined in its own and New Zealand's arguments above, was created under the authority of the federal and provincial governments, and was administered, maintained, and enforced by them. Now that it existed, milk producers did not have a choice in its application. Milk producers could not market the milk that they produced without a government assigned quota and a CDC issued license. Milk producers also did not have any input into whether their milk was sold into one of the Special Classes or another. They could not opt not to participate in the Special Class pool.

4.81 In respect of price, the United States stressed that the dairy farmer had no input in the pricing of milk for over-quota production. Canada stated that all over-quota production received the 3 month rolling-average Special Class 5(e) price. The Special Class 5(e) price was approximately 50 per cent of the price obtained for the same milk components in the domestic market in Canada. The milk producer had absolutely no ability to sell over-quota milk at the domestic price levels. The Special Milk Classes Scheme closed this alternative to the milk producer. Although Canada asserted that the CDC, a Crown corporation, only negotiated the Special Class 5(e) price for the farmers and their boards, Canada had conceded that the price was rarely, if ever, rejected by either. Yet, for example, the British Columbia Consolidated Milk Marketing Order provided in Part VIII, paragraph 31, that "[t]he Board will determine the minimum Producer price for over quota production based upon the calculated world price published by the Commission."<sup>108</sup> It was noteworthy that this regulation did not say that the Board *could* base the Producer price on the Commission published price, but that it *will* base the price on the CDC published price. Similarly, the Manitoba Milk Producers newsletter published monthly the CDC Special Class price for over-quota production and indicated that this was the price that would appear on producers' monthly pool statements.<sup>109</sup> Again, this left little question but that as a practical matter, the CDC calculated price was the only price available for over-quota milk.<sup>110</sup> In this sense, the United States argued that it would be more accurate to state that the CDC was negotiating a milk price for the dairy exporter, rather than for the dairy farmers. This was because a dairy processor with an opportunity for an export sale approached the CDC with the price that it could obtain in the international market for the dairy product export, such as butter, or cheese. The CDC then negotiated with the processor/exporter an "assured margin" which incorporated an

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<sup>108</sup> "Commission" was defined elsewhere in the Order to mean the Canadian Dairy Commission. Part I, paragraph 3 of the Order. (United States, Exhibit 43)

<sup>109</sup> The United States noted that in each month, *Milkline*, the Manitoba newsletter reports the over-quota prices in this manner: "The following is the price for over-quota production (world price) effective September 1, 1996, as calculated by the Canadian Dairy Commission." (Emphasis added.) The world price will be reported regularly in the *Milkline* and on the monthly pool statement. (United States, Exhibit 47)

<sup>110</sup> The United States noted that it was worth considering what alternative the board had if it found the CDC negotiated price to be unacceptable. Given that milk was a highly perishable product, the board did not have long to consider its options. Furthermore, since the Class 5(e) permits were only issued, according to Canada, when the milk in question was surplus to domestic requirements and could not be sold in the domestic market at the prices set for that market, what real alternative did the board have except to accept the CDC determined price?

amount for profit as well as the processor's costs.<sup>111</sup> This amount was then subtracted from the processor's selling price for butter, cheese, or some other dairy export in world markets. The international sales price for the dairy export, less the processor's "assured margin," was the amount paid to the dairy farmer for his or her milk.

4.82 Thus, the entire calculation procedure was aimed at assuring a price to the processor/exporter that allowed the export to take place at world market prices. While presumably the interests of the dairy producers were considered, the over-riding objective was to ensure that surplus dairy products were exported. The major benefit derived by the milk producers from such exports was that they assisted in administering the supply management of dairy products and producers got some return for this surplus production. Without such exports, the surplus would be destroyed with obvious political ramifications.

4.83 Hence, the United States submitted that Canadian exporters of dairy products were provided with milk priced at the lower Special Class 5(d) and (e) levels only as a result of the Special Milk Classes Scheme, that had been put into place by the joint action of the federal Government of Canada and the provincial governments. Without the government action that required the removal of surplus in-quota and over-quota production at prices negotiated or set by the CDC, those producers of dairy product exports would not receive the lower priced milk necessary for them to compete in international markets. It was not normal commercial practice for a government entity to customize the price of an input to match particular sales opportunities.

4.84 **Canada** maintained that the creation of the Special Milk Classes Scheme was a producer-initiated process and that contrary to the assertions of the Complainants, the Special Milk Classes Scheme was not imposed by governments. It was developed on a bottom-up basis by Canadian producers through their producer organizations and the producer-dominated CMSMC. Through their decisions in these bodies, the producers had reached agreement on the principles that would form the foundations of such a system. In those resolutions, they called on governments to take the necessary steps to provide the enabling authority that would allow such a system to come into being.

4.85 Canada noted that as early as 1993, proposals were being circulated for a revision of the Canadian supply management system to include new features such as possible pooling systems and an optional export programme. The purpose of these proposals had been to respond to perceived new market conditions and to introduce added flexibility and competitiveness so as to take advantage of the new export opportunities that would emerge from the conclusion of the Uruguay Round. In Quebec, for example, an early initiative in this direction was taken at the 14-15 April 1993 meeting of the General Assembly of Fédération des producteurs de lait du Québec to begin the process of renegotiating the terms of the NMMP. Further decisions in the General Assembly in 1994 and 1995 advanced this process, particularly with respect to regional pooling arrangements. These decisions fundamentally modified the basis of the Quebec dairy marketing plan and the conditions that applied to the marketing negotiations conducted between producers and processors in Quebec. Parallel developments were taking place within the industry in other provinces, developments that ultimately culminated in the decisions taken at the CMSMC to propose the Special Milk Classes Scheme. Thus, Canada argued that governments in Canada had not imposed arrangements on the dairy producers and processors. Governments had responded to the initiatives of the industry by providing the discretionary authority required to implement industry proposals, provided those proposals were in the public interest. On the other hand, had the processors and producers rejected the concept of a national Special Milk Classes Scheme, it was quite certain that such a system would never have been implemented.

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<sup>111</sup> The United States noted that Sub-paragraph (vii) of Annex B of the Comprehensive Agreement provided that a processor would receive an assured margin and that the level of the margin would be negotiated by the CDC with the processor. (United States, Exhibit 5)

4.86 Canada argued that the object of the supply-management system in Canada had been to provide the Canadian dairy industry with the means by which they could effectively govern their own affairs, so as to yield a fair return to producers while balancing the interests of processors and consumers. The purpose of the supply management system was to take the necessary steps to match, as closely as possible, the quantity of milk to be marketed for domestic use with Canadian domestic demand. This, coupled with border measures to control imports into the domestic market, allowed for the maintenance of price levels for milk in the domestic market higher than would otherwise be obtained in the absence of such measures. In order to provide Canadian dairy producers with the means to operate such a system, governments in Canada had put in place the legislative and regulatory framework to allow such a self-governing regime to function. Provincial governments had passed enabling legislation to provide for the establishment of producer-run marketing boards.

4.87 It followed that the Canadian dairy marketing system rested on the foundation of the producers themselves. Canada noted that the United States conceded that the producer-run boards were "private entities", "private parties" and "dairy producer organizations".<sup>112</sup> They were organised throughout Canada, from the local level, including co-operatives, and then up to the provincial<sup>113</sup> and national<sup>114</sup> levels. Through these producer organisations, the individual producers maintained close links with each other and had an effective means for the development of policies and other marketing initiatives. At the provincial level, the key producer-controlled institutions were the milk marketing boards (the "producer boards"). In each province, these boards only came into being through an affirmative vote of the producers. In most provinces,<sup>115</sup> and in Ontario and Quebec in particular, the membership of the boards consisted exclusively of producers. Through on-going consultations at the district and provincial levels, the producers held these elected representatives responsible for their actions. In Quebec, many of the important decisions of the board were the subject of individual voting at general meetings of the producers. Thus, without question, the boards were controlled by, and act on behalf of, the producers.<sup>116</sup>

4.88 Canada argued that the heart of the Canadian dairy system was to be found in the CMSMC (paragraph 2.27). The central actors in the CMSMC were the various provincial producer boards. Each province sent a delegation. These delegations were led by "designated representatives" who were senior executives with the respective producer boards.<sup>117</sup> Provincial government officials participate in an oversight role, without having voting rights. It was the producer board representatives who had the right to vote on and thus directly participate in the CMSMC decisions. As a result, for seven of the nine provinces, representing 92 per cent of Canada's dairy producers, the designated representative was a dairy producer elected to the producer board by fellow dairy producers.<sup>118</sup> Canada noted that even a cursory review of the signature pages of the Comprehensive Agreement on Special Class Pooling showed the signatures of producer boards in addition to the signature of government officials. Nevertheless, Canada did not argue that *only* the producers or the

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<sup>112</sup> Canada referred to the United States' Second Written Submission, paras. 59 and 10.

<sup>113</sup> At the provincial level, the key organizations were the producer run boards, e.g. the *Dairy Farmers of Ontario*, the *Fédération des producteurs de lait du Québec*, and the *Manitoba Milk Producers*.

<sup>114</sup> At the national level, the producer organization was the *Dairy Farmers of Canada*.

<sup>115</sup> Canada noted that this did not include Nova Scotia, Saskatchewan and Alberta. These three provinces represent less than 10 per cent of Canadian dairy producers.

<sup>116</sup> Canada noted that the very names of the producer boards in Ontario and Quebec, in particular, gave testimony to the boards' own view of themselves: in Ontario, the *Dairy Farmers of Ontario* and, in Quebec, the *Fédération des producteurs de lait du Québec*.

<sup>117</sup> Except in Nova Scotia, where the designated provincial representative was a member of the Board of the Nova Scotia Milk Producers Federation and the President of the *Dairy Farmers of Canada*.

<sup>118</sup> Canada noted that Annex A (attached to its Second Submission) contained a full list and biographical background to the designated provincial representatives to the CMSMC. Canada also referred to comment #2 in Annex 13 with respect to the mischaracterization of provincial delegation representation in Exhibit 36 of the United States. The only non-dairy producer designated representatives were from Alberta and Saskatchewan, which accounted for less than 8 per cent of Canada's dairy farmers.

industry were involved. The Comprehensive Agreement on Special Class Pooling, like the NMMP and the CMSMC, represented a co-operative arrangement in which all interested parties, the producers, through the producer boards, and government representatives in their public interest capacity<sup>119</sup> participated.

4.89 Canada argued even a minimal knowledge of Canadian political life would confirm that no federal government institution could ever begin to dictate to provincial representatives where provincial jurisdiction and interests were at stake. Indeed, in this case, the chief provincial speakers were representatives of the industry, not government, this made the picture of unilateral federal government action painted by the Complainants even less credible. The true character of the CMSMC, based on co-operation and consensus, was representative of the character of the Canadian dairy system as a whole. Although the processors did not have voting status in the formal arrangements for the CMSMC, they had a prominent role at the CMSMC table. This was because, as a matter of practice, every effort was made to reach a consensus that could be supported by all provincial producer representatives as well as the other stakeholders in the industry.

4.90 Canada noted that the Complainants, rather than addressing the CMSMC, preferred to stress the CDC, a federal crown corporation, suggesting that it was the true controller of the Canadian dairy system. Their approach was understandable given the true character of the CMSMC, i.e., control in the hands of the producers in consultation with other concerned parties, and the difficulties that this presented for the Complainants' case. Canada argued that whereas the NMMP had provided that the CDC could take decisions for the CMSMC where no consensus was reached in the CMSMC, the provisions of the Comprehensive Agreement on Special Class Pooling took that override authority away with respect to all matters covered by that Agreement (paragraph 2.33). Since the matters covered by the Comprehensive Agreement on Special Class Pooling were very broad, this had left very little subject to the original override provision in the NMMP. This reality fundamentally undermined the attempt by the Complainants to allege that it was the CDC that controlled the Canadian dairy system, not the CMSMC.

4.91 Alternatively, Canada noted that the Complainants had argued that even to the extent that the CMSMC ran the system, it was a body composed of government officials. Canada recalled that for meetings of the CMSMC, for seven of the nine provinces, it was the representative of the producers who took the lead in discussions between provincial delegations. This producer representative, the "designated representative", was elected to the respective producer board by fellow dairy producers. As a result, it was producers who spoke most prominently with respect to the various aspects of the Canadian dairy system as they were brought before the CMSMC and this provided an important flavour to the nature of those proceedings. Nonetheless, representatives of provincial governments did attend and did speak at the meetings of the CMSMC when matters arose touching on their responsibility to oversee the public interest. Thus, through its consensus-based decision making structure, the CMSMC served to bring together the representatives of industry who took the lead on operational matters and representatives of government who ensured that the public interest was respected.

4.92 Canada noted that with respect to the processor margins (paragraph 4.81), transactions occurred at the highest milk price which the CDC believed it could achieve, subject to the potential exporter's willingness to participate. Canada argued that there were no standard mark-ups or margins, although the CDC used the return for milk producers that would be generated by making butter and SMP for export as the baseline in negotiating the milk price. The processor margin for CDC export sales was the subject of extensive negotiations between producers and processors following the completion of the Comprehensive Agreement on Special Class Pooling on how the surplus removal system would be implemented.

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<sup>119</sup> Canada noted that this public interest included ensuring that the interests of consumers and the processors were respected.

(e) In- and Over-quota Milk and the Producers' Choice

4.93 **New Zealand** noted that Canada placed considerable emphasis on the distinction between in-quota and over-quota milk that was destined for export. New Zealand maintained that the objective of the Canadian distinction between in-quota and over-quota milk was to distance over-quota milk even further from government agencies such as the CDC and the provincial milk marketing agencies. However, the distinction between in-quota and over-quota milk was an irrelevant distraction. It was an artificial distinction created for Canadian regulatory purposes that had no reflection in reality. Milk was milk in the tank or in Special Class 5(d) or (e). What Canada had done through the Special Milk Classes Scheme was to determine that the revenue that producers received for their milk would be based on one price for a certain quantity of milk and on a different price for another quantity of milk. Canada had decided that exporters were to pay a different price for milk for products destined for export than that for products destined for domestic consumption; it had thus provided an export subsidy regardless of whether the milk sold to processors for export was classified as in-quota or over-quota milk.

4.94 New Zealand noted that the distinction between in-quota and over-quota milk was not clear-cut as Canada described it. Whether or not an increase in producers' supply would constitute over-quota production was a determination made by others, not by the producers. Each province managed a complex system according to its own rules. As the Chairman of the CDC had said in April 1998, "there are almost as many ways to manage provincial quota, over-quota production and payment mechanisms as there are provinces".<sup>120</sup> Most provinces had a complex monthly credit and debit system according to which producers who did not fill their quota one month could carry over "quota credits" for future months, or indeed, in the case of Manitoba, for future years.

4.95 New Zealand noted that Canada claimed that over-quota production arose when producers in a province produced milk in excess of their quotas *and as a result* the province as a whole exceeded its share of the national MSQ in a month. Thus, whether a producer produced what ultimately would be determined to be over-quota milk might depend on the level of production in the province as a whole. Furthermore, it was ultimately the CMSMC which decided what would be sold as in-quota and what would be sold as over-quota milk. Hence, a producer could not know whether milk produced on any particular day, week or month would be treated as in-quota or over-quota, or whether it would be used for domestic or for export purposes. A producer could simply decide to produce more milk. The consequences of producing more milk were in the hands of the milk marketing boards and the CMSMC. Thus, the concept of producers systematically deciding to produce over-quota milk for export purposes after considering current world market prices was far-fetched.

4.96 Nevertheless, New Zealand emphasized that focusing attention on whether a producer produced in-quota or over-quota milk ignored what was really at issue in this case. That was, whether providing exporters with access to lower-priced milk for products destined for export - as occurred with Special Class 5(e) in- and over-quota, as well as with Special Class 5(d) - constituted a subsidy within the meaning of the Agreement on Agriculture.

4.97 New Zealand argued that Canada's claim that individual producers decided, on market considerations, whether to produce over-quota milk misrepresented the facts. Over-quota milk production was not always a result of a deliberate decision by a producer to produce for export.<sup>121</sup> It made sense for producers to slightly overshoot their quotas to allow for fluctuations in milk

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<sup>120</sup> The Chairman of the CDC's Address to the Federation des Producteurs de Lait du Quebec. New Zealand noted that this text was available on the Canadian Dairy Commission's Website (<http://www.cdc.ca>).

<sup>121</sup> New Zealand noted that Canada had noted that only those producers who produce in excess of 105 per cent of their quota were considered to be deliberately producing for the export market. In fact, Canada had admitted that only one third of producers produced milk in excess of 105 per cent of their quota. (Footnote 37 of Canada's First Submission, para. 47)

production caused by weather or biological factors. This was not a deliberate decision to produce for the export market; it was a rational decision to maximise revenue by ensuring they do not underfill their more lucrative in-quota entitlement.

4.98 The **United States** argued that milk was milk; it was not labelled in-quota or over-quota when it was sold – the distinction was not of concern to processors or exporters. What was of concern to exporters was the ability to access their major input at a low cost, which was precisely what classes 5(d) and (e) set out to achieve. Like New Zealand, the United States emphasized that there were a variety of factors, mostly beyond the control of Canadian dairy farmers, that determined whether there was over-quota production in the first place. Many factors, including weather, quality of feed, and the biological condition of the dairy herd, would affect the amount of milk produced in any given time period. Thus, despite a farmer's best efforts to confine production to the amount of his/her quota, doing so was more an art than a science. Production could not be regulated with precision. Moreover, a farmer had an incentive to try to produce the full amount of his/her quota. This was because producing the full amount of quota provided the best opportunity to recover as much of the applicable fixed costs of production as possible since within-quota production was entitled to receive the higher domestic prices, or, at least, a blended price that included primarily higher domestic prices.

4.99 The United States argued that several authorities had testified regarding the difficulty of precisely producing to the level of the quota. Mr. Rick Phillips, Director of Government Affairs, Dairy Farmers of Canada, made the following statement regarding the uncertainty of over-quota production:

"In 1997, Dairy Farmers of Ontario conducted a survey to determine the extent of producer interest in providing milk for the Optional Export Program. Now, as you probably differentiate this milk supply, which represents a conscious and voluntary exposure to world markets from over-quota milk - and I wouldn't want that to be said in public, as well - producers produced or filled their quota, and that's basically a producer behaviour, and the level of over-quota milk as Mr. Core [President of Dairy Farmers of Ontario] has stated a bit earlier, is sort of dependent on the biological conditions that they find on the farm. In fact, if you happen to be in a state where the feed is good and the cows are calving properly and there is not a whole bunch of diseases, these can add together to create a fairly significant level of over-quota milk. When in fact, under normal chance circumstances, if you didn't have a lot of good things happening at the same time, the level of over-quota milk would be much less."<sup>122</sup>

4.100 The United States noted that Mr. Phillips' views were confirmed by the testimony of Mr. Guy Jacob, President, Canadian Dairy Commission, before Canada's Parliamentary Standing Committee on Agriculture and Agri-Food.

"Last year the quota was cut by 3%. A farmer had the choice of reducing his production by 3%. He could sell one cow out of that barn and reduce his net revenue. He had to reduce his production because the quota was cut last year by 3%. That's the choice he has. He may decide to keep his production at the level of the previous year and then produce 3% over quota. Then it may happen that this year the feed was a little better, the climate was a little better, and it

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<sup>122</sup> Testimony before the Canadian International Trade Tribunal. (United States, Exhibit 33)

just happens that he's producing 6% over his quota. That milk is being removed by the CDC at the international price."<sup>123</sup>

4.101 The United States argued that when the level of production by dairy farmers was so greatly influenced by factors largely beyond the producers' control, Canada's assertion that an increase in over-quota production in a single year evidenced the willingness of its farmers to sell at world price levels was simply not credible. Rather, farmers' willingness to sell milk for use in the OEP<sup>124</sup> would be a far better gauge of interest in selling at the Special Class 5(e) price for export. Yet testimony from Mr. Phillips<sup>125</sup>, indicated that dairy farmers in Ontario had shown very little interest in participating in the OEP. There had been virtually no use of the OEP for the first two years of its authorized usage.<sup>126</sup> Any increase in usage during the 1997/98 year was most likely attributable to the unusual level of over-quota production in that year and the fact that farmers had an opportunity to obtain a higher price for their milk under the OEP than from the CDC dictated price under Special Class 5(e). For example, Manitoba was selling milk for OEP contracts in 1997/98 at \$32 per hectolitre compared to the Special Class 5(e) price of between \$23 and \$25.<sup>127</sup>

4.102 The United States further noted that Mr. Phillips had predicted in hearings before the Canadian International Trade Tribunal that it was very unlikely that dairy producers would voluntarily participate in a new special class:

"So, again, I would note that a 5-B, which is a typical Class 5 price, most of the variable costs are covered. But when we go down to the world price, the \$23.38 in this instance, look across there, you find that the cutoff point is around 18 percent of producers whose variable costs would be covered. That means that a vast majority of producers would definitely not want to produce milk at the world price."<sup>128</sup>

4.103 The United States also observed that Mr. Phillips had testified that only one-half of one per cent of producers in Ontario had shown any interest in participating in the OEP that, like the Special Classes, involved the sale of milk for export at approximations of world market prices.<sup>129</sup>

4.104 The United States stressed that Canada's argument that an increase in over-quota production since the implementation of the Special Milk Classes was evidence that milk producers were deliberately choosing to export milk at world market prices was flawed. First, over-quota production actually declined in the first full year, 1996/97, after the implementation of the Special Milk Classes Scheme. The annual report of the Dairy Farmers of Canada showed that over-quota production actually declined between 1995/96 and 1996/97, both in actual volume and as a percentage of total

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<sup>123</sup> United States, Exhibit 45, pp. 21-22. The United States noted that it was significant that Mr. Jacob's testimony had been given in March 1998, nine months into the 1997/98 marketing year. Thus, his comments had particular force respecting the reasons for over-production in that year, including the reduction in the quota that was made at the outset of the marketing year. Mr. Jacob also made the following additional observation about the unpredictability of production levels: "If we could manage to put in some kind of a system instead of having just over-quota production, which is there this year and might not be there next year ... no one can really count on it. A dairy farmer just happens to be producing over quota.", p. 15.

<sup>124</sup> Para. 2.57(b) refers.

<sup>125</sup> United States, Exhibit 33.

<sup>126</sup> The United States noted that Mr. Phillips' testimony was confirmed by Canada's answer to the additional questions of the United States.

<sup>127</sup> United States, Exhibit 46.

<sup>128</sup> Hearings before the Canadian International Trade Tribunal in its "Inquiry Into the Importation of Dairy Product Blends", testimony by Mr. Phillips. (United States, Exhibit 33)

<sup>129</sup> *Ibid.* (United States, Exhibit 33)

production.<sup>130</sup> Furthermore, the purported increase in over-quota production between 1996/97 and 1997/98 appeared to be attributable in large part to a decision to reduce the Market Share Quota (MSQ) for 1997/98. The United States noted that information contained in Canada's Exhibit 16 showed that the MSQ had been reduced by one million hectolitres between 1996/97 and 1997/98. When such a major reduction in MSQ occurred, it all but compelled an increase in over-quota production, as it was difficult, if not impossible, for milk producers to reduce production in such a precipitous manner. A one million hectolitre reduction in the MSQ equalled almost one-half of the total over-quota production in 1996/97, which according to the DFC was 2.21 million hectolitres.

4.105 The United States argued that there was the definitional question of what actually constituted over-quota production. Various "flexibility" provisions authorized by several provinces allowed for a departure from the pre-existing practice of determining whether a particular milk producer was over-quota based on an analysis of a dairy farmer's daily or monthly production levels. Canada had confirmed the United States understanding that both Alberta and Manitoba permitted such adjustments.<sup>131</sup> Alberta and Saskatchewan performed a year-end price adjustment which applied under-delivered quota against over-quota deliveries. Manitoba currently allowed flexibility for up to 25 days of quota production. This was characterized as a credit that the dairy farmer could use on a rolling basis to apply against over-quota production. The United States understood that other provinces had similar provisions. In addition, Manitoba had introduced a so-called "cover-off" that provided yet another hedge against over-production.<sup>132</sup> While this "cover-off" mechanism was originally instituted for only the months of August through November, Manitoba later extended it to additional months. To the extent that other provinces had similar arrangements, their existence undermined Canada's contention that there existed a consistent definition of over-quota production that dairy farmers consider in their daily production plans.

4.106 The United States noted that whether milk was in-quota or over-quota and what Class price it received was in fact so confusing, that many milk producers apparently did not know whether their production was over-quota and, if it was, what price they would receive for the over-quota production. The Manitoba Milk Marketing Board's newsletter *Milkline* has responded to milk producers confusion with a number of articles attempting to explain the mechanics of these various schemes.<sup>133</sup> In the face of such uncertainty, it was difficult to comprehend Canada's assertion that dairy farmers were producing over-quota milk in response to price signals from the world market. Moreover, the United States stressed that the price earnings information provided to producers was largely, if not entirely, retrospective.<sup>134</sup> While Canada stated that producers knew that Special Class 5(d) and (e) prices were set on the basis of negotiated transactions, Canada omitted to mention that the returns that producers received from Special Class sales were pooled under the Special Class Agreement if they consisted of in-quota production. In the case of over-quota production, the producer also received a weighted average return based instead on *all* Class 5(e) transactions during the year. Thus, any individual negotiated transaction price was of no direct consequence to an individual producer; his ultimate return from in-quota exports was determined based on the Special Class pooled price and over-quota sales were based on a weighted average Class 5(e) price.

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<sup>130</sup> United States, Exhibit 38.

<sup>131</sup> The United States referred to Canada's replies to the Panel's Questions 4(b) and 4(d).

<sup>132</sup> United States, Exhibit 49.

<sup>133</sup> The United States referred to United States, Exhibit 48 as an example. In addition, it was noted that the British Columbia Milk Marketing Board reported in its May 1998 newsletter that the increase in over-quota production in the four western provinces during 1997/98 had been attributable not to over-production of industrial milk, but was the result of decreased fluid milk sales (beverage milk). The United States noted that presumably, fluid milk had been diverted into the industrial milk classes as a result and then had showed up as over-quota production. Again, this occurrence had nothing to do with milk producers deliberately deciding to accept world market prices for their milk.

<sup>134</sup> The United States referred to Canada's response to the Panel's Question No. 19(g).

4.107 **Canada** recalled that milk to be used in exported products under the Special Classes arose from two sources of milk: in-quota production and over-quota production.

- (a) In-quota milk: Producers, acting collectively through their milk marketing boards and the CMSMC, controlled the quota level and the amount of milk that was likely to be exported from in-quota production. If prices obtained for milk used to make products for export were not high enough, producers could decide, through their boards, to reduce the quantity of MSQ.<sup>135</sup>
- (b) Over-quota milk: Individual producers decided whether to supply milk above their individual production quota in the full knowledge<sup>136</sup> that over-quota shipments would receive world market returns. In fact, considerable numbers of producers voluntarily, as a business matter, chose to engage in over-quota production.

4.108 Canada noted that the Complainants suggested that there was no real distinction between over-quota and in-quota milk: "milk was milk", it was all fungible. Canada argued that this was irrelevant: the molecules of milk were not tracked into export or domestic markets. What was relevant was that the producer was perfectly aware when his milk was picked up at the farm gate that his shipment was within his marketing quota or was "over-quota". If it was "over-quota", then the producer knew that his return for this shipment would be in accordance with actual Class 5(e) prices, world market-based prices. This was true regardless of where the molecules in that truckload of milk actually ended up.

4.109 Canada argued that for both in- and over-quota milk, the essence of the Canadian system was that it exposed milk producers to market signals from the export market and allowed them to make business decisions based on those signals. In contrast to the allegations of the Complainants, the government did not direct milk to be used for manufacturing products for export. On the contrary, while milk sold on the domestic market was subject to marketing quotas and price regulation or approval, the quantity or price of milk sold for use in products destined for export markets was determined on a strictly commercial basis. There was no government involvement whatsoever in decisions to participate in the export market. That was a choice left entirely to the producers. Over-quota production for exports did not constitute any sort of pre-condition for a producer's annual allocation of quota for milk sales into domestic markets. In short, the decision to produce for the export market or not was one that was made by producers alone on the basis of true price signals with the objective of profit maximization. The essential feature was that the milk producer was *exposed* to world market-driven prices for dairy products and *responded entirely* on a commercial, market-driven basis. Canada emphasized that the individual farmers knew their individual quota level and knew that any production above their individual quota would be paid to them at world market prices.<sup>137</sup>

4.110 Canada argued that in the case of in-quota milk, the decision to provide for a certain amount of milk within the annual Market Sharing Quota (the "MSQ") was taken by the producers collectively. These decisions were taken at the producer board-dominated Canadian Milk Supply Management

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<sup>135</sup> Canada noted that most in-quota milk was marketed for domestic use. A limited amount of in-quota milk was marketed for export use. The sources of this milk were the planned fixed amount under Class 5(d) and any additional in-quota milk resulting from the "sleeve" or other milk intended for, but not required by, the domestic market. Canada claimed that the amount of this additional in-quota milk had significantly diminished in recent years. On the other hand, all over-quota milk was intended for the export market, with returns paid to the producer based on Class 5(e) export returns, even if it was required to be re-directed to the domestic market in the event of in-quota shortfall.

<sup>136</sup> Canada stressed that each producer knew the amount of his individual quota and his production. This was clearly indicated on producer cheques. While a producer might not know whether his province was over-quota, the individual over-quota producer received a Class 5(e) return whether or not the province's producers taken collectively were in an over-quota position (Alberta, accounting for 4.77 per cent of Canadian producers was an exception).

<sup>137</sup> Canada noted that this was with the exception of producers in Alberta and Saskatchewan, where under-shipment by some producers would lead to adjustments of the prices paid for over-quota shipments by others.

Committee (the "CMSMC"), in consultation with the processors. Producer representatives on the CMSMC were accountable through a system of producer democracy that began at the district level, with elected district or regional milk committees. Generally elected members of these committees were directors at the provincial level, and provincial boards were the main voice in deciding on production targets in the CMSMC. Thus, the producers were free to collectively determine whether and to what extent they wished to provide in-quota milk for export purposes. There was no evidence of government control, direction or coercion in this process.

4.111 In the case of over-quota milk, any qualified dairy producer in Canada was free to produce as much milk as he or she chose. Specifically, the producer was free to produce any amount of milk over his or her domestic marketing quota, i.e., over-quota production with the understanding that their return for over-quota milk would be based on actual world market-based prices, i.e., the prices realised from Special Class 5(e) sales, taking into account their individual cost structures. The individual over-quota producer received a Special Class 5(e) return whether or not the province's producers taken collectively were in an over-quota position.<sup>138</sup> Accordingly, decisions to participate in over-quota production and to supply milk for export use were market-driven choices made by individual producers. As such, the absence of any government control or direction was clear and unequivocal.

4.112 In respect of the assertions of the United States with respect to testimony of officials of the Dairy Farmers of Canada (DFC) before the Canadian International Trade Tribunal (CITT), Canada argued that the testimony had been taken completely out of context and did not support the US proposition (paragraph 4.102). The context of the DFC testimony was an inquiry by the CITT, initiated at the request of the Canadian government, into issues raised by increased imports of blends of dairy products, particularly butteroil/sugar blends, into Canada. Among the various options considered by the CITT was the possibility that producers may wish to create a Special Class price to service the *domestic* butterfat market at world prices. The DFC testimony to which the United States referred was addressing this option, not the question of individual producers deciding to produce milk at world market prices for the export markets. This distinction had been made abundantly clear in the DFC's Final Agreement before the CITT:

"7.1.6 There is evidence that some dairy producers produce quantities in excess of MSQ. This is done by producers who voluntarily seek to increase production for participation in world markets. Certain low cost producers may also voluntarily decide to actively participate in world markets through the Optional Export programme. These producer decisions, however, must not be confused with a proposal to service the domestic butterfat market using within quota production at world prices. The recent decision to reduce MSQ is clear evidence that dairy producers are not willing to produce irrespective of domestic market requirements."<sup>139</sup>

4.113 In the case of both in-quota and over-quota milk production, the claim of the Complainants that the Canadian dairy system was government-controlled and directed had to fail. Particularly with respect to the marketing of over-quota milk for export purposes, this represented a decision, by the governments, not to intervene, to avoid the use of the discretionary authority provided to the boards

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<sup>138</sup> Canada noted that in Alberta, shipments in excess of an individual farm quota could be offset because of under-production on other farms. In all other provinces and individual that produced milk in excess of the individual farm quota received the world price for that milk, regardless of the production of other individuals.

<sup>139</sup> Canada referred to arguments of the DFC, Dairy Farmers of Ontario, *Federation des producteurs de lait du Québec*, 20 April 1998 (Canada, Exhibit 52, p.21, para. 7.1.6).

and rely instead on market-driven results. To suggest that such a restraint from intervention constituted government action resulting in export subsidies was not logical.

4.114 In respect of pooling, Canada argued that contrary to suggestions from the Complainants, pooling was not an obligation that had been forced on the producers by coercive governments. Pooling was a consensus-based arrangement that the producers, through their boards, had agreed to, pursuant to the terms in the Comprehensive Agreement on Special Class Pooling (the P9 Agreement) and the P6 and P4 Agreements (paragraph 2.24). The producer boards were full signatories of those agreements, which were co-operative agreements involving all interested stakeholders. These agreements were not agreements between governments to impose on the dairy industry and the dairy producers, in particular, certain arrangements and requirements, as suggested by the Complainants. Each producer board had joined in pooling freely, and they were equally free to leave the pooling arrangements. The provincial producer boards could agree at any time to cease any sharing of revenues and markets. Indeed, to give a practical example, the Manitoba producer board had temporarily opted out of the P6 pool, pending their evaluation of their participation. Under the enabling legislative framework, such decisions could not be overridden by provincial or federal governments.

4.115 Canada noted that it was also possible for a provincial producer board to partially withdraw from the pooling of revenues if it so chose. For example, as outlined in US Exhibit 39, under an experimental programme introduced in the province of Manitoba, two per cent of each producer's daily quota had become optional and was no longer pooled. Producers could choose to ship this quantity of their quota, at a known, non-pooled return, based on realised returns in Class 5. The volumes associated with this experimental programme approximated the share of in-quota Class 5(d) and (e) production in Manitoba. By filling this portion of the provincial MSQ through voluntary shipments by producers at non-pooled prices, the producer board reduced the exposure of other producers who did not ship the optional quantity to Class 5 returns. In other words, contrary to US assertions, this was an example of a provincial producer board giving its members an option to increase or decrease their participation in Class 5 sales. Significantly, this was a unilateral decision by the Manitoba producers acting through their board. Contrary to the image of government coercion suggested by the Complainants, no permission was required from the Government of Canada or the CDC. No government sanctions followed this decision by producers to reduce their participation in the pooling of returns. Canada emphasized that the Special Milk Classes Scheme was producer-driven and necessarily based on co-operation and consensus.

4.116 Canada noted that the United States had stated that the amount of in-quota milk sold for export use exceeded that from over-quota sources. While it was true that in-quota export sales did exceed over-quota sales in 1995/96, by 1996/97 the two were in balance. Most recently, in the 1997/98 dairy year, with the growth of over-quota and the full use of the "sleeve" in domestic markets, over-quota export sales had begun to greatly exceed in-quota export sales. It was also suggested that over-quota production was actually in decline. The United States noted that there was a decline from 1995/96 to 1997/98. There was indeed a small decline between those two years but it was misleading to suggest that this was the general trend.<sup>140</sup> In fact, there had been substantial growth the previous year and an even greater increase in 1997-98. It had also been suggested that growth in over-quota production was the result of the reduction of MSQ. Yet this was equally invalid. The growth in over-quota had greatly exceeded any reduction in MSQ.<sup>141</sup>

4.117 Canada noted that the Complainants assumed that when products were exported at lower prices than those same products would command in the home market, there had to be a subsidization

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<sup>140</sup> Canada referred to the graphic attached as Figure 2 of Canada's Annex D.

<sup>141</sup> *Ibid.*

of the lower-priced exported products through profits obtained on the domestic market. Canada rejected these arguments. The Complainants had offered no evidence or explanation of why, in the absence of government direction or without the linking of domestic sales quota to export performance, producers would give away their profits from domestic sales in order to make unprofitable export sales. Indeed, they had failed to demonstrate *any* incentive to finance export sales from domestic profits. This argument was based on an assumption that milk producers behaved irrationally, or that governments somehow, in some unexplained way, forced them to reduce their net profits to engage in export sales. Canada argued that as a result of the supply management system and the presence of border protection, there were two very different markets: (i) a limited domestic market allocated to producers via quotas; and (ii) an open international market available to any producer willing to supply under conditions prevailing in that market. There was nothing in the Canadian milk marketing system that forced producers to supply the international market if they did not want to do so. The Complainants had failed to provide any evidence supporting the existence of any such mandatory performance requirement imposed on Canadian producers that would confer a benefit to exporting processors. Hence, Canada argued that the decision to produce or not to produce was one made on the basis of the same criteria that every commodity producer, indeed, any business person would make – the enhancement of the producer's net profits. The only reason for Canadian producers to sell products for the export market was because they could do so profitably. The protection of the domestic market afforded by tariffs did not alter this basic fact.

4.118 In respect of the price difference between OEP sales and Class 5(e) sales, Canada emphasized that the price difference between OEP sales and Class 5(e) sales stemmed from the commercial terms of the contract under which producers produced OEP milk. In OEP transactions, both the volume of milk supplied to the processor by the individual producer and the price paid for that OEP milk by the processor were contractually negotiated well in advance of the milk production with a view to fulfilling a pre-planned export contract made by the processor with a foreign buyer. By way of contrast, Class 5(e) milk sales were not pre-planned. Class 5(e) milk was normally used in dairy products sold on international spot markets. The pre-planned nature of an OEP transaction provided the processor with a secure supply of milk, an assured level of plant utilization and a guaranteed export sale price for a transaction identified in advance for its superior returns. For this assurance of supply, processors were willing to pay a premium for OEP milk. Canada argued that these market characteristics would exist even if producers negotiated Class 5(e) sales prices on their own or through their producer boards rather than using the CDC as a collective sales agent. As for the matter of processor margins, OEP processor margins were commercially confidential to the individual processor and were not made known to the producers, the producer boards or the CDC.

4.119 Canada argued that over-quota and OEP production came down to a matter of individual producer choice, as was illustrated by the dairy producer leaders who were CMSMC representatives and members of the Board of Directors of Dairy Farmers of Canada. Some of those producer representatives simply aimed to fill their domestic quota and not to participate in export market opportunities through the production of over-quota or OEP milk. For example, the DFC Director for Saskatchewan, Leo Bertoin, had been 0.04 per cent over, 0.03 per cent under and 0.004 per cent over his producer quota for 1995/1996, 1996/1997 and 1997/1998, respectively. By way of contrast, the President of DFC, Barron Blois, a producer from Nova Scotia who was also a provincial spokesperson at the CMSMC, had actively participated in over-quota export opportunities made possible by changing his feeding programme to reduce cash costs. Mr. Blois had consistently been in an over-quota position since the Special Milk Classes Scheme was introduced and was currently producing 20 per cent above his producer quota. The DFC Director for New Brunswick, Jacques Laforge, who

was also the provincial spokesperson for New Brunswick at the CMSMC, had only produced to the level of his domestic quota but had also actively concentrated on available OEP markets.<sup>142</sup>

4.120 The **United States** noted that Canada's argument that producers collectively decided to produce for export as part of their determination of MSQ for the year was contradicted by Canada's experience in 1997. In 1997/98, the MSQ was set at the beginning of the year at a level that presumably built in a specific amount for planned exports, in the so-called "sleeve". However, Canada had stated that almost all of the sleeve had been used last year for the domestic market. Consequently, any decision to produce for export within in-quota production, based on the MSQ at the beginning of the year, simply had not been realized when the domestic marketplace required more milk. Instead, those producers received primarily domestic prices for almost all of their in-quota production. As had been noted, whether milk was classified as in-quota or over-quota was subject to a variety of factors, and especially the fluctuation of MSQ from year to year.

4.121 The United States emphasized the significant increase in MSQ for the 1998/99 year (see table under paragraph 2.31). This increase was the clearest evidence that the CDC/CMSMC had seriously misjudged domestic requirements in the previous year. The reduction in MSQ in 1997/98 also was in large measure responsible for the unusual change in the relative proportion of over-quota versus in-quota exports in that year.<sup>143</sup> Even if domestic consumption in Canada remained at the high levels enjoyed in 1997/98, the 1998/99 increase in MSQ would necessarily result in a significantly higher percentage of in-quota exports in the current marketing year. The United States submitted that the 1997/98 marketing year was an aberration with respect to the low level of in-quota milk that was used for planned exports or determined to be surplus. That situation was primarily a result of a reduction in MSQ that turned out to be totally unjustified by market circumstances. In this connection, the United States noted that this judgment error had been corrected for the 1998/99 marketing year as the MSQ for the current year had been readjusted to restore the full amount of this reduction and actually included an increase over the 1996/97 MSQ level. This should result in a decline in over-quota production. The restoration of MSQ to earlier levels no doubt was a result of milk producers' complaints that they were being compelled to sell milk at Class 5(e) prices by the reduction in MSQ in 1997/98 which bore no relationship to market conditions. The United States argued that this significant shift of MSQ highlighted the artificiality of the over-quota/in-quota distinction, and the inability of milk producers to quickly adjust to dramatic swings in the MSQ such as occurred between 1996/97 and 1997/98. In fact, the reduction in MSQ in 1997/98 of approximately 3 per cent, when factored with Canada's statement that only over-quota production by individual producers above the 105 per cent level could be considered to be deliberate (see Footnote 121), accounted for at least two thirds of all over-quota production during the 1997/98 marketing period. Thus, Canada's assertion that over-quota production reflected milk producers' deliberate decisions was belied by the very information that Canada had submitted.

4.122 Like New Zealand, the United States stressed that the designation of milk as "surplus" was essentially an arbitrary one. The Canadian system was predicated on the assumption that the domestic population would only consume so much butter, so much cheese, so much ice cream and yoghurt, etc., at desired price levels in a given year and that this translated into class prices for milk. However, many of these dairy products were storable. Therefore, the decision to designate milk as "surplus" was really a decision not to build domestic stocks of dairy products for later consumption. Processors resisted stock building because as stocks grew they exercised downward pressure on the prices at which processors could sell their dairy products, and processors' profit margins would be eroded as a result. Producers disliked stocks because dairy product stocks represented a quantity of milk that would not be required at a future date, i.e., milk production would have to be cut while Canadians

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<sup>142</sup> Canada noted that Mr. Laforge filled 100.01 per cent of his quota in 1995-1996 and was currently at almost exactly 100 per cent of his quota. Mr. Laforge has participated in an OEP contract for the sale of evaporated milk to the Caribbean.

<sup>143</sup> The United States referred to Figure 2 of Canada's Response to the First Set of Questions from the Panel.

consumed the products in stock. Canada's solution was to export the surpluses using subsidies, and thereby maintain both high domestic price and production levels.

4.123 The United States refuted Canada's comparison of how prices were established under the OEP versus under Class 5(e) milk (paragraph 4.118). Canada's own explanation supported the conclusion that the Special Class prices were particularly low, given the international dairy marketing conditions. Canada was over-simplifying the commercial context of these sales. While Canada contended that OEP prices could be higher, in part, because they generally involved advance purchases of milk and, therefore, established a secure source of milk for the processors – Canada had earlier stated that many of the export transactions under Special Class 5(e) involved repeat sales involving the same exporters and international customers. If that was true, then the distinction that Canada now attempted to draw between OEP and Class 5(e) sales lacked a factual foundation.

## 2. "Export Subsidy" - the Interpretive Context

### (a) The SCM Agreement and the Agreement on Agriculture

4.124 **Canada** argued that the definition of "export subsidies" for the purposes of the Agreement on Agriculture was found in Article 1(e) of the Agreement. This definition contained two components:

- (a) the first component was "subsidies contingent on export performance";
- (b) the second component included as export subsidies for the purposes of the definition the export subsidies specifically listed in Article 9 of the Agreement.

4.125 Canada further noted that Article 10.1 of the Agreement on Agriculture made an explicit reference to "(e)port subsidies not listed in paragraph 1 of Article 9." Article 10.3 spoke of "no export subsidy, whether listed in Article 9 or not." Thus, Canada submitted that Article 10 in general, and Article 10.1 in particular, recognised the dual nature of the definition found at Article 1(e) of the Agreement. Article 10.1 applied only<sup>144</sup> with respect to "export subsidies" as defined in Article 1(e) other than those export subsidies that were included in the definition by virtue of having been explicitly listed in Article 9. What was left of the definition of "export subsidies" was the first component of the definition (i.e., "subsidies contingent on export performance" without including export subsidies specifically listed in Article 9 of the Agreement). Thus, the "other export subsidies" referred to in Article 10.1 meant "subsidies contingent on export performance", excluding the export subsidies specifically listed in Article 9 of the Agreement.

4.126 The term "subsidies contingent on export performance" itself had two components: (i) "subsidies" and (ii) "contingent on export performance". The term "subsidy" was not defined in the Agreement on Agriculture. Canada's position was that the prime contextual interpretative source for the meaning of the term "subsidy" was the definition of "subsidy" found in the SCM Agreement.<sup>145</sup> While the potential application of other sources for the interpretation of the term "subsidy" in the Agreement on Agriculture could not be excluded, the Complainants had not been able to identify any source having anything like the interpretative force of the definition of "subsidy" found in the SCM Agreement. Accordingly, "other export subsidies", as used in Article 10.1 of the Agreement on Agriculture, included "subsidies" (as interpreted in the context of the SCM Agreement) that were contingent on export performance, other than the export subsidies specifically listed in Article 9 of the Agreement on Agriculture.

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<sup>144</sup> Canada noted that the other instance in which Article 10 applied was with respect to non-commercial transactions but this application was not relevant in the present matter before the Panel (para. 4.258).

<sup>145</sup> Canada agreed that the definition of "subsidy" in the SCM Agreement was not the "definition", in the technical sense, of "subsidy" in the Agreement on Agriculture.

4.127 Canada argued that the list of export subsidy practices found in Article 9.1 served two purposes in the Agreement on Agriculture. On one hand, it served as an exhaustive list of export subsidy practices that were subject to the reduction requirements set out in the Agreement. It also provided an illustrative list of export subsidy practices to be included within the definition of "export subsidy" in Article 1(e) of the Agreement. Both as an exhaustive list under Article 9 and as an illustrative list for the definition in Article 1, the text precisely reflected the common agreement by all Members regarding which practices should be considered "export subsidies" for the purposes of the Agreement on Agriculture. By the same token, the text also reflected where there was an absence of common agreement with respect to whether a particular practice should be considered to be an export subsidy (paragraphs 4.446 and following). In respect of criteria for export subsidies relating to differences between export and domestic prices, no reference could be found amongst the items listed in Article 9.1, with the exception of Article 9.1(b). The fact that a reference to domestic and export prices was included *only* with respect to paragraph (b) of Article 9.1 suggested that the negotiators could agree to such a reference *only* with respect to Article 9.1(b).<sup>146</sup>

4.128 Canada emphasized the importance of the origin and character of the definition of a "subsidy" in the SCM Agreement. The SCM Agreement achieved what had not been possible during the life of the GATT 1947: a definition for the term "subsidy". This definition reflected a compromise reached by the negotiators in the Uruguay Round. As such, it reflected the practical realities of negotiations and represented a statement of what, by the end of the negotiations, the negotiators had been able to agree would be a "subsidy" for WTO purposes. It followed, therefore, that any measure or practice that did not fall within the terms of the definition could not be considered to be a subsidy for WTO purposes, regardless of any other conceptions or proposals as to what ought to constitute a "subsidy". Canada argued that it was not suggesting the agreed definitions of "subsidy" and "export subsidy" were perfect conceptions. There was no doubt that many WTO Members would prefer amendments in pursuit of their own policy objectives preferences. Perhaps proposals would be brought to the negotiating table for the next round of WTO negotiations. What the Complainants could not be allowed to do was to create an effective alteration of the negotiated texts through litigation.

4.129 **New Zealand** claimed that sources relevant to the interpretation of the word "subsidy" were: the Agreement on Agriculture, which provided the immediate context for the interpretation of the term "subsidy", and subsequently, the broader context of the WTO. The latter included, in particular, the SCM Agreement together with its Illustrative List of Export Subsidies, GATT 1994 and WTO/GATT practice.

4.130 New Zealand argued that in the present case, the question of the meaning of the term "subsidy" arose on two occasions: in the interpretation of Article 9.1(a) which referred to "direct subsidies"; and in the interpretation of Article 10 which referred to "export subsidies ... applied in a manner which results in, or which threatens to lead to, circumvention ...". In each case, the question had to be asked what constituted a subsidy. New Zealand contended that the answer to this question had to be sought *initially* in the context of the Agreement on Agriculture and then more broadly in the context of the WTO Agreements as a whole. In this regard, the particular relationship of the Agreement on Agriculture and the SCM Agreement, recognised by the Appellate Body in *Brazil - Measures Affecting Desiccated Coconut*<sup>147</sup>, meant that the SCM Agreement was clearly part of the

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<sup>146</sup> Canada noted that the other provision involving domestic and export price differences in the context of export subsidies was Paragraph (d) in the Illustrative List to the SCM Agreement. In that instance, the example provided was extremely carefully limited to very particular circumstances in recognition of the far-reaching implications of the concept.

<sup>147</sup> Appellate Body Report on *Brazil - Measures Affecting Desiccated Coconut*, (hereafter "*Brazil - Desiccated Coconut*"), WT/DS22/AB/R, adopted 20 March 1997, p.14.

context to be referred to within the meaning of Article 31 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") when interpreting the Agreement on Agriculture.<sup>148</sup>

4.131 However, referring to the SCM Agreement as part of the context for the interpretation of the concept of "subsidy" in the Agreement on Agriculture was not the same as simply fastening onto one definition from the SCM Agreement and treating it as if it were an overriding definition for the purposes of all of the WTO Agreements. In fact, reference to the SCM Agreement could include reference to the definition in Article 1, or to the Illustrative List of Export Subsidies in Annex I, or to parts of those definitions and lists. Reference could also be made within this broader context to what constituted a subsidy under GATT 1947 and under GATT practice.

4.132 In New Zealand's view Canada's approach in this case was based on a fundamental interpretative error. Rather than addressing the key issue of interpretation in this case - the meaning of the term "export subsidy" as used in Article 9.1 and Article 10 of the Agreement on Agriculture - Canada instead focussed on the meaning of the term "subsidy", and proceeded to argue that the exercise of interpretation of this term as used in the Agreement on Agriculture could be largely confined to a consideration of the definition of subsidy found in Article 1 of the SCM Agreement. Canada's failure to locate the interpretation of export subsidies within the Agreement on Agriculture resulted in its ignoring the rules of interpretation applicable to the WTO Agreements which had been endorsed by the Appellate Body, and in limiting the scope of the disciplines that were carefully negotiated in the Agreement on Agriculture. Canada was hence inviting the Panel to read into the WTO Agreements an extravagant interpretative relationship between the Agreement on Agriculture and the SCM Agreement, and to make broad pronouncements on the scope of the SCM Agreement that were not necessary for this dispute.

4.133 New Zealand argued that by its very wording Article 1 of the SCM Agreement was limited to that Agreement. The opening words of Article 1 were "For the purposes of *this* Agreement" (emphasis added). Article 1 went on to say, "a subsidy *shall be deemed* to exist if ..." (emphasis added). Hence, New Zealand argued that the drafters did not intend this to be a definition for all purposes; it was simply a listing of what was deemed to be a subsidy for the purposes of the SCM Agreement. Canada had, in New Zealand's view, interpreted the terms of Article 1 of the SCM Agreement in isolation and therefore ignored the specific context of the SCM Agreement itself. If Canada had interpreted Article 1 in the context of the SCM Agreement as a whole, it would have been forced to conclude that, in the context of a discussion on export subsidies, the meaning of Article 1 had to be read also in the light of the Illustrative List of Export Subsidies. Yet, in New Zealand's view, for Canada, the Illustrative List appeared to stand alone as a separate list of export subsidies having no necessary relationship to Article 1 of the SCM Agreement.

4.134 New Zealand further argued that there was nothing in the Agreement on Agriculture that incorporated the SCM Agreement definition. Indeed, the implication of Article 21 of the Agreement on Agriculture, which subordinated the provisions of GATT 1994 and the other Multilateral Trade Agreements in Annex 1A to the WTO Agreement to any contrary provision in the Agreement on Agriculture, was that if the Agreement on Agriculture was to be dependent on another Agreement, that dependency would have to be express. The fact that at the end of the implementation period agricultural export subsidies would be subject to the disciplines of the SCM Agreement, as contemplated in Article 13(c) of the Agreement on Agriculture, did not necessitate that there had to be a coincidence of definition between the two Agreements on what constituted a subsidy. New Zealand argued that the relevance of Article 21 of the Agreement on Agriculture was that it made plain that in the event of a conflict between the Agreement on Agriculture and another WTO Agreement, the Agreement on Agriculture was to prevail. In other words, if an export subsidy were to meet the terms

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<sup>148</sup> New Zealand noted that the SCM Agreement was particularly relevant, as it contained a list of export subsidies which constituted the background against which the export subsidy provisions of the Agreement on Agriculture were negotiated.

of one of the sub-paragraphs of Article 9.1 (relating to the category of export subsidies subject to reduction commitments) but yet did not meet the definition of Article 1 of the SCM Agreement, it would nonetheless still constitute an export subsidy for the purposes of the Agreement on Agriculture.

4.135 New Zealand argued that to simply transpose the definition provided in Article 1 of the SCM Agreement made no sense within the context of the Agreement on Agriculture. Article 1(e) defined the term "export subsidies" as referring to "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement." At the outset, this was potentially a broader definition than Article 1 of the SCM Agreement because Article 9 subsidies were included within it whether or not they met the definition of subsidy in Article 1 of the SCM Agreement or any other definition. They were export subsidies by virtue of the definition in Article 1(e) of the Agreement on Agriculture. It made no sense to re-test them by reference to some other definition of subsidy.

4.136 New Zealand argued that in effect, the relationship between the export subsidies listed in Article 9.1 of the Agreement on Agriculture and the definition of export subsidies set out in Article 1 of that Agreement was similar to the relationship that existed in the case of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement and Article 3.1 of that Agreement. These were export subsidies *by definition* and they did not need any further testing against a definition of subsidy or export subsidy set out in the respective provisions of the two Agreements.

4.137 New Zealand further argued that while the export subsidies listed in Article 9 of the Agreement on Agriculture were exhaustive of the export subsidies for which reduction commitments had to be entered by Members, they were also, by virtue of their inclusion in the definition of "export subsidies" in Article 1 of the Agreement on Agriculture, indicative or illustrative of the broader category of export subsidies referred to elsewhere in the Agreement. This, too, argued against an interpretation of the term "subsidy" in the Agreement that limited it to the specific requirements of Article 1 of the SCM Agreement. It also had implications for the determination of what constituted an "export subsidy" under Article 10 to which the non-circumvention provisions of that Article applied.

4.138 The **United States** argued that the term "export subsidy" was defined in Article 1(e) of the Agreement on Agriculture, although the term "subsidy" was not. Article 9 of the Agreement on Agriculture, however, set forth a non-exhaustive list of export subsidies. That list served to inform the meaning of the term "subsidy" for the purpose of the Agreement on Agriculture.

4.139 The United States stressed that the meaning of the term "subsidy" in the Agreement on Agriculture had to be determined in its context, including the other WTO Agreements and the GATT 1994; it was not governed either exclusively or primarily by Article 1 of the SCM Agreement. The United States maintained that Canada's argument that the SCM Agreement's definition of "subsidy" was the exclusive basis for discerning the meaning of that term for purposes of all the WTO Agreements, including the Agreement on Agriculture, disregarded the plain meaning of the opening words of Article 1 of SCM Agreement as well as the views of the Appellate Body.<sup>149</sup> The definition of "subsidy" in the SCM Agreement was relevant for purposes of interpreting the same term used in the Agreement on Agriculture, but it was not to be given more weight, however, than the provisions of the Agreement on Agriculture.

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<sup>149</sup> The United States noted that the Appellate Body also recognized this relationship when it stated that "with respect to subsidies on agricultural products ... [t]he Agreement on Agriculture and the SCM Agreement reflect the latest statement of WTO Members as to their rights and obligations concerning agricultural subsidies." Appellate Body Report on *Brazil - Desiccated Coconut*, *op. cit.*, p.13.

(b) The Relevance of the Vienna Convention and Negotiating History

4.140 **New Zealand** argued that there was no need to define the term "subsidy" in the abstract. The term needed definition when it arose in the context of a particular provision of the Agreement. What constituted an export subsidy under Article 10 would necessarily differ from what constituted an export subsidy under Article 9, because Article 10 was concerned with export subsidies that were not listed in Article 9. Yet both articles used the term "subsidy". The correct approach to interpretation in the case at issue was to apply the customary principles of interpretation of public international law as required by Article 3 of the DSU. This meant applying the principles of interpretation set out in the Vienna Convention on the Law of Treaties - that is, giving words their ordinary meaning in their context and in the light of the object and purpose of the treaty as a whole.

4.141 New Zealand argued that there was nothing in the negotiating history of the Agreement on Agriculture or the SCM Agreement that suggested that the negotiators intended that the definition of "subsidy" in the SCM Agreement would be simply accepted as the definition of subsidy in the Agreement on Agriculture, or for that matter in other WTO Agreements. Indeed, the fact that the negotiations were conducted separately, and that two separate Agreements were concluded, suggested that, contrary to the Canadian position, there was no understanding reached that the definition of Article 1 of the SCM Agreement would be the exhaustive or governing definition of subsidy for the purposes of the Agreement on Agriculture. Furthermore, the negotiators did not purport to work out all the details of the relationship between the two Agreements. It was well understood at the end of the Uruguay Round that the relationship between the Agreement on Agriculture and the SCM Agreement was to be worked out in practice.<sup>150</sup>

4.142 New Zealand argued that the Uruguay Round did not result in a universal definition of the term "subsidy" for the purposes of all of the WTO Agreements. There was a definition for the purposes of the SCM Agreement in Article 1 of that Agreement, although that definition had also to be read in the light of the list of export subsidies in the Illustrative List. The Agreement on Agriculture did not contain any such definition. Thus, in interpreting the Agreement on Agriculture other definitions in the WTO Agreements, in particular the SCM Agreement, were relevant but not determinative.

4.143 The **United States** noted that although the Agreement on Agriculture did not list all export subsidies or define the term "subsidy," the Appellate Body had indicated that it was neither necessary nor appropriate to confine the interpretative analysis of the terms of an Agreement to the text of the particular treaty provision.<sup>151</sup> In addition, treaty interpreters could look to the customary rules of interpretation of public international law reflected in the Vienna Convention for assistance in construing the terms of a treaty provision. As an additional aid to interpretation the Appellate Body had emphasized Article XVI:1 of the WTO Agreement<sup>152</sup> which provided that:

"Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the

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<sup>150</sup> New Zealand noted that commentators had noted that "one of the principal tasks for WTO member countries during the implementation period will be to sort out the overlap" between the Agreement on Agriculture and the SCM Agreement; Stewart T. P. (ed.), *The World Trade Organisation: The Multilateral Framework for the 21st Century and US Implementing Legislation*, Washington, American Bar Association, 1996, p. 171.

<sup>151</sup> Appellate Body Report on *Brazil - Desiccated Coconut*, *op. cit.*

<sup>152</sup> *Ibid.*, p. 12.

CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947."<sup>153</sup>

4.144 The United States noted that the reports developed under GATT Article XVI, the Tokyo Round Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the GATT ("the Subsidies Code"), and the SCM Agreement were therefore relevant to interpretation of the term "export subsidy" as used in the Agreement on Agriculture.

4.145 The United States noted that a recurring theme appeared in the GATT and WTO discussions of subsidies. There had long been a reluctance to provide a specific and exhaustive definition of the term "subsidy" for fear of inadvertent exclusion of a particular practice or inability to foresee the development of some new type of subsidy.<sup>154</sup> Thus, a 1960 panel on subsidies noted the longstanding lack of an explicit definition for the term.<sup>155</sup> Another panel "considered that it was neither necessary or feasible to seek an agreed interpretation of what constituted a subsidy."<sup>156</sup> Despite this initial reluctance to confine the scope of the term subsidy by compiling lists of recognized subsidy practices, panels had identified various guidelines inherent in the GATT rules on subsidies as to what could be considered to fall within the term subsidy and what lay outside.<sup>157</sup> Article 1 of the SCM Agreement now provided a definition of subsidy.

4.146 The United States noted that one of the first illustrative lists of subsidies was contained in a 1960 Working Party Report, which was the precursor for the illustrative lists contained in both the Tokyo Round Subsidies Code and the WTO SCM Agreement.<sup>158</sup> That Report set forth a detailed list of measures that had been considered to be export subsidies by a number of Contracting Parties, including both the United States and Canada.<sup>159</sup> Among the practices determined to be an export subsidy were the deliveries by government or governmental agencies of production inputs "for export business on different terms than for domestic business ..."<sup>160</sup> This was, in the view of the United States, the essence of the Special Milk Classes Scheme, which provided for provincial government dairy boards to deliver discounted milk to manufacturers of dairy products for export. During the same year, another panel examined the scope of the export subsidy reporting requirement under Article XVI of GATT 1947.<sup>161</sup> The panel in its review considered whether producer-financed subsidies were notifiable under Article XVI and determined that they were subject to the reporting requirement where the "levy/subsidy schemes affecting imports or exports ... are dependent for their enforcement on some form of government action."<sup>162</sup> The panel's conclusion was that producer-

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<sup>153</sup> The United States noted that the term subsidy had not been expressly defined in either the GATT 1947 or in the Tokyo Round Subsidies Agreement interpreting GATT Article XVI. It had not been until the entry into force of the SCM Agreement (under the WTO), that the term "subsidies" had been defined in either a GATT or WTO Agreement.

<sup>154</sup> BISD 10S/201, L/1442, adopted 21 November 1961, para. 23.

<sup>155</sup> "Operation of the Provisions of Article XVI", adopted 21 November 1961, BISD 10S/208, para. 23. The United States noted that one commentator had noted that in spite of the great care taken by the GATT to establish detailed procedures to regulate the use of subsidies, there was no internationally binding definition of what constituted a subsidy for a substantial time period. Beseler, Antidumping and Anti-subsidy Law p.119.

<sup>156</sup> J. Jackson, "World Trade and the law of the GATT" (1969), citing GATT, BISD 10S/201, para. 23.

<sup>157</sup> The United States referred to, e.g., Working Party Report on *Provisions of Article XVI:4*, L/1381, BISD 9S/185, adopted 19 November 1960, para. 5.

<sup>158</sup> *Ibid.*

<sup>159</sup> *Ibid.*, p. 188 (the "industrialized countries in Western Europe and North America.").

<sup>160</sup> The United States noted that although the example contained in the list referred to inputs consisting of imported raw materials, the concept of differential prices constituting a subsidy when the preferential prices were extended exclusively to export production had been recognized, para. 5. See also, Paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I to the SCM Agreement.

<sup>161</sup> Panel Report on *Review Pursuant to Article XVI:5*, *op. cit.*

<sup>162</sup> *Ibid.*, p.192, para. 12.

financed export subsidies that were part of a government-directed system were essentially indistinguishable from direct government export subsidies.<sup>163</sup>

"The Panel examined the question whether subsidies financed by a non-governmental levy were notifiable under Article XVI. The GATT does not concern itself with such action by private persons acting independently of their government except insofar as it allows importing countries to take action under other provisions of the Agreement. In general there was no obligation to notify schemes in which a group of producers voluntarily taxed themselves in order to subsidize exports of a product. The Panel felt that in view of the many forms which action of this kind could take, it would not be possible to draw a clear line between types of action which were and those which were not notifiable. On the other hand, there was no doubt that there was an obligation to notify all schemes of levy/subsidy affecting imports or exports in which the government took a part either by making payments into the common fund or by entrusting to a private body the functions of taxation and subsidization with the result that the practice would in no real sense differ from those normally followed by governments. In view of these considerations the Panel feels that the question of notifying levy/subsidy arrangements depends upon the source of the funds and the extent of government action,<sup>164</sup> if any, in their collection. Therefore, rather than attempt to formulate a precisely worded recommendation designed to cover all contingencies, the Panel feels that the CONTRACTING PARTIES should ask governments to notify all levy/subsidy schemes affecting imports or exports which are dependent for their enforcement on some form of government action." (Emphasis added)<sup>165</sup>

4.147 The United States argued that the analysis of the May 1960 panel was also reflected in work prepared by the GATT Secretariat in support of the Uruguay Round negotiations on the Subsidies and Countervailing Measures Agreement. In a paper prepared by the Secretariat, broadly examining a variety of issues pertinent to the subsidies negotiations,<sup>166</sup> the Secretariat recounted the discussion of the 1960 Panel Report and its conclusions regarding the lack of a meaningful distinction between the producer-financed export subsidies that were enforceable by a government and direct government subsidization of exports.<sup>167</sup> The United States noted that the SCM Agreement recognized in Article 1.1(a)(1)(iv) that entities other than governments could perform functions normally vested in the government, and that that could also constitute a subsidy (this argument is further developed in paragraph 4.333 and following).

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<sup>163</sup> The United States noted that the Government of Sweden later reached an identical conclusion as observed in its 1990 WTO offer, where it stated that: "In the country list, Sweden has indicated how producer-financed export subsidies in Sweden have had an effect similar to budget financed export subsidies. It is consequently Sweden's opinion that producer-financed export subsidies could be just as trade distorting as government funded export subsidies, and should therefore be tightly circumscribed in order not to compromise reform efforts on the latter form of subsidies. This should be reflected in the disciplines to be worked out under the GATT to govern producer-financed export subsidies."

<sup>164</sup> The United States noted that the high domestic prices which made a levy economically feasible were often, as in the case at issue, a result of government action in fixing import barriers, production quotas, and price supports, although these factors had not been noted by the panel.

<sup>165</sup> Working Party Report on *Provisions of Article XVI:4*, *op. cit.*, para. 12.

<sup>166</sup> "Subsidies and Countervailing Measures," MTN.GNG/NG10/W/4 (28 April 1987).

<sup>167</sup> *Ibid.*, p.9.

4.148 The United States pointed out that in the Uruguay Round, producer-funded export assistance with significant government related action continued to be viewed as an export subsidy. Thus, the discussions during the Uruguay Round in the Secretariat papers prepared for the Chairman of the Committee on Agriculture<sup>168</sup>, as well as the proposed framework agreement developed by Chairman de Zeeuw<sup>169</sup> and the notes prepared by Chairman Dunkel<sup>170</sup> all characterized producer-financed export assistance as export subsidies. The only issue that surrounded producer-financed export payments and other producer-financed export assistance was not whether they were export subsidies, but whether they should be exempted from any disciplines imposed on export subsidies on agricultural products. The Agreement on Agriculture resolved this question by including such subsidies in Article 9.1 of the Agreement.

4.149 The United States argued that producer-financed export subsidies had been treated as export subsidies because they were likely to have the same distorting effect on trade and competition as subsidies paid from a government treasury. Producer-financed subsidies conferred a benefit on the exported product and, when substantial government involvement was present, as in Canada's Special Milk Classes Scheme, the resulting subsidy could not be distinguished from purely governmental action. This fact was recognized in Article 9.1(c) of the Agreement on Agriculture that provided that producer-financed export payments were an export subsidy subject to the Agreement's reduction commitments (further developed in paragraph 4.196 and following).

4.150 In this respect, the United States pointed out that Article 9.1 of the Agreement on Agriculture referenced six broad classes of export subsidy practices which were subject to reduction commitments. There had been no apparent effort in Article 9.1 to specify particular subsidy programmes. Instead the intent had been, as initially set forth in Chairman de Zeeuw's "Framework" and later in Chairman Dunkel's "Checklist" and "Notes", to develop a list as all-encompassing as possible to address "direct budgetary assistance to exports, other payments on products exported and other forms of export assistance."<sup>171</sup> Thus, these export subsidy categories were defined broadly, similar to the illustrative list in the SCM Agreement. In fact, there was substantial commonality between several paragraphs of Article 9.1 of the Agreement on Agriculture and the Illustrative List which results from the drafters' initial consideration of the Illustrative List, as well as the SCM Agreement's definition of export subsidy, as possible models for the export subsidy disciplines in the Agreement on Agriculture. Indeed, the six categories were sufficiently broad that there was potential (and actual) overlap between the coverage of the subsections. For example, subsidies used to reduce the cost of marketing exports of agricultural products that were addressed in subsection (d) of Article 9.1 could also be captured under the broader category of direct export subsidies set forth in Article 9.1(a) of Article 9.1.

4.151 The United States noted that both the SCM Agreement and the Agreement on Agriculture considered the provision of products or services at a price lower for export than the comparable price charged for the like product to buyers in the domestic market to be a central feature of many export subsidies.<sup>172</sup> This principle was also reflected in the language of Article XVI:4 of the GATT 1947, which provided that:

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<sup>168</sup> Note Prepared By the Secretariat in Consultation with the Chairman, AG/W/9/Rev.3, App. C-IV.

<sup>169</sup> MTN.GNG/NG5/W/170. (United States, Exhibit 30)

<sup>170</sup> MTN.GNG/AG/W/1; MTN.GNG/AG/W/1/Add.1. (United States, Exhibits 31 and 32)

<sup>171</sup> MTN.GNG/NG5/W/170, para. 17. (United States, Exhibit 30)

<sup>172</sup> The United States referred to *e.g.*, Paragraph (b) of Article 9.1 of the Agreement on Agriculture and Annex I, Paragraph (d) of the SCM Agreement. One recent work commissioned by the Organization of Economic Cooperation and Development (the "OECD"), found that "Implicit subsidies occur when a government programme or agency provides a subsidy in kind ... In some cases, subsidies take the form of below-market input prices ... " N. Bruce, "Measuring Industrial Subsidies: Some Conceptual Issues", OECD Dept. Of Economics and Statistics Working Paper No. 75 (February 1990), p.2.

"Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."

4.152 The United States submitted that in the unlikely event of a conflict between the definition of subsidy contained in the SCM Agreement and the non-exhaustive list of export subsidies in the Agreement on Agriculture, the latter would prevail for purposes of interpretation of a provision in the latter Agreement. In other words, if one of the six categories of export subsidies set forth in Article 9.1 of the Agreement on Agriculture were determined not to be a "subsidy" within the meaning of Article 1 of the SCM Agreement, the practice would still comprise a "subsidy" for the purposes of the Agreement on Agriculture. This result was dictated by Paragraph 1 of Article 21 of the Agreement on Agriculture which provides that:

"The provisions of GATT 1994 and of the other Multilateral Trade Agreements in Annex 1A to the WTO Agreement shall apply subject to the provisions of this Agreement."

4.153 **Canada** argued that Article 3.2 of the DSU recognized that the covered agreements were to be interpreted in accordance with "customary rules of interpretation of public international law." The Vienna Convention set out some of the applicable rules of international law. The rights and obligations of the Parties under the SCM Agreement and the Agreement on Agriculture must therefore be interpreted in accordance with the Vienna Convention and, in particular, Articles 31 and 32.<sup>173</sup> Canada argued that based on these governing provisions, the interpretation of the text of WTO agreements had to proceed on the following basis:

- (a) the starting point was always the actual text and its ordinary meaning;
- (b) the ordinary meaning of the terms of the agreement was to be read in their context;
- (c) "context" had to comprise the text of the agreement, including other contemporaneous agreements reached by all the parties, as outlined in Article 31.2 of the Vienna Convention; and
- (d) recourse could be taken to supplementary means of interpretation, such as negotiating history, in the event of ambiguity or to confirm a meaning.

4.154 Canada noted that the Appellate Body reiterated in its Report in *India - Pharmaceuticals*,

"The legitimate expectations of the parties to a treaty are reflected in the language of the treaty itself. The duty of a treaty interpreter is to examine the words of the treaty to determine the intentions of the parties. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the *Vienna Convention*. *But these principles of interpretation neither require nor condone the importation into a treaty of words that are not there or the*

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<sup>173</sup> Appellate Body Report on *United States - Standards for Reformulated and Conventional Gasoline* (Hereafter "*US - Reformulated Gasoline*"), WT/DS2/AB/R, adopted on 20 May 1996, pp. 16-17; Appellate Body Report on *Japan - Taxes on Alcoholic Beverages* (Hereafter "*Japan - Liquor Tax*"), WT/DS8/DS10/DS11/AB/R, adopted 1 November 1996, pp. 10-12; confirmed in the Appellate Body Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products* (Hereafter "*India - Pharmaceuticals*"), WT/DS50/AB/R, adopted 16 January 1998, paras. 43-48.

*importation into a treaty of concepts that were not intended.*"<sup>174</sup>  
(emphasis added)

4.155 Canada argued that under Article XVI:1 of the WTO Agreement, the body of adopted pre-WTO GATT panel reports and other "decisions, procedures and practices" had been given a certain status as points of non-binding reference.<sup>175</sup> It was evident from the views of the Appellate Body in *Japan-Taxes on Alcoholic Beverages*<sup>176</sup> that pre-WTO GATT materials carried some weight but it was strictly limited. At best, these materials could be considered as supplementary means of interpretation in the context of the rules of the Vienna Convention. Supplementary means of interpretation were, by definition, supplementary. They were not to be given primacy over the principles set out in Article 31. Nor were they to be treated as having on the same significance as the text or the "context" of the terms in question.

4.156 Canada argued that the weight to be ascribed to pre-WTO materials was also governed by relevance. Where the WTO text in question incorporated a pre-WTO text, then the relevance was stronger. However, in those circumstances where new agreements were reached in the negotiations in the Uruguay Round, materials relating to previous agreements that had been overtaken by the new regime could be of less interpretative value.

4.157 Therefore, Canada argued that the role of the Vienna Convention was fundamental. It was the starting point for any interpretative inquiry and that inquiry had to be conducted in accordance with the principles that were laid out in its provisions. Canada maintained that the United States and New Zealand appeared to be reluctant to begin with the "ordinary meaning" of the term "export subsidies" in its context in the Agreement on Agriculture or to consider the close relationship between the provisions of the SCM Agreement and the Agreement on Agriculture respecting "export subsidies". However, this was not an option open to a treaty interpreter. The starting point under Article 31 of the Vienna Convention must be *ordinary meaning* of the actual words agreed upon by the parties in their context, which in this case included the SCM Agreement.

4.158 Canada maintained that the Complainants, while acknowledging the application of the Vienna Convention, had departed from its principles; they did not appear to give the Vienna Convention adequate recognition as the primary guide to interpretation of WTO Agreements. In particular, the United States appeared to confuse the relationship between Article XVI:1 of the WTO Agreement, which brought prior GATT practice into the WTO, with the principles of the Vienna Convention. This led to an analysis that mixed past GATT practice with the treatment of "export subsidies" under the SCM Agreement.

4.159 Canada reiterated that the Agreement on Agriculture defined an "export subsidy" as a "subsidy" contingent upon export performance. However, the Agreement on Agriculture did not provide a definition of the term "subsidy". Canada recalled that Article 31 of the Vienna Convention directed that the meaning of a term had to be sought in its ordinary meaning and in its context. It then specifically included companion agreements within "context". While there was no express link between the definition of "subsidy" in the SCM Agreement and the definition of the "export subsidy" in the Agreement on Agriculture, such a link should be inferred since the SCM Agreement was part of the "context" of the Agreement on Agriculture. The definition of "subsidy" in the SCM Agreement was the only place a definition of "subsidy" appeared in the WTO agreements as a whole. As was well established, all of the WTO agreements were to be considered as part of a single integrated system and there was a particular relationship between the Agreement on Agriculture and the SCM

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<sup>174</sup> Appellate Body Report on *India - Pharmaceuticals*, *op. cit.*, para. 45.

<sup>175</sup> Appellate Body Report on *Japan - Liquor Tax*, *op. cit.*, p. 14.

<sup>176</sup> *Ibid.*

Agreement with respect to export subsidies on agricultural products.<sup>177</sup> Given the very similar definitions of "export subsidies" in both the SCM Agreement and the Agreement on Agriculture and the fact that the definition of "subsidy" in Article 1 of the SCM Agreement formed part of the definition of "export subsidy" as found in the SCM Agreement, the "subsidy" definition in the SCM Agreement was also applicable to the Agreement on Agriculture.<sup>178</sup> Hence, Canada submitted that the definition of "subsidy" provided in Article 1 of the SCM Agreement was the applicable definition of "subsidy" for the purposes of the Agreement on Agriculture. . This was also consistent with the comments of the Appellate Body on the relationship of the SCM Agreement and the Agreement on Agriculture:

"[W]ith respect to subsidies on agricultural products, the Agreement on Agriculture and the SCM Agreement reflect the latest statement of the WTO members as to their rights and obligations concerning agricultural subsidies."<sup>179</sup>

4.160 Canada further noted that the term "subsidy" was found in both the definition of "export subsidy" in Article 1 and in several items listed in Article 9.1, such as Article 9.1(a). The interpretation of this term had then to be the same in all these provisions. Accordingly, if the practices at issue did not constitute "subsidies" under the SCM Agreement definition, there could not be a subsidy for the purposes of either Article 1 or the relevant items in Article 9.1 of the Agreement on Agriculture.<sup>180</sup>

4.161 Moreover, Canada argued that pursuant to the customary principles of treaty interpretation, a treaty had to be interpreted and applied to reflect the underlying common *intention* of the parties. Parties had therefore to resist seeking through dispute resolution benefits that were not obtained from negotiation. A trade agreement, in particular, expressed a delicate and carefully achieved balance of economic rights and obligations between the parties within a specific historical context. This had been repeatedly acknowledged in GATT practice where, given equally plausible alternative interpretations, GATT panels had applied the interpretation that best maintained the intended balance of the agreement.<sup>181</sup> That approach, reflecting a longstanding principle of public international law, had been affirmed by the Appellate Body in its Reports in the *United States – Restrictions on Imports of Cotton and Man-made Fibre Underwear* and *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* cases.<sup>182</sup>

### 3. The Agreement on Agriculture

#### (a) Outline

4.162 **New Zealand** claimed that the case at issue was about subsidies provided to exporters of dairy products who were granted access to milk for processing into products for export at prices lower than those charged for milk sold for processing into products destined for the domestic market. New Zealand emphasized that the subsidy was financed, not by way of a rebate funded by a direct levy on

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<sup>177</sup> Appellate Body Report on *Brazil - Desiccated Coconut*, *op. cit.*, pp. 11-14.

<sup>178</sup> Canada noted that further linkage was found through Article 13 of the Agreement on Agriculture.

<sup>179</sup> Appellate Body Report on *Brazil - Desiccated Coconut*, *op. cit.*, p.14

<sup>180</sup> Canada acknowledged that the Agreement on Agriculture would take precedence over the SCM Agreement in the event of any conflict between the two. However, there had been no suggestion by either of the Complainants that the two Agreements were in conflict.

<sup>181</sup> Canada referred to *United States - Measures Affecting Alcoholic and Malt Beverages* (1992) (hereafter "*US – Malt Beverages*"), adopted 19 June 1992, DS17/R, para. 5.79, BISD 39S/206 at 296.

<sup>182</sup> Appellate Body Report on *United States – Restrictions on Imports of Cotton and Man-made Fibre Underwear* (hereafter "*US - Cotton Underwear*"), WT/DS24/AB/R, adopted 25 February 1997, p. 15; Appellate Body Report on *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* (hereafter "*US - Wool Shirts*"), WT/DS33/AB/R, adopted 23 May 1997, p. 16.

producers, but under a scheme that *compelled* milk producers to accept a lower price for milk designated for that purpose. Producers were the source of the financing of the subsidy, but the subsidy itself was provided to exporters. Both New Zealand and the **United States** claimed that the Special Milk Classes Scheme were export subsidy practices listed in Article 9.1(a) and (c). As such, these practices were subject to reduction commitments under the Agreement on Agriculture.<sup>183</sup>

4.163 The **United States** noted that the Agreement on Agriculture, Article 1(e), defined export subsidies as "subsidies contingent on export performance, including export subsidies listed in Article 9 of this Agreement." Thus, two elements had to be shown to establish an export subsidy: (i) that a subsidy existed and (ii) that receipt of that subsidy was contingent on export performance. The United States claimed that the Special Milk Classes Scheme was a subsidy because it was a government mandated and controlled system that provided processors with milk at prices well below the comparable price for milk destined for the domestic market. In turn, these low prices allowed the processors to make export sales that would otherwise not be made and to earn "assured margins" on such sales pursuant to the CDC's calculation of the net return to the dairy producer. The subsidy was contingent on export performance because the lower prices could only be obtained for export sales.

4.164 **Canada** emphasized that Article 1 of the Agreement on Agriculture defined "export subsidies" to be "*subsidies* contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement." (emphasis added) Hence, if there were either an export subsidy listed in Article 9 or a subsidy contingent on export performance, there was an export subsidy for the purposes of the Agreement on Agriculture. However, as the sales of milk at differing prices for domestic and export markets, and, in particular, sales of milk under Special Classes 5(d) and (e), did not constitute a "subsidy" pursuant to the definition of the SCM Agreement, it followed that these sales could not constitute a subsidy for the purposes of the Agreement on Agriculture.<sup>184</sup> Therefore, by definition, such sales could not constitute an "export subsidy" within the meaning of the definition in Article 1 of the Agreement on Agriculture. Canada further claimed that the practices at issue did not constitute an "export subsidy" within the meaning of any of the export subsidy practices described in Article 9.1 of the Agreement on Agriculture and, in particular, not within any of the practices cited by the Complainants.

(b) Article 9.1(a)

(i) *The meaning of "direct subsidies, including payments-in-kind"*

4.165 **New Zealand** argued that, interpreted in accordance with the ordinary meaning of the terms of Article 9.1(a), in their context, and in the light of the object and purpose of the Agreement on Agriculture, Classes 5(d) and (e) of the Special Milk Classes Scheme constituted the provision by a government agency of a direct subsidy to an industry contingent upon export performance. This direct subsidy was provided through the foregoing of revenue or through a payment-in-kind within the meaning of Article 9.1(a) of the Agreement on Agriculture.

4.166 New Zealand argued that Canada, in focussing on the word "subsidies" in Article 9.1(a) of the Agreement on Agriculture and interpreting it in isolation, removed it completely from its own context. The term used in fact in Article 9.1(a) was "direct subsidies, including payments-in-kind". There was no justification in the rules of treaty interpretation for taking words individually out of a phrase, giving them each a meaning and then reconstructing the phrase on the basis of those individual meanings. That was divorcing meaning from context completely.

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<sup>183</sup> The United States expressed its total agreement with the arguments presented by New Zealand regarding the applicability of Article 9 and 10 of the Agreement on Agriculture.

<sup>184</sup> Canada noted that Classes 5(a) to (c) were not contingent on export and that no suggestion had been made that they were contingent on export.

4.167 New Zealand argued that the normal usage of the term "payments-in-kind" was in respect of a payment in a form other than money, such as goods or services.<sup>185</sup> The provision of a production input at no charge would clearly be a payment-in-kind. The provision of a production input (milk) at a reduced price was no less a payment-in-kind. New Zealand maintained that Article 9.1(a) referred specifically to "payments-in-kind" as included within the ambit of the concept of "direct subsidies". In the present case, government agencies made milk available to processors for export under Classes 5(d) and (e) at lower prices. This was the alternative Canada had chosen to providing a money sum to compensate processors for export for having to purchase milk at the higher domestic price. The benefit of access to lower-priced milk was provided through the combined actions of the CDC and the provincial marketing agencies. Their actions made the provision of milk by producers at these lower prices mandatory. Through the operation of Classes 5(d) and (e), the government agency provided a subsidy through a "payment-in-kind" within the meaning of Article 9.1(a).

4.168 New Zealand argued that the foregoing of revenue was well recognized as a form of subsidy,<sup>186</sup> a common example being the foregoing of revenue through the remission of taxes. Thus, the ordinary meaning of the term "subsidy" in Article 9.1(a) included "revenue foregone". New Zealand noted that this was further illustrated in Article 9.2 which provided that in determining export subsidy commitment levels in Members' Schedules "revenue foregone" was to be treated as a subsidy. Article 9.2 provided in sub-paragraph (a)(i) that the "budgetary outlay reduction commitments" made by Members in respect of the subsidies listed in Article 9.1 shall in any year constitute the maximum level of expenditure for such subsidies. Article 1(c) of the Agreement on Agriculture defined "budgetary outlays" as including revenue foregone. Since revenue foregone was to be included in calculating levels of reduction commitments, it also had to be included in the concept of a subsidy for which reduction commitments were to be made. Thus, Article 9.2 made clear that the concept of "revenue foregone" was included within the scope of the subsidies listed in Article 9.1.

4.169 New Zealand noted that this conclusion was confirmed by reference to the negotiating history of the export subsidy provisions of the Agreement on Agriculture. The de Zeeuw Text contemplated that states would table lists of "financial outlays and revenue foregone" in respect of subsidy practices.<sup>187</sup> Similarly, the Modalities for the Establishment of Specific Binding Commitments under the Reform Program (the "Modalities document")<sup>188</sup> in the context of export subsidy reduction commitments stated that "the expressions 'outlays' or 'expenditure' shall, unless the context otherwise requires, be taken to include 'revenue foregone'".<sup>189</sup> There had therefore been no doubt that revenue foregone was contemplated as a subsidy that would be subject to export subsidy disciplines.

4.170 New Zealand maintained that its understanding of the interpretation of Article 9.1(a) was confirmed by reference to the preparatory work in the negotiation of that article. From the outset it had been understood that mechanisms to shield exporters from having to pay high domestic prices would be regarded as export subsidies. The text of the "Generic Criteria" produced as a basis for considering export competition issues in the negotiations spoke of any form of subsidy which resulted "in the sale of such products for export at a price lower than the comparable price charged for like products to buyers in the domestic market."<sup>190</sup> The "Illustrative List of Export Subsidy Practices", set

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<sup>185</sup> New Zealand noted that *The Dictionary of Canadian Law* (Toronto, 1991) at p. 755 provided that a "payment-in-kind" meant "remuneration in the form of goods or services".

<sup>186</sup> New Zealand noted that Article 1 of the SCM Agreement included revenue foregone by a government within the definition of a subsidy (see Article 1.1(a)(1)(ii) for example).

<sup>187</sup> "The Framework Agreement on Agricultural Reform Programme" (MTN.GNG/NG5/W/170). (New Zealand, Annex 31)

<sup>188</sup> MTN.GNG/MA/W/24.

<sup>189</sup> The Modalities Document, para.2, Annex 8 (MTN.GNG/MA/W/24).

<sup>190</sup> MTN.GNG/AG/W/1/Add.10 at p. 1 (para. 2).

out to give specific content to that Generic Criteria, included what subsequently became Article 9.1(a).

4.171 New Zealand argued that negotiating history made it clear that providing inputs at a lower price for export constituted a direct subsidy contingent upon export. The means by which the subsidised input was provided was not material. It could be through a transfer of money or it could be through revenue foregone. It could be viewed simply as the foregoing of revenue or it could be viewed as a "payment-in-kind". Regardless of the characterisation given, it constituted a direct subsidy captured by the terms of Article 9.1(a).

4.172 New Zealand argued that the ordinary meaning of the terms of Article 9.1(a), read in the particular context of Article 9 as well as in the broader context of the Agreement on Agriculture and the WTO subsidies regime as a whole, was that a government-mandated scheme whereby milk was made available by a government agency for the production of dairy products for export at prices that were lower than the prices for milk from the same agency for the production of comparable domestic products constituted a "direct subsidy" that was "contingent on export performance". Thus, the foregoing of revenue or the provision of a "payment-in-kind" by government agencies on milk provided to processors under Classes 5(d) and (e) was a subsidy within the meaning of Article 9.1(a) of the Agreement on Agriculture.

4.173 New Zealand argued that it was the lack of choice between supplying the domestic or the export markets which lead producers to forego revenue (addressed in paragraph 4.93 and following). The decision to place milk in one "market" rather than the other was not made by the producer. The decision that the domestic market was satisfied and that, accordingly, milk had to be classified into Special Class 5(d) or 5(e) was made by government. Rational, profit-seeking producers, however, would - if they had the choice - supply their milk to the higher-priced domestic market (even although the influx of more milk into that market may ultimately have the effect of lowering prices). But the decision that they may not do so was made for them. Hence, the distinction between domestic and export markets was government-created: it was, indeed, a legal fiction created by Canada. With regard to in-quota milk, producers collectively forewent revenue by being forced to accept a lower in-quota price by virtue of export sales being pooled with higher-priced domestic sales. With regard to over-quota milk, individual producers forewent revenue by having no choice other than to accept the export price for that portion of their production which was ultimately deemed to be over-quota. Under the Special Milk Classes Scheme, the government of Canada obliged milk producers to forego the revenue they would otherwise have received from sales of milk at domestic prices in order to create an economic incentive for exporters to export. Producers were compelled to forego revenue and the benefit of this revenue foregone was passed on to exporters. Since both in-quota and over-quota milk were allocated to Class 5(e), the foregoing of revenue under Class 5(e) applied as much to over-quota as it did to in-quota milk.

4.174 New Zealand noted that under the old producer levy-based system, producers received the same gross price for all milk produced (both in-quota and over-quota) but were forced, by government regulation, to forego revenue by virtue of a levy to subsidise the cost of exports. The situation was little different under the Special Milk Classes Scheme. Producers were forced to accept a lower price for milk that was subsequently exported. In the case of in-quota milk the revenue received by a producer was reduced by pooling. In the case of over-quota milk, revenue was not pooled and the price was determined by the CDC and the provincial milk marketing agency on the basis of world prices. New Zealand pointed out that the fact that world prices were the benchmark should not obscure the fact that the decision to place milk in one "market" rather than the other was not made by the producer.

4.175 The **United States** argued that the Government of Canada, whether through the CDC or through the provincial governments, played a clear role in the establishment and administration of the

Special Milk Classes Scheme. It was through the CDC that processors obtained a permit for preferentially priced milk for dairy products for export. In the absence of the federal and provincial government authority and legislation for the Special Classes, the processors would be paying the full price for milk.<sup>191</sup> The processors would not be receiving milk at an artificially reduced price tailor-made by the CDC to allow them to make export sales.<sup>192</sup> Thus the requirement under Article 9.1(a) that direct subsidies were provided by governments or their agencies was met.

4.176 The United States argued that Canada's construction of Paragraph 9.1(a) would make the reference to payments-in-kind meaningless. The Canadian argument was contrary to the principles of interpretation under customary international law and, in particular, those that required that the terms of an agreement be given effect, and that they be interpreted in good faith, in context and in light of their object and purpose.<sup>193</sup> Article 9.1(a) covered "direct subsidies, including payments-in-kind". The ordinary meaning of the phrase "payments-in-kind" in the context of Article 9.1(a) was that the provision of artificially low-priced goods was to be regarded in the same way as straight cash. Accordingly, as Classes 5(d) and (e) provided milk at a reduced price contingent on the export of the manufactured product, the measure fell within Article 9.1(a) of the Agreement on Agriculture. It would be inconsistent with the ordinary meaning of the phrase "payment-in-kind" to suggest that the provision of goods without payment would be a subsidy, but that any level of payment, even though less than adequate remuneration, would not be an export subsidy. Moreover, the frequent statements by both industry leaders and Members of Parliament that the Special Classes would allow milk producers to share the "costs" of exports confirm that indeed the government was transferring value from the milk producers to dairy processors.

4.177 The United States argued, in respect of revenue foregone, that the Canadian position was premised on the idea that under Canada's milk marketing system producers could not sell milk into the domestic market that was designated for export as surplus milk. Yet, this division of markets into domestic and export segments was an artificial one and completely a construct of Canada. As New Zealand had stated, there were separate "markets" only because Canada had created a "special milk class" scheme and assigned the export of dairy products to Class 5. The United States recalled that milk was declared surplus to the domestic market in Canada pursuant to the discretion of the Canadian Dairy Commission. This was not a determination based on the operation of a free market. For instance, there was no determination of demand elasticities at different price levels. Instead, prices were maintained at rigid levels in the domestic market and if the market could not be cleared at a particular price level, there was not much latitude to reduce price to sell additional product domestically. Moreover, the declaration of a milk surplus was generally based on conditions within a province, usually without consideration of conditions in other provinces despite the fact that there was considerable movement of milk across provincial boundaries. The United States argued that Canadian consumers would use more milk if domestic prices were lower. Special Classes 5(a) through (c), offering lower priced milk to compete with certain imports, implicitly recognized this market principle. Milk sold at those lower Special Class prices allowed Canadian producers to capture additional sales. If that milk had instead been exported at the still lower Special Class 5(e) prices, there was no question but that the total revenue received by the milk producer would have been less, resulting in "revenue foregone".

4.178 The United States noted that the same principle was demonstrated by the controversy over the substitution of imported butter-oil for butterfat in products such as ice cream. The high domestic milk prices in Canada had caused processors to look for alternative products for inputs in fat-rich products

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<sup>191</sup> The United States noted that prior to the institution of the Special Milk Classes Scheme, dairy exporters paid full domestic prices for milk used in export, but were then rebated a portion of the purchase price to enable them to compete in world markets.

<sup>192</sup> The United States understood that the CDC determined the price paid to the milk producer under Special Class 5(d) and (e) by calculating backward from a "world" price, netting out an assured margin, *i.e.*, profit, for the exporting dairy product manufacturer.

<sup>193</sup> Appellate Body Report on *US - Reformulated Gasoline*, *op. cit.*, p.23.

such as ice cream. If milk were to be sold at lower prices in Canada, milk would retain such product markets. It was for this reason that a proposal had been made to create an additional Special Class to allow Canadian milk producers to be more price competitive with imports of butter-oil. The Canadian International Trade Tribunal, in its report relating to butter-oil imports, considered the possibility of Canadian milk producers simply selling the milk that was displaced by imports of butter-oil into world markets. In conducting an analysis of the impact of such action on Canadian milk producers, the Canadian Tribunal described the effects in terms of "revenue foregone" by the Canadian industry.<sup>194</sup> Thus, this concept was not unfamiliar to the CITT, with its considerable knowledge of the Canadian milk marketing system.

4.179 **Canada** reiterated that sales of milk at differing prices did not constitute a "subsidy" as it was defined in Article 1 of the SCM Agreement. As the Agreement on Agriculture and the SCM Agreement had to be taken together, the definition of "subsidy" in the SCM Agreement was applicable to the term "subsidy" as it was found in Article 9.1(a).<sup>195</sup> It followed that there was no "subsidy", whether direct or not, for the purposes of Article 9.1(a). (Canada's detailed arguments on the application of the SCM Agreement definition of "subsidy" to the measures in question are summarized beginning at paragraph 4.309.)

4.180 In respect of the matter of payments-in-kind, Canada noted that the United States argued that Canada's interpretation of Paragraph (a) would make the reference to payments-in-kind meaningless and New Zealand characterized a sale of dairy inputs at a reduced price as a payment-in-kind. Canada submitted that the Complainants had not clearly articulated what amounted to a payment-in-kind. Canada's position did not seek to make that expression meaningless but rather to give the expression its ordinary meaning. A payment-in-kind arose when a debt was satisfied by the provision of a good or a service rather than being paid for in money. For example, a government could impose a 5 per cent royalty with respect to a concession to drill for oil. If the government permitted that obligation to be discharged by the delivery to it of one barrel of oil for every twenty barrels extracted, that would be a payment-in-kind. In the case of the Canadian dairy system, payment was made for milk in the ordinary sense of the word. A market-based differential between payments was qualitatively different from a payment-in-kind.<sup>196</sup>

4.181 Canada noted that the Complainants sought to find a subsidy in Article 9.1(a) by claiming that there was "revenue foregone" (paragraphs 4.173 and 4.177). Canada submitted that even if the word "payments" were held to include "revenue foregone", there was no revenue for the producers to forego with respect to sales of milk for export use under Special Classes 5(d) and (e). In the context of commercial sales, revenue was foregone when the vendor chose to sell the product at a price lower than the price at which the vendor *could* have otherwise sold it. In other words, if a vendor chose to forego a sale into a higher-priced market in favour of a sale into a lower-priced market, then the vendor had chosen to forego revenue.<sup>197</sup>

4.182 Canada argued that "revenue foregone" implied a choice of markets, a choice foregone. Under the Canadian milk marketing system, milk *could not* be sold in the market for export uses if it was

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<sup>194</sup> United States, Exhibit 42.

<sup>195</sup> Canada noted the acknowledgement of the United States that the meaning of the word "subsidy" was substantially the same for the purposes of the Agreement on Agriculture and the SCM Agreement (paragraph 4.304).

<sup>196</sup> Canada noted that this explanation of its interpretation of the expression "payment-in-kind" was without prejudice to its position that there was no Article 9.1 export subsidy of any kind in this case.

<sup>197</sup> Canada noted that the United States had publicly stated that Canadian milk was sold to the international market at world market prices: *FAS Online*, "Dairy: World Markets and Trade - January 1998": "The US Challenges Canada's Dairy Export Subsidies and Import Protection", p. 2; "Dairy Trade by Selected Countries", p. 2. This was in contrast with the suggestions found in paragraph 40 of the United States Submission that Canadian exports were sold at prices "equal to or below world prices". Further, Canada noted again that since, under the Canadian dairy system, the ultimate decisions to produce for export lay with the dairy producers, they demanded that sales of such milk be made for the best available prices. To do otherwise would be irrational. (Canada, Exhibit 33)

required for Canadian domestic requirements. Thus, sales of milk for export purposes at prices based on world market prices could not be made until there was no opportunity to sell milk into domestic markets at the *higher* domestic prices. This was a basic and rational approach in any commercial operation. Any milk sold for export uses was additional to the domestic demand. The sale of milk at world market prices - not always lower than domestic prices - therefore took place when milk producers in Canada could no longer place their products on the domestic market, and had therefore to try to obtain the highest prices possible in the alternative market, i.e., the market in Canada for milk for use in exports. Suggestions that Canadian milk producers somehow "forewent" revenue otherwise available to them in the domestic market demonstrated a serious misunderstanding of the Canadian milk marketing system.

4.183 Canada argued that rather than representing "revenue foregone", such sales represented revenue enhancement. Canadian producers could choose not to produce any milk in addition to domestic requirements. Accordingly, they could choose not to produce milk for use in export sales. They could choose to limit their revenues to the returns they would get from the domestic markets. Instead, by choosing to produce milk in addition to domestic needs, the returns from which would be based on world market prices, producers chose to try to enhance their total revenues. As a result, the only reasonable approach was indeed the approach adopted by the milk producers in Canada; to find a market in which the highest return was found for milk at any particular time. Thus, in the sale of milk at world market prices, revenue was not foregone but rather enhanced.

4.184 Canada argued that the fact that there was a domestic market and an export market was not a fiction but a fact of life. Canada rejected New Zealand's characterization that producers were "forced" by government to forego their own revenue. The record showed that the producers had collectively and individually chosen to market their product in the manner reflected by the present regime. New Zealand failed to explain how producers making these collective and individual decisions were "foregoing revenue" in the sense understood by Canada and the United States. In addition, it remained Canada's position that there was no revenue foregone, even to producers, when a person willingly sold a product in a market for the price that the market would bear for that product.

4.185 Canada noted that New Zealand built arguments on the basis of the Uruguay Round negotiating document entitled: Modalities for the Establishment of Specific Binding Commitments under the Reform Program (paragraph 4.169). Canada pointed out that the following injunction was found on the cover sheet of the document:

"The revised text is being re-issued on the understanding of participants in the Uruguay Round that these negotiating modalities shall not be used as a basis for dispute settlement proceedings under the WTO Agreement".

4.186 **New Zealand** argued – in respect of Canada's argument that the Special Milk Classes Scheme did not constitute a "payment-in-kind" within the meaning Article 9.1(a), because a payment-in-kind arose when a debt was satisfied by the provision of a good or a service rather than being paid for in money (paragraph 4.194) – that the suggestion that the existence of a debt was a prerequisite to any notion of payment-in-kind would render that concept, in the context of subsidies, completely redundant. If a debt was owed, the payment of it, or its discharge through a payment-in-kind, could not constitute a subsidy. It would simply be the *re*-payment of a debt. To the extent that Canada was suggesting that a payment-in-kind could never be a subsidy and could only be used in the context of the satisfaction of a debt, it was seeking to rewrite Article 9.1(a) to exclude the concept of "payment-in-kind" completely.

4.187 Since Canada's arguments that the Special Milk Classes Scheme did not meet the definition of the term "subsidy" and hence could not be a subsidy within the meaning of Article 9.1(a) of the

Agreement on Agriculture were unfounded (paragraph 4.179), New Zealand's arguments on the applicability of Article 9.1(a) remained unanswered by Canada.

(ii) *The meaning of the term "direct"*

4.188 **New Zealand** argued that the term "direct" in relation to subsidization was used in a variety of senses and its meaning in any particular case had to be derived from the context in which it was used. In the context of subsidies under the GATT 1947, the word "direct" bore a particular meaning which was articulated in the negotiation of Article XVI of the GATT 1947. The term "indirectly" in Article XVI, it was explained, made it clear that "subsidization" could "not be interpreted as being confined to subsidies operating directly to affect trade in the production under consideration."<sup>198</sup> In other words, a "direct" subsidy was one affecting trade in the product directly rather than one affecting trade incidentally or indirectly. In the present case, the subsidy provided was clearly "direct". Revenue was being foregone for the very purpose of affecting the trade in question - indeed of permitting its very existence. Without this foregoing of revenue no export trade would exist.<sup>199</sup> The objective of this foregoing of revenue was to secure export performance. It was not a subsidy that had other objectives with export performance as an incidental effect; it was a subsidy that provided only for products which were destined for export. It was a direct subsidy contingent on export performance, and thus fell within the ordinary meaning of the words of Article 9.1(a).

4.189 New Zealand argued that in Article 9.1(a) the term subsidies had to be interpreted in the light of the fact that this provision was referring to "direct" subsidies and in view of the fact that the category of direct subsidies had to be large enough to include "payments-in-kind." This alone was sufficient to demonstrate that a simple reliance on the definition of the term "subsidy" in Article 1 of the SCM Agreement was inadequate for the interpretation of Article 9.1(a). As this was ignored by Canada, Canada had failed to interpret Article 9.1(a) properly and thus had failed to show that the Special Milk Classes Scheme did not constitute an export subsidy within the meaning of Article 9.1(a). Accordingly, Canada had not discharged the burden of proof placed on it under Article 10.3 of the Agreement on Agriculture (paragraphs 4.290 and following refer).

4.190 **Canada** refuted the broad interpretation of the term "direct" in Article 9.1(a) given by the Complainants. Canada rejected any necessity to enter into such an exercise and referred the Panel to Article 1.1(a)(1) of the SCM Agreement where "direct" was used to qualify a "subsidy" implying a transfer of funds by a government. Canada reiterated that no direct export subsidy existed in Canada for dairy products.

(c) Article 9:1(c)

(i) *The meaning of the term "payment"*

4.191 **New Zealand** noted that the word "payment" was defined in the *Oxford English Dictionary* as: "1. the action, or an act of, paying; the remuneration of a person with money or its equivalent ... 2. a sum of money (or other thing) paid; ...".<sup>200</sup> The *Dictionary of Canadian Law* defined "payment" as "remuneration in any form."<sup>201</sup> The term "remunerate" was defined in the *Oxford English*

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<sup>198</sup> Report of the Drafting Committee of the Preparatory Committee of the UN Conference on Trade and Employment (20 January - 25 February 1947), E/PC/T/34/Rev.1 (29 May 1947), p. 26.

<sup>199</sup> New Zealand noted that Lyle Vanclief, then Parliamentary Secretary to the Minister of Agriculture and Agri-Food had told the Canadian House of Commons in 1995 that if the legislation which was to allow the CDC to implement "special milk classes" were not implemented by 1 August 1995 "dairy exports to the United States using producer-financed levies [would] be in jeopardy. Furthermore, while export subsidies by levies to other destinations could continue to grow for now, these subsidized shipments [would] also have to be reduced over time": House of Commons Debates, Volume 133 (No. 202), Tuesday 16 May 1995, p. 12668.

<sup>200</sup> *The Oxford English Dictionary* (2nd Edition) - Volume XI, Clarendon Press, Oxford, pp. 379-380.

<sup>201</sup> *The Dictionary of Canadian Law*, p. 755.

*Dictionary* as "1. To repay, requite, make some return for (services etc) ... 2. To reward (a person) ... to pay (one) for services rendered ... 3. to give as compensation ... ".<sup>202</sup> New Zealand argued that the term "payments" covered both payments-in-kind and revenue foregone. The ordinary meaning of the term payment included a "payment-in-kind". Adding "in-kind" to the word "payment" simply described the *form* in which a payment was made. In respect of Article 9.1(a), the provision to exporters of lower-priced milk was a "payment-in-kind". It was the delivery of something of value in a form other than by way of a money transfer.

4.192 The **United States** argued that the common meaning of the word "payment" was "the action, or an act, of paying; the remuneration of a person with money or its equivalent; the giving of money, etc. in return for something in discharge of a debt". The word was also defined as "a sum of money (or other thing) paid; pay, wages; or price".<sup>203</sup> The verb "to pay," from which the noun "payment" was derived, was variously defined as "to give what is due, as for goods received; remunerate; recompense; to give or return as for goods, or services; to give or offer." However, "to pay" had also been construed as meaning "to give money or other equivalent value for; to hand over the price of a (thing); to bear the cost of; to be sufficient to buy or defray the cost of".<sup>204</sup> Thus, although the word payment often connoted an exchange of value for the provision of goods or services, or the provision of value on the occasion of a particular event or condition, it could also encompass bearing the cost. This latter meaning was perhaps the most consistent with the word's use in the context of a provision defining subsidies. Thus, the term payment could be used in Article 9.1 consistent with the concept of conferring a benefit through the bearing of a cost.<sup>205</sup>

4.193 In respect of the term "payment", **Canada** refuted that its ordinary meaning included "revenue foregone". The ordinary meaning of the term "payments" was straightforward – it meant "a sum of money."<sup>206</sup> Canada noted that, pursuant to Article 33 of the Vienna Convention, the French language version of the text of this provision provided additional support for its interpretation of the word "payment". The term used in the French text was "versement" which meant literally to remit money.<sup>207</sup>

4.194 Canada recalled that while the United States acknowledged that the common meaning of payment was "the action, or act of paying; the remuneration of a person with money or its equivalent; the giving of money, etc. in return for something in discharge of a debt" (paragraph 4.192), wishing to argue that the ordinary meaning of the word payment included "revenue forgone" and realizing that this "common meaning" was not supportive of their position, the United States had attempted to find an alternative meaning through the verb "pay", pointing to the eleventh listed definition which includes the phrase "bear the cost". This was a frail argument when it was considered that this was found within the eleventh definition of a related word, and did not appear at all the most recent *New Shorter Oxford English Dictionary*.<sup>208</sup> "Payments" had to be interpreted in its "ordinary meaning": i.e. to reflect an action of paying something of value.

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<sup>202</sup> *The Oxford English Dictionary* (2nd Edition) - Volume XIII, Clarendon Press, Oxford, p. 604.

<sup>203</sup> *The Oxford English Dictionary* (2nd Edition), Clarendon Press, 1989, pp. 379-80.

<sup>204</sup> *Ibid*, p. 376, definition no. 11.

<sup>205</sup> The United States noted that this would be consistent with the requirement in the SCM Agreement that a subsidy involve a benefit.

<sup>206</sup> Canada noted that the *New Shorter Oxford English Dictionary* referred to; "1. an act, or the action or process, of paying. (Foll. by *of* the money etc. paid, the debt discharged, the payee; *for* the thing bought or recompensed.) ME. 2. (a sum of) money etc. paid. LME." (Canada, Exhibit 26)

<sup>207</sup> Canada referred *Le Petit Larousse*, 1994: "1. Action de verser de l'argent à qqn, à un organisme, sur son compte, etc.; 2. Somme versée." (Canada, Exhibit 28)

<sup>208</sup> Canada, Exhibit 26.

4.195 Canada noted that New Zealand as well encountered difficulty in establishing that the "ordinary meaning" of the word "payment" included "revenue forgone". New Zealand noted that the *Oxford English Dictionary* definition of "payment" included "remuneration of a person with money or its equivalent" and suggested that the reference to "remunerate" indicated that the term was to be read broadly. Canada argued that there was a major difference between suggesting that payments could be made with a wide variety of items of value, i.e., from actual cash to payment-in-kind, to concluding that the ordinary meaning of "payment" included an indirect result such as "revenue foregone".

4.196 In **New Zealand's** view the dictionary definitions referred to above, indicated that the concept of "payment" had a wide ambit. New Zealand noted that in order to determine how the term payment was being used in the specific case of Article 9.1(c), reference had to be made to the context in which the term was used and the object and purpose of the Agreement on Agriculture as a whole.<sup>209</sup> New Zealand noted that Article 9.1(c) was contained in a provision that identified the mechanisms that states had used to provide export subsidies and which were subject to reduction commitments. One mechanism the negotiators of Article 9.1(c) had in mind was the use of producer levies to fund payments to exporters to compensate for the high cost of a product purchased at domestic rather than at world prices. Such payments were referred to specifically as being included in the definition of "payments on the export of an agricultural product." The wording of Article 9.1(c) made clear that it had not been intended that its provisions be limited only to money paid from the proceeds of a producer levy.<sup>210</sup> An examination of the context in which the word "payments" in Article 9.1(c) appeared confirmed that in the light of the object and purpose of the Agreement on Agriculture as a whole, the term "payments" covered both revenue foregone and payments-in-kind.

4.197 New Zealand emphasized that as Article 9.2 included revenue foregone within the determination of budgetary outlay commitments to be made with regard to the subsidies listed in Article 9.1, the concept of "payments", in Article 9.1(c), had to include "revenue foregone" as they had to be quantified under the heading of "budgetary outlays", and this included, explicitly, revenue foregone. There was no need to provide specifically that "payments" included revenue foregone because the definition of "budgetary outlays" already carried that implication.

4.198 The meaning of the phrase "payments on the export of an agricultural product" in Article 9.1(c) of the Agreement on Agriculture must, however, be distinguished from the term "the payment of subsidies exclusively to domestic producers" under Article III:8(b) of the GATT 1994. In *Canada - Certain Measures Concerning Periodicals* the Appellate Body stated that:

" ... an examination of the text, context, and object and purpose of Article III:8(b) suggested that it was intended to exempt from the obligations of Article III only the payment of subsidies which involves the expenditure of revenue by a government."<sup>211</sup>

4.199 Accordingly, New Zealand noted that the Appellate Body concluded that a reduction in postal rates did not constitute a "payment of a subsidy exclusively to a domestic producer" within the meaning of GATT Article III:8(b). In reaching this conclusion the Appellate Body was influenced by the fact that Article III:8(b) was an exception to the national treatment obligation. In its view, it was

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<sup>209</sup> New Zealand noted that such an approach had been endorsed by the Appellate Body in *Canada - Certain Measures Concerning Periodicals* (hereafter "*Canada - Periodicals*"), WT/DS31/AB/R, adopted 30 July 1997, in seeking to interpret the meaning of the term "the payment of subsidies exclusively to domestic producers" in GATT Article III:8(b): p.34.

<sup>210</sup> New Zealand noted that Article 9.1(c) referred to "payments on the export of an agricultural product ... including payments that are financed through the proceeds of a levy ... "

<sup>211</sup> Appellate Body Report on *Canada - Periodicals*, *op. cit.*, p.34. New Zealand further noted that similar views were expressed in the Panels on *US - Malt Beverages*, *op. cit.* and *Indonesia - Certain Measures Affecting the Automobile Industry*, (hereafter "*Indonesia - Automobile Industry*"), WT/DS54/DS55/DS59/DS64/R, adopted 23 July 1998, p.340.

never intended that exceptions to national treatment by way of subsidies based on tax reductions or other forms of revenue foregone were to be permitted under Article III:8(b).

4.200 In fact, New Zealand maintained that the rationale of the *Canada - Periodicals* decision reinforced the conclusion that the term "payments on the export of an agricultural product" in Article 9.1(c) had to include revenue foregone. The objective of the list in Article 9.1 was to bring agricultural export subsidies under WTO disciplines. An interpretation of Article 9.1(c) that narrowed the scope of the subsidies included therein to direct money transfers would defeat rather than serve the object and purpose of Article 9. It would expand the opportunity for Members to avoid their WTO obligations - precisely what the Appellate Body in *Canada - Periodicals* was seeking to avoid. Such a conclusion was strengthened when the object and purpose of the export competition provisions of the Agreement on Agriculture as a whole were considered. Revenue foregone, which was simply an alternative way of securing a benefit that could be obtained through the direct transfer of money, had to be included in the concept of "payment" under Article 9.1(c) if the progressive reduction of export subsidies through reduction commitments was to be successful.

4.201 New Zealand noted that under the old producer levy system, the CDC, acting in concert with provincial milk marketing boards or agencies, transferred money to exporters to compensate for the cost of processors purchasing milk for products for export at domestic rather than at world prices. Under Classes 5(d) and (e) of Special Milk Classes, processors were permitted to purchase milk for products for export at world rather than at domestic prices. The difference between the two approaches was one of form only. In each case, the processor for export was being shielded from the high domestic cost of milk. In each case, the processor for export was being provided with a subsidy that was captured by the phrase "payments on the export of an agricultural product" in Article 9.1(c) of the Agreement on Agriculture. Under Classes 5(d) and (e) revenue was foregone by provincial milk marketing boards or agencies providing access to milk from producers to processors at "special class" prices. The provincial milk marketing board or agency forewent the revenue that it would have received if the milk had been sold at domestic prices.

4.202 New Zealand contended that although the provincial milk marketing board or agency was the vehicle for providing the special milk classes subsidy, it was the producer who bore the financial cost. The role of the provincial board or agency was one of a conduit - to pass on to the producer through the pooling arrangements the revenue that results from Special Milk Class sales. In fact, what the agency passed on to the producer were the *losses* that resulted from sales of milk at world market prices. It was the producer who forewent the revenue that would have been received if all milk was sold to processors at domestic prices. The Special Milk Classes Scheme shrouded in complexity the obvious fact that it was the producer who made the "payments on the export of an agricultural product" that brought the scheme within Article 9.1(c).

4.203 New Zealand claimed that, in substance, the revenue foregone by producers "on the export of an agricultural product" was the equivalent of a subsidy provided to such processors by a direct money transfer financed from the proceeds of a levy on "an agricultural product from which the exported product is derived" - a form of subsidy that Article 9.1(c) expressly enjoined. Hence, the Special Milk Classes Scheme involved an elaborate structure for a very simple subsidy. It consisted of the foregoing of revenue on the export of an agricultural product. That foregoing of revenue could be viewed as a foregoing by a provincial milk marketing board or agency, or it could be viewed as the foregoing of revenue by producers. The difference between the two was largely a matter of accounting. The form could differ, but the substance remains the same.

4.204 As noted under Article 9.1(a), New Zealand argued that Classes 5(d) and (e) of the Special Milk Classes Scheme could also be characterised as providing payments-in-kind - something that was equally encompassed in the ordinary meaning of the term "payment". A payment-in-kind involved remuneration through something other than, or something equivalent to, money. The provision of

goods (milk) at a reduced price, instead of providing a money sum to compensate for the higher price that would be paid for milk for processing into products destined for the domestic market, was a payment-in-kind. It was a direct substitute for a payment by way of money transfer. And that, of course, was its intent. It should be seen as a substitute for the old "money-transfer" subsidies paid by Canada from producer levies. It was a "payment-in-kind" that fell within the concept of "payments on the export of an agricultural product" under Article 9.1(c).

4.205 The **United States** claimed that like the producer levy programme it replaced, the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture. By the express terms of that sub-paragraph, there was no requirement that an export subsidy be a charge on the public account. By way of example, the Article specified that payments subject to its coverage may be "financed from proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the export product is derived." As argued under Article 9.1(a), the United States claimed that the term "payment" was broad enough to include instances in which value was given by some other means than the actual transfer of funds (paragraph 4.192). If this were the case, then a fortiori "payment" included situations where value was given to another by means such as a product, in this case milk, at less than the market price.

4.206 The United States noted that the term payment was used twice in Article 9.1(c), but was not defined there or elsewhere in the Agreement on Agriculture.<sup>212</sup> The United States noted that the Vienna Convention counselled that the ordinary meaning of a term was to be given in light of its context, which, in this case, was the Agreement on Agriculture and, more specifically, that Agreement's provisions governing export subsidy disciplines. The meaning of the term "payment" had also to be fixed by considering the object and purpose of the pertinent treaty. Article 9.1, as a whole, broadly identified the subsidies, including payments within Article 9.1(c), that were to be taken into account in calculating the maximum level of expenditure for export subsidies that a Member could incur in a given year consistent with its Schedule of Concessions and Commitments and Articles 3 and 8 of the Agreement on Agriculture. This level constituted the Member's budgetary outlay reduction commitment. The term "budgetary outlays" was defined in Article 1(e) of the Agreement on Agriculture to include "revenue foregone." Thus, for example, not only direct subsidies, such as those described in Article 9.1(a), but also reduced charges, i.e., revenue foregone, as described in Paragraph 1(c), counted toward the budgetary outlays that were subject to the reduction commitments, whether or not charged to the public account.

4.207 The United States argued that in this context, and given that the purpose of Part V of the Agreement was to impose discipline on export subsidies, the term "payment" had to be construed consistently with the broad meaning given to budgetary outlays. If such outlays, and thus the applicable reduction commitments overall were expressly defined to include revenue foregone, then one consistent construction was to construe "payments" in a similar manner. Such an interpretation was consonant with the purpose of the Agreement to bring export subsidies under the transitional disciplines established by the reduction commitments. Considered from this perspective, if the total expenditures subject to reduction commitments were defined as total budgetary outlays and revenue foregone, then the individual expenditures had logically to comprise all payments, including price reductions that had the same economic effect as an export rebate. By mandating the sale of industrial milk at a discount, the Government of Canada was conferring a benefit to milk processors equivalent in its trade distorting effect to an export rebate. Moreover, the principle that an export subsidy could be accorded in the form of sales of products at a loss, or by offering goods or services for export at a more advantageous price than when offered for sales for domestic consumption, was not only inherent in the Agreement's definition of budgetary outlays, but was also reflected in the provisions of

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<sup>212</sup> The United States noted that although the word "outlay" was used elsewhere in Article 9, it was defined in Article 1 of the Agreement to include revenue foregone, no definition of the word "payment" appeared in Article 1 with the other defined terms.

Article 9.1(a), (b) and (e) which defined "payments-in-kind," sales of non-commercial stocks, and discounted transport and freight charges as forms of subsidization.<sup>213</sup>

4.208 In addition, the United States noted that the context of Article 9.1(c) also included the related subsidy reduction commitments contained in Articles 3, 8, and the remainder of 9 of the Agreement on Agriculture. These provisions were collectively intended to impose meaningful disciplines on the use of export subsidies. The Agreement on Agriculture thus narrowed the universe, and amount, of potential subsidies in several respects. First, Article 3 specified that no export subsidies were to be provided "in respect of any agricultural product not specified" in a Member's schedule. A Member could not introduce subsidies for products that were not identified in its schedule and which had not been subsidized during the pertinent base period. Furthermore, Article 9.1 referenced a broad cross-section of subsidy practices that were intended to capture the agricultural subsidies used by the Members at the time of negotiation of the Agreement. Such subsidies were made subject to reduction commitments pursuant to Articles 3, 8 and 9 of the Agreement, with significant reductions required in both subsidy outlays and the quantity of exports that benefitted from subsidies to occur during the transition period. In addition, Article 10, to protect Article 9 disciplines on export subsidies, prohibited the introduction of any subsidies not listed in Article 9 that either "results in, or which threatens to lead, to circumvention of export subsidy commitments ... " And finally, Article 3 of the SCM Agreement, when read in conjunction with Article 13 of the Agreement on Agriculture, provided that if a Member did not comply with the export subsidy disciplines contained in the Agreement on Agriculture, any offending export subsidy was to be subject to the terms of the SCM Agreement and its prohibition on export subsidies.<sup>214</sup>

4.209 Hence, the United States argued that given the Agreement on Agriculture's comprehensive treatment of export subsidies, which revealed the Members' intent to establish real and effective disciplines respecting export subsidies, a narrow construction of the term "payment" that would result in a weakening of the export subsidy reduction commitments and disciplines, would be contrary to the over-arching objective and purposes of the relevant treaty provisions as a whole.

4.210 In this regard, the United States noted that Professor Tangermann also compared the pernicious effect of producer-financed export subsidies with price pooling by state export agencies and concluded that the latter should be subject to the same export competition disciplines:

"Where a state agency sells domestically at a price above the price charged for exports, while domestic producers are paid the average price, exports are implicitly subsidized. To see why, it is best to compare this policy to one of producer-financed export subsidies. In the latter case, a levy is charged on the domestic sales, and the proceeds are then used to finance export subsidies. Under a price pooling regime, the same prices can result, and it is only the technical nature of financial flows which is different, but not the economic result. Hence, price pooling differs from producer-financed export subsidies only in form, not in substance. Countries should, therefore,

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<sup>213</sup> The United States noted that the concept that subsidies that resulted in a price lower for export sale than for domestic consumption were export subsidies was, of course, a fundamental aspect of the export subsidy discipline contained in Article XVI of the GATT. Article XVI:4 stated, in relevant part: "... contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."

<sup>214</sup> Paragraph (c) of Article 13 of the Agreement on Agriculture, the so-called "Peace Clause", provided that export subsidies that conformed fully to the export subsidy disciplines contained in Part V of the Agreement were "exempt from actions based on Article XVI of GATT 1994 or Articles 3, 5, and 6 of the Subsidies Agreement." Article 3 of the SCM Agreement, which contained the prohibition on export subsidies, stated that the prohibition was inapplicable to the extent provided in the Agreement on Agriculture.

not be allowed to escape their export subsidy commitments by using a price pooling regime."<sup>215</sup>

4.211 The United States argued that in construing the text of Article 9.1(c), it was clear that the reference to the levy financed export rebates was made for purposes of illustration, and did not limit the scope of Article 9. Thus, the language in Article 9.1(c) relating to the "payments that are financed from the proceeds of a levy" commenced with the introductory word "including", indicating that payments so financed constituted only one example of the types of payments which fell within the scope of the Article 9 subsidy disciplines. There was nothing in the text of the paragraph to provide a basis for concluding that other types of producer-financed funding for export payments, such as discounted prices, would be excluded from the subsidy constraints imposed by Article 9.1(c). To the contrary, subsidies that were the functional equivalent of producer-financed levies had to be assumed to be included in Article 9.1(c) disciplines.

4.212 The United States argued that Canada's Special Milk Classes Scheme differed from the producer levy programme that preceded it only in form, not substance. Revenue foregone (on export sales under the Special Classes) by the milk producers, which translated into discounted prices for dairy product manufacturers, was equivalent to the export rebates paid to such manufacturers under the levy system. To exclude such discounted milk from the coverage of Article 9.1(c) because the benefit or payment received by the dairy product exporter was in the form of a lower milk price, rather than in the form of an export rebate contingent on export of a product in which the milk had been used, would elevate form over substance. Hence, the Special Milk Classes Scheme, like the producer levy programme that it replaced, qualified as "payments on the export of an agricultural product" within the meaning of Article 9.1(c). First, the discounted milk prices provided for in Special Milk Classes 5(d) and (e) were available only in connection with the production of dairy products for export and, thus, were provided "on the export of an agricultural product". Second, the lower prices extended to milk processors, contingent on the use of the milk for production of dairy products for export, were the same both in substance and economic effect as the earlier levy-financed export rebates and, therefore, were likewise a "payment" within the meaning of that term as used in Article 9.1(c) of the Agreement.<sup>216</sup>

4.213 **Canada** submitted that the sales of milk under Special Classes (d) and (e) did not constitute an export subsidy within the meaning of Article 9.1(c) as it could not be shown that "payments" were made on the export of products from Canada.

4.214 Canada argued that, in accordance with the Vienna Convention, the interpretation of the text of WTO agreements had to proceed on the following basis: (i) the starting point was always the actual text and its ordinary meaning; (ii) the ordinary meaning of the terms of the agreement was to be read in their context; (iii) "context" had to comprise the text of the agreement, including other contemporaneous agreements reached by all the parties, as outlined in Article 31.2 of the Vienna Convention, and (iv) recourse could only be had to supplementary means of interpretation, such as negotiating history, in the event of ambiguity or to confirm a meaning.

4.215 Canada noted that New Zealand argued that support for the proposition that payment should include revenue forgone could be found the *Canada - Periodicals* case (paragraph 4.198 and

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<sup>215</sup> "A Developed Country Perspective of the Agenda for the Next WTO Round of Agricultural Negotiations," Stefan Tangerman, paper presented at the Graduate Institute of International Studies, p. 22-23. (United States, Exhibit 24)

<sup>216</sup> The United States noted that the Appellate Body considered the subsidy exception contained in Article III:8(b), which included the phrase "payment of subsidies exclusively to domestic producers," in *Canada - Periodicals*, *op. cit.* The meaning of that phrase had received consideration in a number of GATT disputes, *e.g.*, *US - Malt Beverages*, *op. cit.*, para. 5.8. The United States, however, submitted that these decisions gave considerable weight in interpreting the phrase in Article III:8(b) to its context and the purpose of the treaty provision. That context and purpose, involving the construction of an exception to the principle of national treatment, was unquestionably different than that presented by Article 9.1(c) of the Agreement on Agriculture.

following). In that case, the Appellate Body had ruled that the term "payment" as it appeared in Article III:8(b) of the GATT 1994 did not include a reduction of postal rates since Article III:8(b) was an exception and should be interpreted narrowly. New Zealand suggested that on the basis that Article 9.1 was a positive obligation the reverse should hold true: its terms should be interpreted *broadly*. Canada submitted that this misconstrued the proper interpretive approach. The fundamental rule was that of "ordinary meaning" under Article 31 of the Vienna Convention. In the case of an exception, the exceptional approach of a narrow approach was applied. Absent an exception, the interpreter had to revert to the fundamental rule of "ordinary meaning".

4.216 Canada argued that it was also noteworthy that in Article 1 of the SCM Agreement, the drafters were careful to add a provision covering "government revenue that is otherwise due is forgone", they had realized that the ordinary meaning of the preceding provision relating to "direct transfers of funds" would not be sufficient to cover "revenue forgone".

4.217 Canada refuted the allegations that the interaction between Article 9.2 and Article 9.1 implied that the defined meaning of "budgetary outlays", i.e., including "revenue forgone" was applicable to "payment" in Article 9.1(c). This would be to set aside the ordinary meaning of a word based on an indirect inference and notwithstanding the clear contextual confirmation provided by Annex 2.

4.218 Canada noted that in *United States - Reformulated Gasoline*, the Appellate Body undertook a comparison of the words used in different paragraphs of Article XX to determine the meaning of the test set out in Article XX(g). The Appellate Body noted that *different words* were used in the different paragraphs so as to properly describe the required relationship or degree of connection between the objectives in question and the measures implemented: "necessary" in certain paragraphs, "relating to" in certain others, "for the protection of" in another, and so on. Accordingly, the Appellate Body held that:

"It does not seem reasonable to suppose that the WTO Members intended to require, in respect of each and every category, the same kind of degree of connection or relationship between the measure under appraisal and the state interest or policy sought to be promoted or realised."<sup>217</sup>

4.219 Hence, Canada argued that it could be presumed that specific words carried specific meanings and that the use of different words in a treaty text meant that the parties to the treaty intended different meanings to be applied to those differing terms. The approach to the interpretation of the term "payments" in Article 9.1(c) in the context of Article 9.1 as a whole should be no less rigorous. Canada argued that the choice of different terminology in each provision of Article 9.1 clearly indicated that negotiators had very precise and distinct concepts in mind with respect to each provision. In the light of the terms used in the other provisions, the selection of the word "payment" in Article 9.1(c) indicated an intention to apply a precise and limited ambit to the application of Article 9.1(c). Accordingly, the term "payment" had to be given its ordinary meaning and not be construed so as to encompass practices that could be covered by the use of broader terms such as "subsidies".

4.220 Canada argued that the negotiating history of Article 9.1 demonstrated that with respect to Article 9.1(c) in particular, the course of the agriculture negotiations had been to narrow the scope of that provision. Thus, the essential issue was what the parties agreed to at the end of the negotiations. In the context of the Agreement on Agriculture, this very point was made in one of the exhibits relied

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<sup>217</sup> Appellate Body Report on *US - Reformulated Gasoline*, *op. cit.*, p. 18.

upon by the United States (paragraph 4.210).<sup>218</sup> Therein, Professor Tangermann identified production quotas with over-quota output sold at world market prices and price pooling arrangements as matters not presently covered under the Agreement on Agriculture and thus were subjects to be pursued in *future negotiations*.<sup>219</sup> Professor Tangermann recognized that the proper way to reconcile the divergent economic theories was by multilateral negotiation, not negotiation through litigation. Canada argued that it was apparent that Professor Tangermann viewed the results of the Uruguay Round in agriculture as having an unsatisfactory economic result. While Professor Tangermann was entitled to his opinion as to the outcome he would consider to be desirable<sup>220</sup>, the Agreement on Agriculture was not concerned with any particular economic theory but rather with specific legal obligations that were agreed to by Members.

4.221 Canada argued that if, indeed, the intention of the negotiators had been to stretch the meaning of "payment" beyond its ordinary meaning, this would have been provided for specifically. For example, the terms "budgetary outlay" and "outlay" had been defined in Article 1 of the Agreement on Agriculture as including "revenue foregone". Payment, however, which did not incorporate "revenue foregone" in its ordinary meaning, was not similarly defined. Confirmation of this could be found in the treatment of the word "payment" as it was used elsewhere in the Agreement on Agriculture. "Payment" appeared prominently in Annex 2 with respect to domestic support. In Article 5 of Annex 2 the reference was to "payments (or revenue forgone, including payments in kind)". Clearly, the drafters were aware that the ordinary meaning of payment did not include "revenue forgone" and specific provision for its inclusion would be required. The absence of any counterpart in Article 9.1 could only lead to the conclusion that in the case of Article 9.1(c) the drafters intended the ordinary meaning of "payment" to stand.

4.222 Canada further claimed that the negotiating history of the Agreement on Agriculture also supported Canada's submission that the term "payment" had to be construed precisely. Article 32 of the Vienna Convention permitted recourse to supplementary means, including the *travaux préparatoires*, to support the interpretation arrived at under Article 31.

4.223 Canada noted that Annex 7 to the Draft Dunkel Working Papers dated 21 November 1991 provided a proposed list of measures that would be deemed to be "export subsidies" for the purposes of reduction commitments.<sup>221</sup> As such, this list, which reflected earlier draft texts circulated in the summer of 1991<sup>222</sup>, was a precursor to the eventual Article 9.1 in the Agreement on Agriculture. In particular, Article 3(k) of this draft was an early version of the text that would ultimately become Article 9.1(c). This paragraph referred to "subsidies", not "payments". The text of Paragraph 1(c) continued to refer to "subsidies" in the text of the 12 December Dunkel draft.<sup>223</sup> On

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<sup>218</sup> "A Developed Country Perspective on the Agenda for the Next WTO Round of Agriculture Negotiations", paper presented at the Graduate Institute of International Studies, Stefan Tangermann, contained in United States, Exhibit 24.

<sup>219</sup> *Ibid.*, p. 21: "Much effort was made in the Agreement on Agriculture to define export subsidies as precisely as possible, through appropriate wording in Article 9. However, there may be reasons to *consider some improvements*. In particular, there are policies which effectively may result in cross-subsidisation of exports and which may not be clearly enough outlawed by the current wording. Two cases in point are production quotas with above-quota output sold at world market prices, and price pooling arrangement." (emphasis added) Further at p. 23 Professor Tangermann wrote of the difficulty of getting countries to address this perceived problem and suggested two solutions: "However, *one could seek agreement* that new regimes of this type (ad (*sic*) new changes to old regimes resulting in the same type of effects on exports) established after the Uruguay Round are included in the definition of export subsidies. Alternatively, *one could agree explicitly (in some appropriate legal form)* that such regimes fall under Article 10 of the Agreement on Agriculture, i.e., that they amount to 'circumvention of export subsidy commitments'." (emphasis added)

<sup>220</sup> *Ibid.* p. 21: "Such exports may, therefore appear *not to fall* under the export subsidy commitments under the Agreement on Agriculture. *From an economic point of view* this situation is not quite satisfactory." (emphasis added) Further at p. 22-23: "It is, therefore somewhat problematic, to say the least, that the Agreement on Agriculture so far does not include such indirect cross-subsidisation in its definition of export subsidies."

<sup>221</sup> Canada, Exhibit 29.

<sup>222</sup> Canada, Exhibit 30.

<sup>223</sup> Canada, Exhibit 53.

17 December 1991, Canada submitted to Arthur Dunkel a number of specific redrafting proposals on the agriculture text. Amongst these was an amendment to Paragraph 1(c) so as to substitute the word "payments" for the word "subsidies".<sup>224</sup> The text of Article 9(1) of the "Draft Final Act" of 20 December 1991 reflected this change and referred to "payments".<sup>225</sup> This drafting history confirmed that the term "payments" was specifically and deliberately selected in place of a broader term. Accordingly, the word "payment" in Article 9(1)(c) had to be interpreted strictly in accordance with its ordinary meaning.

4.224 Moreover, Canada recalled its argument as set out under Article 9.1(a) that even if the word "payments" were held to include "revenue forgone", there was no revenue for the producers to forego with respect to sales of milk for export use under Special Classes 5(d) and (e) (paragraph 4.181 and following).

4.225 **New Zealand** noted that in the context of Article 9.1(c), Canada denied that the Special Milk Classes Scheme fell within the Agreement on Agriculture because (i) the word "payments" in Article 9.1(c) did not encompass revenue foregone and hence could not encompass what occurred under special milk classes, and (ii) even if the term "payments" did encompass revenue foregone, in fact no revenue was foregone under special milk classes. New Zealand refuted both contentions.

4.226 New Zealand maintained that in arguing for a restrictive meaning of the term "payments", Canada relied on both a contextual reading of the provision and negotiating history. In New Zealand's view, Canada had misread the context in which the term "payments" appeared and drawn inadmissible conclusions from the negotiating history.

4.227 New Zealand maintained that Canada sought to draw meaning for the word "payments" from the broad context of the Agreement on Agriculture, arguing that since in Article 5 of Annex 2 to the Agreement the terms "revenue foregone" and "payments in kind" were expressly included after the word payments, then the failure to mention either of these in Article 9.1(c) meant that they were excluded. New Zealand pointed out that Canada conveniently omitted to state that the term in Article 5 of Annex 2 was "direct payments" which in that context, given its connotation of money transfers, would have otherwise excluded "revenue foregone" or "payments-in-kind".

4.228 Furthermore, New Zealand argued that Canada had opted to explain the term payments by looking at the broader context of the Agreement on Agriculture, and focusing on domestic support disciplines, while ignoring the actual context of Article 9 itself. New Zealand emphasized that Article 9.2 made it clear that export subsidy reduction commitments were to include subsidies in the form of revenue foregone. It would thus defeat the purpose of Article 9 disciplines to read revenue foregone and payments-in-kind out of the definitions on which those commitments were based. The negotiators of Article 9 could not have intended such a result.

4.229 New Zealand argued that the express reference to revenue foregone and payments-in-kind in Article 5 of Annex 2, as well as the reference to revenue foregone in Article 9.2 (and other similar references in Annex 2, Articles 1(a), 2, 3 and 4; and Annex 3, Article 2), confirmed that subsidization by these particular means was specifically contemplated as being subject to the disciplines of the Agreement on Agriculture.

4.230 New Zealand noted that Canada further argued that the use of different terms to describe the export subsidy in question in each of the different sub-paragraphs of Article 9.1 was evidence that different meanings for each of those terms was intended. However, the examples used all proved the opposite of Canada's contention. Each was an example of a subsidy, and thus it could not seriously be

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<sup>224</sup> Canada, Exhibit 31.

<sup>225</sup> Canada, Exhibit 32.

contended that only those sub-paragraphs where the word "subsidies" was used were, in effect, to be interpreted as referring to a subsidy or, as the Canadians stated, to be interpreted as broadly as express repetition of the word "subsidy" would require.

4.231 New Zealand noted the inference drawn by Canada from the fact that the word "payments" had been inserted in Article 9.1(c) of Article 9.1 in place of the word "subsidies" during the drafting phase - it appeared that Canada was of the view that this was done to *limit* the scope of the discipline in Article 9.1(c) so as not to include revenue foregone or payments-in-kind (paragraph 4.223). However, no negotiating history was cited by Canada to verify this assertion. In arguing that the change in wording indicated an intention to narrow the scope of Article 9.1(c), Canada overlooked the fact that at the same time as the change to the word "subsidies" was made, language was inserted aimed clearly at broadening the scope of that same sub-paragraph. The text was changed to make subsidies financed from the proceeds of a producer levy simply an example of the coverage of the provision rather than its specific referent.

4.232 New Zealand considered Canada's use of negotiating history in the context of Article 9.1(c) as problematic. Article 32 of the Vienna Convention permitted recourse to negotiating history as a *supplementary* means of interpretation to confirm a meaning or to resolve ambiguity or absurdity.<sup>226</sup> Canada claimed that it was using negotiating history simply to confirm a meaning. However, rather than showing a pattern of consistency in the use of the term, Canada was seeking to show that since the word "payments" differed from the word used in earlier drafts, that this confirmed the meaning Canada sought to ascribe to it. This was not using negotiating history to confirm a meaning. It was seeking confirmation by the drawing of a negative inference from the negotiating history. That was not, in New Zealand's view, what Article 32 contemplated.

4.233 Furthermore, New Zealand argued that given the nature of the negotiations in the Uruguay Round, the only negotiating history that could be referred to were the successive drafts of provisions. In the absence of negotiating records reflecting the intentions of the drafters, the meaning of changes in those successive drafts could be no more than conjecture. In the absence of records of the negotiators' discussions, there was no justification for choosing one explanation over another. New Zealand argued that in the present case, the use of the word "payments" could well have been designed to avoid the circularity that the word "subsidies" would have entailed. Paragraph 9.1(c) was defining a subsidy; to have called it a subsidy at the outset - especially when no particular characterisation, such as "direct" was needed - would have been tautologous. In short, the Canadian explanation of the meaning of the term "payments" on the basis of negotiating history proved nothing.

4.234 New Zealand noted that the issue of producer-financed export subsidies was the subject of considerable discussion in the negotiations on agriculture. The "conditions governing government participation in the operation of producer-financed subsidy schemes" was identified in the de Zeeuw Text as an issue to be resolved.<sup>227</sup> The negotiating document of 2 August 1991 identified, under the heading of "General Criteria", differential pricing arrangements as falling within the concept of an export subsidy.<sup>228</sup> The Illustrative List recognised specifically as an export subsidy, in Paragraph (k):

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<sup>226</sup> New Zealand argued that the WTO Agreements, including the WTO Agreement on Agriculture, were to be interpreted in accordance with Articles 31 and 32 of the Vienna Convention on the Law of Treaties 1969 (the "Vienna Convention"). New Zealand noted that Article 31 of the Vienna Convention required that a treaty be interpreted in accordance with "the ordinary meaning to be given to the terms of a treaty in their context and in the light of its object and purpose". Article 32 provided that the preparatory work and the circumstances of the conclusion of a treaty could be referred to as a "supplementary means of interpretation" to confirm a meaning derived from the application of Article 31, or where the application of the approach set out in Article 31 produced a result that was "ambiguous or obscure," or was "manifestly absurd or unreasonable."

<sup>227</sup> MTN.GNG/NG5/W/170, p.6 (para. 22).

<sup>228</sup> MTN.GNG/AG/W/1/Add.10, p.1 (para. 2).

"Subsidies on exports of agricultural products which are financed from the proceeds of a levy on producers of that product or on producers of the primary product from which the exported product is derived, under programmes in whose establishment, operation or financing governments are directly or indirectly involved."

4.235 New Zealand argued that this provision was clearly the precursor to Article 9.1(c) of the Agreement on Agriculture. New Zealand further argued that both the reference in the "General Criteria" to differential pricing and the terms of Paragraph (k) clearly treated schemes such as that now found in "special milk classes" as subsidies. Two changes were, however, made to Paragraph (k) before it found its way into Paragraph (c) of Article 9.1. First, the word "payments" was substituted for the word "subsidies" at the beginning of the sub-paragraph. Second, the provision was not limited to subsidies financed by producer levies. Producer levy-based subsidies became simply an illustration of producer-financed subsidies. Both of these changes confirmed the conclusion that Special Classes 5(d) and (e) of the Canadian scheme fell within Article 9.1(c). The word "payments" carried within it both the sense of revenue foregone and payment-in-kind. The change to make clear that producer-levy-financed subsidies were not the only producer-financed subsidies that were covered by the sub-paragraph, only reinforced the conclusion that subsidies, such as that provided under "special milk classes", were to be covered.

4.236 New Zealand noted that following Canada's approach, if the word "subsidies" had been used in Article 9.1(c), it would have had to have been interpreted in accordance with Article 1 of the SCM Agreement. This of itself would have qualified the scope of the subsidy under Article 9.1(c). Yet, as Canada had acknowledged (paragraph 4.127) that Article 9.1 provided an "illustrative list" of export subsidies and hence broadened the scope of the concept of export subsidies under Article 1 of the Agreement on Agriculture. By this analysis, in order to be consistent, Canada should be arguing that the use of the word "payments" in Article 9.1(c) was designed to expand the scope of the measures beyond that which would have been covered if the word "subsidies" had been used.

4.237 New Zealand argued that whether it was viewed as revenue foregone by the provincial milk marketing board or agency, or revenue foregone by the producer – which was, in New Zealand's view, precisely the type of subsidisation that Article 9.1(c) was designed to capture – or whether it was viewed as a payment-in-kind, the provision of lower-priced milk to the processors of dairy products for export, under Special Classes 5(d) and (e), was a "payment on the export of an agricultural product" within the meaning of Article 9.1(c).

4.238 The **United States** claimed that Canada had misrepresented the conclusions of Professor Tangermann regarding the applicability of the Agreement on Agriculture's disciplines on export subsidies to Canada's Special Milk Classes Scheme (paragraph 4.220). Canada had focussed on a discussion in the Tangerman article that related to quota systems that involved the export of the actual product subject to the quota, for example, sugar from the European Communities, a different situation than was represented by Canada's Special Milk Classes Scheme, where it was the export processor who benefitted from the low priced over-quota production. Canada failed to mention the more pertinent conclusions reached by Professor Tangerman later in his article, which specifically addressed the Canadian dairy regime: "Countries should, therefore, not be allowed to escape their export subsidy commitments by using a price pooling regime. It should be clear that an effective constraint on the extent of price pooling is established through the commitments on export subsidies."(footnotes omitted) United States, Exhibit 24, at p.33. In footnote 13 of his paper, Professor Tangerman said: "This may have serious implications for the new price pooling regime for milk established in Canada, which substituted for the producer-financed export subsidies used in Canada prior to the conclusion of the Uruguay Round."

4.239 **Canada** noted that New Zealand disputed the precision of "payment" by arguing that the expression "direct payment" would have been used if that precision had been intended (paragraph 4.227). This contradicted New Zealand's position on "direct subsidy" – New Zealand had argued that "... a 'direct' subsidy was one affecting trade in the product directly rather than one affecting trade incidentally or indirectly." (paragraph 4.188). In Canada's view, Article 9.1(c) export subsidies were not limited to direct payments (i.e., it did not exclude payments affecting trade incidentally or indirectly) but they were limited to "payments" in the ordinary meaning of the word. Canada argued that the negotiators had felt the need to clarify references to direct payment in Annex 2 by explicitly including the concept of "payment-in-kind." Had the negotiators intended to include that concept in Article 9.1(c) they would have explicitly included it in this provision as well. The fact that they did not was significant in interpreting the Agreement.

4.240 Canada further noted that the Complainants had suggested that the term "payment" in Article 9.1(c) included "revenue foregone". While "revenue foregone" was part of the definition of subsidy, it was not part of the ordinary meaning of "payment". For example, it was common for retail establishments in Canada to offer price discounts to persons over 60 or 65 years of age. It was not at all common for these discounts to be considered "payments" received by these shoppers. Canada further noted that the United States had acknowledged that the concept of revenue foregone was generally associated only with circumstances involving a governmental treasury and public funds, such as where taxes were forgone.<sup>229</sup> Canada reiterated that even if "payment" were to include revenue foregone, there was no revenue foregone as producers received the best price available in either the domestic market or the export market (paragraph 4.181 and following). Moreover, the only payment was the commercial payment made by the processor to obtain the product. In addition, there was no evidence of these payments being financed by virtue of government action.

(ii) *Financed by virtue of governmental action*

4.241 **New Zealand** argued that the requirement of governmental involvement in subsidization under Article 9.1(c) was clearly met in the present case (see arguments set out in paragraph 4.41 and following). The government action concerned did not have to involve the government itself paying money or foregoing revenue because immediately after the phrase "financed by virtue of government action" were the words "whether or not a charge on the public account is involved." Moreover, the words "by virtue of" indicated that while the involvement of government had to be present, government action need not be the sole or exclusive agent in the financing of the subsidy.

4.242 In the specific context of export subsidies under the Agreement on Agriculture, the phrase "financed by virtue of governmental action" in Article 9.1(c) suggested that the intention of the drafters of the Agreement on Agriculture was *not* that there be a *high* threshold for government involvement in order to constitute subsidisation. Canada's actions in respect of the Special Milk Classes Scheme met the appropriate threshold.

4.243 New Zealand noted that Canada had admitted that the government involvement in its dairy supply management system was sufficient to meet the requirement that any "payments" had been "financed by virtue of governmental action." In Annex B to its Second Written Submission, Canada stated:

"Canada does not deny that the previous producer-funded levy/rebate scheme fell within the deeming provision in Article 9.1(c) of the Agreement on Agriculture. That scheme has been replaced."<sup>230</sup>

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<sup>229</sup> Canada referred to the US response to the Panel's Question 4 (p.5) to New Zealand and the United States.

<sup>230</sup> Annex B of Canada's Second Written Submission, p.7.

4.244 New Zealand maintained that what had been replaced was the way in which exporters were relieved from the high domestic price of milk; what was not replaced was the nature or level of government involvement in the system. According to the description that Canada had provided of its system, decisions were made by producers operating through dairy marketing boards and the CMSMC. The role of the CDC was simply to implement these producer-made decisions. That, presumably, was what the CDC was doing when the producer levy/rebate system was in operation, and that was what the CDC was, according to Canada, doing today. Hence, even accepting, for purposes of argument, the Canadian depiction of the role of government in the operation of the system, then an admission that the producer-levy scheme fell within Article 9.1(c) was an admission that the existing Special Milk Classes Scheme had to be "financed by virtue of governmental action".

4.245 In view of this admission by Canada, the only issue under Article 9.1(c) was whether the action of providing lower-priced milk to exporters constituted a "payment" within the meaning of that provision. New Zealand argued, in light of the discussion under Section (i) above, that since the term "payments" in Article 9.1(c) of the Agreement on Agriculture included the foregoing of revenue or payments-in-kind, the Special Milk Classes Scheme constituted a payment on the export of an agricultural product *financed by virtue of governmental action* within the meaning of Article 9.1(c) and hence constituted an export subsidy.

4.246 The **United States** noted, in respect of the second condition to the applicability of Article 9.1(c), i.e. that the export payment be "financed by virtue of governmental action", that as the term "governmental action" was not defined in the Agreement on Agriculture, resort to the Vienna Convention for assistance in interpreting that term was appropriate.

4.247 The United States maintained that the ordinary meaning of the phrase "financed by virtue of governmental action" reasonably included circumstances in which the financial underpinning of an export payment was fixed by the undertakings of a government entity. In this context, government action could include activity either at the federal level or provincial level, or by both, in a federal system. By the very terms of Article 9.1(c), its scope was not limited to export subsidies funded by charges on the public account. To the contrary, the section explicitly stated that a charge on the public account was not a prerequisite to its coverage. By inference, there had to be financing based on some form of contribution from private entities that was mandated by a government, whether national or local in jurisdiction. Article 9.1(c)'s specific inclusion of "payments that are financed from the proceeds of a levy," in this context, made clear that a levy imposed on an agricultural product to support either its export, or that of a product derived from it, and which was administered by a government, meant that government action to administer and enforce such producer levies satisfied the requirement that a payment be "financed by virtue governmental action". By logical extension, similar administrative and enforcement actions by a Member government of other forms of subsidies financed through joint, but not voluntary<sup>231</sup>, producer actions had to be included within the scope of Article 9.1(c) as well. This construction of the phrase "financed by virtue of governmental action" was consistent with both the purpose and objective of the reduction commitment provisions of the Agreement, as well as the historical background against which the treaty was negotiated. As had been noted earlier, the inclusion of producer-financed subsidies within the listing of export subsidies subject to reduction commitments was the result of the view that such subsidies were no different from subsidies funded by a government's treasury in terms of the deleterious effect which they had on trade (paragraph 4.146).

4.248 The United States maintained that the concerted action of Canada's federal and provincial governments in establishing and enforcing the levy system and then introducing and administering the special milk class price system satisfied the Article 9.1(c) requirement that the export payments be

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<sup>231</sup> The United States noted that, as had been indicated, the participation of dairy farmers in the special milk class price system was not voluntary, nor was their participation in the predecessor producer levy/rebate programme.

financed by virtue of governmental action. Thus, the actions of the Canadian government pervaded virtually every aspect of the producer-financed export subsidies, which were now entirely dependent on the Special Milk Classes Scheme (see the United States' argument under paragraph 4.54 and following).

4.249 The United States contended that the Canadian government's involvement in every aspect of supply management, including the Special Milk Classes, and the pooling arrangements through which the Special Milk Class prices were made possible, demonstrated that the financing of the milk discounts, which constitute "payments on the export" of dairy products, was accomplished by virtue of action by the Government of Canada. Accordingly, all prerequisites for the applicability of Article 9.1(c) to the Canadian Special Milk Class system were satisfied, and this producer-financed export subsidy was, therefore, subject to the export subsidy reduction commitments set forth in Part V of the Agreement on Agriculture.

4.250 **Canada** maintained that the sales of milk under Special Classes 5(d) and (e) did not constitute an export subsidy within the meaning of Article 9.1(c). In order to show that Special Classes 5(d) and (e) were export subsidy practices within the meaning of Article 9.1(c), the Complainants had to show that (i) "payments" were made on the export of products from Canada; and (ii) that such "payments" were "financed by virtue of governmental action". Canada claimed that this test had not been met.

4.251 Canada contended, in respect of the differences in the nature of government involvement between the new Special Milk Classes Scheme and the old levy-based system (paragraph 4.242), that under the old system, the CDC had made payments directly to processors to rebate the price of milk already paid by the processors exporting dairy products. Such payments would only take place if exports were taking place. These payments were financed by levies imposed on all producers for every hectolitre of milk produced. The funds were held in an account by the CDC and could be used by it, at its own discretion, in any amount necessary to make any sale it felt to be appropriate. Producer boards were aware of CDC actions only as they were reported in accounting to the CMSMC for the overall cost of the surplus disposal programme. The boards exercised control by approving a levy rate, after which the operation of the programme passed to CDC. Individual producers were aware only of the levy rate on their production, and of the year-end adjustments that sometimes resulted if not all the levy funds were spent over the course of a dairy year. Levies were mandatory payments not unlike taxes. The payments were issued by the CDC under general direction of the CMSMC, not unlike government subsidies (although there was no government money involved). In addition, under the old system, over-quota production was discouraged and penalised. The discouragement of over-quota production was not merely a policy decision, but was a result of Canada's obligation under GATT Article XI:2(c)(i) to limit production and marketing as a condition of maintaining quantitative import restrictions.

4.252 Canada argued that the current Canadian dairy export arrangements were entirely different. No levies were imposed on producers any longer. The CDC did not have any pot of money with which to make payments to exporters, and in fact, no payments were made to processors. For each transaction under Classes 5(d) and (e), processors and the CDC as the agent of producers commercially negotiated the price of milk. The producer boards reviewed each transaction and had the ultimate authority to reject or accept the CDC recommendation with respect to any particular Class 5(d) or (e) permit. The producer boards acted in this system as true commercial representatives of the producers, seeking to ensure that the terms of each sale were to their benefit. Producers were made aware on each milk cheque of the returns achieved for Class 5(e) transactions. They had the necessary information to make a decision whether to seek, through their producer boards, any adjustments to quota levels needed to minimise in-quota sales under Class 5(e). They were also in a position to assess clearly, on an individual basis, the attractiveness of over-quota production, which

was no longer penalised. As Canada had demonstrated, significant numbers of them had decided that such production was worthwhile, and they had pursued it.

4.253 Accordingly, Canada contended that the practices in dispute did not constitute payments that were "financed by virtue of government action." The basis for the sale of milk for export purposes was through arm's length negotiations involving processors and agents acting for producers. This resulted in sales based on world market prices. Such conditions could not fall within the concept of "financed by virtue of government action".

(d) Article 10

(i) *Outline*

4.254 **New Zealand** argued that, in the alternative, the Special Milk Classes Scheme constituted an export subsidy within the meaning of Article 1 of the Agreement on Agriculture that operated to circumvent Canada's export subsidy commitments under Article 9 of that Agreement. Hence, Canada was in breach of its obligations under Article 10 of the Agreement on Agriculture.

4.255 The **United States** claimed that even if the Panel determined that neither Article 9.1(a) nor 9.1(c) encompassed the Special Milk Classes Scheme, it was nonetheless an export subsidy within the meaning of Article 10 of the Agreement on Agriculture. This conclusion followed from the treatment of producer-financed subsidies as export subsidies in the 1960 Working Party Report relating to the notification of export subsidies under Article XVI of the GATT 1947. This conclusion was also compelled by an analysis of the Special Milk Classes Scheme under the SCM Agreement (paragraph 4.301 and following).

4.256 The United States further claimed that the object and purpose of Article 10.1 of the Agreement on Agriculture was to prevent the circumvention of export subsidy commitments. This was reinforced by Article 10.3 which placed the onus on an exporting Member to demonstrate that any exports in excess of its scheduled commitments were not subject to export subsidies. Canada concurred in this construction of the Article 10.3 obligation. Hence, the United States claimed that that Special Milk Classes Scheme resulted in, and threatened to lead to, circumvention of Canada's WTO subsidy reduction commitments.

4.257 **Canada** submitted that Article 10 did not apply in the present case as it could not be established that there existed export subsidies other than the export subsidies listed in Article 9.1, nor could it be established that there was actual or threatened circumvention of the export subsidy commitments. Canada noted that Article 10.1 consisted of three components. There had to be either:

(a) an export subsidy other than an export subsidy listed in Paragraph 1 of Article 9 (i.e., a subsidy contingent on export performance);

**or**

(b) a non-commercial transaction;

**and**

(c) components (a) or (b) or both had to be applied in a manner which resulted in, or threatened to lead to circumvention of the subsidy reduction commitments found in Article 9 as elaborated in each Members schedule.

4.258 Canada's position was that neither component (a) or (b) existed in the current case and thus it was not necessary to consider the application of component (c) in order to resolve the dispute. Canada claimed that neither the United States nor New Zealand relied upon component (b) in furtherance of their claims.<sup>232</sup> The only remaining possibility for the application of Article 10.1 was if the practices constituted export subsidies other than an export subsidies listed in Article 9.1. Canada submitted that the analysis applied by Canada demonstrated that no such export subsidy existed.

(ii) *"Export subsidy" within the meaning of Article 10*

4.259 **New Zealand** argued that even if the export subsidy provided under the Special Milk Classes Scheme was not encompassed by the list of subsidies in Article 9.1, it would still constitute an export subsidy within the meaning of Article 10. The basic definition of an export subsidy for the purposes of the Agreement on Agriculture was found in Article 1(e). That provision defined "export subsidies" as "subsidies contingent upon export performance." There was no doubt that access to lower-priced milk under Special Classes 5(d) and (e) was contingent on the milk being used in the production of products for export and hence was "contingent upon export performance". Any measure not listed in Article 9 that came within this definition would thus meet the requirements of Article 10.1. This would include, for example, any measures that met the definition of subsidy under Paragraph (d) of the Illustrative List of Export Subsidies in Annex I to the SCM Agreement. The question was whether providing this lower-priced milk was a subsidy.

4.260 New Zealand noted that the Agreement on Agriculture did not define the concept of a subsidy; accordingly recourse had to be had to the broader context of the WTO Multilateral Trade Agreements in Annex IA to the WTO Agreement in order to determine what fell within the scope of a "subsidy". In this regard, guidance could be obtained from the SCM Agreement which provided both a definition of what constituted a "subsidy" for the purposes of that Agreement and an Illustrative List of Export Subsidies. New Zealand noted that Canada's arguments against the application of Article 10 of the Agreement on Agriculture were simply an extension of its argument that Article 1 of the SCM Agreement provided the definition of subsidy for the Agreement on Agriculture. Since, Canada argued, the Special Milk Classes Scheme did not provide a subsidy within the meaning of Article 1 of the SCM Agreement or of the Illustrative List of Export Subsidies in Annex I of that Agreement, then there was no export subsidy within the meaning of Article 10.

4.261 New Zealand claimed that the Special Milk Classes Scheme did come within the definition of Article 1 of the SCM Agreement, and also constituted a subsidy under Paragraph (d) of the Illustrative List (Section 4). Thus, even if the Panel were to conclude that the specific provisions of Article 9.1(a) or 9.1(c) had not been met, there would still be an export subsidy within the meaning of Article 10 that circumvented or threatened to lead to circumvention of Canada's export subsidy commitments. New Zealand argued that the scope of the concept of export subsidy under the Agreement on Agriculture was broader than the definition of subsidy under Article 1 of the SCM Agreement. Export subsidies under the Agreement on Agriculture included those subsidies listed in Article 9.1 of that Agreement. As Canada had acknowledged (paragraph 4.127) in addition to being an exhaustive list for the purposes of Article 9.1, the Article 9.1 list was an illustrative list of export subsidies for the purposes of Article 1 of the Agreement on Agriculture. Thus, in determining what constituted an "export subsidy" for the purposes of Article 10 of the Agreement on Agriculture, guidance could be sought from the types of measures included in Article 9.1.

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<sup>232</sup> In response to a Panel question, the United States noted that it had not relied in its claims on the second part of Article 10.1, which directed that non-commercial transactions shall not be used to circumvent export subsidy reduction commitments. The United States argued that to the extent that transactions involving non-commercial dairy products had occurred, those transactions appeared to be included within the scope of the subsidies specifically enumerated in Article 9.1 of the Agreement and, therefore, reliance on the second part of Article 10.1, even if applicable, appeared to be unnecessary. New Zealand stated that it was not making a case in the context of non-commercial transactions in the context of Article 10.1 of the Agreement on Agriculture.

4.262 New Zealand noted that in the present case, the Canadian scheme differed only from the previous levy-based system by virtue of a "book-keeping entry" (that is, milk was now being provided at a reduced price "contingent upon export", instead of being provided previously at full price with a rebate being subsequently paid). New Zealand had argued that such a change in book-keeping did not remove the scheme from the reach of Article 9.1. However, in the event that the Panel did not accept this, New Zealand believed that the "special milk class" scheme was, nonetheless, precisely the kind of circumventory measure that the negotiators of Article 10 would have intended to catch. It was a measure analogous to an Article 9.1 measure and thus one that fell within the scope of an "export subsidy" within the meaning of Article 1 of the Agreement on Agriculture and hence was an export subsidy under Article 10.

4.263 The **United States** noted that the Agreement on Agriculture defined export subsidies as "subsidies contingent on export performance, including subsidies listed in Article 9 of this Agreement." (Article 1(e)) The reference in Article 10.1 to "export subsidies" not listed in Article 9, was thus intended to capture all export subsidies within the meaning of Article 1(e) of the Agreement other than those specifically described in Article 9.1 of the Agreement on Agriculture. Because neither Article 10, nor any other provision of the Agreement on Agriculture, expressly defined the term "subsidy", it was necessary, consistent with "customary rules of interpretation of public international law", to consider the context, object and purpose of this particular treaty provision to give meaning to that term. The context of Article 10 included the remaining provisions of the Agreement on Agriculture, as well as the provisions of other relevant WTO Agreements, including the Agreement on Subsidies and Countervailing Measures. Both the Illustrative List of Export Subsidies contained in Annex I of the SCM Agreement and Article 1 of that Agreement informed the meaning of "subsidies" for purposes of the Agreement on Agriculture (Section 4). Therefore, measures that satisfied the requirements of either the Illustrative List or Article 1 of the SCM Agreement also would be subsidies for purposes of Article 10 of the Agreement on Agriculture.

4.264 **Canada** argued that it had shown that the sales of milk in question did not constitute an "export subsidy" under Article 1 of the Agreement on Agriculture. More specifically, Canada had shown that there was no "subsidy" as that term was defined in the SCM Agreement and that there was no practice that fell within the list of "export subsidies" in the Illustrative List attached to that agreement. As a result, there was no "export subsidy not listed in Paragraph 1 of Article 9". Therefore, Article 10.1 could not apply.

(iii) *"Circumvention"*

4.265 **New Zealand** noted that prior to the conclusion of the Uruguay Round, Canada disposed of its surplus milk through subsidised exports financed by producer levies. New Zealand argued that the essence of the producer levy-based subsidy scheme had been that exporters of dairy products would be compensated for the high domestic price of milk. Producers would pay the cost of this subsidy. Canada's new scheme achieved precisely the same result. In substance, nothing had changed under the Canadian system. The financial effects for the producer and the exporter were essentially the same. Under the old scheme the exporter of dairy products benefited from a subsidy that provided protection from the high domestic cost of inputs in the production of those products, and the producer paid the cost of this subsidy. Exactly the same situation existed today.

4.266 New Zealand argued that the export competition rules in the Agreement on Agriculture sought to discipline action by governments that shielded the exporters of dairy products from actual costs in the production of those products. Producer levy-based subsidies were expressly included in Article 9 for that reason. A scheme that in substance and effect achieved precisely the same result as the producer levy-based subsidy was circumvention. That this was the case was evident from the introduction of the Special Milk Classes Scheme. It came into effect on 1 August 1995, the day on which the export subsidy reduction commitments in Canada's WTO Schedule became effective. New

Zealand noted that the objective of Canada's Special Milk Classes Scheme of avoiding the consequences of abolishing the producer levy-based subsidies and replacing them with a system that would have precisely the same economic effect, had been acknowledged openly by Canadian government and Canadian dairy industry officials. Lyle Vanclief, then Parliamentary Secretary to the Minister of Agriculture and Agri-Food, told the Canadian House of Commons Committee on Agriculture:

"We're not changing; we're not changing anything in the price of the milk, just the way in which it's done... Rather than the levies being collected, being paid x number of dollars and then having a levy taken off that for that portion of the milk to meet these demands, the price is being pooled and the bottom line, the net, is being paid to the producer in the first place."<sup>233</sup>

4.267 New Zealand contended that the effect of the Special Milk Classes Scheme was to circumvent Canada's export subsidy commitments under the Agreement on Agriculture. Canada's export subsidy commitment for butter by volume for 1995/1996 was 9,464 tonnes. Its actual exports for that year were 14,574 tonnes. For 1996/1997, its commitment in respect of butter was 8,271 tonnes. Its actual exports were 15,567 tonnes. Canada's export subsidy commitment in respect of cheese by volume for 1996/1997 was 11,773 tonnes. Its actual exports were 20,086 tonnes. Canada's export subsidy commitment for "Other Milk Products" by volume for 1996/1997 was 35,649 tonnes. Its exports of whole milk powder alone in 1996/1997 were 36,632 tonnes. New Zealand concluded that there was a pattern that showed that Canada's exports of major dairy products, with the exception of skim milk powder, had increased dramatically since the introduction of the Special Milk Classes Scheme. These exports of subsidised products completely undermined the export subsidy commitments made by Canada on becoming a Member of the WTO. The Special Milk Classes Scheme clearly constituted circumvention of Canada's export subsidy commitments and given Canada's rapidly expanding exports of dairy products on the basis of the incentives provided by "special milk classes", there was a threat of further circumvention of Canada's export subsidy commitments.

4.268 The **United States** noted that to determine the meaning of the term "circumvent", it was necessary to consider the ordinary meaning of the term.<sup>234</sup> The ordinary definition of the verb to circumvent (from which the noun "circumvention" was derived) was to overreach, outwit, avoid or evade.<sup>235</sup> Thus, Article 10.1's mandate that export subsidies, other than those listed in Article 9.1, were not to be used in a manner that resulted in, or threatened to lead to, circumvention of the export subsidy commitments had to be construed to mean that such other export subsidies were not to be used to evade or avoid the export subsidy disciplines contained in Article 9.1.

4.269 The United States argued that a broad construction of the term "export subsidy" was justified by the object and purpose of Article 10.1. Article 10.1 of the Agreement on Agriculture was an anti-circumvention provision. Its purpose was to ensure that reduction commitments on the export subsidies listed in Article 9.1 were not undermined. It recognized that Members might introduce export subsidies of a kind not listed in Article 9.1, but which would nevertheless achieve the same or similar results in practice. Pursuant to Article 10.1, those "other export subsidies" were subject to the same export reduction commitments.

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<sup>233</sup> *House of Commons Committee on Agriculture Hearing* (30 May 1995) at p.9 of the material downloaded from [www.parl.gc.ca](http://www.parl.gc.ca) on 27 March 1997. (New Zealand, Annex 2)

<sup>234</sup> Appellate Body Report on *Brazil - Desiccated Coconut*, *op. cit.*, p.15.

<sup>235</sup> *The Oxford English Dictionary*, 2nd Edition, Clarendon Press, 1989.

4.270 The United States recalled that the reduction commitments entailed both a reduction in the amount of the outlays, and also a reduction in the quantity of exports subsidized.<sup>236</sup> The commitments specific to each Member were set forth in Section IV, Part II, of each Member's schedule. Thus, an export subsidy bestowed by a Member which subsidized exports of a specific product in excess of the quantity set forth in its Schedule for a specific year would constitute a circumvention within the plain meaning of Article 10.1, of that country's reduction commitments for that product.

4.271 The United States noted that this construction of the circumvention language in Article 10.1 was consistent with both the object and purpose of the export subsidy disciplines contained in Part V of the Agreement and the Agreement as a whole. As stated in the preamble to the Agreement,<sup>237</sup> the Members' objective in concluding the Agreement included the goal of establishing a fair and market-oriented agricultural trading system and specific binding commitments respecting export competition. Thus, the object and purpose of Article 10.1 required that a Member not use any export subsidies in connection with export quantities exceeding the levels to which commitments had been made in the Member's respective schedules.<sup>238</sup> To allow otherwise would significantly undermine those subsidy disciplines, and thereby permit evasion of the reduction commitments which represented a fundamental aspect of the reform in agricultural trade. In this connection, the language of Article 10.3 discussed was highly pertinent (paragraph 4.295 and following). This provision directed that if a Member exceeded its reduction commitment relating to the quantity of subsidized exports of a specific product, it had to demonstrate that no export subsidy had been granted with regard to those exports that exceed the volume commitment. The key operative language in this provision was that *no export subsidy, whether or not listed in Article 9*, was permitted with regard to that quantity of exports that exceeds the reduction commitments. Any subsidy of a quantity of exports that was greater than the reduction levels adopted in the pertinent Member's schedule was inconsistent with that Member's obligations under the Agreement in Agriculture.

4.272 Hence the United States argued that to the extent that a country provided an export subsidy that fell outside the export subsidy categories set forth in Article 9.1, that export subsidy could not be used to circumvent the subsidy reduction commitments. Consequently, an application of an export subsidy to a quantity of exports that was greater than that set forth in a Member's schedule would by definition constitute a circumvention of its obligations under Articles 3, 8 and 9 of the Agreement.

4.273 The United States maintained that Canada had transformed its producer-financed export levies by adopting a new subsidy regime in an apparent effort to evade any reduction commitment. This was precisely the action that Paragraphs 1 and 3 of Article 10 were designed to address. The drafters of Article 9.1 knew that the export subsidy disciplines would be undermined if Members were free to substitute different export subsidies from those listed in Article 9. Article 10.1 was simply intended to preclude such substitution if the export subsidies either resulted in, or threatened, circumvention of the reduction commitments contained in a Member's schedule.

4.274 The United States recalled that the officials of the Government of Canada and the Canadian dairy industry had stated that the special milk class price system was designed to support exports in the same manner that the pre-WTO levy/export rebate system had subsidized exports. Moreover, it was estimated by Canadian officials that the conversion to the special milk class price system would not alter the economic equation, in terms of revenue received and costs incurred, for either the dairy farmers or the dairy product producers.

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<sup>236</sup> Article 3.3, 8, Agreement on Agriculture.

<sup>237</sup> The United States noted that the panel in *United States – Import Prohibition of Certain Shrimp and Shrimp Products* (hereafter "*US – Shrimp-Turtle*"), WT/DS58/R, adopted 6 November 1998, para. 7.42, had observed that the preamble of an agreement may assist in determining its object and purpose.

<sup>238</sup> The United States noted that Article 3.3 limited the use of export subsidies listed in Article 9.1 to the specific subsidy outlays and export quantities specified in each Member's schedule.

4.275 In conclusion, the United States argued that Canada's special milk class price system was an export subsidy of dairy products in excess of the limits for Canada under the Agreement on Agriculture, whether they fall under Article 9 or Article 10 of that Agreement. As a result, those subsidies did not benefit from the exemption in Article 13(c)(ii) of that Agreement on Agriculture. Consequently, these export subsidies were also inconsistent with Canada's obligations under Article 3 of the SCM Agreement.

4.276 **Canada** argued that the Complainants were basing themselves more on rhetoric than on law, in arguing that Canada was circumventing the obligations of the Agreement on Agriculture because it was pursuing the same *objectives* (preserving the integrity of the Canadian milk supply management system) as it pursued prior to the entry into force of the WTO Agreement. The Complainants' arguments relied on statements made by Canadian officials to the effect that, in bringing Canada's measures into conformity with the WTO Agreement, Canada would continue to seek the same objectives as before. Yet, Canada argued that Article 10.1 manifestly did not regulate *objectives*. It simply stated that "*export subsidies* not listed in Paragraph 1 of Article 1" were not to be used in a way that would circumvent the commitments.

4.277 Canada argued that the statement made by the United States was unnecessarily broad in saying that an export subsidy, irrespective of whether it is covered by Article 9.1, in excess of the quantity set out in its Schedule "would constitute a circumvention within the plain meaning of Article 10.1" (paragraph 4.270). It was only "export subsidies" other than those covered by Article 9.1 that could possibly be subject to Article 10. An export subsidy covered by Article 9.1 that exceeded the quantity commitments was not a circumvention of Article 9 but rather a violation of Article 8. The United States was mistaken to the extent that they appeared to suggest that the use of export subsidies listed in Article 9 in excess of a Member's subsidy reduction commitments under that Article gave rise to a separate claim of circumvention under Article 10. Canada concurred that where export subsidies, other than those listed in Article 9.1, had been applied to a commodity subject to subsidy reduction commitments in excess of the reduction commitment level specified in a Member's schedule for that commodity, a presumption of circumvention pursuant to Article 10 would arise. The critical issue was whether any such "export subsidies" had been granted.

4.278 Canada stressed the importance of the exact nature of Article 10.1. It *did not* say that parties could not use mechanisms other than "export subsidies" in order to attain the general or political objectives for which "export subsidies" were previously used. To the contrary, it was drafted to have a very targeted and limited meaning: to limit the use of "export subsidies" defined in Article 1 of the *Agreement on Agriculture*, not listed in Article 9.1, to circumvent export subsidy reduction commitments. The drafters did not intend it to be used to limit the rights of Members to use measures that the negotiators of the Agreement on Agriculture did not agree should be restricted.

4.279 Canada argued that bringing measures into conformity with the WTO Agreements while trying to achieve the same policy objectives did not, in itself, constitute "circumvention" or an "evasion" of the reduction commitments. The Canadian statements quoted in the Complainants' submissions had to be viewed in that light. Canada did not dispute that following the entry into force of the WTO Agreement, it intended to preserve the integrity of the Canadian milk supply management system. Indeed, the continued preservation of certain domestic agricultural programmes within the legal framework established by the Agreement on Agriculture was the intention of almost every WTO Member. The special regime provided for in the Agreement on Agriculture made no sense seen in any other light.

4.280 Canada argued that the change from a levy system to the present system of individual and collective producer decisions based on market-based prices for exports was one of the many steps taken to bring Canadian measures into conformity with WTO commitments in the implementation process; the character and effect of the new system compared to the pre-Uruguay Round levy

system was profoundly different. With the introduction of the Special Milk Classes Scheme, Canada moved from a penalty-based system designed to limit production closely to domestic requirements for GATT 1947 Article XI purposes, to a new market-driven opportunity system that offered producers the chance to take commercial risks and enter the export market. Presented with opportunity, rather than penalties, those producers who wished to enter the new environment could do so with a completely different attitude. However, since no one was forced to do so, producers also had the option to rely only on the domestic market. Hence, it was quite accurate to indicate to producers that, *if they so chose*, they could decide not to export and there would be no great impact on their positions.

4.281 Canada argued that it was inaccurate to suggest that there was circumvention because the Special Milk Classes Scheme were essentially the same and that in substance, nothing had changed. Canada noted that there had indeed been a significant increase in exports from Canada under the new Special Milk Classes Scheme, reflecting the fact that it was a different system. Hence, if the old and new systems were the same, as argued by the Complainants, then they had to explain why the current system was producing such different results. Those producers that did not wish to participate in export markets (beyond the limited amount included in-quota) could remain largely unaffected by the export market. Those who wished to do so could have an unlimited commercial opportunity to participate in export markets on the basis of actual world price signals. In practice, therefore, Canada's new export policies for dairy exports reflected the assurances of continuity provided to producers by Ministers in 1995, while at the same time opening up new opportunities, consistent with the new rules negotiated under the WTO. In summary, Canada submitted that the introduction of the new Special Milk Classes Scheme demonstrated Canada's *intention* to be consistent with its WTO obligations and not to circumvent them.

4.282 **New Zealand** stressed that the objective of Article 10 was to discipline circumvention. It was designed to capture measures which did not meet the particular definitions in Article 9.1, but which nevertheless had the same economic effect as a subsidy subject to Article 9 reduction commitments. Measures analogous to those listed in Article 9.1, although not technically meeting the strict letter of Article 9, clearly were in the minds of drafters seeking to avoid circumvention of Article 9 commitments. Hence, the illustrative role of Article 9.1 export subsidies in the definition of export subsidies under Article 1 of the Agreement on Agriculture.

4.283 New Zealand noted that Canada had also argued that even if there was an export subsidy there was still no "circumvention". The essence of the Canadian position was that there was no prohibition under the WTO against adopting measures that achieved the same objectives as were achieved by previously used export subsidies. However, New Zealand contended, that was not the issue. What was at issue in this case was whether it was permissible under the Agreement on Agriculture to introduce an export subsidy that had the same effect as an export subsidy for which reduction commitments have been made. Article 10 clearly proscribed such subsidies because they circumvented export subsidy reduction commitments. New Zealand believed that this was what had occurred in this case. Canada had introduced a measure that constituted an export subsidy. That subsidy achieved precisely the same effect as the export subsidy based on producer levies which Canada abandoned because it fell within Article 9.1 of the Agreement on Agriculture. Whether Canada intended or did not intend that the new measure comply with its WTO obligations was irrelevant. Article 10 did not require that there be any proof of intent to circumvent, it only required that there be actual or threatened circumvention of commitments.

4.284 New Zealand noted that Canada rested its response to the argument that the Special Milk Classes Scheme contravened Article 10 of the Agreement on Agriculture simply on the basis that the measure was not a subsidy within the meaning of the SCM Agreement, and hence did not fall within Article 10 of the Agreement on Agriculture. This approach to the interpretation of the Agreement on Agriculture was flawed. More specifically, in the context of Article 10, it constituted a denial of the

object and purpose of that provision which was to prevent circumvention of export subsidy commitments. Interpreting the meaning of "export subsidy" under Article 10 had to involve looking at the term in its particular context and in the broader context of the Agreement on Agriculture as a whole. Thus, the broad scope of the concept of export subsidy under Article 1 of the Agreement on Agriculture, for which Article 9.1 provided an "illustrative list", and the object of preventing circumvention which lay at the heart of Article 10, provided an important part of the context for the interpretation of the meaning of "export subsidy" under Article 10.

4.285 New Zealand argued that the ambit of "circumventing" or simply of "threatening to lead to circumvention" was very broad and this gave some insight into the objective of Article 10. Article 10 was included in the Agreement on Agriculture because Members were concerned that the export subsidy commitments undertaken under Article 9 could be nullified by subsidies that did not fit the precise definition of Article 9 but equally had the effect of shielding exporters from the actual cost of production of goods destined for export. That object and purpose also had to be taken into account in determining what constituted an export subsidy for the purposes of Article 10.

4.286 New Zealand submitted that the broad scope of the definition of export subsidy in Article 1(e) of the Agreement on Agriculture, together with the circumvention objective of Article 10, lead to the conclusion that the Special Milk Classes Scheme was an export subsidy that was being applied in a manner that circumvented, or threatened to lead to circumvention, of Canada's export subsidy commitments under Article 10 of the Agreement on Agriculture.

4.287 Moreover, New Zealand argued that in Article 10 the term "export subsidies" was found in a context that was concerned with the prevention of actual or threatened circumvention of export subsidy commitments. The context, and object and purpose, of Article 10 argued for a flexible construction of the term "export subsidy" in order that Article 10 could live up to the intentions of its drafters. What would undermine, or threaten to undermine, a Member's reduction commitments would naturally vary according to the particular circumstances of each case. This meant therefore, that the determination of whether a measure constituted an export subsidy for the purposes of Article 10, had to be made on a case-by-case basis.

4.288 New Zealand argued that in this regard, an analogy could be drawn between the non-circumvention objective of Article 10 and the non-circumvention objectives of GATT Article XXIII:1(b) which was concerned with redressing actions that nullified or impaired a Member's legitimate expectations of benefits from tariff negotiations. In *Japan - Measures Affecting Consumer Photographic Film and Paper* the Panel took the view that in order to achieve this purpose, "it is important that the kinds of government actions considered to be measures covered by Article XXIII:1(b) should not be defined in an unduly restrictive manner."<sup>239</sup> Under the Agreement on Agriculture, the type of measure to which Article 10 applied had already been prescribed. It was an "export subsidy". Nevertheless, the importance of achieving the purpose of non-circumvention under Article 10 meant that the term export subsidy should not be interpreted in an "unduly restrictive manner". Indeed, seeking to draw a sharp line around the definition of "export subsidy" by means of an exhaustive and prescriptive definition could well encourage the adoption of measures that exhibited the same subsidisation effects as Article 9.1 subsidies but which did not fall strictly within its terms. This could lead to evasion of the Agreement's export subsidy disciplines, and thereby fundamentally undermine Article 10's anti-circumvention purpose. The anti-circumvention provision itself would be circumvented.

4.289 New Zealand argued that in the present case, if the "special milk class" scheme was found not to constitute an export subsidy under Article 9.1(c) because the provision of lower-priced milk to exporters was, for instance, not regarded as a "payment", then the fact that the measure was not

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<sup>239</sup> Panel Report on *Japan - Photographic Film*, *op. cit.*, para.10.50.

materially different in terms of its subsidization effect from an export subsidy listed in Article 9.1, and the actual or threatened circumventory nature of the measure, had to be relevant considerations in determining whether it constituted an export subsidy within the meaning of Article 10. Similarly, if the Special Milk Classes Scheme was not found to be an export subsidy under Article 9.1(a), the scheme could still nonetheless meet the definition of export subsidy in the context of Article 10. The circumventory nature of the scheme would again be a relevant factor to be taken into account. Taking account of these considerations, it was New Zealand's view that even if the "special milk class" regime failed to meet the test of Article 9, it would nevertheless constitute an export subsidy which circumvented, or threatened to circumvent, Canada's export subsidy commitments within the meaning of Article 10.

(iv) *Article 10.3 – the Burden of Proof*

4.290 **New Zealand** noted that the Agreement on Agriculture contained, in Article 10.3, a provision which had implications for the burden of proof.<sup>240</sup> Article 10 was concerned with the prevention of circumvention of export subsidy commitments. A Member which claimed that quantities exported in excess of reduction commitment levels were not subsidised "must establish" that no export subsidy had been granted. The language was mandatory and unequivocal. New Zealand maintained that the fact that this obligation was intended to be a stringent one, and one applicable in the context of dispute settlement, was made clear from the preparatory work relating to Article 10. The negotiating Draft Text on Agriculture of 12 December 1991 provided as follows:

" ... a *prima facie* case of circumvention of budgetary outlay commitments shall be deemed to exist where it is established that:

- (a) subsidies contingent on exports which are not subject to reduction have been or are being resorted to at the national or sub-national level; and
- (b) the volume of subsidized exports of the product concerned exceeds the volume of exports that could have been subsidized, or which can reasonably be expected to be subsidized ...<sup>241</sup>

4.291 New Zealand argued that the language of a "*prima facie* case" was the language used by the Appellate Body under the rules relating to burden of proof. In the *EC – Hormones*, the Appellate Body paraphrased the approach of the Panel:

"The initial burden lies on the complaining party, which must establish a *prima facie* case of inconsistency with a particular provision of the *SPS Agreement* on the part of the defending party .... When that *prima facie* case is made, the burden of proof moves to the defending party, which must in turn counter or refute the claimed inconsistency. This seems straightforward enough and is in conformity with our ruling in *United States - Shirts and Blouses*,

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<sup>240</sup> Article 10:3 of the Agreement on Agriculture stated: "Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidised must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question."

<sup>241</sup> New Zealand, Annex 35.

which the Panel invokes and which embodies a rule applicable in any adversarial proceedings."<sup>242</sup>

4.292 New Zealand argued that the effect of a rule deeming that a *prima facie* case had been made out, as the earlier drafts of Article 10 provided, was to reverse the burden of proof. Under such a rule, the normal obligation on the complaining party to establish a *prima facie* case was dispensed with. The burden started with the responding party. This was the explicit effect of the language used in the earlier drafts of Article 10. Although the wording of Article 10 had changed, and no explicit reference to a *prima facie* case was retained, the earlier draft provided guidance to the thinking of the negotiators of the rules on circumvention. The changes made to the wording of what became Article 10.3 were not incompatible with the express terms of the earlier draft. They simply stated, in a more general way, that there was an obligation on a Member whose exports of a product in respect of which reduction commitments had been made exceeded the volume of those commitments, to "establish" that no subsidy had been granted. In effect, once it had been "established" that the exports of a Member were in excess of its reduction commitments, the burden was then on that Member to "establish" that no subsidy had been granted. The burden of proof clearly shifted.

4.293 Hence, New Zealand argued that properly interpreted in its context, Article 10.3 spoke to dispute settlement situations. It imposed a specific obligation on Members that would usually arise only in a dispute settlement context. Where a Member was challenged in dispute settlement proceedings on the ground that the quantities of its exports exceeded its reduction commitment levels, then that Member "must establish" that no export subsidy had been granted in respect of those quantities. Such a rule could only have the effect of placing the burden on the Member against which the complaint had been made to establish that no subsidisation has occurred.

4.294 New Zealand noted that Article 10.3 had important implications for the case at issue. Since the quantities of butter exported by Canada in 1995/1996 and 1996/1997 exceeded the reduction commitments made by Canada in respect of butter for both of those years, Article 10.3 required that Canada "must establish" that no export subsidy had been granted in respect of butter. Since the quantity of cheese exported by Canada in 1996/1997 was in excess of Canada's reduction commitment for cheese for that year, Article 10.3 required that Canada "must establish" that no export subsidy had been granted in respect of cheese. And since the quantity of whole milk powder exported by Canada in 1996/1997 exceeded Canada's reduction commitments in respect of "Other Milk Products", Article 10.3 required that Canada "must establish" that no export subsidy has been granted in respect of whole milk powder. In each case, the burden of proof lay on Canada. In this respect, New Zealand noted that Canada had acknowledged that the burden of proof was on Canada to establish that no export subsidy existed in respect of the Special Milk Classes Scheme.

4.295 The **United States** argued that Article 10.3, which complemented the prohibition on circumvention contained in Article 10.1, required the exporting Member to establish that export subsidies had not been provided with respect to those quantities of a product exported that were greater than the annual export quantities set forth in that Member's schedule for the product in question. The imposition of this requirement in Article 10.3, emphasized the seriousness which the Agreement attached to the possibility of circumvention of the export subsidy reduction commitments. Its application in the context at issue meant that Canada had to establish that no export subsidy had been granted in respect of the quantity of exports that were in excess of its reduction commitments. As the export quantities for butter, cheese, and dairy products in the "other dairy product" category exceeded the reduction commitments for those categories in Canada's Schedule, Canada had to show that such exports did not benefit from export subsidies.

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<sup>242</sup> Appellate Body Reports on *EC – Measures Concerning Meat and Meat Products (Hormones)*, (hereafter "*EC – Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, paragraph 98.

4.296 The United States submitted that Canada could not meet the requirement of Article 10.3 because the quantities of the identified dairy products that were exported exceeded the reduction commitments and the special milk class price system was an export subsidy.

4.297 **Canada** agreed that the wording of Article 10.3 had the effect of reversing the usual burden of proof rule as set out above. Thus, once it had been established that the exporting country had exported quantities of a product in excess of the level of the reduction commitment for that product, the burden lay on that exporting country to show a prima facie case that the exports in excess of the reduction commitment were not subject to export subsidies. Once such a prima facie case had been established, the burden of proof moved to the complaining party. Canada claimed that it had clearly surpassed any prima facie standard in demonstrating that no export subsidies had been granted with respect to the products in question.

(e) Other Relevant Provisions of the Agreement on Agriculture

(i) *Article 8 and 3.3*

4.298 **New Zealand** argued that Canada's provision of export subsidies under Article 9.1(a) and (c) of the Agreement on Agriculture in excess of its scheduled export subsidy commitments was a violation of Article 3.3 of that Agreement. Furthermore, Canada was in violation of its obligation under Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement on Agriculture.

4.299 The **United States** argued that as the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1 of the Agreement on Agriculture, Canada was in breach of Article 3.3 of the Agreement on Agriculture not to provide export subsidies in excess of its quantity commitments levels specified in Section II of Part IV of its Schedule. Furthermore, Canada was in breach of Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement and with the commitments specified in its Schedule.

4.300 **Canada** argued that **Error! Bookmark not defined.**Article 8 did not apply. As Canada had shown that sales of milk at differing prices for domestic and export markets did not constitute an "export subsidy" as that term was defined in Article 1 of Agreement on Agriculture, the practice at issue did not fall within the scope of Article 8.

#### **4. Agreement on Subsidies and Countervailing Measures ("SCM Agreement")**

(a) Outline

4.301 **New Zealand** claimed that even on the basis of its own approach to the interpretation of the term "subsidy", under the SCM Agreement, Canada had not shown that the Special Milk Classes Scheme fell outside the definition of subsidy. New Zealand argued that the scheme constituted a subsidy within the meaning of Article 1 of the SCM Agreement in the following respects:

- (a) it constituted the provision by government of a good within the meaning of Article 1.1(a)(1)(iii);
- (b) or alternatively the government had entrusted a private body to perform the same function within the meaning of Article 1.1(a)(1)(iv); and
- (c) it constituted a form of income or price support within the meaning of GATT Article XVI, under Article 1.1(a)(2).

4.302 New Zealand noted that Article 1 of the SCM Agreement provided that a subsidy shall be deemed to exist when there was a financial contribution by a government or any public body, or any form of income or price support in the sense of Article XVI of GATT 1994, and a benefit was thereby conferred. The Special Milk Classes Scheme consisted of a financial contribution by government. Alternatively, the Special Milk Classes Scheme might be viewed as a form of income or price support in the sense of Article XVI of GATT 1994. In either case, a benefit was conferred within the meaning of Article 1 of the SCM Agreement.

4.303 In addition, the Special Milk Classes Scheme constituted the provision of an export subsidy within the meaning of Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement.

4.304 The **United States** considered that the definition of subsidy was substantially the same for purposes of the Agreement on Agriculture and the SCM Agreement. As the SCM Agreement was one of the other Agreements set forth in Annex 1A of the Marrakesh Agreement, the SCM formed part of the context of the Agreement on Agriculture.

4.305 The United States claimed that even if it were to be assumed that the SCM Agreement was dispositive of what constituted an export subsidy, solely for purposes of argument and without prejudice to the views of the United States concerning the applicability of Articles 9 and 10 of the Agreement on Agriculture, Paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I lead directly to the conclusion that the Special Milk Classes Scheme was an export subsidy. Hence, the United States claimed that the Special Milk Classes Scheme, and specifically the provision of lower priced milk through Special Class 5(d) and (e) to exporters, constituted an export subsidy within the meaning of the Agreement on Agriculture as well as the SCM Agreement.

4.306 **Canada** claimed that the sale of milk for export purposes in Canada did not constitute a "financial contribution by a government or a public body" pursuant to Article 1.1(a)(1) of the SCM Agreement. Nor did it constitute "any form of income or price support in the sense of Article XVI of GATT 1994". Nor did the sale of milk in Canada for export constitute a "benefit" for the purchaser over and above the normal commercial conditions that applied in such a market; there could be no "benefit" as the term should be interpreted under Article 1 of the SCM Agreement.

4.307 Hence Canada submitted that the sale of milk at differing prices did not constitute a "subsidy" within the meaning of Article 1 of the SCM Agreement. As noted, the term "subsidy" as it was used in the definition of "export subsidy" in the Agreement on Agriculture had to be interpreted in accordance with the definition of subsidy in Article 1 of the SCM Agreement. Accordingly, since there was no "subsidy", there could not be any "export subsidy" for the purposes of the Agreement on Agriculture.

4.308 Further, Canada claimed that the practices at issue were not "export subsidies" in the sense of Paragraph (d) of Illustrative List of Export Subsidies attached to the SCM Agreement. Although Paragraph (d) was the only item on this list that was in any way relevant to the issue at hand, it was concerned with differences between internal domestic prices and export prices. Indeed, other than Article 9.1(b) of the Agreement on Agriculture, it was the only provision in either the Agreement on Agriculture or the SCM Agreement that touched on such price differentials. Canada had demonstrated that its Import for Re-Export Program (paragraph 2.11) provided exactly the conditions that would exclude a measure from the application of Paragraph (d). This confirmed that the practices in question did not fall within the meaning of the term "export subsidy" for SCM Agreement or Agreement on Agriculture purposes. Accordingly, Canada claimed that not only was there no subsidy within the meaning of the Agreement on Agriculture and the SCM Agreement but, in particular, there was no prohibited export subsidy as set out in the Illustrative List of Export Subsidies found in Annex I of the SCM Agreement.

(b) Article 1

(i) *Article 1.1(a)(1) – Financial Contribution*

4.309 **Canada** claimed that there was no financial contribution by government pursuant to Article 1.1(a)(1) and, accordingly, the sale of milk for export purposes in Canada did not constitute a "financial contribution by a government or a public body" pursuant to Article 1.1(a)(1).

4.310 Canada submitted that under Article 1.1(a)(1), the term "financial contribution by a government or any public body" was defined exhaustively<sup>243</sup> and was limited to the circumstances described in the four sub-paragraphs (i) to (iv). Accordingly, if the practices at issue did not fall within any of the items in (i) to (iv), then the practices could not be considered to be "financial contributions by government or any public body". Moreover, there could be measures or practices which could arguably fall within the meaning of the term "financial contribution" but did not fall within one of the various descriptions in sub-paragraphs (i) through (iv). In such a case, the measure or practice was outside the scope of what was a "financial contribution" for the purposes of the subsidy definition.

4.311 Canada noted that the plain meaning of the term "financial contribution" was that something of value was being contributed to a recipient by the donor. In this case, "financial contribution by a government or any public body" meant that there was a transfer of something of value to a recipient from a government or other public body. In the absence of any evidence that there was any such transfer of resources, there could not be a "financial contribution". Each of the items set out in (i) to (iv) had to be interpreted as reflecting this basic concept. Canada submitted that an examination of each of the items set out in sub-paragraphs (i) to (iv) of Article 1.1(a)(1) demonstrated that none of them applied to the practices at issue.

**Sub-paragraph (i)**

4.312 **Canada** noted that sub-paragraph (i) included as "a financial contribution by government or any public body", "a government practice involv[ing] a direct transfer of funds (e.g. grants, loans and equity infusion), and potential direct transfers of funds or liabilities (e.g., loan guarantees)". This provision covered the most common form of financial contribution made in connection with subsidies, i.e., the direct payment to a recipient of funds from government treasuries. Canada argued that it was evident from the facts that the practices in dispute did not involve any direct grants or transfer of funds from governments to any recipient. There was nothing in the marketing of milk for export at world prices analogous to a government grant, loan or equity infusion were anything like a potential direct transfer of funds or liabilities such as a loan guarantee. No evidence or allegation to the contrary had been offered by the Complainants.

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<sup>243</sup> Canada argued that the use of the term "i.e." indicated that the items that followed were intended to be an exhaustive, rather than an illustrative list. In this regard, Canada noted that the Uruguay Round negotiators agreed to replace the term "such as" in the Cartland I draft of the SCM Agreement, MTN.GNG/NG10/W/38 (18 July, 1990), with "i.e." in Cartland II, MTN.GNG/NG10/W/39/Rev.1 (4 September 1990), thus clearly indicating an intent to move from an illustrative definition to an exhaustive definition. (Canada, Exhibit 25) Canada also noted that "e.g." was also used within the subsidy definition in Article 1 to indicate an illustrative list. (Canada, Exhibit 25)

**Sub-paragraph (ii)**

4.313 **Canada** recalled that sub-paragraph (ii) included as "a financial contribution by government or any public body" circumstances where "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)". This provision referred to any practice under which a government chose not to collect tax or other duties owing to it<sup>244</sup> and thus made financial contribution to the person owing the revenue to the government. It was clear that the practices at issue did not involve any such foregoing of government taxes, duties or other government monies owing. No evidence to the contrary has been offered by the Complainants.

**Sub-paragraph (iii)**

4.314 **Canada** noted that sub-paragraph (iii) included as "a financial contribution by government or any public body" a situation where "a government provides goods or services other than general infrastructure, or purchases goods". Canada argued that the various levels of government in Canada did not provide milk to anyone. As demonstrated in Part I, the Canadian dairy industry was composed entirely of privately-owned farms producing milk for sale to privately owned or co-operative dairy processors. While these sales took place within a framework established by legislation, it was the private actors that produced and sold the milk. The core of the system was operated on the foundation of the decisions by producers made on a strictly commercial basis.

4.315 Canada reiterated that the milk marketing boards were "producer-run". They did not constitute government or government agencies. To the contrary, they were established pursuant to referenda of dairy producers in each of the respective provinces and, in most provinces, they were controlled by the elected representatives of the dairy producers. While legislation required that the boards take into account a broader range of interests than those of the producers alone, the fact remained that the boards operated as an extension of the commercial operations of the individual dairy producers of Canada.

4.316 Canada argued that if the conduct of commercial operations by private producers and processors within a regulatory framework constituted Government provision of the good or service provided through the commercial transactions, then virtually all activities in a modern economy could be so characterized. For example, labour provided through collective agreements established under government labour laws or determined by minimum wage laws could be considered labour provided by government.

4.317 Furthermore, Canada argued that sub-paragraph (iii) had to be read in the context of the term "financial contribution". Thus, in order for government to be providing goods within the meaning of the provision, it had to be demonstrated that this provision of goods involved a contribution of a financial nature from public resources controlled by the government. The sale of milk to processors by producers collectively through or with the participation of producer-run marketing boards could in no way be construed as the provision of goods by government or any public body, nor was it the provision of goods that entailed a governmental financial contribution.

4.318 Canada contended that the participation of the milk marketing boards in providing milk sourced from producers to processors did not involve any "financial contribution" from the boards. The boards acted as agents for the producers in collecting and selling milk to the processors. With respect to exports, processors purchased the milk through or with the participation of the boards for prices based on the world market return being obtained by the processors. Thus, the producers only

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<sup>244</sup> Canada argued that the intent of the negotiators to link the term "government revenue" to taxes or duties was made clear both by the reference to "tax credits" as the illustrative example provided in the provision and the discussion of "duties" in the footnote to the provision.

received for the milk a market price paid initially to the board as their agent. This was best illustrated by a counter-example. If the boards were purchasing milk at high domestic prices and then reselling the milk to the processors at low prices and absorbing the difference, then it might be open to argue that the boards would be making a "financial contribution", albeit of a non-governmental type. However, in the case of Canadian dairy exports, as agents of the producers the boards paid to the producers what the boards receive from the processors for the milk. As Canada had described, the price paid back to the producers was flowed entirely through the board and there was no "adjustment" or "contribution" by the boards to this revenue stream. This reinforced the conclusion that there was no "financial contribution" to the processors by the boards, and therefore Article 1.1(a)(1) could not apply.

4.319 **New Zealand** argued that the Special Milk Classes Scheme involved a financial contribution within the meaning of Article 1.1(a)(1)(iii). The Special Milk Classes Scheme involved the providing of goods by the combined action of governmental agencies - the CDC and the provincial milk marketing boards (Section 1). Canada's denial of this was based on its view that the Special Milk Classes Scheme involved producers operating collectively without significant government involvement. However, New Zealand held that role of government in the operation of the Special Milk Classes Scheme was integral and essential. The providing of lower-priced milk to exporters - which was the export subsidy in this case - was effected through the joint action of the CDC and the provincial milk marketing boards.

4.320 New Zealand further noted that Canada argued that in any event there was no financial contribution because the boards were simply agents of producers; what was passed on to exporters was the producer's milk. New Zealand noted that the boards did not pass milk on to exporters because they were acting as agents of producers. Boards had a right to dispose of milk regardless of the wishes of producers. A producer could not deny the board the right to sell its milk - a producer could not revoke the "agency". Nor could this, according to New Zealand, be seen just as a matter of the decision of the provincial milk marketing board. The system under which milk - a good - was provided to exporters did not just involve that board. It was an operation involving both federal and provincial action.

4.321 The **United States** argued that where surplus milk was provided to processors/exporters under Classes 5(d) and (e), this involved the Canadian Government through its legislative arrangements providing goods (i.e. milk) at prices below those prevailing in the domestic market. Hence, the provincial milk marketing boards, on behalf of the milk producers in their respective provinces, provided milk at prices lower than available on the domestic market to processors. The processors used that low priced milk in manufacturing dairy products for export. Those same marketing boards, moreover, operated under the authority of powers delegated to them by the federal and provincial governments. The boards did not receive their authority and powers from the milk producers. Thus, their actions, together with those of the Canadian Government, acting through the CDC, provided goods, here milk, to processors. The United States claimed that this constituted a subsidy under Article 1.1(a)(1)(iii) of the SCM Agreement.

#### **Sub-paragraph (iv)**

4.322 **Canada** noted that the first part of sub-paragraph (iv) included as "a financial contribution by government or any public body" circumstances where "a government makes payments to a funding mechanism". This provision was intended to cover a situation where a government, rather than making direct payments from its treasury to the targeted recipients as described in sub-paragraph (i), provided bulk funding to some other body or mechanism for the subsequent re-distribution of the financial contributions. As previously noted with respect to sub-paragraph (i), there was no evidence that any level of government in Canada made any contribution, either directly (i.e., sub-paragraph (i))

or indirectly through a funding mechanism (i.e., sub-paragraph (iv)) of funds with respect to the sale of milk at differing prices.

4.323 Canada argued that none of the "functions" set out in sub-paragraphs (i) through (iii) in Article 1.1(a)(1) were carried out by government with respect to the practices at issue. Similarly, it could not be said that any government in Canada "entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments" as set out in the second part of Article 1.1(a)(1)(iv). In this regard, Canada stressed that to show that the practices of a private body fell within the terms of this provision, three elements had to be proven: (i) there had to be direction or entrustment of a function to a private body by government; (ii) the function had to be one listed in subclauses (i) to (iii); and (iii) that function had to be one that was *normally* carried out by government and "in no real sense differs from practices *normally* followed by governments".

4.324 Canada argued that its government did not "entrust or direct" any private body to carry out any of the functions detailed in (i) through (iii) with respect to sales of milk for export purposes in Canada. In particular, governments in Canada did not so "entrust<sup>245</sup> or direct" the milk marketing boards in Canada to carry out such functions. Canada recalled that the boards were not directed by governments (Section 1). Boards had come into existence on a vote of the producers in a province. They were entrusted *by producers* who had elected them and to whom they were responsible to act on their behalf and to market their products; they were therefore not "entrusted" by governments to undertake any of the activities referred to in Article 1 of the SCM Agreement.

4.325 Canada argued that there could be no basis for suggesting that that the marketing of milk, whether for domestic or export sale, was one that was *normally* carried out by government and that in no real sense differed from practices normally followed by governments. A distinction had to be made between the regulatory functions of the boards and their commercial activities. In the exercise of certain regulatory functions, the boards might engage in activities that were governmental in nature and that could be considered "normally followed by governments." The establishment and enforcement of quality standards for milk delivered from farms and the establishment of quotas for domestic purposes, for example, could be argued to fall within the range of such activities. However, the marketing of milk, i.e., arranging the collection of milk from farms and its delivery to processing plants, negotiating payments with processors and remitting funds to producers, was not a function *normally* carried out by government. Indeed, the structure and the autonomy of the boards, indicated that governments had essentially no responsibility, direct or indirect, in this area, except that of general oversight in support of the public interest.

4.326 Canada noted that this was particularly true with respect to sales of milk for *export* purposes. Governments had not "entrusted" a private body, i.e., the milk marketing boards, with a mandate to sell inputs for products for export at a price lower than those destined for domestic consumption. The sale of milk to processors for export purposes was the result of arm's length bargaining between willing buyers and willing sellers without any government direction or expectation of the outcome. Thus, there had been no entrustment by government as required under the paragraph. In addition, what this provision manifestly did not capture, contrary to the contentions of the Complainants, was regulatory frameworks, stipulated by law, through which private interests had the opportunity of maximizing their returns in commercial markets and in accordance with commercial considerations. Moreover, since the milk marketing boards were selling milk through arm's length sales to processors

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<sup>245</sup> Canada noted that the meaning of "entrust" was related to the companion word "direct": see the *New Shorter Oxford English Dictionary on Historical Principles*, Lesley Brown (ed.), (Oxford: Oxford University Press, 1993) (the "NSOED"): "to invest with a trust; give the responsibility for a task; commit the... execution of (a task) to a person." (Canada, Exhibit 26)

at market prices, this practice could not be constructed to be a "financial contribution" to the processors under any common sense analysis.

4.327 **New Zealand** argued that even if the provincial milk marketing board was not a body with governmental attributes, and was indeed just an agent of producers, there would still be a "financial contribution" within the meaning of sub-paragraph (iv) of Article 1.1(a)(1) of the SCM Agreement, which applied to circumstances where a government "entrusts or directs a private body to carry out one or more of the type of functions" set out *inter alia*, in Paragraph (iii) of Article 1.1(a)(1). In the present case, what would now be viewed as a private body, the provincial milk marketing agency, had been entrusted with providing the goods in question.

4.328 New Zealand further noted that sub-paragraph (iv) also stipulated that the practice that was alleged to constitute a subsidy "in no real sense, differs from practices normally followed by governments." On this ground, Canada denied the applicability of sub-paragraph (iv), arguing that no such function of providing goods had been entrusted by government to a private body and that the functions in question were not normally carried out by governments. The first aspect of this response was no more than a reiteration of Canada's denial of government involvement in the Special Milk Classes Scheme (Section 1, paragraph 4.41 and following). In respect of the second aspect, Canada argued that although the regulatory function of milk marketing boards could be viewed as functions normally carried out by governments, the marketing of milk was not. However, the effect of the Special Milk Classes Scheme was to reallocate income from producers to exporters, and the reallocation of income within society was a function normally carried out by government. Thus, contrary to Canada's claims, the Special Milk Classes Scheme did provide a financial contribution within the meaning of Article 1.1(a)(1) of the SCM Agreement.

4.329 Furthermore, in respect of Article 1.1(a)(1)(iv), and functions that "would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments", New Zealand drew the Panel's attention to Canada's own implementation of that provision in its own domestic legislation contained in the Special Import Measures Act.<sup>246</sup> Section 2(1.6) of that Act incorporated the terms of Article 1.1(a)(1)(iv) of the SCM Agreement by providing that a financial contribution that amounted to a subsidy existed where:

"(d) the government permits or directs a non-governmental body to do any thing referred to in any of paragraphs (a) to (c) where the right or obligation to do the thing is normally vested in the government and the manner in which the non-governmental body does the thing does not differ in a meaningful way from the manner in which the government would do it."

4.330 In New Zealand's view, the language adopted by Canada in this legislative implementation of the definition of subsidy under the SCM Agreement reflected, presumably, what Canada understood the provisions of the SCM Agreement to mean. Thus, it was revealing that Canada used the phrase "permits or directs" in its implementing legislation for the phrase "entrusts or directs" in Article 1.1(a)(1)(iv). However, in the case at issue, Canada took the view that the legislative basis for the Special Milk Classes Scheme was enabling only. Canada argued that "enabling legislation" did not compel any action. Canada did not, it argued, "entrust or direct" milk marketing boards with any of the functions listed in sub-paragraphs (i) through (iii) of Article 1.1(a)(1) (paragraph 4.340).

4.331 In New Zealand's view it was clear that the Special Milk Classes Scheme would meet the requirements of Section 2(1.6)(d) of Canada's Special Import Measures Act and thus if it were a measure of another country would constitute a subsidy under Canadian law. However, Canada

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<sup>246</sup> Special Import Measures Act, S.C. 1984, c.25, s.2.

appeared to want to apply a different standard in this case and deny that the Special Milk Classes Scheme met the requirements of the provision of the SCM Agreement on which Section 2(1.6)(d) was based.

4.332 New Zealand argued, moreover, that the Canadian legislative incorporation of sub-paragraph (iv) precisely reflected the intent of the drafters of Article 1 of the SCM Agreement. The origin of the words that appeared in sub-paragraph (iv) was the 1960 Report of the Panel on Subsidies on Review Pursuant to Article XVI:<sup>247</sup> where the Panel took the view that the requirements of GATT Article XVI would be met in schemes where "the government took a part either by making payments into a common fund or by entrusting to a private body the functions of taxation and subsidisation with the result that the practice would in no real sense differ from those normally followed by government." These words made clear that the "practice" was the practice of taxation or subsidisation and that the manner in which it was being performed by the private body was in no real sense different from the way governments undertook such practices. This was the present day import of sub-paragraph (iv) and it had been identified correctly in Canada's Special Import Measures Act.

4.333 The **United States** argued, like New Zealand, that the Special Milk Classes Scheme provided a subsidy under Article 1.1(a)(1)(iv) of the SCM Agreement. Thus, even if the provincial milk marketing agencies were not considered to be acting as government bodies, there would still be a "financial contribution" within the meaning of sub-paragraph (iv) of Article 1.1(a)(1) because they were entrusted with government functions. The provincial milk marketing boards, together with the CDC, had been entrusted to price goods to allow their export at competitive levels. Furthermore, this was a function normally provided by government within the meaning of Paragraph (iv) since the Special Milk Classes Scheme operated to reallocate income from one group (the milk producers) to another class (the dairy processors), a common function of government. Indeed, the levy system that the Special Classes replaced, performed the same governmental function.

4.334 The United States argued that the applicability of Article 1.1(a)(1)(iv) of the SCM Agreement depended on the fulfilment of three conditions. More specifically, the existence of the financial contribution necessary to the finding of a subsidy under Paragraph (iv) required that: (i) a government entrusted or directs a private body to carry out one or more of the type of functions illustrated in Paragraphs (i)-(iii) of Paragraph (a)(1) to Article 1.1; (ii) such functions would normally be vested in the government; and (iii) the practice, in no real sense, differed from the practices normally followed by governments. The United States contended that Canada incorrectly concluded that none of the foregoing conditions were met by the Special Milk Classes Scheme.

4.335 In respect of the first factor, the United States argued that the Government of Canada together with the provincial governments made provision for milk producers, through their provincial marketing boards, to supply milk for export at prices that were below those available to manufacturers of dairy products for sale in the domestic market. By doing so, the government shifted certain costs from the processors to the milk producers, and also provided a good to the processors. Thus, a function provided for under Article 1.1(a)(1), was entrusted to a private entity. Both the Comprehensive Agreement and the CDC Act provided specifically for the delegation of certain federal powers, including powers of the CDC, to the marketing boards to establish pools, set prices, and collect payments. There was no dispute that the boards exercised delegated government powers, including the power to set prices, to establish quotas, and to pool revenue. Thus, they had been entrusted with governmental powers.

4.336 The United States further argued, in respect of the first requirement, that Paragraph (d) of the Illustrative List Export Subsidies in Annex I of the SCM Agreement was relevant as it was part of the context of Article 1 of that Agreement. Thus, the language of Article 1 was informed by the practices

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<sup>247</sup> Panel Report on *Review Pursuant to Article XVI:5*, *op. cit.*

identified as export subsidies in Annex I. As set out in further detail below (paragraph 4.385 and following), Paragraph (d) of the Illustrative List specified that the "provision by governments or their agencies either directly or indirectly through government-mandated schemes" of goods on more favorable terms for export was an export subsidy. Both Paragraphs (iii) and (iv) of Article 1 had to be interpreted with this in mind. Otherwise, a fundamental contradiction in meaning would result with that practice constituting an identified export subsidy for purposes of the Illustrative List, but not being a subsidy for purposes of Article 1. Therefore, a government-mandated scheme, such as Canada's Special Milk Classes Scheme, that resulted in the provision of goods within the meaning of the Illustrative List also satisfied the requirement of Paragraph (iii) of Article 1 of the same Agreement that the provision, directly or indirectly, of goods by a government, constituted a financial contribution. Hence, since the provision of a good was a government function specifically listed in Article 1.1(a)(1)(iii) of the Agreement, the first requirement for the application of Article 1 was satisfied.

4.337 The United States argued that the Special Milk Classes Scheme also satisfied the second requirement because the subsidized provision of goods and the fixing of prices were functions normally vested in governments. Indeed, it was a common practice in the agricultural sector for governments to influence the price level for agricultural products, especially basic food articles such as milk. Whether the Special Milk Classes Scheme was viewed as providing goods at lower prices for exports or as fixing price levels for milk used for the manufacture of export products, the function involved was one normally vested or performed by governments. Canada's argument that there was no specific order from the federal or provincial government to producers to set prices for milk used in exports at a particular level was inaccurate and beside the point. First, over-quota milk could only be sold for export at the Special Class 5(e) price. The producer had no choice. In-quota milk was sold at prices negotiated by the CDC, that were rarely modified. Second, pursuant to Article 1.1(a)(1)(iv) of the SCM Agreement it was unnecessary for the government to set the price for the milk if it entrusted that function to the milk boards, which it had done. The entire rationale for Paragraph (iv) was that practices of private parties entrusted with government functions were to be treated as subsidies where the practice, "in no real sense, differs from practices normally followed by governments" and a benefit was thereby provided.

4.338 Furthermore, the United States argued the common governmental function of shifting costs and reallocating income from one private entity to another was the very function previously fulfilled by the levy/rebate system, which Canada had acknowledged was replaced with the Special Milk Classes Scheme. Further, the United States argued that the conclusions reached by the 1960 Working Party that considered, inter alia, whether producer-financed subsidies were to be notified pursuant to Article XVI:1 of GATT 1947 supported this construction of Paragraph (iv).<sup>248</sup> The United States emphasized, moreover, that the language in the SCM Agreement that was contained in Article 1.1(a)(1)(iv) respecting "functions normally vested in the government" and "which in no real sense, differs from practices normally followed by governments", first appeared in the 1960 Working Party report. Furthermore, the Working Party had found that producer-financed levy/rebates satisfied those requirements where there was sufficient government involvement in the programme.

4.339 Finally, the United States argued that the Special Milk Classes Scheme operated to establish prices for milk for export in a manner that was indistinguishable from practices normally followed by governments. The inclusion of this practice in the Illustrative List certainly supported the conclusion that it was a recognized, albeit unwelcome, government practice. That practice, moreover, was specifically subject to the export subsidy disciplines contained in both the Agreement on Agriculture and the SCM Agreement. Moreover, producer-financed subsidy schemes, in which governments performed a substantial function, were treated as export subsidies in the Agreement on Agriculture, and before that in the 1960 Working Party Report, precisely because they did not differ in any

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<sup>248</sup> *Ibid.*

practical sense from the practices normally followed by governments. Thus, contrary to Canada's conclusions, each of the prerequisites to the applicability of Article 1.1(a)(1) of the SCM Agreement was satisfied by the Special Milk Classes Scheme.

4.340 **Canada** refuted the US argument that Canada made provision for milk producers, through their provincial marketing boards, to supply milk for export at prices that were below those available to manufacturers of dairy products for sale in the domestic market (paragraph 4.335). Canada claimed that the facts made it clear that there was no governmental requirement placed on milk producers, through their marketing boards to supply milk for export, let alone a governmental requirement to sell that milk for export at a prescribed price. Permitting producers to adopt a course of action did not amount to entrusting or directing a private body to carry out a government function.

4.341 Furthermore, Canada rebutted the United States claim that the government shifted costs from processors to producers (paragraph 4.338). The costs of production were always borne by the producers. Processors paid the highest price that producer boards could obtain given the externally-determined economic realities of the markets in which they sold the final products. Producers were not forced to provide milk at any given price but rather milk was supplied pursuant to negotiated agreements. Thus, there was no shifting of costs. Moreover, the United States' explanation also failed to address why a significant number of producers would choose to produce above their quotas if the effect was to shift costs to them from processors. The only rational explanation would be that producers were coerced to act against their own best interests but no such coercion existed. Canada noted that the United States also claimed that this alleged government action provided a good to the processors. This directly contradicted their own statement that producers, through their marketing boards supplied the milk.

4.342 Moreover, Canada noted in respect to the requirement regarding functions normally vested in the government, that the United States characterized the government function in this case to be one of reallocation of wealth within society. Canada argued that sales of milk by milk producers at market prices did not "reallocate" income at all. A willing buyer purchased a good from a willing seller in an arm's length transaction at the market price. Although obviously money changed hands, the ordinary language to describe such a transaction was that the seller *earned* income, not that the transaction reallocated income from one party to the other. The redistribution of wealth that occurred through transactions at market prices was not a practice normally followed by governments when they sought to redistribute income. Government actions to reallocate income were generally achieved through government charges (taxes) and payments (subsidies) in which government forced one group in society to give up income which it either had or could otherwise obtain, and provided another group with income that would not be forthcoming in the market. Canada maintained that the key characteristic of sales of milk under Special Classes 5(d) and (e) was that governments did *not* control the sales prices, and they did not delegate to anyone else the power to control the sales prices. The implicit assumption in the US arguments was that any transaction at market prices, as opposed to controlled domestic prices, had to be considered a "reallocation of income." In fact, it was the absence of control over prices for export use that formed the basis of the Complainants' case. Canada was a small country on world dairy markets. It was a price taker. It would be the purest of nonsense for any Canadian government to claim to control the price at which Canadian dairy exports took place.

4.343 The drafters of the SCM Agreement in providing for a definition of "subsidy" were careful to distinguish in Article 1.1(a)(1) between the circumstances where governmental "financial contributions" referred to a government practice involving a direct transfer of funds, the foregoing of government revenue or a government making payments to a funding mechanism (sub-paragraphs (i), (ii) and (iii)) and the indirect provision of the governmental financial contribution through a "private body" (sub-paragraph (iv)). Accordingly, where the entity in question was a private body, as conceded in this circumstance (US reference in paragraph 4.335), the applicable provision was sub-paragraph (iv). Hence the drafters had carefully circumscribed the circumstances under which

Paragraph (iv) could apply to a private body. The government had to "entrust or direct" the private body and the function must be "one which would normally be vested in the government and the practice, in no real sense, differs from the practices normally followed by governments." Thus, in the context of "subsidies", the drafters of the SCM Agreement appreciated that where private bodies were involved, careful limits had to be drawn against the implication of governmental activity.

(ii) *Article 1.1(a)(2) – Income or Price Support in the sense of Article XVI of GATT 1994*

4.344 **Canada** argued that the practices at issue did not fall within the description of "any form of income or price support in the sense of Article XVI of GATT 1994". Article XVI:1 of GATT 1994 included as a subsidy "any form of price or income support, which operates directly or indirectly to increase exports from ... its territory". This clearly contemplated a system under which exports were encouraged independently of market forces. As described above, the practice under which milk was sold for export purpose in Canada was exclusively linked to market forces. Dairy producers received a return on their sales of milk for export purposes based on actual sales into export markets. It was in response to these price signals that milk was produced for the export market.

4.345 Canada noted that it had been long established in GATT practice that supply management systems which relied on border measures to support domestic price levels were not to be considered "subsidies" under Article XVI. This view was reflected in the 1960 Report of the Panel on Subsidies on "Review Pursuant to Article XVI:5":

"It was generally agreed that a system under which a government, by direct or indirect methods, maintains such a price by purchases and resale at a loss is a subsidy. Such purchases would need only to cover part of the production to involve a subsidy and, in determining loss on resale, such expenses as holding stocks should be taken into account. The Panel considered, however, that there could be other cases in which a government maintained a fixed price above the world price without resort to subsidy. *One such case might be that in which a government fixes by law a minimum price to producers which is maintained by quantitative restrictions or flexible tariff or similar charges. In such a case, there would be no loss to the government, and the measure would not be governed by Article XVI.*"<sup>249</sup>(emphasis added)

4.346 Canada argued that it was evident that the supply management system in Canada did not constitute a subsidy pursuant to the above comments. The exclusion in this passage from the subsidy concept of any system where higher domestic prices were supported by tariff measures was particularly noteworthy in the context of this dispute.<sup>250</sup>

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<sup>249</sup> *Ibid*, para.11.

<sup>250</sup> Canada noted that the fact that the Panel emphasized that their decision was based on the fact that there was "no loss to the government" had importance for the interpretation of Article 1 of the SCM Agreement as a whole, since the drafters of that Article expressly linked the definition of "subsidy" to Article XVI of the GATT 1994. There was an implication in this concept that there had to be some transfer of value from public sources to the recipients, resulting in a loss to treasuries in some way. This was also consistent with the analytical approach adopted by the Working Party Report in Australian Subsidy on Ammonium Sulphate, (GATT/CP.4/39) 3 April 1950 at paragraph 10: "The working party then examined the question of whether the Australian Government had complied with the terms of Article XVI on subsidies. It noted that, although this Article is drafted in very general terms, the type of subsidy which it was intended to cover was the financial aid given by a government to support its domestic production and to improve its competitive position either on the domestic market or on foreign markets".

4.347 In respect of GATT 1994 Ad Article XVI:B:3, Canada argued that in the case of systems for the stabilization of domestic prices for primary products<sup>251</sup>, an export subsidy was not involved where two tests were met: (i) the system had resulted in, or was designed to result in, export prices higher than the domestic prices; and (ii) the system did not stimulate exports unduly or otherwise seriously prejudice the interests of other contracting parties. With respect to the first test, Canada contended that its system for the sale of milk for export purposes contemplated the possibility of export prices higher than the domestic price. Indeed, in recent months as certain domestic milk prices in the United States had exceeded domestic prices in Canada, price levels in Special Classes 5(a) through (c) (which were linked to price levels in US markets and could be used either for export or domestic purposes) had exceeded price levels in the domestic use classes. In addition, since Canada's system for sales of milk for export purposes was based on world market conditions, it could not be alleged that it stimulated exports unduly or otherwise seriously prejudiced the interests of other WTO Members. Thus, Canada's dairy supply management system did not involve an export subsidy pursuant to this provision.

4.348 Canada argued that the drafters of the SCM Agreement expressly incorporated the concept of "income and price support", as defined by Article XVI, into Article 1 of the SCM Agreement and that practices such as those used for the sale of milk in Canada for export purposes were clearly excluded from this definition. This suggested that the intent of the negotiators was that such programmes did not fall within the concept of "subsidy" in the Article 1 of the SCM Agreement.<sup>252</sup> Accordingly, Canada argued that the sale of milk in Canada for export purposes could not constitute "any form of income or price support in the sense of Article XVI of GATT 1994" as provided for in Article 1.1(a)(2). Hence, the practices at issue in this dispute did not correspond with either half of the first part of the two-part test in Article 1.1, and consequently, there could be no "subsidy" pursuant to that definition.

4.349 **New Zealand** noted that Article 1 of the SCM Agreement included within the definition of a subsidy "any form of income or price support in the sense of Article XVI of GATT 1994". Section A.1 of Article XVI of GATT 1994 included within its scope income or price support "which operates directly or indirectly to increase exports of any product". Section B.4 of Article XVI of GATT 1994 included subsidies which resulted "in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." These definitions clearly encompassed a scheme under which the government ensures that milk was made available for the production of products for export at a price that was lower than that for milk available for the production of equivalent products for domestic consumption.

4.350 New Zealand further noted that Canada denied that the Special Milk Classes Scheme constituted a form of income or price support within the meaning of Article XVI of GATT 1994. Article XVI:1, Canada argued, contemplated a system under which exports were encouraged independently of market forces (paragraph 4.344). Thus, Canada's reasoning here, too, was based largely on its argument that dairy exporters responded to market signals and not to any incentives provided through the Special Milk Classes Scheme. The reality was, in New Zealand's view, otherwise. The allocation of milk to domestic or export markets was not the decision of the producer

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<sup>251</sup> Canada noted that Ad Article XVI:B of GATT 1994 stated in part: "For the purposes of Section B, a "primary product" is understood to be any product of farm, forest or fishery, or any mineral, in its natural form or which has undergone such processing as is customarily required to prepare it for marketing in substantial volume in international trade."

<sup>252</sup> Canada argued that the comments of the Appellate Body in *Brazil - Desiccated Coconut, op. cit.*, had to be noted in this context. At p. 14 they noted that "The Agreement on Agriculture and the SCM Agreement reflect the latest statement of WTO members as to their rights and obligations concerning agricultural subsidies." They went on to comment that these Agreements "represent a substantial elaboration of the provisions of the GATT 1994", and recognized that pursuant to Annex 1A, the other goods agreement prevail in the event of a conflict with GATT 1994. However, the Appellate Body cautioned that "this does not mean that the other goods agreements in Annex 1A, such as the SCM Agreement, supersede the GATT 1994" and cited with approval the comments of the panel that "Article VI of the GATT 1994 and the SCM represent an inseparable package of rights and disciplines that must be considered in conjunction." Canada argued that similar logic also applied to the relationship of Article XVI and the SCM Agreement and the Agreement on Agriculture.

(as argued under paragraph 4.93 and following). Milk was sold for export rather than domestically not in response to market signals but in response to the determination of federal and provincial representatives operating through the CMSMC. Moreover, it was not the incentive for the *producer* that was in issue. It was the *exporter* who received the support. Exporters were encouraged to export because they were shielded from domestic prices, precisely the incentive to export regardless of market conditions that Canada said was contemplated by Article XVI.

4.351 New Zealand further noted that Canada argued that its system met the requirements of Ad Article XVI:B:3 of GATT 1994 (and was not therefore a subsidy for the purposes of Article XVI of GATT 1994) because the system contemplated the possibility of export prices being higher than domestic prices. But Canada's argumentation in support of this related only to Special Classes 5(a) through 5(c) and did not deal at all with Special Classes 5(d) and (e), the provisions that were in issue in this case. Moreover, it was extremely unlikely that the prices for these latter classes would ever rise to such an extent that they would exceed Canadian domestic prices. World prices would have to rise over 300 per cent before the Special Class 5(e) price approached the Canadian domestic price. Thus, in respect of those sub-classes, the requirements of Ad Article XVI:B:3 could, realistically, never be met. Further, in New Zealand's view, the Canadian system *did* operate to "stimulate exports unduly" within the terms of Ad Article XVI:B:3 given that, absent special milk classes, Canadian dairy exports would be largely uneconomic and would be severely curtailed.

4.352 New Zealand noted Canada's attempt to deny the applicability of Article 1.1(a)(2) of the SCM Agreement which incorporated within the definition of "subsidy" any form of income or price support in the sense of Article XVI of GATT 1994. New Zealand noted that Canada cited, in paragraph 4.345, as authority for this, a passage from the 1960 Report of the Panel on Subsidies<sup>253</sup> where the Panel said that a situation where a government fixed a minimum price to producers and maintained it simply by "quantitative restrictions or flexible tariff or similar charges" "*might*" be a case where there was no subsidy. Canada then extrapolated from this qualified comment the absolute proposition that the Panel was of the view that *any* system where higher domestic prices were supported by tariff measures would not represent a subsidy. In New Zealand's view Canada had failed to make any allusion whatsoever to the Panel's key conclusion<sup>254</sup> regarding producer-funded subsidies: that the requirements of GATT Article XVI would be met in schemes where "the government took a part either by making payments into the common fund or by entrusting to a private body the functions of taxation and subsidisation with the result that the practice would in no real sense differ from those normally followed by government". New Zealand's conclusion that the Canadian scheme did indeed provide price or income support in the sense of GATT Article XVI, and that the requirements of Ad Article XVI:B:3 could never realistically be discharged by Canada, had not been rebutted.

4.353 The **United States** argued that even if Canada's supply management regime with its price classification system were found to be a system of stabilization of domestic prices within the meaning of Ad Article XVI, the Canadian Special Milk Classes Scheme *clearly* resulted in "the sale of the product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Because the special milk class price system did not result, and was not designed to result, in "the sale of the product for export at a price higher than the comparable price charged for the like product to buyers in the domestic market" it did not, and could not, satisfy the exception from treatment as a subsidy contained in Ad Article XVI. Thus, when Canada's special milk class price system was analyzed within the framework of Ad Article XVI, the result reached was the same as under the SCM and Agreement on Agriculture: the special milk class price system was an export subsidy.

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<sup>253</sup> Panel Report on Review Pursuant to Article XVI:5, *op. cit.*

<sup>254</sup> *Ibid.*

4.354 **Canada**, in response to a question by the Panel as to why Canada felt there was not "price or income support in the sense of Article XVI" when Canada had a positive Aggregate Measurement of Support ("AMS") with respect to dairy products, argued that its *domestic support commitments* were not price or income support in the sense of Article 1.1(a)(2) of the SCM Agreement. The term "market price support", as it was used with respect to Domestic Support in Annexes 3 and 4 of the Agreement on Agriculture, was fundamentally different in content and purpose from the term "price or income support in the sense of Article XVI of GATT 1994".

4.355 Canada argued that Market Price Support ("MPS") was a term chosen to be one of the elements to be used in calculating a comprehensive measurement of domestic support through the AMS in the Agreement on Agriculture. AMS was intended to be a broad measurement of government support in favour of agricultural producers, for the purpose of developing reduction commitments. As such, it had been, and was, a very ad hoc measure, not a rigorous measurement of "subsidies" as they might be otherwise understood or defined. Thus, MPS was a negotiated measuring device adopted for a specific purpose in the Agreement on Agriculture negotiations. It bore no linkage or lineage with any other concept of "price support", and in particular, was quite distinct from the term "price or income support in the sense of Article XVI of GATT 1994", as it used in the SCM Agreement. In contrast, the purpose of the use of the term "price or income support in the sense of Article XVI of GATT 1994" in the SCM Agreement was to bring some price support systems within the ambit of the disciplines on export subsidies in that Agreement. This built on the similar purposes captured in the language of Article XVI of the GATT 1994 itself. In that case, the term was restricted to the specific circumstances as set out in Interpretative Note 2 ad Paragraph 3 of Article XVI and as discussed in the 1960 Report of the Panel on Subsidies. Accordingly, unlike MPS, this term was to be linked directly to the concept of "subsidies".

4.356 Canada noted that it had indicated (for 1995/96) – with respect to Canada's notifications of its AMS under the Agreement on Agriculture – that it had MPS with respect to butter and skim milk powder. This notification was based on the gap between the fixed external reference price (the 1986-88 average export minimum prices agreed under the International Dairy Arrangement) and an "applied administered price" (the CDC support prices, as operated at that time). Canada emphasized that although the CDC continued to announce a "Support Price", this had become a misnomer – whereas the CDC used to use a "Support Price" as the basis for a standing offer to purchase programme, this had been terminated. The CDC "Support Price" was now essentially used as a reference price by the CMSMC and the provincial producer boards as a target in their negotiations with processors, with the objective that milk prices not be too far out of line in different provinces. As such, it no longer appeared to constitute an "applied administered price" for the purposes of MPS calculation.

4.357 Canada stressed that the issue before the panel was whether Special Classes 5(d) and (e) constituted "export subsidies" for the purposes of the Agreement on Agriculture. In that regard, the definition of "export subsidy", in the context of the definition of "subsidy" as it was found in Article 1 of the SCM Agreement, bore no relationship, textually or historically, to the formula used to calculate MPS or APS as a result of the Uruguay Round.

4.358 **New Zealand** did not accept the conclusion reached by Canada where it sought to distinguish the term "market price support", in the Agreement on Agriculture, from the reference to "any form of income or price support" in Article 1 of the SCM Agreement. The Aggregate Measurement of Support (which included specific provision for calculating market price support) as it was defined in Article 1 of the Agreement on Agriculture, would certainly catch all forms of income and price support within the meaning of GATT Article XVI. This was made very clear, for example, in Paragraph 6 of Annex 2 of the Agreement on Agriculture which defined the conditions when (decoupled) "income support" can be exempted from the Aggregate Measurement of Support. Conversely, in Paragraph 1(b) of the same Annex, "price support to producers" was specifically

excluded from the category of exempt domestic support and thus must be included in the Aggregate Measurement of Support.

4.359 In New Zealand's view, the linkage between the two concepts was confirmed by Article 13 of the Agreement on Agriculture. That Article, setting out the applicability of certain provisions of other agreements to measures covered by the Agreement on Agriculture stated, in Paragraph (b), that "domestic support measures ... as reflected in each Member's Schedule" (i.e., the AMS commitments) shall be "exempt from actions based on Paragraph 1 of Article XVI of GATT 1994 ...".

4.360 New Zealand noted that Canada stated that the support price no longer appeared to constitute an 'applied administered price' for the purposes of "[market price support] calculation" (paragraph 4.356). New Zealand disagreed with this on the basis that support prices were still used by the CDC to buffer domestic supplies seasonally and, to a very minor extent regionally and between processors<sup>255</sup> and they also assisted producer boards in "establishing domestic price levels."<sup>256</sup> Despite the fact that buffer stocks might represent only a small part of domestic production, the effect of the CDC, a government agency, purchasing and selling stocks on the basis of support prices meant that those support prices represented the market clearing level for the products concerned - applied administered prices remained, as did price and income support in the sense of Article XVI:1 of GATT 1994.

4.361 **Canada** emphasized that the reference in Article 1.1(a)(2) was to Article XVI as a whole and not just to the Paragraph 1 of Article XVI. The phrase "any form of income or price support" did not appear in Paragraph 1 of Article XVI; it did as a subset of the term "subsidy": i.e., "any subsidy, including any form of income or price support". The plain meaning of this was that the term "subsidy" was to include "any form of income or price support" and the notification obligations in Paragraph 1 attaching to "subsidies" had necessarily to apply to income or price support systems.

4.362 Canada noted that Paragraph 3 of Article XVI stated that "contracting parties should seek to avoid the use of subsidies on the export of primary products". The second sentence then set out stronger injunctions with respect to the use of "such subsidies" in certain circumstances. Thus, both Paragraph 1 and Paragraph 3 were concerned with "subsidies", with Paragraph 3 concerned with certain kinds of "subsidies": i.e., export subsidies on primary products. The fundamental principle of interpretation applicable in this circumstance was that the same term (e.g., "subsidy") should be interpreted consistently when it was used in the same agreement. Where the same term was used within a single article the presumption in favour of consistency in interpretation was all the stronger. Absent any direction to the contrary, there was no reason to consider the meaning of the term "subsidy" in Paragraph 1 to differ from the use of the term "subsidy" in Paragraph 3. Paragraph 1 referred to all "subsidies" and Paragraph 3 referred only to some of those "subsidies"; those "subsidies" that were export subsidies on primary products. However, any "subsidy" that fell within the parameters of Paragraph 3 was also a "subsidy" for the purposes of Paragraph 1.

4.363 Canada argued that the term "any form of income or price support" was expressly included in the term "subsidy" in Paragraph 1. Although this express inclusion was not repeated in Paragraph 3, if the term "subsidy" was to have a consistent meaning throughout Article XVI, then the term "subsidy" as it was used in Paragraph 3 had also to include "any form of price or income support", except to the extent that there was any express direction to the contrary. There was, in fact, such an express exclusion. It was found in Interpretative Note 2 to Paragraph 3 in Ad Article XVI. This note stated that "a system for the stabilisation of the domestic price or of the return to domestic producers of a primary product independently of the movement of export prices", (i.e., price or income support),

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<sup>255</sup> New Zealand referred to paragraph 57 of Canada's First Submission.

<sup>256</sup> New Zealand referred to paragraph 45 of Canada's Second Written Submission.

under certain specified conditions, "shall not be considered to involve a subsidy on exports within the meaning of paragraph 3". Thus, the term "subsidies on exports" as it appeared in Paragraph 3 shall not include these particular types of income or price supports. The carve-out in the Ad Article of certain kinds of price and income support systems served as confirmation that, as a first step, all income or price support systems were in fact implicitly included in Paragraph 3, mirroring the express inclusion in Paragraph 1.

4.364 Canada argued that the presumption had to be that the meaning of the term "subsidy" was consistent throughout Article XVI. Since the subsidies referred to in Paragraph 3, export subsidies, were a subset of all subsidies, any practices which were declared not to be "subsidies" in Paragraph 3 could not be considered to be "subsidies" for the purposes of Paragraph 1 if the principle of consistency of interpretation was to be upheld. It was important in this context to note that the Ad Article referred to "within the meaning of paragraph 3", not "for the purposes of paragraph 3". The latter formulation might suggest that, notwithstanding the usual meaning of "subsidy", the provisions of Paragraph 3 did not apply to these particular income or price support systems. The choice of the word "meaning", however, directed the interpretative note to the meaning of the word, as it was used in Paragraph 3, but without restricting that application to Paragraph 3. Since the principle of consistency of interpretation presumed that the meaning that applied in one part of an Article, i.e., Paragraph 3, also had to apply in the rest of the Article, the application of the Ad Article flowed into the consistent interpretation of the term "subsidy" throughout Article XVI. Accordingly, the term "subsidy" in Paragraph 1 of the Article XVI had the same meaning as it had in Paragraph 3. It included all income or price support systems other than those specifically excluded by the Ad Article. Similarly, the term "all income or price support" as it was expressly used with respect to "subsidy" in Paragraph 1, had to have the same consistent meaning as the implied term "all income or price support" as it was necessarily implied with respect to "subsidy" in Paragraph 3.

4.365 Canada recalled that the reference in Article 1 of the SCM Agreement was to "any form of income or price support in the sense of Article XVI of the GATT 1994". If the application of the Ad Article was only to Paragraph 3 of Article XVI, and did not flow to Paragraph 1, then there would be a different meaning for "any form of price and income support" for each of the two paragraphs. The result would be that the reference in Article 1 of the SCM Agreement to "any form of income or price support" would be left in a state of confusion and therefore meaningless. Consequently, in Canada's submission, particularly in the context of this case, "any income or price support" as it was used in Paragraph 1 of Article XVI could not be interpreted without reference to Paragraph 3 or Ad Article XVI. In this respect, Canada noted that the GATT Analytical Index, 1995, at p. 445 directed the reader to "Interpretative Note 2 ad Paragraph 3 of Article XVI" for the interpretation of the phrase "including any form of income or price support", as it was used in Paragraph 1 of Article XVI. This clearly reflected an accepted interpretative approach to the provisions of Article XVI. The reference to "Article XVI" in Article 1 of the SCM Agreement, rather than any particular paragraph of the Article, provided confirmation and endorsement of this approach.

4.366 The United States noted that Canada did not explain why it maintained the obviously cumbersome and complex arrangements for milk exports, i.e., the Special Milk Classes Scheme, if sales of surplus production were not a necessary element of its milk price support system. Although it might be true that Canada's domestic support arrangements could survive without export sales, either its domestic prices would be lower or its domestic production levels would be forced to be lower to maintain the current price levels. It was to avoid these results that the levy system existed, and later was replaced by the Special Milk Classes Scheme when the levy system was explicitly defined to be an export subsidy. Even if Canada eliminated its planned export programme, Canada would still have a structural surplus of skim milk powder that would have to be exported if domestic prices levels were to be maintained.

4.367 The United States argued that Canada's analysis of Article XVI reflected a serious omission with respect to its application of Interpretative Note 2 to Paragraph 3 of Ad Article XVI. Canada stressed that the term "subsidy" as it was used in Paragraph 3 had also to include "any form of price or income support", except to the extent that there was any express direction to the contrary. Canada had then noted that such an "express exclusion" existed in Interpretative Note 2 to Paragraph 3 in Ad Article XVI. It referred to the "system for the stabilization of the domestic price" under certain specified conditions shall not be considered an export subsidy within the meaning of Paragraph 3. In the view of the United States, Canada had completely glossed over with oblique reference to "certain specified conditions" that Canada's system did not satisfy the criteria for such conditions. First, the system had to result only "at times" in the export sale of the product at a price lower than the comparable domestic price. For that reason, the Contracting Parties had to also determine "(a) the system has also resulted, or is so designed as to result, in the sale of the product for export at a price higher than the comparable price charged for the like product to buyers in the domestic market; and (b) the system is so operated, or is designed so to operate ... as not to stimulate exports unduly or otherwise seriously to prejudice the interests of other contracting parties." The Canadian regime failed in all respects. Canada's contention, moreover, that the rare instance in which Special Class 5(a) through 5(c) prices might be higher than domestic prices satisfied the criteria of the exception set forth in Ad Article XVI ignored the fact that Class 5(a) through 5(c) milk was sold at exactly the same price in both domestic and export markets. Canada, indeed, argued that access to Class 5(a) through (c) were not conditioned on export. Consequently, by Canada's own analysis, if the exception was not available, the system was a subsidy on exports within the meaning of Article XVI.3 and, in turn, a subsidy within the meaning of Article XVI as a whole.

(iii) *Article 1.1(b) – "Benefit"*

4.368 **Canada** argued that an analysis of whether the sale of milk through negotiated prices conferred a "benefit" had to begin with an understanding of what was meant by that word. The word "benefit" had not been defined in the SCM Agreement or in any of the other covered agreements. In the absence of a definition, recourse had to be made to the principles of treaty interpretation in customary international law, as expressed in Articles 31 and 32 of the Vienna Convention. Following this approach, Canada submitted that the word "benefit" as it was found in Article 1.1(b) of the SCM Agreement, could only be read as meaning a competitive advantage in trade. This conclusion flowed naturally from the ordinary meaning of "benefit", the context in which it was found and the object and purpose of the SCM Agreement read as a whole.

4.369 Canada argued that to establish ordinary meaning, some guidance could be obtained from authoritative dictionaries. In this respect, the New Shorter Oxford English Dictionary referred to "an advantage" or a "pecuniary profit".<sup>257</sup> Furthermore, Canada noted that WTO agreements were authentic in English, French and Spanish.<sup>258</sup> Under Article 33 of the Vienna Convention, the terms of each authentic text were presumed to be the same. If there was a difference of meaning, the meaning which "best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted."<sup>259</sup> Canada noted that in the French language text of the SCM Agreement, the word used for "benefit" was "*avantage*". Canada argued that this lent support to reading "benefit" in the English text as carrying the meaning of "advantage".

4.370 Canada argued that the SCM Agreement was about the maintenance of fair trade between producers. It was intended to discipline government contributions that resulted in a competitive advantage to certain producers. In this context, and in the light of the object and purpose of the

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<sup>257</sup> NSOED, Canada, Exhibit 26.

<sup>258</sup> Marrakesh Agreement Establishing the World Trade Organisation, signature provisions.

<sup>259</sup> Vienna Convention, Article 33.

provision, the expression "benefit" could only be interpreted to mean "competitive advantage". A broad reading of the word "benefit" would make governments liable for virtually any financial activity they undertook, regardless of whether or not that activity had a trade-distorting effect. In a commercial context, understanding "benefit" to mean "an advantage", meant that the transaction in question provided something to the recipient that would not be available in the ordinary course of business (for example, goods purchased at above market price or inputs provided at less than commercially prevalent prices). In either case, the action by government had provided something to the recipient over and above what was available in the market. Moreover, Canada argued that if "benefit" was to be read as carrying a broader meaning, this would have the effect of rendering the term meaningless and redundant since nearly any financial contribution could be said to provide a benefit in some aspect of that wider sense. This would be contrary to the basic rules of treaty interpretation.<sup>260</sup> Canada contended that the above confirmed that the term "benefit", as it was used in the SCM Agreement, was best understood to mean an "advantage". Canada contended that no "benefit" in the sense of some advantage outside of normal commercial returns can be found in the sale of milk in Canada at differing prices for domestic and export purposes.

4.371 Canada argued that the Complainants' submissions were premised on the assumption that there was only one market for dairy products in Canada. They argued that there were at least two distinct markets for the sale of dairy products. One market was the sale of dairy products for domestic consumption and the other was the sale of dairy products for export. In fact, there were sub-markets within each of these general markets. To find a "benefit", it had to be demonstrated that the ability of processors to obtain dairy products surplus to domestic requirements, on terms and conditions negotiated at arms length between producers (acting collectively) and processors, at the price that such products commanded in the international marketplace, conferred any assistance or advantage to the buyer. Canada failed to see how neutrality with respect to the purchase and sale of products at the price that was normal and customary in a particular market, could be said to be a "benefit".

4.372 Canada submitted that the relevant market for any product was the market in which it would compete. Since Class 5(d) and (e) milk could not, by definition, be sold in the domestic consumption market, the relevant market in which the price of such milk had to be examined was the export market as this was the only market in which the product can be sold. There could be no "benefit" where products were sold into a market at prices that the market would bear. Thus, Canada argued that the sales of milk in Canada for export use did not in themselves constitute a "benefit" for the purchaser over and above the normal commercial conditions that applied in such a market. Accordingly, there could be no "benefit" as that term had to be interpreted under Article 1 of the SCM Agreement.

4.373 Canada argued that even if both a governmental "financial contribution" and a "benefit" were found, the word "thereby" in Article 1.1(b) required that there was no "subsidy" until a causal link was established between the two elements. In other words, it was necessary to show that the "benefit" was conferred from the "financial contribution".

4.374 **New Zealand** noted that Canada's denial that any "benefit" was conferred by the operation of the Special Milk Classes Scheme was based largely on its view that Special Classes 5(d) and (e) milk were sold on the basis of arm's length transactions engaged in by producers or their agents and not by governments. There could be no "benefit", Canada asserted, because the exporter was simply obtaining milk at the only price at which it was available. Milk was exported, Canada claimed, only when there was no further domestic demand, thus there was no alternative domestic market to which the price can be compared. New Zealand contended that such an explanation assumed that there were

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<sup>260</sup> Canada noted that in particular, in the Appellate Body Report on *US - Reformulated Gasoline*, *op. cit.*, p.23, the Appellate Body stated: "One of the corollaries of the 'general rules of interpretation' in the Vienna Convention is that interpretation must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility."

two markets, domestic and export, that operate without governmental restraint. However the domestic market was only "satisfied", to use Canada's term, because the government said it was. Even when the market was "satisfied" it would still be possible to release more product into the market. Left to their own devices, producers would do just that. They would make the rational commercial decision to sell their product on the domestic market. While this would ultimately bring prices down, equally, greater quantities would be sold. Thus, the decision to provide milk at a lower price for the "export market" was not the result of the normal operation of the marketplace. Offering milk to exporters at a price lower than the domestic price was a conscious decision taken by government under the Special Milk Classes Scheme. It was a decision that conferred a benefit because in the absence of the Special Milk Classes Scheme exporters would have to pay domestic prices to access milk and would then clearly sell any products on world markets at a loss. The recipient was indeed, even in the terms that Canada used, being provided with something that "would not be available in the ordinary course of business" (paragraph 4.370) Thus the requirement that a benefit be conferred in order to meet the definition of "subsidy" in Article 1 of the SCM Agreement was met.

4.375 New Zealand maintained that Canada's contention that the Special Milk Classes Scheme did not provide a subsidy within the meaning of Article 1 of the SCM Agreement could not, therefore, be supported.

4.376 The **United States** argued that for purposes of Article 1 of the SCM Agreement, the Special Classes provided a benefit to the dairy product export manufacturers. While the United States did not necessarily accept Canada's construction of the term "benefit", the application of the term even as construed by Canada resulted in the conclusion that export processors received a benefit in the form of lower priced milk. Since those processors had no other source for such low priced milk<sup>261</sup> and they could not sell their dairy products into world markets if they were compelled to pay the much higher domestic prices in Canada for milk<sup>262</sup>, the processors clearly received a competitive *advantage* that they would otherwise lack.

4.377 Canada's argument that there was no benefit, moreover, rested solely on its theory that milk producers sold for export at approximations of world price levels free of all government compulsion. This view entirely ignored the fact that milk subject to surplus removal had to be sold for export at the lower prices fixed by the CDC or not be sold at all. The United States claimed that data (set out in US Exhibit 57) clearly indicated that over-quota component prices set by the CDC often undercut world prices for butter and SMP. Given that milk was a highly perishable product, and the initiation of surplus removal meant that no other processors in a province had a need for the milk, the Special Class price under surplus removal constituted what was essentially a take it or leave it price to the milk producer. Mr. Doyle, from the Dairy Farmers of Canada, stated this concept most concisely:

"From the producer standpoint, the revenue generated is what is reflected in 5-E and that is not a price setting as you use as an expression; its a price taking. It's the result of whatever the market provided for after costs."<sup>263</sup>

4.378 The United States submitted that a recent decision by Revenue Canada in a Canadian countervailing duty investigation involving refined sugar from the European Union was relevant to

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<sup>261</sup> The United States noted that Canada reported that the Import for Re-Export Program did not provide imported milk to its processors except in a form of more limited utility, e.g., as milk powder (the Import for Re-Export Program is further addressed in the following Section of this report).

<sup>262</sup> United States, Exhibit 25.

<sup>263</sup> Excerpt from Mr. Doyle's testimony before the Canadian International Trade Tribunal in its examination of the butter oil blend issue.

this issue. One of the subsidies that Revenue Canada examined was the payment of refunds to sugar processors selling their products onto the world market. Revenue Canada determined that those refunds constituted a benefit because the payments covered "the price difference between the EU price level and the world price level, thereby allowing the exporters to be competitive in export markets." Canada's Special Milk Classes Scheme also resulted in a price difference with lower priced milk available only to exporters to allow them to be competitive in world markets. Revenue Canada's conclusion that such price differentials constitute a benefit to exports compelled the conclusion that the Special Classes also conferred a benefit to Canadian processors.<sup>264</sup>

4.379 **Canada** refuted the US contention that processors received a benefit in the form of lower priced milk. Canada argued that there was no "benefit" conferred where products were sold into a market at prices that reflected the economic realities of that market. Likewise, the Canada refuted the US contention that what Canada called the market price was a "take it or leave it" price negotiated by the CDC. This was factually inaccurate. The CDC negotiated as agent for the producers and, as the principals, the producers had the right to approve or reject the transaction. The negotiated price was a price at which a willing buyer was prepared to purchase from a willing seller. It was difficult to see how such commercially-based sales conferred a benefit.

4.380 Canada contested the methodology in which the United States had constructed Canadian dairy prices as set out in Exhibit 57 (referred to in paragraph 4.377). The United States had converted actual over-quota returns for the 1995/96 to 1997/98 dairy years to US dollars, and compared them to prices reported for New Zealand and Australia. The United States then selected milk component prices under Class 5(e) from different individual provinces and converted these to US dollars after which conversion factors were assigned to each component to calculate the alleged value of milk reflected by the component prices. Canada argued that this procedure was flawed. It was almost impossible to create an accurate per hectolitre milk price from milk component prices for use in cheese and other products. This was because the protein and other solids prices for cheese were very different than for other products. For cheese making, protein was more highly valued, while the other solids were lower-priced. In making skim milk powder, protein and other solids had the same value. Moreover, different products contained different proportions of the various components. Therefore, from month to month and from province to province, as the composition of production changed, a crude conversion from component prices to a hectolitre price using fixed coefficients yielded an incorrect number. This result was clearly displayed in the "Calculated Milk Price" line (first page of Exhibit 57) where the United States reported that its estimate of farm level over-quota returns based on the components conversion methodology were vastly different than the actual over-quota returns for each of the dairy years studied. In other words, the data manipulations had generated incorrect answers.

4.381 Furthermore, in the following panel of the table in Exhibit 57, the United States took estimated prices for butter and skim milk powder in Northern European ports, which it used as a proxy for world dairy prices, and converted these to an estimated world price for milk. Unfortunately, it used inappropriate conversion factors. Butter and skim milk powder were joint products produced in more or less fixed proportions from standard whole milk. Canadian dairy experts considered these proportions to be 4.365 kg. of butter and 8.51 kg. of skim milk powder per hectolitre of milk. The United States had assumed 4.875 kg. of butter and 8.51 kg. of skim milk powder, thus overstating the value of a hectolitre of milk, and biasing its world price estimate upward. In the last line of the table in Exhibit 57, the United States attempted a comparison between prices of raw milk to processors on one hand with retail-packaged milk on the other. This was a basic analytical error (paragraph 4.439).

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<sup>264</sup> Final Determination of Subsidizing of Refined Sugar from the European Community, Statement of Reasons, Revenue Canada. See United States, Exhibit 55.

4.382 Canada further argued that the graph in Exhibit 57 suffered from similar methodological errors as the table. First, the component prices achieved in sales under Class 5(e) as reported by "various [unidentified] provincial newsletters" reflected the values of these components in a broad range of dairy products, for which different components had different values. A simplistic conversion from reported component prices to butter and skim milk powder prices produced inaccurate results. Second, the United States appeared to be comparing component values of raw milk as paid for by processors at their plants, with a survey of prices for finished butter transported to Northern European ports. Any analysis that failed to make allowances for processor margins, marketing costs and transportation before comparing these "constructed" plant-gate prices with finished goods prices obviously lacked credibility.

4.383 Canada noted that New Zealand argued that there was a benefit because the notion of a domestic market and an export market was an artificial construct designed by Canada. Canada argued that far from being an artificial construct, the differences between Canadian domestic and international dairy markets were a basic business reality to which producers and processors had to respond. Neither the Agreement on Agriculture nor the SCM Agreement required Members to eliminate all domestic and international pricing differences. Canadian dairy producers had simply adjusted themselves to the objective fact that these differences existed.

(c) Paragraph (d) of the Illustrative List of Export Subsidies

(i) *Outline*

4.384 **New Zealand** noted the Illustrative List in Annex I to the SCM Agreement made clear that the provision of inputs solely for use in exports on more favourable terms than for domestic production constituted an export subsidy. There was no doubt that what occurred under Classes 5(d) and (e) of the Special Milk Classes Scheme would constitute a subsidy within the meaning of Paragraph (d) of the Illustrative List. Under a government-mandated scheme, lower-priced milk was being made available to processors contingent upon export. The terms and conditions under which such milk was made available were more favourable than those commercially available on world markets since the existence of tariff restrictions on the importation of milk into Canada meant that the choice between domestic and imported products was not unrestricted within the meaning of the footnote to Paragraph (d). New Zealand claimed that the Special Milk Classes Scheme met the conditions set out in Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement which made it clear that such differential pricing schemes fell within its scope.

4.385 The **United States** argued that Paragraph (d) of Annex 1 of the SCM Agreement was particularly germane to consideration of whether Canada's Special Milk Classes Scheme constituted an export subsidy as this paragraph specifically addressed the situation where a government provided inputs to exporters at a price which was below the price at which the same materials were made available to manufacturers in the domestic market. This, after all, was precisely the function and objective of the Special Milk Classes Scheme. The conclusion that a differential pricing system for products destined for export fell within the concept of an export subsidy under Article 10 of the Agreement on Agriculture, as well, was, thus, reinforced by reference to the Illustrative List of Export Subsidies in the SCM Agreement. The Illustrative List made clear that the provisions of inputs solely for use in exports on more favorable terms than for domestic production constituted an export subsidy.

4.386 The United States argued that there were essentially four conditions that had to be fulfilled to satisfy Paragraph (d): (1) the provision of goods had to be by governments or mandated by them, either directly or indirectly; (2) the goods had to be used in the production of exported goods; (3) the goods had to be provided on terms or conditions more favorable than for provision of like or competitive products in the production of goods for domestic consumption; and (4) the goods had to be made

available on terms or conditions more favorable than those commercially available on world markets to the exporters. The United States argued that Canada's Special Milk Classes Scheme satisfied each of the requisite factors and, therefore, was an export subsidy within the meaning of the SCM Agreement.<sup>265</sup>

4.387 In conclusion, the United States argued that because the Special Classes had satisfied each of the criteria identified in Paragraph (d) of the Illustrative List, the Special Classes were deemed to be an export subsidy for purposes of the SCM Agreement. And as the SCM Agreement was part of the context of the subsidy provisions of the Agreement on Agriculture, the fact that the Special Classes comprised a subsidy under the Illustrative List argued for their treatment as a subsidy under the Agreement on Agriculture as well.

4.388 **Canada** argued that the facts demonstrated that the sale of milk in Canada for export use differed significantly from the practice described in Paragraph (d). This significant difference between the practices at issue and the practices *explicitly* described as export subsidy practices raised a clear implication that the Canadian practices did not fall within the conception of "subsidies" or "export subsidies" in the SCM Agreement or the Agreement on Agriculture. In Canada's view there were three elements that had to be met if a practice or measure relating to goods was to fall within the description provided in Paragraph (d):

- (a) the raw materials for use in the production of exported goods had to be provided by government or their agencies, either directly, or indirectly through a *government-mandated* scheme;
- (b) the raw materials were provided on terms or conditions more favorable than those that apply to raw material for use in goods for the domestic market; and
- (c) those terms and conditions were also more favorable than those commercially available on world markets to exporters.

4.389 Canada claimed that none of the three criteria applied to sales of milk under Special Classes 5(d) and (e) and therefore such sales were not deemed to be an "export subsidy" under this provision. Moreover, given the careful delineation of this type of "export subsidy", it was highly suggestive that a reverse proposition was true: the practices at issue were *not* to be considered to be "export subsidies" for the SCM Agreement, or in turn, for the Agreement on Agriculture. It was Canada's position that the practices in question did not fall within Paragraph (d) of the illustrative List. This raised a strong presumption that the practices in question were not "export subsidies" for the purposes of the SCM Agreement and, in context, for the Agreement on Agriculture.

(ii) *Government mandated ...*

4.390 **New Zealand** argued that the scheme could be viewed as either the provision by a government or its agency of products for the use in the production of exported goods, or it could be viewed as the provision of such products by producers through a government-mandated scheme. The role of the CDC and of the provincial milk marketing boards and agencies in providing lower-priced milk for the production of dairy products for export was one of implementing a government-mandated scheme.

4.391 The **United States** argued that the provision of milk at the Special Class prices was mandated by the federal and provincial governments and the Special Class prices were only available for milk

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<sup>265</sup> The United States noted that it had already established that the Special Milk Classes Scheme was an export subsidy because it satisfied the criteria alternatively of Article 9.1 or 10 of the Agreement on Agriculture.

used in production of export products. The United States submitted that the Panel consider at least two relevant factors in analyzing the mandatory nature of Canada's Special Class System: (i) the various GATT and WTO cases, including *Japan – Photographic Film*, *EEC – Dessert Apples*, and *Japan - Semiconductors*, which were each pertinent to a determination whether there was a government measure requiring compliance; and (ii) milk that was determined to be surplus by the CDC had to be sold at the Special Class 5(e) price when sold to processors for export.

4.392 **Canada** argued that milk for use in export markets was not provided by governments in Canada or their agencies. Nor was milk provided "indirectly" through "government-mandated schemes". Paragraph (d) required that the scheme in question be "mandated"<sup>266</sup> by government and not merely permitted or enabled. The distinction was critical. The ordinary meaning of the word "mandated" implied an act by government directing a certain outcome or course of action. This was confirmed by reference to dictionary definitions of "mandate" which confirmed that the term required a direction or order by superior body, not a mere empowerment. The New Shorter Oxford English Dictionary referred to a "mandate" as being: "a command, an order, an injunction"; "a legal command from a superior to an inferior"; and "instruction as to policy supposed to be given by the electors to a parliament". Canada pointed out that this also appeared to be the understanding of the United States who carefully distinguished "authorize" and "mandate", equating the latter with "require", with respect to their Uruguay Round implementing legislation.<sup>267</sup>

4.393 **New Zealand** refuted Canada's arguments that the requirements of Paragraph (d) of the Illustrative List of Export Subsidies had not been met because milk was not provided by a "government-mandated" scheme, and that the terms and conditions on which milk was sold were not more favourable than those commercially available on world markets to exporters. Canada derived a definition of "mandated" by choosing selectively from the dictionary definition of the word "mandate" in its noun form. But, the term "government-mandated" used the past participle of the verb "to mandate". Included amongst the Oxford English Dictionary definitions of the verb form of mandate were "to delegate authority to". The term "mandated" was defined to mean "permitted to act on behalf of a group".<sup>268</sup> The critical distinction that Canada wished to make dissipated in the face of a more accurate use of dictionary definitions.

4.394 New Zealand claimed that it had already been demonstrated that the Special Milk Classes Scheme *did* involve the provision of goods by government. Moreover, with regard to the alternative argument regarding the *indirect* provision of goods through government-mandated schemes, Canada's attempt to rely on dictionary definitions of the word "mandate" were not credible in light of definitions of the verb form of mandate, which was the form in which it was used in the term "government-mandated", were examined. The Oxford English Dictionary recorded that the term "mandated" in this form was frequently used to mean "permitted to act on behalf of a group".<sup>269</sup> The Special Milk Classes Scheme thus met this aspect of Paragraph (d).

4.395 **Canada** argued that the first listed definition of the verb form of "mandate" was "to command." The definition that New Zealand used was part of the last listed definition of the verb form of "mandate." The first part of this last listed definition read "To give a mandate to, to delegate authority to (a representative, group, organization, etc.)." As this definition began with giving "a mandate" to someone, an examination of the noun form of the word "mandate" was more than warranted. In looking at the noun form in the Oxford English Dictionary: "1. A command, order,

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<sup>266</sup> In defining "mandate", the *NSOED* referred to: "a command, an order, an injunction"; "a judicial or legal command from a superior to an inferior". (Canada, Exhibit 26)

<sup>267</sup> Canada, Exhibit 27, p.213.

<sup>268</sup> New Zealand referred to the *Oxford English Dictionary*, Second Edition, Volume IX, p. 301.

<sup>269</sup> *Ibid.*

injunction; 2.a. A judicial or legal command from a superior to an inferior." Canada maintained that the ordinary meaning connoted more than merely the sense of "permitted or enabled." In respect of "mandate", Canada further argued that the immediate context<sup>270</sup> of the words confirmed Canada's understanding that "government-mandated" means "government-ordered" or "government commanded." Item (c) of the Illustrative List of Export Subsidies of the SCM Agreement (the "Illustrative List") identifies as a subsidy the following:

"(c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipment."

4.396 Canada argued that the meaning of "mandated" in Item C of the Illustrative List was that of "commanded" or "ordered." That which made such discounted charges on export shipments an "export subsidy" was the government involvement requiring that they be given. For example, a private transport company that offered better rates for transport to some destination rather than to others, even if those destinations were foreign, would not be considered an export subsidy for the purposes of the WTO Agreements. To hold otherwise would require all Members to know and take responsibility for all transport charges on every shipment within their territory. Indeed, the mere fact that such companies were allowed to charge different rates to different clients, certainly could not mean to say that such private party practices were "government-mandated." The same logic would apply to Article 9.1(e) of the Agreement on Agriculture. Hence, moving to Paragraph (d) of the Illustrative List then, it seemed natural to read "government-mandated" in the same fashion as "mandated by government." Truly, such a reading coincided with the very notion of governmental control with respect to a measure identified as being a "government subsidy." The measure had necessarily to be imposed by the government as this item itself added as a condition "... if (in the case of products) such terms or conditions are more favourable than those commercially available...".

4.397 Canada further argued that its interpretation was consistent with the object and purpose of Paragraph (d). That was, to identify as a governmental export subsidy the provision of inputs for export purposes at artificially advantageous terms or conditions, whether by government or at the insistence of government. Furthermore, the Agreement as a whole did not purport to restrict private party actions but rather was concerned with constraining governments from providing subsidies or from entrusting or directing private parties to do so. Producer boards were private parties who were not directed by government to carry out subsidy functions and they were entrusted by their members to act on their behalf, not by government.

4.398 Canada argued that this approach to schemes or actions carried out by non-governmental entities was also reflected in the text of the definition of "subsidy" in Article 1 of the SCM Agreement and the use of the word "imposed" in Article 9(1)(c) of the Agreement on Agriculture. In Canada, milk producers and the marketing boards that represented producers were completely free to participate or not participate in export opportunities as they choose. Moreover, boards were not required by any government direction to establish or operate the Special Class export practices. This was entirely a matter of their own choice. The most that could be said was that governments made it possible for boards to put special class arrangements into place. The Complainants had provided no evidence that the goods in question were provided through a government-mandated scheme.<sup>271</sup>

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<sup>270</sup> In respect of the term "mandate" Canada argued that the Appellate Body had noted that a treaty interpreter ought not to stop at the ordinary meaning of a word. The analysis had to continue to consider the context in which the word was found, as well as the object and purpose of the provision itself, and if necessary, of the agreement as a whole: Appellate Body Report on *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, (hereafter "*US – Shrimp-Turtle*"), WT/DS58/AB/R, adopted 6 November 1998, pp. 41-42, para. 114-116.

<sup>271</sup> Canada maintained that New Zealand's arguments with respect to this provision were flawed by their assumption that there was a "government-mandated scheme".

(iii) *Terms or conditions more favourable ...*

4.399 **New Zealand** argued that the terms and conditions on which milk was made available were more favourable than for the provision of like or directly competitive products for the production of goods for domestic consumption. Milk was made available at the lower world price and not at the higher domestic price.

4.400 The **United States** argued that the Special Class 5(d) and (e) prices were uniformly lower than prices for the same milk components sold in the same market categories in the domestic market. Although Canada could dispute that the Special Class prices were fixed by the CDC, there was no question that the provincial marketing boards had to establish a price and that they did so through powers delegated to them by the federal and provincial government in their respective jurisdictions over provincial and inter-provincial trade and exports.

4.401 **Canada** noted that while milk could be sold in Canada for export purposes at prices which were lower than those for milk for use in products destined for the domestic market, this was not always so. In fact, as discussed with respect to Article 1.1(a)(2) of the SCM Agreement, recently the prices of some dairy components under Classes 5(a) and (b), which were linked to US domestic milk prices, had begun to exceed prices for milk classes in Canada for domestic use. Therefore, it was not always true that milk sold for export was sold on terms and conditions more favourable than those that apply to milk for domestic use.

4.402 The **United States** argued, in respect of prices for Special Classes 5(a), (b) and (c), that the only instances in which such prices could be argued to be higher than domestic prices, according to the data from the Canadian International Trade Tribunal, would be if prices to different end-use classes were compared. For example, by comparing the price of butterfat used in yoghurt with butterfat used in cheese. Such a comparison would be entirely inappropriate, however, as the Canadian system specifically differentiated among product markets in establishing price levels. Thus, the only appropriate comparison would be between prices for the same component in the same product market. This was the approach which the United States took, and using that approach, the resulting comparisons uniformly showed the Special Class prices to be lower than domestic prices for each of the three major milk components, i.e., butterfat, proteins, and other solids.

(iv) *Terms and conditions more favorable than those commercially available ...*

4.403 **New Zealand** further claimed that the requirement that the terms and conditions be more favourable than those commercially available on world markets were also met. A footnote to Paragraph (d) indicated that the term "commercially available" meant "that the choice between domestic and imported goods is unrestricted and depends only on commercial considerations." In the case of milk for processing into exported products, the choice between domestic and imported products was not unrestricted. Canada's tariff restrictions on the importation of milk meant that the terms and conditions on which milk was provided for processing into exported products under "special milk classes" were more favourable than those commercially available to Canadian processors on world markets.

4.404 The **United States** claimed that the terms and conditions for access to Special Class 5(d) and (e) were more favorable than those commercially available on world markets to Canada's dairy product exporters. The United States noted that Canada conceded that, in fact, "[w]ith respect to milk of HS 0401, no permits have been issued for milk for manufacturing purposes under the Import for Re-Export Program".<sup>272</sup> Thus, the record was presently clear that Canadian exporters had no access to imported fluid milk under the Import for Re-Export Program. Therefore, its exporters did have access

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<sup>272</sup> Canada's reply to New Zealand's Question 1(b).

to milk under the Special Milk Classes Scheme on terms and conditions that were more favorable than those commercially available to them within the meaning of Paragraph (d) of the Illustrative List.<sup>273</sup>

4.405 **Canada** argued on this point that the requirement was essentially a requirement that inputs not be provided at prices lower than exporters obtained for similar inputs on world markets. Sales of milk for export purposes under Special Classes (d) and (e) were tied directly to sales of the resulting dairy products into world markets and producers sought to obtain the optimum return from such sales to processors. The result was that milk inputs were not provided to processors at less than world market levels.

4.406 Canada noted that the footnote to Paragraph (d) stated that the term "commercially available" meant that "the choice between domestic and imported products is unrestricted and depends only on commercial considerations". Canada claimed that processors seeking to use imported dairy inputs had unhindered access to inputs on the world market for use in re-exported dairy products from Canada. Canada operated an Import for Re-Export Program under the provisions of the *Export and Import Permits Act* pursuant to which permits were freely issued to processors to access inputs on the world market, subject only to the condition that imported products met Canadian sanitary requirements and that all resulting manufactured products be re-exported from Canada. Canada argued that inputs imported under the Import for Re-Export Program were not part of Canada's scheduled tariff quota commitments. Such imports entered under supplemental import permits issued by the Department of Foreign Affairs and International Trade. As such, these imports were not counted against Canada's TRQ commitments. Accordingly, processors had an unrestricted choice between domestic and imported inputs for exported dairy products that depended only on commercial considerations.

4.407 Canada argued that due to the perishable nature of the product and difficulty in shipping, there was little trade in fluid milk for manufacturing purposes. Trade in milk consisted largely of trade in the storable and tradeable milk derivatives, such as skim milk powder, whole milk powder and butter. The commercial availability of these substitutable dairy ingredients, through the Import for Re-Export Program, provided effective international competition for sales of milk for processing purposes to Canadian customers. Canada noted the fact that the programme had been used in not insignificant quantities and that prices paid for imported dairy products under the Import for Re-Export Program were negotiated between Canadian buyers and foreign suppliers. This supported Canada's position that processors made their choices based on commercial considerations.

4.408 **New Zealand** argued that the granting of permits under an Import for Re-Export Program, to which Canada referred in passing, did not mean that the choice between imported and domestic products was "unrestricted" within the terms of the footnote to Paragraph (d). Paragraph (d) did not grant Members the right to provide each input into a product at lower prices for export than for domestic uses where tariff protection was provided as long as there happened to be a scheme in place that allowed the temporary import of those inputs for manufacture in bond. A duty draw-back mechanism was not sufficient justification for governments to provide car engines, wheels and other vehicle components at cheap prices solely for export use. In short, Canada had failed to provide any evidence that the choice between imported and domestic products was "unrestricted" within the meaning of Paragraph (d) of the Illustrative List.

4.409 New Zealand argued that it was clear that the prices of products derived from over-quota milk would be below domestic market prices in order that exports could be commercially viable from the

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<sup>273</sup> The United States noted that although Canada asserted that exporters had access to other dairy inputs, such as milk powder and evaporated milk, through the Import for Re-Export Program, the United States in its response to the Panel's Question 5 had demonstrated that such products simply were not substitutable in any practical sense for the liquid milk that Canada's exporters receive through the Special Milk Classes Scheme.

exporters' point of view<sup>274</sup>. New Zealand also believes that there was a risk that such prices would also be below world market prices. Although Canada argued that the CDC must negotiate vigorously with exporters in order to maintain the confidence of producers and the CMSMC, the reality was that the alternative to disposing of Class 5(e) milk by way of export was to pour it away. Accordingly, when pressure for effective surplus removal was added to the need for exporters to obtain a profit margin, the result could well be that prices paid by exporters were below world market prices.

4.410 New Zealand maintained that Canada's image of unhindered access was hardly in accord with the reality that permits were issued on a discretionary basis and goods were imported subject to the "within access" tariff. A tariff was a form of restriction. This in itself would be enough to render the Program inconsistent with the requirement set out in the footnote to Paragraph (d). New Zealand also commented on the careful use of language in the Canadian submissions relating to the Import for Re-Export Program by virtue of which Canada asserted that processors had unhindered access to "dairy inputs", rather than to "milk" on the world market. It had become clear that the shift in language that was used in preceding paragraphs which had referred to "milk" was anything but stylistic. It simply would not have been accurate for Canada to have said that processors had unhindered access to milk on the world market. Canada had admitted that "no permits have been issued for milk for manufacturing purposes under the Import for Re-Export Program".<sup>275</sup> But the other dairy "inputs" to which Canada referred were simply not relevant to the current case, which was about the provision of lower-priced milk to exporters. Canada had further sought to ascribe this lack of trade to the "perishable nature" of milk and "difficulty in shipping", although it did not explain why shipping milk a short distance across the Canada-United States border was more "difficult" and likely to lead to a "perishing" of the product, than shipping it potentially much longer distances from within Canada.

4.411 Hence, New Zealand maintained that in practice, milk was not "commercially available" on world markets to Canadian processors under the Import for Re-Export Program. Thus, the terms and conditions on which "special class" milk was made available were more favourable than those commercially available on world markets. Clearly, the requirements of Paragraph (d) of the Illustrative List were met.

4.412 The **United States** recalled that Canada had admitted in its response to the Panel's questions that milk in liquid form was *not* imported into Canada for use in manufacturing.<sup>276</sup> Thus, such milk was clearly not commercially available within the meaning of Paragraph (d). Canada sought to imply that phytosanitary barriers did not exist. The United States noted that in their argumentation on this context, Canada referred to *dairy products*, not milk. This statement did not alter the fact that milk was not entering Canada. Also Canada sought to argue that the components of milk and milk itself were the same. This was not true as the ingredients had a much narrower range of applications, than the whole milk product. These other dairy products were not "like or directly competitive" products within the meaning of Paragraph (d). In addition, the other dairy products mentioned by Canada certainly could not be used by Canada's processors for many end-uses that were served by liquid milk. For example, a manufacturer of skim milk powder or butter could not import those same products to replace the milk that he received under the Special Milk Classes Scheme. This was a critical consideration because a considerable portion of Canada's dairy product exports consisted of butter and skim milk powder.

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<sup>274</sup> For example, Figure 3 of New Zealand's First Submission provided a representation of the price of the butterfat component of butter manufactured from Class 4(a) milk and that manufactured from Class 5(e) milk.

<sup>275</sup> Canada's responses to New Zealand questions of 20 October 1998.

<sup>276</sup> Canada's Response to Question 1 from New Zealand: "With respect to milk of HS 0401, no permits have been issued for milk for manufacturing purposes under the Import for Re-Export Program."

4.413 Furthermore, the United States argued that the very modest level of imports reported by Canada emphasized their lack of competitiveness with milk available through the Special Classes. The total volume of such imports, such as milk powder and evaporated milk, comprised less than 5 per cent of Canada's export volume of dairy products, and significantly less than 1 per cent of Canada's domestic consumption of milk. These volumes indicated that processors had decided that the other dairy products to which Canada referred were not available on as favorable terms and conditions as milk under the Special Milk Classes Scheme. Such paltry import volumes also provided unrefuted evidence that Canada's processors did not find such other dairy products to be directly competitive with the industrial milk provided by Canada's Special Milk Classes Scheme.

4.414 Furthermore, the United States claimed that Canada had failed to demonstrate that those other dairy products were available on terms and conditions as favorable as those provided by the Special Classes. For example, Canada admitted that milk in Special Class 5(e) was provided at world prices or an approximation of world prices, and also conceded that milk ingredients imported under the Re-Export Program had to bear an in-quota duty rate. Even if the Panel accepted Canada's argument regarding the direct competitiveness of the milk ingredients (which the United States submitted misstated the competitiveness of such products), the imports had to be higher priced as they were subject to import tariffs and the underlying purchase price was a world market price. Thus, by definition such imports were available on less favorable terms and conditions than those provided by the Special Classes.

4.415 Hence, the United States concluded that the application of the Illustrative List of Export Subsidies resulted in a finding that the Special Milk Classes Scheme was an export subsidy. Consideration of the criteria regarding subsidies contained in Article 1 of the SCM Agreement only confirmed this result.

4.416 **Canada** argued, in respect of its sanitary requirements, that under Paragraph 26(1)(a), (b) and (c) of the Dairy Product Regulations<sup>277</sup>, under the Canadian Agricultural Products Act, dairy products imported into Canada had to originate in a country that had "standards for dairy products that are at least equivalent to those set out in these regulations", and "a system for inspection for dairy products and establishments that are at least equivalent to that in Canada". The product had to also "meet the standards for a similar dairy product that is produced in Canada" and "has been prepared under conditions at least that equivalent to those required by these regulations".<sup>278</sup> These standards did not prevent US dairy products from entering Canada. As a matter of practice, the Canadian Food Inspection Agency (CFIA) routinely approved the import of dairy products into Canada from the United States on the basis that standards in the United States met the standards set out in the regulations. Once imported into a province, raw milk would be subject to the same provincial standards as milk produced in that province. These standards would not pose any barrier for milk sourced in the United States. Thus, while there were sanitary standards, these were normal routine matters and did not pose anything like the "effective prohibition" as suggested by the United States. Canada argued that although it was true that there had not been any imports of raw industrial milk in recent years under the Import for Re-Export Program, this does not reflect any denial of access to the Canadian market. There had not been a *request* to the CFIA for approval of the import of industrial milk under their sanitary regulations. The reasons for no imports of industrial milk into Canada were commercial, not regulatory.

4.417 Canada noted that the United States had suggested that there was a qualitative difference for manufacturing purposes between liquid milk and milk components that limited the use of milk components to certain niche products. Canada argued that milk components were not different

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<sup>277</sup> P.C. 1979 – 3088, as amended.

<sup>278</sup> Canada, Exhibit 54.

products – they were simply part of the same product. The quality of milk components such as skim milk powder, butter or other milk ingredients had greatly improved in recent years. This had now reached the point that it was argued that final product quality was actually enhanced by the use of specialized whey protein concentrates in place of skim milk in ice cream for example. Where components were competitive with liquid milk, questions of cost would come into play. Costs of transport of a product such as liquid milk were considerable when it was considered that up to 87 per cent of the product consisted of water. In addition, raw milk could be a less economically efficient input for a manufacturer than dairy products that supplied the components needed for a particular manufacturing process. Hence, Canada argued that the supposed barriers to liquid milk for Canadian processors from the United States did not exist. There was no commercial basis to suggest that liquid milk and tradeable milk components could not be used for the same manufacturing processes.

4.418 In sum, Canada argued that processors had unrestricted access to dairy product inputs through the Import for Re-export Program, and they had access to those products at world market prices. Inputs sold to processors through Special Classes 5(d) and (e) were sold at world market prices. The use of the Import for Re-Export Program indicated that these two sources of supply effectively competed. Processors had not shown any overwhelming preference for ingredients sourced under Special Classes 5(d) and (e). Hence, it could be concluded that Special Class prices were not more favourable than prices commercially available to Canadian exporters on world markets. Given that prices of dairy inputs were available to processors at internationally competitive prices, both through the Import for Re-Export Program and through Special Classes 5(d) and (e), and both avenues were used, this suggested that Special Classes 5(d) and (e) could not be said to provide a "benefit."

4.419 Canada contended that the imports under the Import for Re-Export Program in recent years had been of significant quantities.<sup>279</sup> Furthermore, these imports of dairy inputs from the United States entered Canada duty-free. For all products imported under the Programme in 1998, the average trade-weighted tariff was less than 1 per cent.

4.420 **New Zealand** noted that the Appellate Body had indicated that whether something was a "like" or a "directly competitive" product was to be determined on a case-by-case basis.<sup>280</sup> Applying the relevant factors, such as the product's end use, consumer tastes and preferences, and the product's properties, nature and quality, to skim and whole milk powder, New Zealand was of the view that skim milk powder and whole milk powder were not "like or directly competitive" products with fluid milk in the context of the production of the products that are exported from Classes 5(d) and (e). In other words, processors would not import skim milk powder or whole milk powder at world prices in order to export the same products - skim milk powder and whole milk powder - at the same world prices. Skim milk powder and whole milk powder were two important products exported from Special Class 5(d) or (e) milk. For other products (principally butter and cheese) exported from Special Class 5(d) or (e) milk, while it might be technically possible to substitute skim milk powder or whole milk powder for milk in their production, it was highly unlikely that this would be an economically viable approach given the resultant products had to be exported at world prices. In general, such a reconstitution of milk only occurred for sales of liquid milk in domestic markets where domestic production was insufficient to meet demand. As Canada had stated "there have not been any imports of raw industrial milk in recent years under the Import for Re-Export Program".<sup>281</sup> New Zealand considered that this was further evidence that the choice between domestic and imported milk was not unrestricted and did not depend only on commercial considerations in the meaning of Paragraph (d) of the Illustrative List of Export Subsidies.

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<sup>279</sup> Statistics on imports under the Import for Re-Export Program in recent years were attached to Canada's Second Oral Statement of 18 November 1998 ("Comments by Canada on Oral Statement of United States").

<sup>280</sup> Appellate Body Report on *Japan – Liquor Tax*, *op. cit.*, pp.20-21; Appellate Body Report on *Canada – Periodicals*, *op. cit.*, p.21.

<sup>281</sup> Canada's Oral Submission of 17 November 1998, para. 74.

4.421 New Zealand contended that the primary reference of the term "products" in brackets in the last part of Paragraph (d) was to the term "imported or domestic products" in the second line of the paragraph. New Zealand understood the paragraph to mean that, in order to constitute a subsidy, the imported or domestic products in question had to be made available on terms more favourable than the terms commercially available on world markets for "like or directly competitive" products. The bracketed reference to "products" made clear that there was no such limitation in the case of services.

4.422 The **United States** argued that the express reference to "like or directly competitive" products in Paragraph (d) of the Illustrative List was made in connection with the discussion of products provided "for use in the production of goods for domestic consumption". However, because Paragraph (d) contemplated a comparison between the "terms or conditions" applicable to products used in the production of exported goods and those "commercially available" on world markets to exporters, that comparison could only be meaningful if the products themselves were comparable. Thus, any products available on the world market used in such comparison had to also be "like or directly competitive" with the products used in the production of exported goods. The United States emphasized that it did not consider milk powders to be "like or directly competitive" with fluid industrial milk within the meaning of that phrase as used in Paragraph (d) of the Illustrative List of Export Subsidies.

4.423 The United States argued that the natural starting point for construing the meaning of the phrase "like or directly competitive products" was the definition of "like product" contained in the SCM Agreement. Footnote 46 of that Agreement stated that "[t]hroughout this Agreement the term 'like product' shall be interpreted to mean a product which is identical, i.e., like in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has characteristics closely resembling those of the product under consideration." Although the definition of like product appeared in Part V of the SCM Agreement, use of the clause "throughout this Agreement" made clear that this definition was equally applicable to the provisions of the Illustrative List of Export Subsidies contained in Annex I to the Agreement. The United States noted that the definition of "like product" contained in the SCM Agreement had been applied in only one WTO proceeding to date: *Indonesia - Certain Measures Affecting the Automobile Industry*.<sup>282</sup> There the Panel emphasized that the definition required not only that the characteristics of the products being compared resemble one another, but that the characteristics "closely" resembled one another.<sup>283</sup> The Panel had also found that an important element to be considered were the physical characteristics of the products involved, although its analysis need not be confined to physical characteristics alone.<sup>284</sup> In addition, the Panel had observed that tariff classification principles might be useful because they provided "guidance as to which physical characteristics between products were considered significant by Customs experts."<sup>285</sup>

4.424 In light of the above, the United States first observed that for customs classification purposes fluid milk and milk powders were classified in different categories. Fluid milk was classified in item 0401, whereas milk powders were classified in 0402. Second, there were obvious differences in the physical characteristics of fluid and powdered milk, the foremost being that one was in liquid form

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<sup>282</sup> Panel Report on *Indonesia - Automobile Industry*, *op. cit.* The United States further noted that the term "like product" appeared in various provisions of the GATT 1994, as well as the WTO Agreements, and its meaning had been determined to depend on its precise usage in a particular agreement. Thus, the Appellate Body in *Japan - Liquor Tax*, *op. cit.*, p. 21, stated: "The concept of 'likeness' is a relative one that evokes the image of an accordion. The accordion of 'likeness' stretches and squeezes in different places as different provisions of the *WTO Agreement* are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term 'like' is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply."

<sup>283</sup> Panel Report on *Indonesia - Automobile Industry*, *op. cit.*, para. 14.172.

<sup>284</sup> *Ibid.*, 14.172. 14.173.

<sup>285</sup> *Ibid.* The Appellate Body in *Japan - Liquor Tax*, *op. cit.*, also found the tariff classification of a good to be relevant to the determination of "likeness", p. 21.

while the other has been dried to powdered form. In addition, fluid industrial milk contained butterfat, whereas skim milk powder contained no butterfat at all. These physical differences resulted in constraints on the use of milk powders in particular end-uses, and/or require additional processing steps for their use. Skim milk powder, because it lacked butterfat, could not alone be used for any of the multitude of dairy end-uses where butterfat was required. That butterfat had been added in any formulation using skim milk powder where butterfat was required underscored the lack of competitiveness of skim milk powder in such end-uses. Fluid industrial milk because it contained butterfat was not subject to a similar constraint. This fact, in itself, suggested that skim milk powder and fluid industrial milk did not "closely resemble" each other in terms of physical characteristics and, therefore, were not like products. The United States noted that the same conclusion, i.e., that it was not a like product, was warranted with respect to whole milk powder. Again, whole milk powder and fluid milk were not classified in the same tariff category, and differed in terms of their physical form, one being in a liquid form, the other being a powder. Although both fluid industrial milk and whole milk powder contained butterfat, the fact that all liquid had been removed from whole milk powder meant that in almost all instances before it can be used it had to be rehydrated. This process was both time consuming and required additional costs, as well as additional equipment. The US industry estimated this cost to be approximately US\$70 per hundredweight.

4.425 The United States further noted that whether the powder was produced using high intensity heat or lower temperatures also would affect the nature of the powder produced and the range of products in which it could be used without alteration of the final processed dairy product. For example, powdered milk produced with high temperatures required a lengthier period, often as much as 24 hours, for rehydration. The high temperatures used also frequently imparted a taste to the powder which altered the flavour of the finished product from that which would be obtained by using fluid milk. In many instances, the powder, once rehydrated, was used only in products where its taste would be obscured by means of flavouring, such as in ice cream.

4.426 The United States further noted that the differences in physical characteristics also evidenced itself in the manner in which the respective products were used. In broad terms, in Canada 40 per cent of fluid milk was used for beverage purposes, 40 per cent was used in the production of cheese, and 20 per cent was used in all other dairy products. In comparison, relatively small amounts of milk powder were used for beverage purposes in Canada or the United States. Only comparatively small amounts of powder milk were used in cheese, and primarily for fortification, i.e., to increase the protein level. For example, in two of the primary cheese products, mozzarella and cheddar, milk powder normally represented no more than 3 per cent of the product by weight. Powder could be used to fortify cheese because of its relatively high protein level compared to fluid milk. Another physical difference was the high perishability of fluid milk. Whereas fluid milk would spoil within a period of days even when refrigerated, milk powder could be stored for lengthy periods of time, measured in months, if not years.

4.427 The United States noted that two separate GATT Panel reports had concluded that the differences between fluid milk and various products derived from milk were sufficient that they generally did not constitute like products or compete directly within the meaning of Article XI:2 of the GATT 1947. In *Japan - Restrictions on Imports of Certain Agricultural Products*<sup>286</sup>, a Panel examined a broad variety of dairy products, including processed cheese, prepared whey, skim milk powder, and whole milk powder and determined that "a product in its original form and a product processed from it could not be considered to be 'like products'" for purposes of Article XI:2.<sup>287</sup> In

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<sup>286</sup> Report on *Japan – Certain Agricultural Products*, *op. cit.*

<sup>287</sup> *Ibid.*, p. 231, para. 5.3.1.4.

*Canada - Import Restrictions on Ice Cream and Yoghurt*<sup>288</sup>, another Panel reached a similar conclusion, finding that neither ice cream nor yoghurt competed directly with raw milk.

"The Panel considered that the term compete directly with ... 'imposed a more limiting requirement than merely 'compete with'... The essence of direct competition was that a buyer was basically indifferent if faced with a choice between one product or the other and viewed them as substitutable in terms of their use. Only limited competition existed between raw milk and ice cream and yoghurt." (emphasis in original)<sup>289</sup>

4.428 The United States argued that the conclusions in the cited Panel reports were equally applicable in the present context. Although those Panels were interpreting the terms "like product" and "directly competitive" in the context of Article XI:2 of the GATT, the use of those terms in the SCM Agreement should be given an equally narrow meaning. In fact, the 1987 Panel Report on *Japan - Customs Duties, Taxes and Labeling Practices on Imported Wines and Alcoholic Beverages* stated that it was aware of the "very narrow definition" for the term "like product" for antidumping purposes.<sup>290</sup> Since the definition of like product in the Antidumping Agreement was identical to that currently found in the SCM Agreement, the *Alcoholic Beverages* Panel's observations regarding the narrow definition of "like product" were germane to this dispute. Given all of the foregoing, including the significant differences in physical characteristics described above, milk powders and fluid milk were not "like products".

4.429 The United States submitted that, for very similar reasons, milk powders and fluid industrial milk were not directly competitive products.<sup>291</sup> Because the phrase "directly competitive products" was not defined in the SCM Agreement, the ordinary meaning of the term in light of its context, and the object and purpose of the provision were our starting point, consistent with Article 31 of the Vienna Convention. The purpose of the requirements in Paragraph (d) that a product be "like or directly competitive" and that the product be provided on "terms and conditions" no less favorable than the product supplied by the government of the country of exportation were to allow a determination whether a benefit was conferred to an exporter when the government provided for a product to be received on more favourable terms for export than for production for domestic consumption. This determination necessitated a comparison between products that closely resembled each other, otherwise the risk of an apples to oranges comparison might result. A determination whether products were provided on the same favorable "terms and conditions" would be impossible unless the products closely resembled each other. Products that were materially different would not be comparable for purposes of determining the equivalence of the applicable terms and conditions. Therefore, to construe the phrase "directly competitive" to encompass products that while substitutable for certain purposes were not interchangeable for most end-uses, either because of differences in physical characteristics or other reasons, would appear to undermine the ability to determine whether the applicable terms or conditions were similar.

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<sup>288</sup> Panel Report on *Canada - Yoghurt*, *op. cit.*

<sup>289</sup> *Ibid.*, p. 89, para. 73.

<sup>290</sup> Panel Report on *Japan - Alcoholic Beverages*, (hereafter "*Japan - Alcoholic Beverages*") L/6216, BISD 34S/83, adopted 10 November 1987, pp. 115-116, para. 5.6.

<sup>291</sup> The United States noted that in the different context of Article III:2 of the GATT 1994, the Appellate Body in *Japan - Liquor Tax*, *op. cit.*, indicated that the category of "directly competitive or substitutable products" may be broader than the class of "like products", but stated that this determination was "a matter for the panel to determine based on all relevant facts in that case" and had to be determined on a case-by-case basis (p.25). The Appellate Body further observed that consideration of such factors as physical characteristics, common end-uses, and tariff classifications were appropriate for this purpose. *Ibid.*

4.430 The United States noted that, as indicated above, the *Canada - Yoghurt* Panel found that to be "directly competitive" a buyer would have to be indifferent in its choice between the products in issue. In the view of the United States, a buyer would not be indifferent to the choice between fluid industrial milk and milk powders because of the differences in physical characteristics, limited substitutability in end-uses, and the additional processes associated with reconstituting powders prior to their use in further manufacture of dairy products. Consequently, milk powders were not "like or directly competitive" with industrial milk provided through the special class system.

4.431 The United States submitted that cheese imported by Canada in the Import for Re-Export Program was not like or directly competitive with fluid industrial milk based on the significant and obvious physical differences between the products, as well as the inability to substitute cheese in most of the end-uses for milk. The United States also noted that beyond the question of whether milk powders were like or directly competitive products, there was the separate question of whether milk powder imports were available on the same favorable terms or conditions on which fluid milk was available to exporters under the special class system. The United States submitted that they were not. Import data supplied by Canada pertaining to the Import for Re-Export Program indicated that virtually all such imports consist of various manufactured dairy products, not raw milk, as was available under Special Classes 5(d) and (e). Moreover, those dairy ingredients were on a "milk equivalent" basis priced higher than industrial milk provided pursuant to Special Classes 5(d) and (e).

4.432 The United States used Canada's data<sup>292</sup> on quantities and values of selected dairy products imported under the Import for Re-Export Program to calculate the equivalent price, or cost, of "milk" imported for calendar years 1995, 1996, 1997 and 1998 to date.<sup>293</sup> The products selected included dry milk, not containing sweetening matter, with greater than 1.5 per cent fat, or whole milk powder (WMP), cheese of all types, and fluid milk, not concentrated, containing no sweetening matter, with between 1 and 6 per cent fat. These three products accounted for approximately 75 per cent of the total value of 1997 dairy product imports for re-export.<sup>294</sup> Unit values of imports for re-export were computed in a straightforward manner (total value/total quantity), converted to US dollars per metric tonne, with international prices, as reported by the US Department of Agriculture, provided as a comparison. These unit values were then converted to a milk equivalent basis, using yield factors and manufacturing margins based on a combination of data from the CDC and factors used by the US Department of Agriculture, as shown in the immediately following table. Comparative data for Special Class prices 5(d) and (e) were computed for calendar year 1997 and for 5(e) for marketing year 1996/97.<sup>295</sup> The 1997 price data for Special Classes 5(d) and (e) were based on statistics from Agriculture and Agri-Food Canada<sup>296</sup>, and were weighted-averages based on 71 per cent and 81 per cent, respectively, of the 1997 volume of milk sold under Special Classes 5(d) and (e) in Canada (calculations also attached). The 1996/97 marketing year price data for Special Class 5(d) and (e) were computed based on Class 5(e) component values for Quebec, which represented 64 per cent of total Class 5(e) milk sales in 1997, using milk composition factors of 3.9 per cent for butterfat, 3.3 per cent for protein, and 5.21 per cent for other milk solids.

4.433 The United States contended that, based on the above-described calculations, contrary to Canada's assertion, Canadian processors did not have access to dairy products under the Import for Re-Export Program at prices comparable to prices for raw milk available under Classes 5(d) and (e).

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<sup>292</sup> The United States referred to the data attached to Canada's comments on the US Oral Statement at the Second Substantive Meeting of the Panel ("Comments by Canada on Oral Statement of United States, Second Panel Hearing, November 17-18, 1998").

<sup>293</sup> Contained in US Exhibit 65.

<sup>294</sup> The United States claimed that imports of skim milk powder under the Import for Re-Export Program were at such extremely low levels during the last two calendar years that their presence could not be considered to provide an alternative to milk provided through the Special Classes Scheme.

<sup>295</sup> The United States noted that the most complete and reliable data available was for 1997 and marketing year 1996/97.

<sup>296</sup> Attached to United States, Exhibit 56.

The "milk equivalent" prices for whole milk powder, cheese, and fluid milk imported through the Import for Re-Export Program were in each instance higher than the corresponding prices for special class 5(d) and (e) milk.

4.434 **Canada** noted that the reference to "products", within brackets, in the last part of Paragraph (d) of the Illustrative List, included "like or directly competitive products". Paragraph (d) referred initially to both "products or services"<sup>297</sup> and then subsequently again to both "products and services"<sup>298</sup>. The second reference to "products and services" was modified by the phrase "like or directly competitive". The use of the word "product" in the final condition of Paragraph (d)<sup>299</sup> followed the reference to "like or directly competitive products and services". Thus, the word "product" referred back to the antecedent reference to "like or directly competitive products and services." Accordingly, the purpose of the use of the word "product" in the bracketed portion in the final condition in Paragraph (d) was to indicate that this final condition applied only with respect to "products"; not to both "products and services". Since the antecedent reference was to "like or directly competitive products and services", then the qualifying term "like or directly competitive" similarly applied to "products" in the final condition.

4.435 Canada argued that in the dairy industry in Canada, and abroad, skim milk powder and whole milk powder were considered to be like or directly competitive with whole milk. In addition, raw milk could be a less economically efficient input for a manufacturer compared to dairy products that supplied the components needed for a particular manufacturing process. Milk powder was, of course, much cheaper to transport due to the fact that raw milk is over 80 per cent water. Milk powders could be reconstituted for use in the manufacture of some dairy products. They could also be used to standardize for protein and butterfat for a variety of products. Indeed, to the extent that there was a cost advantage to do so, dairy product manufacturers would use milk powders instead of raw milk. Thus, to a certain extent, milk powders competed in the same markets and fulfilled the same needs and uses as fluid industrial milk. These products could be used interchangeably in many applications. The differences between fluid industrial milk and milk powders primarily related to storage and transportation, not end-use.

4.436 Canada drew the Panel's attention to the US Dairy Export Council website where the US dairy processing industry claimed: "U.S. powdered milk can be easily reconstituted into wholesome drinking milk or used as an ingredient in baked goods, dairy products, confections and other prepared foods".<sup>300</sup> Similarly, a study prepared by the United States Department of Agriculture (USDA) had stated, in respect of SMP that it "can be substituted for fresh skim milk or condensed skim milk in many manufactured products" and "converted easily back to milk, and with little formulaic adjustment...[and] can be substituted for condensed skim in many processing operations".<sup>301</sup> Canada further noted that the United States claimed that SMP normally represented no more than 3 per cent of (mozzarella and cheddar cheese products) by weight (paragraph 4.426). However, the same USDA study just referred to stated that, on a skim equivalent volume basis, skim milk powder usage had grown to "25.4% of the dairy ingredients in the manufacture of mozzarella and other Italian-cheeses in one region of the United States and 16.1% nationally".<sup>302</sup> Perhaps it was for this reason that the US

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<sup>297</sup> " ... of imported or domestic products or services for use in the production of exported goods ... "

<sup>298</sup> " ... for provision of like or directly competitive products or services ... "

<sup>299</sup> " ... if (in the case of products) such terms or conditions are more favorable than those commercially available on world markets to their exporters."

<sup>300</sup> [http://www.usdec.org/cgi\\_win/usdec.exe/section24](http://www.usdec.org/cgi_win/usdec.exe/section24)

<sup>301</sup> A Review of Class III – A Pricing under Federal Milk Marketing Orders, Dairy Division, Agricultural Marketing Service, United States Department of Agriculture, March 1995, pp.1–2.

<sup>302</sup> *Ibid.*, at pp. 17 and 22, referring to the years 1992 to 1994.

Dairy Export council proudly proclaimed on its website that "the US milk powder industry is capable of unrestrained growth."<sup>303</sup>

4.437 Canada argued that the GATT Article XI Panel Reports relied on by the United States (paragraph 4.427 and following) had little to do with whether, for the purposes of Paragraph (d) of Annex I of the SCM Agreement, milk powders and fluid industrial milk were "like or directly competitive products." GATT Article XI:2(c)(i) was concerned with restrictions on the importation of primary products "in any form". This expression was subject to the definition in Ad Article XI:2(c). Furthermore, GATT Article 2(c)(i) created an exception to the general prohibition created in Article XI:1, and thus had been construed narrowly.<sup>304</sup> The "like or directly competitive products" concept in Paragraph (d) of the Illustrative List of Annex I to the SCM Agreement was a defining part of that list and thus was to be given its full and ordinary meaning in accordance with the principles of treaty interpretation.

4.438 Canada argued that the United States had given scant attention to more authoritative and more relevant Appellate Body jurisprudence on concepts of "directly competitive or substitutable products"; jurisprudence that plainly supported the conclusion that milk powders directly competed with fluid industrial milk.<sup>305</sup> Apart from being of minimal relevance, the Panel Report in *Canada – Yoghurt* relied on by the United States was readily distinguishable on its facts. That Panel had considered whether, from the standpoint of the end-use consumer, ice cream and yoghurt competed directly with fresh milk. This was an entirely different issue from assessing, from the standpoint of processors, whether milk powders and fluid industrial milk were "like or directly competitive" products. In respect of the other GATT Article XI case cited by the United States (*Japan – Restrictions on Imports of Certain Agricultural Products*) seemed to lend support to the common-sense proposition that milk powders competed directly with fluid milk. What the United States failed to mention was that the Panel in that case appeared to accept that milk powders and certain other dried and condensed milk products "could compete directly with fresh milk for manufacturing use."<sup>306</sup>

4.439 Canada refuted the validity of the "milk equivalent" prices calculated by the United States as provided in US Exhibit 56 (paragraph 4.432). Canada argued that dividing the total reported trade value by the total reported trade volume in trade statistics was an unreliable guide to actual prices. Thus, the data submitted by the United States (the Dairy Market Review attached to Exhibit 36) showing the highest Canadian domestic milk price for Class 1 use was C\$65.35/hl (US\$48/hl), together with an estimate of import costs of US\$116/hl. Canada argued that it was obvious that either the estimated unit import value was wrong, or the data was not comparable. The alternative was to assume that Canadian importers freely chose supplies that were twice as expensive as the most expensive domestic alternative. Canada noted that in the case at issue, much of the fluid milk imported under the Import for Re-export Program was imported in retail packages for use on cruise ships. It was hence, clearly inappropriate to make price comparisons between retail packages on one hand and milk supplies from farmers to processors on the other.

4.440 Similarly, Canada argued that the United States estimates of unit import value for "cheese of all types" was simply an average of high and low value cheese of vastly different types. These were

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<sup>303</sup> A Review of Class III – A Pricing under Federal Milk Marketing Orders, Dairy Division, Agricultural Marketing Service, United States Department of Agriculture, March 1995, pp.1–2.

<sup>304</sup> Panel Report on *Japan – Certain Agricultural Products*, *op. cit.*, para. 5.1.3.7; Panel Report on *Canada – Yoghurt*, *op. cit.*, para. 59.

<sup>305</sup> Canada referred to the Appellate Body Report on *Japan – Liquor Tax*, *op. cit.* and the Appellate Body Report of *Canada – Periodicals*, *op. cit.*

<sup>306</sup> Appellate Body Report on *Japan – Liquor Tax* *op. cit.*, para. 5.3.1.4. Canada noted that the Panel went on to find that milk powders did not meet the perishability requirements of Ad Article XI:2(c), which had no counterpart in Paragraph (d) of Annex I to the SCM Agreement.

average import values, together with unsubstantiated conversion factors were then used to generate a "milk equivalent cost of cheese imported for re-export". This approach was invalid because the yield of cheese from a hectolitre of milk varied widely between varieties of cheese. As the mix of varieties imported varied from year to year, a conversion using some "standard" yield of "generic" cheese from a hectolitre of milk would bear no consistent relationship to the actual value of milk used in the production of imported cheeses. In the case of whole milk powder, which was a much more uniform commodity product for which it may be valid to use a simple conversion formula, the United States data showed that, the US estimated average Class 5(e) price was very similar to the estimated "milk equivalent cost of WMP imported for re-export" in 1997 and 1998. While the problems noted above with respect to the use of unit import values remained, this gave an indication that, in the one situation in Exhibit 56 where the construction of milk equivalent prices on the basis of formulae was most defensible, the resulting data supported Canada's argument.

4.441 Canada further noted that on page four of Exhibit 56 the United States estimated milk prices in Classes 5(d) and (e) on the basis of prices estimated for individual provinces (except Ontario). The resulting estimated prices were incorrect. The actual Canadian average return for Class 5(d) sales in the 1997 calendar year was \$26.22/hl. For Class 5(e), the return was \$22.98/hl.<sup>307</sup> Canada argued that the discrepancy between these real figures and the values constructed by the United States was partly explained by the fact that the United States included a Class 5(d) price of \$11.98/hl for Manitoba, although it was self-evident that this was a data error in the 1997 Dairy Market Review. (For the record, the correct datum should have read \$22.01). This should have been obvious from the fact that the Class 5(d) prices reported in the Review for all other provinces were between \$31.31/hl and \$21.66/hl. It was questionable statistical practice to simply use what was clearly an anomalous figure without verifying from other sources. In addition, the data set used by the United States did not include prices from Ontario. The flaws in the data presented by the United States meant that no weight can be attached to them.

4.442 The **United States** noted that Canada carefully qualified its statement in respect of the "like or directly competitive" nature of milk powders with fluid milk (paragraph 4.435). Canada stated that milk powders could be used in the manufacture of *some* dairy products. Similarly, Canada stated that to a *certain extent* milk powders competed in the same markets. The United States argued that direct competition contemplated more than a *certain* degree of competition or the ability to substitute for fluid milk in *some* uses.

(d) Article 3

4.443 The **United States** argued that once a violation of Part V of the Agreement on Agriculture had been found, Canada had to bring the operation of its export subsidies into conformity with its obligations, particularly those establishing its export reduction commitments respecting the quantity of subsidized exports. This was true, regardless of whether a separate violation of the SCM Agreement was also found.

4.444 The United States noted that Article 3 of the SCM Agreement was addressed by Article 13 of the Agreement on Agriculture. That provision directed that only export subsidies that conformed with Part V of the Agreement on Agriculture were exempt from challenges pursuant to Article 3 of the SCM Agreement. Furthermore, the United States claimed that Article 3 of the SCM Agreement was within the Panel's terms of reference. Consequently, the United States requested that the Panel make separate findings respecting the consistency of the Special Class system with the SCM Agreement,

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<sup>307</sup> Canada noted that as dairy farmers in Canada were actually paid based on the butterfat, protein and other solids components of milk, it was possible to generate differing estimates of the price of a hectolitre of milk depending whether one used the average composition of milk delivered or a standard milk composition. At the individual farm level, payment was based on the components delivered by the farmer, so, while the problem of translating to hectolitres of milk complicated life for analysts, it had no impact on the farm-level economics of the system.

including a finding whether the Special Class system provided a prohibited export subsidy within the meaning of Article 3.

4.445 The United States claimed that as Canada's Special Milk Classes Scheme was an export subsidy of dairy products in excess of the limits for Canada under the Agreement on Agriculture, whether they fell under Article 9 or Article 10 of that Agreement, as a result, those subsidies did not benefit from the exemption in Article 13(c)(ii) of that Agreement on Agriculture. Consequently, the United States claimed that these export subsidies were also inconsistent with Canada's obligations under Article 3 of the SCM Agreement.

## 5. Protected Markets and Export Subsidies

4.446 **Canada** did not deny that its milk production sector enjoyed a level of protection through tariffs. That was a right negotiated and set out in its WTO Schedules, Schedules which had been accepted by the Complainants. Nor did Canada deny that such protection could lead to higher prices for milk which benefited milk producers, but only with respect to the *domestic* market. The very purpose of tariffs was that the targeted domestic industry would enjoy higher domestic prices. This was accepted as a basic feature of the WTO system and was true for all WTO Members that maintained tariffs, including the two Complainants. Canada argued that the submissions of the Complainants failed, in particular, to recognize: (i) that sales of milk for export use in Canada were based on the commercial practices of producers and their reactions to world market signals; (ii) that the logical conclusion of their arguments would be to deem the existence of export subsidies wherever exported products were subject to tariff protection in their home market, thus prohibiting most such exports and undermining one of the most fundamental features of the WTO system; and (iii) that the selling of products at differing prices for domestic and export markets was a common international practice that had never been treated as an export subsidy for GATT/WTO purposes.

4.447 Canada argued that nothing in the WTO Agreements revealed a common intention to treat sales of a product in different markets at differing prices as implying the existence of a subsidy for the lower-priced good. Canada maintained that if the Complainants' arguments were to succeed, the basis of the consensus on the negotiated use of tariff protection for sensitive sectors, as captured in the GATT 1947 and the WTO Agreements, would be undermined. In character, a tariff was simply a tax and, as such, represented an incontestable government intervention in support of a domestic industry. The result of accepting the Complainants' line of reasoning would be that an export subsidy would be found every time a product was exported at its world market price from a market protected by tariffs *at any level*, since the very point of any tariff was to raise by government intervention the price of a good from its world market level. Given the absolute prohibition in the SCM Agreement on export subsidies, the Complainants' arguments, taken to their logical conclusion, would lead to an absolute prohibition on the exportation of any product at world market prices from a domestic market protected by tariffs. This could not have been the intention of the drafters of the WTO Agreements.

4.448 Moreover, Canada argued that the right to export while maintaining tariffs was clearly built into the "tariffication" decision incorporated in the results of the Uruguay Round. WTO Members agreed that all non-tariff barriers, including quantitative restrictions maintained under *GATT 1947* Article XI(2)(c)(i), would be converted into equivalent tariffs. The condition under Article XI for the maintenance of such quantitative restrictions was that domestic production of the product in question had to be restricted. This limited any potential for production for export purposes. By converting Article XI quantitative restrictions into tariffs under Article II of the GATT 1994, this condition was removed. Thus, WTO Members had agreed that under the new WTO regime, Members maintaining the new equivalent tariffs would not have to restrict their domestic production. Canada argued that this shift clearly contemplated new production in addition to domestic needs, e.g., production for export while maintaining Article II tariffs. Thus, the new "tariffied" tariffs were to be treated in

exactly the same way as all other tariffs had been since 1947 – there was a common expectation that the product subject to the tariff could be exported.

4.449 Canada argued that far from an anomaly, the sale of goods into domestic and export markets at differing prices was a common practice for many WTO Members. For example, the peanut market in the United States had a structure similar to the Canadian milk market. The United States peanut market was protected from external competition by high tariffs (155 per cent *ad valorem* on shelled peanuts and 192.7 per cent *ad valorem* for peanuts in shell) and domestic competition was limited through quotas.<sup>308</sup> There was no quota for production for export of peanuts. Any additional quantity produced by a farmer above the specified quota had to be "sold for whatever can be obtained on the international market".<sup>309</sup> As a result, the United States had a 25 per cent share of the world peanut market. The domestic prices for peanuts for edible use were about twice as high as the world market price.<sup>310</sup>

4.450 Canada recalled that the use of differing prices for export sales of dairy products was also part of the marketing system used in California. At the November 1997 meeting of the Committee on Agriculture, Canada had asked the United States whether it could confirm that milk marketing plans established by the State of California provided lower prices for dairy components to be used in the manufacture of yoghurt, soft fresh cheese (fromage frais), uncreamed, creamed, or partially creamed cottage cheese, sour cream, sour half-and-half, or light sour cream which was sold for use outside the boundaries of the United States, than for dairy components to be used for manufacturing similar products for sale within the United States. The United States confirmed Canada's understanding of the matter.

4.451 Canada argued that even if the enabling authority of the producer boards were to be eliminated, producers would operate on the basis of economic differences between the domestic market and the world market. As a matter of very simple economic reality, so long as there was a level of border protection maintained by Canada, dairy product prices in Canada would continue to exceed world price levels. Such differences in pricing were linked to the level of border protection maintained and other general economic conditions in the Canadian market. In these circumstances, producers would seek to exploit these tariff-generated differentials in their commercial relations with Canadian processors. This would occur independently of any legislative framework.

4.452 **New Zealand** argued that compliance with export subsidy commitments by a Member whose domestic market was protected by tariffs did not prohibit it from exporting at world market prices. A Member that protected its domestic market by high tariffs could export in accordance with its export subsidy commitments. It could also, of course, export without the use of export subsidies. In this respect, New Zealand noted that Canada's export data indicated that Canada did export dairy

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<sup>308</sup> American Peanut Coalition (APC) testimony before the Trade Subcommittee of the Ways and Means Committee of the US House of Representatives, 12 February 1998 p. 3 (Exhibit 23): "Congress moved to decouple farm income support from production decisions in the Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR" Act). This 'freedom-to-farm' bill eliminated deficiency payments and marketing loans and replaced them with transition payments for virtually all farm commodities. This was in keeping with the concept of 'decoupled income support' in the 'green box' of permitted policies that were exempt from reductions in the Uruguay Round. As a result of the 1996 Farm Bill, farmers now have the freedom to farm almost everything, except peanuts. Only farmers who own or lease a production quota can legally grow peanuts to be sold for edible use." The APC further noted at p. 4: "In spite of the peanut programme, the US is a significant exporter of peanuts, having a 25% share of the world market. This occurs as a result of the fact that US peanuts grown outside of the peanut quota are required to be exported or put to non-edible uses."

<sup>309</sup> The United States Government Accounting Office GAO/RCED-93-18, *Making the Peanut Program Responsive to Market Forces*, "Appendix II: GAO's, Technical Economic Analysis of the Peanut Program", p.60. (Canada, Exhibit 24)

<sup>310</sup> *Ibid.*, pp.62-63. In 1989, the quota support price for peanuts was \$0.3318 per pound (in 1991 dollars). The world price for US peanuts was \$0.1853 per pound (in 1991 dollars). In 1998, those prices were in the order of \$0.45 per pound on world markets and \$0.65 on US domestic markets.

products: in 1997/98, 4 per cent of cheese and 21 per cent of "other milk products" exports were exported from outside Special Classes 5(d) and (e).<sup>311</sup>

4.453 New Zealand argued that there was no blanket prohibition under the WTO of differential pricing between domestic and exported agricultural products. What the WTO required was that any such difference result from private and not from government action. The objection of New Zealand in this case was that through the actions of governments and their agencies Canada was using export subsidies to bridge the gap between its high domestic prices and lower world market prices in excess of its scheduled allowance. The subsidy existed because, in accordance with the relevant definitions of export subsidy, a government was involved in a scheme which required milk producers to supply lower priced milk to exporters of dairy products as an incentive for them to undertake exports which would, in the absence of the export subsidy, be unlikely. The removal of government from such a scheme, and not just the pretence of removal of the kind Canada asserted in this case, would mean that the Agreement on Agriculture would not apply. Exporters would be free to export without limit based on commercial considerations rather than export subsidies.

4.454 New Zealand emphasized that it was not indeed suggesting that Canada did not have the right to export dairy products. Canada, like any Member, was perfectly free to export dairy products provided that it did so in accordance with its WTO obligations. It could export up to its export subsidy commitment levels. And it could export whatever quantity it wanted without the use of subsidies at all. What New Zealand was denying was Canada's claim that it was allowed to use export subsidies which came within Article 9.1 of the Agreement on Agriculture in excess of its export subsidy commitments or to use export subsidies not covered by Article 9.1 that had the effect of circumventing or threatening to circumvent those commitments.

4.455 In respect of Canada's arguments on Article XI (paragraph 4.448), New Zealand noted that it was not surprising that Canada cited no authority for what it claimed the WTO Agreements "contemplated" as a result of tariffication, nor could it. Tariffication was not concerned with whether a country was an exporter or an importer or both. Tariffication was not about the right to export. It was concerned with market access barriers. However, it certainly was not within contemplation that having liberalised agricultural trade with the converting of quotas into tariffs, Members would now be free to use export subsidies inconsistent with the express requirements of the Agreement on Agriculture. New Zealand argued that Article XI did not in fact prevent producers from producing any quantity of product and it did not prevent that product from being exported. What Article XI did do was to require that in those countries which chose to put in place quantitative restrictions on imports, the proportion of imports could not fall below the level which would have pertained had the quantitative restrictions not existed.

4.456 The **United States** submitted that this broader question, raised by Canada, went beyond the scope of the case, and need not be addressed by this Panel. The United States was not contesting in this dispute either Canada's right to set tariffs or to pursue supply management in its dairy sector. The question presented by the Complainants was not only a different one, but was also much narrower, i.e., whether Canada's Special Milk Classes Scheme constituted an export subsidy subject to the reduction commitments contained in the Agreement on Agriculture. The question whether, in the absence of any other governmental action, exports at prices below tariff protected domestic prices constituted an export subsidy, was not before the Panel.

4.457 The United States contended that Canada was confusing the issue by suggesting that the position of Complainants meant that a country with high tariffs and high domestic prices necessarily engaged in differential pricing and therefore bestowed an export subsidy. Canada asserted that such price differences were simply a result of existing tariff protection. Although this, in part, could be the

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<sup>311</sup> Canada's answer to Question No. 1 by the Panel, 20 October 1998.

case, it would be unreasonable to assume that the WTO Members were unaware of protective tariffs or supply management systems when they concluded the SCM Agreement and the Agreement on Agriculture or when they adopted GATT 1994. The United States argued that there could be many circumstances where a WTO Member could have a lower price for export of agricultural products and a higher price for domestic use without implicating any of a Member's WTO obligations. The answer to this question depended in substantial part on the level and nature of government involvement in the export of the agricultural products. Canada was wrong in assuming that the price differential occasioned by the existence of a tariff barrier necessarily resulted in both a financial contribution and a benefit to the exporter. The situation where merely a protective tariff existed stood in sharp contrast to one where in addition to a tariff, a Member had constructed a scheme, such as the Canadian Special Milk Classes Scheme, where both the quantities exported and the export prices were determined largely by the intervention of governments.

4.458 The WTO Agreements on Agriculture and Subsidies imposed specific disciplines on export subsidies. What was noteworthy was that none of the relevant Agreements provided an exemption from the export subsidy disciplines when differential pricing resulted from government action. The only provision that implicitly addressed this issue was Paragraph (d) of the Illustrative List of Export Subsidies in the SCM Agreement. Paragraph (d) provided an exemption from its coverage where any benefit that would otherwise result from the provision of a good at a lower price by the government was negated by the availability of such goods on as favorable terms and conditions on the world market. Canada did not satisfy the requirements of that exemption. Moreover, even if Canada did meet those requirements, it would only be exempted from the disciplines of that provision, not the additional restrictions on export subsidies included in the Agreement on Agriculture and the SCM Agreement.

4.459 If Canada merely maintained tariff protection for its milk producers and the Canadian federal and provincial governments otherwise were not involved in the regulation of prices and exports of dairy products, the United States would not have requested the formation of this Panel. A situation in which tariff protection alone resulted in differential pricing for domestic and export manufacturers involved no financial contribution or benefit in the sense of the SCM Agreement. The mere imposition of tariffs, including any price differential that might result, had never been considered to constitute an export subsidy. In addition, where only tariffs existed, there was always the possibility that the world markets into which the goods were sold could reflect either prices at a higher or lower level than existed domestically. This was because domestic prices were not simply a function of the level of tariffs. The extent of competition within the domestic market, including the number of producers, the availability of alternative products, the level of production, the elasticity of demand, and other economic factors also had a direct bearing on domestic price levels. Thus, the existence of a price differential could not be assumed to exist and even where a differential existed it could not be assumed to result solely from the imposition of a tariff on imported goods.

4.460 The United States argued that Canada could not isolate the Special Milk Classes Scheme from the environment in which it operated, and particularly from the supply management system. It was convenient, but not convincing, for Canada to argue that the Special Classes did not provide for the establishment of domestic prices at levels higher than those applicable to exports, when the supply management system clearly established those prices. This was not a particularly pertinent issue. What was dispositive respecting the existence of the subsidy was that the governments in Canada had set in place a mechanism through which processors were provided lower priced milk. Whether the higher price for domestically-sold milk was fixed under the Special Classes or by some other government intervention was simply not relevant.

## B. IMPORTATION OF MILK

### 1. Outline

4.461 The **United States** recalled that in implementing its Uruguay Round market access commitments, Canada established a tariff-rate quota for fluid milk and cream (hereinafter "fluid milk") with an in-quota level of 64,500 tonnes. Part I, Section IB of Canada's Schedule, provided that fluid milk encompassed in tariff item number 0401.10.10, which entered within the tariff-rate quota at the MFN rate of 17.5 per cent, beginning in 1995.<sup>312</sup> The rate of duty applicable to entries within the tariff-rate quota receiving MFN treatment would decline to 7.53 per cent at the end of the six-year implementation period. Fluid milk imports outside of the 64,500 tonne tariff-rate quota bore an initial rate of duty equal to 283.3 per cent, declining to 241.3 per cent in 2001. The United States claimed that for all intents and purposes, the over-quota tariff rate precluded imports of fluid milk outside of the tariff-rate quota.<sup>313</sup>

4.462 The United States maintained that Canada, in addition, imposed unjustified constraints on access to the tariff-rate quota that impeded market access at even the lower, in-quota tariff rate. Canada only permitted cross-border retail purchases of C\$20, or less, by residents of Canada for their own personal use to qualify for entry within the tariff-rate quota. By confining the scope of fluid milk entries that were eligible for the lower in-quota rate, Canada granted imports of fluid milk treatment less favorable than that provided for in the appropriate Part of Schedule V and, thus, had acted inconsistently with its obligations under Article II:1 of the GATT 1994. Because Canada administered the tariff-rate quota through a general permit restricting any single import entry to a value of C\$20 and subjected such entries to a personal use restriction, Canada's licensing procedures introduced additional trade impediments that were inconsistent with its obligations under Article 3 of the Agreement on Import Licensing Procedures ("the Import Licensing Agreement").

4.463 The United States claimed that it was clear that Canada imposed unjustifiable limitations, including both a dollar value and personal use restriction, on fluid milk imports under its General Permit for dairy products. The United States submitted that those restrictions were not justified by the language in Canada's schedule and were inconsistent with its obligations under Article II:1(b) of the GATT 1994 and Article 3 of the Import Licensing Agreement.

4.464 **Canada** claimed that its current treatment of fluid milk imports was fully consistent with the terms and conditions of the tariff item for fluid milk (HS 0401.10.10) in its Schedule. Canada noted that the United States did *not* argue that it had not received the level of access that it had negotiated. Rather, it was a particular type of access that was now the subject matter of this dispute. Canada denied that the continuation of its limited concession on *consumer imports of packaged fluid milk*, granted in respect of its residents who engaged in cross-border shopping, was a general concession on fluid milk including *commercial and bulk trade in fluid milk*.

4.465 Canada stressed that the agreed record of negotiations between Canada and the United States throughout the Uruguay Round of negotiations conclusively proved that the United States was well aware of the nature and meaning of Canada's concession and the terms and conditions under which it had been granted. The claims of the United States were in conflict with the clear and common understanding of the negotiators from both Canada and the United States of Canada's offer in the Uruguay Round negotiations with respect to access to fluid milk.

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<sup>312</sup> The United States noted that imports from the United States within the tariff-rate quota received preferential duty rates under terms of the North American Free Trade Agreement.

<sup>313</sup> "The Canadian Dairy Industry: Institutional Structure and Demand Trends in the 1990s". (United States, Exhibit 25)

4.466 Canada further denied that the Import Licensing Agreement required Canada to impose import controls where none were required. Such controls would only cause inconvenience to cross-border shoppers.

4.467 Canada claimed that in making this claim, the United States was seeking to obtain through dispute settlement a broader and different type of access for trade in fluid milk than that agreed upon in negotiations.

## 2. Article II:1 of GATT 1994

4.468 The **United States** argued that Canada's administration of its TRQ was inconsistent with Article II:1 of the GATT 1994. Article II:1(b) required that a Member provide tariff treatment no less favorable than was provided for in its Schedule of Concessions to imports from the territories of other WTO Members and exempt such imports from any customs duty in excess of the rate bound in the importing Member's Schedule. The Appellate Body had recently elaborated on the requirements of Article II:1(b) in its Report in *Argentina - Footwear*:

"In accordance with the general rules of treaty interpretation set out in Article 31 of the Vienna Convention, Article II:1(b), first sentence, must be read in its context and in light of the object and purpose of the GATT 1994. Article II:1(a) is part of the context of Article II:1(b); it requires that a Member must accord to the commerce of other Member's "treatment no less favourable than that provided for" in its Schedule. It is evident to us that the application of customs duties in *excess* of those provided for in a Member's Schedule, inconsistent with the first sentence of Article II:1(b), constitutes "less favourable" treatment under the provisions of Article II:1(a). A basic object and purpose of the GATT 1994, as reflected in Article II, is to preserve the value of tariff concessions negotiated by a Member with its trading partners, and bound in that Member's Schedule, a reduction in its value by the imposition of duties in excess of the bound tariff rate would upset the balance of concessions among Members."<sup>314</sup>

4.469 The United States noted that Canada allowed only fluid milk entries that were made pursuant to a general permit by a resident of Canada making retail purchases for the person's own, or their household's, personal use to qualify for the lower rate of duty under the tariff-rate quota. The language of Canada's Schedule, however, did not justify that limitation. By denying access for all other entries under the tariff-rate quota, and thereby imposing duties on those other entries in excess of those provided for in its Schedule, Canada was granting tariff treatment less favorable than was provided for in its Schedule of Concessions.

4.470 The United States noted that Canada justified its ban of entries other than small purchases for the personal use of the Canadian resident from the tariff-rate quota on the language in column seven of its Schedule, which Canada claimed constituted a "term, condition, or qualification" within the meaning of Article II:1(b).<sup>315</sup> Canada asserted that this language properly limited the scope of eligibility for the lower in-quota duty rate to imports of fluid milk made in cross-border trade by retail customers for their own personal use. However, the text which appeared in Schedule V relating to tariff item number 0401.10.10 did not warrant Canada's interpretation. The pertinent language was

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<sup>314</sup> Appellate Body Report on *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel, and Other Items* (hereafter "*Argentina - Footwear*"), adopted 22 April 1998, WT/DS56/AB/R, para.47.

<sup>315</sup> Canada's answers to questions posed during consultations with the United States. (United States, Exhibit 34)

as follows "This quantity represents the estimated annual cross border purchases imported by Canadian consumers".

4.471 The United States argued that for the text relied on by Canada to create a condition on the applicability of the lower in-quota tariff rate, that language had to clearly establish the limitation that Canada had imposed on the scope of the concession.<sup>316</sup> The language in Schedule V, however, did not permit the interpretation that Canada had adopted. First, there was no basis to conclude that the language on which Canada relied constituted a "term, condition, or qualification." The language that the quantity of the tariff-rate quota "represents the estimated annual cross border purchases" simply described the manner in which the size of the tariff-rate quota was determined. The language in Canada's Schedule could not be construed to constitute a limitation on the access under the tariff-rate quota; there was no indication from the language contained in the Schedule that any type of limitation, other than the quantitative limitation to 64,500 tonnes, was provided for.

4.472 Second, the United States maintained that contrary to principles of treaty interpretation, Canada's construction of the language in its Schedule imputed words that were not there.<sup>317</sup> The words "cross-border purchases" contained in the Schedule could not be construed to limit eligibility to the in-quota rate to retail purchases valued at C\$20, or less, for the personal use of the purchaser. All imports that were the result of a sales transaction of some type were "cross-border purchases". These words could not be read to differentiate between retail purchases for personal use and other types of purchases. Similarly, the phrase "imported by Canadian consumers" did not limit the scope of eligibility in the manner suggested by Canada. The ordinary meaning of the word "consumer" was "one that consumes" or "a person who acquires goods or services; a buyer."<sup>318</sup> The word "consumer" did not distinguish between retail purchases for personal use and other types of transactions. Purchasers who consumed milk in their business endeavours, whether it be manufacturing or some other pursuit were also "consumers". Therefore, Canada lacked any textual support in its Schedule for the limitations that it had imposed on access to the in-quota rate. Absent language in its Schedule that constituted a "term, condition, or qualification" within the meaning of Article II:1 of the GATT 1994, Canada acted in derogation of its obligations under Article II when it provided treatment less favorable to any imports than was provided for in its Schedule.

4.473 Furthermore, the United States argued that Canada's manner of administering the tariff-rate quota through the use of a general permit also resulted in treatment less favorable than provided for in its Schedule and, thus, was also inconsistent with its obligations under Article II:1. More specifically, Canada conditioned use of the general permit on each import entry of dairy products being valued at less than C\$20 and for the personal use of the importer. Neither of these restrictions appeared as a "term, condition, or qualification" in Canada's Schedule of Concessions. Yet, Canada denied the in-quota duty rate to any entries which did not meet the requirements of the general permit. By doing so, Canada denied all entries which could otherwise qualify for the 64,500 tonne tariff-rate quota the lower duty rate under the in-quota rate that was provided for in Canada's Schedule. As a result such entries were subjected to duties in excess of those provided for in Canada's Schedule.

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<sup>316</sup> The United States noted the relevance of the Appellate Body's findings in the Appellate Body Report on *European Communities, United Kingdom, and Ireland - Customs Classification of Certain Computer Equipment*, (hereafter *EC - Computer Equipment*), WT/DS62/67/68/AB/R, adopted 22 June 1998, "[t]he security and predictability of tariff concessions would be seriously undermined if the concessions in Member's Schedules were to be interpreted on the basis of the subjective views of certain exporting Members alone." While this referred to the views of exporting Members, it would be even more true for importing Members, who by drafting the text of their tariff concessions were in the best position to specify clearly the scope of the concessions.

<sup>317</sup> The United States noted the statement of the Appellate Body noted in *India - Pharmaceuticals*, *op. cit.*, para. 45: "The duty of a treaty interpreter is to examine the words of the language of the treaty itself. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the Vienna Convention. But these principles of interpretation neither require nor condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that are not intended."

<sup>318</sup> Webster's II, New Riverside University Dictionary, 1994.

4.474 **Canada** argued that it had the right, **Error! Bookmark not defined.** under Article II, to set terms and conditions on the application of customs duties. Canada had the obligation, under Article II of the *GATT 1994*, not to impose "ordinary customs duties in excess of those set forth and provided" in its Schedule. Article II further provided that such obligation was "subject to the terms, conditions or qualifications set forth in that Schedule."

4.475 Canada noted that prior to the entry into force of the WTO Agreements, GATT 1947 panel practice had interpreted this "qualification" provision in two ways. First, each Contracting Party had the right to impose conditions on the concessions granted in the form of bound tariffs, so long as those conditions were not, in themselves, inconsistent with GATT 1947. Second, each Contracting Party could, *in addition to* making concessions in the form of bound tariffs, set down other concessions ("terms") in its Schedule. Canada noted that in *European Economic Community - Imports of Beef from Canada*,<sup>319</sup> the Panel held that:

"... the European Economic Community had, by virtue of the footnote in the Schedule, reserved its right to set conditions for the entry under the levy-free tariff quota in question. *The Panel further found that the right to set conditions was presupposed in Article II:1(b) of the General Agreement.*"<sup>320</sup> (emphasis added)

4.476 Canada further noted that in *United States - Restrictions on Imports of Sugar*<sup>321</sup> the Panel noted that Article II:1(b) "permits contracting parties to qualify the obligation to exempt products from customs duties in excess of the levels specified in the Schedule."<sup>322</sup> The Panel found, however, that Contracting Parties could not, in their Schedules, qualify their obligations under *other* Articles of the GATT.<sup>323</sup> In *United States - Restrictions on the Importation of Sugar and Sugar Containing Products Applied under the 1955 Waiver and under the Headnote to the Schedule of Tariff Concessions* (hereafter "*US - Sugar II*")<sup>324</sup>, the Panel found that "the General Agreement does not oblige contracting parties to make concessions and specifically allows them in Article II:1(b) to subject to conditions the concessions they decide to make."

4.477 Canada noted that, in the recent report on *Computer Equipment*<sup>325</sup>, the Appellate Body made a number of observations about the interpretation of tariff schedules and Article II of the GATT 1994 that were relevant to this dispute. As a first principle, the Appellate Body stated that items in tariff schedules to the GATT 1994 were to be considered to be integral parts of a treaty and as such to be subject to the customary principles of treaty interpretation, as set out in the Vienna Convention. As such, they were to be interpreted on the basis of the common intention of the parties :

"The security and predictability of tariff concessions would be seriously undermined if the concessions in Members' Schedules were

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<sup>319</sup> Panel Report on *European Economic Community – Imports of Beef from Canada* (hereafter "*EEC – Beef*"), L/5099, BISD 28S/92, adopted 10 March 1981.

<sup>320</sup> *Ibid*, para. 4.5(a).

<sup>321</sup> Panel Report on *United States – Restrictions on Imports of Sugar* (hereafter "*US – Sugar*"), L/6514 BISD 36/S331, adopted 22 June 1989.

<sup>322</sup> *Ibid*, para. 5.2. Canada noted that in paragraph 5.3, the Panel concluded that: "... Article II gives contracting parties the possibility to incorporate into the legal framework of the General Agreement commitments additional to those already contained in the General Agreement and *to qualify such additional commitments*, not however to reduce their commitments under other provisions of that Agreement." (emphasis added)

<sup>323</sup> *Ibid*, para. 5.3

<sup>324</sup> Panel Report on *US – Sugar II*, L/6631, 37S/228, adopted on 7 November 1990.

<sup>325</sup> Appellate Body Report on *EC - Computer Equipment*, *op. cit.*

to be interpreted on the basis of the subjective views of certain exporting Members alone.

(...)

The purpose of treaty interpretation under Article 31 of the *Vienna Convention* is to ascertain the *common* intentions of the parties. These *common* intentions cannot be ascertained on the basis of the subjective and unilaterally determined "expectations" of *one* of the parties to a treaty. Tariff concessions provided for in a Member's Schedule - the interpretation of which is at issue here - are reciprocal and result from a mutually-advantageous negotiation between importing and exporting Members. A Schedule is made an integral part of the GATT 1994 by Article II:7 of the GATT 1994. Therefore, the concessions provided for in that Schedule are part of the terms of the treaty. As such, the only rules which may be applied in interpreting the meaning of a concession are the general rules of treaty interpretation set out in the *Vienna Convention*.<sup>326</sup> (emphasis in the original)

4.478 Canada further noted that to determine that common understanding, the Appellate Body then referred to Articles 31 and 32 of the Vienna Convention :

"Pursuant to Article 31(1) of the *Vienna Convention*, the meaning of a term of a treaty is to be determined in accordance with the ordinary meaning to be given to this term in its context and in the light of the object and purpose of the treaty"

(...)

"The application of these rules in Article 31 of the *Vienna Convention* will usually allow a treaty interpreter to establish the meaning of a term. However, if after applying Article 31 the meaning of the term remains ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable, Article 32 allows a treaty interpreter to have recourse to:

... supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion.

With regard to 'the circumstances of [the] conclusion' of a treaty, this permits, in appropriate cases, the examination of the historical background against which the treaty was negotiated."<sup>327</sup>

4.479 Canada recalled that on the point of the circumstances under which the treaty interpreter should examine the "historical background against which the treaty was negotiated," the Appellate Body quoted Sir Ian Sinclair:

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<sup>326</sup> *Ibid*, paras. 82, 84.

<sup>327</sup> *Ibid*, paras. 85-86.

".. the reference in Article 32 of the Convention to the circumstances of the conclusion of a treaty may have some value in emphasising the need for the interpreter to bear constantly in mind the historical background against which the treaty has been negotiated."<sup>328</sup>

4.480 Canada noted that the Appellate Body had also specifically rejected the idea, as suggested by the Panel in the *EC - Computer Equipment* case, that the burden of clarifying the scope of a tariff concession rested solely on the importing Member. Returning to its view that the key issue in treaty interpretation was one of determining the *common intention*, the Appellate Body made the question one of common burden:

"We consider that any clarification of the scope of tariff concessions that may be required during the negotiations is a task for *all* interested parties."<sup>329</sup> (emphasis in original)

4.481 In this context, the Appellate Body commented on the burden this placed on the exporting member :

"Tariff negotiations are a process of reciprocal demands and concessions, of "give and take". It is only normal that importing Members define their offers (and their ensuing obligations) in terms which suit their needs. On the other hand, exporting Members have to ensure that their corresponding rights are described in such a manner in the Schedules of importing Members that their export interests, as agreed in the negotiations, are guaranteed. There was a special arrangement made for this in the Uruguay Round. For this purpose, a process of verification of tariff schedules took place from 15 February through 25 March 1994, which allowed Uruguay Round participants to check and control, through consultations with their negotiating partners, the scope and definition of tariff concessions.<sup>330</sup> Indeed, the fact that Members' Schedules are an integral part of the GATT 1994 indicates that, while each Schedule represents the tariff commitments made by *one* Member, they represent a common agreement among *all* Members."<sup>331</sup> (emphasis in original)

4.482 Canada noted that the United States acknowledged the application of the *EC - Computer Equipment* dispute. However, the brief quotation selected from the case and accompanying comment found in the submission of the United States did not reflect the full opinion of the Appellate Body as set out above. The United States attempted to suggest that the case stood for the proposition that a greater burden lay on the importing Member in matters regarding the interpretation of a tariff item. In fact, as noted above, the Appellate Body had expressly rejected this idea which had been suggested in the Panel Report and had pointed emphatically to the determination of the common intention of the Parties as being the central purpose of treaty interpretation. Moreover, in this context, the Appellate Body made it clear that if a greater burden lay anywhere, it was with the exporting Member.

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<sup>328</sup> I. Sinclair, *the Vienna Convention on the Law of Treaties*, 2<sup>nd</sup> ed., (Manchester University Press, 1984), p.141.

<sup>329</sup> Appellate Body Report on *EC - Computer Equipment*, *op. cit.*, para. 110.

<sup>330</sup> Footnote in the original report: "MTN.TNC/W/131, 21 January 1994. See also *Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994*, para. 3."

<sup>331</sup> Appellate Body Report on *EC - Computer Equipment*, *op. cit.*, para.109.

4.483 Canada argued that it had a right, under Article II of the GATT 1994, to impose such terms and conditions on its tariffs as set out in its Schedule. Furthermore, in respect to the level of clarity and "notice" needed to ensure that other Members were aware of the value and the nature of the concession they were receiving, terms and conditions were to be treated without distinction from specific tariff items.

4.484 Canada argued that where, in the course of a new tariff regime, a term or condition was introduced and, in particular, where that condition had been the specific subject of on-going negotiations over many months, it was indeed the responsibility of the exporting country to seek clarification if that country considered that there was any uncertainty or ambiguity in the term or condition. Canada had informed the United States at all material times about the terms of access that it proposed to grant to imports of fluid milk in Canada's tariff Schedule. This condition was not novel and posed no surprise for US negotiators as it simply represented a continuation in tariffed form of the long-standing regime in place for fluid milk imports into Canada. The fact that the US side in the negotiations had been seeking greater access than that being offered by Canada did not affect the central question of what had been the nature of Canada's offer. The United States were fully aware of not only the existence of a term or condition, but also the nature of the specific condition on access to the Canadian fluid milk market. The United States could therefore not have had any legitimate expectation that Canada would make any additional concession for the import of commercial shipments of milk in bulk into Canada and thus, there could be no common understanding between the parties to the negotiations in that regard. Indeed, the bilateral negotiating history - the best evidence of what the parties understood - clearly indicated that this issue had been expressly negotiated and that the United States had failed to get additional access because of its failure to provide for practical access with respect to its own fluid milk market.

4.485 Canada recalled that at the conclusion of the Uruguay Round, pursuant to Article 4 of the Agreement on Agriculture, Canada converted its existing quantitative restrictions on the importation of fluid milk into a bound tariff on fluid milk.<sup>332</sup> In view of the volume of cross-border trade in consumer-packaged fluid milk, Canada incorporated an additional concession in its Schedule, subject to a condition. The qualified concession, a TRQ for the importation of consumer-packaged fluid milk by Canadian consumers (64,500 tonnes), was set out in Canada's Schedule V and reflected the estimated volume of cross-border trade in fluid milk in the period 1989-91.

4.486 Canada noted that since the implementation of the TRQ, Canada had, in accordance with its qualified concession under Article II, permitted the importation of consumer-packaged fluid milk by Canadian consumers at the lower tariff rate. Such imports were made under the authority of the General Import Permit No.1 under the Export and Import Permits Act.<sup>333</sup> General import permits operated to provide standing authority for imports made within the parameters of the terms and conditions set out in the permit. No additional specific permit or other formality was required for qualifying imports.

4.487 Canada noted that in current circumstances, Canada had not deemed it necessary to impose any monitoring of quantities being imported at the border. The result was that the Canadian border was now effectively open and unrestricted to cross border imports of consumer packaged milk by Canadians for personal use. Canada reserved the right to limit quantities to the 64,500 tonnes stipulated in its Schedule at some future date if circumstances change. In accordance with its qualified concession, Canada had applied the over-quota tariff to fluid milk shipments in commercial containers or in bulk.

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<sup>332</sup> Canada, Exhibit 34.

<sup>333</sup> R.S.C. 1985, Chap. E-19. (Canada, Exhibit 35)

4.488 Canada noted that the United States claimed that the words appearing in the "other Terms and Conditions" column had to be read as not stating any term or condition but rather as being no more than a historical note to indicate the source of the TRQ quantity. In short, the United States asked this Panel to ignore or render ineffective a part of Canada's Schedule that Canada had expressly stated to be a "term and condition" of access. Canada argued that this was inconsistent with the principles of interpretation under customary international law and, in particular, those that required that the terms of an agreement be given effect, and that they be interpreted in good faith, in context and in the light of their object and purpose.

4.489 Canada refuted the attempt by the United States to argue that the terms "cross-border purchases" and "consumer", as they appeared in the terms and conditions to the tariff item, had to be read as including commercial bulk purchases was not sustainable. First, it was straining the ordinary meaning of the language to suggest that the term "consumer" embraced large commercial enterprises. A further examination of reference sources did not support such a view. In ordinary legal usage in Canada and the United States the word "consumer" connoted acquisitions by individuals for personal usage. This meaning was evident from legal dictionaries<sup>334</sup> and statutory usage in both Canada and the United States.<sup>335</sup> It was also used in the sense of an individual who purchased a good or service for personal use, as opposed to a purchase made in the course of his trade or profession is also used in several international treaties.<sup>336</sup> Canada submitted that its interpretation of the word "consumer" was the one that was consistent with the ordinary meaning of that word. In fact, Canada argued that at all relevant times, throughout Uruguay Round negotiations the United States had been thoroughly conscious that the distinction between imports for personal use and commercial imports was at the heart of discussions between Canada and the United States on this issue. Accordingly, the claims by the United States in this regard lacked credibility.

4.490 Canada recalled that the Appellate Body had stressed<sup>337</sup>, that a treaty had to be read so as not to render a part of the text redundant or meaningless. The construction that the United States would seek to place on the words in the column entitled "Other Terms and Conditions" ("This quantity represents the estimated annual cross border purchases imported by Canadian consumers.") would leave it without purpose or meaning. The United States argued that the words in question did not indicate any term or condition but merely constituted a historical note explaining the source of the 64,000 tonnes figure. Since there was no need for Canada to set out the source for TRQ figure in the Schedule, the United States suggested that Canada had thrown in redundant words, without purpose or need, into its tariff schedule. This was clearly untenable. To the contrary, the implication of the words in the terms and conditions column was that they established a condition of within-quota access for fluid milk: importation by the consumer in consumer packages.

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<sup>334</sup> Canada, Exhibit 36. Therein, see *Black's Law Dictionary*, 6<sup>th</sup> ed., (West Publishing Co.: Minneapolis Minn., 1990): "Consumer Individuals who purchase, use, maintain, and dispose of products and services... Consumers are to be distinguished from manufacturers (who produce goods) and wholesalers and retailers (who sell goods). A buyer (other than for the purpose of resale) of any consumer product." See also *The Dictionary of Canadian Law*, 2<sup>nd</sup> ed., (Carswell: Toronto, 1995): "Consumer A natural person. An individual. *Consumer Goods* Goods that are used or acquired for use primarily for personal, family or household purposes.

<sup>335</sup> Canada, Exhibit 37. Therein, see *Uniform Commercial Code*, Article 9-109: Goods are (1) "consumer goods" if they are used or bought for use primarily for personal, family or household purposes.

<sup>336</sup> Canada, Exhibit 38. Canada noted that examples of such usage included Article 5.1 of the European Communities Convention on the Law Applicable to Contractual Obligations (Rome 1980): "1. This Article applies to a contract the object of which is the supply of goods or services to a person ("the consumer") for a purpose which can be regarded as being outside his trade or profession, or a contract for the provision of credit for that object."

<sup>337</sup> Appellate Body Report on *US - Reformulated Gasoline*, *op. cit.*, p.23: "one of the corollaries of the 'general rule of interpretation' in the *Vienna Convention* is that interpretation must give meaning and effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility." This passage was repeated by the Appellate Body in *Japan - Liquor Tax*, *op. cit.*, p.12.

4.491 Canada noted that the context of a provision included its place in the agreement and the other parts of the agreement that may be of relevance.<sup>338</sup> The most obvious and fundamental contextual elements of the words in question had to be the heading under which they appeared, in the case at issue: "Other Terms and Conditions". This context clearly indicated that a term or condition affecting the TRQ was to be found in the words that fell thereunder. Therefore, contrary to the assertions of the United States, a premise was established that there was a term or condition in Canada's TRQ entry on fluid milk beyond mere quantity. That term and condition was that fluid milk had to be imported by the consumer in consumer packages to benefit from the lower tariff. Any other interpretation would have to explicitly ignore the context in which the words in question appeared and would therefore be inconsistent with the customary principles of international law, codified in part in the Vienna Convention. Canada noted that the legal principle of *in dubio mitius*, may also apply with respect to the interpretation of the terms and conditions in Canada's Schedule regarding fluid milk.

4.492 Canada argued that to the extent that there was any ambiguity, or that the terms persisted in remaining obscure, recourse could be had to the negotiating history of the agreement.<sup>339</sup> Following the Report of the Appellate Body in *Computer Equipment*, with respect to tariff issues, such recourse to negotiating history could be particularly appropriate. To exclude any consideration of negotiating history from the interpretation of the tariff line at issue, the United States had to establish that the text of the tariff line was, in fact, *unambiguous*. Canada was of the view that the meaning of the term and condition in the tariff line was clear on its face and in context. If the Panel considered that the meaning was not entirely clear, then, at the very least, the text was raising some element of uncertainty. Accordingly, in accordance with the rules of interpretation under the Vienna Convention, there could be reference to the negotiating history to find the common understanding of the Parties.

4.493 Canada recalled that prior to the conclusion of the Uruguay Round, Canada had maintained a quantitative restriction on fluid milk under the Export and Import Permits Act (the "EIPA"). Fluid milk was originally included as "butterfat in any form" for *EIPA* purposes. Butterfat was listed on the *Import Control List* beginning in 1958, pursuant to the *EIPA*. Accordingly, fluid milk was permitted to enter Canada only under the authority of import permits issued under the *EIPA*. A general import permit (*General Import Permit No. 1*)<sup>340</sup> was issued in 1970 providing authority for the importation of fluid milk in consumer packaging up to the value of C\$10.00 per entry.<sup>341</sup> Individual permits for the commercial importation of milk were not issued. As such, this import regime had been a long-established feature of Canada-United States trade, as was well understood by officials on both sides of the border. For reasons of geography and the perishable nature of the product, imports of fluid milk into Canada originated almost exclusively in regions of the United States close to the Canadian border and were described at the time as "cross-border shopping". Canada argued that at all times, the United States *was well aware* of the details of Canada's pre-Uruguay Round regime for fluid milk. It was understood that any successor regime implanted in the context of tariffication at the conclusion of the Uruguay Round would reflect Canada's then-existing regime for fluid milk. Canada might agree in the process to enhance the access it provided but such enhancement would start with the premise of the existing regime. Thus, the United States could not argue that a reference to "cross-border shopping by Canadian consumer" was novel or isolated or that its meaning was obscure to its officials. Hence, the circumstances of the Uruguay Round negotiations made it crystal clear that

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<sup>338</sup> Canada recalled that Article 31.1 of the Vienna Convention stated: "The context for the purposes of the interpretation of a treaty shall comprise, *in addition to the text*, including its preamble and annexes ... " (emphasis added)

<sup>339</sup> Canada recalled that Article 32 of the Vienna Convention states: "Recourse may be had to supplementary means of interpretation, including preparatory work of the treaty or the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning *ambiguous* or obscure; or (b) leads to a result which is manifestly absurd or unreasonable."

<sup>340</sup> Canada drew the Panel's attention to the attached copy of amendment to *General Import Permit No. 1* C.R.C. 1978, c. 613, expanding butter to include dairy products. (See Exhibit 39)

<sup>341</sup> Canada noted that this had been increased to C\$20.00.

United States officials fully understood that it was Canada's intention to limit access to the TRQ for fluid milk to cross-border purchases.

4.494 Canada argued that its item on fluid milk in its Schedule fully reflected the position that Canada took through negotiations with the United States and its contents posed no questions for those US officials that were party to those discussions. Only after the Uruguay Round negotiations were over had the United States tried to gain access for what it was unable to negotiate. Canada argued that the following points emerged from the record of the Uruguay Round Negotiations<sup>342</sup>:

- (a) Canada was prepared to discuss with the United States in the closing days of the Uruguay Round the possibility of new additional access for fluid milk but Canada had made it clear throughout these discussions that any such additional access would be contingent on having effective equivalent access to the US market. The chief barrier to access to the US market was, and remained, the non-recognition of Canadian sanitary inspection standards for US purposes, the so-called "equivalency" issue.
- (b) Canada had advised the United States that at a minimum it would maintain the then-existing access to Canada for consumer purchases of fluid milk, i.e., cross-border shopping.
- (c) Canada had made it explicit that the treatment of existing cross-border shopping access and the creation of additional access of a non-consumer variety were separate and distinct matters.
- (d) It was evident not only in Canada's own records, but more crucially, by *jointly drafted documents* exchanged by Canadian and US officials, US officials were fully aware that Canada was treating consumer imports of fluid milk as a distinct matter from any consideration of additional access for non-consumer imports, and that any such new non-consumer access was to be contingent on a resolution of the "equivalency" problem.
- (e) The failure of Canada and the US to reach an agreement with respect to a resolution of the equivalency problem meant that, as Canadian officials had advised throughout, Canada's offer on fluid milk was to maintain access for consumer imports but not to give any access for non-consumer shipments.

4.495 Canada submitted that its concession of a TRQ for cross-border trade in consumer-packaged fluid milk was fully consistent with Article II. Canada asserted that, read in good faith and in context, and in view of the rich record of negotiations between the two countries, the conditions in question could not mean anything other than stated at the outset by Canada: that the TRQ remained open to consumer-packaged fluid milk in cross-border trade, but not to bulk or commercial fluid milk.

4.496 The **United States** noted that in the recent report on *Computer Equipment*<sup>343</sup>, the Appellate Body had stated that items in tariff schedules to the GATT 1994 were to be considered to be integral parts of a treaty and as such to be subject to the customary principles of treaty interpretation, as set out in the Vienna Convention. Accordingly, pursuant to Article 31.1 of the Vienna Convention, the meaning of a term in a treaty was to be determined in accordance with the ordinary meaning to be given to the term in its context and in the light of the object and purpose of the treaty. The language in Canada's Schedule stating that the quantity provided for under the tariff-rate quota "represents the estimated annual cross-border purchases imported by Canadian consumers" failed to limit market

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<sup>342</sup> Canada made reference to Exhibits 40 – 50.

<sup>343</sup> Appellate Body Report on *EC - Computer Equipment*, *op. cit.*

access in the manner Canada now asserts it intended. The indicated language did not in its ordinary meaning allow an interpretation that permitted the actual constraints imposed by Canada on eligibility of imports for the in-quota rate. Because the language did not create the "term, condition, or qualification" which Canada now claimed it intended to establish at the time of its inclusion, Canada was providing treatment less favorable to imports of fluid milk than was provided for in its Schedule. Canada, therefore, was acting inconsistently with its obligations under Article II:1(b) of the GATT 1994.

4.497 The United States noted that Canada raised three arguments in response to the US complaint. First, Canada contended that the words in its Schedule would be rendered meaningless if they were not construed to limit the scope of market access as Canada had intended. Second, Canada argued that the meaning of the word "consumer" was so clear that its use obviously confined imports under the in-quota rate to small, retail purchases for the personal use of Canadian residents. Third, Canada asserted that the meaning of the words in the Schedule was agreed between the United States and Canada. Each of Canada's contentions was without merit.

4.498 The United States did not agree that the language in Canada's Schedule was made meaningless by denying those words the meaning that Canada now attributed to them. While the United States agreed with the principle of treaty interpretation, articulated by the Appellate Body, that words were to be given effect, here the question was what was the operative word to which effect was to be given. The only operative word in Canada's Schedule relating to fluid milk was the word "represents". However, the schedule statement that the quantity of the tariff-rate quota "represents" an estimated amount of trade did not operate to limit access in the manner Canada contended. It was simply a narrative statement explaining the basis for arriving at the in-quota quantity. Canada's choice of language was not at all the same as saying "access is limited to", or "this quantity is available only for." Canada attempted to read into the language in its Schedule a meaning and effect that were not there. The starting point for any treaty interpretation was the plain text of the treaty, which was also the best statement of the intent and agreement of the parties. That text was unambiguous and, therefore, Canada had failed to demonstrate any basis for examination of the negotiating history between the United States and Canada respecting market access for milk. Indeed, resort to such an examination would contravene the very principles of treaty interpretation which Canada cited in its argument.

4.499 The United States argued that this language remained from Canada's efforts to comply with certain specific modalities for market access set forth in the Agreement on Modalities for the Establishment of Specific Binding Commitments under the Reform Programme, which were Part B of the Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations.<sup>344</sup> The modalities required "minimum access opportunities" for products for which there were "no significant imports." The modalities required that such opportunities would "represent in the first year of the implementation period not less than 3 per cent of corresponding domestic consumption in the base period ... and shall be expanded to reach 5 per cent of that base figure by the end of the implementation period." Canada had no significant imports of milk during the relevant period and was consequently faced with the prospect of a requirement to import milk in volumes equal to 5 per cent of domestic consumption. Canada's trade statistics showed no imports of milk, because milk was subject to an absolute quantitative restriction under its Import Control List. Faced with this stark reality, Canada had seized upon the idea of demonstrating the existence of some "current access". The imports that Canada relied on were unrecorded imports entered by returning Canadian shoppers. Such milk was not subject to formal customs entry. Consequently, no trade data was compiled. In creating a tariff-rate quota for milk as part of the required tariffication process, Canada sought to dress up this unknown quantity of trade as "current access" within the meaning of

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<sup>344</sup>Canada Exhibit 32: MTN.TNC/W/FA, p. L.19 (20 December 1991).

the modalities. Paragraph 11 of Section B of Part B<sup>345</sup> provided that "current access opportunities on terms at least equivalent to those existing shall be maintained as part of the tariffication process." In the absence of any official trade statistics to justify a current access concession, rather than the more onerous minimum access concession, Canada had to place in its schedule an ostensible basis for this lesser concession. There had been various estimates concerning the volume of this unreported trade. Estimates ranged as low as approximately 35,000 tonnes and as high as 80,000 tonnes. When Canada reported in its Schedule that it would permit access for 64,500 tonnes at in-quota duty rates, it was appropriate that Canada stated how this level of "current" access was determined. The explanatory note in its Schedule that the volume represents the estimated amount of cross-border purchases by Canadian residents explained the derivation of the quantity adopted for in-quota market access. Contrary to Canada's contention, the ordinary meaning of the language served a purpose and was not meaningless.

4.500 The United States argued that Canada's attempt to demonstrate that the word "consumer" could only refer to a retail customer, purchasing small quantities of a product was also flawed. Canada sought to give a special meaning to that term, but Article 31.4 of the Vienna Convention permitted a special meaning only when it could be established that the parties so intended. Canada had not met this burden. The United States noted that the facts did not support Canada's assertion that language in its Schedule, and Canada's current interpretation of that language, was agreed to by the United States and Canada. At most Canada had shown that it had used the language in the schedule in its own internal memoranda. None of the exhibits tendered by Canada showed that the United States had shared a common understanding of the words or, more importantly, that the United States had agreed to the limitations that Canada now reads into that language. Unless Canada could demonstrate a common intent of the parties to give a special meaning to the term "consumer", its ordinary meaning was the only basis for interpretation of Canada's Schedule under the Vienna Convention.

4.501 The United States argued that Canada could have clearly established the limitation on access to the tariff-rate quota that it now claimed to have intended. For example, Canada could have instead specifically stated that the quantity eligible for the in-quota rate was limited to purchases by its residents for their personal use. Canada could have said that access under the tariff-rate quota was limited to milk entered under its General Permit No. 1 for dairy products. Or Canada could have used the same language which it used in the case of yoghurt and ice cream, and indicated, as it did for each of those products, that eligible entries were limited to access in "retail sized containers only".<sup>346</sup> Canada did not use the same limiting language that it used for yoghurt and ice cream for fluid milk. In such circumstances, the United States questioned how could it be understood that Canada sought to impose the same restriction on fluid milk access.

4.502 The United States noted that the United States used the term "ultimate consumer" in its Schedule for a related purpose.<sup>347</sup> The term there was defined to exclude institutions that could prepare, but did not consume food articles, such as hospitals, prisons, restaurants, hotels and bakeries. Furthermore, the US schedule was very precise in identifying equivalent limitations on imports into the United States. Thus, the United States schedule specifically stated that the words "prepared for marketing to the ultimate consumer" means "that the product is imported in packaging of such sizes and labeling as to be readily identifiable as being intended for retail sale to the ultimate consumer without any alteration in the form of the product or its packaging".<sup>348</sup> The United States argued that in light of this very distinct use of a related term by the United States in the US Schedules Canada

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<sup>345</sup> *Ibid*, p.L.26

<sup>346</sup> Canada's Schedule V. (United States, Exhibit 51)

<sup>347</sup> The United States referred to excerpts from Schedule XX. (United States, Exhibit 52)

<sup>348</sup> *Ibid*.

could not arrive at the conclusion that the United States shared Canada's intended construction of the word "consumer". The US use of the modifying adjective "ultimate" indicated that the United States believed it necessary in its Schedule to distinguish between the more narrow category encompassed by the words "ultimate consumer" and a broader category that includes all consumers. Indeed, there was no basis for Canada's arguments that the United States understood Canada's poorly communicated intent. Yet, despite Canada's failure to offer any explanation, Canada insisted that the two countries agreed on a common meaning for the term.

4.503 The United States refuted Canada's efforts to establish the ordinary meaning of the term "consumer". Specifically, Canada relied to a major extent on the meaning given to a phrase, in fact, a term of art under the Uniform Commercial Code – "consumer goods" – that did not appear in Canada's Schedule and which possessed a connotation of its own, distinct from the word "consumer". The attempt to attribute the meaning of an entirely distinct phrase to the words in the Schedule was entirely inappropriate. Furthermore, entirely missing from Canada's argument regarding the meaning of the word "consumer" was any reference to the New Shorter Oxford English Dictionary on Historical Principles,<sup>349</sup> that it regularly cited for a variety of definitions. The New Shorter Oxford English Dictionary defined "consumer" to mean "a person who or thing which squanders, destroys, or uses up; a user of an article or commodity, a buyer of goods or services". Clearly, this definition was at odds with the more restricted definition of the term "consumer" offered by Canada. In fact, there was nothing in the New Shorter Oxford English Dictionary definition to limit the meaning of the word "consumer" to individuals purchasing goods for their own personal use in small, retail packages.

4.504 The United States further refuted the Canadian contention that the negotiations between the United States and Canada at the end of the Uruguay Round regarding market access lent support to Canada's argument. Canada's assertion that its market access offer for dairy was always in the form of "current" access was entirely unfounded. Canada was fixated on the idea of modifying Article XI of the GATT to allow quantitative restrictions on imports to remain inviolate. Canada had resisted the concept of tariffication of quantitative restrictions to the very end of the Uruguay Round. Thus, to suggest that Canada had any long-held position regarding any level of market access for fluid milk was misleading. Canada's first offer relating to market access, moreover, had been based on the Dunkel modalities, with access initially set at 3 per cent of its market, increasing to 5 per cent at the end of the implementation period.<sup>350</sup> The United States acknowledged that Canada indicated that this offer would only remain on the table if enhanced access to the US market for dairy products was provided. Negotiations between the two countries through the end of 1993 and the beginning of 1994 were aimed at reaching agreement on how such improved market access for a variety of products could be achieved. The negotiations were unsuccessful. Then in February 1994, Canada had submitted its final schedule to the WTO, including the 64,500 tonne tariff-rate quota for fluid milk. There had never been any agreement between the United States and Canada relating to either the size or nature of this tariff-rate quota, or the language used in Canada's Schedule.

4.505 The United States noted that given that Canada had commenced discussions of tariffication and market access at such a late date, resolution of the differences in position were not resolved by the time Canada was compelled to submit its Schedule. When it did so in February 1994, there certainly was no agreement between the United States and Canada on either the content of its concessions respecting fluid milk or the meaning of the terms used to describe the concession. Thus, Canada's selection of 64,500 tonnes as the quantity which represented so-called cross-border trade, was a number that it reached independently. Moreover, its choice of language to describe what that 64,500 tonnes represented was also made unilaterally.

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<sup>349</sup> Lesley Brown (ed.), (Oxford: Oxford University Press, 1993).

<sup>350</sup> United States, Exhibit 53.

4.506 **Canada** stressed that it did not claim that the United States agreed with Canada's action – what it claimed was that the United States' negotiators understood it. The United States had accepted Canada's Schedule, including the tariff item at issue, in the full knowledge of the meaning and implications of the terms and conditions placed in that Schedule with respect to fluid milk. Canada argued that under the interpretation advanced by the United States, everything but the purely grammatical sense of the words was ignored. This rendered an analysis incomplete. The Appellate Body, in *United States – Import Prohibition of Certain Shrimp and Shrimp Products*<sup>351</sup>, had recently reaffirmed the importance of examining each element of Article 31.1 of the Vienna Convention. In particular, regarding the interpretation of the chapeau of Article XX of the GATT 1994, the Appellate Body noted that the Panel "...did not expressly examine the ordinary meaning of the words...",<sup>352</sup> that it had "... failed to scrutinize the *immediate* context of the chapeau,"<sup>353</sup> and finally, that it "...did not look into the object and purpose of the *chapeau*."<sup>354</sup> (emphasis in original).

4.507 Canada noted that in support of its interpretation, the United States asserted that the only operative word in the Schedule was the word "represents" and claimed that this was merely a narrative statement explaining the basis for arriving at the in-quota quantity. However, the United States had not examined of the meaning of that term. Canada submitted that even at this initial stage of analysis, there were two potential meanings of the term "represents" as it was used in the Schedule. First, the word was defined as meaning to "...bring clearly and distinctly to mind, esp. by description or imagination."<sup>355</sup> Thus, the word operated to more precisely identify the 64,500 tonnes found under the "Initial Quota" and "Final Quota" columns as being cross-border purchases of fluid milk by Canadian consumers. A second definition could be "... of a quantity: indicate or imply another quantity." The TRQ dealt with quantities. The figure of 64,500 tonnes was found in the "Initial Quota" and "Final Quota" columns of the Schedule. Thus, the word "represents," in its ordinary meaning, instructed the reader to have in mind cross-border purchases of fluid milk by Canadian consumers when reading 64,500 tonnes under the initial/final quota columns of Canada's Schedule.

4.508 Canada noted that a single dictionary meaning did not exhaust the search for ordinary meaning and that the dictionary meaning of "consume" also included the concept of "eat up, drink down, devour". This definition carried with it the concept of a person actually ingesting the article in question. Thus, in the context of an agricultural product, this definition was part of the ordinary meaning.

4.509 Canada further argued that, continuing with the analysis expounded by the Appellate Body, it was evident that the United States had, at the outset, failed to consider the context of the Canadian terms and conditions attached to its TRQ for fluid milk. The immediate context of these words was that they were found in the column entitled "Other Terms and Conditions," which in itself followed the columns entitled "Initial Quota" and "Final Quota." The inescapably logical conclusion was that the words found under "Other Terms and Conditions" were just that: terms and conditions that applied to the quantity described as the initial/final quotas. Had these words merely represented "a narrative statement explaining the basis for arriving at the in-quota quantity," they would not have found a place in the Schedule. Turning to the object and purpose of the "Other Terms and Conditions" column, this was evidenced by the very words describing the function of the column. This column had been provided to allow Members to describe the terms and conditions that they had attached to the TRQ applicable to the product in question, not to describe how they had arrived at the TRQ itself.

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<sup>351</sup> Appellate Body Report on *US – Shrimp-Turtle*, *op.cit.*

<sup>352</sup> *Ibid.*, p. 42, para. 115.

<sup>353</sup> *Ibid.*, pp.42-43, para. 116.

<sup>354</sup> *Ibid.*, p. 43, para. 116.

<sup>355</sup> *The New Shorter Oxford English Dictionary on Historical Principles*, Lesley Brown (ed.), (Oxford: Oxford University Press, 1993).

4.510 In respect of the negotiating history, Canada recalled that it had clearly indicated to the United States, as set out in jointly drafted documents, that it intended to continue its access for US milk imported by Canadian consumers while non-consumer utilization would continue to be blocked until equivalency was established. Canada's intentions had been clear. Canada maintained that if the United States had had any doubt about whether or not Canada's Schedule provided access consistent with their interpretation of the negotiations and resulting treaty terms, it would have been their responsibility to verify the meaning of the term and condition. It had been their responsibility to ensure that their interpretation of what access was agreed to in the negotiations was ensured.<sup>356</sup>

4.511 Canada did not concede, in respect of the US references to other language used by both Canada and the United States in their respective schedules, that such other language would necessarily have any adverse bearing on the language it had chosen with respect to its obligations. Indeed, the use of different words with respect to different categories of products merely illustrated that the terms and conditions applicable thereto were formulated in their own differing contexts, and thus had to be examined accordingly. Again, this illustrated the importance of heeding the guidance provided by the Vienna Convention when interpreting the terms of a treaty,<sup>357</sup> particularly when faced with interpreting tariff schedules.<sup>358</sup>

### 3. Article 3 of the Agreement on Import Licensing Procedures

4.512 The **United States** argued that Canada administered the tariff-rate quota on fluid milk through general import permits provided for under Canada's Export-Import Permit Act.<sup>359</sup> By virtue of the general permit, residents of Canada were confined in any single import entry to C\$20 worth of dairy products, limited to their personal or household use.<sup>360</sup> The two limitations, i.e., personal use and a specific dollar value, were imposed in addition to both the requirement for a general permit and the quantitative limit on the volume of fluid milk eligible for the in-quota rate under Canada's WTO Schedule. These additional constraints on imports were inconsistent with the requirements of Import Licensing Agreement. Specifically, Article 3.2 of the Import Licensing Agreement provided that:

"Non-automatic licensing shall not have trade-restrictive or -  
distortive effects on imports additional to those caused by the  
imposition of the restriction."

4.513 The United States argued that the obligation encompassed in Article 3.2 reflected the Import Licensing Agreement's objectives that the flow of international trade not be "impeded by the inappropriate use of import licensing procedures" and that "licensing procedures should be no more administratively burdensome than absolutely necessary to administer the relevant measure".<sup>361</sup> Hence, the general permit, by imposing two conditions on entry that were additional to the licensing requirement itself, added another impediment to fluid milk trade between the United States and Canada and resulted in procedures that were more administratively burdensome than necessary to administer the measure. By limiting entries to the personal use of the importer, the general permit restricted trade beyond those constraints that would result from the mere act of licensing imports. By confining the value of imports, the general permit further impeded trade and was also inconsistent with Article 3.5(i) of the Agreement, which directed Members to "take into account the desirability of

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<sup>356</sup> Appellate Body Report on *EC - Computer Equipment*, *op. cit.*, para. 82, 84.

<sup>357</sup> Appellate Body Report on *US - Shrimp-Turtle*, *op. cit.*, 50, p. 42.

<sup>358</sup> Appellate Body Report on *EC - Computer Equipment*, *op. cit.*, para. 82, 84.

<sup>359</sup> Responses to Questions from the US on Fluid Milk TRQ, Letter, dated 24 November 1997 (Answer to Question 31. United States, Exhibit 34)

<sup>360</sup> United States, Exhibit 34.

<sup>361</sup> Preamble, WTO Import Licensing Agreement, paras. 8 and 9.

issuing licenses for products in economic quantities." The limitation on imports to C\$20 appeared to eliminate all but individual consumer retail purchases of milk.

4.514 Finally, the United States argued that Canada had failed in its obligation under Article 3.5(iv) to provide information respecting the value and volume of fluid milk within the tariff-rate quota. This data was requested by the United States during consultations in November 1997, and Canada advised that such information had not been developed despite assurances in earlier consultations that the data would be made available.<sup>362</sup>

4.515 **Canada** argued that Article 1.1 of the Import Licensing Agreement defined import licensing as being administrative procedures used for the operation of import licensing regimes requiring the submission of an application or other documentation to the relevant administrative body as a prior condition for importation. Canada did not require Canadian residents to apply for or acquire import permits for the importation of less than C\$20 worth of dairy products. There were no administrative procedures associated with the general import licensing regime in respect of such import. Therefore, that Agreement did not apply.

4.516 **Error! Bookmark not defined.**Canada further argued that its administration of the fluid milk tariff quota was consistent with the Import Licensing Agreement. Imports of fluid milk for personal use into Canada were freely made by Canadians under the terms of General Import Permit No.1. Individual permits were not required. Further, in the current circumstances, Canada had not considered it necessary to monitor the flow of such milk imports into Canada. Any such inspection regime would not be practicable, since it would, in effect, require the stopping of all returning Canadians at the many Canada-US border crossing points to inspect and record the contents of their grocery bags. Moreover, it would introduce an unwanted and unneeded interference in such import trade. No restrictions were placed on imports that were additional to the terms and conditions incorporated in Canada's tariff concession. Accordingly, this regime was in complete compliance with the requirements of Article 3.2 of the Import Licensing Agreement. Since any monitoring regime for such imports was neither realistic nor practicable, the provisions of Article 3.5(iv), cited by the United States did not apply.

4.517 The **United States** claimed that there could be no dispute that the Import Licensing Agreement applied to tariff-rate quotas. The Appellate Body in two separate disputes resolved the question by affirming that the Agreement's scope includes tariff-rate quotas.<sup>363</sup> Despite this clear statement by the Appellate Body, Canada argued that the Import Licensing Agreement did not apply in this instance because Article 1.1 limited the scope of import licensing to "the operation of import licensing regimes requiring the submission of an application or other documentation to the relevant administrative body as a prior condition for importation" (paragraph 4.515). Hence, Canada asserted that because its General Permit for dairy imports did not require any administrative procedures for imports of less than C\$20, the Import Licensing Agreement was inapplicable.

4.518 The United States noted that Canada chose to ignore the fact that under Canada's Export and Import Permits Act administrative procedures existed for obtaining import licenses in situations in which the General Permit was inapplicable, e.g., where the desired dairy imports were valued at more than C\$20.<sup>364</sup> While Canada rarely, if ever, granted licenses under those procedures for fluid milk

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<sup>362</sup> Consultations on 19 November 1997. Answers to question 24. (United States, Exhibit 34)

<sup>363</sup> In the proceedings involving *European Communities - Regime for the Importation, Sale, and Distribution of Bananas*, WT/DS27/AB/R, adopted 25 September 1997, para. 194 and *European Communities - Measures Affecting the Importation of Certain Poultry Products*, WT/DS69/AB/R, adopted 23 July 1998, paras. 120-122.

<sup>364</sup> The United States noted that Canada described the nature of the applicable procedures in its answer to question 5 from the United States. Specifically, Canada stated that pursuant to paragraph 8.3(3) of the Act, "where goods have been included on the Import Control List and the Minister has determined an import access quantity for the goods pursuant to subsection 6.2(1), the Minister may issue (a) a permit to import those goods in a supplemental quantity to any resident of Canada who applies for the permit ...".

imports, it presumably did grant licenses for other dairy products. For example, the United States assumed that Canada issued licenses for dairy imports under Canada's Import for Re-Export Program.<sup>365</sup> More importantly, Canada had administrative procedures in place for licensing such imports. The fact that Canada elected not to grant such licenses did not negate the existence of those licensing procedures. It would be a most curious result for a country to establish licensing procedures, but then be able to avoid the disciplines of the Import Licensing Agreement simply because it refused to grant any licenses. Canada's procedures, thus, remained within the scope of the Import Licensing Agreement.

4.519 The United States argued that Canada could not be allowed to use GATT inconsistent measures to argue that the Import Licensing Agreement was inapplicable. Canada maintained procedures under its Import-Export Permits Act to permit dairy imports, including fluid milk, that did not qualify under the General Permit. Canada's refusal to grant licences under that authority did not diminish the reality of those procedures. Moreover, these procedures were precisely the subject of the Import Licensing Agreement's disciplines. Canada could not deny the Agreement's applicability by simply disclaiming the existence of any relevant procedures.

4.520 **Canada** recalled its position that the Import Licensing Agreement did not apply to the General Import Permit system. The United States understood this statement as being a claim by Canada that the Agreement did not apply to tariff quotas generally. Canada could not understand how the United States could have read its statement in this way and affirmed that the Import Licensing Agreement applied to any tariff quota administration regime falling in the description of Article 1.1 of that Agreement.

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<sup>365</sup> The United States noted that Canada stated in its response to the questions from the Panel and from New Zealand that the Import for Re-Export Program had not allowed the importation of fluid milk classified in tariff item 0401.10. (Response to Question 1(b) from New Zealand)

## V. SUMMARY OF THIRD PARTY SUBMISSIONS

### A. AUSTRALIA

#### 1. Introduction

5.1 Australia stated that as an agricultural exporter, and in particular, as a major exporter of dairy products Australia had a direct commercial interest in the outcome of the dispute at issue. As the export subsidy provisions of the Agreement on Agriculture were of major systemic importance to Australia, Australia's submission focussed on the question whether the delivery of cheap in-quota milk to manufacturers for export under Classes 5(d) and (e) provided export subsidies under the Agreement on Agriculture.<sup>366</sup>

5.2 Australia claimed that the Special Milk Classes Scheme delivered export subsidies within the meaning of the Agreement on Agriculture. As a result Canada was in breach of its export subsidy quantity reduction commitments for butter, cheese and other milk products under the Agreement on Agriculture. It followed that Canada was in breach of its commitments under Articles 3, 8, 9 and 10 of the Agreement on Agriculture and Article 3 of the SCM Agreement.

5.3 Australia disagreed with the United States line of argument regarding the functional equivalence of Canada's new dairy regime with its former system of producer-financed levies, which appeared to fall under Article 9.1 of the Agreement on Agriculture. Australia contended that this was not a trade impact issue but one of rules and so such a line of argument was not relevant. The WTO Agreement did not prevent a Member from bringing itself into conformity with the rules by measures that could have similar trade and production impact. In Australia's view the new regime provided export subsidies under the WTO rules regardless of the status of previous arrangements.

#### 2. Discussion

##### (a) Relationship between the Agreement on Agriculture and the SCM Agreement

5.4 Australia noted that the Agreement on Agriculture itself did not contain a definition of "subsidy". Accordingly, the context of the Agreement on Agriculture needed to be examined for guidance, i.e. the WTO Agreement, in particular Annex 1A. The generic agreement on subsidies in the goods sector was the SCM Agreement. In the absence of any other indication, normal rules of interpretation suggested that that definition should be taken for other agreements in Annex 1A of the WTO Agreement. Moreover, there were explicit legal linkages between the Agreement on Agriculture and the SCM Agreement. In particular Article 13 of the Agreement on Agriculture provided a temporary derogation from aspects of the SCM Agreement provided that the conditions set out therein were fulfilled. Article 3.1 of the Agreement on Agriculture specifically referred to commitments limiting subsidization. The SCM Agreement was the vehicle by which the subsidy was defined for goods under the WTO Agreement. Article 31 of the Vienna Convention underlined that the Panel needed to interpret the meaning of "subsidy" in its context which included the WTO Agreement as a whole and the SCM Agreement in particular.

5.5 On the issue of the relationship between Article 1(e) of the Agreement on Agriculture<sup>367</sup> (which provided guidance for what constituted an export subsidy under that agreement) and

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<sup>366</sup> Australia's submission was limited to the issue of measures affecting dairy exports.

<sup>367</sup> Article 1(e) of the Agreement on Agriculture: "export subsidies' refers to subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement;"

Article 3.1(a) of the SCM Agreement<sup>368</sup>, the ordinary meaning of these terms in the context of Annex 1A of the WTO Agreement would imply that the definitions were the same. If there were measures that fell under Article 3.1(a) of the SCM Agreement but not the definition of export subsidy under Article 1(e) of the Agreement on Agriculture, then they would not be covered by Article 13(c) of the Agreement on Agriculture. That would appear to lead to a result other than the intention of Article 13 of the Agreement on Agriculture and so be ruled out under Articles 31.1 and 32(b) of the Vienna Convention.

(b) Classes 5(d) and (e) under the Special Milk Classes Scheme constitute export subsidies

5.6 Where in-quota milk was provided to processors/exporters under Classes 5(d) and (e), this involved the Government, through its legislative arrangements, providing goods (i.e. milk) at prices below those prevailing in the domestic market. Thus the measure provided a subsidy under Article 1.1(a)(iii) of the SCM Agreement. In the alternative, this was a subsidy under Article 1.1(a)(iv) of the SCM Agreement. The measure provided a benefit to the processor/exporter concerned, since it received the raw material (milk) at a price that enabled it to export the processed product concerned. This supply of milk was contingent upon the export of the processed dairy product. Accordingly, the measure constituted a subsidy that conferred a benefit on the recipient and was contingent upon export performance. Thus it fell under Article 3.1(a) of the SCM Agreement. Accordingly, it was an export subsidy within the meaning of the Agreement on Agriculture (as well as the SCM Agreement) and so came under Canada's obligations under Articles 3, 8, 9 and 10 of the Agreement on Agriculture. In the alternative, if the Panel found that this measure fell under Article 3.1(a) of the SCM Agreement but was not an "export subsidy" within the meaning of the Agreement on Agriculture, then it would be prohibited under Article 3 of the SCM Agreement, since it would not receive cover from Article 13(c) of the Agreement on Agriculture.

5.7 Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement underscored that the provision of low priced inputs could be an export subsidy. In addition, while the calculation issue was in respect of countervail, Article 14(d) of the SCM Agreement indicated that such a measure would be a countervailable subsidy. Article 9.1(a) of the Agreement on Agriculture through its reference to "payments-in-kind" made it clear that cheap inputs in lieu of cash were regarded as direct subsidies.

5.8 Australia noted that given that Canada's exports exceeded the commitments in its Schedule, it was irrelevant whether the measure fell under the types of export subsidies listed in Article 9.1 of the Agreement on Agriculture, since Article 10.3 of the Agreement on Agriculture placed the onus on Canada to show that it had not breached its commitments whether or not it fell under Article 9.1 of the Agreement on Agriculture.

5.9 Classes 5(d) and (e) of the Special Milk Classes Scheme were designed to make products for export competitive through the supply of cheap milk based on the export price of the exported product. The "world price" of the milk, which was calculated by the CDC (whether product was exported by the CDC or where there were exporter-initiated proposals for export), was below the price of the milk that would be commercially available to processors/exporters without the operation of the scheme. The "world price" was negotiated by the CDC with the processor or exporter. The prices in Class 5 were in fact on the individual components of milk (butterfat, protein, other solids). The CDC was constructing what it termed a "world price", which would appear not to be commercially available to producers without the operation of the Special Milk Classes Scheme. Australia noted that while Canada argued that processors/exporters conceptually had access to milk at world market prices under its Import for Re-Export Program, the price of obtaining and using such

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<sup>368</sup> Article 3.1(a) of the SCM Agreement: "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;" [footnote in original omitted]

milk was not taken into account when the price of the Class 5(d) or (e) milk to the processor/exporter was determined and was more favourable. There appeared to be no connection between the price of imported milk conceptually available at the factory under the Import for Re-Export Program and the prices charged for milk under Classes 5(d) and (e). Accordingly, the measure provided milk at a price below an adequate level of remuneration contingent upon the export of the manufactured product and therefore would constitute an export subsidy, under both the Agreement on Agriculture and the SCM Agreement.

(c) Export Subsidies under Article 9.1 of the Agreement on Agriculture

(i) *"Provision by governments or their agencies"*

5.10 The Canadian Government, whether through the CDC or through the provincial marketing boards, played a clear role in the establishment and administration of the Classes 5(d) and (e) in the Special Milk Classes Scheme. The CDC was mandated under the CDC Act<sup>369</sup> to establish and operate the pooling of revenues from milk sales, to determine the percentage of total production represented by Classes 5(d) and (e) including in each province, and to calculate the "world price" for the purposes of Classes 5(d) and (e). Moreover, it was through the CDC that processors/exporters obtained a permit for cheap milk for dairy products for export. The requirement under Article 9.1(a) that the direct subsidies were provided by governments or their agencies was thereby met.

5.11 Australia did not agree with Canada's argument that in effect the Canadian dairy export regime was in some way not governmental. The regime for exports from in-quota milk under Classes 5(d) and (e) were an integral part of the Canadian dairy regime, which operated under legislative authority at both the Federal and Provincial levels. In the absence of legislative backing the scheme would not be able to operate.

5.12 In respect of Canada's claim that the permits issued by the CDC were recommendations to the marketing boards and that the CDC was not mandated to decide whether processors/exporters obtained product at world prices for export, Australia noted that the processor/exporter could not receive milk products at world prices without the permit issued by the CDC.

(ii) *"Direct subsidies, including payments-in-kind"*

5.13 Article 9.1(a) covered "direct subsidies, including payments-in-kind". The ordinary meaning of this phrase was that the provision of cheap goods was to be regarded in the same way as straight cash. Accordingly, since for Classes 5(d) and (e) the cheap milk was provided by the Government contingent on the export of the manufactured product, the measure fell under Article 9.1(a) of the Agreement on Agriculture. It would be inconsistent with the ordinary meaning of the phrase to suggest that the provision of goods without payment would be a subsidy but that any level of payment, even though less than adequate remuneration, would convert the measure from being a subsidy.

5.14 Processors/exporters accessed cheap milk under Classes 5(d) and (e) for the export of dairy products, compared with access to milk to produce the same product for the domestic market, and so the measure met the requirement of Article 9.1(a) that the provision of direct subsidies was "to a firm, to an industry, to producers of an agricultural product ...".

5.15 Processors/exporters requested a permit to export product under the Special Milk Classes Scheme. Milk destined for Classes 5(d) and (e) for processing into export product had been

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<sup>369</sup> Australia noted that Paragraph 9(1) of the CDC Act indicated the delegation of the CDC powers, by agreement with a province or a Board, of the Commission's powers under paragraphs 9(1)(f)-(i).

determined by the CDC. Classes 5(d) and (e) had been established solely for the export of dairy products and the provision of lower priced industrial milk was related specifically to the export of that product. Processors/exporters did not have access to the lower priced industrial milk unless the dairy product was to be exported. The subsidy provided through the Classes 5(d) and (e) was therefore "contingent upon export performance".

5.16 Accordingly, the measure satisfied the definition in Article 9.1(a) of the Agreement on Agriculture.

(d) Article 3 of the Agreement on Agriculture

5.17 Australia argued that since the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1 of the Agreement on Agriculture, Canada was in breach of Article 3.3 of the Agreement on Agriculture not to provide export subsidies in excess of its budgetary outlay and quantity commitments levels specified in Section II of Part IV of its Schedule and in breach of Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement and with the commitments specified in its schedule.

(e) Article 10 of the Agreement on Agriculture

5.18 In the alternative, even if it were found that the export subsidies provided under Classes 5(d) and (e) were not captured within the meaning of Article 9.1 of the Agreement on Agriculture, Australia argued that Canada would appear to be in breach of Article 10.1 of the Agreement on Agriculture. The object and purpose of Article 10.1 of the Agreement on Agriculture was to prevent the circumvention of export subsidy commitments. This was reinforced by Article 10.3 which placed the onus on an exporting Member to demonstrate that any exports in excess of its scheduled commitments were not subject to export subsidies. As noted above, in Australia's view the measure provided an export subsidy and so the onus was on Canada to demonstrate that it was not in breach of its export subsidy commitments.

(f) Article 3 of the SCM Agreement

5.19 The measure in question fell under Article 3.1(a) of the SCM Agreement. Since Canada was in breach of its export subsidy commitments under the Agreement on Agriculture, it did not receive cover through Article 13(c) of the Agreement on Agriculture, and so was in breach of Article 3 of the SCM Agreement. In the alternative, if the Panel found that the measure was not an export subsidy within the meaning of the Agreement on Agriculture but was an export subsidy under Article 3.1(a) of the SCM Agreement, then again Canada would receive no cover from Article 13(c) of the Agreement on Agriculture, and so would be in breach of Article 3 of the SCM Agreement.

B. JAPAN

## 1. Introduction

5.20 Japan, as both a producer and major importer of dairy products<sup>370</sup>, expressed concern in respect of the effect of Canada's measures on international prices of dairy products. Such measures could give rise to inappropriate competition within the global dairy market, which in turn would bring about negative effects on the domestic markets. Hence, Japan considered that it had a substantial trade interest in the current matter.

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<sup>370</sup> Japan noted that, for example, Japan was the largest importer of trade in cheese: 24 per cent of the total imports in the world was shared by Japan (as reported in 1996 in the "Dairy Compendium" by the Australian Dairy Corporation) and Japan's imports of Canadian cheese amounted to 283 tonnes in FY1995 and 1,236 tonnes in FY1996.

5.21 Japan considered that the export subsidies were highly trade-distortive and had therefore argued for their termination. As a result of the Uruguay Round Negotiations, the WTO Agricultural Agreement provided that the Members had to phase out export subsidies and prevent the circumvention of such subsidies.

5.22 In Canada, a gap between export prices of dairy products and the domestic prices was created by the Special Milk Classes Scheme. Japan noted that the exportation of Canada's dairy products had been expanding under this Scheme. Japan considered that Canada's Special Milk Classes Scheme was an export subsidy, or, in the alternative, resulted in or threatened to lead to the circumvention of Canada's export subsidy reduction commitments.

## **2. Legal Arguments**

(a) Canada's Special Milk Classes Scheme provided an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture

5.23 Japan considered that Canada's Special Milk Classes Scheme fell into the category of an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture, and that the actual amount of dairy products exported from Canada exceeded the level set forth in its Schedule. Consequently, Japan believed that the measures at issue were inconsistent with Articles 3.3 and 8 of the Agreement on Agriculture.

5.24 Article 9.1(c) provided the following two conditions for export subsidies: (i) "payments on the export of an agricultural product"; and (ii) payments that were "financed by virtue of governmental action". Concerning the first condition of Article 9.1(c), the price reduction provided by the Special Class 5(d) was available only for the milk destined for the production of dairy products for export purposes. Indeed, this was in practice and economically-speaking nothing else but "payments on the export of an agricultural product". With regard to the second condition of Article 9.1(c), the Special Milk Classes Scheme was founded through the Comprehensive Agreement on Special Class Pooling, which was an Agreement between the federal and provincial governments and operated by the CDC, whose authority to do so was given by the CDC Act and which was amended in 1995. This meant that the system was operated "by virtue of governmental action". Therefore, Japan considered that the price reduction under the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture, and accordingly had to be subject to reduction commitments under that Agreement.

5.25 Japan further noted that under Article 3.3 and Article 8 of the Agreement on Agriculture, Members were obliged not to provide export subsidies on agricultural products in excess of the budgetary outlay and the quantity commitment levels specified in their Schedule, and not to provide export subsidies "otherwise than in conformity with" the commitments in their Schedule. Japan noted that the volume of Canadian exports had exceeded the level of its export subsidy commitments under the Agreement on Agriculture in respect of most of the dairy product categories.<sup>371</sup> Hence, Japan claimed that the Canadian measure at issue, being an export subsidy provided for in Article 9.1(c), was not consistent with Article 3.3 and, accordingly, not consistent with Article 8 of the Agreement on Agriculture.

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<sup>371</sup> Japan noted that, for example, the volume of exports for butter in 1995/96 was 14,845 tonnes from Canada, the ceiling volume of which was 9,464 tonnes for the same period.

- (b) By operating the Special Milk Class System, Canada circumvented or threatened to circumvent its export subsidy commitments

5.26 Japan argued that even if the Panel were not to find that the Special Milk Classes Scheme provided an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture, Japan still believed that Canada's Special Milk Classes Scheme was inconsistent with Article 10.1 of the Agreement on Agriculture. Article 10.1 provided that the export subsidies not listed in Article 9.1 were not to be applied in a manner which resulted in, or threatened to lead to, circumvention of export subsidy commitments. If the Panel did not find the Scheme was an export subsidy as provided for in Article 9.1(c), Japan considered that the Scheme constituted an export subsidy within the meaning of Article 1(e) of the Agreement on Agriculture. This was because access to lower-priced milk under Class 5(d) was permitted exclusively for the purpose of processing dairy products for export and was "contingent upon export performance".

5.27 Under Class 5(d) of the Special Milk Classes Scheme, processors of dairy products benefitted from the price reduction instead of foregoing revenue by the provincial government agencies. Such price reduction, within the meaning of Article 1(e), constituted a "subsidy", the interpretation of which was supported by the negotiating history on export subsidies.

5.28 Japan noted, in addition, that the apparent purpose of the Special Milk Classes Scheme was to avoid the consequences caused by the termination of the producer levy-based subsidies and to replace them with a system that would have precisely the same economic effect. In this regard, Japan believed that this system was "applied in a manner which results in, or which threatens to lead to, the circumvention of their export subsidy commitments" within the meaning of Article 10.1 of the Agreement on Agriculture.

- (c) Canada was requested to bring the measures at issue into conformity with the Agreement on Agriculture.

5.29 Japan argued that while it was understandable that the Government of Canada needed to establish certain domestic measures for a stable supply of dairy products through a sound development of dairy farming, the policy objectives in themselves could not justify the introduction of export subsidies which, in the case at issue, were highly trade-distortive and inconsistent with the Agreement on Agriculture.

5.30 Japan respectfully requested Canada to realize its domestic policy purposes through measures consistent with the WTO Agreement, and, also requested the Panel to recommend to the DSB that Canada bring its measure into conformity with its obligations under the Agreement on Agriculture.

## VI. INTERIM REVIEW

6.1 On 5 February 1999, the Panel issued its interim report to the parties. On 18 February, Canada and the United States requested the Panel to review precise aspects of the interim report, in accordance with Article 15.2 of the DSU. New Zealand did not seek review of any aspect of the interim report. Neither of the three parties requested the Panel to hold a further meeting. We subsequently allowed the parties to comment on the comments we received on 18 February. On 26 February, all three parties submitted such comments.

6.2 Canada suggested that certain corrections and additions be made to the descriptive part of our report. The complainants did not object to these corrections and additions. Where appropriate, we redrafted the relevant sections accordingly. Canada also noted that Table 2 in paragraph 2.41 of our report contains confidential data. We deleted the relevant data from the last column of Table 2, inserted an appropriate footnote regarding the availability of this data in any appeal proceedings, and expressed the indications we derived from this column in paragraph 2.41. We kept the remaining columns in Table 2 since the data contained therein was already made public by Canada in its notifications under the Agreement on Agriculture.

6.3 On the basis of factual comments received by Canada we also redrafted paragraphs 7.54 and 7.59.

6.4 We incorporated certain US suggestions in the descriptive part of our report. Other suggestions had already been taken into account as a result of US comments on the descriptive part of our report. In the light, *inter alia*, of Canada's objections to other US requests for review, we did not add language to paragraphs 7.10, 7.48 and 7.152 of our report.

6.5 The United States further suggested deleting the reference made in the interim report to the concept of "obiter dicta" in respect of our examination under Article 10 of the Agreement on Agriculture. We followed this suggestion (to which Canada did not object and with which New Zealand agreed) in order to clarify the matter. We stress, however, that our examination and findings under Article 10 are made in the alternative, i.e., in the event our findings under Article 9.1 should not be adopted and the DSB decides the dispute based on the alternative claims of violation of Article 10. Accordingly, we redrafted paragraphs 7.119, 7.136 and 8.1 and footnote 530

## VII. FINDINGS

### A. CLAIMS OF THE PARTIES

#### 1. The Special Milk Classes Scheme

7.1 New Zealand and the United States claim that the volume of Canadian exports of certain dairy products, under a scheme known as "Special Milk Classes", exceeds Canada's export subsidy commitments. Pursuant to this scheme, milk is classified into five Classes according to its end use and market destination. Classes 1 to 4 cover milk for use on the domestic market. Class 5 - the so-called "Special Class" – applies to milk intended for export as well as milk for use in products which face import competition in the domestic market. Class 5 is further subdivided into five sub-classes. Classes 5(d) and (e) apply exclusively to milk for use in exported products. Class 5(d) consists of the so-called "traditional planned exports". Class 5(e) covers milk that is to be exported for surplus removal purposes.<sup>372</sup>

7.2 Both complainants focus on Classes 5(d) and (e) of the Special Milk Classes Scheme.<sup>373</sup> They consider that these Classes in the context of Canada's supply and price management system constitute:

- (a) an export subsidy in the sense of Article 9.1 of the Agreement on Agriculture which should be counted against Canada's export subsidy reduction commitments; or, in the alternative,
- (b) an export subsidy not listed in Article 9.1 which is applied in a manner which results in, or threatens to lead to, circumvention of Canada's export subsidy commitments, contrary to Article 10.1 of the Agreement on Agriculture.

The complainants conclude that under both alternatives the scheme results in export subsidies granted contrary to the Agreement on Agriculture (in particular, Article 3.3, Article 8 and/or Article 10.1 thereof).

7.3 The United States further claims that, to the extent that the scheme is an export subsidy contrary to the Agreement on Agriculture, it also violates Article 3 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") which prohibits export subsidies.

7.4 The dairy products in question are: butter, cheese and "other milk products". The relevant marketing years are: 1995/1996 and 1996/1997.<sup>374</sup> Both complainants also refer to marketing year 1997/1998 which ended on 31 July 1998 and for which data only became available - and was submitted to us - after our first substantive meeting. However, in doing so neither of the complainants explicitly incorporated this marketing year under its claims. Since, moreover, marketing year

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<sup>372</sup> See paras. 2.38 - 2.40.

<sup>373</sup> New Zealand's claims only cover Classes 5(d) and (e). The United States, on the other hand, submits that subsidized exports are made under each of the Special Classes but – as it states in its answer to Panel Question 1 to the complainants – "places particular emphasis on the subsidized exports occurring as a result of the operation of Special Classes 5(d) and (e)". Below, the Panel also addresses Classes 5(a) to (c) which cover milk for domestic use as well as milk for export. See para. 7.41 and footnotes 453 and 496.

<sup>374</sup> See Table 1 in para. 3.1 above. The US claims only cover marketing year 1996/1997 but this for all three products (US answer to Panel Question 2 to the complainants). The claims by New Zealand cover both marketing years 1995/1996 and 1996/1997 and this in both cases for all three products at issue, except that "other milk products" are not included for marketing year 1995/1996 (New Zealand answer to Panel Question 2 to the complainants).

1997/1998 only ended some four months *after* the establishment of this Panel (on 25 March 1998), we are not called upon to make findings in respect of that marketing year.<sup>375</sup>

7.5 In response Canada argues that the Special Milk Classes Scheme does not constitute an export subsidy either:

- (a) in the general sense covered by the Agreement on Agriculture (in so doing Canada refers in particular to Article 1 of the SCM Agreement, arguing that the scheme is not a "subsidy" and can therefore *a priori* not be an "export subsidy"); or
- (b) in the specific sense stipulated in any of the six sub-paragraphs of Article 9.1 or in Article 10.1 of the Agreement on Agriculture.

Canada submits that since the exports subject to this scheme are, therefore, not generated by export subsidies, they do not have to be counted against its scheduled reduction commitments, nor can they constitute a circumvention of these commitments in the sense of Article 10.1. Canada concludes, therefore, that the Special Milk Classes Scheme fully conforms to both the Agreement on Agriculture and to the SCM Agreement.

## **2. The tariff-rate quota for fluid milk**

7.6 The United States also claims that access to the tariff-rate quota for fluid milk - which Canada granted in the Uruguay Round negotiations - is being restricted contrary to Canada's obligations under Article II of GATT 1994 and Article 3 of the Agreement on Import Licensing Procedures. The restrictions referred to are as follows: (i) entries are only allowed for consumer packaged milk for personal use by Canadians; and (ii) entries are limited to those valued at less than C\$20.

7.7 To this claim, Canada responds that in its Schedule it limited access to the tariff-rate quota to cross border imports of consumer packaged milk by Canadians for personal use. Canada claims that this is clear from the "terms and conditions" attached to this concession in its Schedule, as well as from the negotiating history that led to this concession.

## **3. Other claims raised in the requests for this Panel**

7.8 We note that the requests by the United States and New Zealand for the establishment of this Panel also alleged violations of Articles X, XI and XIII of GATT 1994. However, neither the United States nor New Zealand further pursued any of these claims during the Panel proceedings.

### **B. THE SPECIAL MILK CLASSES SCHEME**

#### **1. Summary of claims and arguments of the parties**

- (a) New Zealand and the United States

7.9 New Zealand and the United States claim that under Classes 5(d) and (e), processors of dairy products for export are given access to milk at prices lower than those applying to milk for the manufacture of the same products for domestic consumption. In their view, this is done in order to

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<sup>375</sup> Our terms of reference, set out in document WT/DS103/5 and WT/DS113/5, only mandate us to "examine, in the light of the relevant provisions of the covered agreements cited by the United States in document WT/DS103/4 and by New Zealand in document WT/DS113/4, the matters referred to the DSB respectively by the United States and New Zealand in these documents" (emphases added). These documents, the requests for this Panel, were submitted to the DSB and incorporated in our terms of reference on 25 March 1998. The matters referred to therein, and thereby subjected to our review, do not include within their scope marketing year 1997/1998.

remove surpluses of milk in a way that allows Canadian processors/exporters of dairy products to compete in export markets.

7.10 With respect to milk produced within the limits of the allocated producer quotas ("in-quota milk"), the Complainants argue that making milk available for use in exports at lower prices - under either Class 5(d) or (e) - can only be sustained because of the government's involvement, in particular the governmentally-imposed pooling of the relatively low returns from these exports with the higher returns obtained from milk sold for use on the domestic market. On these grounds, New Zealand and the United States submit that Classes 5(d) and (e) constitute an export subsidy whereby, as a result of extensive governmental involvement, *producers* are required to share the cost of selling milk at lower prices for export use and *processors/exporters* benefit from the cheaper milk made available to them to be competitive on export markets. In their view, the mechanism stimulates the removal of milk surpluses by way of exports.

7.11 In response to questions put to them by the Panel, the complainants clarified that their claims also cover exports generated under Class 5(e) from milk produced *in excess of* the allocated producer quotas ("over-quota milk"). This milk, as well, is sold for export at a lower price than the domestic milk price. However, as opposed to in-quota milk sold for export, the relatively low revenues from over-quota milk for export are generally *not* pooled with the higher revenues from milk used domestically. Nevertheless, for the complainants, the extent of federal and provincial governmental involvement in the arrangements under which milk is made available for export at lower prices – irrespective of whether the returns are pooled - suffices to conclude that the dairy products produced with over-quota milk are being exported with the help of export subsidies. According to the complainants, it is irrelevant for the processor producing for export - who can buy the milk at a cheaper price - whether the milk was produced in- or over-quota. The complainants submit that the competitive benefit thereby granted to processors/exporters could not exist without the governmentally established and enforced Special Milk Classes Scheme and that this benefit thus constitutes an export subsidy.

(b) Canada

7.12 Canada argues that the Special Milk Classes Scheme is producer driven and not directed by the government. Canada submits that milk producers producing for export follow commercial considerations and react to world market signals, not to government directions. According to Canada, the government does play a role in the scheme but one that is limited and essentially responsive to the initiatives of the industry. For Canada, the government only has an oversight function to protect the public interest.

7.13 With respect to in-quota milk sold for export, Canada argues that producers are free to collectively determine whether and to what extent they wish to provide in-quota milk for export purposes. According to Canada, the lack of government control, direction or coercion in exporting milk at a lower price is even more apparent with respect to over-quota milk. Canada submits that any qualified dairy producer in Canada is free to produce as much milk as it chooses. Milk produced over-quota is sold for export at a price based on actual world prices. According to Canada, that is also the price the producer receives since the returns from over-quota milk are not pooled with higher domestic milk returns.

7.14 Canada further argues that under the Agreement on Agriculture it was required to replace earlier quantitative restrictions on imports of milk with tariffs. Under the former quantitative restrictions regime, Canada had an obligation to also impose domestic restrictions on the production of milk (in accordance with Article XI:2(c)(1) of GATT). Under the new regime, no such domestic restrictions are required. As a result, Canada was free to produce more, including milk for export. According to Canada, the fact that it imposes tariffs leads to higher domestic prices. For exports,

however, lower prices have to prevail in order to compete on world markets. A system of sales at differing prices for domestic and export markets is the consequence. Upholding the complainants' claims would, according to Canada, mean that any such two-tiered system would constitute an export subsidy. This would, according to Canada, in effect mean that a Member imposing tariffs on imports of a product (e.g., milk) can no longer export that product (e.g., milk domestically produced) without being considered to be granting export subsidies.

## **2. The Panel's decision of 16 December 1998**

7.15 We submitted three sets of questions to the parties. The first set was submitted subsequent to our first substantive meeting; the second set after our second substantive meeting; and the third set after receipt of the answers to the second round of questions. We gave ample opportunity to each of the parties to comment on each others' answers.

7.16 After receipt of the US answers to our second set of questions, Canada raised an objection. In a letter dated 8 December 1998, Canada requested us to disregard US Exhibits 56 and 57 – containing data comparing milk prices under Classes 5(d) and (e) to milk equivalent prices under the Import for Re-Export Program (Exhibit 56) and to so-called international prices for milk, butter and skim milk powder (Exhibit 57) – which had been submitted by the United States together with its answers to the second round of Panel questions (in particular, Panel Questions 13 and 14 to the complainants<sup>376</sup>). Canada made this objection on three grounds. First, Canada argued, these Exhibits contain substantial new factual information that is not required to respond to the Panel's questions. Second, according to Canada, the Exhibits are not relevant to the Panel questions at hand. Third, Canada submitted, the figures have been developed using a highly suspect and very opaque methodology that resulted in some glaring inaccuracies in the numbers. In response, the United States, in a communication dated 14 December 1998, noted that its Exhibits 56 and 57 are directly responsive to the Panel's questions and that, even if the methodology used in these Exhibits were to be flawed, this would not be a basis to disregard the data; at most, the weight to be given to this evidence could be affected.

7.17 Paragraph 7 of our Working Procedures provides as follows:

"Parties shall submit all factual evidence to the panel no later than during the first substantive meeting, except with respect to evidence necessary for purposes of rebuttal submissions or answers to questions. Exceptions to this procedure will be granted upon a showing of good cause. In such cases, the other party shall be accorded a period of time for comment, as appropriate".

In a letter sent to the parties on 16 December 1998 the Panel decided the following:

"First of all the Panel would like to thank the parties for their considered and thorough replies to the Panel's questions, which have helped to clarify both the specific matters in respect of which questions have been raised as well as related issues before the Panel.

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<sup>376</sup> Question 13 reads: "The Import for Re-Export Program - a) Does the reference to 'products', within brackets, in the last part of Paragraph (d) of the Illustrative List, include 'like or directly competitive products'? - b) Do you consider that skim or whole milk powder are 'like or directly competitive' with fluid industrial milk?". Question 14 reads: "Please comment on Question 18 to Canada below". Question 18 to Canada reads: "If sales of products under special class 5(e) are to be competitive in world markets, the price at which products derived from out of quota milk are made available to exporters will have to be below market prices, in order for the transactions to be commercially viable from the exporters' point of view. Is there a risk or threat of such prices for particular transactions being below world market prices? Please comment in detail on this matter taking into account your replies to question 17 above. New Zealand and the United States are also invited to comment on this matter".

In the Panel's view the data submitted by the United States is both relevant and responsive in the general context in which the Panel's questions were raised, including, in the case of question 13, the competitive relationship between the products in question.

In these circumstances the Panel, whose responsibility or task it is to decide what ultimately is or is not relevant and material in this case, does not consider that it would be appropriate at this stage to exclude from consideration this or any other generally relevant information or data that has been submitted to it.

However, the Panel notes the concerns expressed by Canada regarding the volume and complexity of the data submitted by the United States and in the circumstances extends to Canada an additional week (until 23 December) to provide the Panel with more extensive or additional comments on the United States replies than was possible within the previously established time limits".

### **3. The Agreements referred to and the sequence in which the Panel will address the claims**

#### **(a) The Agreement on Agriculture and the SCM Agreement**

7.18 Both complainants invoke the Agreement on Agriculture. Article 2 of this agreement provides that it applies to the agricultural products listed in Annex I. The "agricultural products" set out in Annex I include the products at issue in this dispute (butter, cheese and "other milk products"), all of which fall under HS Chapter 4. We thus find that the Agreement on Agriculture applies to the issue at hand.

7.19 The United States also invokes Article 3 of the SCM Agreement, which contains, *inter alia*, a general prohibition on export subsidies. However, according to its own terms, Article 3 of the SCM Agreement is qualified in its application to agricultural export subsidies by the provisions of the Agreement on Agriculture. Article 3.1 provides as follows:

"Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited ...".

In this respect, Article 21 of the Agreement on Agriculture also provides that:

"[t]he provisions of GATT 1994 and of other Multilateral Trade Agreements in Annex 1A to the WTO Agreement [including the SCM Agreement] shall apply subject to the provisions of this Agreement".

7.20 The general position under the Agreement on Agriculture is that a Member is permitted to use export subsidies but only within the limits of the budgetary outlay and quantity commitment levels, if any, that are specified in that Member's WTO Schedule. The use of agricultural export subsidies beyond such scheduled limits is in effect prohibited by Article 3.3, Article 8 and Article 10 of the Agreement on Agriculture.

7.21 The use of export subsidies beyond such scheduled limits is, in principle, also actionable under the prohibition in Article 3 of the SCM Agreement. However, by virtue of Article 13 (c) (i) of the Agreement on Agriculture, export subsidies that conform fully to Part V of the Agreement on

Agriculture are exempt from actions based on Article 3 of the SCM Agreement for the duration of the "implementation period" (*in casu*, up to 31 December 2003).

7.22 Accordingly, our conclusion with respect to whether the Special Milk Classes Scheme constitutes an export subsidy within the meaning of the Agreement on Agriculture that fully conforms with Part V of that Agreement (which includes Articles 8 to 11 as well as, by reference, Article 3.3), may be dispositive of the US claim for breach of Article 3 of the SCM Agreement.

7.23 On these grounds<sup>377</sup>, the Panel will first examine the claims made under the Agreement on Agriculture. At the same time we note that the parties do not disagree that the SCM Agreement is important to the contextual interpretation of the provisions of the Agreement on Agriculture dealing with export subsidies. As stated by the Appellate Body in its report on *Brazil – Measures Affecting Desiccated Coconut*:

"[W]ith respect to subsidies on agricultural products ... [t]he *Agreement on Agriculture* and the *SCM Agreement* reflect the latest statement of WTO Members as to their rights and obligations concerning agricultural subsidies".<sup>378</sup>

(b) The Agreement on Agriculture

(i) *General outline*

7.24 As this is the first case brought before a panel which involves the substantive provisions of the Agreement on Agriculture relating to export subsidies, we consider it appropriate to provide an outline of these provisions. They form part of the context within which the specific provisions invoked by the complainants and the related claims must be addressed. They also reflect the object and purpose of the Agreement on Agriculture, another element we need to take into account when examining the issues before us.<sup>379</sup>

7.25 As enunciated in the preamble to the Agreement on Agriculture, the main purpose of the Agreement is to "establish a basis for initiating a process of reform of trade in agriculture"<sup>380</sup> in line with, *inter alia*, the long-term objective of establishing "a fair and market-oriented agricultural trading system".<sup>381</sup> This objective is pursued in order "to provide for substantial progressive reductions in agricultural support and protection sustained over an agreed period of time, resulting in correcting and preventing restrictions and distortions in world agricultural markets".<sup>382</sup>

7.26 The general aim of the Uruguay Round negotiations on agriculture was to "achieve greater liberalisation of trade in agriculture and bring all measures affecting import access and export competition under strengthened and more operationally effective GATT rules and disciplines".<sup>383</sup> In the case of export competition this was to be achieved by "improving the competitive environment by increasing discipline on the use of all direct and indirect subsidies and other measures affecting directly or indirectly agricultural trade, including the phased reduction of their negative effects and

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<sup>377</sup> See paras. 7.19-7.22.

<sup>378</sup> Appellate Body Report on *Brazil – Desiccated Coconut*, *op. cit.*, p. 14.

<sup>379</sup> In accordance with the principles of treaty interpretation contained in the Vienna Convention on the Law of Treaties (Article 31).

<sup>380</sup> Preambular paragraph 1.

<sup>381</sup> Preambular paragraph 2.

<sup>382</sup> Preambular paragraph 3.

<sup>383</sup> Punta del Este Declaration, Ministerial Declaration on the Uruguay Round, MIN.DEC, 20 September 1986, p. 6.

dealing with their causes".<sup>384</sup> The results of these negotiations take the form of: (i) the specific binding reduction commitments on both export subsidies and domestic support which have been incorporated in Members' Schedules pursuant to Article 3.1 of the Agreement on Agriculture as constituting "commitments limiting subsidization"; and (ii) the rules set out in the Agreement on Agriculture itself, which are designed to protect the scheduled commitments and provide a new framework to govern the use of agricultural export subsidies and domestic support.

7.27 The fundamental general provision of the Agreement on Agriculture concerning export subsidies is Article 8:

"Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule".

Article 1(e) of the Agreement defines the term "export subsidies" ("unless the context otherwise requires") as referring to: "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement". This listing of export subsidies and the related base period for subsidised export quantities and budgetary outlays served as the basis for the establishment of the scheduled Uruguay Round reduction commitments. Under Article 9.1 the following export subsidies are subject to reduction commitments under the Agreement:

- (a) the provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance;
- (b) the sale or disposal for export by governments or their agencies of non-commercial stocks of agricultural products at a price lower than the comparable price charged for the like product to buyers in the domestic market;
- (c) payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived;
- (d) the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight;
- (e) internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments;
- (f) subsidies on agricultural products contingent on their incorporation in exported products".

7.28 By virtue of Article 3.3 of the Agreement, the list in Article 9.1 lays the foundation for the core rules of the Agreement relating to export subsidies. Article 3.3 provides:

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<sup>384</sup> *Ibid.*

"Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule".

7.29 The Article 3.3 prohibition relates exclusively to the export subsidies listed in Article 9.1. All other subsidies contingent upon export performance as defined in Article 1(e) of the Agreement are subject to the provisions of Article 10 relating to the prevention of circumvention of export subsidy commitments. Article 10.1 provides as follows:

"Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments".

Thus, a Member may use export subsidies not listed in Article 9.1 within the limits of its scheduled reduction commitments. However, as stipulated by Article 10.1, such subsidies may not be applied so as to circumvent these and other export subsidy commitments under the Agreement on Agriculture.

(ii) *The specific provisions relied upon by the parties*

7.30 Both complainants invoke Articles 3.3, 8, 9.1 and 10 of the Agreement on Agriculture, quoted above.

7.31 Since Article 9.1 sets out the explicit reduction commitments entered into by Canada, as opposed to Article 10 which deals with circumvention of those commitments, we shall first examine whether the Special Milk Classes Scheme involves an export subsidy listed in Article 9.1. Both complainants also first address Article 9.1. We prefer this sequence to Canada's approach of first examining whether the scheme is a "subsidy" more generally with particular reference to the SCM Agreement. What needs to be examined here in the first place is whether an "export subsidy" is provided for quantities of exports of agricultural products in excess of the reduction commitments made by Canada under the Agreement on Agriculture. In our view, the most specific and appropriate language provided to make this determination is found in Article 9.1 of the Agreement on Agriculture - setting out specific practices as "export subsidies" explicitly made subject to Canada's reduction commitments -; not in Article 1 of the SCM Agreement pursuant to which certain practices are deemed to be a "subsidy" for purposes of the SCM Agreement.

#### **4. Burden of proof as a consequence of Article 10.3 of the Agreement on Agriculture**

7.32 We note, prior to our analysis of Article 9.1, that Article 10.3 provides as follows:

"Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question".

7.33 This provision shifts the burden of proof from the complainant to the defendant. A defending party (i.e., the exporting country) alleging that exports in excess of its reduction commitment level are not subsidized must demonstrate that no export subsidy in respect of this excess has been granted. All

parties in dispute agree that the wording of Article 10.3 has this effect of reversing the usual burden of proof.<sup>385</sup>

7.34 In this dispute, all parties agree that the actual exports of butter, cheese and "other milk products" made by Canada, exceed Canada's reduction commitment levels and this for both marketing years at issue (1995/1996 and 1996/1997).<sup>386</sup> Canada claims that these quantities exported in excess of its reduction commitment levels are *not* subsidized. It is thus for Canada to establish that the quantity of exports exceeding its commitment levels has *not* been made subject to "export subsidies". In other words, for purposes of the claims before us, it is for Canada to present evidence sufficient to establish a presumption that the Special Milk Classes Scheme does *not* involve an "export subsidy, whether listed in Article 9 or not". Once such presumption is established, it is for New Zealand and the United States to present evidence to rebut this presumption.<sup>387</sup> New Zealand and the United States responded *in extenso* to the claim that the export quantities in question are not subject to export subsidies. Thus, our task is essentially to weigh the evidence and determine whether Canada has met the burden imposed by Article 10.3.

## 5. Article 9.1(a) of the Agreement on Agriculture

7.35 The complainants rely on Article 9.1(a) and (c). Both provisions define a type of export subsidy that is subject to Canada's reduction commitments. The parties do not disagree that there may be some degree of overlap between various sub-paragraphs of Article 9.1. The complainants submit that the provision of milk under Classes 5(d) and (e) of the Special Milk Classes Scheme involves export subsidies under both Article 9.1(a) and Article 9.1(c).

7.36 We first examine whether there is an Article 9.1(a) export subsidy at issue. Article 9.1(a) subjects the following type of action to Canada's export subsidy reduction commitments:

"the provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance".

7.37 The complainants submit that in this case Canadian government agencies – in particular, the Canadian Dairy Commission ("the CDC") and the provincial milk marketing boards acting under delegated authority – make milk available to processors/exporters under Classes 5(d) and (e) at prices lower than the prevailing domestic milk price. In their view, this constitutes an export subsidy under Article 9.1(a).

7.38 Under Article 9.1(a), an export subsidy exists if the following conditions are fulfilled:

- (a) the presence of "direct subsidies, including payments-in-kind";
- (b) provided "by governments or their agencies";
- (c) "to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board";  
and

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<sup>385</sup> See, in particular, Canada's answer to Panel Question 14 to Canada.

<sup>386</sup> See Table 2 in para. 2.41 above.

<sup>387</sup> See Appellate Body report on *United States – Measures Affecting Imports of Woven Wool Shirts and Blouses from India*, adopted on 23 May 1997, WT/DS33/AB/R, pp. 13-14.

(d) which are "contingent on export performance".

7.39 The record shows that milk is made available to *processors/exporters* under Classes 5(d) and (e). We consider that Article 9.1(a) applies to processors and exporters as either "a firm", "an industry" or "producers of agricultural products". We note that no party argued that producers or exporters were to be excluded from the application of Article 9.1(a). We thus find that the third condition under Article 9.1(a) is met in the instant case.

7.40 The record also shows, and Canada does not argue otherwise, that lower priced milk under Classes 5(d) and (e) is only available to processors for the processing of *dairy products which will be exported*. Accordingly, access to milk at a discounted price under Classes 5(d) and (e) is "contingent on export performance" in the sense of the fourth condition under Article 9.1(a). Milk for the production of *dairy products to be sold on the Canadian market* is only available at a higher price under one of the other milk classes (Classes 1 to 5, excluding 5(d) and (e)). A processor that buys milk under Classes (d) or (e), but subsequently uses the milk for domestic purposes, has to pay the price differential up to the level of the domestic milk price, plus interest calculated on the price differential starting from the time of transaction to the date of payment.<sup>388</sup>

7.41 The United States also makes claims under milk classes other than Classes 5(d) and (e). In this regard, we note that milk under such other classes is also available (often exclusively) to processors which produce for the domestic market. Accordingly, access to milk under such other classes is not "contingent on export performance". We therefore find that such other milk classes do not involve an export subsidy under Article 9.1(a).

7.42 The question is then whether the availability of milk under Classes 5(d) and (e) also meets the first and second conditions of Article 9.1(a): (i) does it provide "direct subsidies, including payments-in-kind"; and (ii) are such direct subsidies provided "by governments or their agencies"?

(a) "direct subsidies, including payments-in-kind"

(i) *General criteria*

7.43 The plain language of Article 9.1(a) makes clear that "payments-in-kind" are a form of direct subsidy. Hence, a determination in the instant matter that "payments-in-kind" exist would also be a determination of the existence of a direct subsidy.

7.44 We first note that, when referring to subsidies (as Article 9.1(a) does), the ordinary meaning of the term "payment" cannot reasonably relate to a "payment" as the term is understood in contract law (e.g., pay for labour or the price of a good). Rather, it connotes a gratuitous act, a bounty or benefit provided, for example, in pursuit of a policy objective (e.g., in the area of export subsidies, the stimulation of exports to dispose of surpluses in the domestic market). A reading of Article 9.1(a) to the effect that a "payment" exists only if a benefit is granted, is further mandated by the general context of this provision which includes Article 1 of the SCM Agreement.<sup>389</sup> That provision explicitly requires that a "benefit" be conferred for there to be a "subsidy" under the SCM Agreement.<sup>390</sup>

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<sup>388</sup> See Canada's answer to Panel Question 23 to Canada. In Quebec, the processor will also have to pay a penalty of \$12/hL.

<sup>389</sup> See para. 7.23.

<sup>390</sup> Article 1.1(b) of the SCM Agreement provides: "For the purpose of this Agreement, a subsidy shall be deemed to exist if: ... (b) a benefit is thereby conferred".

7.45 Secondly, the term "payments-in-kind" in Article 9.1(a) must be ordinarily construed to include payment in goods or labour as opposed to payment of money.<sup>391</sup> We agree with the complainants that both the provision of a good at no price and the provision of a good at a price lower than the normal price (whatever this normal price may be) can be considered as a payment in kind.

(ii) *Milk sales under Special Milk Classes 5(d) and (e): the provision of milk for the processing of dairy products for export at a lower price*

7.46 In the present case, no money is given gratuitously to processors/exporters. However, the complainants submit that under the Special Milk Classes Scheme processors/exporters receive a payment in kind, namely *milk at a price which is lower than that of milk sold for use on the domestic market*.

7.47 We noted above that a benefit must be conferred for a payment in kind to exist in the sense of Article 9.1(a).<sup>392</sup> In this case, the question thus arises whether the provision of milk to processors/exporters under Classes 5(d) or (e) confers a benefit to these processors/exporters. This, in turn, raises the question of what the appropriate benchmark is for determining whether the provision of a good at a certain price confers a benefit.<sup>393</sup> Does it suffice, as the complainants argue, that milk for export use is provided to processors at a price below the *domestic milk price* for there to be a benefit conferred to these processors (hereafter referred to as "the first benchmark", namely the domestic milk price)? Or, does one need to establish that processors/exporters receive milk under Classes 5(d) and (e) at a price which is not only lower than the domestic milk price, but also lower than the price of milk these processors/exporters can obtain from any other source, in particular the price of milk they can source from the world market (hereafter referred to as "the second benchmark", namely the lowest milk price to be obtained from any other source)?

7.48 If milk were provided below the lowest milk price to be obtained from any other source (i.e., below the second benchmark), it would *a fortiori* be provided below the domestic milk price (i.e., below the first benchmark). In other words, if we were to find that milk is provided below the second benchmark, there would be no need to further examine whether it is also provided below the first benchmark. Without making a finding on the issue of the appropriate benchmark we shall, therefore, in the first instance, proceed on the assumption that the second benchmark, although more favourable to Canada, is appropriate in the circumstances. In our view, if the price of milk under Classes 5(d) and (e) is lower than the price at which processors/exporters can obtain milk from any other source, a bounty or benefit – i.e., something they would otherwise not have obtained – would, indeed, be conferred. If this were the case, we consider that processors/exporters would be receiving "payments-in-kind" in the sense of Article 9.1(a).

7.49 We therefore next examine whether processors/exporters can access milk from any other source on terms and conditions, in particular prices, as favourable as those offered under Classes 5(d) and (e).

7.50 We note, first, that under Classes 5(d) and (e) milk is made available to processors for export at a significantly lower price than the price of milk *for domestic use*.<sup>394</sup> Canada does not contest this. Classes 5(d) and (e) thus make available milk at prices that are clearly below the first benchmark we

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<sup>391</sup> The *New Shorter Oxford English Dictionary* defines "in kind" as "in goods or labour as opp. to money; (b) in a similar form, likewise" (Ed. Brown, L., Clarendon Press, Oxford, Volume 1, p. 1489).

<sup>392</sup> See para. 7.44.

<sup>393</sup> We note, in this respect, that Article 1.1(b) of the SCM Agreement – to which we referred when noting the requirement of a "benefit" being conferred in paragraph 7.44 above – only requires that there be a benefit in the general sense and that the benefit in fact be conferred by the measure or arrangement which is alleged to be a subsidy.

<sup>394</sup> See Table 3 in para. 2.51.

referred to above.<sup>395</sup> Moreover, referring to the second benchmark, it is not disputed that sourcing milk from any of the other milk classes for use mainly on the domestic market (Classes 1 to 5(c)) would not offer processors/exporters the same favourable price as that of milk available under Classes 5(d) or (e).<sup>396</sup>

7.51 Second, given the high tariffs applied by Canada to imports of fluid milk<sup>397</sup> (283.8 per cent, declining to 241.3 per cent in 2001), the price of milk under Classes 5(d) and (e) is not only significantly lower than the domestic milk price, it is also significantly lower than the duty paid price of imported fluid milk. Canada does not dispute this nor does it contest that for all intents and purposes the over-quota tariff rate it imposes on imports of fluid milk effectively precludes such imports. For purposes of the second benchmark, importing fluid milk cannot therefore be considered as a source of milk at the same favourable price as that of milk offered under Classes 5(d) or (e).

7.52 Canada submits that processors for export can access their milk inputs on equally favourable terms and conditions as those under Classes 5(d) and (e) under its special Import for Re-Export Program.<sup>398</sup> With respect to imports of fluid milk under this Program Canada acknowledges that "there have not been imports of raw industrial milk in recent years under the Import for Re-Export Program".<sup>399</sup> Canada argues, however, that under the Import for Re-Export Program processors/exporters can nonetheless import milk derivatives, such as skim milk powder, whole milk powder, butter and butter derivatives. According to Canada, these milk components are not different from milk, but part of the same product and can be used for the same manufacturing processes as milk.

7.53 We note that under the Import for Re-Export Program the decision as to whether fluid milk or milk derivatives may enter the Canadian market depends, first and foremost, on the discretionary authority of the Department of Foreign Affairs and International Trade. The statutory authority for the Program is contained in paragraph 8 of the Export and Import Permits Act. Paragraph 8 (1) allows the Minister responsible for the Act to "issue to any resident of Canada applying therefor a permit to import goods included in an Import Control List, in such quantity and of such quality, by such persons, from such places or persons and *subject to such other terms and conditions as are described in the permit or in the regulations*".<sup>400</sup> Canada states that the authority of the Minister to set these terms and conditions is not subject to any specified regulations. Therefore - even if imports of fluid milk and milk derivatives under the Import for Re-Export Program could in theory be made at an equally favourable price to the one offered under Classes 5(d) and (e) - the fact that the Minister has to issue a permit before such imports are allowed and that the Minister disposes of a wide discretion in doing so, is proof that these imports are not effectively available under equally favourable terms and conditions as those offered under Classes 5(d) and (e). After all, whether or not processors for export access fluid milk or milk derivatives under this Program depends, in the first place, not on commercial considerations (i.e., price), but on the discretion of Canadian authorities.

7.54 We further note that processors for export have so far never accessed *fluid milk* for commercial use under this Program.<sup>401</sup> Canada argues that no such imports of fluid milk are made due to commercial reasons, namely, the high costs of transport of fluid milk. Canada also refers to the

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<sup>395</sup> See para. 7.47.

<sup>396</sup> See Table 3 in para. 2.51.

<sup>397</sup> Other than the fluid milk falling under the 64,500 tonnes tariff-rate quota which Canada restricts to cross border imports by Canadians of consumer packaged milk for personal use, valued at less than C\$20 per entry.

<sup>398</sup> See para. 2.11.

<sup>399</sup> Canada's oral statement at the second substantive meeting, para. 74. In its comments on US Exhibit 56, Canada clarified that "much of the fluid milk imported under the Import for Re-export Program is imported in retail packages for use on cruise ships".

<sup>400</sup> Emphasis added.

<sup>401</sup> See para. 7.52 and footnote 399.

fact that fluid milk is of a perishable nature and thus of limited tradability. We note, however, that fluid milk could be imported from the United States (given its proximity to Canada). In view of the US claim before this Panel to have wider access to the Canadian market for fluid milk (under Canada's tariff-rate quota)<sup>402</sup>, one can assume that imports of fluid milk are, in principle, technically and commercially viable. Nonetheless, under the Import for Re-Export Program no such imports are made. In our view, this indicates that the specific sales terms and conditions under the Program are clearly not commercially attractive relative to those offered under Classes 5(d) or (e).

7.55 In addition, with respect to access to *milk derivatives* under the Import for Re-Export Program, we note the Complainants' arguments that there are inherent differences between fluid milk - available under Classes 5(d) and (e) - and milk derivatives which can be imported under the Program. Skim milk powder, for example, does not contain any butterfat, thus requiring additional processing for its use in certain dairy products. Because fluid milk contains butterfat it is not subject to a similar constraint. Whole milk powder, on the other hand, does contain butterfat but since all liquid has been removed from it, for most end-uses it has to be rehydrated before it can be used. The same constraint applies to skim milk powder, but not to fluid milk. In both instances, additional time and cost are involved when using milk powder as an input rather than fluid milk. The United States further submits that the use of milk powder might also alter the flavour of the finished product from that which would be obtained by using fluid milk. Canada seems to acknowledge some of these elements when it states that "milk powders can be reconstituted for use in the manufacture of *some* dairy products ... Thus, *to a certain extent*, milk powders compete in the same markets and fulfil the same needs and uses as fluid industrial milk".<sup>403</sup>

7.56 In our view, even if such milk derivatives were directly competitive with fluid milk, we note that (i) figures submitted by the United States indicate – albeit in general terms only - that the milk equivalent prices for the milk derivatives imported under the Import for Re-Export Program were, over the last four years, *higher* than the price of fluid milk provided under Classes 5(d) and (e)<sup>404</sup>; and (ii) processors for export have revealed an overwhelming preference for Classes 5(d) and (e) milk, as opposed to sourcing inputs from the Program (exports generated with Classes 5(d) and (e) milk account for approximately 95 per cent of total actual exports).<sup>405</sup> Indeed, in our view, the fact that fluid milk and milk derivatives surplus to Canadian domestic requirements are regularly disposed of (without accumulation of stocks) raises a presumption that the terms and conditions available under Classes 5(d) and (e) are more favourable than those under the Import for Re-Export Program. The elements outlined above indicate that milk derivatives cannot, for all practical purposes, be sourced under the Program on equally favourable terms and conditions as those under Classes 5(d) or (e).

7.57 For the above reasons<sup>406</sup>, we find that Canada, in relation to Classes 5(d) and (e), has *not* met its burden<sup>407</sup> of establishing that the Import for Re-Export Program provides processors for export with access to milk - or even milk derivatives for that matter - on equally favourable terms and conditions as those available under Classes 5(d) or (e).

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<sup>402</sup> See paras. 7.142 ff.

<sup>403</sup> Canada's answer to Panel Question 28(f) to Canada, emphasis added.

<sup>404</sup> See US Exhibit 56. In our decision of 16 December 1998, outlined above in para. 7.17, we decided that we can take cognizance of the figures contained in this Exhibit. We carefully considered Canada's objections to these figures set out in Canada's comments of 23 December 1998. Although these figures seem to include certain inaccuracies and can therefore only provide a general indication, we do not consider that Canada's objections are so serious that no weight at all should be attached to Exhibit 56. We note, moreover, that Canada did not provide figures or indications to effectively rebut the general tendency shown by the US figures. Moreover, in the view of the Panel, the fact that some of the data supplied by Canada on exports under the Import for Re-Export Program related to imports and re-exports of dairy products by visiting cruise ships, casts doubt on the relevance of this data and of the Program itself.

<sup>405</sup> See Canada's answers to Panel Questions 1 and 3(b) to Canada.

<sup>406</sup> See paras. 7.52-7.56.

<sup>407</sup> See para. 7.34.

7.58 More generally - and for all the reasons outlined above<sup>408</sup> - we find that the provision of milk to processors/exporters under Classes 5(d) and (e) at a price significantly lower than the domestic milk price (i.e., below the first benchmark) and on terms and conditions which are more favourable than those under any other alternative source, including under the Import for Re-Export Program (i.e., below the second benchmark) – confers a "benefit" (in terms of both the first and second benchmarks we set out earlier<sup>409</sup>) to these processors/exporters and, for that reason, constitutes a payment in kind – namely, the provision of a good at a discounted price - in the sense of Article 9.1(a).

(iii) *Milk sales under Special Milk Classes 5(d) and (e): the provision of milk for the processing of dairy products for export by the CDC with an assured margin for the processor*

7.59 In addition to milk being offered at a discounted price otherwise not available, we note that with respect to the export sales conducted by the CDC itself – for which the CDC engages a processor to make dairy products with milk sourced under Classes 5(d) or (e) - there is another element which indicates that processors for export receive special treatment (i.e., a benefit) under Classes 5(d) and (e) which is otherwise not granted on commercial grounds. That is, no matter how low the world price is for the dairy product that a processor is requested to produce - and thus no matter how low the milk price should be in order for the processor to be able to produce the dairy product at such a low price - a Canadian processor for export is always sure to obtain a certain "margin".<sup>410</sup> This processor "margin" covers the cost of transforming milk into, e.g., butter or skim milk powder, and a return on investment for the processors.<sup>411</sup> This margin ensures that, in respect of exports by the CDC, processors are able to access milk at a price which enables the CDC to sell the processed dairy products on the world market at a competitive price. But for the Special Milk Classes Scheme, this guarantee offered to processors/exporters would not be commercially available.

7.60 In our view, this assured processor margin for certain exports generated with milk sourced under Classes 5(d) and (e) confirms the finding we made in paragraph 7.58, namely that the provision of milk to processors/exporters under Classes 5(d) and (e) on the reported favourable terms and conditions confers a benefit to these processors/exporters and, for that reason, constitutes a payment in kind in the sense of Article 9.1(a).

(iv) *Concluding remarks on the payment in kind offered to processors/exporters*

7.61 But for Classes 5(d) and (e), processors for export under the current Canadian milk regime would have to pay a significantly higher price for milk. By accessing this milk, these processors/exporters are effectively shielded from the high domestic milk price, the high import tariffs on fluid milk and – at least in respect of those exports made by the CDC itself - the risk of having to sell dairy products for sale on the world market at a reduced margin or at a loss.

7.62 We want to stress, however, that the existence of this "payment in kind" to processors does not in and of itself establish the existence of an export subsidy within the meaning of Article 9.1(a). In our view, in particular the existence of parallel markets for domestic use and for export with different prices does not necessarily constitute an export subsidy.<sup>412</sup> Whether or not the "payments-in-kind" to

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<sup>408</sup> See paras. 7.53-7.56.

<sup>409</sup> See para. 7.47.

<sup>410</sup> See Section 1 (vii) and 2 (v) of Annex B to the Comprehensive Agreement on Special Class Pooling stating, respectively, "the processor will receive a reduced margin" and "[p]rocessors will receive full margin for the product sold".

<sup>411</sup> See Canadian International Trade Tribunal, Profile of the Canadian Dairy Industry, Staff Report, reference No. GC-97-001, New Zealand Exhibit 8, p. 36.

<sup>412</sup> The price differential may, for example, be a consequence of high – but WTO consistent - import tariffs that can cause domestic prices to be higher than the world market price. In such scenario, efficient producers may take the decision – based on their own profitability - to also produce and sell milk for export, albeit at a lower price than the domestic price. If the decision to sell in either the domestic market or the export market is one made by the individual producer and based on commercial grounds only (e.g., on an allocation of sales to the two markets

processors in this dispute constitute an export subsidy depends on the government's involvement in providing it.<sup>413</sup> This relates to the second condition under Article 9.1(a).

(b) provided "by governments or their agencies"

7.63 Under this condition, we need to examine whether the milk made available to processors for export at a discounted price under Classes 5(d) and (e) – which we found earlier to constitute a payment in kind – is provided by the Canadian governments or their agencies.

(i) *The provision of milk under Classes 5(d) and (e) is not financed by governmental funds but by milk producers either collectively (in-quota) or individually (over-quota)*

7.64 All parties agree that under Classes 5(d) and (e) no governmental funds are directly involved.<sup>414</sup> Neither the Canadian government nor its agencies buy milk at the high domestic price to sell it subsequently, at a loss, at a lower price for export, whereby the cost would be covered by governmental funds. It is undisputed that only the milk producers finance the sales of milk for export. For milk produced within a producer's quota and subsequently exported, the price differential between the price for export and the higher domestic price is collectively borne by all Canadian milk producers. This is so because all in-quota export revenues are pooled with all other in-quota milk returns. This pooling results in an average or pooled milk price – lower than the domestic price - which is the same for all in-quota milk produced by a given producer. Any milk produced over-quota necessarily obtains the lower price for export. However, in principle, only the individual producer who produces the over-quota milk bears the cost of such lower returns. This is so because returns of over-quota milk by one producer are generally not pooled with in-quota returns obtained by other producers.<sup>415</sup>

7.65 In our view, the fact that the government does not grant governmental funds to *finance* the payment in kind does not prevent this payment in kind from being *provided* by the government or its agencies in the sense of Article 9.1(a). The ordinary meaning of the word "provide" is not restricted to a financial contribution. The dictionary meaning of the word "provide" is rather:

"1. foresee. 2. take appropriate measures in view of a possible event; make adequate preparation ... 4. prepare, get ready, or arrange (something beforehand) 5. equip or fit out with what is necessary for a certain purpose; furnish or supply with something 6. ... make available; yield, afford".<sup>416</sup>

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with a view to obtaining a maximised total revenue, taking into account the inherently limited domestic demand for milk and the lower price for export) - not a decision by the government or its agencies taken on behalf of the producers - such scenario would, in our view, not appear to be an export subsidy in the sense of Article 9.1.

<sup>413</sup> In this respect, we note the Panel Report on *Review Pursuant to Article XVI:5 (of GATT 1947)*, addressing the question of when subsidies are notifiable under Article XVI of GATT. There, the Panel stated the following:

"The Panel examined the question whether subsidies financed by a non-governmental levy were notifiable under Article XVI. The GATT does not concern itself with such action by private persons acting independently of their governments except insofar as it allows importing countries to take action under other provisions of the Agreement. In general terms there was no obligation to notify schemes in which a group of producers voluntarily taxed themselves in order to subsidize exports of a product ... the Panel feels that the question of notifying levy/subsidy arrangements depends upon the source of the funds and the extent of government action, if any, in their collection. Therefore ... the Panel feels that CONTRACTING PARTIES should ask governments to notify all levy/subsidy schemes affecting imports or exports which are dependent for their enforcement on some form of government action" (adopted 24 May 1960, BISD9/188, p. 192).

<sup>414</sup> In any event, the complainants did not contest the extent to which the full costs associated with the administration of the scheme for exporting milk surplus to Canadian domestic requirements, are effectively recovered by the CDC and the provincial governments or agencies.

<sup>415</sup> See, however, para. 7.112.

<sup>416</sup> *The New Shorter Oxford English Dictionary*, Ed. Brown, L., Clarendon Press, Oxford, Volume 2, p. 2392.

- (ii) *The degree of government involvement required for there to be a "provision by governments or their agencies" under Article 9.1(a)*

7.66 Canada does not argue that governments are not involved in providing milk under Classes 5(d) and (e). Rather, its position is that governments only have an implementing and oversight role to play in the establishment and efficient operation of the system. According to Canada, such government intervention does not approach the level required by Article 9.1(a). The complainants contend that the system would not exist without governmental intervention and that none of the provisions at issue requires that governments dictate every aspect of a measure for an export subsidy to exist. The complainants conclude that in this case the government involvement in the Special Milk Classes Scheme does meet the level required by Article 9.1(a).

7.67 The question of government involvement required under Article 9.1(a) is one of degree that must be addressed on a case-by-case basis. In this dispute, we need to examine first how milk is made available under Classes 5(d) and (e). Thereafter, we need to assess the extent to which Canadian governments or their agencies are involved in this process. On that basis – and applying the ordinary meaning of the term "provision by governments or their agencies" referred to above<sup>417</sup>, in its context and in light of the object and purpose of the Agreement on Agriculture<sup>418</sup> - we will then decide whether or not the payment in kind made under Classes 5(d) and (e) can be said to be provided by Canada's governments or their agencies.

- (iii) *How milk for export is made available under Classes 5(d) and (e)*

#### Sales of milk for export under Class 5(d)

7.68 Class 5(d) covers so-called "traditional" export sales. These traditional sales – which are calculated into the national quota and thus constitute in-quota milk - are linked to certain trade opportunities, such as tariff-rate quotas of third countries that are traditionally made available to Canadian exporters, as well as sales arising out of longer term trading relationships. The volume of Class 5(d) is a set amount annually fixed by the Canadian Milk Supply Management Committee ("the CMSMC").

7.69 Exporters with access to these traditional markets approach the Canadian Dairy Commission ("the CDC") with proposals to purchase milk under Class 5(d). The CDC negotiates the transaction, including the milk price, and issues a permit which will allow the exporter to obtain the required milk for use in the planned exports from one of the provincial marketing boards. The permits issued by the CDC under Class 5(d) specify the dairy products to be exported.

#### Sales of milk for export under Class 5(e)

7.70 Both in-quota milk – mainly the so-called "sleeve" or safety margin which is finally not used in domestic markets<sup>419</sup> - and over-quota milk can be exported under Class 5(e). The removal of surplus milk by means of exports under Class 5(e) is composed of two operational elements: a CDC-initiated and a processor-initiated surplus removal element.

7.71 A first possibility is that the CDC itself initiates "preemptive surplus removal". In doing so, it "will be guided by an advisory group established by the CDC for that purpose".<sup>420</sup> This advisory

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<sup>417</sup> See para. 7.65.

<sup>418</sup> See paras. 7.24 ff.

<sup>419</sup> See para. 2.40.

<sup>420</sup> Section 1(i) of Annex B to the Comprehensive Agreement on Special Class Pooling.

group, the Surplus Removal Committee ("SRC"), decides whether surplus milk is available in the system. If so, the CDC can activate the preemptive surplus removal program. To do so, the CDC does not have to seek further agreement from the provincial marketing boards that milk surplus to domestic requirements is available. If the CDC decides to activate the program, it will actively remove surplus by contracting with processors for the manufacture of products suitable for export. At this stage, two possibilities arise: either (i) the CDC, acting in its own right, purchases the dairy products and exports them through transactions it negotiates with state importers in other countries, or (ii) the CDC issues permits to processors which will allow these processors to buy milk under Class 5(e) from one of the provincial marketing boards, whereafter these processors themselves, or through traders, export the dairy products produced. The permits issued by the CDC under Class 5(e) specify the dairy products to be exported. In both instances, it is the CDC which negotiates the milk price with the processor. In the event of exports by the CDC itself, it is also the CDC which negotiates and grants the processor margin.<sup>421</sup>

7.72 A second possibility arises during the period in which the CDC initiated surplus removal program is inactive. In these circumstances, "access to CDC contracts to dispose of surpluses will be available when requested by individual processors".<sup>422</sup> In practice, a processor wanting to produce for export first negotiates the terms of a potential sale of dairy products with a foreign buyer. The processor then needs to access milk, in order to produce the dairy product, at a price which will allow it to make the transaction. To do so, the processor has to obtain a permit from the CDC, allowing it to buy milk under Class 5(e). This permit also specifies the dairy products to be exported. The CDC can only issue such permit "when all demand for milk by processors in the province in harmonized Classes 1 to 5(d) is met". It is the CDC which negotiates the milk price with the processor. Once the processor obtains a Class 5(e) permit from the CDC, it approaches the local marketing board which in practice provides the processor with the milk at the negotiated price. Under this second possibility, the CDC itself can also buy the processed dairy products – produced with Class 5(e) milk - and export them in its own right. In that event, processors receive "full margin for product sold", a margin negotiated and granted by the CDC.<sup>423</sup>

(iv) *The extent to which Canada's governments or their agencies are involved in the making available of milk under Classes 5(d) and (e)*

#### Canada's governments and their agencies

7.73 Canada is a federal state with a federal government and ten provincial governments. Regulatory jurisdiction over trade in dairy products is divided between the federal government and the provinces. The federal government has constitutional authority over interprovincial and international trade. All other aspects of production and sale of milk are under provincial jurisdiction. Both the Canadian federal government and provincial governments are "governments" for the purposes of Article 9.1(a).<sup>424</sup>

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<sup>421</sup> Section 1 (vii) of Annex B to the Comprehensive Agreement on Special Class Pooling.

<sup>422</sup> Section 2 (i) of Annex B to the Comprehensive Agreement on Special Class Pooling.

<sup>423</sup> Section 2 (v) of Annex B to the Comprehensive Agreement on Special Class Pooling.

<sup>424</sup> Article XXIV:12 of GATT 1994, part of the context of Article 9.1(a), provides as follows: "Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territory". The Understanding on the Interpretation of Article XXIV of GATT 1994, under Article XXIV:12, explicitly provides that "[t]he provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked in respect of measures affecting its observance taken by regional or local governments or authorities within the territory of a Member". These provisions imply that all GATT provisions apply to "regional and local governments and authorities" within a WTO Member, in accordance with the general principle of public international law that a party to a treaty "may not invoke the provisions of its internal law as justification for its failure to perform a treaty" (set out in Article 27 of the Vienna Convention on the Law of Treaties). Article XXIV may act to limit the obligation of a WTO Member, which is a federal State, to secure the implementation of its GATT obligations. However, in our view, it does not limit the applicability of the provisions of GATT 1994 (see

7.74 Three bodies play a direct decision-making role under Classes 5(d) and (e): the CDC, the provincial marketing boards and the CMSMC.

7.75 First, the CDC is a Canadian Crown Corporation. That the CDC is an "agency" of Canada's federal government in the sense of Article 9.1(a) is undisputed.<sup>425</sup>

7.76 Second, the provincial milk marketing boards are established and operate within a legal framework set up by federal and provincial legislation.<sup>426</sup> These boards exercise powers in respect of inter-provincial and external trade delegated to them by the federal government through the CDC, as well as powers delegated to them by provincial authorities. Three of these boards (Alberta, Nova Scotia and Saskatchewan) are, according to Canada, agencies of the provincial government. Orders or regulations issued by the provincial marketing boards can be enforced before the Canadian courts. In most provinces, individual decisions by the boards are subject to appeal to a provincial supervisory board or commission (of which Canada recognizes the governmental nature).

7.77 While we acknowledge that producers play an important role in the provincial marketing boards, we also note that these boards act under the explicit authority delegated to them by either the federal or a provincial government. Accordingly, they can be presumed to be an "agency" of one or more of Canada's governments in the sense of Article 9.1(a).<sup>427</sup> In this respect, we refer to paragraph 2 of the *Ad* note to Article XVII:1 of GATT 1994<sup>428</sup> as well as to Article XXIV:12 of GATT 1994<sup>429</sup>, both constituting part of the context of Article 9.1(a). That the provincial marketing boards cannot issue orders or regulations without the backing of provincial or federal authority was confirmed by the Canadian courts in the so-called *Bari II* case.<sup>430</sup> In that case, it was found that the provincial marketing boards could not act at the inter-provincial or international level since they did not have the necessary federal authority. This shortcoming has now been rectified by amending the CDC Act.

7.78 In our view, the fact that most of the provincial boards are not formally incorporated as government agencies and that all or most of them are composed, completely or partially, of

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Panel Reports on *Canada – Measures Affecting the Sale of Gold Coins*, L/5863, unadopted, dated 17 September 1985, paras. 53-54 and 63-64; *Canada – Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies*, adopted on 22 March 1988, 35S/37, p. 91, para. 4.33; and *Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, adopted on 18 February 1992, 39S/27, p. 86, para. 5.35).

<sup>425</sup> See paras. 2.12-2.15.

<sup>426</sup> See paras. 2.16-2.20.

<sup>427</sup> In this respect, we refer to Article 7:2 of the Draft Articles on State Responsibility of the International Law Commission (ILC) - which might be considered as reflecting customary international law - which states: "The conduct of an organ of an entity which is not part of the formal structure of the State or of a territorial governmental entity, but which is empowered by the internal law of that State to exercise elements of the governmental authority, shall also be considered as an act of the State under international law, provided that organ was acting in that capacity in the case in question" (Report of the ILC on the Work of its 48<sup>th</sup> Session, General Assembly, Official Records, 51st Session, Supplement No. 1 (A/51/10), under Chapter III).

<sup>428</sup> Paragraph 2 of the *Ad* note to Article XVII:1 of GATT 1994 states: "The activities of Marketing Boards which are established by contracting parties and which do not purchase or sell but lay down regulations covering private trade are governed by the relevant Articles of this Agreement". Since, accordingly, GATT 1994 applies to such activities of "marketing boards" - and the Canadian provincial milk marketing boards are, in our view, such "marketing boards" - one can assume that most of the activities of the Canadian milk marketing boards are governmental in nature.

<sup>429</sup> Provincial marketing boards acting under the authority explicitly delegated to them by federal or provincial governments are, in our view, "regional" or "local" authorities in the sense of Article XXIV:12 of GATT 1994, outlined above in footnote 424. See, in this respect, the 1988 Panel Report on *Canada – Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies*: "The panel noted that there was no dispute that the provincial liquor boards were 'regional authorities' within the meaning of Article XXIV:12" (adopted on 22 March 1988, 35S/37, p. 91, para. 4.33) and the 1992 Panel Report on *Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*: "The Panel noted that the parties to the dispute agreed that the provincial liquor boards were 'regional authorities' within the meaning of Article XXIV:12 of the General Agreement and that this Article was therefore applicable to all provincial practices at issue" (adopted on 18 February 1992, 39S/27, p. 86, para. 5.35).

<sup>430</sup> *B.C. Milk Marketing Board v. Bari Cheese et al.* (11 August 1993), Vancouver C912303 (B.C.S.C.); (14 August 1996), (B.C.C.A.), unreported.

individuals which are also dairy producers, does not alter our conclusion. When - and to the extent that - these boards act under explicit delegated governmental authority, they can be presumed to act as an agency of the government.<sup>431</sup> Nor is our conclusion altered by the fact that the authority thus delegated to the boards offers the boards a certain discretion. It is precisely *because* the boards receive the authority from the governments to regulate certain areas themselves that their actions become governmental. What is important though is that Canadian governments maintain the ultimate control and supervision of most, if not all, of the boards' activities.<sup>432</sup> These governments define, and approve changes to, the boards' mandates and functions.<sup>433</sup>

7.79 The third body which plays a decision-making role under Classes 5(d) and (e) is the CMSMC.<sup>434</sup> The CMSMC was established by the National Milk Marketing Plan (NMMP) which, in turn, is "a federal-provincial agreement in respect of the establishment of a National Milk Marketing Plan for the purposes of regulating the marketing of milk and cream products relating to Canadian domestic requirements and for any additional industrial milk requirements in Canada".<sup>435</sup> The NMMP was entered into by nine provinces<sup>436</sup> and the CDC. The bodies signing on behalf of each province are typically the provincial milk marketing board, the provincial supervisory board (which provides oversight of the operations of the provincial marketing board and is recognized by Canada as a provincial authority) and the provincial Minister for Agriculture. These two entities and the provincial Minister for Agriculture select a single "designated representative" who casts the vote on behalf of the province concerned. The CDC chairs the CMSMC and also has the right to vote. Decisions by the CMSMC are taken by consensus. In certain cases, disagreement is resolved by decision of the CDC. The CMSMC is also "the supervisory body which will oversee the implementation"<sup>437</sup> of the Comprehensive Agreement on Special Class Pooling. This agreement was concluded by the same bodies that are signatories to the NMMP and prevails over the NMMP. Decisions by the CMSMC under the Comprehensive Agreement on Special Class Pooling are taken by consensus. Instead of the CDC resolving disagreements, under the Comprehensive Agreement on Special Class Pooling a specific dispute settlement procedure is provided for.<sup>438</sup>

7.80 We have found that all of the signatories to the NMMP and the Comprehensive Agreement on Special Class Pooling - i.e., the provincial governments and provincial supervisory boards, the CDC

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<sup>431</sup> If we were to accept Canada's argument - namely, that the provincial marketing boards are not governmental agencies because they are composed mainly of milk producers and producer-driven - it would mean that also a decision by a government minister - being, for example, also a farmer or having his or her electoral base in the agricultural sector - which favoured farmers would, for that reason, no longer constitute a governmental action but a private action by farmers.

<sup>432</sup> In the *Bari III* case, for example, the Supreme Court of British Columbia found that the sub-delegation by the Governor in Council (of certain governmental powers granted to him under the CDC Act) to the CDC, the CMSMC and the provincial boards constitutes valid sub-delegation. The Court found that the functions sub-delegated are administrative, not legislative; that the sub-delegation was done out of "administrative necessity"; and that "sufficient direction has been provided ... as to how [the CDC, the CMSC and the boards] are to perform these functions" (*British Columbia Milk Marketing Board and Canadian Dairy Commission v. Luigi Aquilini et al.*, Reasons for Judgment of the Hon. Mr. Justice Wong, 12 September 1997, para. 117).

<sup>433</sup> This delegation of governmental authority to the boards should be distinguished from the government's involvement in creating a legal framework for, e.g., private banks (an example referred to by Canada). The boards are not only provided with a framework within which they can operate; they receive the authority to themselves regulate certain aspects of the milk market. Private banks, on the contrary, are legally recognized and subject to certain rules and thus operate within a framework set by the government. However, they do not - like the boards - receive the power to regulate themselves, e.g., the financial markets.

<sup>434</sup> See paras. 2.27-2.33.

<sup>435</sup> Introduction (A) to the NMMP. On the NMMP, see paras. 2.21-2.26.

<sup>436</sup> All Canadian provinces are parties to the NMMP except for Newfoundland which is, according to Canada, not a party to the NMMP because its milk producers produce almost exclusively for the local fluid milk market and because Newfoundland has not traditionally contributed to the industrial milk supply that is the subject of the NMMP.

<sup>437</sup> Schedule I, Section 1 of the Comprehensive Agreement on Special Class Pooling.

<sup>438</sup> Annex D to the Comprehensive Agreement on Special Class Pooling, according to which the CMSMC first acts as the Supervisory Body in an attempt to resolve the dispute prior to arbitration by an arbitration Panel. The CDC acts as secretariat for all dispute settlement purposes.

and the provincial marketing boards – may be considered as "agencies" of Canada's governments or are effectively Canada's provincial governments. Hence, we must presume that actions taken by these "agencies" or governments through the CMSMC are, in turn, actions taken by an "agency" of Canada's governments. We recognize the influential role played by producers in the CMSMC. At the same time, however, and considering the structure, delegated powers and responsibilities of the CMSMC as outlined above<sup>439</sup>, the concrete government involvement in the CMSMC is more than obvious. The NMMP itself states that "the participation of the Federal and Provincial authorities is required to assure the adoption and implementation" of the NMMP.<sup>440</sup> Most decisions by the CMSMC require the agreement of both the CDC (an agency of the federal government) and the provincial governments signatories to the NMMP (the provincial government is one of the three bodies appointing the "designated representative" of a province). In some instances, the CDC may even decide alone when there is a disagreement between the signatories of the NMMP.

The concrete government involvement in making milk available under Classes 5(d) and (e)

7.81 Given our earlier considerations that the CDC is a government agency and that most of the actions taken by the provincial milk marketing boards and the CMSMC can also be regarded as taken by an "agency" of the government, the answer to the question of whether the milk made available under Classes 5(d) and (e) – which we found earlier to be a payment in kind - is provided by Canada's governments or their agencies, becomes more apparent.

7.82 Under both Classes 5(d) and (e) processors/exporters can only access milk if they obtain a permit from the CDC, a government agency. It is not the individual producer who decides what milk it thus sells for export. It is the CDC, acting on the advice of the Surplus Removal Committee ("SRC")<sup>441</sup>, the CMSMC or the provincial marketing boards, which decides whether domestic requirements are met and whether, therefore, milk should be considered as "surplus" and be exported. Such exports are made, not necessarily because no more milk could be sold on the domestic market at a higher price, but mainly in order to maintain the high domestic price.<sup>442</sup> As noted by the current President of the CDC, Mr. Guy Jacob:

"... the [CDC] is the organization that issues permits whereby secondary processors or exporters can purchase milk at lower prices. In other words, in order for an exporter to be able to buy milk at a lower price, he must first obtain a permit from the [CDC]. It is also the [CDC] that has the ultimate responsibility to ensure that secondary processors or exporters that purchase milk at a lower price do in fact use that milk for the purpose for which the permit was issued".<sup>443</sup>

7.83 Under both Classes 5(d) and (e), once a processor/exporter has obtained the required permit from the CDC, it has to appeal to the provincial marketing board to actually obtain the milk. Although the board is not under an obligation to provide such milk, Canada submits that in practice it always

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<sup>439</sup> See para. 7.79.

<sup>440</sup> Preamble (B) to the NMMP, fourth paragraph.

<sup>441</sup> See para. 7.71.

<sup>442</sup> In the Standing Committee on Agriculture and Agri-Food of 17 March 1998, US Exhibit 45, p. 5, one Member of Parliament (Mr. Jean-Guy Chrétien) argued that many processors are willing and could produce far more dairy products for the domestic market but that they cannot access the required milk; whereas other processors, producing for export, have a much wider access to milk given that "there is no danger of flooding the domestic market". In reply, Mr. Guy Jacob, President of the CDC, stated: "Yes, we are hearing the same message from processors and producers ... Processors are saying that they would have markets and could process more milk if the raw material were available".

<sup>443</sup> Standing Committee on Agriculture and Agri-Food of 17 March 1998, US Exhibit 45, p. 2.

does so. It is, again, not the individual milk producer which independently allocates part of its production to export sales, but rather the provincial marketing board which makes such milk available at the request of the CDC. All milk sales in Canada necessarily have to pass through the provincial marketing board. An individual producer only decides how much it *produces*; it has no control over what part of its production will be exported. The producer only knows that for over-quota production, a lower export return will be obtained.

7.84 It is the CMSMC which sets and periodically adjusts the quota level and thereby decides what share of a producers' milk production is labelled as over-quota and thus obtains lower export returns.<sup>444</sup> It is also the CMSMC which annually sets the amount of milk allowed for export under Class 5(d). For both Classes 5(d) and (e) it is the CDC which, finally, takes the decision whether milk actually gets exported by issuing the required permit. No link exists between what is over-quota for an individual producer and what actually gets authorized for export by the CDC. Indeed, the CDC can even decide that over-quota milk should in fact not be exported but sold domestically to make up a shortfall.<sup>445</sup>

7.85 We recall, in addition, that the CDC negotiates the milk price for transactions under Classes 5(d) and (e), as well as – for exports made by the CDC itself - the processor margin; that the large majority of export sales under these Classes are initiated by the CDC<sup>446</sup>; and that the CDC itself is a major exporter of processed dairy products.<sup>447</sup>

(v) *The Panel's finding on whether the milk is provided by governments or their agencies*

7.86 As outlined above, the CDC, advised by other bodies acting under the authority delegated to them by governments, decides whether or not any and how much milk can be exported. The CDC then – in a very direct way, by providing a permit – makes milk available under Classes 5(d) and (e). Finally, the provincial milk marketing boards, acting under delegated authority, physically offer the milk to processors. We find, therefore, on the basis of the specific circumstances of this case, that the milk made available to processors for export under Classes 5(d) and (e) at a discounted price, is provided by Canada's governments or their agencies in the sense of Article 9.1(a).

(c) The Panel's finding under Article 9.1(a)

7.87 We found earlier that the provision of lower priced milk to processors for export under Classes 5(d) and (e) constitutes a payment in kind to processors/exporters contingent on export performance.<sup>448</sup> We also found that this milk is provided by Canada's governments or its agencies.<sup>449</sup> On these grounds<sup>450</sup>, we find that the making available of milk under Classes 5(d) and (e) constitutes an export subsidy within the meaning of Article 9.1(a).

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<sup>444</sup> The quota level can vary considerably year by year and can even be adjusted during the year, so that it may be difficult for the producer to adjust production to its quota. In 1995/1996 and 1996/1997 the national quota for industrial milk (Market Sharing Quota or MSQ) was 44.2 million hL. In 1997/1998 it was decreased by 3 per cent to 43.3 million hL. In 1998/1999, on the other hand, it was increased by 4 per cent to 44.7 million hL.

<sup>445</sup> This over-quota milk then obtains the higher domestic price, the benefit of which does not go directly to the individual producer (who only gets the lower Class 5(e) return) but is shared among all producers.

<sup>446</sup> In 1995/1996, 96.6 per cent of surplus removal was initiated by the CDC; in 1996/1997, 91.49 per cent; in 1997/1998, 70.61 per cent.

<sup>447</sup> See statement by Mr. Guy Jacob, President of the CDC, Standing Committee on Agriculture and Agri-Food of 17 March 1998, US Exhibit 45, p. 4: "The [CDC] remains a major exporter. Last year [1997] its direct exports totalled some 200 million dollars".

<sup>448</sup> See para. 7.61.

<sup>449</sup> See para. 7.86.

<sup>450</sup> See also paras 7.39 and 7.40.

## 6. Article 9.1(c) of the Agreement on Agriculture

7.88 We have found that the Special Milk Classes Scheme involves an export subsidy as listed in Article 9.1(a). The complainants submit that this scheme also constitutes an export subsidy as listed in Article 9.1(c). This provision subjects the following type of action to Canada's export subsidy commitments:

"payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived".

7.89 In our view, the first part of Article 9.1(c) – "payments on the export of an agricultural product that are financed by virtue of governmental action" - includes the core elements of an export subsidy as listed in that provision. The subsequent part provides further clarification – in an illustrative way - as to the meaning of these core elements. We, therefore, consider that there are two conditions that have to be met for there to be an export subsidy as provided in Article 9.1(c):

- (a) the presence of "payments on the export of an agricultural product";
- (b) which are "financed by virtue of governmental action".

We next examine whether these two conditions are met in this case.

- (a) "payments on the export of an agricultural product"

7.90 We found earlier that the provision of milk at a discounted price under Classes 5(d) and (e) involves "payments-in-kind" in the sense of Article 9.1(a) to processors/exporters that are "contingent on export performance".<sup>451</sup> Under Article 9.1(c) we need to examine whether such provision of milk involves a "payment on the export of an agricultural product". In our view, if the word "payment" in Article 9.1(c) were to include "payments-in-kind", we would have to conclude that the provision of milk at a discounted price under Classes 5(d) and (e) also constitutes a "payment" in the sense of Article 9.1(c). Since, as we saw earlier<sup>452</sup>, the provision of this cheaper milk is only available in case the dairy products produced with it are actually exported, we would then also need to conclude that it constitutes a payment "on the export of an agricultural product".<sup>453</sup> In our view, the term "payment on the export of an agricultural product" means, indeed, that the payment is conditional or contingent on the export of such product (*in casu*, the processed dairy products that are specified in the CDC permits issued under Classes 5(d) or (e)). Our finding as to whether or not the Special Milk Classes Scheme also involves "payments on the export of an agricultural product" in the sense of Article 9.1(c) thus only depends on whether or not the word "payment" in this provision covers not only payments in money but also "payments-in-kind". This is the issue we examine next.

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<sup>451</sup> See paras. 7.40 and 7.58.

<sup>452</sup> See para. 7.40.

<sup>453</sup> Referring to para. 7.41, to the extent that the US claims also cover any of the milk classes other than Classes 5(d) and (e), we note that all of these other milk classes can also (often exclusively) be accessed by processors which produce for the domestic market. Nothing offered under these other milk classes can thus constitute a payment "on the export of" an agricultural product. We therefore find that these other milk classes do not involve an export subsidy as listed in Article 9.1(c).

7.91 We recall that according to the rules of treaty interpretation set out in Article 31 of the Vienna Convention on the Law of Treaties, the meaning of a term is to be determined by reference to its ordinary meaning, read in its context, and in the light of the object and purpose of the treaty.

7.92 As to the ordinary meaning of the word "payment", we note that the *Oxford English Dictionary* defines "payment" as

"1. the action, or an act of, paying; the remuneration of a person with money *or its equivalent*; the giving of money, *etc.* in return for something in discharge of a debt".<sup>454</sup>

This indicates that the ordinary meaning of the word "payment" includes both the act of remunerating a person with money and the act of remunerating a person with its equivalent in kind, a so-called "payment in kind". Indeed, benefits available under the export rebate system in place before the Special Milk Classes were introduced<sup>455</sup> and the provision of *more milk for the same price* under this scheme are, in our view, both captured by the ordinary meaning of the word "payment".

7.93 The validity of this interpretation is confirmed when taking into account the context of the word "payment" as it is used in Article 9.1(c). The immediate context to turn to is, in our view, the second part of Article 9.1(c) which further defines the kind of "payment" required. It refers to a "charge" on the public account (an element *not* required for there to be an Article 9.1(c) export subsidy). We consider that a "charge" can arise both as a consequence of a transfer of money and of the provision of a good at a discounted price. The second part of Article 9.1(c) also provides an example of an export subsidy as listed in that provision. In so doing, it refers to payments "*financed from the proceeds of a levy*". "Financing" a "payment" can, in our view, be done by way of a transfer of money but also by means of charging a discounted price for a good. Therefore, the second part of Article 9.1(c), in our view, implicitly confirms that the notion of "payment" in Article 9.1(c) also covers payments-in-kind, such as the provision of milk at a reduced price.

7.94 We consider that the other provisions of the Agreement on Agriculture also form part of the context of Article 9.1(c). Article 9.1 identifies certain practices as export subsidies subject to the reduction commitments made by WTO Members. These commitments take the form of a ceiling imposed on "budgetary outlays" and on the quantity of exports for which export subsidies can be granted. They are specified for each year of the implementation period in the Schedule of the WTO Member concerned. According to Article 9.2(a), the export subsidy commitment levels represent "*with respect to the export subsidies listed in [Article 9.1]: (i) in the case of budgetary outlay reduction commitments, the maximum level of expenditure for such subsidies that may be allocated or incurred in that year in respect of the agricultural product, or group of products, concerned*".<sup>456</sup> In principle, the ceiling on "budgetary outlays" thus applies to *all* export subsidies listed in Article 9.1, including the Article 9.1(c) export subsidies. The concept of "budgetary outlay", however, is defined in Article 1(c) as including "revenue foregone". Since, therefore, the notion of "payment" in Article 9.1(c) would also include "revenue foregone", it can be implied that "payment" thereby not only includes payment in money terms but also payments-in-kind, i.e., "revenue foregone" by providing milk for use in exports at a discounted price (whereby, *in casu*, higher returns to be obtained on the domestic milk market are "foregone" by producers). In other words, since "revenue foregone" is to be taken into account in calculating the *levels* of reduction commitments – including the level of export subsidies as listed in Article 9.1(c) – it should, implicitly, also be included in the

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<sup>454</sup> *The Oxford English Dictionary* (2<sup>nd</sup> Edition) – Volume XI, Clarendon Press, Oxford, pp. 379-380 (emphasis added).

<sup>455</sup> We note in this respect that Canada, during our proceedings, acknowledged that its previous levy system – where levies were imposed on all milk producers and pay backs were made to processors/exporters with the proceeds of these levies – involved "payments" in the sense of Article 9.1(c).

<sup>456</sup> Emphasis added.

*definition* of the export subsidies for which these reduction commitments are made, including the definition of export subsidies under Article 9.1(c). In our view, this consideration confirms our interpretation that "payment" in the sense of Article 9.1(c) includes "payments-in-kind".

7.95 The idea that the export subsidies identified in Article 9.1 generally, and Article 9.1(c) in particular, also include payments-in-kind and, specifically, the provision of a good at a reduced price, is also confirmed in other sub-paragraphs of Article 9.1. Article 9.1(a) refers to "direct subsidies, including payments-in-kind". Article 9.1(b) mentions the sale or disposal for export of non-commercial stocks "at a price lower than the comparable price charged for the like product to buyers in the domestic market". Article 9.1(d) refers to a *reduction in the costs* of marketing exports. Finally, Article 9.1(e) is directed at *reduced* internal transport and freight *charges* on export shipments. None of the provisions under Article 9.1 – not even Article 9.1(a) which deals with "direct subsidies" – seems to be limited to contributions in money terms only; all of them, in one way or another, explicitly or implicitly, include reference to payments-in-kind such as lower prices or a reduction in costs or charges. In our view, this consideration further confirms our interpretation that "payment" in the sense of Article 9.1(c) includes payment in kind.

7.96 Canada argues that if the drafters of the Agreement on Agriculture had intended the word "payment" in Article 9.1(c) to include payment in kind they would have explicitly added such language. Canada refers to other provisions where such language was added. It refers, in particular, to paragraph 5 of Annex 2 of the Agreement on Agriculture which mentions "direct payments (or revenue foregone, including payments in kind)". However, in our view, this inclusion of "payments in kind" does not qualify or add to the meaning of the word "payment", but to the meaning of the word "*direct* payment". Moreover, if another provision, part of the context of Article 9.1(c), defines "*direct* payments" as including "payments in kind", we consider that it can be presumed that the more general word "payments" in Article 9.1(c) *a fortiori* includes "payments in kind". Nowhere in the Agreement on Agriculture is the word "payment" as such explicitly qualified as excluding or including payment in kind. Article 9.1(a), for example, refers to "*direct subsidies* [not "payments"], including payments-in-kind". As we noted earlier, the ordinary meaning of the word "payment" as well as the context in which it is used in Article 9.1(c), on the contrary, indicate that "payment" includes not only payment in money terms but also payment in kind.<sup>457</sup>

7.97 In the same vein, Canada refers to the Appellate Body report on *Canada – Periodicals* where the term "payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges" in Article III:8(b) of GATT 1994 was interpreted as only including "the payment of subsidies which involve the expenditure of revenue by a government".<sup>458</sup> A reduction of postal rates granted by Canada Post for the distribution of certain publications was thus found to be excluded from the exemption under Article III:8(b). In our view, however, one needs to distinguish the term "payments" as used in Article III:8(b), from that in Article 9.1(c) and this because of the different context in which it is set and the different object and purpose it serves. First, Article III:8(b) only provides a specific *exemption* to the national treatment provisions in Article III for the payment of *certain production* subsidies, namely "the payment of subsidies exclusively to domestic producers".<sup>459</sup> It does not in any way provide a general definition of what a subsidy – let alone an export subsidy – is for purposes of GATT 1994 (and even less so for

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<sup>457</sup> We are not convinced either by Canada's argument that the French text of Article 9.1(c) uses the word "versement" which, according to Canada, connotes only payments in money terms. We note, in this respect, that the French text of Article 9.1(a), when addressing "payments-in-kind", uses the term "versements en nature". This, in our view, confirms that also the meaning of the French term for "payment", namely "versement", does not exclude payment in kind, i.e., "versement en nature".

<sup>458</sup> Appellate Body report on *Canada – Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, p. 36.

<sup>459</sup> Article III:8(b) states: "*The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers ...*" (emphasis added).

purposes of the Agreement on Agriculture). Article 9.1(c), on the other hand, provides a concrete example of an export subsidy, not constituting an exemption to any other provision, but part of a positive list of export subsidies made subject to reduction commitments under the Agreement on Agriculture.<sup>460</sup> Second, Article III:8(b) exempts the "payment of subsidies exclusively to domestic producers" from Article III obligations and provides certain "payments" as an example of such subsidies. In other words Article III:8(b) when giving the example of certain "payments" does not define or further clarify the broader term "subsidy" or "payments" – the latter term being the only one provided in Article 9.1(c) and the term we have to interpret here - but the more narrow term "payment of subsidies exclusively to domestic producers". Recalling also the textual and contextual elements proper to Article 9.1(c) set out above<sup>461</sup> – and not to be found under Article III:8(b) - we thus consider that Canada's reference to Article III:8(b) of GATT 1994 does not alter our interpretation that "payment" in Article 9.1(c) also includes payment in kind.

7.98 Canada further claims that there is no revenue for the producers to forego with respect to sales of milk for export use under Classes 5(d) and (e) and, therefore, no payment in kind made by these producers. It submits that under the Canadian milk marketing system, such milk *cannot* be sold in the market for export uses if it is required for Canadian domestic requirements. Thus, sales of milk for export purposes at prices based on world market prices cannot be made until there is no opportunity to sell milk into domestic markets at the higher domestic prices. According to Canada, "revenue foregone" implies a choice of markets, a choice foregone and in this case producers do not have a choice.

7.99 In response to Canada's argument, we agree that the milk producer - with respect to Classes 5(d) and (e) milk - does *not* have a choice to make between selling its milk at a higher price for domestic use or at a lower price for export. However, we do so for reasons different from those put forward by Canada. As we noted earlier, it is not the milk producer that takes the decision where to allocate its milk production.<sup>462</sup> It is the CDC (acting on the advice of the SRC), the CMSMC and the provincial marketing boards, that decide whether domestic requirements are met and whether, therefore, milk should be considered as "surplus" and be exported. Such exports are made, not necessarily because no more milk could be sold on the domestic market at a higher price, but mainly in order to maintain the high domestic price.<sup>463</sup> If it is thus decided - by means of the issuance of a CDC permit under Classes 5(d) or (e) – that in-quota milk is to be exported, the milk producer *has to* accept a lower price. Through the pooling of all in-quota milk returns, this lower price is reflected in a lower average pooled price granted to milk producers for all of their in-quota milk. With respect to *over-quota* milk, it is again because of Canada's governments or their agencies – through the CMSMC – that a certain quantity of milk is labelled as over-quota. Once so labelled, milk necessarily obtains a lower price based on the world market price. Therefore, whenever producers produce milk over-quota, as defined by Canada's governments or their agencies, they *have to* sell it at a lower export related price.

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<sup>460</sup> In this respect, we note the Panel Report on *Indonesia – Certain Measures Affecting the Automobile Industry*, adopted 23 July 1998, WT/DS54/R, which highlights the special and different context and object and purpose of Article III and Article III:8(b) in particular, when it states in para. 14.33: "As was the case under GATT 1947, we think that Article III of GATT 1994 and the WTO rules on subsidies remain focused on different problems. Article III continues to prohibit discrimination between domestic and imported products in respect of internal taxes and other domestic regulations, including local content requirements. It does not "proscribe" nor does it "prohibit" the provision of any subsidy *per se*"; and in para. 14.43: "We consider that the purpose of Article III:8(b) is to confirm that subsidies to producers do not violate Article III, so long as they do not have any component that introduces discrimination between imported and domestic products. In our view, the wording "payment of subsidies exclusively to domestic producers" exists so as to ensure that only subsidies provided to producers, and not tax or other forms of discrimination on products, be considered subsidies for the purpose of Article III:8(b) of GATT".

<sup>461</sup> See paras. 7.92-7.96.

<sup>462</sup> See paras. 7.82 ff.

<sup>463</sup> See para. 7.82 and footnote 442.

7.100 Canada is, therefore, correct that producers do not have a choice to make with respect to the allocation of Classes 5(d) and (e) milk. However, in our view, this is so (i.e., the producers' choice is predetermined) *not* – as Canada implies - because of commercial reasons (e.g., because of a lower domestic demand the producer - depending on its profitability – decides, in order to maximize its total revenue, to allocate a certain share of its production to lower priced export markets), but because of governmental actions. Under the Canadian system, selling milk for use in the domestic market is no longer an option (i.e., the choice for a higher return is taken away) mainly because the quotas - set by Canadian governments or their agencies - are met; *not* because there is no more domestic demand for milk. As noted earlier, producers would likely be able to sell more milk domestically if they were allowed to do so, albeit probably at a somewhat lower price.<sup>464</sup> In conclusion, we consider that producers do forego a choice or revenue – albeit through governmental action - and, therefore, make a payment in kind to processors/exporters in the sense of Article 9.1(c).

7.101 In conclusion, a careful examination of the ordinary meaning of the term "payment" in Article 9.1(c), in its context and in light of the object and purpose of the Agreement on Agriculture, leads us to the conclusion that it does include payment in kind and thus, *in casu*, the provision of milk at a reduced price. Recalling our considerations in paragraph 7.90, we thus find that the provision of milk to processors/exporters under Classes 5(d) and (e) involves a "payment on the export of an agricultural product" in the sense of Article 9.1(c).

(b) payments "financed by virtue of governmental action"

7.102 We recall that it is not in dispute that the payments-in-kind made under Classes 5(d) and (e) do *not* directly involve a charge on the public account.<sup>465</sup> The cost of selling milk at a reduced price for export is not borne by the government. It is borne by the milk producers either *collectively* (by means of pooling the lower in-quota export returns with the higher domestic returns and paying out an average pooled price for all in-quota milk to all producers) or, at least in principle, *individually* (with respect to over-quota milk, revenues of which are generally not pooled with higher returns from other milk producers). However, in our view, it is clear from the language of Article 9.1(c) that producer-financed payments can in principle be covered by this provision. "[W]hether or not a charge on the public account is involved" is explicitly stated to be irrelevant for purposes of Article 9.1(c). Moreover, Article 9.1(c) explicitly provides an example of a producer-financed payment, covered by Article 9.1(c), namely "payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived". The word "including" indicates that such payments financed from levies on agricultural products constitute only one example of a producer-financed export subsidy as listed in Article 9.1(c). In order to decide whether or not the scheme at issue here is another example of such export subsidies, we need to determine next whether or not this scheme involves payments "financed by virtue of governmental action".

7.103 We found earlier that the type and degree of government involvement in the making available of milk to processors/exporters under Classes 5(d) and (e) is such that the payment in kind involved is "provided by" Canada's governments or their agencies in the sense of Article 9.1(a).<sup>466</sup> We recall, in particular, that Canada's governments or their agencies through the Special Milk Classes Scheme decide when milk is to be exported, negotiate the price for such milk and actually provide the milk to processors/exporters.

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<sup>464</sup> *Ibid.*

<sup>465</sup> See para. 7.64.

<sup>466</sup> See para. 7.86.

7.104 We note, in addition, that it is the provincial milk marketing board, assisted by the CDC and operating under federal and/or provincial authority delegated to it, that (i) calculates the monthly pay cheque to be sent to each milk producer according to the relevant pooling arrangements and the specific rules or regulations the province concerned applies with respect to payments for over-quota milk; and (ii) eventually pays the milk producers a monthly income based on their production and the milk returns obtained through the scheme during a certain period. All milk necessarily passes through the intermediary of the provincial milk marketing boards which, together with the CDC and the CMSMC, arrange all milk sales, cash the returns obtained from processors/exporters for the milk sold and, finally, re-route these returns – including, in particular, the returns from milk sold under Classes 5(d) and (e) - to the individual milk producers on the basis of complex calculations.

7.105 We further note that, by virtue of the CDC Act, the CDC is, *inter alia*, authorized to (i) "distribut[e] money to producers of milk or cream received from the marketing of any quantity of milk or cream"<sup>467</sup>; (ii) "establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream, the basis on which that payment is to be made and the terms and manner of payment that is to be made in respect of the marketing of any quantity of milk or cream"<sup>468</sup>; and (iii) "collect the price paid or to be paid to the Commission, or to any producer in respect of the marketing of any quantity of milk or cream ... or recover that price in a court of competent jurisdiction".<sup>469</sup> The CDC also calculates the returns received by each province for Special Milk Classes sales, based on data provided by provincial marketing boards, and may audit the books of processors/exporters to ensure that they have used Classes 5(d) and (e) milk for export purposes.

7.106 On these grounds<sup>470</sup>, we find that the payment in kind offered under Classes 5(d) and (e), namely the provision of milk at a discounted price to processors/exporters, although it is not financed directly with governmental funds, is, nevertheless, "financed by virtue of governmental action" in the sense of Article 9.1(c).

#### Additional considerations with respect to sales of in-quota milk

7.107 We find additional support for our finding in the previous paragraph, in so far as it relates to *in-quota* milk sold under Classes 5(d) or (e), in the fact that the returns of in-quota milk are pooled with all other in-quota milk returns.<sup>471</sup>

7.108 At the national level, a system which pools all returns from in-quota milk in Special Class 5 was set up in the Comprehensive Agreement on Special Class Pooling. This agreement was concluded by the same bodies that established the CMSMC. Its implementation is overseen by the CMSMC, a body we considered earlier to be (at least to some extent) an agency of Canada's governments.<sup>472</sup> Moreover, in order to allow the CDC to administer this pooling system, the federal CDC Act was amended. Subsection 9(1), paragraph (f) of the Act, as amended, grants federal authority to the CDC to "establish and operate a pool or pools in respect of the marketing of milk or cream".

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<sup>467</sup> CDC Act, Subsection 9(1), paragraph (f), (i).

<sup>468</sup> CDC Act, Subsection 9(1), paragraph (g).

<sup>469</sup> CDC Act, Subsection 9(1), paragraph (h).

<sup>470</sup> See paras. 7.103-7.105.

<sup>471</sup> In this respect, we note that New Zealand and the United States have argued that Classes 5(d) and (e) constitute an export subsidy to milk *processors/exporters* financed by milk producers contingent on the export of the processed *dairy product*. Neither complainant suggested that the pooling of in-quota milk returns represents a payment to some *milk producers* financed by other milk producers contingent on the export of *milk*.

<sup>472</sup> See para. 7.80.

7.109 At an inter-provincial level, one pooling agreement was concluded between six eastern provincial boards ("the P6 Agreement"), another between four western provincial boards ("the P4 Agreement"). Both of these agreements pool all in-quota milk returns other than Special Class 5 returns (which are pooled nationally). These agreements were typically concluded by the relevant provincial governments, marketing boards and supervisory boards, all of which we presumed earlier to be agencies of Canada's governments.<sup>473</sup> Also the CDC itself is a signatory to both of these agreements. An example of how pooling of in-quota milk actually occurs is provided in paragraphs 2.59 to 2.63 above.

7.110 The authority vested in the provincial marketing boards to conclude, operate and enforce any of these three pooling agreements was delegated to them either by federal authorities (to the extent inter-provincial and international trade is involved, e.g., by the CDC<sup>474</sup>) or by provincial authorities (which have constitutional authority over all other aspects of production and sale of milk). The orders and regulations of the boards in respect of pooling – established pursuant to federal and provincial enabling legislation – can be enforced by the provincial boards before the normal courts by means of, e.g., a request for civil injunction or civil damages.

7.111 On these grounds, we consider that each of the three pooling arrangements are imposed on milk producers by virtue of governmental action. The pooling agreements are compulsory. Individual producers cannot opt-out of these pooling systems with respect to their in-quota milk.<sup>475</sup> It is this pooling mechanism that "finances" the payment in kind provided by the producers to the processors/exporters under Classes 5(d) and (e) with respect to in-quota milk. The pooling ensures that the producer which sells in-quota milk for export at a discounted price, does not have to bear the *total* cost of the "payment" thus provided to the processor/exporter. *All* milk producers share this cost by putting their higher returns from milk sold for domestic use in the same pool. The net result is that all producers obtain one average pooled price for all their in-quota milk. This pooling system confirms our finding that the provision of in-quota milk under Classes 5(d) and (e) is a payment in kind "financed by virtue of governmental action".<sup>476</sup>

#### Additional considerations with respect to sales of over-quota milk

7.112 We note, finally, that even though returns of *over-quota* milk sold under Class 5(e) are *generally* not pooled with other *in-quota* milk returns, over-quota milk returns are also, at least to some extent, pooled. This again occurs, we consider, by virtue of governmental action. First, any over-quota milk return is pooled annually with all other over-quota milk returns. On a monthly basis, the individual milk producer receives, from its provincial marketing board, a price for its monthly over-quota share. This price is *not* the actual return for the transaction made, but a three-month moving average of all returns achieved nationally for over-quota milk. Moreover, at the end of the dairy year, an adjustment is made to ensure that the total monthly payments made to individual producers correspond, on an averaged basis, to the total returns generated nationally that year by all over-quota milk sales. Therefore, even though each export transaction may – and mostly does - generate a different price (depending on the competitive conditions in the export market concerned, the dairy product in question and the delivery terms and timing of the transaction), at the end of the year an individual milk producer is not affected by this spectrum of variables, but receives a nationwide

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<sup>473</sup> See paras. 7.73 ff.

<sup>474</sup> In Schedule II to the Comprehensive Agreement on Special Class Pooling, the CDC, subject to the approval of the Governor in Council, authorizes the provincial boards "insofar as it is necessary to enable the Boards to fully carry-out the program as set out in [the Comprehensive Agreement on Special Class Pooling] and its Annexes, to exercise all the powers of the [CDC] set out in paragraphs 9(1)(f) to (i) of the [CDC Act]".

<sup>475</sup> See Canada's answer to Panel Question 4(d) to Canada.

<sup>476</sup> See para. 7.106.

average pooled return for all of its over-quota milk.<sup>477</sup> Second, depending on the applicable provincial regulations, some degree of pooling also takes place between over-quota returns and in-quota returns. This is achieved, in some provinces, by offsetting over-quota production of some producers against under-quota production of others.<sup>478</sup> These so-called "flexibility" provisions or "fall incentives" essentially excuse over-quota production in certain months. This variable determination of what is labelled as over-quota milk in each province by virtue of provincial regulations, not only results in a shared financing of certain over-quota sales (including by those producers which did not produce over-quota); it also confirms that it is not the individual producer but Canada's governments or their agencies that essentially determine when milk receives the lower export return. In our view, this pooling of over-quota returns confirms our finding in paragraph 7.106 that the provision of over-quota milk under Class 5(e) is also a payment in kind "financed by virtue of governmental action".

(c) The Panel's finding under Article 9.1(c)

7.113 We found earlier that the provision of lower priced milk to processors for export under Classes 5(d) and (e) constitutes a "payment" to these processors/exporters "on the export of an agricultural product".<sup>479</sup> We also found that this "payment" is "financed by virtue of governmental action".<sup>480</sup> On these grounds, we find that the making available of milk under Classes 5(d) and (e) constitutes an export subsidy within the meaning of Article 9.1(c).

## 7. Article 3.3 of the Agreement on Agriculture

7.114 We have found that the provision of milk to processors/exporters at a reduced price under Classes 5(d) and (e) constitutes an export subsidy as listed in Article 9.1(a)<sup>481</sup> and Article 9.1(c).<sup>482</sup> We recall that Article 3.3 provides as follows:

"Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule".

7.115 We further note that, according to figures submitted by Canada, the total amount of exports generated through Classes 5(d) and (e) exceeds Canada's quantity reduction commitment levels as set out in Section II of Part IV of its Schedule and this (i) for all of the dairy products in dispute (butter, cheese and "other milk products") and (ii) during both marketing years at issue (1995/1996 and 1996/1997).<sup>483</sup> The relevant figures are reflected in the table below:

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<sup>477</sup> See Canada's answer to Panel Question 34 to Canada.

<sup>478</sup> For example, in the provinces of Alberta, Manitoba and Saskatchewan, according to Canada's answer to Panel Question 20(b) to Canada and US Exhibits 39 and 58.

<sup>479</sup> See paras. 7.90 and 7.101.

<sup>480</sup> See paras. 7.103 ff.

<sup>481</sup> See para. 7.87.

<sup>482</sup> See para. 7.113.

<sup>483</sup> See Table 2 in para.2.41.

Product	Marketing Year	Canada's Export Quantity commitment level	Total exports generated through Classes 5(d) and 5(e)
Butter	1995/1996	9,464	9,527
	1996/1997	8,271	10,312
Cheese	1995/1996	12,448	13,751
	1996/1997	11,773	20,409
Other milk products	1995/1996	36,990	37,358
	1996/1997	35,649	60,300

7.116 On these grounds<sup>484</sup>, we find that Canada provides export subsidies as listed in Article 9.1 in respect of the three dairy products at issue, and this for both marketing years in dispute, in excess of the quantity commitment levels specified in its Schedule, contrary to its obligations under Article 3.3.

## 8. Article 10 of the Agreement on Agriculture

7.117 We have found that the Special Milk Classes Scheme involves an export subsidy as listed both in Article 9.1(a) and in Article 9.1(c). In the alternative – i.e., in the event we would have found that the scheme does *not* involve an export subsidy as specified in either Article 9.1(a) or Article 9.1(c) – the Complainants submit that this scheme, nevertheless, constitutes an export subsidy contrary to Article 10.1 of the Agreement on Agriculture. This provision reads as follows:

"Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments".

7.118 The Complainants only invoke the first phrase of Article 10.1. We note that this phrase only applies to "export subsidies *not* listed in paragraph 1 of Article 9". Export subsidies listed in Article 9.1 cannot, therefore, be found to contravene Article 10.1.<sup>485</sup> Having found that Canada's Special Milk Classes 5(d) and (e) involve export subsidies as listed in Article 9.1, we thus decide this dispute on the basis of Article 9.1. None of the complainants requested the Panel to make concurrent findings on both Article 9.1 and Article 10.1. In our view, the text of Article 10.1 and our findings based on Article 9.1 exclude such concurrent findings in respect of the same export subsidies. If our findings under Article 9.1 are adopted by the DSB, we consider that making additional findings under Article 10.1 would not be warranted in the light of the mutually exclusive relationship between Article 9.1 and Article 10.1.

7.119 However, in our examination of the claims relating to violations of Article 9.1 *or* Article 10.1, we also noted the following elements:

- (a) both complainants requested a finding on Article 10.1 in the event that Article 9.1 were found not to be applicable;

<sup>484</sup> See paras. 7.114-7.115.

<sup>485</sup> However, in our view, the mutual exclusiveness of Article 9.1 and Article 10.1 does not prevent that one element or aspect of a given scheme may constitute an export subsidy as listed in Article 9.1, while another element or aspect of the same scheme may be covered by Article 10.1 and that, as a result, the factual elements to be considered under both provisions might well be closely related if not the same in certain respects.

- (b) the complainants and Canada disagree on how Article 10.1 should be construed and on the consistency of Canada's Special Milk Classes Scheme with Article 10.1;
- (c) both Article 9.1 (referring to Article 3.3) and Article 10.1 prohibit specified export subsidies and, in so doing, complement each other by focusing on different subsidy elements. As a result, the precise borderline between Article 9.1 and Article 10.1 export subsidies may not always be clear-cut. Indeed, so far this borderline has never been clarified in WTO legal or dispute settlement practice;
- (d) if our findings under Article 9.1 were to be reversed, the Appellate Body could be called upon to examine the claims made under Article 10.1. This examination would require a complex factual assessment and the weighing of evidence submitted by the parties to this dispute, an exercise which could go beyond the jurisdiction of the Appellate Body and make it impossible for the DSB to provide recommendations and rulings on all legal claims within the time-frame prescribed by the DSU;
- (e) if the DSB adopts our findings on Article 9.1, the DSU's declared objectives of "prompt settlement" of disputes (Article 3.3 of the DSU), of a "satisfactory settlement of the matter in accordance with the rights and obligations under [the DSU] and the covered agreements" (Article 3.4 of the DSU), of "a positive solution to a dispute" (Article 3.7 of the DSU) and of "effective resolution of disputes to the benefit of all Members" (Article 21.1), may be facilitated if the parties would have at their disposal the Panel's examination of the matter under Article 10.<sup>486</sup> On this point, we recall the following statement by the Appellate Body:

"The principle of judicial economy has to be applied keeping in mind the aim of the dispute settlement system. This aim is to resolve the matter at issue and 'to secure a positive solution to a dispute'.<sup>487</sup> To provide only a partial resolution of the matter at issue would be false judicial economy. A panel has to address those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member with those recommendations and rulings 'in order to ensure effective resolution of disputes to the benefit of all Members'<sup>488</sup>."

On these grounds, and in particular in order to (i) enable the Appellate Body and the DSB to make findings on Article 10.1 in the event that it considers it necessary<sup>490</sup> and (ii) avoid a continuation of the

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<sup>486</sup> In this respect, we also note Article 19.1 of the DSU providing that a panel "[i]n addition to its recommendations ... may suggest ways in which the Member concerned could implement the recommendations".

<sup>487</sup> A footnote refers to DSU, Article 3.7.

<sup>488</sup> A footnote refers to DSU, Article 21.1.

<sup>489</sup> Appellate Body report on *Australia – Measures Affecting Importation of Salmon*, WT/DS18/AB/R, adopted 6 November 1998, para. 223.

<sup>490</sup> In this respect, we refer to the dispute on *Australia – Measures Affecting Importation of Salmon* (WT/DS18/AB/R, adopted 6 November 1998), where the Appellate Body, after having reversed certain Panel findings, was "unable to come to a conclusion on [the claim under Article 5.6 of the SPS Agreement] due to the insufficiency of the factual findings of the Panel and of facts that are undisputed between the parties" (para. 213; see also para. 241). See also the Appellate Body Report on *Canada – Certain Measures Concerning Periodicals*

dispute over Canada's obligation to bring its dairy products marketing regime into conformity with its obligations under the Agreement on Agriculture, we have decided to proceed with our examination under Article 10.1 and to include that examination in our report as one on which no recommendation or ruling by the DSB would be necessary if our findings under Article 9.1 are adopted. We emphasize that our examination of Article 10.1 is made in the alternative only, i.e., assuming that Classes 5(d) and (e) do not involve export subsidies as listed in Article 9.1.

(a) The two elements under Article 10.1

7.120 In our view, for there to be a violation of Article 10.1, two elements need to be established:

- (a) the presence of "export subsidies not listed in paragraph 1 of Article 9";
- (b) which are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments".

7.121 Article 10.1 - in particular the second condition thereunder - has to be read together with Article 10.3, which provides:

"Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question".

7.122 Reading the second element of Article 10.1 together with Article 10.3, we note that all parties to this dispute agree that one example of applying export subsidies "in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" is a situation where export subsidies other than Article 9.1 export subsidies are granted to a product subject to subsidy reduction commitments in excess of the reduction commitment level.<sup>491</sup> We see no reason, in the circumstances of this case, to disagree with this interpretation of Article 10.3. In our view, Article 10.3 does, indeed, address both (i) the question of who bears the burden of proving whether or not an export subsidy is at issue in a specific instance<sup>492</sup>, and (ii) the question of when certain export subsidies can be said to be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments.

7.123 We recall that, in this case, figures submitted by Canada show that for all of the dairy products in dispute and this during both marketing years at issue, the total amount of exports generated through Classes 5(d) and (e) exceeds Canada's reduction commitment level.<sup>493</sup> We also recall our consideration above that granting export subsidies "other" than those listed in Article 9.1 in excess of the relevant reduction commitment level for the subsidized product concerned, is sufficient to conclude that Article 10.1 is violated.<sup>494</sup> Therefore, in the circumstances of this dispute, whether or not Article 10.1 is

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(WT/DS31/AB/R, adopted 30 July 1997, p. 22: "We note that, due to the absence of adequate analysis in the Panel Report in this respect, it is not possible to proceed to a determination of like products [under Article III:2, first sentence, of GATT 1994]"). In this respect, see also the Panel Report on *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products* (WT/DS50/R, adopted 16 January 1998) where the Panel decided to continue its examination under Article 63 of the TRIPS Agreement after it had found a violation under Article 70.8 of that Agreement (para. 7.44: "Although the United States formulates it [the Article 63 claim] as an alternative claim in the event that the Panel were to find that India has a valid mailbox system in place, and we have, as stated above, found that the current mailbox system in India is at variance with Article 70.8(a) of the TRIPS Agreement, we believe it necessary to make our findings clear on the issue of transparency in order to avoid a legal vacuum in the event that, upon appeal, the Appellate Body were to reverse our findings on Article 70.8").

<sup>491</sup> See, in particular, Canada's answer to Panel Question 16 to Canada.

<sup>492</sup> See paras. 7.32-7.34.

<sup>493</sup> See para. 7.115, referring to Table 2 in para. 2.41.

<sup>494</sup> See para. 7.122.

violated depends on whether or not Classes 5(d) and (e) involve an "other" export subsidy in the sense of Article 10.1. In other words, in this dispute, we only need to further examine whether the first element of Article 10.1 is met.

(b) An "other" export subsidy under Article 10.1

7.124 The Article 10.1 concept of "[e]xport subsidies not listed in paragraph 1 of Article 9" is not further defined in Article 10 itself. Article 1(e) states, however, that:

"[i]n this Agreement, unless the context otherwise requires: ... 'export subsidies' refers to *subsidies contingent upon export performance*, including the export subsidies listed in Article 9 of this Agreement".<sup>495</sup>

For purposes of Article 10.1, we thus need to examine whether Classes 5(d) and (e) involve "subsidies contingent upon export performance" in the sense of Article 1(e) other than those listed in Article 9.1. Since we assumed earlier – in the alternative and for purposes only of our examination under Article 10.1 – that Classes 5(d) and (e) do *not* involve export subsidies as listed in Article 9.1, we need to examine next whether they do, nevertheless, constitute export subsidies in the sense of Article 1(e).<sup>496</sup>

7.125 In our view, Article 1(e) covers a wider range of "export subsidies" than the specific practices listed in Article 9.1. Article 1(e) explicitly states that it "includes" – and is thus not limited to – export subsidies listed in Article 9.1. We consider, therefore, that any subsidy contingent upon export performance other than one listed in Article 9.1 is covered by Article 10.1. Accordingly, measures which meet some but not all of the definitional elements of the individual export subsidy practices listed in Article 9.1 would be covered by Article 10.1, provided that they meet the basic requirement of Article 1(e) that they are "subsidies contingent upon export performance". However, neither the wording of Article 9.1, Article 10 nor Article 1(e) explicitly indicates which of the Article 9.1 limitations are no longer valid under Article 10.1. The guidance that *can* be derived from Article 9.1, as part of the context of Article 1(e) and Article 10.1, is that Article 10.1 must include certain payments-in-kind and producer-financed schemes which do not fully meet all elements under, respectively, Article 9.1(a) or Article 9.1(c). In this respect, it could, for example, be argued that where Article 9.1(a) addresses the provision by governments or their agencies of "direct subsidies, including payments-in-kind" contingent on export performance, Article 10.1 can be presumed to cover the indirect version of such subsidies.

7.126 We find further guidance to interpret the meaning of a subsidy contingent upon export performance for the purposes of Article 1(e) and Article 10.1, *inter alia*, in the SCM Agreement which is, we consider, part of the general context of Article 1(e) and Article 10.1. Article 1 of the SCM Agreement, for example, includes as a subsidy "any form of income or price support in the sense of Article XVI of GATT 1994" whereby a benefit is conferred. However, since in this case we need to interpret the meaning of certain "export subsidies", we consider it more appropriate, without prejudice to the scope of Article 10.1, to examine what practices are considered under the SCM Agreement to be "export subsidies", rather than to examine how that Agreement defines the more general concept of a "subsidy" in its Article 1. Annex I to the SCM Agreement – the Illustrative List of Export Subsidies – identifies practices which are, under Article 3 of the SCM Agreement,

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<sup>495</sup> Emphasis added.

<sup>496</sup> With reference to para. 7.41 and footnote 453, to the extent that the US claims also cover any of the milk classes other than Classes 5(d) and (e), we note that all of these other milk classes can also (often exclusively) be accessed by processors which produce for the domestic market. Nothing offered under these other milk classes is thus "contingent upon export performance". We therefore find that these other milk classes do not involve an export subsidy in the sense of Article 10.1.

"subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance". Both complainants invoke Paragraph (d) of the Illustrative List which provides that the following action is an "export subsidy" for purposes of the SCM Agreement:

"The provision by governments or their agencies either directly or indirectly through government-mandated schemes, of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters".

A footnote added to the term "commercially available" states:

"The term 'commercially available' means that the choice between domestic and imported products is unrestricted and depends only on commercial considerations".

7.127 Given that Paragraph (d) deals with the provision of products at different prices for, on the one hand, use in the production of *exported goods* and, on the other hand, use in the production of goods *for domestic consumption*, we agree with the parties that Paragraph (d) under the Illustrative List is the most relevant one to this case. We next examine whether the provision of milk at a lower price for export under Classes 5(d) and (e) falls within the scope of Paragraph (d).

7.128 In our view, Paragraph (d), applied to the facts of this case, requires the presence of three elements:

- (a) the provision of "imported or domestic products ... for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products ... for use in the production of goods for domestic consumption";
- (b) such provision of products for use in the production of exported goods is provided "by governments or their agencies either directly or indirectly through government-mandated schemes"; and
- (c) the more favourable terms or conditions for such products for use in the production of exported goods are also "more favourable than those commercially available on world markets to their exporters"; these terms or conditions will only *not* be more favourable than those commercially available on world markets when the choice to be made by processors/exporters between buying either domestic products or imported products "is unrestricted and depends only on commercial considerations".

7.129 As to the first element under Paragraph (d), it is undisputed that through Classes 5(d) and (e) domestically produced milk is provided for use in the production of exported goods (processed dairy products) on terms and conditions more favourable than for provision of the same domestically produced milk for use in the production of dairy products for domestic consumption.<sup>497</sup> As we found

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<sup>497</sup> See Table 3 in para. 2.51.

earlier, the price differential between milk for use in exports and milk for use on the domestic market is significant.<sup>498</sup> We thus find that the first element under Paragraph (d) is met.

7.130 Examining the second element under Paragraph (d), we recall our analysis under Article 9.1(a) on the basis of which we found that under Classes 5(d) and (e) milk for export at a discounted price is "provided by" Canada's "governments or their agencies".<sup>499</sup> Even if we would have found that such lower priced milk is *not* "provided by" Canada's "governments or their agencies" – something we could assume here given that our examination under Article 10.1 is one in the alternative, i.e., on the assumption that the scheme is *not* an Article 9.1(a) export subsidy - we still consider that the evidence of record, outlined in paragraphs 7.68 to 7.85, is conclusive for us to find that such milk is, nevertheless, "provided by" Canada's "governments or their agencies either directly *or indirectly through government-mandated schemes*"<sup>500</sup> in the sense of Paragraph (d). Indeed, in the event milk were not directly provided by Canada's governments or their agencies under Classes 5(d) and (e), in our view, it is at least indirectly provided through government-mandated schemes. For there to be such schemes we do not consider it necessary, as argued by Canada, that the federal or provincial governments specifically direct a certain outcome or course of action to be achieved or taken by the CDC, the provincial marketing boards or the CMSMC. In our view, the ordinary meaning of the term "government-mandated" scheme – in its immediate context of products being provided "*indirectly through government-mandated schemes*" – also includes the delegation of authority by the government to its agencies which, in turn, set up a "government-mandated" scheme.<sup>501</sup> We thus find that in this case the second element under Paragraph (d) is met.

7.131 Finally, referring to the third element under Paragraph (d), we recall our examination of whether or not the provision of milk to processors/exporters under Classes 5(d) and (e) confers a benefit to these processors/exporters, in such a way that one can conclude that a payment in kind is made to them in the sense of Article 9.1(a).<sup>502</sup> We recall, in particular, those paragraphs where we applied the benchmark of whether processors/exporters can access milk, or for that matter milk derivatives, from any other source - in particular the world market - on terms and conditions equally favourable to those offered under Classes 5(d) and (e).<sup>503</sup> There we found that "the provision of milk to processors/exporters under Classes 5(d) and (e) at a price significantly lower than the domestic milk price ... and *on terms and conditions which are more favourable than those under any other alternative source, including under the Import for Re-Export Program* ... - confers a "benefit" ... to these processors/exporters and, for that reason, constitutes a payment in kind – namely, the provision of a good at a discounted price - in the sense of Article 9.1(a)".<sup>504</sup> Even if we had found that Classes 5(d) and (e) do *not* involve the payment in kind referred to in Article 9.1(a) - something we could assume here given that our examination under Article 10.1 is one in the alternative, i.e., on the assumption that the scheme is *not* an Article 9.1(a) export subsidy - we nevertheless consider that the evidence of record is conclusive for us to find that the provision of milk under Classes 5(d) and (e) is made on "terms or conditions ... more favourable than those commercially available on world markets" in the sense of Paragraph (d). We refer, in particular, to paragraphs 7.52 to 7.56 which, in our view, provide sufficient proof that the choice to be made by processors/exporters between accessing milk under Classes 5(d) or (e) and sourcing milk, or for that matter milk derivatives – in the event these milk

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<sup>498</sup> See para. 7.50.

<sup>499</sup> See paras. 7.63-7.86.

<sup>500</sup> Emphasis added.

<sup>501</sup> The *New Shorter Oxford English Dictionary* (Ed. Brown, L., Clarendon Press, Oxford, Volume 1, p. 1683) defines "mandate" as follows: "1. Command, require by mandate; necessitate ... 4. Give a mandate to, delegate authority to (a representative, group, organization, etc.)".

<sup>502</sup> See paras. 7.46 ff.

<sup>503</sup> See paras. 7.49-7.58.

<sup>504</sup> Para. 7.58, emphasis added.

derivatives could be considered to be directly competitive with fluid milk (an issue which is in dispute<sup>505</sup>) and assuming that the availability of a directly competitive product is relevant in cases where the like product is not available – is not a choice which is "unrestricted and depends only on commercial considerations" in the sense of the footnote to Paragraph (d). We recall, in particular, the discretion granted to the Minister of Foreign Affairs and International Trade who has to issue a permit for imports to be allowed<sup>506</sup>; the fact that to date commercial imports of fluid milk cannot, for all practical purposes, enter Canada<sup>507</sup>; and the figures submitted to us which indicate – albeit in general terms only - that under Classes 5(d) and (e) milk can be sourced on more favourable terms and conditions than under, e.g., the Import for Re-Export Program, an indication reflected also in the overwhelming preference of processors/exporters for milk under Classes 5(d) and (e).<sup>508</sup>

7.132 For the above reasons<sup>509</sup>, we find that Classes 5(d) and (e) involve an export subsidy as listed in Paragraph (d) of the Illustrative List of Export Subsidies annexed to the SCM Agreement. We do not consider it necessary in this case to decide whether the fact that a scheme involves an export subsidy under the SCM Agreement necessarily means that it also constitutes an export subsidy under Article 1(e) of the Agreement on Agriculture. We are not called upon – and do not intend here – to decide whether the scope of the concept of export subsidy under the SCM Agreement is the same as, or different than, that under the Agreement on Agriculture. We do find, however, that in the circumstances of this case and on the grounds outlined above<sup>510</sup>, Classes 5(d) and (e) – assuming, in the alternative, that they do *not* constitute an export subsidy as listed in either Article 9.1(a) or Article 9.1(c) – nevertheless involve an "other" export subsidy in the sense of Article 10.1.

7.133 Given our finding in the previous paragraph and recalling: (i) our consideration above that granting export subsidies "other" than those listed in Article 9.1 in excess of the relevant reduction commitment level for the subsidized product concerned, is sufficient to conclude that Article 10.1 is violated<sup>511</sup>; and (ii) the fact that for all of the dairy products in dispute and this during both marketing years at issue, the total amount of exports generated through Classes 5(d) and (e) does exceed Canada's reduction commitment levels, we find that Canada – in the alternative, i.e., only in the event Classes 5(d) and (e) do not involve export subsidies as listed in either Article 9.1(a) or Article 9.1(c) – has acted inconsistently with its obligations under Article 10.1 with respect to all three dairy products at issue and during both marketing years in dispute.

## **9. Article 8 of the Agreement on Agriculture**

7.134 Recalling that Article 8 of the Agreement on Agriculture provides that "[e]ach Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement", we also find that as a consequence of the violations of either Article 3.3 (through Article 9.1) or Article 10.1 we found earlier<sup>512</sup>, Canada has acted inconsistently with its obligations under Article 8.

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<sup>505</sup> See para. 7.55.

<sup>506</sup> See para. 7.53.

<sup>507</sup> See para. 7.54.

<sup>508</sup> See para. 7.56.

<sup>509</sup> See paras. 7.129-7.131.

<sup>510</sup> See paras. 7.124-7.131.

<sup>511</sup> See para. 7.122.

<sup>512</sup> See, respectively, in paras. 7.116 and 7.133.

## 10. Article 3 of the SCM Agreement

7.135 The United States also claims that the provision of milk under Classes 5(d) and (e) is inconsistent with Canada's obligations under Article 3 of the SCM Agreement which contains, *inter alia*, a general prohibition on export subsidies.

7.136 We have found that the Canadian scheme is inconsistent with: (i) Canada's obligations under both Article 3.3 and Article 8 (through Article 9.1(a) and Article 9.1(c))<sup>513</sup>; or (ii) in the alternative, Canada's obligations under both Article 10.1 and Article 8<sup>514</sup>, of the Agreement on Agriculture. Therefore, the exemption provided for in Article 13(c)(i) of the Agreement on Agriculture from actions under Article 3 of the SCM Agreement for "export subsidies that conform fully to the provisions of Part V" of the Agreement on Agriculture, does not apply. In principle, the scheme could therefore also be subjected to an examination under Article 3 of the SCM Agreement.

7.137 Article 3 is identified in the US request for this Panel and could thus, in principle, be presumed to fall within the Panel's terms of reference.<sup>515</sup> The question then arises whether we could and, as the case may be, should apply the principle of judicial economy and decide *not* to examine the US claim under Article 3. We recall the Appellate Body's statement in *Australia – Salmon*, quoted earlier<sup>516</sup>, which provides the most recent statement on when judicial economy can be exercised.

7.138 We note, firstly, that although the United States extensively referred to the SCM Agreement as *context* of its claims under the Agreement on Agriculture, the US arguments on its *claim* under Article 3 of the SCM Agreement are minimal.<sup>517</sup> The US' only argument under Article 3 is effectively that because Canada violated its export subsidy commitments under the Agreement on Agriculture, it thereby automatically violates its obligations under Article 3 of the SCM Agreement.<sup>518</sup>

7.139 Secondly, we note that Article 4 of the SCM Agreement (entitled "Remedies") provides for "special or additional rules and procedures on dispute settlement" (as referred to in Article 1.2 of the DSU) in respect of claims made under Article 3. Article 4 sets out rights and obligations which may benefit either party to a dispute. It obliges panels to give recommendations that differ from those generally made under the DSU, a right which may be beneficial to complaining parties. Pursuant to Article 4.7, a panel *has to* recommend to the DSB that the subsidy be withdrawn without delay and *has to* specify the time-period allowed for such withdrawal. However, Article 4 also requires, in paragraph 2, that a request for consultations "include a statement of available evidence with regard to the existence and nature of the subsidy in question", a provision which may work to the advantage of the defending party. The same is true, in our view, in respect of Article 4.5 which states that "[u]pon its establishment, the panel may request the assistance of the Permanent Group of Experts ... with

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<sup>513</sup> See paras. 7.116 and 7.134.

<sup>514</sup> See paras. 7.133 and 7.134.

<sup>515</sup> The question arises, however, whether we can examine the Article 3 claim at all (even though Article 3 is mentioned in the US Panel request) given that in the US request for consultations and for establishment of this Panel, the United States only invoked - as a legal basis for consultations and a Panel on its SCM claim - Article 30 of the SCM Agreement, i.e., the general provision on "Dispute Settlement" (together with Articles 4 and 6 of the DSU), and *not* the more specific Article 4 of the SCM Agreement which sets out certain special and additional dispute settlement procedures for cases involving prohibited subsidies. We note that - given the multiple claims submitted in this dispute (both under the Agreement on Agriculture and the SCM Agreement) - the United States could, for example, have invoked Article 4 as a legal basis to obtain recommendations with respect to its Article 3 claim, while at the same time waive its right to, *inter alia*, those elements of the accelerated procedure under Article 4 that are at odds with the usual timetable applicable under the DSU. However, as further discussed below, we do not consider it necessary to answer these questions in this case.

<sup>516</sup> See para. 7.119.

<sup>517</sup> The only US argument is, indeed: "Consequently, these export subsidies are also inconsistent with Canada's obligations under Article 3 of the SCM Agreement" (US first submission, para. 125).

<sup>518</sup> In this respect, we note, however, that as opposed to our examination of this dispute under the Agreement on Agriculture (where Canada was found to bear the burden of proof, see para. 7.34), under Article 3 of the SCM Agreement, the usual rules on burden of proof apply.

regard to whether the measure in question is a prohibited subsidy". Article 4 also imposes a time-frame that is stricter than the usual DSU time-frame for the settlement of disputes. These shorter time periods may also be advantageous to defending parties in that their situation will need to be clarified more rapidly.

7.140 However, in this case the United States never invoked or even referred to the rules and procedures contained in Article 4. It did not do so in its request for consultations, in its request for a panel or in any of its submissions before the Panel, nor did it at any stage in this dispute pursue the matter within the framework of Article 4. Given that the United States – and, as a result, also Canada and the Panel - did not at any point proceed under Article 4, we consider it inappropriate at this stage - given also our earlier findings of violation of the Agreement on Agriculture - to further pursue the US claim under Article 3.

7.141 On the grounds set out above<sup>519</sup>, and in view of the particular circumstances of this case, we thus conclude that we should apply the principle of judicial economy and, therefore, do not examine Article 3 of the SCM Agreement.

## C. THE TARIFF-RATE QUOTA FOR FLUID MILK

### 1. Facts and claims of the parties

7.142 In Part I of Canada's Schedule to GATT 1994, Canada established a tariff-rate quota for fluid milk (HS 0401.10.10 and 0401.20.10) of 64,500 tonnes. In-quota imports are subject, initially, to a maximum duty of 17.5 per cent (a rate to be decreased to 7.5 per cent in 2001). Fluid milk imports outside of the 64,500 tonnes tariff-rate quota bear an initial rate of duty equal to 283.8 per cent, declining to 241.3 per cent in 2001. In its Schedule, Canada specified under "Other terms and conditions" that "[t]his quantity [64,500 tonnes] represents the estimated annual cross-border purchases imported by Canadian consumers".

7.143 Referring to its Schedule, Canada currently restricts access to the tariff-rate quota to cross border imports by Canadians of consumer packaged milk for personal use, valued at less than C\$20 per entry. Such imports are made under the authority of the General Import Permit No.1 issued under the Export and Import Permits Act. For such imports, no individual permits are required and no duty is being imposed, not even the in-quota duty. Moreover, the quantity of these imports is not monitored so that it is not known whether the tariff-rate quota is actually filled or not, or exceeded. Commercial shipments of milk are not allowed under the tariff-rate quota.

7.144 The United States claims that by confining the scope of fluid milk entries that are eligible under the tariff-rate quota to cross border imports by Canadians of consumer packaged milk for personal use valued at less than C\$20 per entry, Canada grants imports of fluid milk treatment less favourable than that provided for in Canada's Schedule and, thus, acts inconsistently with its obligations under Article II:1(b) of GATT 1994. The United States further claims that because Canada administers the tariff-rate quota through a general permit restricting any single import entry to a value of C\$20 and subjects such entries to a personal use restriction, Canada's licensing procedures introduce additional trade impediments that are inconsistent with its obligations under Article 3 of the Agreement on Import Licensing Procedures ("the Licensing Agreement").

7.145 Canada responds that the limited access to the tariff-rate quota is provided for in its Schedule, read in light of its negotiating history, and that, accordingly, Article II:1(b) of GATT 1994 is complied with. Canada argues that since no restrictions are placed on imports that are additional to

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<sup>519</sup> See paras. 7.138-7.140.

the terms and conditions incorporated in Canada's Schedule, Canada's import regime is in complete compliance with the Licensing Agreement.

## 2. Article II:1(b) of GATT 1994

7.146 Article II:1(b) of GATT 1994 provides:

"The products described in Part I of the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory to which the Schedule relates, and subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from ordinary customs duties in excess of those set forth and provided therein".<sup>520</sup>

This provision needs to be read in the context of Article II:1(a) of GATT 1994 which states:

"Each contracting party shall accord to the commerce of the other contracting parties treatment no less favourable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement".<sup>521</sup>

7.147 The 64,500 tonnes tariff-rate quota established in Part I of Canada's Schedule can thus only be subject to the 17.5 per cent (in 2001, 7.5 per cent) duty rate set out in Canada's Schedule. Any other "terms, conditions or qualifications" with respect to the access to this tariff-rate quota need to be set forth in Canada's Schedule. In this dispute, two "conditions" effectively imposed by Canada are at issue:

- (a) the fact that only consumer packaged milk for personal use can fall within the tariff-rate quota; and
- (b) the fact that only entries valued at less than C\$20 qualify for the tariff-rate quota.

7.148 The only "terms, conditions or qualifications" set forth in Canada's Schedule are contained in the following phrase, mentioned under "Other terms and conditions", next to the quota quantity of 64,500 tonnes:

"This quantity represents the estimated annual cross-border purchases imported by Canadian consumers".

If we were to find that this phrase does *not* include the two conditions currently imposed by Canada, Canada would be in violation of Article II:1(b). Our finding on the US claim of violation of Article II:1(b) thus depends on the interpretation we give to this phrase.

7.149 On the interpretation of a particular term in a Member's Schedule, the Appellate Body in its report on *European Communities – Customs Classification of Certain Computer Equipment*, stated as follows:

"84. ... Tariff concessions provided for in a Member's Schedule - the interpretation of which is at issue here - are reciprocal and result

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<sup>520</sup> Underlining added.

<sup>521</sup> Underlining added.

from a mutually-advantageous negotiation between importing and exporting Members. A Schedule is made an integral part of the GATT 1994 by Article II:7 of the GATT 1994. Therefore, the concessions provided for in that Schedule are part of the terms of the treaty. As such, the only rules which may be applied in interpreting the meaning of a concession are the general rules of treaty interpretation set out in the Vienna Convention.

85. Pursuant to Article 31(1) of the *Vienna Convention*, the meaning of a term of a treaty is to be determined in accordance with the ordinary meaning to be given to this term in its context and in the light of the object and purpose of the treaty [the Appellate Body then quotes Articles 31(2) to (4)].

86. The application of these rules in Article 31 of the *Vienna Convention* will usually allow a treaty interpreter to establish the meaning of a term. However, if after applying Article 31 the meaning of the term remains ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable, Article 32 allows a treaty interpreter to have recourse to:

... supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion.

With regard to "the circumstances of [the] conclusion" of a treaty, this permits, in appropriate cases, the examination of the historical background against which the treaty was negotiated".<sup>522</sup>

7.150 Accordingly, we need to examine first the ordinary meaning to be given to the relevant terms in Canada's Schedule in their context and in the light of the object and purpose of GATT 1994.

7.151 The phrase "[t]his quantity represents the estimated annual cross-border purchases imported by Canadian consumers" is mentioned under the heading "Other terms and conditions", next to the quota quantity. Even though one can thus presume that this phrase includes certain "terms and conditions" related to the tariff-rate quota, we find it difficult to read specific access restrictions into this phrase. The words "[t]his *quantity represents the estimated* annual ..." <sup>523</sup> are, in our view, introducing "terms" related to the *quantity* of the quota – i.e., describing the way the size of the quota was determined – rather than setting out "conditions" as to the *kind* of imports qualified to enter Canada under this quota. In particular, the ordinary meaning of the word "represent" in this context does not, in our view, call to mind the setting out of specific restrictions or conditions.<sup>524</sup>

7.152 Even if the phrase could be said to include restrictions on access to the tariff-rate quota, we do not see how the two conditions *at issue in this dispute* could be read into this phrase. First, the restriction that only entries valued at less than C\$20 qualify for the tariff-rate quota can nowhere be found in Canada's Schedule. Nowhere is any reference made to a maximum value per entry. Second,

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<sup>522</sup> Adopted on 5 June 1998, WT/DS62/AB/R, paras. 84-86, underlining added.

<sup>523</sup> Emphasis added.

<sup>524</sup> The *New Shorter Oxford English Dictionary*, for example, defines "represent", as used in this context, as: "1. Bring into the presence of someone or something ... 2. Bring clearly and distinctly to mind, esp. by description or imagination ... 5. ... b. Of a quantity: indicate or imply (another quantity) ..." (Ed. Brown, L., Clarendon Press, Oxford, Volume 2, p. 2552).

the requirement that only consumer packaged milk for personal use can fall within the tariff-rate quota, could only be referred to in the words "cross-border purchases imported by Canadian consumers". One could interpret these terms as restricting access to Canadians only (as opposed to, e.g., US citizens or residents) who make cross-border purchases. However, in our view, the ordinary meaning of the words "cross-border purchases" by "consumers" in this context does not warrant the conclusion that only *consumer packaged milk for personal use* can enter under the tariff-rate quota. An imported good, by definition, crosses a border. Also, the dictionary meaning of "consumer" is not restricted to a person buying *for personal use in small retail packages*. All dictionary definitions of "consumer" referred to by the parties include wider definitions without these restrictions.<sup>525</sup>

7.153 We find support for our view that the two access restrictions at issue here are not set forth in Canada's Schedule when comparing the phrase in dispute to other "terms and conditions" specified in Canada's Schedule, in particular those in the field of milk and dairy products which are part of the immediate context of the phrase we need to interpret. With respect to the tariff-rate quota for cream, under "Other terms and conditions", the far more precise and mandatory phrase "sterilized cream, minimum 24 per cent butterfat, in cans of a volume not exceeding 200 ml" is added. For the tariff-rate quotas established for yoghurt and ice cream, the following is added: "access for yoghurt [ice cream] in retail sized containers only". No such restrictive language can be found in the phrase at issue here.

7.154 In this respect, we also refer to the object and purpose of Article II of GATT 1994, namely "to preserve the value of tariff concessions negotiated by a Member with its trading partners, and bound in that Member's Schedule. Once a tariff concession is agreed and bound in a Member's Schedule, a reduction in its value by the imposition of duties in excess of the bound tariff rate would upset the balance of concessions among Members"<sup>526</sup>; as well as to the object and purpose of the WTO Agreement, generally, and of GATT 1994, namely "the security and predictability of the reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade".<sup>527</sup> We cannot read the access restrictions imposed by Canada in its current Schedule. The principles of security and predictability, as well as those of treaty interpretation, do not "condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that are not intended".<sup>528</sup>

7.155 On these grounds, we consider that the meaning of the terms at issue can be established by examining their ordinary meaning in their context and in the light of the object and purpose of GATT 1994. In accordance with the rules of treaty interpretation referred to above<sup>529</sup>, we see no need to also examine the historical background against which these terms were negotiated. We do note, however, that the drafting history of the relevant part of Canada's Schedule is inconclusive, possibly supporting both the view of Canada and that of the United States.<sup>530</sup>

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<sup>525</sup> The *New Shorter Oxford English Dictionary*, for example, defines "consumer" as "1. A person who or thing which squanders, destroys, or uses up. 2. A user of an article or commodity, a buyer of goods or services. Opp. *producer*" (Ed. Brown, L., Clarendon Press, Oxford, Volume 1, p. 490). The *Black's Law Dictionary*, referred to by Canada, defines "consumer" as: "Individuals who purchase, use, maintain, and dispose of products and services ... Consumers are to be distinguished from manufacturers (who produce goods) and wholesalers and retailers (who sell goods). A buyer (other than for the purpose of resale) of any consumer product" (West Publishing Co., Minneapolis Minn., 1990).

<sup>526</sup> Appellate Body report on *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel, and Other Items*, adopted on 27 March 1998, WT/DS56/AB/R, para. 47.

<sup>527</sup> Appellate Body report on *European Communities – Customs Classification of Certain Computer Equipment*, op. cit., para. 82.

<sup>528</sup> Appellate Body report on *India – Patent Protection for Pharmaceutical and Agricultural Chemicals*, adopted on 19 December 1997, WT/DS50/AB/R, para. 45.

<sup>529</sup> See para. 7.149.

<sup>530</sup> No agreement between Canada and the United States as to whether or not the phrase in dispute includes the two access restrictions imposed by Canada, can be derived from the drafting history. Canada argues that during the Uruguay Round negotiations it

7.156 We, therefore, find that Canada, by restricting the access to the tariff-rate quota for fluid milk to (i) consumer packaged milk for personal use and (ii) entries valued at less than C\$20, acts inconsistently with its obligations under Article II:1(b) of GATT 1994.

### **3. The Licensing Agreement**

7.157 Since we have found above that the two access restrictions imposed by Canada with respect to its tariff-rate quota for fluid milk are contrary to Canada's obligations under Article II:1(b) of GATT 1994, we see no need to examine whether in so doing Canada also violates Article 3 of the Licensing Agreement.

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clearly indicated to the United States that "it intended to continue its access for US milk imported by Canadian consumers while non-consumer utilisation would continue to be blocked until equivalency was established" (Canada's oral statement at our second substantive meeting, para. 129). The United States, on the other hand, submits that the phrase at issue was added to clarify that the tariff-rate quota was a continuation of "current access" opportunities already available before the Uruguay Round negotiations; not a phrase limiting access to the quota as such. In so doing, the United States argues, Canada avoided granting the "minimum access opportunities" for products for which there are no significant imports (ranging from 3 to 5 per cent of domestic consumption) referred to in the Agreement on Modalities for the Establishment of Specific Binding Commitments under the Reform Program (MTN.TNC/W/FA, p. L.19, 20 December 1991).

## VIII. CONCLUSIONS

8.1 In the light of the above findings we conclude that Canada:

- (a) through Special Milk Classes 5(d) and (e) - and this for all of the dairy products in dispute (butter, cheese and "other milk products") and for both marketing years at issue (1995/1996 and 1996/1997) - has acted inconsistently with its obligations under Article 3.3 and Article 8 of the Agreement on Agriculture by providing export subsidies as listed in Article 9.1(a) and Article 9.1(c) of that Agreement in excess of the quantity commitment levels specified in Canada's Schedule; and
- (b) by restricting the access to the tariff-rate quota for fluid milk to (i) consumer packaged milk for personal use and (ii) entries valued at less than C\$20, acts inconsistently with its obligations under Article II:1(b) of GATT 1994.

8.2 Since Article 3.8 of the DSU provides that "[i]n cases where there is an infringement of the obligations assumed under a covered agreement [including the Agreement on Agriculture and GATT 1994], the action is considered *prima facie* to constitute a case of nullification or impairment", we conclude that - to the extent Canada has acted inconsistently with its obligations under the Agreement on Agriculture and GATT 1994 - it has nullified or impaired benefits accruing to New Zealand and the United States under these Agreements.

8.3 We *recommend* that the Dispute Settlement Body requests Canada: (i) to bring its dairy products marketing regime into conformity with its obligations in respect of export subsidies under the Agreement on Agriculture<sup>531</sup>; and (ii) to bring its tariff-rate quota for fluid milk into conformity with GATT 1994.

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<sup>531</sup> In this respect, we recall our findings under Article 10.1 and Article 8 of the Agreement on Agriculture (paras. 7.117-7.134).