

**CANADA – MEASURES AFFECTING
THE IMPORTATION OF MILK
AND THE EXPORTATION OF DAIRY PRODUCTS**

Second Recourse to Article 21.5 of the DSU by
New Zealand and the United States

Report of the Panel

The report of the Panel on Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products, Second Recourse to Article 21.5 of the DSU by New Zealand and the United States is being circulated to all Members, pursuant to the DSU. The report is being circulated as an unrestricted document pursuant to the Procedures for the Circulation and De-restriction of WTO Documents (WT/L/452).

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I. INTRODUCTION

1.1 On 23 December 1999, pursuant to Article 21.3(b) of the DSU, Canada, New Zealand and the United States agreed (WT/DS103/10-WT/DS113/10) on the reasonable period of time for implementation of the recommendations and rulings of the Dispute Settlement Body (the DSB) in the matter of "Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products". According to the terms of the 23 December 1999 agreement, as amended on 11 December 2000 (WT/DS103/13-WT/DS113/13), the staged implementation process, including any new measures for the export of dairy products, was to be completed by 31 January 2001.

1.2 On 19 January 2001, Canada circulated to all Members of the DSB (WT/DS103/12/Add.6-WT/DS/113/12/Add.6) its "final status report", pursuant to Article 21.6 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (the DSU). In that report Canada affirmed "that it will be in full compliance with the rulings and recommendations of the DSB by the conclusion of the implementation period" on 31 January 2001.

1.3 New Zealand and the United States consider that Canada has failed to comply with the above-mentioned recommendations and rulings of the DSB by 31 January 2001.

1.4 Without prejudice to their rights under the WTO, and in accordance with paragraph 1 of the 21 December 2000 "Agreed Procedures between Canada, New Zealand and the United States under Articles 21 and 22 of the Dispute Settlement Understanding in the follow-up to the dispute in *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*" (WT/DS113/14 and WT/DS103/14, respectively) ("Agreed Procedures"), New Zealand and the United States requested consultations with Canada on 2 February 2001. Consultations were held on 9 February 2001, but failed to resolve the dispute.

1.5 On 16 February 2001, pursuant to Article 21.5, and as envisaged in the Agreed Procedures, New Zealand and the United States accordingly requested the establishment of a panel in this matter and requested that the DSB refer the matter to the original panel, if possible (WT/DS113/16 and WT/DS103/16, respectively.)

1.6 On 16 February 2001, New Zealand and the United States also requested authorization from the DSB, pursuant to Article 22.2 of the DSU, to suspend the application to Canada of tariff concessions and other obligations under the General Agreement on Tariffs and Trade 1994 (GATT 1994) covering trade in the amount of US\$35 million for each complainant. On 28 February 2001, pursuant to Article 22.6 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), Canada objected to the level of suspension of tariff concessions and other obligations under the GATT 1994 proposed by New Zealand and the United States (WT/DS113/17 and WT/DS103/17, respectively). In accordance with the provisions of Article 22.6 of the DSU and as envisaged in the Agreed Procedures, Canada therefore requested that this matter be referred to arbitration.

1.7 In accordance with the "Agreed Procedures", the Complainants did not object to the referral of the level of suspension of concessions or other obligations to arbitration pursuant to Article 22.6 of the DSU. In this case, New Zealand and the United States agreed to request the arbitrator to suspend its work until either (a) the adoption of the Article 21.5 compliance panel report; or (b) if there were an appeal, the adoption of the Appellate Body report.

1.8 At its meeting on 1 March 2001, the DSB decided, in accordance with Article 21.5 of the DSU, to refer to the original panel, if possible, the matter raised by New Zealand and the United States in documents WT/DS113/16 and WT/DS103/16, respectively.

1.9 The report of the Article 21.5 panel was circulated to Members on 11 July 2001. On 4 September 2001, Canada notified the DSB of its intention to appeal certain issues of law covered in the Panel Report on *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* (Recourse to Article 21.5 by New Zealand and the United States) and certain legal interpretations developed by the panel. The Appellate Body rendered its report on 3 December 2001.

1.10 On 6 December 2001, New Zealand (WT/DS113/23) and the United States (WT/DS103/23) requested the establishment of a second Article 21.5 panel as they considered that there continued to be "a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings of the DSB" between Canada and New Zealand and Canada and the United States, respectively, within the terms of Article 21.5 of the DSU. New Zealand and the United States therefore requested, pursuant to Article 21.5 of the DSU, that this matter be referred to the original panel.

1.11 On 18 December 2001 Canada, New Zealand and the United States agreed to an amendment of the "Agreed Procedures" which provides that the arbitration requested by Canada under Article 22.6 will remain suspended until the DSB finds that Canada has failed to comply with the recommendations and rulings of the DSB or that the measures taken by Canada to comply with the recommendations and rulings of the DSB are inconsistent with the covered agreements as referred to in the second Article 21.5 compliance panel request. Alternatively, if the DSB were to find that Canada has complied with the recommendations and rulings of the DSB, the Complainants will withdraw their request under Article 22.2 of the DSU. Further, the amendment stated that following establishment of the second compliance panel in accordance with paragraph 2 of the Understanding, the Complainants will request that, with the exception of all matters relating to Panel composition, the work of the Panel be suspended pursuant to Article 12.12 of the DSU until 18 February 2002.

1.12 At its meeting on 18 December 2001, the Dispute Settlement Body (DSB) decided, in accordance with Article 21.5 of the DSU, to refer to the original panel the matter raised by New Zealand and the United States in documents WT/DS113/23 and WT/DS103/23, respectively.

(i) *Terms of reference*

1.13 At that DSB meeting, it was also agreed that the Panel should have standard terms of reference as follows:

"To examine, in the light of the relevant provisions of the covered agreements cited by the United States in document WT/DS103/16 and by New Zealand in document WT/DS113/16, the matter referred to the DSB by the United States and New Zealand in those 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."

(ii) *Composition of Panel*

1.14 The Panel was composed on 17 January 2002 as follows:

Chairperson: Mr Ernst-Ulrich Petersmann
Members: Mr Guillermo Aguilar Alvarez
Mr Peter Palecka

1.15 Argentina, Australia and the European Communities reserved their third party rights.

1.16 The Panel held a meeting with the Parties on 22-23 April 2002 and with the Third Parties on 23 April 2002. The report of the Panel was submitted to the Parties on 24 June 2002.

II. FACTUAL ASPECTS

(i) *Previous system*

2.1 Under the Canadian supply management system, introduced on 1 August 1995, a processor who wished to export had to obtain a permit from the Canadian Dairy Commission (CDC), allowing it to buy milk under Special Milk Class 5(d) and (e). Class 5(e), referred to as "surplus removal", was made up of both in-quota and over-quota milk. Class 5(d) referred to specific negotiated exports including cheese under quota destined for the markets of the United States and the United Kingdom, as well as evaporated milk, whole milk powder and niche markets. The permit also specified the dairy products to be exported. The CDC only issued Special Milk Class 5(e) permits when all demand for milk in the domestic market was met. Once the processor had obtained the CDC permit, it approached the local marketing board, which made milk available to the processor at the regulated price and with a guaranteed margin. Prices for Classes 5(d) and (e) were negotiated and established on a case-by-case basis with the processors/exporters. The CDC conducted these negotiations in accordance with the criteria agreed upon in the Canadian Milk Supply Management Committee (CMSMC).

(ii) *Canada's implementation measures*

2.2 Canada's implementation of the rulings and recommendations of the DSB left in place the domestic price support mechanism and production quota but eliminated Special Milk Class 5(e) and restricted exports of dairy products under Special Milk Class 5(d) to Canada's export subsidy commitment levels.¹ Canada also created a new class of domestic milk, Class 4(m), under which any over-quota milk can be sold as animal feed at a regulated price on the domestic market.² In addition, Canada deregulated milk for export processing (other than milk exported under Special Milk Class 5(d)) by introducing a new category of "commercial export milk" (CEM), by definition exempt from the pricing regulations applicable to milk destined for the domestic market and destined for export. There are no volume, pricing or timing restrictions on such exports.

2.3 The diversion of CEM or of products made therefrom onto the domestic market is prohibited and subject to penalties. Under pre-commitment contracts, producers decide in advance of production how much milk to sell as CEM which is then delivered first out of the tank to processors.³ Price and volume of CEM are negotiated directly between the processor and the producer.⁴ The governments in Ontario and Quebec require that all export participants operate through a single commercial export exchange.⁵ These "bulletin boards" are part of the operational framework within which commercial export transactions take place.⁶

¹ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)* WT/DS103/AB/RW and WT/DS113/AB/RW, paras. 4 and 79.

The full titles of the relevant panel and Appellate Body reports are provided in the Annex on page 94.

² *Ibid.*, para. 4.

³ *Ibid.* The panel in *Canada - Dairy (Article 21.5 – New Zealand and US)* noted that DFO General Milk Regulation 09/00 defines CEM as milk that is pre-committed and first out of a producer's tank.

⁴ *Ibid.*, paras. 4 and 79.

⁵ Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 3.8.

⁶ *Ibid.*

2.4 Pursuant to the *Canadian Dairy Commission Act*⁷, the *Dairy Products Marketing Regulations*⁸ have been modified to exclude CEM and cream from federal licensing⁹, quota¹⁰ and levy requirements¹¹ and from the requirement to market this milk through the provincial marketing boards. Furthermore, the milk delegation orders issued to provinces pursuant to *the Agricultural Products Marketing Act*, R.S.C. 1985, c. A-6, have been amended to remove provincial authority regarding CEM or cream.¹² As a consequence of the changes made under *the Dairy Products Marketing Regulations* and the *Ministerial Direction*¹³, the regional pooling agreements (the P-9, P-6 and P-4 Agreements) do not apply to CEM. The national pooling agreement, the P-9, provides for a domestic surplus management Class, Class 4(m).

(iii) *Previous panel and Appellate Body judgements*

2.5 In its report of 17 May 1999, the original panel in *Canada - Dairy* concluded that Canada "through Special Milk Classes 5(d) and (e) ... 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; ..."¹⁴ In its report of 23 September 1999 the Appellate Body upheld the findings in the original panel report with respect to Articles 3.3, 8 and 9.1(c) of the *Agreement on Agriculture*.¹⁵ In respect of Article 9.1(a), the Appellate Body did not uphold the reasoning of the panel, but it reserved its judgement on the question of whether Classes 5(d) and 5(e) conferred export subsidies within the meaning of Article 9.1(a).¹⁶ The Appellate Body recommended that Canada bring those measures found to be inconsistent with its obligations under the *Agreement on Agriculture* into conformity with that agreement.¹⁷ Canada's implementation of the Appellate Body ruling has resulted in the elimination of Special Milk Class 5(e) and the restriction of Class 5(d) to the export of dairy products within Canada's export subsidy commitment levels.¹⁸

2.6 Considering that Canada had failed to comply with the above-mentioned recommendations and rulings of the DSB by 31 January 2001 or since the expiry of that period, New Zealand and the United States requested consultations with Canada on 2 February 2001 (WT/DS103/15-WT/DS113/15) and subsequently the establishment of a panel pursuant to Article 21.5 of the DSU (WT/DS103/16-WT/DS113/16).

2.7 The Article 21.5 panel submitted its report to the parties on 5 July 2001 (WT/DS103/RW). The panel concluded that Canada had continued to act inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*, by providing export subsidies within the meaning

⁷ R.S.C. 1985, c. C-15 (Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 3.6).

⁸ SOR/94-466 (Exhibit CDA-1B). The Dairy Products Marketing Regulations were amended by *the Regulations Amending the Dairy Products Marketing Regulations*, C. Gaz. 2001.II.57 (Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 3.6).

⁹ *Supra*, note 31, s. 3(3) and s. 7 (Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 3.6).

¹⁰ *Ibid.*, s. 4, 5 and 6.

¹¹ *Ibid.*, s. 3(3).

¹² See Order Amending Milk Orders Under the *Agricultural Products Marketing Act*, SOR/2001-16, C. Gaz. 2001.II.67 (Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 3.6).

¹³ Published in Canada Gazette, 3 January 2001.

¹⁴ Para. 8.1(a).

¹⁵ Appellate Body Report, *Canada - Dairy*, DSR 1999:V, 2057, para. 144(b).

¹⁶ *Ibid.*, para. 144(a).

¹⁷ *Ibid.*, para. 145.

¹⁸ Canada Gazette Part II, Vol.135, No.1: Regulatory Impact Analysis Statement for the Regulations under the Canadian Dairy Commission Act amending the Dairy Products Marketing Regulations. The amendment to section 7.1 "provides that export subsidies for Canadian dairy products will be provided only by a program established under para. 9(1)(i) of the CDC Act (Special Milk Class 5(d))." (New Zealand's Exhibit NZ-6)

of Article 9.1(c) of the *Agreement on Agriculture* in excess of its quantity commitment levels specified in its Schedule for exports of cheese, for the marketing year 2000/2001.

2.8 On 4 September 2001, Canada appealed certain issues of law covered in the Article 21.5 panel report, pursuant to Article 16.4 of the DSU. The Appellate Body rendered its report on 3 December 2001.¹⁹ In reversing the panel's finding on the correct benchmark for the determination of the existence of "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture* and in consequently reversing the panel's findings that the provision of CEM constitutes "payments" and export subsidies under that provision, the Appellate Body also reversed the panel's finding that Canada has acted inconsistently with its obligations under Articles 3.3 and 8 of that Agreement. Because the Appellate Body considered that in light of the factual findings by the panel in *Canada – Dairy (Article 21.5 – New Zealand and US)* it was unable to determine whether or not the measure at issue was an export subsidy within the meaning of Article 9.1(c) and consequently whether or not Canada's measures were consistent with its WTO obligations, it could not complete the analysis of the parties' claims under Article 10.1 of the *Agreement on Agriculture* and declined to examine the consistency of the measure at issue with Article 3.1 of the Agreement on Subsidies and Countervailing Measures (*SCM Agreement*).²⁰

¹⁹ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*.

²⁰ *Ibid.*, paras. 121, 125, 126 and 127.

III. MAIN ARGUMENTS

3.1 **New Zealand** requests that the Panel find that Canada has breached Articles 3.3, 8 and 9.1(c) of the *Agreement on Agriculture*. In the alternative to its argument on Article 9.1(c), New Zealand requests the Panel to find that Canada has breached Article 10.1 of the *Agreement on Agriculture*. New Zealand therefore requests the Panel to recommend to the DSB that Canada bring its export measures into conformity with its obligations under the *Agreement on Agriculture*.

3.2 The **United States** requests that the Panel find that Canada has breached Articles 3.3, 8, and 9.1(c), or alternatively, Article 10.1, of the *Agreement on Agriculture*. In addition, the United States requests that the Panel find that Canada has breached Article 3 of the SCM Agreement. The United States requests that the Panel direct Canada to bring its export measures for dairy products into conformity with its WTO obligations.

3.3 **Canada** requests the Panel to reject the claims of New Zealand and the United States and find that Canada's measures, including federal measures and the provincial measures of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, Nova Scotia, New Brunswick and Prince Edward Island, fully implement the recommendations and rulings of the DSB and are consistent with Canada's WTO obligations.

A. BURDEN OF PROOF

3.4 Referring to Article 10.3 of the *Agreement on Agriculture*, **New Zealand** and the **United States** submitted that Canada bears the burden of establishing that its dairy management measures, including those taken to comply with the DSB's recommendations, have not subsidized dairy exports in excess of its commitment levels under that *Agreement*.

3.5 **Canada** does not contest its burden of proof under Article 10.3 of the *Agreement on Agriculture*.

B. ARTICLE 9(1)(C) OF THE AGREEMENT ON AGRICULTURE

3.6 The **Complainants** submitted that there are two key questions to be resolved in determining whether Canada's CEM scheme provides export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. First, whether there have been "payments" on the export of an agricultural product and, second, whether any such payments have been "financed by virtue of governmental action." According to the complainants, the CEM scheme fulfils both of these conditions and thus constitutes an Article 9.1(c) export subsidy.

1. "Payments"

3.7 The **Complainants** noted that in the original *Canada - Dairy* proceeding²¹, the Appellate Body accepted that the concept of "payments" in Article 9.1(c) of the *Agreement on Agriculture* includes the notion of "payments-in-kind", and this was not contested in *Canada - Dairy Article 21.5*.²² Furthermore, it is uncontested that the provision of a product at a discount constitutes such an in-kind payment because it is equivalent to the provision of a portion of the product free of charge.

²¹ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 112.

²² *Ibid.*, para. 71.

3.8 **Canada** submitted that for a measure to fall within Article 9.1(c) of the *Agreement on Agriculture*, there must be "payments on the export of an agricultural product that are financed by virtue of governmental action."

(i) *Average total costs of production-proper value*

3.9 The **Complainants** noted that in *Canada - Dairy Article 21.5* the Appellate Body gave content to its statement in *Canada - Dairy* that discounts amounting to "payments" arose because the Special Milk Class milk for export was sold to processors at "reduced rates (that is at below market-rates)."²³ At issue was the question of the benchmark against which any such "discount" should be measured. The Appellate Body stated that the existence of a "reduced rate" and hence a "payment" should be determined by comparing the CEM price to the "*proper value*" of the milk to the producer.²⁴ If the CEM price proved to be lower than the milk's value to the producer, the producer's sale of that milk at the CEM price would constitute a transfer of resources - a "payment" - to the export processor.

3.10 This led the Appellate Body to conclude, the Complainants continued, that the "proper value" of milk to producers, should be measured in terms of the producers' "average total costs of production". If the export prices obtained by producers were sufficient to recover their average fixed and variable costs of production, they would not suffer a loss (i.e. a transfer of resources) in the long run. In that circumstance, under the Appellate Body's standard, no "payments" would take place within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. It concluded that the "average total cost of production" must be determined "by dividing the fixed and variable costs of producing *all* milk, whether destined for domestic or export markets, by the total number of units of milk produced for both these markets."²⁵

3.11 The Complainants submitted that there is no universal criterion or standard for determining "cost of production". However, for the purposes of determining whether there has been a "payment" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, the Appellate Body has set out what has to be taken into account in this case in an "average total cost of production" determination. It noted that milk production "requires an investment in fixed assets, such as land, cattle and milking facilities, and an outlay to meet variable costs, such as labour, animal feed and health-care, power and administration."²⁶ These "fixed and variable costs", it concluded, would have to be recouped in the long-term in order for producers to be profitable.²⁷

3.12 Referring to paragraph 87 of the Appellate Body report in *Canada - Dairy Article 21.5* concerning fixed and variable costs and to paragraph 92 with respect to the correct benchmark in this case, **Canada** submitted that the method adopted by the Appellate Body is to determine what it costs a producer to produce milk, so that this number can be fairly compared to prices of CEM. Furthermore, the use of the words "investment" and "outlay" is indicative of what the Appellate Body considered as cost of production in the context of costs actually incurred and expended by the producer. Canada considered that these words, along with the idea expressed by the Appellate Body that "fixed and variable costs are the total amount which the producer must spend in order to produce the milk and the total amount it must recoup in the long-term to avoid making losses", do not allow for the consideration of imputed amounts.

²³ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 113.

²⁴ *Ibid.*, para. 74.

²⁵ *Ibid.*, para. 96.

²⁶ *Ibid.*, para. 87.

²⁷ *Ibid.*

3.13 Canada submitted that the approach adopted by the Appellate Body is consistent with the arguments put forward by Canada before the first *Canada - Dairy Article 21.5* panel. This method also provides a relevant standard for assessing an individual producer's cost of production for purposes of these proceedings, as it is based on values to which producers actually respond when deciding whether to enter the export market, and not on government intervention. This method of measuring cost of production is also consistent with the Generally Accepted Accounting Principles (GAAP). In the context of GAAP, "cost" is "[t]he amount of the expenditure to obtain goods or services"²⁸ and "expenditure" is "[a] disbursement, a liability incurred ... for the purpose of obtaining goods."²⁹ Therefore, Canada submitted, the costs to be included in the measurement of cost of production are those that result from actual expenditures and would exclude imputed costs and returns.

(ii) *The Canadian Dairy Commission*

3.14 The **Complainants** noted that the Canadian Dairy Commission (CDC) makes an annual cost of production determination as the basis for setting the target price for industrial milk. Thus, the Complainants considered it appropriate to look at that determination to see whether it provides an assessment of the "average total cost of production" that conforms with the test set out by the Appellate Body.

3.15 The Complainants further noted that the guidelines for the CDC's cost of production determination are set out in the CDC publication *National Cost of Production Input to the Pricing of Industrial Milk, Handbook of COP Principles and Practices (CDC Handbook)*.³⁰ The stated policy objective of the CDC's cost of production exercise is to provide "efficient producers with the opportunity for a fair return for their labour and investment."³¹ The cost of production determined by the CDC has traditionally been based on a consolidation of the results of provincial cost of production surveys. The provincial surveys cover a sample of dairy operations designed to represent "an efficient segment of the dairy industry."³² Each province calculates the cost of production for a hectolitre of milk "on a standardised basis, for each producer in each provincial sample."³³ The data is "collected for the provincial study by trained technicians" and "accounting concepts are based on generally accepted accounting principles (GAAP) and that "[e]ach provincial study is subject to audit by the CDC."³⁴ The most recent survey was completed by the CDC itself using a uniform approach across Canadian provinces.³⁵ Thus, the national cost of production measurement that results from the CDC's calculation represents the cost of production of a standardised, efficient producer.

3.16 The Complainants submitted that although the CDC's methodology understates the actual costs of milk production, it appears to conform in large measure with the requirements for determining the average total cost of production set out by the Appellate Body in *Canada - Dairy Article 21.5*. The four major components utilised by the CDC for determining the cost of production are cash costs, government rebates and other revenues, capital costs, and family labour. The CDC accounts for both the fixed and the variable costs incurred in the production of milk. It identifies labour as a cost and includes paid labour, family labour and management. It includes a return on investment in fixed assets, thus, according to the Complainants, addressing capital costs. The Complainants considered that it is essential that the CDC do all of this in order to ensure that the

²⁸ *Terminology for Accountants*, page 58 ("cost"). (Canada's Exhibit CDA-1).

²⁹ *Ibid.*, page 88 ("expenditure").

³⁰ Exhibit NZ-4 and Exhibit US-22.

³¹ *CDC Handbook*, section 2.1.

³² *Ibid.*

³³ *Ibid.*, section 4.3.

³⁴ *Ibid.*

³⁵ See Exhibit NZ-5, CDC Executive Summary of 2000 COP Determination.

efficient producer does not suffer a loss over the long term. The CDC's cost of production determination is part of the process leading to the setting of the target price for industrial milk. That target price has to allow efficient milk producers "to recover their cash costs, labour and investment related to the production of industrial milk."³⁶ The Complainants considered, however, that although the CDC's determination of the cost of production represents a reasonable guide to the "average total cost of production" test set by the Appellate Body, it is a conservative determination of the cost of production of milk in Canada.

3.17 The **United States** recalled that every year the CDC surveys Canadian dairy farms in order to calculate their cost of production. The CDC then uses this information to set the domestic price for milk (see paragraph 3.14 above). The United States was of the view that the methodology used by the CDC corresponds to the standard set forth by the Appellate Body in this case.

3.18 Recalling the statement by the Appellate Body that the average total cost of production calculation had to be made on the basis of "all" milk³⁷, the **Complainants** noted that the CDC's determination of cost of production excludes certain producers from its calculation. First, producers whose production is less than 60 per cent of the average provincial yearly production are excluded.³⁸ This is essentially an exclusion of small, inefficient farms and thus of farms with higher production costs. Second, the CDC Handbook explains that the calculation does not include the 30 per cent of farms with the highest costs of production.³⁹ These exclusions are designed to meet the CDC's objective of focusing on efficient producers. However, since those excluded are producers with a higher cost of production, the cost of production measurement reached by the CDC underestimates the average total cost of production of milk in Canada as a whole and thus lowers the reported average total cost of production.

3.19 **Canada** submitted that contrary to the position adopted by the Complainants (see paragraphs 3.14-3.18 above) the CDC methodology does not correspond to the requirements for determining the average total cost of production set out by the Appellate Body. The CDC methodology is prepared for a different purpose than the one put forward by the Appellate Body. The CDC methodology, which reflects government economic and social policy objectives (i.e., the government's intervention in the marketplace), embodies not only actual monetary costs incurred in milk production, but also imputed returns to dairy farm resources that do not involve actual outlays.

3.20 With respect to the claim by the Complainants in paragraph 3.18 above concerning the exclusion of small producers from the sample, Canada explained that only the province of Ontario collects cost of production data from a sample representative of all dairy farms, regardless of production levels. Data from this province show that the cost of production for all dairy farms is not significantly higher than the cost of production for those with production of at least 60 per cent of the provincial average. Since Ontario is one of the largest milk-producing provinces, it is not unreasonable to assume that these results are representative of the entire country. Canada submitted in conclusion that the data do not support a finding that a "payment" within the meaning given to that term by the Appellate Body under Article 9.1(c) for purposes of these proceedings is being made by independent milk producers to dairy processors on the production and sale of CEM.

(iii) *Administered domestic price*

3.21 Referring to Canada's arguments with respect to the inappropriateness of the CDC's calculations in relation to the Appellate Body's standard (see paragraph 3.19 above), the

³⁶ *CDC Handbook*, section 2.2.

³⁷ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 96.

³⁸ *CDC Handbook*, section 4.1.

³⁹ Handbook of COP Principles and Practices, page 7.

United States submitted that it is the actual economic cost of production which is being measured in both instances. That the ultimate price set by the Canadian government reflects "government economic and social policy objectives" does not affect the accuracy or relevance of the underlying cost data. The Appellate Body recognized that it is the administered *price* that is based "not only on economic considerations but also on other social objectives," not the underlying cost data.⁴⁰ Indeed, fundamental economic theory holds (as well as just basic common sense) that the absence of a cash outlay does not mean that a cost was not actually incurred.

3.22 Thus, the inclusion of costs for family labour, management services and capital is consistent with the Appellate Body standard and grounded in economic theory. These are costs that are incurred by the producer and if not recovered will result in losses in the long run. This is precisely what the Appellate Body's standard seeks to measure. In economic terms, the United States continued, these costs represent opportunity costs or the costs associated with opportunities that are foregone by not putting the producers' resources to their best use.⁴¹ These resources include family labour, its managerial services and its capital. There is a cost associated with using all of these resources.

3.23 **Canada** submitted that the CDC cost calculation is used as the major element in setting the administered domestic price. Accordingly, the CDC cost calculation together with the administered price ensures that the statutory objective of the CDC, which is to "provide efficient producers of milk and cream with the opportunity of obtaining a fair return for their labour and investment"⁴², is met. To guarantee that the calculation of target returns provides a fair return to "efficient producers", the CDC methodology eliminates 30 per cent of the producers in each provincial sample with the highest cost of production.

3.24 **New Zealand** submitted that there are two distinct aspects to the determination of the administered price for milk. The first is the computation of the cost of production of milk on the basis of surveys, and the second is the setting of the target or administered price in the light of that computation and of other factors. The former, as described in the CDC Handbook, is an objective process. Costs are based on the results of provincial surveys, and there is no suggestion that the data in these surveys are anything other than objective. Nor is there a suggestion that the figures used are not actual figures resulting from those surveys. They are not figures that have been inflated or discounted on the basis of economic and social objectives.

3.25 It is the second part of the process, the fixing of the administered price, New Zealand continued, in which governmental economic and social objectives come into play. The price can be set above or below the amount determined by the cost of production calculation. That is a matter of social choice. As well as taking the cost of production survey into account, the CDC sets the target price after giving consideration to "consultations with major dairy industry stakeholder representatives from the farm, processing, further processing, restaurant and consumer sectors, as well as other economic indicators".⁴³ That a choice exists here does not taint the CDC's methodology for determining the cost of production and turn it into one that is based on social choice rather than on the objective collection and computation of data.

⁴⁰ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, para. 81.

⁴¹ Mansfield, Edwin, *Microeconomics: Theory and Applications* (Fourth Edition, New York: W.W. Norton and Company, 1982), p.178. Exhibit US-35.

⁴² *Canadian Dairy Commission Act*, R.S.C. 1985, c. C-7, section 8. (Exhibit CDA-3)

⁴³ See Exhibit NZ-7, "Increases to Support Prices for Butter and Skim Milk Powder", CDC News Release, 14 December 2001.

(iv) *Imputed costs*

3.26 **New Zealand** submitted that even if the government chooses an administered price which is the same as the result of the CDC's cost of production analysis, this does not make that analysis any less relevant to the Appellate Body's average total cost of production test. Furthermore, both debt and equity represent alternative means of financing an investment in fixed assets.

3.27 **Canada** explained that to meet the statutory objective described above (see paragraph 3.23 above), the CDC is required to include imputed or assigned returns to unpaid labour, management, and owner's equity (i.e., residual amounts resulting from the operation of an enterprise) in its calculation of cost of production. However, such amounts are not actual outlays expended on the production of milk, nor do they represent an investment in fixed assets and, according to Canada, it is these that the Appellate Body sought to include in the total cost of production. Accordingly, such amounts should not be included in the cost of production calculated on the basis of the approach put forward by the Appellate Body.

3.28 Returns on labour and equity are essentially the profits of the enterprise; Canada continued, they are not costs of production. The profit of an enterprise is the residual amount that is available after the cost of production and other expenses are deducted from the revenues of the enterprise.⁴⁴ This profit is the amount that is available to remunerate those who have a stake in the enterprise for their investment of capital and labour, and to reinvest in the enterprise. In its report, the Appellate Body did not consider profit as an amount that the producer must spend to produce the milk or that must be recovered in the long-term to avoid making losses. Canada considered that there is therefore strong support in the Appellate Body's reasoning that such profit is distinct from and should not be included in the calculation of cost of production.⁴⁵

3.29 Referring to Canada's arguments above and to Article 31 of the *Vienna Convention on the Law of Treaties*, **New Zealand** considered that the context in which the words "investment" and "outlay" appear makes very clear that the Appellate Body refers to the production of goods and services involving an "investment in economic resources"⁴⁶, i.e. far from the "actual expenditures" limitation that Canada wishes to place on the term investment. Further, after identifying the "investment" and "outlay" that will represent the producer's fixed and variable costs, the Appellate Body said, "[t]hese fixed and variable costs are the total amount which the producer must spend in order to produce the milk and the total amount it must recoup in the long-term to avoid making losses."⁴⁷ Canada focuses on the notion of "spending", which accords with its view that only actual expenditures are to be included, and ignores the notion of "recouping" in order to avoid losses. New Zealand considered that a producer that sells its product at a price that does not allow it to recover imputed costs is absorbing those costs to the benefit of the purchaser. This is nothing more than a transfer of economic resources from the producer to the purchaser. In the opinion of New Zealand, the reasoning of the Appellate Body with respect to marginal costs also applies to imputed costs.

⁴⁴ *CICA Handbook – Accounting*, vol. I (Toronto: The Canadian Institute of Chartered Accountants, 1998), Section 1000, para. 27 [hereinafter "*CICA Handbook*"]. (Exhibit CDA-4)

⁴⁵ In the paragraphs of the Appellate Body report *Canada - Dairy (Article 21.5 - New Zealand and US)* in which the Appellate Body explained the meaning of total cost of production (particularly para. 87), profit is not mentioned. Para. 95 contains a direct reference to profit, but the structure of this phrase "not only to recover the total cost of production, but also in the hope of making profits" strongly suggests that, in the view of the Appellate Body, profit is distinct from average total cost of production and, by extension, not part of the standard reflecting proper value.

⁴⁶ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 87.

⁴⁷ *Ibid.*

3.30 New Zealand submitted that generic definitions of terms without reference to the context in which they appear or the purpose for which they are used are misleading. GAAP does not provide a universal definition of the words "cost" and "expenditure" applicable in all circumstances, and thus it provides no guidance to the particular circumstances of determining whether payments within the meaning of Article 9.1(c) of the *Agreement on Agriculture* have been made. In short, it is not possible to achieve the objective the Appellate Body was seeking to achieve by narrow definitions of the terms "investment", "outlay", "cost" and "expenditure" that result in costs that producers incur being left out.

3.31 The **United States** noted that according to the Appellate Body, analysis under Article 9.1(c) must be based on a "standard that focuses upon the motivations of the independent *economic operator*".⁴⁸ Consistent with this line of reasoning, the Appellate Body explained that "[f]or any *economic operator*, the production of goods or services involves an investment of *economic resources*."⁴⁹ The Appellate Body then offered some examples of the types of fixed and variable costs that should be taken into account in calculating the cost of production for milk producers. It is clear from the Appellate Body's statements and reasoning that the production of milk involves an "investment of economic resources," and that all economic costs should be taken into account, not just actual cash outlays as argued by Canada. If an economic operator recuperates only its actual cash outlays, it will incur losses in the long run and eventually fail. Canada's selective reliance upon the use of the words "investment" and "outlay" is inconsistent with the context in which they were used by the Appellate Body.

3.32 With respect to the arguments in paragraph 3.28 above concerning returns on labour and equity, **New Zealand** considered that Canada's use of the term "profit" is highly ambiguous. New Zealand submitted, and as the CDC's cost of production methodology recognises, that labour, management and owner's equity are costs that are incurred by the producer. Producers who do not cover those costs in selling milk are not recouping their losses over the long term as the Appellate Body contemplated. Failure to include a return on family labour or on investment in the price that a producer charges a processor involves a transfer of economic resources from the producer to the processor – precisely what the Appellate Body's test is seeking to discover. Although, as pointed out in paragraph 3.16 above, the CDC's methodology is a conservative one and underestimates the true cost of production, it provides a reasonable guide to the application of the average total cost of production test.

3.33 The cost of labour and equity capital represent an "opportunity cost", i.e., the income that these resources could generate if put to an alternative use and this opportunity cost must be recovered in the long run if a business is to continue. It makes no economic sense to say that a producer who employs family labour has a lower cost of production than a producer who uses hired labour. Nor does averaging across producers produce a meaningful average total cost of production if the costs of some producers (those who hire labour) are taken into account and the costs of other producers (those who use family labour) are not.

3.34 The **United States** considered that Canada's suggestion (see paragraph 3.28 above) that the farm which hires labour and management services is incurring a cost, while the farm that uses family labour and management is making a profit is absurd. It further submits that it is equally absurd to suggest that the farm that finances its operations with debt incurs a cost (i.e. interest expense), but that the farm that finances its operations with equity is making a profit. Any economic operator, including the Canadian dairy farmer, will take these non-cash costs into account in calculating its cost of production to determine whether it is going to be able to stay in business in the long run.

⁴⁸ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 92.

⁴⁹ *Ibid.*, para. 87.

3.35 The United States noted that Canada does not dispute the accuracy of the CDC's calculation of the cost of family labour, management and capital, which is relied upon by the Complainants. Rather, Canada argues that, as a conceptual matter, those costs should not be included. According to the United States, Canada's proposed standard does not represent the true economic cost of producing milk and is not consistent with the Appellate Body report in this case.

3.36 **Canada** considered that there are essentially four main points of contention between the Parties in determining how to apply the standard put forward by the Appellate Body: (i) whether an amount for imputed returns to family labour, management and owner's equity should be included in the calculation of "average total cost of production"; (ii) how to treat marketing costs and quota; (iii) whether the "average total cost of production" should be calculated on the basis of the total costs of production of individual producers or the total costs rolled into a single industry-wide average; and (iv) Canada's presentation of its data on cost of production and CEM returns.

3.37 According to Canada, there are a number of reasons to reject the Complainants' position with respect to imputed returns. First, had the Appellate Body intended imputed returns or opportunity costs to be included in the calculation of cost of production, it could have said so since it was aware of their inclusion by the CDC in its calculation of a cost of production figure, as referred to in paragraph 100 of its report. Instead, the Appellate Body described the cost of production standard to be applied in these proceedings in terms of "investment"⁵⁰ and "outlay"⁵¹. The words "opportunity costs" or "imputed returns" do not appear in the language used by the Appellate Body.

3.38 Secondly, Canada continued, the inclusion of imputed returns in the calculation of cost of production reflects the government's intervention in the domestic marketplace. Imputed returns are included in the CDC methodology for calculating cost of production because the purpose of that methodology is to set prices that provide dairy farmers "with the opportunity of obtaining a fair return for their labour and investment." The Appellate Body was quite clear that, in determining whether a "payment" exists under Article 9.1(c), a distinction had to be drawn between circumstances where government intervenes in a marketplace and circumstances, as in this case, where a producer acts in the ordinary course of business. To accept the argument of the Complainants would be to substitute the determination of an acceptable profit by private parties in commercial transactions with a government assessment of what this profit should be, and, thus, to effectively draw the government back in where it does not belong.

3.39 Further, returns on family labour, management and owner's equity are derived from the profits of the dairy enterprise. According to Canada, the Appellate Body did not intend to include any measure of "profit" in its definition of total cost of production. Its explanation of total cost of production (particularly paragraph 87) does not include profit. Paragraph 95 contains a direct reference to "profit" and the structure of the sentence "... not only to recover the total cost of production, but also in the hope of making profits" indicates in the view of Canada that the Appellate Body considers that "profit" is distinct from "average total cost of production". This is not surprising, as independent milk producers do not need to recover "profits". To avoid making a loss, producers need to recoup their costs.

3.40 Canada considered that a determination of what constitutes an appropriate amount for imputed returns to family labour, management and owner's equity is highly speculative and subjective. In commercial export transactions, profit margins are a function of individual decisions made by each independent economic operator. Thus, subjecting a determination of profitability to WTO scrutiny would be contrary to the requirement of the Appellate Body for an "objective

⁵⁰ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 87.

⁵¹ *Ibid.*

standard". To do so would also introduce uncertainty and unpredictability into export subsidy disciplines under the *Agreement on Agriculture*. Accepting the cost of production figure calculated by the CDC would lead to these results because it includes a policy-driven determination of profitability. The CDC methodology is appropriate for the purposes for which it is used. However, this purpose is different from the one put forward by the Appellate Body.

3.41 Finally, Canada reiterated that arguing that the cost of production calculated by the CDC is the appropriate benchmark is another way to reintroduce the same benchmark specifically rejected by the Appellate Body. The CDC calculation of cost of production is the major element in setting the administered domestic price, and both are established through government intervention. Comparing the CDC cost of production to prices of CEM is, therefore, no different than comparing these prices to Canada's administered domestic price. Indeed, the cost of production calculated by the CDC varies little from the administered domestic price.

(v) *Quota as an intangible asset*

3.42 Another limitation on the CDC's cost of production determination, the **Complainants** submitted, is the exclusion from the calculation of the cost of holding production quota. There appears to be no justification for this exclusion. In *Canada - Dairy Article 21.5*, the Appellate Body stated that the cost of production calculation must include the fixed costs of producing all milk.⁵² The cost of holding production quota is a fixed cost⁵³ which would increase the CDC's total average cost of production.

3.43 The Complainants submitted further that a quota is an intangible asset and a resource defined by the International Accounting Standards Committee (IASC), as "(a) controlled by an enterprise as a result of past events; and (b) from which future economic benefits are expected to flow to the enterprise."⁵⁴ As such, the standard set for intangible assets by the IASC, (IAS 38) requires that it be "amortised on a systematic basis over the best estimate of its useful life."⁵⁵ **New Zealand** added that the IFCN includes quota in its list of factors to be incorporated in any dairy cost of production calculation.⁵⁶ Since quota represents a considerable expenditure by a producer,⁵⁷ failure by the CDC to include quota within its cost of production calculation again understates the true cost of production.

3.44 **Canada** replied that there are several reasons why quota costs should not be included in such a calculation. First, quota is an entitlement to *sell* milk onto the regulated domestic market at a higher price; it is not a restriction on *production*⁵⁸ and there is no requirement in Canada for producers to hold quota in order to produce and sell milk. Furthermore, it does not make sense to treat costs associated with the acquisition of quota as a cost of production of *all* milk, since producers can and do produce and sell CEM without quota. Arguing that quota represents a cost of production is adding to the finding of the Appellate Body words that are not there. The Appellate Body has called for an examination of costs that the producer spends in producing the milk. Also, since any quota costs are marketing expenses associated with sales in the domestic market, it follows that these

⁵² Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 96.

⁵³ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 6.53 and footnote 147.

⁵⁴ See Exhibit NZ-18, *International Accounting Standards Committee*, "International Accounting Standard: Intangible Assets", September 1998, page 3.

⁵⁵ *Ibid*, page 5.

⁵⁶ See Exhibit NZ-6.

⁵⁷ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 6.53 and footnote 147.

⁵⁸ Quota only limits a producer's right to obtain the domestic administered price (specifically Classes 1 through 5(d) excluding 4(m)), not his or her overall production level. However, a producer who pre-commits can also sell CEM under contract. Milk production in excess of domestic quota can be marketed under Class 4(m), albeit at a low price. Also, the Panel will recall from the previous Article 21.5 proceedings that there are producers in Canada who do nothing other than produce commercial export milk and these producers do not hold any quota.

costs should be recovered from returns obtained from that market. Furthermore, Canada continued, as concerns the argument with respect to amortisation of a quota due to its nature as an "intangible asset" in paragraph 3.43 above⁵⁹, no such amortisation is appropriate. North American accounting standards do not require the cost of acquisition of assets such as quota to be amortised at all. The useful life of quota is indefinite.⁶⁰ According to CICA, "...[w]hen an intangible asset is determined to have an indefinite useful life, it should not be amortised until its life is determined to be no longer indefinite."⁶¹ The Financial Accounting Standards Board of the United States also states that intangible assets with indefinite useful lives do not need to be amortised.⁶² However, an annual test of the value of the asset compared to its purchase cost is required. In the case of Canadian dairy quota, no impairment of value would be detected by such a test and therefore no current year cost in 2000 or 2001 would be recorded for quota in the financial statements of Canadian dairy farms prepared according to GAAP. Accordingly, there are no quota costs that need to be considered.

3.45 With respect to Canada's argument that quota is not a restriction on production (see paragraph 3.44 above) **New Zealand** submitted that this argument is a continuation of Canada's distinction between costs related to production and costs related to selling. New Zealand reiterated that a producer has to recover all of these costs if it is to remain in business, regardless of whether those costs are listed in the same column on a balance sheet. Thus, quota costs cannot be dismissed by treating them as relating to sale rather than to production. As concerns Canada's argument with respect to the indefinite life of a quota, New Zealand submitted that regardless of whether intangible assets should or should not be amortised, quota represents an investment that has to be recovered if the producer is to avoid losses over the long term. Hence, quota also has to be included in determining the average total cost of production if the result is to provide a meaningful test of whether there is a transfer of economic resources from producers to processors for export.

3.46 The **United States** considered that regardless of how quota is treated under accounting principles, it represents an economic cost to farmers that produce for the domestic market - a cost that is usually quite high.⁶³ In accordance with the Appellate Body's determination, the cost of production should be based on all milk production, regardless of the milk's ultimate destination. Accordingly, any and all costs associated with the domestic market, such as quota, should be included in the benchmark. Even Canada admits that this is a cost that producers will seek to recover from the returns of milk sold in the domestic market.

(vi) *Cost of capital*

3.47 The **United States** considered that the CDC's calculation is understated also because the cost of capital is calculated based upon the acquisition cost or book value of assets, such as land, as opposed to the market value of the assets.⁶⁴ The real cost of production for a producer is dependent

⁵⁹ The IASC is an advisory body to national standards setters; however all the regulatory and compliance force is at the national level. Canada notes that on the IASC web site (<http://www.iasc.org.uk/>), the IASC itself says that it "has no authority to require compliance with its accounting standards".

⁶⁰ *CICA Handbook – Accounting*, Section 3062, para. 15 states that "[w]hen no legal, regulatory, contractual, competitive, economic or other factors limit the useful life of an intangible asset to the enterprise, the useful life of the asset is considered to be indefinite." (Exhibit CDA-6)

⁶¹ *Ibid.*, para. 10.

⁶² *Goodwill and Other Intangible Assets*, Summary of Statement No. 142 (Financial Accounting Standards Board), June 2001. (Exhibit CDA-7)

⁶³ Indeed, Canada itself has emphasised that "there is an active commercial market in the trading of quota at privately negotiated rates." (See para. 54 of the second submission of Canada in the proceedings in the first recourse to Article 21.5 of the DSU.) For example, for butter fat, quota can cost as much as CDN \$25,000 per kilogram in Quebec and CDN \$20,000 per kilogram in Ontario.

⁶⁴ Exhibit US-22, page 3.

upon the current market value of the property, not what that particular producer happened to pay for the asset any number of years ago.

3.48 With respect to the argument by the United States in paragraph 3.47 above concerning capital costs, **Canada** explained that GAAP requires assets to be recorded at their historical cost. Financial statements are prepared primarily using the historical cost basis of measurement whereby transactions and events are recognized in financial statements at the amount of cash or cash equivalents paid or received or the fair value ascribed to them when they took place.⁶⁵ Other bases of measurement are also used but only in limited circumstances.⁶⁶

3.49 The **United States** responded that, regardless of how capital is recorded according to accounting principles, its economic cost is measured by its market value. Thus, the fact that the CDC uses book value to estimate the cost of capital results in an understatement of the cost of production. However, the fact that the CDC methodology understates the cost of milk production does not mean that the CDC methodology cannot be used in this proceeding. As explained, for instance, in paragraphs 3.53 - 3.54 above, even with this understated cost estimate, the average CEM price is below the average total cost of production for dairy farmers in Canada.

(vii) *Cost of Marketing Milk*

3.50 **Canada** was also of the view that, in accordance with the approach put forward by the Appellate Body, costs of *marketing* milk (i.e., transportation, administration and marketing fees) should not be included in the calculation of cost of *production* of milk, as these are not outlays that the producer must incur in the physical production of milk to the point of the farm gate. This is consistent with GAAP, which holds that production costs are classified separately from sales and marketing expenses.⁶⁷ Canada submitted that while marketing expenses are not costs of production, a producer would normally seek to recover those expenses from the returns obtained from the market in which the goods are sold.

3.51 Canada submitted that, contrary to what the Complainants assert, Canada did take marketing costs into account. However, marketing costs are not production costs. Including these in cost of production would therefore not be consistent with the Appellate Body's approach based on the cost of producing milk, not marketing milk. In Canada's view, the Complainants make an assertion, which is not supported by the words of the Appellate Body. As mentioned above, while marketing costs are not production costs, they are costs that must be recovered if a producer hopes to make a profit. Although Canada did not include marketing costs in its calculation of cost of production, Canada did deduct marketing costs attributable to sales in the export market from the prices of CEM to reflect actual returns from sales in that market (see also paragraphs 3.50 above and 3.65 below). Having done this, Canada considered that it has provided a fair and consistent comparison between the cost of producing milk and the net returns from selling it.

3.52 The **Complainants** considered that the farm gate is only relevant if the sale takes place there. In short, the exclusion of marketing costs from the calculation of the average total cost of production undermines the value of that test for determining whether producers are transferring economic resources to processors. The Complainants submitted that the Appellate Body set a standard which included all costs an economic operator must recover in order to avoid incurring losses in the long run. Indeed, Canada even acknowledges that the producer will attempt to recover marketing costs

⁶⁵ *CICA Handbook – Accounting*, Section 1000, para. 53. (Exhibit CDA-4)

⁶⁶ *Ibid.*, para. 54.

⁶⁷ *CICA Handbook – Accounting*, Section 3030, para. .06. (Exhibit CDA-5)

from the sale of milk. As a matter of fact, the Complainants added, there is no other revenue stream from which to recover these costs or to which these costs should be allocated.

(viii) *Calculation of average total cost of production (single producer versus industry-wide average)*

3.53 The **Complainants** noted that in *Canada - Dairy Article 21.5*, the Appellate Body took the view that there would be "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture* if the price paid for milk by processors for export was lower than the "average total cost of production." They considered that in the present case, even the CDC's own calculation of cost of production shows that test is easily met. The Complainants further noted that based on this data, the CDC estimated that the average total cost of production per hectolitre of milk in Canada was CDN \$57.51 in 1998, CDN \$56.43 in 1999, CDN \$57.27 in 2000 and CDN \$58.12 in 2001. This data alone is sufficient to establish that Canada's average total cost of production exceeds CEM prices by a substantial margin. Public information posted by Ontario and Quebec show that the weighted average price of CEM in the 12-month period between August 2000 and July 2001 was CDN \$29.⁶⁸

3.54 Thus, the **United States** submitted, the average total cost of production exceeded the average price for that period by CDN \$28.27.⁶⁹ Further, inasmuch as it is extremely unlikely that costs of production could have dropped more than CDN \$20 since July 2001 (the last dairy year for which CDC data is presently available), it is a virtual certainty that the average total costs of production (as estimated by the CDC) have exceeded CEM prices since that time. Adjusting for the CDC's exclusions as described above would show that the difference between CEM prices and producers' costs of production (and hence the size of the "payments" for Article 9.1(c) purposes) is much greater than the CDN \$20 plus margin that the basic comparison of CEM prices and CDC data above would suggest. Thus, producers have failed to recover their fixed and variable costs by a substantial margin making the so-called "market" transactions for CEM demonstrably uneconomic in the long run. The Appellate Body's test for the existence of "payments" under the CEM scheme is easily met.

3.55 The **Complainants** concluded that, applying the test set out by the Appellate Body in *Canada - Dairy Article 21.5*, processors have access to milk at a price that is less than the "average total cost of production" of that milk. In the words of the Appellate Body, "the price charged by the producer is less than the milk's proper value to the producer."⁷⁰ Accordingly, Article 9.1(c) "payments" from producers to export processors have occurred under the CEM scheme.

3.56 **Canada** submitted that, when applying the approach put forward by the Appellate Body to calculate a producer's on-farm average total cost of production for all milk, the result would be a figure that would include the following costs: costs associated with fixed costs (i.e., interest payments, depreciation of buildings and equipment, and net heifer replacement cost) and an outlay to meet variable costs (i.e., costs for materials such as feed, seed, fertilizer, and water; costs for hired labour; costs of farm administration; and costs for property taxes and insurance). The complete list of elements in the calculation appears in "Explanation of COP Calculation".⁷¹

3.57 Based on the above, Canada explained that it calculated producers' average total cost of production, relying on the most recent and comprehensive data on milk production costs from annual provincial surveys based on a statistically valid national sample of milk producers, thus obtaining a representative sample of 274 dairy farms (broken down into "deciles") whose costs are surveyed. These data were for the year 2000. Canada noted that the CDC uses the same data in establishing its

⁶⁸ Exhibit US-3.

⁶⁹ *Ibid.*

⁷⁰ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 73.

⁷¹ Exhibit CDA-8

cost of production figure. The validity of using these data in making the cost computations for purposes of these proceedings is not in dispute.

3.58 The number of producers in the sample from which the data are gathered is considered representative of the population of producers in Canada.⁷² To be consistent with the approach put forward by the Appellate Body, Canada included the production outlays of the 30 per cent high cost producers that are excluded by the CDC in its methodology. In other words, the cost of production figures presented by Canada are based on the entire population in the sample, and not just the most efficient 70 per cent. Although the Complainants have criticised that aspect of the CDC methodology, Canada was of the view that its method of calculating cost of production resolves the Complainants complaint.

3.59 There is a significant variation of average total cost of production among individual producers given that in Canada there are in excess of 19,000 dairy production enterprises. Applying the Appellate Body's approach as detailed above shows total cost of production figures ranging from CDN \$18.53/hl for the lowest decile⁷³ to CDN \$46.60/hl for the highest decile. Given the Appellate Body's focus on the cost of production of individual producers and not an industry-wide average, Canada was of the opinion that it is more relevant for the purposes of these proceedings to examine a range of total costs of production and not a single average total cost.⁷⁴ The results of Canada's cost of production computations are presented in Exhibit CDA-9.⁷⁵

3.60 With respect to Canada's examination of "a range of total costs of production and not a single average total cost." (see paragraph 3.56 above), the **Complainants** were of the view that this is not consistent with the Appellate Body's requirement that the "payment" is to be measured by the average total cost of production for all milk. **New Zealand** considered that, as a matter of principle, the determination of whether subsidization exists on the basis of deciles of producers – groups that may be constantly changing – does not provide any sort of predictability either in terms of making WTO commitments or in terms of applying them.⁷⁶ Nor can the question of subsidization depend upon whether a particular individual producer sells above or below the cost of production. Contrary to the express words of the Appellate Body and to the practice of the CDC, Canada seeks to reinterpret the requirement that all milk be considered in determining the average total cost of production as a "focus on the cost of production of individual producers and not an industry-wide average". Canada cites no authority for this proposition.

3.61 The **United States** submitted that the Appellate Body did not find that the existence of a "payment" under Article 9.1(c) does depend upon whether any given individual producer may or may not happen to recoup its total cost of production. The United States further submitted that, Canada's statement that the Appellate Body "focus[ed] on the cost of production of individual producers and

⁷² The data used do not include producers whose milk production is less than 60 per cent of the annual average in their province. Thus, Canada is unable to include those producers in its calculations. However, those small farms provide 18 per cent of Canada's total milk production. Since the average production costs are weighted by production, the omission of this small sub-population should not lead to a dissimilar result.

⁷³ All producers in the data sample were ranked according to their cost of production and then divided into ten equal groups (deciles). The lowest decile is the one with the lowest average cost. Exhibit CDA-9 presents the results for all deciles. Commercial export milk prices and returns are also presented by deciles.

⁷⁴ For any given statistical average, some farms will necessarily be above and some below, especially where costs vary widely (as dairy production costs do). That a producer may fall above an industry average production cost does not affect that farmer's production and sales decisions, or determine whether he or she may make money in a particular market at a given time and price. What matters is the producer's cost structure and other individual circumstances, not industry cost averages.

⁷⁵ Cost of Production Results. (Exhibit CDA-9)

⁷⁶ The European Communities also raises concerns about the predictability of individual-based producer cost of production determinations. European Communities' Third-Party Submission, para. 13.

not an industry-wide average" (see paragraph 3.56 above) is contradicted by the Appellate Body's explanation of the calculation of the new standard. Referring to paragraph 96 of the Appellate Body's report with respect to *all* milk, the United States submitted that the Appellate Body was focused on an industry-wide average, and not on individual producers. For this reason, and other reasons explained below, Canada's exhibits, including exhibit 14 in particular, should be disregarded because they are only based upon the cash outlays of individual producers (broken down into "deciles") and therefore are inconsistent with the Appellate Body's standard.

3.62 **Canada** submitted, with reference to Complainants' arguments for an industry-wide "average total cost of production", that the Appellate Body's reference to "all milk" in paragraph 96 of its report refers to the need to include the production costs of *all* milk, domestic and export. It nowhere says or suggests that the cost of production analysis requires the averaging of all producers into a single industry-wide cost. As concerns "the milk producers" in paragraph 104, the Appellate Body stated that the standard for these proceedings is "the average total cost of production of the milk producers". "Milk producers" cannot automatically be interpreted as meaning the "industry". Rather, a review of the Appellate Body's report and the words used in the finding on "payment" supports Canada's position that "average total cost of production" be calculated on an individual producer basis rather than on an industry-wide basis.

3.63 With respect to the number of instances in the Appellate Body report where it referred to producer in the singular, Canada submitted that the focus should be on the costs associated with the actual producer, not the costs associated with the industry as a whole. Consistent with the approach of the Appellate Body, Canada recorded all actual production costs for a representative sample of individual producers in the industry and presented these figures in deciles and ranges. Presentation on a basis of ranges is, according to Canada, the best available measure of individual producers' costs and decisions.

3.64 The next step in the analysis of whether a "payment" exists under Article 9.1(c), Canada submitted, is to compare the total average cost of production of individual producers against the returns realised on sales of CEM. Accordingly, Canada has identified the prices of CEM to which the cost of production ranges of individual producers should be compared.

3.65 The only prices of CEM publicly available in Canada are from the three provinces that have electronic commercial exchanges (i.e., bulletin boards), namely Quebec, Ontario, and Manitoba which account for approximately 80 per cent of all production of CEM.⁷⁷ CEM prices are not readily available from the other provinces as this information is proprietary and confidential in nature. The information obtained from these commercial exchanges reveals that from August 2000 (i.e., the date when commercial export transactions began) to January 2002, CEM prices ranged from a low of CDN \$23.79/hl to a high of CDN \$40.12/hl.⁷⁸ It should be noted, Canada continued, that prices on the commercial exchanges overstate the actual returns to producers because they include marketing expenses.⁷⁹ As a result, Canada deducted these amounts from the prices referred to above.⁸⁰ With these deductions, the CEM returns range from a low of CDN \$20.69/hl to a high of CDN \$37.02/hl.

3.66 According to Canada, comparing average total costs of production of individual producers to CEM returns demonstrates how producers are able to sell CEM at prices that cover their average total cost of production.⁸¹ Indeed, the costs of production of over three-quarters of milk producers (fully 77 per cent), accounting for three-quarters of milk production, fall within the range of CEM returns.

⁷⁷ CEM Producers & Volumes. (Exhibit CDA-10)

⁷⁸ CEM Bulletin Board Prices and Volumes (Ranges). (Exhibit CDA-11)

⁷⁹ See Explanation of CEM Returns in Exhibit CDA-12.

⁸⁰ See CEM Returns and Volumes (Ranges) in Exhibit CDA-13.

⁸¹ Comparisons of Production Costs and CEM Returns. (Exhibit CDA-14)

The results provide strong support for Canada's position that payments are not being provided by producers to processors through CEM transactions.

3.67 **New Zealand** submitted that the results which Canada achieves with its cost of production analysis are questionable as it has not included producers whose milk production is less than 60 per cent of the annual average in their province (see footnote 72 above). Thus, Canada still excludes a significant category of producers whose costs are likely to be higher. Furthermore, although Canada states that "CEM returns range from a low of CDN \$20.69/hl to a high of CDN \$37.02/hl" (see paragraph 3.65 above), an analysis of the data provided by Canada shows that only 28 per cent of CEM milk has been sold for prices greater than CDN \$29.90/hl. By contrast, approximately 60 per cent of producers have average costs in excess of that figure even using costs of production as defined by Canada.⁸² New Zealand submitted that this gives quite a different impression than that found in paragraph 3.66 above where Canada states that 77 per cent of producers have average costs less than the highest CEM price. By failing to account for the low proportion of CEM sales at prices in excess of CDN \$29.90/hl, Canada's statement is misleading. If the costs of production were as calculated by the CDC (which itself is an underestimation of the average total costs of production as detailed above), Canada's decile approach would show that no Canadian producer has costs of production less than the average CEM price.⁸³

3.68 Referring to Canada's arguments in paragraphs 3.65 and 3.66 above, the **United States** replied that exhibit CDA-14 is misleading and distortive since it suggests that the producers with the higher cost of production are obtaining the higher CEM return. Yet, there is no evidence to suggest that the farms in decile 10 of production costs in CDA-9 are obtaining the CEM returns in decile 10 in CDA-13. The United States was of the view that Canada implicitly recognizes this in footnote 85 above. In other words, even though CDA-14 insinuates that the high cost producers are matched with the high CEM returns, Canada acknowledges that its conclusion is really based on the fact that there must be individual producers represented within the range somewhere that are recovering their total cost of production in the CEM "market." As explained above, however, the Appellate Body's standard requires a comparison of the "average total cost of production." Obviously, in crafting this standard, the Appellate Body realised that some producers would recover their cost of production and some would not.

⁸² See New Zealand Analysis of Canadian Exhibits CDA-9 and CDA-13 set out in Exhibit NZ-24.

⁸³ Canada does not provide a single figure representing the average cost of production using its methodology. Nevertheless, from Exhibit CDA-9 it is clear that the average is around CDN \$31/hl, some CDN \$26/hl less than the CDC figure set out in para. 3.53 above. This margin, when applied to each decile in Exhibit CDA-9, indicates that when CDC costs of production are used no Canadian producer has costs of production less than the average CEM price of around CDN \$29/hl.

3.69 Even using Canada's cost of production calculation (which excludes several of the actual costs described above),⁸⁴ the United States continued, Canada's exhibit 14 shows that roughly 60 per cent of Canadian producers could not cover their costs of production at CDN \$30. Furthermore, a review of the information presented on CDA-13 shows that approximately 70 per cent of milk sold on the CEM "market" obtains a return of CDN \$30 or less.

3.70 There is only a minority of high-cost producers, **Canada** replied, whose costs would not be covered by the prices of CEM.⁸⁵ However, as noted by the Appellate Body, the majority of Canadian dairy farmers choose not to participate in the CEM market.⁸⁶ Such a situation is likely to continue unless, and until, individual producers perceive that it is in their economic interests to participate. As of December 2001, less than 40 per cent of producers (approximately 8,000) in Canada had participated in such a transaction and many of these (34 per cent) did so for only a short time.⁸⁷ Furthermore, as held by the Appellate Body, even if the average total cost of production of an individual producer who participates in CEM sales happens to be above the prices of CEM, that does not *ipso facto* mean that a payment is provided by that producer. The Appellate Body held that to the extent a producer is able to recoup his or her total cost of production in the long-term, there would be no "payments".⁸⁸

3.71 As concerns the Complainants' arguments with respect to Canada's presentation of its data on cost of production, Canada explained that the average cost to produce one hectolitre of milk ranges from a low of CDN \$7.01 to a high of CDN \$66.80 while CEM returns, i.e. the price minus the marketing costs, range from CDN \$20.69 to CDN \$37.02. The exhibits and narrative explain the calculations. A comparison of the costs and revenues in Exhibit CDA-14 shows that since CEM transactions commenced in August 2000, the costs of production of over three-quarters of milk producers fall within the range of CEM returns.

3.72 Canada submitted that the data available for the short period since CEM sales began (August 2000) do not allow for a realistic consideration of whether producers who may sell CEM at a price that does not cover their average total cost of production would recover such costs in the long-term. As with any new market, this first year of operation represents a period of adjustment. Producers are testing out the market, determining whether to become regular producers of CEM; to revert to domestic sales only; or to strike some balance between the two. Whatever they do depends upon the producer's individual economic situation. In short, Canada considers that the data provide no support for the position of the Complainants that CEM transactions are uneconomic in the long run (see for instance paragraph 3.54 above, and paragraphs 3.78 and 3.132 - 3.133 below).

3.73 Commenting on Canada's arguments in paragraphs 3.70 and 3.72 above, **New Zealand** considered those arguments faulty. Whether transactions are economic in the long-term is not a matter of trial and error. It is a matter of simple economics. Products that are sold at a price that does not allow the producer to recover all costs of production are going to be uneconomic. There is no need to wait to see if this will happen. By eliminating imputed costs from any cost of production

⁸⁴ Canada also claims that it has resolved the downward bias in the CDC calculation complained of by the Complainants by including in its calculations the 30 per cent of high-cost producers excluded by the CDC. However, in footnote 72 above Canada admits that it has not included the producers whose milk production is less than 60 per cent of the annual average in their province, which accounts for 18 per cent, or almost one-fifth, of Canada's total milk production. Because small farms tend to have higher costs of production, the exclusion of these producers further understates the true average total cost of production.

⁸⁵ The production of producers who can cover their cost of production by commercial export milk sales is more than enough to account for total commercial export milk production. Commercial export milk production accounts for 3.6 per cent of Canada's total milk production. (Exhibit CDA-10)

⁸⁶ Appellate Body Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, paras. 79 and 117.

⁸⁷ Frequency of Producers Participating in CEM. (Exhibit CDA-15)

⁸⁸ Appellate Body Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 87.

determination, Canada is obscuring the issue of whether sales of CEM involve a transfer of economic resources from producers to processors for export.

3.74 **Canada** was of the view that there is nothing misleading about the data. Indeed, Canada's presentation of costs and returns was clear enough for both the United States and New Zealand to determine that about 40 per cent of Canadian producers are able to cover their costs of production with CEM returns of CDN \$29.90, which they claim to be close to the average price of CEM (see also paragraph 3.70 above). Indeed, Canada continued, had the Complainants picked the lower end of the spectrum of returns, they would have found that a substantial number of Canadian producers could participate in CEM transactions and cover their costs of production. For example, only 10 per cent of returns on CEM have been below CDN \$25.25; yet the average total production costs of nearly 25 per cent of Canadian milk producers are below this amount. Regardless of what average CEM return the Complainants choose as a basis for their argument, the data presented by Canada demonstrates that producers are clearly able to sell CEM at prices that cover their "average total cost of production."

3.75 Commenting on Canada's arguments in paragraph 3.72 above with respect to "the too short period since commercial export sales began", the **United States** considered that in referring to the long run, the Appellate Body was describing the types of costs that must be recovered in order to avoid losses. The point is that if the average total cost of production exceeds the average CEM price, the producer will incur losses in the long run. The comparison is accomplished *now*, not at some point in the indefinite future. In order to remain faithful to the Appellate Body's standard and avoid comparing apples to oranges, the United States continued, the average total cost of production must be compared to the average CEM price. As explained in paragraph 3.53 above, the average CEM price for Quebec and Ontario for the dairy year 2000 was approximately CDN \$29.⁸⁹ For the same time period, the CDC calculated the average total cost of production as CDN \$57.27. Even with this understated cost, the average total cost of production exceeded the CEM price by a substantial margin. Hence, applying the test set forth by the Appellate Body, "payments" from producers to processors have occurred under the CEM scheme.

3.76 **Canada** considered that, if a producer's participation in the CEM market were to be examined on the basis of the producer's most relevant consideration, whether the transaction covers all of his or her incremental costs of production for the additional milk required for that transaction (fixed and variable), one would conclude that an even greater proportion of producers could successfully participate in the CEM market. Canada submitted that for the reasons stated above, "payments" within the meaning of Article 9.1(c) are not being provided by Canadian producers to processors with respect to CEM transactions.

3.77 With reference to Canada's arguments that it has met the test set forth by the Appellate Body with respect to producers average total cost of production, **New Zealand** replied that Canada's calculation of the cost of production of milk does not include all of the costs of producing milk. If producers sell milk to processors at prices which do not cover the average total cost of producing milk they are, in effect, making a transfer of economic resources to the processor. The result is the same as making a monetary payment to the processor. It is a payment-in-kind and hence a "payment" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. The determination of whether there has been a transfer of economic resources, New Zealand continued, must be based on a real measurement of the cost of production, covering both what a producer spends and what he/she must recover over the long term in order to avoid making losses.⁹⁰ If the test for determining the average total cost of production fails to do this, then it is ineffective in measuring whether economic resources have been transferred from producer to processor for export.

⁸⁹ Exhibit US-3.

⁹⁰ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 87.

3.78 New Zealand considered that what Canada has shown is that when producers sell milk on the CEM market, they do not recover an amount that is sufficient to avoid making losses. They are foregoing a portion of the "proper value" of milk, thus transferring economic resources to processors for export. They are making "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

3.79 New Zealand submitted in conclusion that Canada has misinterpreted the Appellate Body's average total cost of production test and constructs instead a cost of production calculation that does not measure the costs that producers must spend and recover in order to avoid making losses. A proper application of the test set out by the Appellate Body in *Canada - Dairy Article 21.5* shows that producers make "payments" to processors for export by selling milk at a price that is less than the average total cost of production.

3.80 **Canada** replied that the "payment" issue is not about whether "average total cost of production" should be calculated on a "cash-basis accounting" or on an "economic costs" basis. It is well recognized that there is no standardised method for measuring production costs in the agricultural sector, in Canada or internationally. The issue is about interpreting the findings and the particular words of the Appellate Body in establishing "average total cost of production", a determination which must be consistent with the Appellate Body's finding that prices of CEM must be compared against "some objective standard or benchmark". The debate is over what costs an independent milk producer acting by itself without government interference must spend in order to produce the milk and the total amount it must recover in the long-term, in order to avoid making a loss.

3.81 The cost methodology employed by Canada in this case is based on fixed and variable costs representing the amount the producer must spend to produce milk and that he or she must recoup in the long-term to avoid making a loss. Canada considered that its use of actual outlays for fixed and variable costs is consistent with the findings of the Appellate Body. By contrast, the CDC methodology is not the right benchmark in these proceedings since it has been developed to serve domestic policy objectives and to that end includes certain imputed amounts that are not actual costs that the producer must spend to produce milk and recoup to avoid making a loss. However, Canada is not challenging the validity of the cost survey data included in the CDC calculation or the purpose for which the CDC calculation is used.

(ix) *Definition of "export subsidies"*

3.82 The **Complainants** submitted that in determining the meaning of "export subsidies" under Article 10.1, it was noted by the panel in *Canada - Dairy* that Article 1(e) of the *Agreement on Agriculture* defines export subsidies, unless the context requires otherwise, as "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement"⁹¹, an approach confirmed by the Appellate Body in *US-FSC*.

3.83 **Canada** noted that the *Agreement on Agriculture* does not define the term "subsidy". However, as the Appellate Body has indicated, the definition of "subsidy" in Article 1.1 of the *SCM Agreement* provides important contextual guidance in defining an "export subsidy" under Article 1(e) of the *Agreement on Agriculture*.⁹² The definition of "subsidy" under the *SCM Agreement* consists of two discrete elements: (i) a "financial contribution" or "income or price

⁹¹ Panel Report, *Canada - Dairy*, DSR 1999:VI, 2097, para. 7.124. This approach has been confirmed by the Appellate Body in *US-FSC*, paras. 190-196.

⁹² Appellate Body Report, *US-FSC*, para. 136.

support" by a government; (ii) which confers a benefit.⁹³ Canada considered that the claims above ignore the very basis of this dispute. The report of the Appellate Body in the original proceedings found that government was indispensable to enable the supply of milk for export purposes since government agencies stood completely between producers of the milk and the processors or exporters.⁹⁴ In response to this finding, Canada has removed those governmental agencies and permitted producers and processors to enter into export transactions free of governmental control. Canada has thus deregulated the CEM market, meaning that the government has no hand in setting the time, amount, or price of export sales. The only design in Canada's implementation of CEM is to remove government influence from the export business.

3.84 Canada submitted that as "integral parts"⁹⁵ of a "single undertaking"⁹⁶, sharing numerous cross linkages⁹⁷ the two Agreements should, to the extent permitted by the wording, be interpreted consistently. Extremely helpful in this regard are the insights into Article 9.1(c) provided by the government "financial contribution" concept, which, as suggested by the Appellate Body in *Canada - Aircraft*⁹⁸ and by the panel in *US - Export Restraints*⁹⁹, is, according to Canada, a cornerstone to the meaning of a "subsidy" in the *SCM Agreement*. In particular, *US - Export Restraints* holds that government entrusting or directing a private body to carry out certain functions contains the notions of government *delegation* or *command*.¹⁰⁰

3.85 *US - Export Restraints* expressly rejects the proposition that the focus should be on the *effects* or *results* of government action, Canada continued, suggesting instead that the focus should be on the *nature* of that action: "the existence of a financial contribution by a government must be proven by reference to the action of the government".¹⁰¹ In the words of the panel in *US - Export Restraints*: "we do not see how the reaction of private entities to a given governmental measure can be the basis on which the Member's compliance with its treaty obligations under the WTO is established." This finding is fully consistent with the Appellate Body's statement in this case that governmental action that merely enables a private person to make and finance a payment is too tenuous a linkage to support a finding of an export subsidy under Article 9.1(c). Thus, the perceived effects of government action on private behaviour or, to put it another way, on the presumed reaction of private entities to governmental intervention in the domestic market cannot be the basis for assessing WTO consistency. Canada submitted that the test proposed by the Complainants is substantially broader than the test applied under the subsidy definition in the *SCM Agreement* and attempts to impose a construction on the language of Article 9.1(c) it cannot reasonably bear.

3.86 **New Zealand** replied that Canada seeks to limit the scope of the definition of export subsidy in the *Agreement on Agriculture* by the words used in the *SCM Agreement*. Canada's arguments ignore the language of Article 9.1(c) and seek to undermine the ordinary meaning of the provision by asking the Panel to refer to unrelated provisions (and language) in the *SCM Agreement*. In so doing, Canada refers to jurisprudence which has taken note of the linkages between, and shared heritage of,

⁹³ Panel Report, *US - Export Restraints*, para. 8.20; Panel Report, *Canada - Export Credits*, para. 7.64; and Appellate Body Report, *Brazil - Aircraft*, DSR 1999:III, 1161, para. 157.

⁹⁴ Appellate Body Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 120.

⁹⁵ Marrakesh Agreement Establishing the World Trade Organization, Article II.2.

⁹⁶ Appellate Body Report, *Brazil - Desiccated Coconut*, DSR 1997:I, 167, at 177.

⁹⁷ For example, both the *SCM Agreement* and the *Agreement on Agriculture* share a common core definition that refers to "subsidies contingent ... upon export performance." See *US-FSC*, para. 121.

⁹⁸ Appellate Body Report, *Canada - Aircraft*, DSR 1999:III, 1377, para. 156.

⁹⁹ Panel Report, *US-Export Restraints*, para. 8.20.

¹⁰⁰ *Ibid.*, para. 8.29.

¹⁰¹ *Ibid.*, para. 8.34.

the *Agreement on Agriculture* and the *SCM Agreement*,¹⁰² but then, in the opinion of New Zealand, over-states that linkage and heritage.

3.87 **Canada** retorted that the term "subsidy" is used by New Zealand throughout its argument on "financed by virtue of governmental action", which is the core term of the very same *SCM Agreement*. Canada's case is focused on the words of Article 9.1(c) as interpreted by the Appellate Body. The *SCM Agreement* is part of the context that must be taken into account in interpreting those words. There is support for this argument in the preamble of Article 9.1(c), which provides that "[t]he following export subsidies are subject to reduction commitments under this Agreement" and in the finding of the Appellate Body in *US-FSC* and the original Appellate Body finding in this case.

3.88 The **Complainants** replied that *US - Export Restraints* was brought under Article 1.1(a)(1)(iv) of the *SCM Agreement*, not the *Agreement on Agriculture*, and therefore the report in that dispute provides no support for Canada's position. As concerns the concept of "financial contribution", the *SCM Agreement* has no relevance to Article 9.1(c) of the *Agreement on Agriculture*, which is concerned with "payments" and not with a "financial contribution". Moreover, Article 1.1(a)(1)(iv) of the *SCM Agreement* links the concept of "financial contribution" to an "entrustment" or "direction" by government.¹⁰³ The words "entrust" and "direct" are nowhere to be found in Article 9.1(c) of the *Agreement on Agriculture* and therefore offer no contextual guidance to its interpretation.

2. "financed by virtue of governmental action"

3.89 The **Complainants**, referring to the second element of Article 9.1(c) of the *Agreement on Agriculture*, noted that in *Canada - Dairy* the Appellate Body stated that "payments" were to be regarded as "financed by virtue of governmental action" if "governmental action" was "indispensable" to the transfer of economic resources.¹⁰⁴ In *Canada - Dairy Article 21.5*, the panel took the view that governmental action would be indispensable to the provision of lower-priced milk to processors for export if governmental action, *de jure* or *de facto* prevents Canadian milk producers from selling more milk on the regulated domestic market, at a higher price, than to the extent of the quota allocated to them; and obliges Canadian milk processors to export all milk contracted as lower priced CEM, and, accordingly, penalises the diversion by processors of milk contracted as CEM to the domestic market.¹⁰⁵

3.90 The panel considered that these two conditions were met, stating that "the payment is "financed by virtue of governmental action" in that lower priced CEM would not be available to Canadian processors *but for* the above federal and provincial actions (i) restricting supply on the domestic milk market, obliging producers, at least *de facto*, to sell outside-quota milk for export, and (ii) obliging processors to export all milk contracted as CEM, and penalising diversion by processors of CEM into the domestic market."¹⁰⁶

3.91 The **United States** added that in its recent report in this dispute, the Appellate Body concluded that, because it could not complete the analysis of the "payment" prong of Article 9.1(c) due to the lack of data on costs of production, it need not decide whether the panel was correct that the alleged payments had been "financed by virtue of government action." Thus the Appellate Body neither reversed nor affirmed the panel's conclusion on this point.

¹⁰² See, for example, Appellate Body Report, *Brazil - Desiccated Coconut*, DSR 1997:I, 167, at 169-170; and Appellate Body Report, *US-FSC*, para. 136.

¹⁰³ Panel Report, *US-Export Restraints*, paras. 8.26-8.44.

¹⁰⁴ Appellate Body Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 120.

¹⁰⁵ Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 6.42.

¹⁰⁶ *Ibid.*, para. 6.77. Emphasis in original.

3.92 The **Complainants** noted that the Appellate Body in *Canada - Dairy Article 21.5* analysed the meaning of the phrase "financed by virtue of governmental action" and observed that "Mere governmental action" is not enough. "The words "by virtue of" indicate that there must be a demonstrable link between the *governmental action* at issue and the *financing* of the payments".¹⁰⁷ The payments have to be financed in some way "as a consequence of the governmental action."¹⁰⁸ Although the Appellate Body recognised the difficulty of defining in the abstract the precise link that is necessary between governmental action and the financing of payments, the Complainants continued, it noted that governmental action which establishes a regulatory framework "merely enabling a third person freely to make and finance 'payments'" is insufficient.¹⁰⁹ However, the Appellate Body recognized that "the existence of such a demonstrable link must be identified on a case-by-case basis, taking account of the particular governmental action at issue and its effects on 'payments' made by a third person."¹¹⁰

3.93 The Complainants recalled the Appellate Body's acknowledgement that, taken as a whole, the panel's reasoning was "directed towards establishing the demonstrable link between governmental action and the financing of the payments."¹¹¹ However, the Appellate Body said, "even though Canadian governmental action prevents further domestic sales, we do not see how producers are obliged or driven to produce additional milk for export sale. As we have said above, each producer is free to decide whether or not to produce additional milk for sale as CEM."¹¹² Thus, the Appellate Body disagreed with the panel's characterisation of the CEM measures as, "obliging producers, at least *de facto*, to sell outside-quota milk for export."¹¹³

3.94 In the present case, the Complainants continued, the "payment" is financed by the producer accepting a price for export milk that does not cover the "average total cost of production" of milk (i.e., a payment-in-kind). These payments have to be "financed by virtue of governmental action" for the requirements of Article 9.1(c) of the *Agreement on Agriculture* to be fully met. The term "financed" as it appears in Article 9.1(c) covers both "the financing of monetary payments and payments-in-kind."¹¹⁴ The question, then, is whether this financing by producers of "payments" to processors can, in the words of the Appellate Body, be demonstrably linked to, or seen to be a consequence of, governmental action.¹¹⁵ There has to be, as the Appellate Body said, a "tighter nexus between the mechanism or process by which the payments are financed, even if by a third person, and governmental action."¹¹⁶

3.95 **Canada** submitted that the Appellate Body held that "the link between governmental action and the financing of payments will be more difficult to establish, as an evidentiary matter, when the payment is in the form of a payment-in-kind rather than in monetary form, and all the more so when the payment-in-kind is made, not by the government, but by an independent economic operator."¹¹⁷ Thus, Canada continued, in this case, which involves an alleged payment-in-kind made not by a government but by independent operators, the Appellate Body standard would require a particularly clear and convincing showing of the required linkage. Canada considered that the facts of this case do not permit such a finding. The Appellate Body also held that "[i]t is extremely difficult ... to define in the abstract the precise character of the required link between the governmental action and the

¹⁰⁷ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 113. Emphasis in original.

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.*, para. 115.

¹¹⁰ *Ibid.*, para. 115.

¹¹¹ *Ibid.*, para. 116.

¹¹² *Ibid.*, para. 117.

¹¹³ *Ibid.*

¹¹⁴ *Ibid.*, para. 114.

¹¹⁵ *Ibid.*, para. 113.

¹¹⁶ *Ibid.*

¹¹⁷ *Ibid.*

financing of the payments, particularly where payments-in-kind are at issue."¹¹⁸ However, that is what the Complainants are asking the Panel to do.

3.96 The governmental action by virtue of which payments are financed in the present case, the **Complainants** submitted, is the very construction of the CEM scheme itself. This has two components; (i) a prohibition on producers selling non-quota milk into the domestic market, with appropriate sanctions to support this prohibition, and (ii) the exemption of processors for export from the requirement to purchase only from milk supplied under Classes 1 to 5(d).¹¹⁹ In *Canada - Dairy Article 21.5*, the Appellate Body distinguished between "a regulatory framework simply enabling a third person freely to make and finance" those "payments"¹²⁰ and circumstances where there was a demonstrable link between the financing of "payments" and governmental action.¹²¹

3.97 Referring to the arguments with respect to the measures described in paragraph 3.96 above, **Canada** responded that it does not deny that the governmental actions referred to by the Complainants establish a framework under which processors have access to milk for export without those processors having to pay the administered price. As Canada has repeatedly explained, and the Appellate Body has accepted, processors and producers freely negotiate the prices of CEM. However, even if a sale of CEM by a producer to a processor at less than the administered domestic price or "average total cost of production" calculated by the CDC were to constitute a "payment", which Canada denies, that "payment" would not be "financed by virtue of governmental action" by the mere fact that it has occurred. As already stated, the Appellate Body rejected this as being sufficient to meet the "financing" element of Article 9.1(c), because such a conclusion would not give meaning to the word "finance".

3.98 With respect to the arguments concerning "the very construction of the CEM scheme", Canada considered that this fails to consider the Appellate Body statement that "[g]overnments are constantly engaged in regulation of different kinds in pursuit of a variety of objectives."¹²² In particular, the Appellate Body envisaged that "governmental action might establish a regulatory framework merely enabling a third person freely to make and finance "payments". In this situation, the link between the governmental action and the financing of the payments is too tenuous for the "payments" to be regarded as "*financed* by virtue of governmental action" (emphasis added) within the meaning of Article 9.1(c). Rather, there must be a tighter nexus between the mechanism or process by which the payments are *financed*, even if by a third person, and governmental action."¹²³

3.99 Canada submitted further that the Complainants' arguments in paragraph 3.96 above with respect in particular to the "two components" are without merit. Even though these governmental actions may exist, it does not mean they "finance" any "payments". The fact that processors do not have to pay the higher regulated price is not proof that "payments" to processors are "financed by virtue of governmental action". On the contrary, Canada explained, the measures identified by the Complainants as the governmental action that finances "payments" protect a producer's entitlement to the higher domestic price. They have no relation or "link" to any alleged sale by a producer of milk to a processor at below his or her cost of production. These "measures" also include restrictions on sales into the domestic market. It is these measures taken in combination which protect a producer's entitlement to the higher domestic price (supply management).

¹¹⁸ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 115.

¹¹⁹ Like the CEM Scheme, Class 5(d) provides discounted milk to processors for export, but unlike CEM, Class 5(d) is recognised by Canada as providing export subsidies.

¹²⁰ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 115.

¹²¹ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, paras. 6.50-6.54.

¹²² Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 115.

¹²³ *Ibid.*

3.100 The **Complainants** submitted that even if the producers are freely choosing to produce non-quota milk, as the Appellate Body observed, once they do so, governmental action prohibits them from selling this milk onto the higher priced domestic market, i.e. they have no choice but to sell it in the export market. If the producer were making the decision, the choice would obviously be to sell in the higher-priced domestic market and recover its fixed and variable costs. From the producer's perspective, the governmental action is the prohibition against the selling of non-quota milk into the higher-priced domestic market. The Complainants were of the view that it is easy to see the "demonstrable link" between the government's prohibition on selling milk in the domestic market without quota and the "payment" made by the producer's sale of non-quota milk in the CEM market. It is also easy to see that the financing of the "payments" made by producers to processors – the selling of milk at a price that is less than the average total cost of production – is "a consequence of"¹²⁴ governmental action, and that the governmental action is "indispensable" to the financing of the "payments".¹²⁵ Producers are not forced to produce extra milk. But when they do, they have no option but to sell in the CEM market and thereby make a "payment" to processors.¹²⁶

3.101 Referring to Canada's arguments in paragraph 3.99 above, the **United States** submitted that Canada does not explain how exempting export milk from the high domestic price protects a producer's entitlement to that high price. The United States reiterated that Canada could manage and control its domestic supply of milk without exempting export milk from the high price. It may mean that Canada's dairy processors would no longer be able to export because they cannot compete without subsidization, but the right to maintain and subsidize domestic production does not also provide a right to subsidize export production beyond the applicable reduction commitments.

3.102 Since the arguments made by the Complainants are the same arguments as those they made before the first Article 21.5 panel and Appellate Body, **Canada** considered that the language used by the Appellate Body in addressing the "financed" element of Article 9.1(c) is therefore of the utmost relevance. A careful review and a proper application of this language, provides, according to Canada, a strong indication that the Appellate Body considered the arguments of the Complainants and did not find them convincing. It is not unreasonable to argue that the Appellate Body contemplated and rejected anticipated arguments by the Complainants. Indeed, the Appellate Body appeared to suggest that unless the Complainants can come up with something better than a simple assertion that "access equals financing", their claims should be rejected.

3.103 Canada further submitted that the Appellate Body standard with respect to a "demonstrable link" requires a particularly clear and convincing showing of the required linkage. The facts of this case do not permit such a finding. For a "demonstrable link" to exist between governmental action and the financing of payments, the former must be focused or directed towards the latter. There must be a clear and evident connection between the two. Government obliging or directing producers to produce and sell CEM would be but one example of such a link. Other examples are found under Canada's Special Class system. The Panel is well aware that under the former Class 5(e), Canada controlled the volume of milk for export, set the price, pooled producer revenues, paid the producers, and issued permits to processors. Canada exercised similar controls under the earlier producer-levy system.

3.104 By removing governmental action at every stage of the export transaction, which Canada did based on the decision of the Appellate Body in the original dispute, such transactions, when they occur, are not "financed by virtue of governmental action". When individual producers and

¹²⁴ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 113.

¹²⁵ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 6.41.

¹²⁶ The only other permitted avenue for disposal of over-quota milk (other than destruction) is for use in animal feed under Class 4(m) – a use which obtains substantially lower prices than the export market.

processors, not government, decide to produce, purchase and sell milk for export and determine the price, volume and timing of the transactions, Canada considered that there is a complete absence of governmental action on which the "demonstrable link" of which the Appellate Body spoke can be established. In contrast to the former Special Class 5(e) and the levy example in Article 9.1(c), the measures identified by the Complainants are not focused or directed towards the financing of export transactions.

3.105 The **Complainants** considered that focusing on the producer, shows only part of the picture. It is the processor for export who receives the "payment" and thus can export. For the processor, the link between access to lower-priced milk and governmental action is clearly "demonstrable". If there were no prohibition on the sale of non-quota milk into the domestic market, producers would not make low-priced sales of milk to processors for export. Processors would have to access their milk from that domestic market at the higher prices that pertain there. It is governmental action that makes it possible for processors to receive these "payments" from producers. Furthermore, the "governmental action" by virtue of which "payments" are financed goes beyond the prohibition on the sale of non-quota milk into the domestic market. Without the governmental exemption of processors from purchasing milk at the higher regulated prices for export purposes there would be no CEM market and this exemption which is made explicit in provincial marketing regulations¹²⁷ (i.e. governmental action) is available only to processors for products that are exported.

3.106 The Complainants noted that milk qualifying as "CEM" is exempt from most domestic regulations, including the domestic price regulations that cover milk for the domestic market. Without this exemption, the CEM scheme could not function as prices for processors then would be too expensive and therefore un-competitive on world markets, i.e., milk is available in the CEM market only because the economically rational choice of selling it at above the "average total cost of production" has been denied by governmental action. In other words, the Complainants continued, producers are selling in the export market, not because there is no demand in the higher-priced domestic market and the producers are therefore making a commercial choice to sell in the lower-priced export market, but because they cannot sell non-quota milk in the domestic market due to the government prohibition. As a result, the producer is foregoing revenue not based upon "commercial" reasons but as a direct consequence of governmental action. This situation described and relied upon by the panel has not changed under the substituted provincial export programmes.

3.107 The Complainants submitted that even if Canada considers the prohibition of non-quota milk in the domestic market as necessary to maintaining the integrity of its supply management system, it does not mean that the CEM scheme is a logical consequence or necessary feature of a supply management system. Other countries operate dairy supply management systems without this feature. The Complainants referred in particular to the system maintained by the European Communities. The Complainants considered that the government-created CEM scheme is not an unintended consequence of Canada's domestic supply management system. Nor is it a "spill-over" benefit of that system (see also paragraph 3.115 below). It represents a deliberate choice of the Canadian government to make lower-priced milk available for processors for export. Without the exemption from the cost of the higher-priced domestic milk, Canadian processors could not compete on the world markets for dairy products.

3.108 **Canada**, referring to paragraph 113 of the Appellate Body report in *Canada - Dairy Article 21.5* with respect to "a demonstrable link", submitted that contrary to what is suggested by the Complainants, any alleged "payments" made by an independent private party would not be "financed by virtue of governmental action" by the mere fact that the government, somehow, regulates some

¹²⁷ Exhibits NZ-9 to NZ-17. Examples of the relevant provincial exemptions are set out in footnote 22. See also Exhibit US-26.

aspects of the industry within which that private party operates. Export transactions occurring outside of Special Class 5(d) take place without government interference or control of any kind, and as such, do not benefit from export subsidies. The facts of this dispute establish without question that even if "payments" were made by certain independent producers, which Canada denies, any such payments would not be financed as a consequence of any governmental action. Accordingly, Canada has fully implemented the recommendations and rulings of the Dispute Settlement Body (DSB), reflecting the findings and conclusions of the original panel, as modified by the Appellate Body in *Canada–Dairy*.¹²⁸

3.109 Canada submitted that the Appellate Body contemplated and rejected the position of the Complainants. Accordingly, even if it can be said that a "CEM scheme" exists, such a "scheme" is one into which producers and processors voluntarily decide to enter without government compulsion, direction, or control. The mere fact that such a "scheme" exists would not be sufficient to establish a clear and convincing linkage to the financing of any "payments".

3.110 The **Complainants** responded with respect to Canada's arguments in paragraph 3.98 (tighter nexus) and 3.108 (demonstrable link) above that Canada seeks to read into the Appellate Body's report words which are not there and to mis-characterise the position taken by the Complainants. They do not argue, as Canada alleges (see paragraph 3.108 above), that payments made by an independent party would be financed by virtue of governmental action "by the mere fact that the government, somehow, regulates some aspects of the industry within which that private party operates." Similarly, Canada mis-characterises the Appellate Body's findings as the Appellate Body made no findings with respect to the question of "financed by virtue of governmental action" and could therefore not have "contemplated and rejected" the position of the Complainants, as Canada claims (see paragraphs 3.102 and 3.109 above). Furthermore, although the Appellate Body disagreed with the panel's characterisation of the CEM scheme as "obliging producers, at least *de facto*, to sell outside-quota milk for export", it also noted that "the Panel's reasoning, taken as a whole, was directed towards establishing the demonstrable link between governmental action and the financing of the payments".¹²⁹ (See also paragraph 3.93 above.)

3.111 Contrary to assertions made by the Complainants, **Canada** argued, producers do not take surplus production or "non-quota milk" and sell it as CEM. Rather, producers pre-plan and pre-commit their milk production, including the production of CEM. Governments are not involved in this independent decision-making process. Pre-commitment and first milk out of the tank do not provide processors with a predictable supply of milk. These practices merely provide the framework under which processors can enter into enforceable private contracts with individual producers for milk supplies.

3.112 Canada, noting the Appellate Body's reversal of the panel's finding with respect to "driven or obliged"¹³⁰ and further noting that the Appellate Body did not directly address the second measure identified by the panel as governmental action that finances payments (i.e., the sanction for diversion of export milk into the domestic market), submitted that the reasoning of the Appellate Body must also apply in rejecting the panel's finding regarding the effects of this measure. There is no link between this measure and the financing of any alleged payments. A penalty provision on *processors* for diversion of dairy products manufactured with CEM after production does not, in any way, oblige or drive *producers* to produce and sell this milk. It does not alter the basic conclusion reached by the

¹²⁸ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, and Panel Report *Canada - Dairy (Article 21.5 – New Zealand and US)*.

¹²⁹ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 116. In footnote 90 of its report, the Appellate Body outlined in detail the approach taken by the panel in establishing the demonstrable link between the governmental action and the financing of the payments.

¹³⁰ *Ibid.*, para. 117.

Appellate Body that each producer is free to decide whether or not to produce additional milk for sale as CEM.

3.113 Without a government "mechanism or process" that either makes unprofitable sales on behalf of producers or obliges or drives them to do so, Canada considered that there is an absence of evidence based on which to find the demonstrable link. For Article 9.1(c) to apply, there must be governmental action focused or directed towards the financing of the alleged "payments" (e.g., setting prices, controlling volume, managing producer returns, as under Special Class or producer levy systems). A regulatory framework that merely enables a third person freely to make and finance "payments" is, according to Canada, insufficient to engage Article 9.1(c). Accordingly, any alleged "payments" that may be made by independent producers are not, "financed by virtue of governmental action".

3.114 Replying to the arguments by Canada above, the **Complainants** considered that they clearly identify, in paragraph 3.94 above, the elements of governmental action by virtue of which payments are financed in the present case. They considered that the governmental action that finances the payments in this case is manifest. The Complainants noted that in addressing the issue of "financed by virtue of governmental action", Canada focuses on the producer, ignoring the fact that the recipient of the subsidy is the processor, i.e. the focus in this case must be on the *dairy processor*. Thus, the question is whether the processor for export receives a subsidy which is financed by virtue of governmental action, a question the Complainants believed should be answered in the affirmative.

3.115 The Complainants reiterated that it is the enforced segregation of the market that permits exporters to purchase milk for export at discounted prices. By exempting milk for export from the high domestic administered price, Canada has created a separate pool of milk that would not otherwise exist and which is available exclusively for dairy processors for export. It is the government exemption of export milk from the high domestic price which finances the payment to processors. This is not a case where there are "spill-over benefits" from the domestic supply management system, as mentioned earlier (see paragraph 3.107 above). Canada has made the deliberate choice to exempt export milk from the higher domestic price so that its processors can compete in the world market. This exemption is not necessary to maintain the Canadian domestic supply system, a fact that Canada itself has recognised.¹³¹ Rather, the government has chosen to subsidize its processors in this way in order to help them increase their exports. Without this government exemption, there would be no low-priced milk for export. It constitutes government action which is indispensable to the transfer of resources from the producers to the processors.

3.116 Referring to the Complainants arguments in paragraph 3.115 above with respect to the focus on the processor confuses, according to **Canada**, the concept of "financed by virtue of governmental action" with the concept of "benefit". The issue is whether the alleged "payments" by independent producers are "financed by virtue of governmental action". This determination is made by considering the relationship between the governmental actions identified by the Complainants and the "financing" of the alleged "payments". As concerns the exemption from the high domestic administered price, Canada replied that it does not dispute that, as a consequence of these deregulation measures, processors are not required to pay the administered domestic price for commercial export milk. This can be characterized as an "exemption". An "exemption" from the requirement to pay the administered domestic price is not necessary to the protection of entitlement to the domestic administered price. However, the fact that processors have access to milk for export without paying the administered domestic price and, thereby, having no limits on their ability to export, is not *per se* WTO inconsistent. There is no obligation under the *Agreement on Agriculture* to limit exports. The obligation rather is to limit exports that benefit from export subsidies. Not having to pay the

¹³¹ Canada's Response to Question No. 14.

administered domestic price does not ensure processors access to milk for export at any particular price. Prices are whatever processors and producers agree they will be. Canada was of the view that the fact that processors have access to milk without paying the administered domestic price does not amount to governmental action by virtue of which payments are financed within the meaning of Article 9.1(c). There is no tight nexus or "demonstrable link" between this governmental action and the financing of any alleged "payments".

3.117 The **United States**, referring to the Appellate Body's observation concerning the "demonstrable link" test as set out in paragraph 3.92 above¹³², and to what it considered as Canada's misinterpretation of that report (see paragraph 3.113 above), submitted that if the fact that producers are not obliged to sell into the export market were determinative of the second prong of Article 9.1(c), the Appellate Body would have found that the second prong was not satisfied as it would not have needed additional facts to complete that analysis. Referring to paragraph 116 of the Appellate Body's report in *Canada - Dairy Article 21.5*, the United States noted that it did not so find. The United States considered that the fact that producers are not obliged to sell into the export market is irrelevant. There is no basis in the text of Article 9.1(c) for the conclusion that the governmental action prong requires that the government force producers to participate in the subsidy programme, or even that the governmental action be "focused or directed towards the financing of the alleged payments," as claimed by Canada (see paragraph 3.113 above). The point is that once farmers do produce over-quota milk, they are compelled by government action to transfer economic resources to the processors.

3.118 **New Zealand** submitted with reference to Canada's position (shared by the European Communities¹³³) regarding the "demonstrable link", that there is nothing in the WTO disciplines on export subsidies to suggest that government compulsion to participate in a subsidy scheme is a necessary precondition to the establishment of an export subsidy. As the Appellate Body pointed out, "each producer is free to decide whether or not to produce additional milk for sale as CEM", and they are not "obliged or driven" to produce such milk.¹³⁴ The decision to participate in a subsidy programme will depend on a number of factors. For example, the cross-subsidization resulting from sales at the higher administered domestic price¹³⁵ may make it "rational" for a producer to produce CEM milk. The motivations of producers may, as the Appellate Body pointed out, be relevant to determining the existence of a "payment"¹³⁶, but they are not relevant to the determination of whether payments have been financed by virtue of governmental action.

3.119 To meet the requirements of Article 9.1(c) there must be, as the Appellate Body has said, a "demonstrable link" between the receipt of that subsidy by the processor and the governmental action in question which has to show that the governmental action is indispensable to the receipt of the subsidy. Producers choose whether to produce CEM milk. What is relevant is that the CEM scheme, established and maintained by governmental action, provides processors for export with access to milk at prices below the average total cost of production.

3.120 The Appellate Body¹³⁷ made clear, New Zealand continued, that where governmental action merely establishes a regulatory framework that enables a third person freely to make and finance "payments", this does not constitute the necessary "demonstrable link". The CEM scheme, however, is constructed so that processors for export are exempted from the requirement to pay the higher

¹³² See also Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 115.

¹³³ Paras. 4.36 and 4.37 below.

¹³⁴ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 117.

¹³⁵ This possibility was noted by the Appellate Body at para. 94 of *Canada - Dairy (Article 21.5 – New Zealand and US)*.

¹³⁶ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 92.

¹³⁷ *Ibid.*, para. 115.

domestic administered price that is applicable to all other milk. As a result, any producer entering into a sale and purchase transaction with a processor necessarily makes a "payment" to the processor. A payment is financed as a matter of course whenever a producer sells milk on to the CEM market.

3.121 New Zealand considered that it is irrelevant that producers decide whether or not to enter the CEM market. Under SMC, producers had the same choice as to whether or not to produce over-quota milk.¹³⁸ Furthermore, Canada has not addressed the elements of governmental action that the Complainants have identified. Since the burden of proof in this case rests with Canada, it has not discharged that burden. Indeed, on the key question of whether governmental measures underpin the operation of the CEM scheme, Canada appears to concede the point. Canada explains the measures that the Complainants identify as the governmental action which finances the payments in this case as measures that "protect a producer's entitlement to the higher domestic price"(see paragraph 3.99 above). If this is true, then it is also true that the same governmental action ensures that processors for export remain shielded from these higher domestic prices, ensuring that Canadian milk products are able to compete on the lower-priced world markets.

3.122 The **United States** reiterated that whether or not producers are freely choosing to produce milk for export¹³⁹, producers are not freely choosing to finance the payment. The government has made this choice by ensuring that the sale of that milk from the producer to the processor includes a transfer of economic resources to the processors. The transfer is guaranteed by the exemption from the higher administered price for domestic milk which the United States considered has nothing to do with maintaining the domestic supply system. In Canada's terms, it is governmental action "focused and directed"(paragraph 3.113 above) to the financing of payments to processors. The "demonstrable link" between the government action and the financing of the payment is, according to the United States, crystal clear.

3.123 **New Zealand** added that Canada's attempt to import the idea that governmental action must be "directed" towards the financing of a payment in order to show a "demonstrable link" (see paragraph 3.113 above) is unsubstantiated and un-compelling. New Zealand was of the opinion that what Canada is really trying to do is have the Panel distance itself from the language of Article 9.1(c) of the *Agreement on Agriculture*. This would not only turn the interpretative rules of the *Vienna Convention* on their head, but would render Article 9.1(c) meaningless.

3.124 New Zealand considered that Canada's proposed test for determining whether "payments" have been "financed by virtue of governmental action" is inconsistent with the Appellate Body's requirement that there be a demonstrable link between the payment and the governmental action. As has been shown, the demonstrable link resulting from the governmental action in respect of both producers and processors for export is clear. The action of government is indispensable to the transfer of economic resources from producers to processors for export.

3.125 The **United States** was of the view that Canada's arguments mis-characterize the United States position and misstate the Appellate Body report. It has been demonstrated that Canada has failed to meet its burden of showing that the "payments" are not financed by virtue of governmental action. The evidence is quite clear that only through the exercise of governmental powers do processors receive "payments" when they purchase milk for export production. There is unquestionably a demonstrable link between governmental action and the financing of the payment.

¹³⁸ See, for example, Panel Report, *Canada - Dairy*, DSR 1999:VI, 2097, paras. 2.39-2.58.

¹³⁹ See para. 117 of the Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, and for example para. 12 of the United States second submission to the panel in the proceedings on the first recourse by the United States to Article 21.5 of the DSU.

3.126 **New Zealand** submitted that from the perspective of export subsidies, Canada's deregulation involves replacing one form of regulation with another form of regulation. While it is a fact that export subsidies on agricultural products are yet to be eliminated, this provides no justification for Canada's claim that the definition of subsidies under the *Agreement on Agriculture* is somehow narrower than the one that applies under the *SCM Agreement*.¹⁴⁰ The definition in Article 9.1(c) of the *Agreement on Agriculture* must be applied in accordance with its terms.

C. ARTICLE 10.1 OF THE AGREEMENT ON AGRICULTURE.

3.127 The **Complainants** submitted that even if Canada's CEM scheme would be found not to satisfy the requirements of Article 9.1(c), it would nevertheless violate Article 10.1 of the *Agreement on Agriculture* by providing export subsidies that circumvent (or threaten to circumvent) Canada's export subsidy commitments.

3.128 **New Zealand** referred to *Canada - Dairy*, in which case the panel said that the application of the first part of this provision requires two elements to be established. First, there must be "export subsidies not listed in paragraph 1 of Article 9". And second, those export subsidies must be "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments."¹⁴¹ Alternatively, if it can be shown that "non-commercial transactions" have been used to circumvent export subsidy commitments, this too will constitute a violation of Article 10.1. The **United States** added that in *US - FSC*, the Appellate Body stated that the obligations under Article 10.1 come into play when three factors are present: the two factors mentioned above plus that the subsidy is contingent on export.¹⁴²

3.129 The **Complainants** reiterated that in determining the meaning of "export subsidies" under Article 10.1, it was noted by the panel in *Canada - Dairy* that Article 1(e) of the *Agreement on Agriculture* defines export subsidies, unless the context requires otherwise, as "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement"¹⁴³, an approach confirmed by the Appellate Body in *US - FSC*.¹⁴⁴ Referring to the panel report in *Canada - Dairy*¹⁴⁵, the Complainants submitted that since Article 10 applies to export subsidies other than those listed in Article 9, it therefore applies to any subsidy contingent upon export performance that is not included in the export subsidies listed in Article 9.1.

3.130 **Canada** noted that the Parties agree that the *SCM Agreement* provides the appropriate context for identifying any export subsidy under Article 10.1.

(i) *Illustrative List of Export Subsidies*

3.131 The **Complainants** considered that specific guidance can be obtained from the practices considered in the *SCM Agreement* to be export subsidies, focusing in particular on paragraph (d) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement*.¹⁴⁶ Paragraph (d) specifically addresses the situation where a government provides inputs, indirectly through a government-mandated scheme, to exporters "on terms or conditions more favourable than for

¹⁴⁰ See para. 117 of the Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, and for example para. 12 of the United States second submission to the panel in the proceedings on the first recourse by the United States to Article 21.5 of the DSU.

¹⁴¹ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 7.120.

¹⁴² Appellate Body Report, *US - FSC*, paras. 135-154.

¹⁴³ Panel Report, *Canada - Dairy*, DSR 1999:VI, 2097, para. 7.124. This approach was confirmed by the Appellate Body in *US - FSC*, paras. 190-196.

¹⁴⁴ *Ibid.*, paras. 190-196.

¹⁴⁵ Para. 7.125

¹⁴⁶ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, paras. 7.126 - 7.132.

provision of like or directly competitive products or services for use in the production of goods for domestic consumption." A footnote to paragraph (d) provides: "The term 'commercially available' means that the choice between domestic and imported products is unrestricted and depends only on commercial considerations."

3.132 The Complainants further considered that the CEM scheme, like the Special Milk classes scheme, fulfils all of the elements of paragraph (d) for the provision of an export subsidy which were identified in *Canada - Dairy*.¹⁴⁷ First, dairy processors continue to have access to milk for dairy products for export which is priced on more favourable terms than would be available to such processors when producing for domestic consumption, and on terms that are uneconomic to producers. The "terms or conditions ... for the provision of like or directly competitive products ... for use in the production of goods for domestic consumption," in paragraph (d), are indisputably less favourable than those for the provision of CEM for export processing: milk used for dairy products for domestic consumption must be quota milk under the domestic supply management system, for which processors must pay the high domestic price.

3.133 Second, the Complainants continued, the product - milk at below domestic rates - has been provided "by governments or their agencies directly or indirectly through government-mandated schemes." Milk is made available for processors for export through a government-mandated exemption of such milk from the higher regulated price and the enforced exclusion of such milk from the domestic market. Producers' only other options are to destroy such milk, or to sell it for animal feed at the even more uneconomic government-set Class 4(m) price. Government action creates the CEM market, including by exempting export processors from the requirement to purchase high-price in-quota milk; government action ensures a steady and predictable supply of CEM by requiring that producers pre-commit to CEM sales and deliver CEM first out of the tank; and the government polices the market, preventing the diversion of CEM milk and products into the higher-return domestic market (which would have the effect of driving up CEM prices and destroying the scheme's economic benefit - deep discounts on milk - to export processors).

3.134 Third, the Complainants submitted, the terms and conditions on which milk is made available to processors for export are more favourable than those available to them on world markets. The facts underlying the original panel's finding on this point have not changed. For all practical purposes, commercial imports of fluid milk for processing cannot enter Canada due to import restrictions.¹⁴⁸ Thus, if processors want to export dairy products, their only choice is to use domestically-produced milk. The Complainants were of the view that this is not a choice which is "unrestricted and depends only on commercial considerations" in the sense of the footnote to paragraph (d).

3.135 Referring to Canada's argument that imported milk is available to processors for export under its Import for Re-Export Program (IREP), the Complainants submitted, as was noted in the panel reports in both *Canada - Dairy* and *Canada - Dairy Article 21.5*, that access to milk under the IREP depended on the discretionary issue of a permit by the Minister as well as on the payment of the in-quota tariff rate¹⁴⁹, not on commercial considerations.¹⁵⁰ Both panels concluded that the terms and conditions for accessing imported milk under that Program were not commercially attractive in comparison with milk available under Special Milk Classes 5(d) and 5(e).¹⁵¹ With respect to IREP, the Appellate Body in *Canada - Dairy Article 21.5* observed that "[i]n assessing whether alternative sources of supply are available on more favourable terms, we consider that panels should take account of all the factors which affect the relative "attractiveness" in the marketplace of the different goods or

¹⁴⁷ *Ibid.*, para. 7.128.

¹⁴⁸ Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, paras. 7.53-7.55, 7.131.

¹⁴⁹ *Ibid.*, paras. 4.71 and 4.78.

¹⁵⁰ *Ibid.*, paras. 6.25-6.26 and 7.53.

¹⁵¹ *Ibid.*

services."¹⁵² The Appellate Body went on to emphasise that if an import permit was "granted to importers as a matter of course, in the context of straightforward import procedures, and if import fees were only administrative charges to cover expenses, these formalities would be unlikely, on their own, to mean that imports were available on less favourable terms and conditions."¹⁵³ If the terms and conditions on which IREP was made available were more favourable, the Complainants were of the view that the amount of milk obtainable through IREP would be significantly larger.¹⁵⁴ Thus, Canada's CEM scheme constitutes the provision of export subsidies within the meaning of paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement*.

3.136 **Canada** submitted that the alleged export subsidy under Article 10.1 of the *Agreement on Agriculture* is not an export subsidy of the type identified under Item (d) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement* as alleged by the Complainants. Referring to the text of Item (d), Canada submitted that the term "commercially available" means that the choice between domestic and imported products is unrestricted and depends only on commercial considerations. Three requirements must all be found to exist for a measure to fall within the definition of an export subsidy in Item (d) of the Illustrative List: (i) the raw materials for use in the production of exported goods must be provided by government or their agencies either directly or indirectly through a government-mandated scheme; (ii) the raw materials must be provided on terms and conditions more favourable than those that apply to raw materials for use in the production of goods for the domestic market; and (iii) those terms and conditions must be more favourable than those commercially available on world markets to processors.¹⁵⁵

3.137 A threshold issue relating to the first requirement, Canada continued, is the meaning of the provision of goods by governments "directly or indirectly through government-mandated schemes." In that regard every export subsidy illustrated in Annex I of the *SCM Agreement* is by definition an Article 1.1 "subsidy" that is contingent on export performance. The words "indirectly through a government-mandated scheme" in Item (d) must therefore have a meaning consistent with Article 1.1(a)(1)(iv). To hold otherwise would impermissibly graft a new type of "financial contribution" onto the definition of "subsidy" in the *SCM Agreement*. As the Appellate Body has held, "... 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 were not intended."¹⁵⁶

3.138 With respect to Canada's arguments in paragraph 3.137 above, **New Zealand** submitted that Article 3.1 of the *SCM Agreement* makes it clear that the subsidies listed in the Illustrative List are export subsidies for the purposes of the *SCM Agreement*. Once it is determined that a particular practice falls within the description contained within one of the paragraphs of Annex I, then that practice is deemed to be an export subsidy, without further reference to Article 3.1 or Article 1.1 of the *SCM Agreement*. As has been recognised in a number of rulings¹⁵⁷ there is therefore no need for paragraph (d) practices to be then examined through the spectrum of Article 1.1 of the *SCM Agreement*. As concerns Canada's reference to the Appellate Body's ruling on *India - Patents*, New Zealand submitted that this case appears to contradict Canada's position. By arguing that paragraph (d) has to be limited by reference to Article 1.1 of the *SCM Agreement* and, more specifically, has to be read in the context of Article 1.1(a)(1)(iv) of the *SCM Agreement*, Canada is

¹⁵² Appellate Body Report, *Canada Dairy (Article 21.5 – New Zealand and US)*, footnote 55.

¹⁵³ *Ibid.*

¹⁵⁴ In addition, it should be noted that because government action has foreclosed the option to sell additional milk on the domestic market, processors for export are in a position to negotiate a price that is below the price they would have to pay through IREP even if it were available on commercial terms. Producers have no option if they produce non-quota milk other than to sell it to processors for export.

¹⁵⁵ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 7.128.

¹⁵⁶ Appellate Body Report, *India – Patents*, DSR 1998:I, 9, para. 45.

¹⁵⁷ See for instance Panel Report, *Canada - Autos*, para. 10.197 and Panel Report, *Brazil - Aircraft Article 21.5*, para. 6.42.

indeed trying to introduce the terms "entrust" and "direct" into paragraph (d)¹⁵⁸ - terms that are only found in Article 1.1(a)(1)(iv).

3.139 **Canada** reiterated that the Canadian governments do not directly themselves provide CEM to processors, nor do they "entrust or direct" producers to do so through an authoritative instruction or command. Thus, the first of the three requirements of Item (d) is not met. The issue of whether the other two conditions of Item (d) are met is, therefore, moot. However, it is undisputed that CEM itself is sold at prices set by the world market.¹⁵⁹ When the panel in *Canada - Dairy Article 21.5* addressed Item (d), the point of contention was whether the world market terms were "available" to processors through Canada's IREP. The panel's decision in that prior proceeding that world market terms are not available to processors through IREP was based on its findings with respect to IREP's requirement that imports are subject to securing a permit from the Department of Foreign Affairs and International Trade. The Appellate Body addressed this finding in its discussion of possible benchmarks for determining the existence of "payments" under Article 9.1(c) of the *Agreement on Agriculture*.

3.140 Referring to the situation described by the Appellate Body in its report in *Canada - Dairy Article 21.5*¹⁶⁰ concerning the terms and conditions on which IREP is available, **Canada** submitted that of the 2,317 IREP permit requests from August 2000 (when commercial export sales commenced) to February 2002, no request was denied. Further, the fees involved are minuscule, less than one tenth of one per cent (0.025 per cent) of the IREP import values. Nor, contrary to the Complainants' suggestions (see paragraph 3.135 above), do the in-quota tariff duties assessed on IREP imports affect processor decisions. Dairy products are imported under IREP duty-free (including imports from the United States and significant levels of imports of certain dairy products from New Zealand), or at rates of 7.5 per cent or less. Where tariffs are assessed, duty drawback permits the importer to recover these low tariffs.¹⁶¹ In short, Canada asserted, the permitting requirement, fees, and any applicable in-quota tariff rates associated with IREP are not formalities that make IREP a commercially non-viable alternative to CEM.

3.141 **New Zealand**, referring to the arguments in paragraphs 3.131-3.135 above, and to Canada's response in paragraph 3.140 with respect, in particular, to Canada's duty drawback scheme, submitted that, as acknowledged by Canada, processors for export face an additional administrative hurdle in having to lodge an application in relation to a duty drawback scheme as well. As the Appellate Body in *Canada - Dairy Article 21.5* observed, New Zealand continued, "panels should take account of all the factors which affect the relative 'attractiveness' in the marketplace of the different goods or services" when assessing whether alternative sources of supply are available on more favourable terms.¹⁶² New Zealand reiterated that IREP milk would not be an attractive proposition for processors for export when they are faced with the in-quota tariff rate and permit fees on top of the discretionary issuance of the permit itself and other regulatory requirements.

3.142 The other relevant element, **Canada** submitted, is to determine whether CEM prices are available to exporters through IREP. As the Appellate Body has stated, a finding under this element requires, in the context of the current dispute, an examination of the competitive relationship between CEM and imports under IREP.¹⁶³ The Appellate Body also noted that "[i]mports under IREP,

¹⁵⁸ See para. 3.139 below.

¹⁵⁹ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 83.

¹⁶⁰ Footnote 55, page 23

¹⁶¹ Drawback is limited on exports to the United States and Mexico under separate and unrelated requirements of the North American Free Trade Agreement.

¹⁶² Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, footnote 55.

¹⁶³ *Ibid.*, para. 67.

generally, involve whole milk powder, while CEM involves fluid milk."¹⁶⁴ Canada has already presented data demonstrating the comparability of prices for whole milk powder imported under IREP and prices for CEM¹⁶⁵, and current data show that the milk equivalent price of whole milk powder continues to be competitive with the price of CEM.¹⁶⁶ For the above reasons, therefore, neither the first nor the third prerequisites for an Item (d) violation have been met.

3.143 In response to Canada's arguments in paragraph 3.142 (and footnote 166) above, the **United States** submitted that it does not agree that a discretionary permit requirement, no matter how routine its issuance, and an administrative fee constitute "formalities" which do not affect the commercial attractiveness of the IREP option. Such "formalities" are at a minimum an administrative burden that will make IREP purchases less attractive than CEM purchases which require no such steps. Indeed, as mentioned elsewhere, the fact that the IREP is so infrequently accessed constitutes persuasive evidence that its terms and conditions are less favourable than those available under Canada's export schemes.

3.144 Second, Canada relies upon imports of whole milk powder which must be re-hydrated for most end-uses requiring additional time and expense. Third, Canada admits that a tariff rate of 7.5 per cent applies to many imports under the IREP¹⁶⁷, an additional cost which renders the terms of IREP imports less favourable than CEM milk which does not incur that cost. Further, the IREP would require obtaining duty drawback, an additional factor that renders the conditions of IREP less favourable. Fourth, and perhaps most important, the United States continued, the prices of IREP whole milk powder are less favourable than the prices of CEM fluid milk, using the conversion factor that the Dairy Farmers of Canada recommends (7.78 litres of milk from one kilogram of whole milk powder) provides a milk equivalent price of CDN \$37.70/hl at the port, which is more than the average price of CEM milk.¹⁶⁸ Moreover, to be properly compared with CEM milk prices, transportation and re-hydration charges must be added to the already non-competitive IREP price.

3.145 Finally, whole milk powder is not used in the production of cheese or "other milk products," the two categories of exports at issue here. Rather, whole milk powder is predominately used in the production of confectionery products (i.e. candy) in Canada. Thus, the evidence does not support Canada's assertion that Canadian manufacturers of cheese and "other milk products" are accessing whole milk powder imports under the IREP or, even if they were, that the terms are as favourable as under the CEM scheme. Thus, because the CEM scheme satisfies each of the criteria identified in Paragraph (d) of the Illustrative List, the CEM scheme provides export subsidies for purposes of the SCM Agreement. As the SCM Agreement is part of the context of the Agreement on Agriculture, the fact that the CEM scheme provides subsidies identified in the Illustrative List supports a finding that the CEM scheme constitutes an export subsidy under Article 10.1 of the Agreement on Agriculture.

3.146 With respect to Canada's arguments concerning paragraph (d) of the Illustrative List, the United States considered that Canada's arguments are without legal support. Because the question in this case is one of export subsidies, as this panel stated in its original report, it is more appropriate "to

¹⁶⁴ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, footnote 37.

¹⁶⁵ See Canada's response to Panel Question No. 10 in *Canada - Dairy Article 21.5* proceedings.

¹⁶⁶ In 2001, Canada imported 15,737,202 kgs. of whole milk powder under IREP, which represents a value of CDN \$46,387,255. Therefore, the average price of whole milk powder per kilogram was CDN \$2.95. As Canada explained in answer to question no. 10 from the previous *Canada - Dairy Article 21.5* panel, there is no standard conversion factor for whole milk powder. However, using a conversion factor of 11 kg., the standard used by the CDC and commonly used in the Canadian dairy industry and by Canadian dairy research institutes, the price of whole milk powder would be CDN \$32.42/hl, or as argued by the United States using a conversion factor of 12.04 kg., the price would be CDN \$35.49/hl, both of which fall within the range of commercial export milk prices, i.e., CDN \$23.79-CDN \$40.13/hl.

¹⁶⁷ Imports from the United States are exempt from these tariffs as a result of the North American Free Trade Agreement.

¹⁶⁸ See Exhibit US-34.

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." In doing so, the panel considered paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I to the SCM Agreement to be the most relevant paragraph. Referring to the conditions to be fulfilled to satisfy the requirements of paragraph (d) of the Illustrative List, the United States reiterated that for the reasons discussed above in paragraphs 3.131-3.135, Canada's CEM scheme satisfies each of these elements. Contrary to Canada's suggestion, the United States continued, it is not necessary first to conduct a separate analysis to demonstrate that the specific terms of Article 1.1(a)(1)(iv) are satisfied in order to fulfil the requirements of paragraph (d). Indeed, Canada itself agrees with this approach. In *Brazil - Aircraft*, Canada argued, and the panel agreed, that if a measure satisfies the Illustrative List, it is not necessary to consider whether it satisfies the broader definition of a "subsidy" in Article 1 of the *SCM Agreement*.¹⁶⁹ The United States considered finally that it has established under the fourth element of paragraph (d) that the terms and conditions on which milk is made available to processors for export are more favourable than those available to them from other sources.

3.147 **Canada** submitted, in response to the Complainants arguments with respect to Item (d) of the Illustrative List (see paragraphs 3.145 - 3.146, above) that in *US-FSC*, the Appellate Body held that all export subsidies prohibited by the SCM Agreement must meet the general definition of subsidy set out in Article 1.1 and in *Canada - Autos*, the panel noted that, "all [of the] practices identified in the Illustrative List are subsidies contingent on export performance." In *Brazil - Aircraft*, the panel held that once it is shown that a measure falls under the Illustrative List, it is *per se* an export subsidy, and it is not necessary to have regard to Article 1. Here, in contrast, there is an issue as to the meaning of what is meant by "indirectly through a government mandated scheme." It is, therefore, necessary to have regard to Article 1 of the SCM Agreement.

3.148 Further, in *US-Export Restraints*, Canada continued, the panel held that under the SCM Agreement Article 1 "subsidy" definition, a transfer of economic resources can be effected either directly under subparagraphs (i) to (iii) or indirectly through private bodies under subparagraph (iv). The panel held that a provision of goods only leads to a finding of a financial contribution under Article 1.1(a)(1)(iv), that is, the government only provides goods indirectly through a private body, if government entrusts or directs a private body to provide goods through delegation or an authoritative instruction or command. Canada submitted that it has demonstrated that government, in this case, has not delegated or given any instruction or command to individual producers to provide CEM to processors. Rather, individual producers and processors enter into commercial export transactions of their own volition.

3.149 Canada considered that there is no valid legal basis for not adopting an interpretation of "indirect" in Item (d) that is consistent with a meaning of that concept in Article 1. Accordingly, Canada does not provide goods "indirectly through a government mandated scheme" within the meaning of Item (d). It is also clear that neither the government nor their agencies provide CEM to processors directly. The first element of Item (d) not having been met, there is no export subsidy within the meaning of that provision.

3.150 **New Zealand** submitted, with respect to the arguments in paragraphs 3.147 - 3.149 above that no authority is cited, and of course none could be, for limiting the meaning of "indirectly" in paragraph (d) by reference to a specific provision of Article 1.1 - a provision that Canada, not the treaty, describes as "indirect" subsidization. New Zealand considered that Canada's arguments have no foundation in the text of paragraph (d).

¹⁶⁹ Panel Report, *Brazil - Aircraft Article 21.5* para. 6.42. This is consistent with the text of Article 3.1(a) of the SCM Agreement which provides that subsidies illustrated in Annex I shall be prohibited.

3.151 As concerns the arguments above with respect to administrative formalities, **Canada** submitted that these arguments have already been rejected by the Appellate Body. Nor does Canada agree that a tariff makes imports under IREP less attractive. Canada considered in particular that a tariff subject to drawback, falls into the same category of "administrative formalities" as permits and fees. They are widely used throughout the world and cannot be considered a meaningful impediment to importation, in particular, when as in this case, 95 per cent of all dairy products imported under IREP come in at or very close to duty free.

3.152 Finally, Canada considered that it is not true that prices under IREP are less favourable to processors than prices of CEM. Canada presented evidence on pricing under IREP before the first Article 21.5 panel and in its first written submission in this proceeding. For all of these reasons, Canada submitted that it does not provide export subsidies on the production and sale of CEM to processors within the meaning of Item (d) of the Illustrative List of Export Subsidies.

(ii) *SCM Agreement and Article XVI of GATT*

3.153 The **Complainants** submitted that Article 1.1 of the *SCM Agreement* is also relevant, providing further guidance in interpreting the meaning of the term "export subsidy" in Article 10.1 of the *Agreement on Agriculture*. This provision provides further context to Article 1(e) of the *Agreement on Agriculture*, which states that the term "export subsidies" "refers to subsidies contingent upon export performance".¹⁷⁰ Article 1.1 includes within the definition of a subsidy "any form of income or price support in the sense of Article XVI of GATT 1994". Article XVI describes supports which "operate directly or indirectly to increase exports of any product" (section A.1). Furthermore, section B.4 of Article XVI proscribes subsidies that "result[] in the sale of [the subsidized] product for export at a price lower than the comparable price charged for the like product in the domestic market". This includes Canada's CEM scheme whereby the federal and provincial governments and agencies have created a system which makes milk available to processors for export at below both its domestic price and its average total cost of production, milk which would not be available without the CEM scheme. The CEM scheme is thus a subsidy within the meaning of Article 1.1 of the *SCM Agreement*, as elaborated in Article XVI of GATT 1994.

3.154 Furthermore, **New Zealand** added, in both instances, the CEM scheme constitutes a "subsidy" within the meaning of Article 1.1(a)(2) of the *SCM Agreement*, and the fact that a "benefit" pursuant to Article 1.1(b) is conferred is self-evident, as milk priced below its proper value is made available to processors for export, thereby reducing processor costs.¹⁷¹

3.155 Canada cannot deny, the **United States** continued, that dairy products produced for export using CEM are priced lower than the same dairy products produced for domestic consumption. Finally, Canada does not dispute that there are no restraints on the availability of the export subsidies created by the CEM scheme. Consequently, the export schemes have already resulted in or threaten to lead to the circumvention of Canada's reduction commitment within the meaning of Article 10.1.

3.156 Thus, the **Complainants** concluded, the CEM scheme is a subsidy within the meaning of the *SCM Agreement*, and hence is an "export subsidy" within the meaning of Article 10.1 of the *Agreement on Agriculture*. It is a subsidy "contingent upon export performance". Only processors for export are granted access to milk that is priced below both its domestic price and its average total cost of production and the products must be sold on the export market.

¹⁷⁰ Appellate Body Report, *US - FSC*, para. 136; Appellate Body Report, *US - FSC Article 21.5*, paras. 193-195; and Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 7.126.

¹⁷¹ Appellate Body Report, *US - FSC Article 21.5*, para. 191.

3.157 **Canada** submitted that there is no basis upon which to classify commercial milk transactions as "income or price support" (see paragraph 3.153 above). Canada considered that the Complainants' position lacks legal analysis and factual support. First, the arguments of both Complainants regarding Article 1.1(a)(2) of the *SCM Agreement* focus on the perceived effects of commercial export transactions. Such casual treatment of this element confuses the alleged measure with its effect, both of which are required to be shown. Canada referred to the panel in *US - Export Restraints* which noted that the definition of "subsidy" in Article 1 reflects the Members' agreement not only as to the types of government action subject to the *SCM Agreement*, but also that not all government actions that may affect the market come within the ambit of the *SCM Agreement*.

3.158 Second, Canada continued, both Complainants refer to Article XVI:4 of GATT 1994 (see paragraph 3.153 above) in support of their pure "effects" based analysis. However, the Appellate Body has already indicated that the reference to "income or price support" in Article 1.1(a)(2) of the *SCM Agreement* is to Article XVI:1 of GATT 1994 only. In the opinion of Canada, the allegations of the Complainants do not demonstrate any element of "support" of any kind in the sense of Article 1.1(a)(2) of the *SCM Agreement*. There is no evidence, since no such evidence exists, that the government establishes either a support or target price for CEM transactions or any manner of government-set income target measures for the benefit of dairy processors. CEM prices are determined based on the independent decisions of processors as to what price they are willing to pay and the independent decision of producers as to whether or not they are willing to accept that price.¹⁷² There is no "income support" programme for processors.

3.159 The **United States** reiterated that an analysis of Article 1.1(a)(2) of the *SCM Agreement* also supports a finding under Article 10.1 of the *Agreement on Agriculture*. The United States considered, however, that there is no support in the language of that provision for requiring that the government set a "target" price or income level. Article 1.1(a)(2) points instead to "any form of income or price support in the sense of Article XVI of GATT 1994." Nor is there any requirement in Article XVI that the government set a "target" price or income level. Canada provides income and price support to its exporters by exempting milk used in the production of export products from the high domestic price. It is undisputed that Canadian processors could not compete in the export market without the low-price inputs (CEM milk) available to them as a result of this exemption. Thus, although the individual prices of the export contracts are negotiated by the producers and processors themselves, this government exemption from the high domestic price necessarily operates to increase the exports of dairy products from Canada. Without it, the processor would have to purchase its milk for export at the higher domestic price. This is not the "perceived effects of commercial export transactions" as argued by Canada.¹⁷³ This is the guaranteed result of the government-mandated price exemption.

3.160 Referring to New Zealand's arguments concerning "benefit" in paragraph 3.146 above, Canada replied that the *US-FSC* was a case involving the foregoing of *government* revenue through a taxation regime. The United States does not attempt to establish the required conferral of a "benefit" for purposes of establishing a subsidy through Article 1.1(a)(2) of the *SCM Agreement*. In any event, Canada has already shown that producers who are selling milk to processors in CEM transactions are able to recover their average cost of production over time. Accordingly, they are not providing goods at less than adequate remuneration, and no benefit therefore exists.¹⁷⁴

3.161 Referring to the Complainants' arguments in paragraph 3.153 above and Canada's response in paragraph 3.157 above, **New Zealand** replied that the panel in *US - Export Restraints* made it clear

¹⁷² Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 79.

¹⁷³ In any event, the *US - Export Restraints* case cited by Canada is inapposite. That case was brought under Article 1.1(a)(1)(iv), not Article 1.1(a)(2). Furthermore, the language relied upon by Canada is *obiter dictum*.

¹⁷⁴ Appellate Body Report, *US-FSC*, para. 136.

that its decision was focused solely upon the specific language of Article 1.1(a)(1)(iv).¹⁷⁵ With respect to "benefit", New Zealand submitted that the Appellate Body in *US - FSC* indicated that where costs have been reduced, a "benefit" has been conferred. This clearly applies to the present case where processors for export are being provided with milk that is priced below its proper value. New Zealand considered that to make a distinction between government revenue foregone and a "benefit" was misplaced because a "benefit" would exist whether costs are reduced by revenue foregone by government or foregone by an independent economic operator.

3.162 With respect to the Complainants' arguments concerning income or price support (see for instance paragraph 3.153 et sequitur above) **Canada** considered that there is no support in the text of Article 1 of the *SCM Agreement* for the Complainants' theory that Canada is providing a form of "income or price support" within the meaning of Article XVI of GATT 1994. Contrary to the Complainants' assertions, there are no guarantees that any income will be generated unless it is in the economic interests of producers and processors that sales occur. The conclusion that because Canada does not prevent sales of CEM from occurring at prices mutually agreed to between buyer and seller, Canada is "supporting" the income generated by these sales is, according to Canada, inconsistent with the concept of "support". Such a conclusion would mean that any measure that enables income to be generated by milk producers could likewise be considered to be income support.

3.163 Canada submitted that there is no authority in GATT jurisprudence for such a wide interpretation of "income or price support". While this expression has never been explicitly defined under GATT law or practice, the 1960 *Panel Review Pursuant to Article XVI:5* provides some context. The panel noted that measures had to be analysed on a case-by-case basis but, in considering such matters, spoke of cases such as where a government maintains domestic prices above the world price by purchases and resales at a loss. This is far from, in the words of the Appellate Body, "...establish[ing] a regulatory framework merely enabling a third person freely to make and finance 'payments'". Canada reiterated that for these reasons, it does not provide export subsidies on the production and sale of CEM to processors within the meaning of Article 1.1(a)(2) of the *SCM Agreement* and Article XVI of GATT 1994.

(iii) *Circumvention of Export Subsidy Commitments*

3.164 The **Complainants** submitted that through the combined exercise of federal and provincial authority, Canada has established mechanisms in the various provinces to provide processors for export with milk that is below its domestic price and its average total cost of production, the very export subsidy that was concluded in the *Canada - Dairy* Appellate Body report to be contrary to Canada's obligations under the *Agreement on Agriculture*. The Complainants, referring to the Appellate Body report in *US - FSC*¹⁷⁶ noted that "to circumvent" meant to "find a way round, evade..." i.e. a Member would have found a way around or evaded its obligations if it could transfer by another means the very same economic resources or benefits that it would be prohibited from providing in another form under Article 3.3 and Article 9.1 of the *Agreement on Agriculture*.¹⁷⁷

3.165 **New Zealand**, referring to Article 10.3 (burden of proof) of the *Agreement on Agriculture* and to the panel in *Canada - Dairy*¹⁷⁸, noted that the effect of Article 10.3 is that exporting in excess of reduction commitments raises a presumption that there has been circumvention of those commitments, and thus there is a burden on the Member to establish that the quantities in question are not subsidized. Equally, where a Member has taken measures which will enable the export of subsidized products in excess of reduction commitments, those measures threaten to lead to

¹⁷⁵ See, for example Panel Report, *US - Export Restraints*, para. 8.75.

¹⁷⁶ Appellate Body Report, *US - FSC*, para. 148.

¹⁷⁷ *Ibid.*, para. 150.

¹⁷⁸ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 7.122.

circumvention, even though no quantities in excess of reduction commitments have yet been exported. Thus, New Zealand continued, in the context of the present case, to the extent that Canada's CEM scheme enables the export of subsidized dairy products in excess of Canada's reduction commitment levels, it threatens to lead to circumvention of those commitments. To the extent that dairy products have been exported in excess of Canada's reduction commitments, there has been actual circumvention of Canada's reduction commitments. In either circumstance, there has been a violation of Article 10.1 of the *Agreement on Agriculture*.

3.166 The **United States** considered that the export subsidy conferred by the CEM scheme "results in, or threatens to lead to, circumvention of export subsidy commitments."¹⁷⁹ Canada has thus evaded its export subsidy commitments by finding a new means (the CEM scheme) to transfer to export processors the very same economic benefits (i.e. discounted milk) that it was prohibited from transferring under the SMC scheme condemned by the DSB under Article 9.1(c) of the *Agreement on Agriculture*. In *US - FSC*, the Appellate Body concluded that: "... under Article 10.1 it is not necessary to demonstrate *actual* 'circumvention' of 'export subsidy commitments'. It suffices that 'export subsidies' are applied in a manner ... which *threatens to lead to circumvention* of export subsidy commitments."¹⁸⁰ In determining whether circumvention of export subsidy commitments is likely to result, the Appellate Body concluded that the structure and other characteristics of the measure are pertinent.¹⁸¹

3.167 Under the CEM scheme, the United States continued, the Canadian government requires that non-quota milk be excluded from consumption in the domestic market. The direct consequence of that exclusion is that such milk must be used to produce either products for export or animal feed. The availability of discounted milk for export is confined only by the export opportunities available to Canada's dairy product processors. The revised export schemes lack any internal limit or control on the volume of discounted milk going to processors for export.

3.168 As in *US - FSC*, the absence of any constraints on the use of the CEM export subsidy confirms, according to the United States, that it is likely to threaten to lead to circumvention of Canada's dairy export subsidy commitments. Moreover, in this case there is not only threatened, but actual circumvention of Canada's export commitments. Indeed, Canada's exports of cheese and "other milk" products in the dairy year 2000-2001 exceeded (or for purposes of Article 10.1, circumvented) the limitations to which Canada committed itself in the *Agreement on Agriculture*.¹⁸² Thus, the threat of additional, unchecked circumvention of Canada's dairy export subsidy commitments is no mere possibility—it is underway.

3.169 **Canada** responded that there has been no circumvention of Canada's export subsidy commitments within the meaning of Article 10.1 of the *Agriculture Agreement* since, as Canada has demonstrated, there is no export subsidy involved in commercial export milk transactions. Accordingly, the issue of circumvention is moot.

3.170 **New Zealand** submitted that Article 10.1 of the *Agreement on Agriculture* is essentially focused on ensuring that the export subsidy disciplines of the *Agreement on Agriculture* are not circumvented. But, this is clearly what Canada is attempting to do with the CEM scheme. New Zealand considered that the CEM scheme is simply a replacement for Special Milk Class 5(e). CEM is achieving precisely what was achieved under Special Milk Classes until the scheme was ruled to be

¹⁷⁹ Article 10.1 of the *Agreement on Agriculture*.

¹⁸⁰ Appellate Body Report, *US - FSC*, para. 148.

¹⁸¹ *Ibid.*, para. 149.

¹⁸² See Exhibit US-1; Panel Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 6.8. Canada is also on track to exceed its commitments for cheese and "other milk" products for the dairy year 2001-2002.

contrary to Canada's obligations under the *Agreement on Agriculture*. New Zealand considered that a clearer case of circumvention could not be found.

3.171 The *Canada - Dairy* panel's observation in paragraph 7.125 of its report acknowledges that the drafters of Article 10 were trying to capture those export subsidies that did not technically meet the strict letter of Article 9.1, but nevertheless produced the same subsidization consequences. This idea was referred to as well by the Appellate Body in *US - FSC*, New Zealand continued (see also paragraph 3.146 above).

(iv) "*Non-commercial transactions*"

3.172 **New Zealand** submitted that even if it is not accepted that Canada has applied export subsidies not listed under Article 9.1 of the *Agreement on Agriculture* in a manner which results in, or threatens to lead to, circumvention of export subsidy commitments in the sense of the first part of Article 10.1 of the *Agreement on Agriculture*, it has provided for "non-commercial transactions" in the sense of the second part of the same article. New Zealand considered that a non-commercial transaction is one in which private profit-maximising individuals would not, from choice, engage. They involve transactions on terms that have not been freely negotiated in an open market.

3.173 In the present case, New Zealand continued, the "market" in which these transactions take place is completely constructed. The processors for export are being provided with milk that is priced at below domestic prices and below the average total cost of production. This is achieved by prohibiting the sale of such milk in the regulated domestic market and by exempting processors for export from the obligation to purchase milk at the regulated domestic prices. Transactions that take place in such a "market" are not commercial transactions resulting from the normal operation of markets. Indeed, they are "non-commercial transactions" within the meaning of Article 10.1 of the *Agreement on Agriculture*.

3.174 The **United States** submitted that Canada's revised export scheme is in contravention of the second clause of Article 10.1 of the *Agreement on Agriculture*. Despite the "market" trappings of the contractual arrangements between producers and processors in the sale of CEM, the United States considered that those transactions are demonstrably "non-commercial" as CEM sales are uneconomic for milk producers, who do not come close to recovering their costs of producing the milk. CEM prices have regularly fallen short of producers' fixed and variable costs of production by more than CDN \$20 per hectolitre. Producers engage in these uneconomic CEM transactions, the United States continued, because the only other alternatives legally available to them - disposal, or Class 4(m) sales for animal feed - offer even less of a return on their investment. The Canadian government thus leaves them no choice but to engage in "non-commercial" sales of their non-quota milk. Those sales to export processors, in turn, have resulted in the circumvention (and threaten further, unlimited circumvention) of Canada's export subsidy reduction commitments.

3.175 The next factor in the analytical framework suggested by the Appellate Body is to consider whether the availability of discounted milk pursuant to the CEM scheme is "contingent on export performance."¹⁸³ As explained above, under the CEM scheme, the availability of discounted milk is dependent on use of the milk in the manufacture of dairy exports. Severe financial penalties prevent the sale of the discounted milk or its products for any purpose other than export. In sum, the United States submitted, Canada's CEM scheme comprises "export subsidies" or "non-commercial transactions" within the meaning of Article 10.1 of the *Agreement on Agriculture*, even if the CEM scheme is found not to meet strictly the definitional requirements of Article 9.1(c) of the Agreement. CEM subsidies or transactions have already resulted in the circumvention of Canada's export subsidy

¹⁸³ Appellate Body Report, *US - FSC*, para. 141.

reduction commitments, and they threaten continued, indeed unlimited, circumvention of those commitments. As such, the CEM scheme violates Article 10.1 of the *Agreement*.

3.176 **Canada** submitted that there is nothing non-commercial about the CEM market. Nothing in the context of the *Agreement on Agriculture* detracts from or expands the ordinary meaning.¹⁸⁴ Producers when they decide to sell CEM, are acting in a purely commercial manner with a view to making a profit. They are engaged in an arm's-length business transaction with processors. Unlike, for example, buffer stocks of commodities that governments compile and then dispose of by any means possible such as donations or food aid, such transactions cannot be dismissed as "non-commercial." Both buyer and seller are entering into a commercial contract and assuming commercial risks. These choices are theirs, not those of the government. Canada concluded that there has been no circumvention of Canada's export subsidy commitments within the meaning of Article 10.1 of the *Agriculture Agreement* since there is no export subsidy involved in CEM transactions. Accordingly, the issue of circumvention is moot.

3.177 **New Zealand** rejected Canada's view with regard to "non-commercial" (see paragraph 3.168 above) submitting that since it has been established that sales on the CEM market take place at prices that are lower than the average total cost of production, they are by definition non-commercial transactions. Hence, there is circumvention within the meaning of Article 10.1 of the *Agreement on Agriculture*.

3.178 Replying to the arguments in paragraph 3.168 above with respect to non-commercial transactions, the **United States** submitted that the export market is a wholly contrived market. It is created by the Canadian government. As noted by the panel in the first Article 21.5 proceedings, there is no difference between the "domestic" market and "export" market in terms of the buyers, sellers and products they trade.¹⁸⁵ The only difference is the price of milk, which is a result of government intervention. The United States reiterated that it has demonstrated that the average price of CEM milk does not allow producers to recoup their total average cost of production in the long run. Producers engage in these uneconomic CEM transactions because the only other alternatives legally available to them - disposal, or Class 4(m) sales for animal feed - offer even less of a return on their investment. If they produce milk without quota, the Canadian government leaves them no choice but to engage in "non-commercial" sales of this milk in the CEM market. Those sales to export processors, in turn, have resulted in the circumvention (and threaten further, unlimited circumvention) of Canada's export subsidy reduction commitments.

3.179 Canada reiterated that it has not created or contrived a market for CEM. Canada has simply removed governments from decisions related to the purchase and sale of CEM. Private parties decide whether and on what terms they wish to participate in the global market for dairy products. Canada certainly did not "contrive" or "create" this global market. The transactions in which producers and processors enter are, therefore, commercial. In addition, the context of other provisions under the *Agreement on Agriculture* suggests a far narrower meaning. Articles 9.1(b) and 10.4(a) refer to "non-commercial" in the sense of transactions occurring outside of the normal market of private buyers and sellers, such as governmental sales or other disposals of food stocks for international food aid. Commercial export sales clearly do not fit within that context.

D. ARTICLES 1.1 AND 3 OF THE SCM AGREEMENT

3.180 The **United States** submitted that in addition to constituting violations of Articles 9.1(c), or in the alternative, Article 10 of the *Agreement on Agriculture*, Canada's measures affecting the

¹⁸⁴ See Exhibit CDA-19.

¹⁸⁵ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 6.16

exportation of dairy products constitute prohibited export subsidies pursuant to Articles 1.1 and 3.1 of the *SCM Agreement*. Notwithstanding the change that Canada imposed on the form of its programmes, Canada's measures continue to meet the Appellate Body's definition of a "subsidy" under Article 1.1 of the *SCM Agreement*.¹⁸⁶ Canadian governmental authorities continue to provide milk for export products at a reduced rate. Under Canada's new scheme, the CDC, CMSMC, the provincial governments, the milk marketing boards and the new provincial programmes - with their penalties for milk that is not properly channelled - all work to ensure that this is the case. The Appellate Body found that, in such circumstances, "the recipient is paid in the form of goods or services."¹⁸⁷ This, in the opinion of the United States, constitutes a financial contribution under Article 1.1(a)(1)(iii) of the *SCM Agreement*.

3.181 The United States, referring to the Appellate Body report in *Canada - Aircraft*¹⁸⁸ with respect to the term "benefit", submitted that because of the incentive to sell milk at lower prices for export, the dairy processors who export are the beneficiaries of the CEM scheme in Canada. Without this scheme, milk at such discounted prices would not be available through any other channel to processors for export. Since those processors have no other source for such low-priced milk 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, the processors clearly receive a competitive advantage that they would otherwise lack. Since the milk for export is provided on lower terms than would otherwise be available on the market, absent the provincial pricing systems, the financial contribution provides a benefit within the meaning of Article 1.1(b) of the *SCM Agreement*.

1.182 The United States submitted furthermore that Canada's CEM scheme requires that milk purchased at the exempted CEM price must be exported. As such, these subsidies are "contingent on export performance" and therefore prohibited under Article 3.1 of the *SCM Agreement*. Under the CEM scheme, when a milk dealer is unable to show that all the quantities of components of the volume of milk have been exported, the milk dealer must pay a penalty. Canada's CEM scheme is, therefore, "contingent ... upon export performance" and, as such, provides prohibited subsidies under Article 3.1 of the *SCM Agreement*.

3.183 In conclusion, the United States submitted that Canada's introduction of the CEM scheme to replace Special Milk Class 5(e) cannot conceal the fact that dairy processors continue to receive milk for use in the production of exported goods at prices substantially below the proper value of the milk to the producers. This price benefit is conferred through export mechanisms authorised, administered, and enforced through governmental action. Thus, there can be no doubt that Canada's current export regime for dairy products, consisting of both Special Milk Class 5(d), and the CEM scheme, provides an export subsidy within the meaning of the *Agreement on Agriculture*.

3.184 **Canada**, referring to the Appellate Body in *Canada - Aircraft*¹⁸⁹, replied that the nature of the government action is determinative as to whether a "financial contribution" exists under Article 1.1(a)(1). If a government has not acted in a manner enumerated in Article 1.1(a)(1), then a "financial contribution" does not exist and there can be no "subsidy". "Financial contribution" under Article 1.1(a)(1)(iii) contemplates a direct provision of goods by government. Canada already has demonstrated that governments do not provide milk to processors. Producers have the option to allocate some, none, or all of their production to the commercial export market. Governments do not make this decision on behalf of the producers. Accordingly, Canada's measures do not meet the definition of "financial contribution" under Article 1.1(a)(1)(iii). A provision of goods can still be

¹⁸⁶ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 87.

¹⁸⁷ *Ibid.*, para. 113.

¹⁸⁸ Para. 157.

¹⁸⁹ Para. 156.

captured under the definition of "financial contribution" in Article 1.1, Canada continued, if governments or their agencies "indirectly" provide these goods to processors in the manner set out in Article 1.1(a)(1)(iv) of the *SCM Agreement*.

3.185 For there to be a "financial contribution" within the meaning of Article 1.1(a)(1)(iv) of the *SCM Agreement*, Canada continued, the government must "entrust or direct" a "private body" to "carry out one or more of the type of functions illustrated in (i) to (iii)." That provision was recently considered in *US–Export Restraints*. In that case the panel found that "the act of entrusting and that of directing therefore necessarily carry with them the following three elements: (i) an explicit and affirmative action, be it delegation [in the case of entrusting] or command [in the case of directing]; (ii) addressed to a particular party; and (iii) the object of which action is a particular task or duty."¹⁹⁰ Something must necessarily be delegated to someone, Canada submitted, or alternatively, someone must necessarily be commanded to do something. Further in that case the panel rejected the notion that the requirements of Article 1.1(a)(1)(iv) are met if there is an effect or a proximate causal relationship between some government action and a benefit. The panel concluded that such an interpretation would read the financial contribution element out of the text of Article 1.¹⁹¹

3.186 Canada has not entrusted or directed producers to provide CEM to processors. Rather, producers provide CEM to processors of their own volition. Canada's measures deregulated the commercial export market and have nothing to do with the decision to produce, sell, or purchase CEM. None of these measures, or the measures which remain in place to regulate the domestic market, contains any notion of delegation or command addressed to any private party to provide CEM to processors. No government laws or regulations direct or command producers to produce or sell CEM. Likewise, no government laws or regulations force processors to purchase this milk. Rather, these decisions are left entirely to individual producers and processors. Accordingly, Canada is not "indirectly" providing goods to processors within the meaning of Article 1.1(a)(iv) of the *SCM Agreement*.

3.187 With respect to the issue of "benefit", Canada considered that it has already demonstrated that producers who are selling milk to processors in CEM transactions are able to recover their average cost of production over time and thus processors are not receiving any "advantage" or "benefit" within the meaning of Article 1.1(b) of the *SCM Agreement*. Thus, since there is no "subsidy" conferred on processors within the meaning of Article 1.1(a)(1)(iii) or (iv) of the *SCM Agreement*, there can be no "export subsidy" under Article 3.1 of the *SCM Agreement*.

3.188 The **United States** submitted that it has demonstrated that Canada's CEM scheme as well as the maintenance of Special Milk Class 5(d) constitute prohibited export subsidies under Article 3 of the *SCM Agreement*.¹⁹² The United States considered that Canada has not rebutted this showing.

3.189 In addition to satisfying the particular terms of Article 1.1 of the *SCM Agreement*, the CEM scheme also satisfies Paragraph (d) of the Illustrative List, as further discussed above. With respect to the federal level of Canada's system, the original panel and the Appellate Body's findings are more than sufficient to demonstrate that the maintenance of Special Class 5(d) is a prohibited export subsidy inconsistent with Article 3 of the *SCM Agreement*. At paragraph 7.132 of the original panel report, the panel found that Special Class 5(d) constituted "an export subsidy as listed in Paragraph (d) of the Illustrative List of Export Subsidies annexed to the *SCM Agreement*." It went on, in the next

¹⁹⁰ Panel Report, *US–Export Restraints*, para. 8.29.

¹⁹¹ *Ibid.*, para. 8.44.

¹⁹² As demonstrated in the United States first written submission, Canada has exceeded its commitment levels and thus failed to conform to its obligations under the *Agreement on Agriculture*. As such, its measures are thus subject to scrutiny under the *SCM Agreement* (that is, Canada may not lay claim to the immunity conferred on conforming agricultural subsidies under *SCM Agreement* Article 3 and the *Agreement on Agriculture* Article 13(c)(ii)).

sentence, to note the "fact" that the scheme involves an export subsidy under the SCM Agreement. Indeed, this Panel need not analyse the particular requirements of Article 1.1 because the CEM scheme falls within the scope of the Illustrative List of Export Subsidies. Canada itself championed this same approach successfully in another case involving export subsidies, i.e. in the original panel. The panel in the Article 21.5 proceedings in that dispute agreed.

3.190 Just as in the *Brazil - Aircraft* dispute, this Panel is confronted with a *per se* violation of Article 3 of the *SCM Agreement*, namely subsidy schemes that are described in the Illustrative List - here, in paragraph (d). The government of Canada, at both the federal and provincial level, provides milk to dairy processors for export "on terms and conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption." Canada's measures are, in Canada's own words, *ipso facto* an export subsidy and therefore prohibited.

3.191 **Canada** replied that since there is no "subsidy" conferred on processors within the meaning of Article 1.1(a)(1) or (2), including within the meaning of Item (d) of the Illustrative List, there can be no "export subsidy" under Article 3.1 of the *SCM Agreement*. When the findings of the Appellate Body are properly applied to the facts of the present case, it is clear that Canada does not provide export subsidies on the production and sale of CEM by independent milk producers within the meaning of the *Agreement on Agriculture* or the *SCM Agreement*. The evidence shows that producers are able to sell CEM at prices that cover their "average total cost of production".

IV. THIRD PARTIES' ARGUMENTS

A. ARGENTINA

1. Article 9.1 of the *Agreement on Agriculture*

(i) "payments"

4.1 **Argentina** submitted that in this case, the supply of CEM (CEM) by Canadian producers amounts to a benefit for the processors that might be qualified as a "payment" under Article 9.1(c) of the *Agreement on Agriculture*. In the context of this case, the Appellate Body established, as a criterion for defining the existence of a payment, that the price charged by the producer of the milk must be less than the milk's "proper value" to the producer. On this basis, the Appellate Body established that the benchmark for comparison of prices charged by Canadian producers and determining whether they were less than the milk's "proper value" to the producer was the "average total cost of production".

4.2 The evidence contributed by the Parties to this proceeding would seem to indicate clearly that this is the case, particularly if we take as a basis the handbook of the CDC. Furthermore, the price agreed between the producer and the processor for export milk cannot simply be seen as a market price. In a market where the Government of Canada artificially distinguishes between the domestic market, which benefits from domestic support, and the export market, it is difficult to conclude that the price agreed among the producers and processors is a market price. How much freedom can there be in this export milk market if the producer does not have alternatives? Producers are under an obligation to sell over-quota milk for export. They end up with a surplus that they cannot limit. They do not have any economically more attractive alternative. Argentina submitted further that the benefit conferred for the sale of CEM is clearly contingent upon exportation. Indeed, financial penalties are even envisaged for cases where milk for export is used for the processing of products for domestic consumption. These facts have not been challenged during these proceedings.

(ii) "by virtue of governmental action"

4.3 Having identified the existence of a payment, it must be established that the payment is "financed by virtue of governmental action". As determined by the Appellate Body, this relationship must be identified case-by-case on the basis of the effect of the governmental action on the payment made by a third party. According to the Appellate Body, "governmental action" embraces a broad range of activities, "including governmental action regulating the supply and price of milk in the domestic market".¹⁹³ Moreover, it is clear from the text of the provision that the action *does not require a charge on the public account* to be considered a subsidy under Article 9.1(c) of the *Agreement on Agriculture*. Although the words 'by virtue of' render governmental action essential, Article 9.1(c) contemplates that payments may be financed by virtue of governmental action even though significant aspects of the financing might not involve government".¹⁹⁴

4.4 According to the criterion established by the original panel, it should be demonstrated that the Canadian system drives milk producers to make these payments. The Appellate Body links this situation with the degree of obligation or conditioning imposed on producers by the governmental system to produce additional milk for export. In the case at issue, it has not been disputed that by virtue of the action of the Canadian Government: (i) the milk produced over the quota for sale in the Canadian domestic market cannot be sold in the domestic market (except under class 4m), and (ii) there is a penalty for diverting this over-quota production to the Canadian domestic market. Producers have

¹⁹³ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 112.

¹⁹⁴ *Ibid.*, para. 114.

no economically attractive alternative to selling it for export (CEM) under the conditions laid down by the system. Producers are thus under an "obligation" to sell over-quota milk for export. If the domestic quota did not exist, milk processors would buy the milk for export at the same price as the milk for domestic consumption, a price that would undoubtedly be higher.

4.5 Argentina considered that Article 9.1(c) of the *Agreement on Agriculture*, covers hypotheses such as the case at issue, in which the processors purchase at a price which amounts to a benefit and do so "by virtue of governmental action", even if not directly financed by the Government. Any other interpretation would deprive the words "by virtue of" of their meaning. For reasons set out above, Argentina submitted that the Canadian regime for the supply of CEM by Canadian producers can be qualified as an export subsidy under Article 9.1(c) of the *Agreement on Agriculture*.

2. Article 10.1 of the Agreement on Agriculture

4.6 Argentina submitted that where it is not possible to demonstrate that a measure constitutes an export subsidy among those listed in Article 9.1, it must be examined to see if it constitutes a circumvention of export subsidy commitments under Article 10.1. Article 1(e) of the *Agreement on Agriculture* contains a definition of "export subsidies", which can be further clarified, if necessary, by reference to the *SCM Agreement*. In *Canada – Aircraft*, the Appellate Body established that a subsidy under Article 1.1 is a financial contribution which confers a benefit on the recipient in terms more favourable than those that would otherwise have been available to the recipient in the market.¹⁹⁵ It is clear from this definition that under the *SCM Agreement*, it is necessary to demonstrate a financial contribution and a benefit to prove that there is a subsidy.

4.7 For the purposes of determining the existence of a financial contribution, account must be taken of the original panel's finding that paragraph (d) of the Illustrative List of Export Subsidies was a "relevant" provision for the purposes of determining the existence of an export subsidy. Argentina submitted that, under the *Agreement on Agriculture*, government action by virtue of which the provision described in paragraph (d) of the Illustrative List takes place for use in the production of exported goods constitutes an export subsidy within the meaning of Article 10.1, even if there is no "charge on the public account". The rest of the *Agreement on Agriculture* itself also forms part of the "context" of Article 10.1. Indeed, it is the most relevant context, since it is the same Agreement.

4.8 Argentina considered that the measure challenged in these proceedings is also a form of income or price support which operates directly or indirectly to increase exports of dairy products. These exports would not be competitive in international markets if the processors were to pay the price required for milk intended for products sold on the domestic market.

4.9 Processors purchase milk on "terms or conditions ... more favourable than those commercially available on world markets to their exporters" (Illustrative List of Export Subsidies, paragraph (d)) given the restrictions imposed by Canada on imports through their tariff level. As stated by the Appellate Body in *Canada - Dairy Article 21.5* with respect to the absence of an express standard for determining which measures involve "payments", "even within Article 9.1 itself, subparagraphs (d) and (c) expressly provide that the domestic market constitutes the appropriate basis for comparison".¹⁹⁶ Furthermore, various paragraphs of the Illustrative List of the *SCM Agreement* contain references linked to the domestic market. Similarly, in *Canada - Aircraft*, the Appellate Body defined the benefit conferred under Article 1.1 of the *SCM Agreement* by comparing it to the market: "the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred', because the trade-distorting potential of a 'financial contribution' can be identified by determining

¹⁹⁵ Appellate Body Report, *Canada – Aircraft*, DSR 1999:III, 1377, para. 157.

¹⁹⁶ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 75.

whether the recipient has received a 'financial contribution' on terms more favourable than those available to the recipient in the market" (paragraph 157 of the Appellate Body report). Given that what is being done here is to determine the existence of a "benefit", Argentina considered that in this case, comparison with the market price is appropriate.

4.10 It is Argentina's understanding that the "benchmark" fixed by the Appellate Body, the "total average cost of production", is limited to the determination of the concept of "payment"¹⁹⁷ in Article 9.1(c) of the *Agreement on Agriculture*, and should not be applied to the concept of "benefit" in the framework of the export subsidies mentioned in Article 10.1. Similarly, it should be borne in mind that the Appellate Body fixed this benchmark as the most appropriate to this case, without suggesting that it be extended to other WTO disputes. For the reasons given above, it is obvious that this type of benefit is contingent on exportation. The financial penalties for the use of export milk in the preparation of products intended for domestic consumption are proof enough.

4.11 Furthermore, Argentina considered that the challenged system at least "threatens to lead to circumvention" of export subsidy commitments assumed by Canada. According to the Appellate Body in *US - FSC*, the absence of limitations to an export subsidy "threatens to lead to circumvention of export subsidy commitments". Here, there is no fixed quota for export milk or limitation of any other kind. In any case, what counts here is Article 10.3 of the *Agreement on Agriculture*, according to which any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy has been granted in respect of the quantity of exports in question. In Argentina's view, the characteristics of the system at issue in these proceedings are such that if it does not qualify as an export subsidy under Article 9.1(c) of the *Agreement on Agriculture*, it constitutes an export subsidy which is inconsistent with Article 10.1, since it at least "threatens to circumvent" the export subsidy commitments of the granting Member.

B. AUSTRALIA

1. Article 9.1 of the *Agreement on Agriculture*

(i) "payments"

4.12 **Australia** submitted that Canada's new category of milk for export processing known as CEM provides milk to dairy processors/exporters for the export of manufactured dairy products below the value of the milk to the producer. There is no limit on the sales of CEM to processors/exporters. Processors are prohibited from selling milk on the domestic market; CEM must be exported. Processors are also exempted from purchasing milk for export at regulated domestic prices. The only way that producers can sell above-quota or non-quota milk is if it is exported or used as animal feed.

4.13 In using the standard of the average total cost of production for determining whether sales of CEM involve "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, Australia considers that sales below the average total cost of production involve "payments" which are financed by virtue of governmental action. To the extent that Canada has exported dairy products in excess of its scheduled export subsidy quantity reduction commitments, it has therefore breached Articles 3.3 and 8 of the *Agreement on Agriculture*.

4.14 Article 9.1(c) of the *Agreement on Agriculture* relates to payments on the export of an agricultural product which are financed by virtue of governmental action. In the original proceedings, it was held that "payments" can include payments-in-kind. The Appellate Body, in its decision of

¹⁹⁷ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 92. "In our view, by relying upon the total cost of production in this dispute, to determine whether there are 'payments', the integrity of the two disciplines [domestic support and export subsidies] is best respected."

3 December 2001, noted that Article 9.1(c) of the *Agreement on Agriculture* does not expressly identify a standard or benchmark for determining when a measure involves "payments" in the form of payments-in-kind. It reversed the panel's finding that the "right benchmark" is the domestic market price. It also rejected the world market price as a valid basis for determining whether the CEM scheme involves "payments".

4.15 Referring to the Appellate Body statement that "the total cost of production includes *all* fixed and variable costs incurred in the production of all the units in question"¹⁹⁸, Australia considered that this raises two issues: what components constitute the fixed and variable costs of producing milk; and whether nationally determined cost of production data based on farm sampling represents an adequate measurement for the average total cost of production. As concerns the Appellate Body statement in paragraph 87 (fixed and valuable costs) of its report and in paragraph 96 (average total cost of production), Australia considered that the Appellate Body clearly was cognisant that "over time" producers will make investments determining both their farming capacity and costs with a view to maximising profits over time.

4.16 Australia noted that there is no agreed international standard/definition which is applied either across the board or on a sector-specific basis of what reflects the cost of production. While there may be existing generally-accepted accounting principles and practices and efforts to develop criteria or guidelines, these vary from jurisdiction to jurisdiction. Each WTO Member therefore adopts different approaches on the methodology on the determination of the average total cost of production. As the Appellate Body notes in the context of the lack of an express standard for determining whether a measure involves "payments", "payments' need to be scrutinised carefully in the context of the facts and circumstances relating to a particular measure and particular case".¹⁹⁹ However, Australia recalls that the purpose of seeking a benchmark or standard is to "isolate" the subsidy element, or as the Appellate Body notes, "whether Canadian export production has been given an advantage".²⁰⁰

4.17 As outlined in the CDC's handbook, there are inherent inaccuracies in using the average total cost of production on all milk produced in Canada. For example, Canada's approach does not fully reflect the most inefficient producers with each provincial sample reflecting 70 per cent of producers and not all costs are reflected in the cost of production, for example, the cost of production quota. The exclusion of these producers and the lack of inclusion of the cost of production quota mean that the CDC's data underestimates the cost of production. Nevertheless, Australia considers that if this CDC methodology constitutes the basis on which Canada sets its target price for industrial milk, and the system of pooling and production quotas, then it serves as a reasonable measure in the context of determining the average total cost of production in relation to the CEM scheme and in the context of the facts and circumstances relating to the CEM scheme.

4.18 Australia considered that the very purpose of the CDC methodology suggests that it would represent a reasonable methodology for determining the average total cost of production. Further, the fact that the methodology also includes imputed returns to dairy farm resources including unpaid labour, management and owner's equity and that this is noted in the CDC Handbook as one of the key cost of production factor, cannot then be rejected by Canada as not constituting actual outlays expended on the production of milk.

4.19 With reference to Canada's argument that the Appellate Body considered that investment and outlays were to be considered in determining the cost of production, Australia submitted that a full accounting of the costs of production at any time would include annual rental value of land,

¹⁹⁸ Appellate Body Report, *Canada – Dairy (Article 21.5- New Zealand and US)*, para. 94.

¹⁹⁹ *Ibid.*, para. 76.

²⁰⁰ *Ibid.*, para. 84.

depreciation of capital (including replacement costs of animals), the annualised values of assets such as quota production rights, the value of owner operator and other family labour as well as paid labour and current production inputs such as feed, seed, chemicals and fertilisers used in feed production and veterinary and other animal husbandry costs.

4.20 Australia concluded that the CEM scheme provides Canadian processors/exporters with milk at a price which is less than the average total cost of production of that milk. Accordingly, there are "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. These "payments" are financed by virtue of governmental action. To the extent that Canada has exported dairy products in excess of its scheduled export subsidy quantity reduction commitments, it has therefore breached Articles 3.3 and 8 of the *Agreement on Agriculture*.

4.21 Referring to the comments in paragraph 4.2 above, **Canada** submitted that as it has demonstrated throughout the entire Article 21.5 process, there is no governmental process that provides CEM to processors. Rather, it is producers who independently elect whether or not to produce and sell their product to processors. If the producer considers that the price being offered is not adequate, the producer will not produce and sell such milk. Indeed, only a minority of Canadian dairy producers (less than 40 per cent as of December 2001) have participated in CEM transactions and many of these have done so for only a short time.²⁰¹

4.22 As concerns the lack of limit on the sales of commercial export milk and, therefore, export milk to processor/exporters, Canada explained that as it has deregulated sales of CEM, no limit on the export of dairy products, other than the limit the market itself sets through the process of supply and demand, is either necessary or appropriate. Deregulation removes the need, and indeed the ability, of governments to impose limitations on volume or price.

4.23 Like other participants in this dispute, Australia recognizes that there is no agreed international standard or definition that is applied either across the board or on a sector-specific basis of what reflects the cost of production (see paragraph 4.16 above). The reason for this is that the standard will vary based upon the purpose of the exercise. The method used in these proceedings must accord with the finding of the Appellate Body in the context of Article 9.1(c) of the *Agreement on Agriculture*.

4.24 The purpose of the CDC methodology for the cost calculation is to establish target returns for milk sold in the domestic market.²⁰² In advocating the adoption of the CDC methodology Australia is, therefore, suggesting the adoption of a benchmark which has already been rejected by the Appellate Body (i.e., the domestic administered price). While Australia is correct that the CDC methodology is used as part of the basis for managing the domestic milk market, this very fact demonstrates how inappropriate it is to use this methodology for the purposes of these proceedings. The Appellate Body considered that the appropriate standard for these types of payments should be determined by the motivation of the independent economic operator involved²⁰³ and not government regulation.

4.25 With respect to the arguments in paragraph 4.17 above, Canada replied that as is clear from Canada's first Submission, among the adjustments made by Canada to reflect the findings of the Appellate Body is to base its calculations on 100 per cent of the sample by adding back the 30 per cent excluded. Further, Canada does not agree with Australia that inclusion of imputed returns or annualised value of dairy quota is consistent with the standard set out by the Appellate Body for the determination of whether or not a payment exists. Estimating values which do not represent monetary costs incurred by producers cannot be reconciled with the Appellate Body's requirement for an objective cost of

²⁰¹ Frequency of Producers Participating in CEM. (Exhibit CDA-15)

²⁰² See para. 3.23 above.

²⁰³ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, para. 92.

production methodology focused on actual outlays. In addition, while Australia appears to support the use of generally accepted accounting principles (GAAP), it also attempts to claim that the cost of production of Canadian producers should include the imputed value of owner-operator and other family labour, land, and quota rights, which clearly is not an approach consistent with GAAP.

C. EUROPEAN COMMUNITIES

1. Article 9.1 of the *Agreement on Agriculture*

(i) "payments"

4.26 Referring to the Appellate Body's understanding with respect to "payments-in-kind", the **European Communities** (EC) submitted that it continues to believe that the term "payments" in Article 9.1(c) of the *Agreement on Agriculture* is confined to transfers of money and referred to all its arguments made before the Appellate Body on that issue.²⁰⁴ Only because the Appellate Body did not reverse the panel's finding that this term also covers "payments-in-kind", was it then faced with the problem of determining the correct benchmark price. Recalling the new average cost of production standard developed by the Appellate Body as the "appropriate standard for these proceedings"²⁰⁵ and the statement, that the "existence of payments is determined by reference to [...] motivations of the independent economic operator who is making the alleged payments"²⁰⁶, the "below average cost of production standard" focusing on producer motivations has at least three fundamental flaws.

4.27 First, there is no legal foundation for such a standard in the *Agreement on Agriculture*. None of its provisions allow the conclusion that the costs of production of a private party can be the benchmark for the existence of an export subsidy. As the United States have pointed out, "cost of production is such a specific, detailed standard, that normally the negotiators of an agreement would have spent a long and difficult negotiation in reaching agreement on that particular standard, and they certainly would be expected to have agreed to reflect it in the text itself".²⁰⁷ Second, a cost of production test determining the existence of a payment by reference to *producer* motivations contradicts the notion of "payment" in Article 9.1(c) of the *Agreement on Agriculture*, which is *recipient-oriented*. The Appellate Body itself stated this clearly where it explained why the term payments could include payments-in-kind:

Instead of receiving a monetary payment equal to the revenue foregone, the recipient is paid in the form of goods or services. But, as far as the recipient is concerned, the economic value of the transfer is precisely the same.²⁰⁸

4.28 The underlying justification for a recipient-oriented approach to the element "payment", the EC continued, is that it equals the basic concept of "benefit" which is one of the two essential elements of the notion of subsidy.²⁰⁹ The decisive criterion for whether the recipient has received a benefit is the market place. In *Canada – Aircraft*, the Appellate Body held that the comparison should be made upon whether the value of what the recipient received is "on terms more favourable than those *available* to the recipient in the market".²¹⁰

²⁰⁴ European Communities' Third-Party Submission to the Appellate Body, para. 16.

²⁰⁵ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, paras. 96 and 98.

²⁰⁶ *Ibid.*, para. 92.

²⁰⁷ Statement by the United States in the meeting of the DSB on 18 December 2001, page 2.

²⁰⁸ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, para. 113.

²⁰⁹ *Ibid.*, paras. 87, 90 and 91.

²¹⁰ Appellate Body Report, *Canada Aircraft*, DSR 1999:III, 1377, para. 157 (emphasis added).

4.29 The EC considers that, if anything, the appropriate standard for determining whether payments have occurred under Article 9.1(c) of the *Agreement on Agriculture* would be what is otherwise available on the market, in particular the world market. The market place criterion can at least be derived from the other examples for export subsidies in Article 9.1 of the *Agreement on Agriculture* as well as Article 14 of the *SCM Agreement* and item d) of the Illustrative List of export subsidies in Annex I of the *SCM Agreement*. By contrast, items (j) and (k) of the Illustrative List, to which the Appellate Body referred, concern governmental export credits or related guarantee or insurance programmes but have not been established to measure whether an indirect subsidy through the provision of goods by private entities exists.

4.30 Third, the EC is seriously concerned that a producer-oriented cost of production test makes the existence of an export subsidy dependent on actions of private entities and sales data to which governments do not have access. The EC would raise the question how WTO Members should be able to calculate and notify their export subsidies and count them against their reduction commitments? The EC considers that the Panel should carefully consider whether to apply the new below-average cost of production standard.

4.31 The EC strongly disagrees with the industry-average approach, because it not only violates the general principle whereby production costs have to be analysed on a producer-by-producer basis, but it also appears to include cost information of farmers who do not produce for the export market. The Appellate Body itself has highlighted that only "about 30 per cent of Canadian producers had participated in CEM transactions".²¹¹

4.32 If the Panel wanted to determine whether Canadian producers sold milk at below-cost, it would need to analyse the production costs of those who actually sold CEM. Only that approach could be squared with the wording of Article 9.1(c) of the *Agreement on Agriculture* whereby there must be a "payment on the export", i.e., only payments are relevant which actually occur by exporting. Moreover, the EC does not consider it possible to deduce the existence of "payments" simply from the fact that there is a differential between average total costs of production of CDN \$57 as determined by the Canadian Dairy Commission for all dairy farmers and a CEM price of CDN \$29.²¹² The alleged average cost of production of CDN \$57 even exceeds the administered *domestic* market price, which, as the EC understands it, averages CDN \$52,92 per hectolitre.²¹³

4.33 The Appellate Body already found that the clear differential between the prices of CEM and the *domestic market price* suggests "the possibility that the prices of CEM might be below the average total cost of production and, thus, might involve "payments under Article 9.1(c)"²¹⁴, but evidently did not consider such differential enough to complete the legal analysis.²¹⁵ The underlying reason for this is that the Appellate Body had already found that the Canadian target price as "administered prices in general, [...] expresses a government policy choice based, not only on economic considerations, but also on other social objectives" and that "there can be little doubt [...] that the administered price is a price that is favourable to the domestic producers."²¹⁶ The Appellate Body had clarified that the sale of CEM by the producer at less than the administered price does not necessarily imply that the producer has foregone a portion of the proper value of the milk to it.²¹⁷

²¹¹ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, footnote 96.

²¹² See for instance paras. 3.53 and 3.75 above.

²¹³ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, para. 101.

²¹⁴ *Ibid.*

²¹⁵ *Ibid.*, paras. 101-103.

²¹⁶ *Ibid.*, para. 81.

²¹⁷ *Ibid.*

4.34 Thus, the very differential between the average price for CEM and the average cost of production determination by the Canadian Dairy Commission is obviously not capable of substantiating the existence of payments under Article 9.1(c) of the *Agreement on Agriculture*. The EC expects to be able to comment further on the methodology to be applied by the Panel to measure the existence of payments after receipt of the rebuttal submissions and reserves its position on this issue.

(ii) "*by virtue of governmental action*"

4.35 The EC recalled that the existence of payments alone is not sufficient to establish an export subsidy under Article 9.1(c) of the *Agreement on Agriculture*. Such "payments" must be "financed by virtue of governmental action". The EC noted that the Appellate Body has essentially replaced the "but for" test applied by the panel by a more elaborate "demonstrable link" approach that reflects the wording of Article 9.1(c) of the *Agreement on Agriculture*.

4.36 Referring to the Appellate Body's considerations, with respect to "demonstrable link" and "financed by virtue of government action" in paragraphs 113 and 115-117 of its report, the EC agreed, for all the reasons it has set out in the appellate proceedings, that the nature and extent of governmental involvement in cases of indirect subsidies must amount to a legal requirement to provide a certain amount of goods at a certain price.²¹⁸ Only this standard gives meaning to the terms "financed" and "imposed" as used in Article 9.1(c) of the *Agreement on Agriculture* and read contextually with the terms to describe a financial contribution under Article 1.1(a)(1)(iv) of the *SCM Agreement* ("directs") and item (d) of the Illustrative List of export subsidies in Annex I of the *SCM Agreement* ("government-mandated").

4.37 The EC considered that the Appellate Body has given full guidance to the Panel on how it would apply that standard to the facts at hand when emphasising: "we disagree with the Panel's characterization of the measure as "obliging producers, at least *de facto*, to sell outside-quota milk for export".²¹⁹ Although the Appellate Body agrees that the Canadian governmental action establishes a regulatory regime whereby some milk producers can make additional profits only if they choose to sell milk, the Appellate Body distinguished this from what could be the decisive governmental action: the imposition of an obligation to *produce* additional milk for sale. Thus, the EC continued, the Appellate Body considers that only where there is an obligation to actually produce additional resources at below-costs there would be a sufficient nexus between governmental action and the provision of milk at below-cost prices and suggested that this nexus is missing in the Canadian system. In short, the EC takes the view that in applying the "demonstrable link" test as elaborated by the Appellate Body, the Panel can only reach the conclusion that even if payments have been made, these cannot have been financed by virtue of governmental action.

4.38 With respect to the payment "on the export", the EC noted that the Appellate Body did not address this element, because it was not appealed, but implicitly declared the panel's approach moot by reversing the findings of the panel on all elements of Article 9.1(c) of the *Agreement on Agriculture*.²²⁰ The EC is concerned that the panel in its original report lightly equated this element with the term "contingent on the export". If this Panel addresses this third element of Article 9.1(c) of the *Agreement on Agriculture* in the course of this proceeding, because it finds that the two other conditions are met, it should carefully consider the meaning of the preposition "on" which contains a temporal element and suggests a closer nexus between the payment and actual exportation than export contingency.

²¹⁸ European Communities' Third-Party Submission to the Appellate Body, paras. 21-25.

²¹⁹ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*, para. 117.

²²⁰ *Ibid.*, para. 126 reversing all findings in para. 6.79 of the panel report.

4.39 In sum, the EC considered that the Panel is faced with the difficult task of carrying out a remand analysis of whether the Canadian compliance measure is a producer-financed export subsidy within the meaning of Article 9.1(c) of the *Agreement on Agriculture* on the basis of a new below cost of production standard that is not rooted in the *Agreement on Agriculture* and where no methodological guidance exists. The EC is seriously concerned about this new standard because it determines the existence of "payments" by reference to producer motivations and not to what is commercially available to the *recipient* on the market, in particular the *world market*.

4.40 **Canada** submitted that it concurred with the observation of the EC that a gap between the CDC calculated target price and CEM prices cannot be assumed to constitute a payment, since "the Canadian target price as 'administered prices in general, [...] expresses a government policy choice based, not only on economic considerations, but also on other social objectives'" (see paragraph 4.33 above). As the EC observed, "[T]he Appellate Body had clarified that the sale of CEM by the producer at less than the administered price does not necessarily imply that the producer has foregone a portion of the proper value of the milk to it".²²¹

4.41 Canada also concurred with the observations made by the EC with respect to the nature of the demonstrable link that is required in this case. Government action that merely enables producers to do something does not meet the test. Given the particular language of Article 9.1(c) of the *Agreement on Agriculture* as well as the difficulty of which the Appellate Body spoke where the alleged "payment" is a payment-in-kind²²², there must be a much clearer and tighter linkage between governmental action and the decisions of private producers to enter into export contracts to satisfy the "financed by virtue of" element of that Article. The nexus of which the Appellate Body speaks between any payment made by independent economic operators and the nature of the governmental action on the part of Canadian governments does not exist in this case. In addition, without a tight nexus governments could not be expected to report and notify "payments" over which they had no control. Thus, as the EC correctly observes, even if payments have been made, which Canada denies, these cannot have been financed by virtue of governmental action.

²²¹ Appellate Body Report, *Canada - Dairy (Article 21.5- New Zealand and US)*

²²² *Ibid.*, para. 115.

V. FINDINGS

A. CLAIMS OF THE PARTIES

1. The Complainants' claims

5.1 New Zealand and the United States claim that Canada's commercial export milk ("CEM") system provides export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

5.2 New Zealand and the United States claim, in the alternative, that Canada's CEM system provides export subsidies or involves non-commercial transactions that are inconsistent with Article 10.1 of the *Agreement on Agriculture*.

5.3 New Zealand and the United States claim that Canada continues to export subsidized dairy products that exceed or threaten to exceed its export subsidy reduction commitment levels in violation of Articles 3.3 and 8 of the *Agreement on Agriculture*.

5.4 The United States claims that Canada's CEM system provides prohibited export subsidies within the meaning of Article 3.1(a) of the SCM Agreement.

5.5 New Zealand and the United States claim that Canada bears the burden of proof, pursuant to Article 10.3 of the *Agreement on Agriculture*, to establish that no export subsidy has been granted in respect of those quantities of dairy products exported in excess of its export subsidy reduction commitment levels.

2. Respondent's claims

5.6 Canada claims that it does not provide export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture* in respect of CEM.

5.7 Canada claims that it does not provide export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*.

5.8 Canada claims that it does not provide export subsidies in excess of its export reduction commitment levels contrary to Articles 3.3 and 8 of the *Agreement on Agriculture*.

5.9 Canada claims that it does not provide prohibited export subsidies in respect of CEM within the meaning of Article 3.1(a) of the *SCM Agreement*.

B. CONTEXT OF THIS CASE

5.10 The claims of the Parties in this case concern Canada's measures taken to comply with the recommendations and rulings of the DSB to the effect that Canada had acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*, through its scheme of Special Milk Classes 5(d) and 5(e), by providing "export subsidies" within the meaning of Article 9.1(c) of that Agreement, in excess of the quantity commitment levels specified in Part IV, Section II of Canada's WTO Schedule.

5.11 The Panel recalls that under its previous system, Canada set a support price for domestic milk tied to a production quota and established Special Milk Class 5(e) for the removal of surplus milk and

Special Milk Class 5(d) for milk and dairy products produced under quota for the export market.²²³ Prices for Classes 5(d) and (e) were negotiated and established on a case-by-case basis between the Canadian Dairy Commission ("CDC") and the processors/exporters.²²⁴ The original panel in *Canada – Dairy* found that milk under Classes 5(d) and (e) was made available to processors for export at a significantly lower price than the price of milk *for domestic use*.²²⁵ In those proceedings, the United States submitted factual evidence showing that the price for cheese was CDN \$27.28 in Special Milk Class 5(d) and CDN \$26.87 in Special Milk Class 5(e) between January to June 1997.²²⁶ All Parties also agreed that Canada's exports of butter, cheese and "other milk products" exceeded Canada's reduction commitment levels for both marketing years at issue (1995-1996 and 1996-1997).²²⁷

5.12 This Panel recalls that the measures taken by Canada to implement the DSB rulings and recommendations, at issue again in this second recourse to Article 21.5 of the *DSU*, left in place the domestic price support mechanism tied to a production quota but eliminated Special Milk Class 5(e) and restricted exports of dairy products under Special Milk Class 5(d) to Canada's export subsidy commitment levels.²²⁸ Canada also created a new class of domestic milk, Class 4(m), under which any non-quota milk can be sold only as animal feed at a regulated price.²²⁹ In addition, Canada introduced a new category of milk for export processing known as "commercial export milk" ("CEM"), the price and volume of which are negotiated directly between the processor and the producer.²³⁰ Under pre-commitment contracts, producers decide in advance of production how much milk to sell as CEM that is delivered "first-out-of-the-tank" to processors.²³¹ Milk that is contracted as CEM is exempt from paying the domestic in-quota price and the diversion of CEM and dairy products made from CEM into the domestic market is subject to financial and other penalties.²³²

C. BURDEN OF PROOF

5.13 As noted in the previous section, New Zealand and the United States claim that Canada bears the burden of proof, pursuant to Article 10.3 of the *Agreement on Agriculture*, to demonstrate that no export subsidy has been granted in respect of those quantities of dairy products exported in excess of Canada's export subsidy reduction commitment levels.²³³ Canada does not dispute the application of Article 10.3 in this case.²³⁴

²²³ Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)* WT/DS103/RW and WT/DS113/RW, para. 3.1.

²²⁴ *Ibid.*

²²⁵ Panel Report, *Canada – Dairy* WT/DS103/R and WT/DS113/R, DSR 1999:VI, 2097, para. 7.50.

²²⁶ *Ibid.*, para. 2.51, reproducing US Exhibit 22

²²⁷ *Ibid.*, para. 7.34.

²²⁸ Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)* WT/DS103/AB/RW and WT/DS103/AB/RW, paras. 4 and 79.

²²⁹ *Ibid.*, para. 4.

²³⁰ *Ibid.*, paras. 4 and 79.

²³¹ *Ibid.*, para. 4.

²³² Panel Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 6.77 and Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 4.

²³³ Para. 3.4 above.

²³⁴ Para. 3.5 above.

5.14 Article 10.3 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."

5.15 The Panel considers, therefore, that with respect to claims made under the *Agreement on Agriculture*, if the Complainants demonstrate that Canada has exceeded its export subsidy reduction commitment levels on certain dairy products, and Canada claims it is not providing export subsidies in relation to those exports, it is then for Canada to establish, pursuant to Article 10.3 of the *Agreement on Agriculture*, that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports exceeding Canada's export subsidy reduction commitment levels.

5.16 On the question of whether Canada has exceeded its reduction commitment levels, New Zealand and the United States have put forward evidence demonstrating that Canadian exports of cheese and "other milk products" in marketing year (August-July) 2000-2001 exceeded those quantities for which Canada has committed to limit its export subsidies. The Complainants also demonstrate that Canada is likely to exceed these quantities in marketing year 2001-2002.²³⁵ The Panel further notes that Canada does not dispute that its exports exceeded the quantity in respect of which it could grant export subsidies for cheese and "other milk products" in 2000-2001 and that they are likely to do the same in 2001-2002.

5.17 Accordingly, the Panel *finds* that the Complainants have established that Canadian exports of cheese and "other milk products" in 2000-2001 have exceeded those quantities in respect of which Canada has committed to limit export subsidies and that they are likely to exceed those quantities again in 2001-2002.

5.18 Having found that Canadian exports of cheese and "other milk products" exceed Canada's reduction commitment levels, and recalling the considerations on the burden of proof as set out in paragraph 5.15 above, the Panel is of the view that an operational interpretation of Article 10.3 requires that the Complainants make a *prima facie* showing that the elements of the claimed export subsidies are present.

5.19 Once the Panel has examined the Complainants claims and arguments, and provided that the Complainants make out a *prima facie* case that certain elements of the Canadian regulation of its dairy industry constitute export subsidies under either Article 9.1(c) or Article 10.1, it will then be for Canada, pursuant to Article 10.3 of the *Agreement on Agriculture*, since it claims that its exports in excess of its commitment levels are not subsidized, to establish that Canadian exports of cheese and "other milk products" do not benefit from these particular types of export subsidies.

²³⁵ New Zealand's Exhibits NZ-1 and NZ-2; United States' Exhibits US-1. Specifically, the evidence put forward by New Zealand shows exports in excess of commitment levels of 9,692 tonnes for cheese and 16,823 tonnes for "other milk products" for 2000-2001 and an estimated excess for cheese of 8,778 tonnes and 32,600 tonnes for "other milk products" for the year 2001-2002. The evidence put forward by the United States shows an excess of exports of 8,748 tonnes for cheese and of 33,488 tonnes for "other milk products" for 2000-2001 and estimated excess of 9,608 tonnes for cheese in 2001-2002. The Panel notes that the Complainants' figures are provided by marketing year.

D. WHETHER EXPORT SUBSIDIES EXIST WITHIN THE MEANING OF ARTICLE 9.1(C) OF THE AGREEMENT ON AGRICULTURE

1. Introduction

5.20 The Complainants claim that Canada's CEM system provides export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

5.21 The relevant text of Article 9.1(c) reads as follows:

"The following export subsidies are subject to reduction commitments under this Agreement: ... (c) payments on the export of an agricultural product that are financed by virtue of governmental action ...".

5.22 The Panel notes that the Complainants have focused their arguments under Article 9.1(c) on: (1) whether there are "payments"; and (2) if so, whether such payments are "financed by virtue of governmental action".

5.23 As for the third element under Article 9.1(c), i.e., whether payments are made "on the export" of an agricultural product, the Panel recalls the finding by the panel in the first Article 21.5 *Canada – Dairy* case that since Canadian federal regulations define CEM as milk that must be exported, any payment in relation to CEM is a payment "on the export".²³⁶ We further recall that Canada neither disputed nor appealed this earlier finding.²³⁷ We shall therefore not examine this issue further in this proceeding.

5.24 Accordingly, the Panel shall restrict its analysis of whether the Complainants make out a *prima facie* case of the existence of an export subsidy, within the meaning of Article 9.1(c), to the two elements actually contested, i.e., whether there are "payments" and, if so, whether such payments are "financed by virtue of governmental action".

5.25 Provided we find that the Complainants make a *prima facie* case with respect to the existence of "payments", it will then be for Canada to attempt to discharge its burden of establishing that no "payments" are being made. Similarly, provided we find that the Complainants make a *prima facie* case that any such payments are "financed by virtue of governmental action", it will then be for Canada to attempt to discharge its burden of establishing that it is not by virtue of governmental action that any such payments are financed.

2. Whether there are "payments"

5.26 The Panel recalls that, as found by the panel and confirmed by the Appellate Body in the original *Canada – Dairy* case, a payment includes a "payment-in-kind".²³⁸ This was reaffirmed by the panel and the Appellate Body in the first *Canada – Dairy* case under Article 21.5 of the *DSU*²³⁹ and has not been re-argued by the Parties in this second examination under Article 21.5.

5.27 At issue before the panel and the Appellate Body in the first Article 21.5 case was the appropriate benchmark to measure whether or not "payments" were being made under Canada's

²³⁶ Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.78.

²³⁷ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 62-63.

²³⁸ Panel Report, *Canada – Dairy*, DSR 1999:VI, 2097, para. 7.101; Appellate Body Report, *Canada – Dairy*, DSR 1999:V, 2057, para. 112.

²³⁹ Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.12; Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 71 and 76.

implementation measures.²⁴⁰ The Appellate Body rejected the Article 21.5 panel's reliance on the regulated domestic price and on world market prices, finding that neither represents an appropriate benchmark for determining whether sales of CEM by producers involve payments.²⁴¹ The Appellate Body stated that the existence of a payment requires a comparison between the prices of CEM and "some objective standard reflect[ing] the proper value" of milk to the producer²⁴², in this case, "the average total cost of production".²⁴³

5.28 The Panel recalls the Appellate Body's reasoning equating "payments" with the transfer of economic resources²⁴⁴ and, on this basis, focusing on whether CEM prices are sufficient to recover average fixed and variable costs of production, and thus on whether producers are able to avoid making losses in the long run.²⁴⁵

5.29 The Panel notes that the Complainants and Canada disagree on how this newly enunciated benchmark of average total cost of production should be interpreted and applied. The Panel, in recalling its analysis in paragraphs 5.18-5.19 and 5.25 above, will first examine whether the Complainants make a *prima facie* showing of the existence of "payments". Provided the Complainants make such a showing, it will then be for Canada, pursuant to Article 10.3 to establish that no "payments" within the meaning of Article 9.1(c) are being made.

(a) Whether the Complainants make a *prima facie* case of the existence of "payments"

5.30 The Complainants ask the Panel to apply the "average total cost of production" benchmark, as enunciated by the Appellate Body, to the determination of whether there are payments in this case.²⁴⁶ Specifically, the Complainants request us to consider that the Appellate Body's cost of production benchmark should be construed as referring to an industry-wide average.²⁴⁷

5.31 For the purposes of applying the Appellate Body's benchmark, the Complainants ask the Panel to rely on survey data collected annually in accordance with the CDC Handbook of COP Principles and Practices ("CDC Guidelines") and used to set the domestic in-quota price ensuring a fair return to efficient dairy producers in the domestic market.²⁴⁸ Complainants contend that the CDC survey data represents a reasonable, albeit conservative, reflection of the cost of production of the Canadian dairy industry.²⁴⁹ They further contend that while the survey data excludes cost of production data for the 30 per cent least efficient producers and for producers with less than 60 per cent of the average annual output in each province²⁵⁰, as well as the cost of domestic quota²⁵¹, the CDC data and Guidelines otherwise account for all the relevant cost elements, i.e., all the fixed and variable costs, of producing a unit of milk.²⁵²

5.32 On the question of which cost elements to include, the Complainants argue that because the Appellate Body referred to *all* fixed and variable costs, imputed costs should be included in such

²⁴⁰ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 74-75, 96, 104.

²⁴¹ *Ibid.*, paras. 82, 85 and 104.

²⁴² *Ibid.*, para. 74.

²⁴³ *Ibid.*, para. 96.

²⁴⁴ *Ibid.*, para. 76.

²⁴⁵ *Ibid.*, para. 87.

²⁴⁶ Paras. 3.11 and 3.55 above.

²⁴⁷ Paras. 3.60-3.61 above.

²⁴⁸ Para. 3.16 above.

²⁴⁹ *Ibid.*

²⁵⁰ Para. 3.18 above.

²⁵¹ Para. 3.42 above.

²⁵² Para. 3.16 above.

calculation.²⁵³ An accurate calculation of the cost of production, they contend, cannot be limited only to cash outlays because the Appellate Body spoke in terms of the investment of economic resources required in the production of goods and the amount a producer must recoup in order to avoid making losses.²⁵⁴ Thus, the Complainants assert a farmer would have to recoup the costs of family labour, return to management and equity, quota and costs for the marketing of milk in order to stay in business.²⁵⁵ It would be inconsistent, they submit, to consider that a farmer using family labour and management makes a profit to the extent that this labour is not remunerated.²⁵⁶ Further, the Complainants point out that equity financing represents just an alternative to debt financing that gives rise to costs.²⁵⁷ On the question of including quota, the Complainants argue that quota is an investment related to the production of milk and thus a cost, regardless of whether or not generally accepted accounting principles ("GAAP") require its amortization.²⁵⁸ As to marketing, transport and administrative costs, the Complainants maintain their exclusion would amount to drawing an artificial distinction between costs of production and costs associated with sale because there would not be any point in a farmer producing milk if that farmer could not afford to sell the milk.²⁵⁹

5.33 The CDC data, the Complainants point out, show an industry-wide average cost of production of CDN \$58.12 per hectolitre in 2001 and of CDN \$57.27 per hectolitre in 2000.²⁶⁰ In contrast, they assert, the average price for CEM was CDN \$29 in 2000 and continued to be close to that level in 2001.²⁶¹ Comparing these figures, they ask the Panel to conclude that sales of CEM are made well below the average total cost of production and that, hence, "payments" within the meaning of Article 9.1(c) are being made.²⁶²

5.34 Recalling the considerations set out in paragraphs 5.18-5.19 above, we *find* that the Complainants' case, as described in paragraphs 5.30-5.33 above, constitutes a *prima facie* showing that "payments" within the meaning of Article 9.1(c) are being made, such that Canada can reasonably attempt to discharge its burden under Article 10.3 of the *Agreement on Agriculture* of establishing why CEM sales do not involve "payments"

(b) Examination of Canada's case on the issue of "payments"

(i) *Canada's position on its implementation of the DSB's recommendations*

5.35 Canada claims that it has fully implemented the rulings and recommendations of the DSB following adoption of the panel and Appellate Body reports in the original case on *Canada – Dairy*.²⁶³ In this connection, Canada states that export transactions outside of Special Class 5(d) occur without government interference of any kind, and as such, do not benefit from export subsidies.²⁶⁴

²⁵³ Para. 3.29 above.

²⁵⁴ Paras. 3.11, 3.29 and 3.77 above citing Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 87.

²⁵⁵ Para. 3.32 above.

²⁵⁶ Paras. 3.32 and 3.34 above.

²⁵⁷ Paras. 3.26 and 3.34 above.

²⁵⁸ Paras. 3.42 – 3.43 and 3.46 above.

²⁵⁹ Para. 3.52 above.

²⁶⁰ Para. 3.53 above, based on Canadian Dairy Commission: Estimated Cost of Producing Milk.

²⁶¹ Para. 3.53 above.

²⁶² Paras. 3.54–3.55 and 3.75 above.

²⁶³ Para. 3.108 above.

²⁶⁴ *Ibid.*

(ii) *Canada's rejection of an industry-wide application of the benchmark*

5.36 The Panel notes that Canada disagrees with the Complainants' contention that the Appellate Body intended an industry-wide calculation of the average total cost of production as the relevant benchmark for determining the existence of payments, within the meaning of Article 9.1(c).²⁶⁵ In so arguing, Canada refers to the Appellate Body's statement that a payment is determined "by reference to a standard that focuses upon the motivations of the independent economic operator who is making the alleged 'payments' – here the producer – and not upon any government intervention in the marketplace."²⁶⁶ Canada asserts that the Appellate Body therefore intended that an appropriate calculation of the average total cost of production should be based on the average costs of individual producers and *not* the entire dairy industry.²⁶⁷ Additionally, Canada refers to the statement by the Appellate Body to the effect that "[t]he average total cost of production [should be determined] ... by dividing the fixed and variable costs of producing *all* milk, whether destined for domestic or export markets, by the total number of units of milk produced for both these markets."²⁶⁸ Rather than speaking here in terms of an industry-wide calculation of the average total production cost, Canada contends that the Appellate Body was merely indicating that both domestic and export production of the individual producer should be taken into account when calculating that average.²⁶⁹

5.37 Canada also draws the Panel's attention to the repeated usage of the singular form of terminology by the Appellate Body in connection with its description of the benchmark.²⁷⁰ These references, Canada maintains, are indicative of the Appellate Body's focus on the cost of production of the *individual* producer.²⁷¹ Moreover, Canada suggests the reference to "milk producers" cannot automatically be interpreted as meaning the "industry".²⁷²

5.38 Canada further argues against using an industry-wide average cost of production benchmark because the application of "a single industry-wide average would prevent efficient producers from being able to participate in legitimate commercial transactions without being deemed to confer a 'payment' merely because of the cost of production of higher cost producers."²⁷³ Canada argues that the application of an industry-wide average is particularly inappropriate because of the large variation of costs of production within the Canadian dairy industry.²⁷⁴

5.39 Moreover, Canada asserts that it would be very difficult for any government under an industry-wide application of the benchmark to monitor and notify its export subsidies, as costs of production within an industry may change from year to year.²⁷⁵

(iii) *Applicable benchmark in this case*

5.40 In view of the fact that the DSB has adopted the Appellate Body Report setting forth the "average total cost of production" as the relevant benchmark to determine the existence of "payments" under Article 9.1(c), and given that all Parties in this Second Recourse to Article 21.5 of the DSU are in

²⁶⁵ Paras. 3.59, 3.62-3.63 above.

²⁶⁶ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 92.

²⁶⁷ Para. 3.62 above.

²⁶⁸ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 96.

²⁶⁹ Para. 3.62 above.

²⁷⁰ Para. 3.63 above referring to statements by the Appellate Body Report in *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 81, 86, 87, 92, 94 and 96.

²⁷¹ Para. 3.63 above.

²⁷² Para. 3.62 above.

²⁷³ Canada's Response to Question No. 63.

²⁷⁴ Para. 3.59 above.

²⁷⁵ Canada's Comments on the Responses of New Zealand and the United States, para. 52.

agreement that this is the benchmark the Panel should apply²⁷⁶, none of them having endorsed the criticisms set forth in the European Communities' Third-Party Submission²⁷⁷, the Panel shall accordingly apply this newly enunciated benchmark in this case.

(iv) *Appellate Body's guidance on the nature of its newly enunciated benchmark*

5.41 In order to assess Canada's proposed interpretation of the Appellate Body's benchmark, the Panel considers it useful to first review the guidance provided by the Appellate Body on this issue.

5.42 The Panel notes in this connection the Appellate Body's statement that "it is significant that Article 9.1(c) of the *Agreement on Agriculture* does not expressly identify a standard or benchmark for determining whether a measure involves 'payments'."²⁷⁸ As general guidance, the Appellate Body said "that there are 'payments' under Article 9.1(c) when the price charged by the producer of the milk is less than the milk's *proper value* to the producer."²⁷⁹ But it went on to explain that "it is necessary to scrutinize carefully the facts and circumstances of a disputed measure, including the regulatory framework surrounding that measure, to determine the appropriate basis for comparison in assessing whether the measure involves 'payments' under Article 9.1(c)."²⁸⁰ Hence, the Panel understands that the standard proposed by the Appellate Body may need to change according to the particular factual and regulatory context.

5.43 In fashioning what it considered to be the appropriate benchmark, the Appellate Body emphasized that "the standard must be objective and based on the value of the milk to the producer."²⁸¹ It then posited that:

"for any economic operator, the production of goods ... involves an investment of economic resources, ... an investment in fixed assets ... and an outlay to meet variable costs These fixed and variable costs are the total amount which the producer must spend in order to produce the milk and the total amount it must recoup, in the long-term, to avoid making losses. To the extent that the producer charges prices that do not recoup the total cost of production, over time, it sustains a loss which must be financed from some other source, possibly 'by virtue of governmental action'."²⁸²

5.44 In recognizing that Members' domestic subsidies may in some instances provide spillover benefits to exports, the Appellate Body considered that such a situation should not automatically be characterized as an export subsidy, but that domestic support should not be used without limit.²⁸³ The Appellate Body thus opined that an appropriate benchmark should respect the separation between the disciplines on domestic and export subsidies.²⁸⁴ It accordingly declared that the average total cost of

²⁷⁶ Paras. 3.9 and 3.12 above.

²⁷⁷ We recall that only the European Communities, as a Third Party, argues against the use of the Appellate Body's "average total cost of production" benchmark, noting that this benchmark has no legal foundation in the *Agreement on Agriculture*, that it inappropriately focuses on the provider, rather than the recipient, of a payment and that it is impractical to apply. The European Communities also observes that other WTO Members, including the United States, critiqued this benchmark in the DSB meeting at which the Appellate Body Report was adopted. (paras. 4.27 – 4.33)

²⁷⁸ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 76.

²⁷⁹ *Ibid.*, para. 73.

²⁸⁰ *Ibid.*, para. 76.

²⁸¹ *Ibid.*, para. 86.

²⁸² *Ibid.*, para. 87.

²⁸³ *Ibid.*, paras. 89-91.

²⁸⁴ *Ibid.*, paras. 91-92.

production is the appropriate benchmark for determining, in the circumstances of this case, whether there are "payments" within the meaning of Article 9.1(c).²⁸⁵

5.45 The Appellate Body also indicated that it favoured reliance on the average of *all fixed and variable costs* incurred in the production of a unit of milk, rather than on the *marginal (variable) costs* incurred in producing an additional unit of milk, noting that:

"[a]lthough a producer may very well decide to sell goods ... if the sales price covers its marginal costs, the producer will make losses on such sales unless all of the remaining costs associated with making these sales, essentially the fixed costs, are financed through some other source, such as through highly profitable sales of the product in another market. ... In the ordinary course of business, an economic operator chooses to invest, produce and sell, not only to recover the total cost of production, but also in the hope of making profits."²⁸⁶

5.46 With the above as background, the Appellate Body concluded that:

"in the circumstances of these proceedings, ... we believe that the average total cost of production represents the appropriate standard for determining whether sales of CEM involve 'payments' under Article 9.1(c) of the *Agreement on Agriculture*. The average total cost of production would be determined by dividing the fixed and variable costs of producing *all* milk, whether destined for domestic or export markets, by the total number of units of milk produced for both these markets."²⁸⁷

(v) *Panel's analysis of the nature of the benchmark*

5.47 The Panel notes that the Appellate Body did not specifically address whether this new benchmark – the average total cost of production of all milk – should be assessed as an industry-wide average or on some other basis more accurately reflecting the actual costs of individual producers and their participation in the CEM market. On the one hand, the Appellate Body's enunciation of the standard seems to be consistent with an industry-wide approach, where it speaks in terms of determining "[t]he average total cost of production ... by dividing the fixed and variable costs of producing *all* milk, whether destined for domestic or export markets, by the total number of units of milk produced for both [domestic and export] markets."²⁸⁸ In a similar vein, the Appellate Body, in recalling the Article 21.5 panel's observation that there is a clear differential between the prices of CEM and the domestic market price, stated that "[t]his suggests the possibility that the prices of CEM might be below the average total cost of production and, thus, might involve 'payments' under Article 9.1(c)."²⁸⁹ On the other hand, the Appellate Body also made references to "[e]ach producer decid[ing] for itself whether, and when, to produce and sell milk as CEM"²⁹⁰ and to the need to focus on the choices and "motivations of the independent economic operator".²⁹¹

5.48 We note some additional textual support in the Appellate Body's analysis for the use of the industry-wide approach. Specifically, the Appellate Body considered that the cost of producing *all* milk should be divided by the *total number of units* of milk.²⁹² Had the Appellate Body wanted us to

²⁸⁵ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 88 and 92.

²⁸⁶ *Ibid.*, paras. 94-95.

²⁸⁷ *Ibid.*, para. 96.

²⁸⁸ *Ibid.*, para. 96.

²⁸⁹ *Ibid.*, para. 101.

²⁹⁰ *Ibid.*, para. 79.

²⁹¹ *Ibid.*, paras. 92 and 96.

²⁹² *Ibid.*, para. 96.

divide the cost of production of the individual producer by the total number of units of milk produced by that producer, it surely would have so instructed. The Appellate Body confirmed that it "adopted as a standard, for these proceedings, the average total cost of production of the milk *producers*".²⁹³ (emphasis added) This would suggest that the Appellate Body was not focusing on individual producer costs, as Canada contends.

5.49 In response to the Complainants' arguments, Canada proposes an interpretation of the Appellate Body's use of the phrase "costs of producing *all* milk" as merely referring to *all* the units of milk, whether produced for the domestic or export market, of each individual producer.²⁹⁴ Given the context in which the Appellate Body referred to "*all* milk", i.e., in setting forth the very method of calculating the average total cost of production, and the absence of express textual directive to that effect, the Panel is not persuaded by Canada's suggestion that we should imply that the Appellate Body intended a calculation for each *individual* producer.

5.50 In our understanding, the Appellate Body reference to "a standard that focuses upon the motivations of the independent economic operator who is making the alleged 'payments' – here the producer – and not upon any government intervention in the marketplace"²⁹⁵, was made in the context of its concern that automatically characterizing any governmental intervention in the form of domestic price support that benefits exports as an export subsidy would collapse the distinction in the *Agreement on Agriculture* between domestic and export disciplines.²⁹⁶ Accordingly, we have some doubts as to Canada's conclusion that the Appellate Body's benchmark should be each individual producer's average cost of production rather than an industry-wide average cost of production.

5.51 At this stage, the Panel is not persuaded that Canada is correct in its proffered interpretation of the benchmark enunciated by the Appellate Body. Nonetheless, in recalling that it is Canada's burden to establish that no payments are being made, we shall examine whether Canada, in relying on the costs to individual producers to determine the average total cost of production, provides a convincing defence that no payments are being made.

(vi) *Canada's critique of the Complainants' reliance on the CDC data and its arguments in favour of individual producer data*

5.52 The Panel notes that Canada, following on from its criticisms of the application of an industry-wide benchmark, proceeds to reject reliance on the CDC Guidelines and survey data as a valid basis for determining the average total cost of production.²⁹⁷ While not contesting the validity of the data collected by the CDC, Canada argues that this data is collected for a different purpose and does not provide relevant information for this case.²⁹⁸ Notably, Canada contends that the CDC Guidelines and the data collected in accordance with these Guidelines serve the economic and social objective of giving a fair return to efficient dairy producers, and that this is different from data on the actual costs of production.²⁹⁹

5.53 Because the CDC Guidelines and the data collected serve economic and social objectives, Canada maintains they do not provide a standard for assessing "payments" that is objective, as required by the Appellate Body.³⁰⁰ Further, because the Appellate Body stated that the relevant standard should

²⁹³ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 104.

²⁹⁴ Para. 3.62 above.

²⁹⁵ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 92.

²⁹⁶ *Ibid.*, paras. 88-92.

²⁹⁷ Para. 3.19 above.

²⁹⁸ Paras. 3.57 and 3.19 above.

²⁹⁹ Para. 3.19 above.

³⁰⁰ Paras. 3.80 – 3.81 above.

focus on the motivations of the independent economic operator and not any government intervention in the marketplace, it is inappropriate, in Canada's view, to rely on the CDC Guidelines, which are reflective of Canadian governmental policy towards the dairy industry.³⁰¹ Moreover, Canada asserts that in proposing reliance on the CDC survey data, the Complainants seek to reintroduce the domestic administered price as the relevant benchmark.³⁰² Canada notes that this benchmark was explicitly rejected by the Appellate Body.³⁰³

5.54 Canada also argues that the CDC survey data is an inappropriate basis for determining the average total cost of production in that it excludes the 30 per cent least efficient farmers, as well as those farmers with less than 60 per cent of the average production/output in each province.³⁰⁴ Canada has indicated that those small farms account for approximately 18 per cent of all milk production in Canada.³⁰⁵

5.55 However, Canada does not reject the cost of production survey data in its entirety.³⁰⁶ Rather, it proposes certain adjustments to the CDC calculations.³⁰⁷ First, Canada proposes including, in principle, the 30 per cent less efficient farms.³⁰⁸ To the eligible pool of more than 19,000 dairy farms in the nine provinces with farms participating in the CEM market, Canada applies a "statistically valid sampling method" to obtain a representative sample of 274 dairy farms whose costs of production are surveyed.³⁰⁹ The costs for each farm are computed on a per unit basis (dollars per hectolitre) and each farm is then ranked from lowest to highest according to its individual cost of production.³¹⁰ Then Canada divides the 274 farms by 10 to create 10 groupings (deciles) of producers.³¹¹ The individual farms are then weighted according to their production and an average weighted cost is calculated for each decile.³¹²

5.56 In order to provide information on the price of CEM contracts, Canada takes price and volume data from 785 CEM contracts, as reflected on the bulletin boards of Quebec, Ontario and Manitoba, and divides this number of contracts into deciles.³¹³ It then calculates an average CEM price, weighted according to volume, for each decile.³¹⁴ To calculate the weighted average return, Canada deducts transport, marketing and certain administrative fees from the price of CEM contracts.³¹⁵

5.57 Comparing the CEM returns of the 785 contracts with the cost of production of 274 dairy farms, Canada purports to show that more than three-quarters (about 77 per cent) of dairy producers can cover their average costs of production through CEM sales.³¹⁶ On the same basis, Canada does not contest the fact that approximately 23 per cent of dairy producers in the sample cannot cover their average costs of production in the CEM market.³¹⁷ Nonetheless, Canada argues it is reasonable to

³⁰¹ Paras. 3.13 and 3.19 above.

³⁰² Para. 3.41 above.

³⁰³ *Ibid.*

³⁰⁴ Paras. 3.19 – 3.20 and 3.23 above.

³⁰⁵ Footnote 72 above.

³⁰⁶ Para. 3.57 above.

³⁰⁷ Paras. 3.56 – 3.58 above and Canada's Exhibit CDA-8.

³⁰⁸ Para. 3.58 above and Canada's Exhibit CDA-8.

³⁰⁹ Para. 3.57 above and Canada's Exhibit CDA-8.

³¹⁰ Canada's Exhibit CDA-8.

³¹¹ Para. 3.57 above.

³¹² Canada's Exhibit CDA-8. While the Panel understands from CDA-8 that the cost of production within each decile is weighted according to output, we note Canada's Response to Question No. 39 to the effect that the cost of production within each decile is not weighted.

³¹³ Canada's Responses to Question Nos. 41-44.

³¹⁴ Canada's Exhibit CDA-11.

³¹⁵ Paras. 3.51 – 3.52 and 3.65 above. The Panel notes that Canada has also deducted these transport and administrative fees from the cost of production calculations.

³¹⁶ Para. 3.66 above.

³¹⁷ Paras 3.66 and 3.70 above.

assume that a rational producer would participate in the CEM market only if he or she could cover his or her production costs.³¹⁸ Therefore, Canada maintains, there is no reason to assume that the 23 per cent of producers who cannot cover their production costs would participate in this market.³¹⁹

(vii) *Panel's assessment of Canada's arguments and data on individual producers' costs*

5.58 We recall Canada's argument that an individual producer's average total cost of production should be the relevant yardstick for determining whether payments are being made.³²⁰ If Canada can convincingly show that the individual producers' costs of production allow the producers to participate in the CEM market without making losses, then, in our assessment, no payments are actually being made.

5.59 Looking at the data Canada adduces, we register concerns as to the objectivity of this evidence: while Canada includes the 30 per cent of producers excluded from the CDC survey data, it does not include cost data from the small farms with less than 60 per cent average output in each province.³²¹

5.60 We further note that, in the data presented by Canada, the unweighted cost of production of the individual producers, in Canada's sample, is as low as CDN \$7.01 and as high as CDN \$66.80³²², while the weighted average cost ranges from CDN \$18.53 to CDN \$46.60.³²³ At the same time, we note that the weighted CEM returns amongst the 785 contracts in the three provinces sampled, range from CDN \$24.15 to CDN \$33.61.³²⁴ We recall the statement by the Complainants, uncontested by Canada, that the simple average of CEM prices in 2000 was approximately CDN \$29.³²⁵

5.61 Thus, in comparing the non-weighted data on the individual producers' costs with the simple average CEM price, we observe that the average cost of production of some producers significantly exceeds the average CEM price. Further, if we are to accept Canada's argument that cost data and CEM returns should be weighted according to output³²⁶, a still significant proportion of producers clearly cannot cover their costs through CEM sales. We recall that Canada does not contest – in fact admits – that approximately 23 per cent of dairy producers in the sample cannot cover their average costs of production in the CEM market.³²⁷

5.62 We also note that, according to Canada's evidence, approximately 8,000 producers, or 40 per cent of all producers (in the nine provinces), have participated, at least on occasion, in the CEM market.³²⁸ Also according to Canada's evidence, CEM production represents approximately 3.6 per cent of all milk production in Canada.³²⁹ Canada has also indicated that participation in the CEM market is usually only short term and that only a minority of CEM producers (12.5 per cent) participate for more than one year.³³⁰ This may suggest that even if there are producers who can cover their

³¹⁸ Canada's Response to Question No. 4(a).

³¹⁹ *Ibid.*

³²⁰ See paras. 5.36-5.37 above.

³²¹ We recall our exposition of Canada's argument at para. 5.54 above as well as at para. 3.58 and footnote 72 above.

³²² Canada's Exhibit CDA-9; Canada's Response to Question No. 41.

³²³ Canada's Exhibit CDA-9.

³²⁴ Canada's Exhibit CDA-13.

³²⁵ Paras. 3.66 and 3.70 above.

³²⁶ Footnote 72 above.

³²⁷ Paras. 3.66 and 3.70 above.

³²⁸ Para. 3.70 above.

³²⁹ Footnote 85 above.

³³⁰ Para. 3.70 above and Canada's Exhibit CDA-15.

marginal costs in the CEM market, CEM sales are not viable for most producers who thus may only participate in the CEM market to the extent necessary to dispose of non-quota surplus milk.³³¹

5.63 Given that Canada accepts that 23 per cent of producers have production costs exceeding CEM returns, and recalling that Canada has invited us to focus on the costs of production of individual producers³³², we consider that Canada in essence asks us to extrapolate from its information that, in fact, no individual producer with costs exceeding CEM returns, sells milk into the CEM market. However, in asking the Panel to assume that only the more efficient producers participate in CEM sales, Canada, it would seem to us, is calling for an assumption that would obviate any examination pursuant to the Appellate Body's benchmark of whether sales below the average total cost of production are being made. We note, however, that the Appellate Body clearly did not exclude the possibility that a producer with total costs of production in excess of CEM returns, might make CEM sales, stating that "[t]o the extent that the producer charges prices that do not recoup the total cost of production, over time, it sustains a loss which must be financed from some other source, possibly 'by virtue of governmental action'."³³³

5.64 Having carefully considered Canada's case for focusing on the individual producer in applying the cost of production benchmark, the Panel *finds* that Canada has neither sought to correlate its data on costs of production of individual producers with any information on participation in the CEM market, nor with that on the returns they might obtain in this market. While speaking of the costs to individual producers, not industry-wide average costs, Canada has only provided the Panel with average costs, albeit averages within ten groupings of producers. The Panel *finds*, moreover, that Canada has not presented any data - indeed, admits it has no data - on the basis of which the Panel could exclude that the 23 per cent of producers with costs of production in excess of the CEM price participate in the CEM market.

5.65 Accordingly, the Panel *finds* that Canada has not been able to demonstrate, pursuant to its proposed reliance on an individual average as the relevant total average cost of production benchmark, that no payments, within the meaning of Article 9.1(c), are being made.

5.66 We recall that at least one of Canada's rationales for having the Panel focus on the costs of individual producers rather than industry-wide averages is the wide variation in the cost-of-production efficiency of dairy farmers in Canada.³³⁴ In pursuit of this factual claim, Canada has presented evidence that merely confirms what Canada initially posited, i.e., that some farmers indeed have costs of production below CEM returns, while others do not. In our view, Canada's approach raises the two following additional problems.

5.67 First, we consider that Canada's proposed focus on the cost of production of individual producers would require a government to have access to, and make available, information on the cost of production of each producer and on whether or not the individual producer participates in the CEM market. It seems to us that only on rare occasion would a government have record-keeping of this magnitude. Quite apart from the administrative cost and unworkability of this approach, we note that even Canada has expressed doubts that the Appellate Body could have intended a benchmark for

³³¹ In this regard, we note that industrial milk production has exceeded Canadian requirements, defined as "domestic consumer demand and planned exports for industrial dairy products", both before and after the introduction of the CEM market. Canada's Exhibit CDA-27, reproducing CDC Annual Report 2000-2001, pages 13-14. We further note that as part of its claimed implementation of the recommendations in the original *Canada - Dairy* case, Canada asserts it has restricted its export subsidies to the quantity commitment levels for subsidized exports as set out in its Schedule. Para. 2.2 above.

³³² See paras. 5.36-5.37 above.

³³³ Appellate Body Report, *Canada - Dairy (Article 21.5 - New Zealand and US)*, para. 87.

³³⁴ Para. 3.59 above.

determining the existence of payments that entails a standard of proof akin to the "beyond a reasonable doubt" standard under criminal law.³³⁵

5.68 Second, the extensive amount of information required under Canada's proposed approach would make it very difficult for WTO Members to ensure that they are respecting their obligations under the *Agreement on Agriculture* in exercising their rights thereunder to grant domestic and export subsidies. In view of the unworkability of Canada's approach, such a Member whose exports also exceed its reduction commitment levels would have great difficulty in establishing that such exports have not benefited from export subsidies.

5.69 We recall that Canada has criticized the Complainants' proposed reliance on an industry-wide average for the cost of production benchmark, arguing that it would be very difficult for any government under an industry-wide application of the benchmark to monitor and notify its export subsidies, as costs of production within an industry may change from year to year.³³⁶ While this may indeed be the case, the Panel considers that monitoring and notification would be even more difficult under Canada's proposed application of the benchmark.

5.70 Nevertheless, we do see some merit in a number of the criticisms Canada expresses in relation to an industry-wide average of cost of production as the relevant benchmark. Specifically, we note Canada's argument that producers who can participate profitably in the CEM market may be deemed to confer payments if the industry-wide average cost of production exceeds CEM prices.³³⁷ In our view, in a market exhibiting great variation in production efficiency, the application of an industry-wide cost of production benchmark could result in producers being deemed to make payments even where not one producer with costs above the industry-wide average would be selling into the export market. In addition to not telling us much – if anything – about whether or not payments to dairy processors are in fact being made, it would be odd, in the Panel's view, if an interpretation of the *Agreement on Agriculture* should result in discouraging exports by efficient farmers, and yet this is what this industry-wide average cost of production benchmark would seem to entail.

5.71 Despite the merits of these critiques, however, the Panel rejects Canada's criticism that reliance on the CDC data would amount to reintroducing the regulated domestic price as the relevant benchmark.³³⁸ The Complainants' proposed reliance on the data collected pursuant to the CDC Guidelines is grounded in their argument, in which we concur, that this data represents a reasonably accurate and objective measure of costs of production of Canadian dairy producers. We agree with the Complainants that the fact that Canada uses this data to set the in-quota price in pursuit of social and economic objectives does not detract from the validity of the data because such objectives may become relevant in setting the in-quota price but not in calculating costs.

5.72 Moreover, we also disagree with Canada that we would in essence be reintroducing the domestic in-quota price as the relevant benchmark because it seems to us that a more accurate reflection of the average total cost of production of *all* of the Canadian dairy industry, i.e., one that also includes cost data from the 30 per cent least efficient farmers, as well as the small producers, would at any rate be substantially higher than the CDC cost figures and the domestic in-quota price.

³³⁵ Canada's Comments on the Responses of New Zealand and the United States, para. 56.

³³⁶ See para. 5.39 above.

³³⁷ We recall in this connection the exposition of Canada's argument at para. 5.38 above.

³³⁸ We recall, in this regard, that Canada does not contest the accuracy of the underlying CDC data.

5.73 In this connection, we take note of the CDC cost of production data, as provided by the Complainants, showing that the average cost of production of the Canadian dairy industry was CDN \$57.27 in 2000 and estimated to be CDN \$58.12 in 2001.³³⁹

5.74 The Panel notes that the Parties agree that the average CEM price in 2001 was approximately CDN \$31.50³⁴⁰ and in 2000 was approximately CDN \$29.³⁴¹ With the average cost of production, as reflected in the CDC survey data, exceeding the average CEM price by a factor of almost two, we consider that this constitutes a strong indication that, on average, payments are being made.³⁴²

(viii) *Canada's proposed exclusion of certain cost elements*

5.75 The parties, however, disagree as to the cost elements to be included in the calculation of the average total cost of production. Accordingly, it is necessary for us to examine whether Canada convincingly shows that certain elements for which the CDC Guidelines make allocation, should not be included in the calculation of average total cost of production in this case.

5.76 Canada argues that only actual costs, and not imputed costs, should be included in the cost calculation.³⁴³ It proposes an interpretation of the term "costs" as being limited to cash outlays.³⁴⁴ Canada therefore seeks to adjust the CDC survey data by excluding from such calculation the costs of family labour, return to management and return to equity.³⁴⁵ Canada also posits that the cost calculation should be limited to production costs only, to the exclusion of production quota, marketing, transport and certain administrative costs.³⁴⁶

5.77 In arguing that the cost calculation should also exclude profits³⁴⁷, Canada refers the Panel to a statement by the Appellate Body to the effect that "an economic operator chooses to invest, produce and sell, not only to recover the total cost of production, but also in the hope of making profits".³⁴⁸ According to Canada's view, the Appellate Body draws a clear distinction between costs to be recouped, on the one hand, and hoped for profits on the other.³⁴⁹ Canada in this context argues that family labour and return to equity are not costs to an enterprise but rather profits, and thus should not be included in calculating the cost of production.³⁵⁰

5.78 Canada also submits, in responding to the Complainants' proposed inclusion of the cost of quota, which we note is not accounted for under the CDC Guidelines, that quota should not be viewed as a restriction on production but rather as an entitlement to sell.³⁵¹ Canada further argues that the cost of quota is to be recouped in a different market, namely, the domestic market.³⁵² In support of its position, Canada points to GAAP that "do not require" the amortization of intangible assets with an

³³⁹ Para. 3.53 above.

³⁴⁰ Canada's Response to Question Nos. 61-62. New Zealand's Response to Question No. 62 and United States' Response to Question No. 62.

³⁴¹ Para. 3.53 above and Canada's Response to Question No. 62.

³⁴² The Panel notes that the data submitted by the various parties on costs of production and CEM prices are comparable with respect to the inclusion of transport, administrative and marketing fees. Canada's Exhibits CDA-11, CDA-12 and CDA-13; New Zealand's First Submission, para. 5.29; United States' First Submission, para. 29.

³⁴³ Paras. 3.37 – 3.38 above.

³⁴⁴ Para. 3.27 above.

³⁴⁵ Paras. 3.28 – 3.40 above.

³⁴⁶ Paras. 3.44 and 3.50-3.51 above.

³⁴⁷ Paras. 3.39 – 3.40 above.

³⁴⁸ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 95.

³⁴⁹ Paras. 3.39 – 3.40 above.

³⁵⁰ *Ibid.*

³⁵¹ Para. 3.44 above.

³⁵² *Ibid.*

indefinite useful life³⁵³, which, in Canada's view, includes production quota. According to Canada, only the impairment in the value of the quota in a given year, if any, as compared to that in a prior year, is to be included as a cost element.³⁵⁴

5.79 As for the exclusion of marketing, transport and certain administrative costs, Canada argues that these are costs arising in connection with *sales*, not production, which occur beyond the farm gate.³⁵⁵

(ix) *Panel's analysis of cost elements to be included/excluded*

5.80 The Panel, in examining which cost elements should be included, recalls the Appellate Body guidance that *all* fixed and variable costs should be included³⁵⁶, thus suggesting that there is no reason *a priori* to use only cash-based accounting methods. The Panel also takes note of the observation by the Appellate Body that the production of goods and services involves an investment of economic resources.³⁵⁷ We therefore consider that we must first determine the ordinary meaning of the words "cost" and "investment" in accordance with Article 3.2 of the *DSU* and Article 31 of the *Vienna Convention on the Law of Treaties* ("*Vienna Convention*"). The word "cost" is defined as an "[e]xpenditure of time or labour; what is borne, lost, or suffered in accomplishing or gaining something ...".³⁵⁸ The word "investment" is defined as "... investing of money (now also time or effort)...".³⁵⁹ Having thus examined the ordinary meaning of the words "costs" and "investment", we do not see any basis that would require us to exclude non-monetary costs *ab initio*.

5.81 Mindful of the argument of Canada, inviting us to have recourse to GAAP in interpreting the meaning to be given to the term "cost of production", we first note that the CDC Guidelines themselves state that they are based on GAAP.³⁶⁰ Second, we consider it useful to turn to the *Anti-Dumping Agreement* for contextual guidance, in line with Article 31 of the *Vienna Convention* and Article 3.2 of the *DSU*. Specifically, we turn to such contextual guidance to discern the relative weight to be given to GAAP in the proper calculation of costs of production. Article 2.2.1.1 of the *Anti-Dumping Agreement* tells us to calculate costs based upon "records kept by ... the producer, provided that such records are in accordance with *generally accepted accounting principles* of the exporting country and reasonably reflect the costs associated with the production and sale of the product ... [and] provided that such allocations have been *historically utilized* by ... the producer" (emphasis added)

5.82 Since Article 2.2.1.1 of the *Anti-Dumping Agreement* instructs that production costs are to be calculated using the allocations historically utilized so long as doing so is in accordance with GAAP, and since the CDC Guidelines purport to be in accordance with GAAP, we see no reason why family labour, return to management and return to equity should not be included in the definition of the cost of production in the present case.

5.83 In this context, the Panel notes the inconsistency between Canada's compensating producers for the elements of family labour, return to management and return to equity, in the domestic market, as borne out by the CDC Guidelines, while proposing to exclude these "*historically utilized*" allocations in applying the Appellate Body's cost of production benchmark. Similarly, we note the inconsistency of

³⁵³ Para. 3.44 above.

³⁵⁴ *Ibid.*

³⁵⁵ Paras. 3.50-3.51 above. Canada also proposes subtracting such costs to obtain the net CEM return.

³⁵⁶ See para. 5.45 above.

³⁵⁷ See para. 5.43 above.

³⁵⁸ *The New Shorter Oxford English Dictionary*, L. Brown (ed.) (Clarendon Press, 1993), Vol. I.

³⁵⁹ *Ibid.*

³⁶⁰ New Zealand's Exhibit NZ – 4 and United States' Exhibit US – 22 reproducing CDC Guidelines.

Canada's including marketing, transport and administrative expenses as costs when setting the domestic target price, while arguing for their exclusion in the calculation of the overall cost of production.

5.84 On whether or not to include the cost of obtaining quota in calculating the overall cost of production, we agree with the Complainants' explanation that this cost represents a real cost – even a cash outlay – that a producer will incur in the production of milk, regardless of which market the producer recoups that cost in. In our understanding, the GAAP, while possibly not requiring the amortization of quota, do not exclude such amortization. Since the Appellate Body, in referring to the total cost of production as including *all* fixed and variable costs, appears to have endorsed a broad interpretation of the term "cost", we doubt that quota should be excluded from such calculation.

5.85 Having examined what elements to include in the overall cost of production calculation, the Panel *finds* that Canada has not demonstrated why family labour, return to management, return to equity, quota and transport, marketing and administrative costs should not be included as costs of production and that, as a corollary, those deductions need to be made to the CDC survey data. In sum, we agree with the Complainants that the elements here mentioned are real costs to the producer who, if not able to recoup them, incurs losses and cannot stay in business over time. The Panel accordingly *finds* that the CDC data represent a sufficient, albeit conservative, approximation of the average total cost of production of the Canadian dairy industry. If anything, additions reflecting the cost of quota, not deductions, should be made to the cost elements reflected in the CDC survey data.

(c) Conclusion on the issue of "payments"

5.86 The Panel recalls its finding at paragraph 5.34 above that the Complainants have presented a *prima facie* case that payments are being made.

5.87 The Panel also recalls its finding at paragraphs 5.64-5.65 above that Canada's proposed approach focused on the costs of production of individual producers, but absent any data reflecting individual producers' costs, their participation or their returns in the CEM market, fails to demonstrate that no payments are being made, within the meaning of Article 9.1(c).

5.88 The Panel further recalls its finding at paragraph 5.85 above to the effect that Canada has not demonstrated why family labour, return to management, return to equity, quota and transport, marketing and administrative costs should not be included as costs of production.

5.89 In light of the Complainants *prima facie* case as to the existence of payments and Canada's failure to establish, pursuant to Article 10.3, that no payments are being made, the Panel *finds* that "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture* are being made.

5.90 The Panel notes that we have made findings of the existence of "payments" based on both the Complainants' and Canada's interpretation of how to apply the Appellate Body's benchmark, thus making it unnecessary to decide *in this case* which of these two interpretations is the correct one.

3. Whether payments are "financed by virtue of governmental action"

(a) Basis for Panel's renewed examination of whether payments are "financed by virtue of governmental action"

5.91 The Panel notes that while the Appellate Body reversed the Panel's finding as to the appropriate benchmark for determining the existence of "payments" under the first element of Article 9.1(c), it neither made a finding as to whether or not payments exist in the current case nor any findings with

respect to the issue of "financ[ing] by virtue of governmental action".³⁶¹ Nevertheless, the Appellate Body, as *dicta*, provided certain indications as to the nature of the governmental action required and as to the causal link to the financing of payments.

5.92 Specifically, the Appellate Body opined that the presence of a "*demonstrable link*" between the governmental action and the financing of the payments is necessary to a showing that payments are financed "*by virtue of*" governmental action.³⁶² The Appellate Body equated this "demonstrable link" with a situation where there is a "*tighter nexus*" between the governmental action and the financing of payments than in a situation where there is a regulatory framework merely enabling a third person freely to make and finance payments.³⁶³

5.93 Thus, we deem it necessary to revisit, with the benefit of the Appellate Body's guidance, the issue of whether payments are "financed by virtue of governmental action".

5.94 At this stage, the Panel recalls its analysis in paragraphs 5.18-5.19 and 5.25 above as to the operational interpretation of Article 10.3. We shall therefore first examine whether the Complainants make a *prima facie* showing of a demonstrable link between governmental action and the financing of payments. Provided that the Complainants make such a *prima facie* case, it will then be for Canada to establish, pursuant to Article 10.3, that any payments are not "financed by virtue of governmental action" within the meaning of Article 9.1(c).

(b) Whether the Complainants make a *prima facie* case

5.95 The Complainants allege that, because a producer supplies CEM at a price which does not cover average production costs, i.e., makes a payment, and because the milk thus sold must be exported pursuant to government mandate, Canada's CEM market cannot be described as a deregulated one in which private individuals freely make and accept payments.³⁶⁴ Specifically, they argue that the prohibition on selling non-quota milk at the higher domestic in-quota price and on diverting CEM back into the domestic market, together with the exemption of the dairy processors from paying this higher price for CEM, constitute the governmental action by virtue of which payments are financed.³⁶⁵

5.96 The Complainants also argue that the Panel should focus its examination on the recipient of the subsidy (here, the processor), not on the provider thereof (the dairy producer).³⁶⁶ In this context, the Complainants observe that under the CEM scheme, it is ensured that whenever producers make a sale they will also be making a payment.³⁶⁷ Arguing that the issue of why producers choose to produce milk for the CEM market is irrelevant, the Complainants contend that what matters is that the choice of where to sell non-quota milk, once produced, is essentially a government-mandated choice.³⁶⁸ The only other "options", in their view, are to destroy the milk or to sell it in the much less attractive market for animal feed.³⁶⁹ Moreover, New Zealand points out, the cross-subsidization resulting from sales at the higher administered domestic price may make it rational for a producer to produce CEM.³⁷⁰

5.97 The Complainants assert that the exemption from the higher domestic regulated price is not necessary to Canada's supply management scheme because the Government need not enable processors

³⁶¹ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 104; 105 and 118.

³⁶² *Ibid.*, para. 113.

³⁶³ *Ibid.*, para. 115

³⁶⁴ See paras. 3.94, 3.96 and 3.120 above.

³⁶⁵ Para. 3.96 above.

³⁶⁶ Para. 3.114 above.

³⁶⁷ Para. 3.120 above.

³⁶⁸ Paras. 3.117 – 3.119 and 3.121 above.

³⁶⁹ New Zealand's First Submission, para. 5.38, United States' First Submission, para. 44.

³⁷⁰ Para. 3.118 above.

to obtain milk below production cost.³⁷¹ Only the prohibition on diversion of non-quota milk back into the domestic regulated market, and not the exemption of processors from paying the higher domestic price, they argue, may be a significant element in Canada's price support scheme.³⁷² Canada's scheme, they argue, functions as a deliberate export subsidy, in the absence of which Canada would not be able to export dairy products.³⁷³

5.98 Recalling our statement in paragraph 5.94 above, the Panel *finds* that the Complainants' case, as described in paragraphs 5.95-5.97 above, provides a *prima facie* showing that payments are being "financed by virtue of governmental action", such that Canada can reasonably attempt to discharge its burden under Article 10.3 of demonstrating why CEM sales are not being financed by virtue of governmental action. We shall therefore turn to an examination of Canada's case on this issue.

(c) Examination of Canada's case on "financed by virtue of governmental action"

(i) *Canada's position regarding the lack of governmental involvement in the export market*

5.99 In recalling a statement of the Appellate Body, to the effect that the causal link would be more difficult to establish when a payment-in-kind is made by an independent economic operator, Canada argues that, on the facts of this case, the Appellate Body standard calls for a "particularly clear and convincing showing of the required linkage".³⁷⁴ Canada then argues that, in the context of the deregulated CEM market, the combination of the prohibition on selling non-quota milk on the domestic regulated market and the exemption of processors from paying the higher regulated domestic price is insufficient to meet the "rigorous standard" put forward by the Appellate Body.³⁷⁵ Specifically, Canada argues that the exemption of the processors from paying the higher domestic price does not ensure processors' access to milk for export at any particular price and that there is thus no tight nexus between the financing of payments and governmental action.³⁷⁶

5.100 Referring to the Appellate Body's distinction between a regulatory framework merely enabling a third person freely to make and accept payments and one for which a tight nexus between governmental action and financing of payments is present, Canada describes its "deregulated" export market as one in which private economic operators engage in transactions at arms length and on a purely commercial basis.³⁷⁷

5.101 Moreover, Canada maintains that the Complainants' argument to the effect that access to CEM without having to pay the domestic administered price equals financing, fails to give meaning to the word "financed".³⁷⁸ The mere fact that processors have access to CEM without paying the domestic administered price and that there are no limits placed on their ability to export is not *per se* WTO-inconsistent, according to Canada.³⁷⁹

5.102 Canada contends that the Government is not involved in the decision to sell non-quota milk as CEM milk because, "for Article 9.1(c) to apply there must be governmental action focussed or directed towards the financing of the alleged 'payment'".³⁸⁰ Canada then gives examples of what type of governmental action it considers would satisfy the test established by the Appellate Body, namely,

³⁷¹ Paras. 3.101 and 3.115 above.

³⁷² Paras. 3.107, 3.101 and 3.115 above.

³⁷³ Para. 3.107 above.

³⁷⁴ Para. 3.95 above.

³⁷⁵ *Ibid.*

³⁷⁶ Para. 3.116 above.

³⁷⁷ See paras. 3.97; 3.104; 3.108-3.109 and 3.113 above.

³⁷⁸ Para. 3.97 above.

³⁷⁹ Para. 3.116 above.

³⁸⁰ Para. 3.103 above.

setting prices, controlling volume or managing producer returns.³⁸¹ In addition, Canada asserts that if there was governmental action "obliging or driving" producers to produce CEM, the demonstrable link would be present.³⁸²

5.103 Canada also contends that to focus on the processor, as the Complainants argue, confuses the concept of "financed by virtue of governmental action" with the concept of "benefit".³⁸³ In its view, the issue is whether the alleged payments by independent producers are financed by virtue of governmental action.³⁸⁴

5.104 Canada maintains, in addition, that under the *Agreement on Agriculture*, WTO Members may provide domestic support to agricultural producers and that the prohibition on diversion of non-quota milk into the domestic market in Canada is necessary to protect the producers' entitlement to the higher domestic support price.³⁸⁵

5.105 In invoking the *SCM Agreement* and the case on *US – Export Restraints* as important contextual guidance, Canada argues that Article 9.1(c) of the *Agreement on Agriculture* should be construed in accordance with Article 1.1(a)(1) of the *SCM Agreement*, and specifically Article 1.1(a)(1)(iv), pursuant to which "a government *entrusts* or *directs* a private body to carry out ... functions ... which would normally be vested in government ...", such as making direct transfers of funds, forgoing revenue or providing goods and services.³⁸⁶

(ii) *Appellate Body guidance on "financing by virtue of governmental action"*

5.106 Before embarking on a detailed examination of Canada's case regarding "financed by virtue of governmental action", we consider that we should first review the guidance by the Appellate Body on this subject. The Appellate Body observed that the text of Article 9.1(c) does not qualify the relevant types of governmental action, but includes governmental action "regulating the supply and price of milk in the domestic market".³⁸⁷ While stating that "mere governmental action" is not enough for there to be export subsidies, it opined that the presence of a "demonstrable link" between the governmental action and the financing of the payments means that payments are financed "by virtue of".³⁸⁸

5.107 The Appellate Body did not exclude that "payments may be financed by virtue of governmental action even though significant aspects of the financing might not involve government".³⁸⁹ At the same time, the Appellate Body was careful to distinguish a "regulatory framework merely enabling a third person freely to make and finance 'payments' [for which] ... the link between the governmental action and the financing of the payments is too tenuous" from a situation where there is "a tighter nexus between the mechanism or process by which the payments are *financed*, even if by a third person, and governmental action".³⁹⁰

5.108 Similarly, the Appellate Body distinguished a situation where a payment *occurs* as a consequence of governmental action from the situation where a payment is *financed* as a consequence

³⁸¹ Para. 3.103 above.

³⁸² *Ibid.*

³⁸³ Canada's Oral Statement, para. 56.

³⁸⁴ Canada's Executive Summary, para. 27.

³⁸⁵ At an early stage in the proceedings, Canada also argued that the exemption of the processors from paying the higher domestic price was also necessary to the domestic price support system. Canada's Submission, para. 66. However, Canada later admitted that this exemption was not necessary to this price support system. Para 3.116 above.

³⁸⁶ Paras. 3.147 - 3.148 above.

³⁸⁷ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 112.

³⁸⁸ *Ibid.*, para. 113.

³⁸⁹ *Ibid.*, para. 114.

³⁹⁰ *Ibid.*, para. 115.

of governmental action and for which a demonstrable link is thus present.³⁹¹ In the former situation, no such demonstrable link is present, according to the Appellate Body, "because the word 'financed', in Article 9.1(c), must also be given meaning".³⁹²

5.109 The Panel recalls that the Appellate Body noted that "[a]lthough the Panel addressed this issue in different ways, ... the Panel's reasoning, taken as a whole, was directed towards establishing the demonstrable link between governmental action and the financing of the payments."³⁹³ At the same time, however, the Appellate Body "disagree[d] with the Panel's characterization of the measure as 'obliging producers, at least *de facto*, to sell outside-quota milk for export'.³⁹⁴ The Appellate Body also noted that it did "not see how producers are obliged or driven to produce additional milk for export sale."³⁹⁵

(iii) *Panel's examination of "financed by virtue of governmental action" in light of the Appellate Body guidance*

5.110 The Panel recalls that in the first Article 21.5 compliance case, for the purpose of determining the link between governmental action and the financing of payments, that panel focused on the prohibition against selling non-quota milk at the domestic in-quota price and the anti-diversion measures, as a result of which CEM, by definition exempt from the domestic pricing regulations, was left as the only viable option to transact outside the regulatory framework of price floors and quota ceilings.³⁹⁶ In this earlier case, the panel spoke in terms of governmental action being "indispensable" to the financing of payments, in other words "establish[ing] the conditions which ensure that the payment takes place."³⁹⁷ The panel also there found that in order to meet the "by virtue of" test in Article 9.1(c), it would have to find that financing does not occur "but for" governmental action.³⁹⁸

5.111 In light of the fact that there has not been any change in the nature or the regulation of the Canadian dairy markets since the first Article 21.5 panel examined this matter, and in light of the Appellate Body's apparent support for the reasoning employed by the first Article 21.5 panel³⁹⁹, this Panel considers that it should initially focus on the same elements of governmental action as in the previous case, but applying a new test directed at determining whether governmental action is *demonstrably linked* to the financing of payments. In proceeding with our analysis, we are mindful of the distinction, rightly emphasized by the Appellate Body, between a situation where a payment is merely incidental to governmental action, and one where there is a tighter nexus between the governmental action and the effecting of a transfer of economic resources.⁴⁰⁰

5.112 The Panel recalls that under the previous supply management system, the Canadian government regulated price and marketing for all categories of milk.⁴⁰¹ Under Canada's implementation measures, the Canadian Government no longer negotiates or sets a price for its new category of export milk, called CEM, but still maintains a target price for domestic milk under quota, as well as for another new, domestic market category of milk, Class 4(m), used as animal feed.⁴⁰² Processors are exempt, by law,

³⁹¹ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 113.

³⁹² *Ibid.*

³⁹³ *Ibid.*, para. 116.

³⁹⁴ *Ibid.*, para. 117.

³⁹⁵ *Ibid.*

³⁹⁶ Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 6.77 and 6.78.

³⁹⁷ *Ibid.*, paras. 6.38, 6.40 and 6.44.

³⁹⁸ *Ibid.*, para. 6.41.

³⁹⁹ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 116.

⁴⁰⁰ We recall in this connection the statement in the Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 115).

⁴⁰¹ Para. 2.1 above.

⁴⁰² *Ibid.*

from paying the higher in-quota price.⁴⁰³ Producers pre-commit to sell any quantity of non-quota milk as CEM and once pre-committed, such milk must be "first-out-of-the-tank", and may not be diverted back into the domestic market.⁴⁰⁴ Processors must account for the destination of all milk contracted as CEM milk and diversion into the domestic market is subject to financial and other penalties.⁴⁰⁵ As under the previous system, Canada places no restrictions on the quantity of milk that may be sold into the export market.⁴⁰⁶

5.113 In relation to Canada's argument that the prohibition on diversion is necessary to the protection of the producer's entitlement to the higher in-quota price, we have doubts that, even assuming a measure may be necessary to a particular supply management system of a WTO Member, such "necessity" can be equated with WTO consistency. Moreover, we have doubts that the exemption of processors from paying the higher domestic in-quota price for CEM, either on its own or together with the prohibition on diversion, is necessary to the protection of the producer's entitlement to that higher price. Indeed, Canada has admitted that this exemption is not necessary to protect the producer's entitlement.⁴⁰⁷

5.114 Looking at the implementation measures in dispute, the Panel notes that the parties have presented arguments on the nexus, or lack thereof, both from the perspective of the processor and from that of the producer. We will begin our examination by considering this matter from the perspective of the processor.

5.115 Looking from the perspective of the dairy *processor*, it is clear that the exemption of processors from paying the higher domestic in-quota price is demonstrably linked to exports of dairy products made with Canadian produced milk because if processors had to pay the in-quota price for CEM, exports of CEM would most likely dry up. As the record undisputedly confirms, the domestic regulated price is well above the world market price for milk.⁴⁰⁸ With milk being a principal ingredient of processed dairy products, Canadian processed dairy products using milk at the in-quota price could not be competitive on world markets. Indeed, we recall Canada's concurring statement to the effect that the exemption was adopted in order to allow for the functioning of a deregulated CEM market.⁴⁰⁹

5.116 Moreover, we consider that a rational, profit-maximizing processor, exempt by law from paying the in-quota price for CEM, will seek to transact for CEM at the lowest possible price. Because the processor has a legal right not to pay the in-quota price, ranging from approximately CDN \$50 to CDN \$56⁴¹⁰, a rational, profit-seeking processor, in our view, will be in a strong position to transact for CEM at a price below the domestic administered price, and thus, below the average total cost of production of Canadian dairy producers. Moreover, we consider that the unattractiveness of the other marketing option for non-quota milk, i.e., Class 4(m) milk, would put processors in a position to drive down the price of CEM still further. Finally, to the extent that milk sourced through IREP is substitutable and competitive with CEM, this would be yet another factor enabling processors to offer to

⁴⁰³ Paras. 3.99 and 3.116 above.

⁴⁰⁴ Para. 2.3 above.

⁴⁰⁵ Para. 2.2 above.

⁴⁰⁶ Para. 2.2 above.

⁴⁰⁷ Para. 3.116 above.

⁴⁰⁸ We recall that the domestic in-quota price in the previous proceedings was shown to range from CDN \$50 to CDN \$ 56. Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 6.10.

⁴⁰⁹ Canada's Response to Question No. 14.

⁴¹⁰ Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.10. In that report, New Zealand submitted that domestic market milk in the various classes sells for between CDN \$49.48 and CDN \$56.06 while the United States gave an average of CDN \$52.92 per hectolitre. Canada did not contest these figures.

transact for CEM at prices even below those for IREP-sourced milk. In this connection, we observe that the prices for CEM are on average lower than those for IREP-sourced milk.⁴¹¹

5.117 By virtue of the prohibition on diversion of CEM back into the domestic market, coupled with penalties, we consider that the Canadian government not only prevents the processor from seeking the highest return available for milk in the domestic market, but also ensures that the only option for a dairy processor producing a particular dairy product and wishing to sell beyond the amount manufactured through the supply of quota milk, is to produce for the export market.

5.118 Looking now from the perspective of the dairy *producer*, we note that the earlier Article 21.5 panel focused its inquiry primarily on the governmental action linked to the *sales* of CEM, not to the decision by the producer whether or not to *produce* milk for sale as CEM, and made findings only with respect to the link between governmental action and the decision to *sell*.⁴¹²

5.119 We recall in this connection that Canada stresses that there is no governmental action obliging or driving producers to produce milk for the CEM market, invoking a statement by the Appellate Body to the same effect.⁴¹³ We also recall the Complainants' argument that the reason for why producers decide to produce milk for the CEM market is irrelevant, given that the Government does not provide any real choice as to where producers may sell non-quota milk once produced.⁴¹⁴

5.120 From an economic perspective, it is clear to us that no meaningful distinction can be made between a producer's decision to *produce* non-quota milk and the decision where to *sell* that milk. These two decisions are in fact part and parcel of one integrated decision by any rational economic operator. Clearly, the decision to produce will be taken in light of the producer's costs and the sales options available, such that a producer will decide to produce only if in doing so that producer will be able to make profits or, at least, avoid making losses. In this sense, we agree with the Complainants that it may not be relevant to focus on the reasons why a producer may decide to produce. We consider that the question of whether governmental action "drives" producers to produce only becomes relevant where making sales would result in losses.

5.121 The Panel sees support for the above position in the Appellate Body's statement that governmental action can include "regulating the supply and price of milk in the domestic market"⁴¹⁵, and that "the existence of a demonstrable link [has to take account] of the particular governmental action ... and its effects on payments made by a third person".⁴¹⁶ In this sense, all that is required is that there be governmental action, such as that regulating the supply and price of milk in the domestic market, the effect of which is that producers make payments to dairy processors. Thus, if governmental action makes possible sales into the CEM market which would otherwise be made at a loss, i.e., not allowing for recovery of fixed and variable costs, we consider, in line with the Appellate Body's statement, that there would then be a demonstrable link between governmental action and the financing of payments.

5.122 In respect of the case before us, the record confirms Canada's regulation of both the domestic in-quota price and volume of milk, as well as the prices for Class 5(d) and Class 4(m) milk.⁴¹⁷ As we

⁴¹¹ We note that the price for IREP whole-milk powder is around CDN \$32.45 per hectolitre, whereas the unweighted CEM price is around CDN \$29 per hectolitre. cf. paras. 3.53, 3.54, 3.67, 3.74, 3.75 and footnotes 83 and 166 above.

⁴¹² Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 6.43-6.48 and 6.77.

⁴¹³ Para. 3.112 above.

⁴¹⁴ Paras. 3.121 – 3.122 above.

⁴¹⁵ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 112.

⁴¹⁶ *Ibid.*, para. 115.

⁴¹⁷ Para. 2.2 above.

understand it, the only sales option available to milk producers, not directly regulated by Canada, is that of the CEM market.

5.123 Due to the prohibition on selling non-quota milk at the in-quota price on the domestic market, the Canadian Government has foreclosed what would otherwise be the first-best option available to dairy producers, that of selling milk at the higher in-quota administered price. As a result of this prohibition, the only remaining options available are to produce and sell milk as CEM or as Class 4(m) animal feed, the latter yielding much lower returns. We note that the price of Class 4(m) animal feed is set by the Canadian Government at around CDN \$10 per hectolitre.⁴¹⁸

5.124 In our view, given the rational, profit-seeking motivations of private economic operators, and the regulation of the price for Class 4(m) by Canada, the Canadian Government ensures that the bulk of non-quota milk will be channelled into the CEM market; only a small fraction of non-quota milk – that which has not previously been pre-committed – will likely be sold as Class 4(m) animal feed.

5.125 In our assessment, the rational, profit-maximizing milk producer, in deciding whether to participate in the CEM market, will take into account the extent to which the income derived from selling milk at the in-quota price allows that producer to sell into the CEM market while at least recovering his or her marginal costs for that additional production. To the extent that the governmental support price for in-quota milk enables producers to cover their fixed and variable costs through production for sales at the in-quota price and make additional sales into the CEM market at marginal cost, we consider that a strong nexus exists.

5.126 With reference to the case before us, we recall Canada's acknowledgement that, pursuant to its proposed method for calculating average total cost of production, approximately 23 per cent of milk producers would be unable to cover their fixed and variable costs in the CEM market.⁴¹⁹ We further recall that, in this connection, Canada's proposed method would exclude imputed costs of family labour, return to management, return to equity and production quota, as well as transport, marketing and administrative costs.⁴²⁰ Nevertheless, we also recall that, in our view, all these costs are properly to be included in a calculation of the average total cost of production.⁴²¹

5.127 If account is taken of these costs, it appears that, absent governmental support through the in-quota price, the percentage of Canadian dairy producers who would be unable to cover their fixed and variable costs through sales into the CEM market would be much higher than the 23 per cent posited by Canada. Indeed, as recalculated by New Zealand, and absent the Canadian support price for in-quota milk, fully 100 per cent of Canadian dairy producers would not be able to cover their fixed and variable

⁴¹⁸ Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.52.

⁴¹⁹ Paras. 3.66 and 3.70 above.

⁴²⁰ See para. 5.76 above.

⁴²¹ See para. 5.85 above.

costs in the CEM market.⁴²² Thus, in the circumstances of this case, the Panel considers that governmental action in the form of regulating the supply and price of in-quota milk produces significant effects on payments made by third persons, in that this governmental action cross-subsidizes many sales that otherwise would not be made or would at least constitute sales at a loss.

5.128 In addition, we recall that the support price for in-quota milk is set in accordance with the CDC Guidelines at a level that rewards only the 70 per cent more efficient dairy farmers.⁴²³ The Panel notes that other sources of information from the Canadian news media, put forward by the Complainants, suggest that a substantially smaller percentage, between 25 and 39 per cent, of dairy farmers cover their costs under the in-quota price set in accordance with the CDC Guidelines.⁴²⁴ In these circumstances, the Panel considers it likely that for a significant percentage of Canadian dairy farmers who are just barely able to cover both their fixed and variable production costs through in-quota domestic sales, the level of the in-quota price creates a strong inducement – to the extent these farmers can cover their marginal costs – to produce additional milk for sale into the CEM market.

5.129 Even though we consider that the governmental action of regulating the supply and price of milk in the domestic market produces effects on and is demonstrably linked to the financing of payments by producers, our analysis here should not be read to suggest that Article 9.1(c) requires that the governmental action *directly* finance payments made by independent economic operators. On the contrary, the Panel considers that the ordinary meaning of Article 9.1(c), and in particular the phrase " ... whether or not a charge on the public account is involved ... ", makes clear that governmental action need not directly finance payments. This reading has been expressly endorsed by the Appellate Body.⁴²⁵

5.130 In addition to the impact of cross-subsidization on the financing of payments by third parties, we also consider that the regulatory policy of "pre-commitment" may also have a similar impact. In our view, a rational, profit-maximizing producer who has purchased an entitlement to sell at the high in-quota price will clearly want to fill the amount of quota he or she holds and will therefore be likely to err on the side of slight overproduction⁴²⁶, thus ensuring full use of the entitlement. The rational

⁴²² New Zealand's Response to Question No. 33

A. Deciles of costs of production	B. Estimated imputed and marketing costs	C. Total costs of production	Percentage of producers	Cumulative percentage of producers
From CDA-9 CDN \$ /hl	NZ rebuttal submission footnote 59 CDN \$ /hl	C.=A.+B. CDN \$ /hl	%	%
41.55-66.80	26	67.55-92.80	10	100
37.77-41.41	26	63.77-67.41	10	90
35.32-37.43	26	61.32-63.43	10	80
33.36-35.25	26	59.36-61.25	10	70
31.74-33.35	26	57.74-59.35	10	60
29.40-31.72	26	55.40-57.72	10	50
27.05-29.33	26	53.05-55.33	10	40
24.84-26.96	26	50.84-52.96	10	30
22.37-24.71	26	48.37-50.71	10	20
7.01-22.07	26	33.01-48.07	10	10

⁴²³ Para. 3.23 above.

⁴²⁴ New Zealand's Exhibit NZ-7, citing press releases from the Dairy Farmers of Canada Board of Directors and the Dairy Farmers of Ontario; United States' Response to Question No. 33, citing US Exhibit 22 from the first Article 21.5 proceeding.

⁴²⁵ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 115; Appellate Body Report, *Canada – Dairy*, DSR 1999:V, 2057, para. 108.

⁴²⁶ See footnote 85.

producer in these circumstances will opt for pre-committing milk production as CEM rather than face having to dispose of the milk as Class 4(m) animal feed.⁴²⁷ Because of the relative unattractiveness of the price for Class 4(m) milk and because a producer cannot channel any non-quota milk that has not been pre-committed into the CEM market, the Panel considers that the policy of pre-commitment, in those provinces where it is required by law⁴²⁸, provides an additional incentive to pre-commit a larger quantity of milk than the producer would market as CEM if able to allocate to that market *ex post*.

(iv) *The SCM Agreement as contextual guidance for Article 9.1 of the Agreement on Agriculture*

5.131 We recall Canada's argument that the concept of export subsidies found in Article 9.1 should be interpreted with reference to Article 1.1(a)(1), and particularly Article 1.1(a)(1)(iv), of the *SCM Agreement* as context.⁴²⁹ On this point, the Complainants argue that Canada is improperly seeking to narrow the scope of the *Agreement on Agriculture*.⁴³⁰ Specifically, they assert that the concept of "financial contribution" in Article 1.1(a)(1) of the *SCM Agreement* has no relevance to Article 9.1(c) of the *Agreement on Agriculture* which is concerned with "payments".⁴³¹ Similarly, they state, the words "entrust[ing] or direct[ing]" in Article 1.1(a)(1)(iv) of the *SCM Agreement* has no bearing on the interpretation of Article 9.1(c) of the *Agreement on Agriculture*.⁴³²

5.132 In the present case, because we consider that there is a demonstrable link between governmental action and the financing of payments within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, we do not see any need to consider whether Article 1.1(a)(1) or Article 1.1(a)(1)(iv) of the *SCM Agreement* may provide relevant context. In addition, we again take note of the Appellate Body's statement that "payment" within the meaning of Article 9.1(c) of the *Agreement on Agriculture* may include a payment made by third parties.⁴³³ In this sense, we agree with the Complainants' arguments that Article 1.1(a)(1) of the *SCM Agreement* has a narrower meaning than Article 9.1(c) of the *Agreement on Agriculture* as interpreted by the Appellate Body. For this same reason, we see no justification for looking to the specific example of "financial contribution by a government" found in Article 1.1(a)(1)(iv), invoked by Canada. Again, "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture* may be made by third parties. Moreover, no Party has ever suggested that the notion of government entrusting or directing private bodies to make financial contributions normally made by a government, within the meaning of Article 1.1(a)(1), has any relevance to this case.

(d) *Conclusion as to whether payments are "financed by virtue of governmental action"*

5.133 The Panel recalls its finding in paragraph 5.98 above that the Complainants make a *prima facie* case of a demonstrable link between governmental action and the financing of payments.

5.134 In light of our analysis above, the Panel *finds* that Canada, pursuant to Article 10.3, has failed to establish that governmental action – in the form of the exemption of CEM processors from paying the

⁴²⁷ The Panel recognizes that producers who have pre-committed milk as CEM, but who are unable to meet their pre-commitment obligation, may be penalized through the operation of the governmental "first-out-of-the-tank" policy whereby the government reallocates milk produced under quota to make up for any shortfall in CEM pre-commitments. Canada's Exhibit CDA-13D in Panel Report, *Canada – Dairy, (Article 21.5 – New Zealand and US)*. However, in our view, this policy does not remove the producer incentives to pre-commit.

⁴²⁸ Para. 3.65 above, citing Canada's Exhibit CDA-10. We note that the three provinces concerned, Ontario, Quebec and Manitoba, account for the bulk of all Canadian milk production, i.e., approximately 80 per cent.

⁴²⁹ See para. 5.78 above.

⁴³⁰ Para. 3.86 above.

⁴³¹ Para 3.88 above.

⁴³² *Ibid.*

⁴³³ Appellate Body Report, *Canada – Dairy*, DSR 1999:V, 2057, para. 113; Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 96 and 115.

higher in-quota price, the prohibition on the diversion of CEM back into the domestic regulated market, the cross-subsidization provided through the in-quota price and the mandated pre-commitment policy – is not demonstrably linked to the financing of payments.

5.135 The Panel therefore *finds* that payments are "financed by virtue of governmental action" within the meaning of Article 9.1(c).

4. Conclusion on Article 9.1(c) of the Agreement on Agriculture

5.136 Having found in paragraph 5.89 above that "payments" are being made, and in paragraph 5.135 above that payments are "financed by virtue of governmental action", and because the Parties have not contested the finding of the first Article 21.5 panel that any payments are made "on the export" of processed dairy products, the Panel *finds* that Canada provides export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

E. ARTICLE 3.3 OF THE AGREEMENT ON AGRICULTURE

5.137 Having found that CEM exports are being subsidized within the meaning of Article 9.1(c), the Panel recalls the original panel's⁴³⁴ and the Appellate Body's⁴³⁵ findings that, as acknowledged by Canada⁴³⁶, Class 5(d) exports are also subsidized within the meaning of Article 9.1(c). Since it is uncontested that Canada's exports of cheese and "other milk products" exceed Canada's export subsidy reduction commitment levels, the Panel *finds* that Canada has provided export subsidies in respect of cheese and "other milk products" in excess of its quantity commitment levels specified in its Schedule, and is therefore in breach of Article 3.3 of the *Agreement on Agriculture*.

F. WHETHER EXPORT SUBSIDIES EXIST WITHIN THE MEANING OF ARTICLE 10.1 OF THE AGREEMENT ON AGRICULTURE

1. Introduction

5.138 In the alternative to their claims under Article 9.1(c), the Complainants have made claims under Article 10.1 of the *Agreement on Agriculture*. Canada claims that it does not provide export subsidies within the meaning of Article 10.1.

5.139 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."

5.140 The Panel recalls that the original panel in *Canada – Dairy*, in its finding under that Article, considered that the elements of an Article 10.1 subsidy are whether there are: (1) export subsidies not listed in paragraph 1 of Article 9; and whether any such export subsidies are (2) applied in a manner resulting in or threatening to lead to circumvention of export subsidy commitments.⁴³⁷ We note that, as

⁴³⁴ Panel Report, *Canada – Dairy*, DSR 1999:VI, 2097, para. 7.113.

⁴³⁵ Appellate Body Report, *Canada – Dairy*, DSR 1999:V, 2057, para. 124.

⁴³⁶ Para. 2.2 above; Panel Report, *Canada – Dairy*, DSR 1999:VI, 2097, para. 8.1 and Appellate Body Report, *Canada – Dairy*, DSR 1999:V, 2057, para 144.

⁴³⁷ We note that the panel did not address the second phrase of Article 10.1 and considered that the first sentence comprised two elements. Panel Report, *Canada – Dairy*, DSR 1999:VI, 2097, paras. 7.118 and 7.120. We recall that the Appellate Body, in discerning the meaning of "to circumvent", noted the dictionary definition of the term as meaning "to find a way round, evade ...". Appellate Body Report, *US – FSC*, para. 148.

the Appellate Body has stated, because Article 10.1 is residual in character to Article 9.1, a measure listed as an export subsidy in Article 9.1 cannot simultaneously be an export subsidy under Article 10.1.⁴³⁸ We also recall that, as the original panel in *Canada – Dairy* stated, "measures which meet some but not all 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'."⁴³⁹

5.141 We have earlier examined whether or not there is an export subsidy within the meaning of Article 9.1(c), and found that an export subsidy within the meaning of Article 9.1(c) exists. However, should our finding under Article 9.1(c) be reversed on appeal, this would mean that at least one of the definitional elements of this provision would not be present. Accordingly, in order to resolve the matter in dispute, we consider it advisable to proceed to examine the Parties' claims and arguments under Article 10.1.

5.142 In recalling our consideration on the operational interpretation of Article 10.3 in paragraphs 5.18-5.19 above and in accordance with our analysis under Article 9.1(c), the Panel will first determine whether the Complainants make a *prima facie* case that certain elements of the Canadian regulation of its dairy industry constitute export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*. Provided we find that the Complainants make a *prima facie* case that export subsidies within the meaning of Article 10.1 exist, it will then be for Canada to attempt to discharge its burden, pursuant to Article 10.3, of establishing that no such export subsidies exist. Similarly, assuming the Panel finds that the Complainants provide a *prima facie* showing that the manner of application of such export subsidies results in or threatens to result in circumvention of export subsidy commitments, it will be for Canada, pursuant to Article 10.3, to establish that the manner of application does not result in or threaten to lead to circumvention of these commitments. In the same vein, should the Panel find that the Complainants make out a *prima facie* case that non-commercial transactions are being used by Canada to circumvent its export subsidy reduction commitment levels, it will then be for Canada to establish the contrary.

2. Whether "export subsidies" exist

5.143 The first issue to be addressed under Article 10.1 is whether or not one or more of the definitional elements of an Article 9.1 subsidy is absent. Here, since the Complainants have only alleged one specific type of Article 9 export subsidy, that found under Article 9.1(c), we need only exclude the simultaneous applicability of Article 9.1(c) and Article 10.1, and not that of the other subparagraphs of Article 9.1 setting forth other types of export subsidies.⁴⁴⁰ Although we have found all definitional elements of an Article 9.1(c) export subsidy to be present, we shall assume for the purpose of our analysis under Article 10.1 that one or more of the definitional elements of an Article 9.1(c) export subsidy is not present.

(a) Whether the Complainants make a *prima facie* case

5.144 The Complainants argue that the *SCM Agreement* and especially paragraph (d) of the *Illustrative List of Export Subsidies* in Annex I⁴⁴¹, as well as Article 1.1(a)(2) of the *SCM Agreement*⁴⁴², provide useful interpretative guidance under Article 10.1 of the *Agreement on Agriculture* on whether

⁴³⁸ Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 121.

⁴³⁹ Panel Report, *Canada – Dairy*, DSR 1999:VI, 2097, para. 7.125.

⁴⁴⁰ Even if it could be argued that the Panel, on its own initiative and despite the lack of any argumentation on the issue, would need to exclude all types of export subsidies listed in Article 9.1, a cursory review of that provision suggests to us that all those types listed involve direct forms of subsidies.

⁴⁴¹ Para. 3.131 above.

⁴⁴² Para. 3.153 above.

subsidies contingent on export performance exist. The United States argues that because the question in this dispute is one of export subsidies, it is more appropriate, as stated by the panel in the original *Canada – Dairy* case, "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."⁴⁴³

5.145 The Complainants state that the CEM scheme fulfils the elements of paragraph (d) of the *Illustrative List* because: (1) the goods are provided on terms more favourable than those for like goods for domestic consumption, since CEM prices are lower than those for domestic milk⁴⁴⁴; (2) the provision of goods is made or mandated by governments for export as a result of the governmentally created and enforced prohibition on sale in the domestic market and because the lower prices are available only for export⁴⁴⁵; (3) the goods are available on terms more favourable than those commercially available on world export markets because of the relative unattractiveness of IREP, i.e., the in-quota tariff, the discretionary issuance of the permit and payment of the permit fee, in comparison to CEM, and the processor's choice thus does not depend on commercial considerations.⁴⁴⁶

5.146 The United States also argues that IREP whole-milk powder is not fully substitutable with fluid milk and that additional costs arise in connection with rehydration.⁴⁴⁷

5.147 The Complainants further contend that Article 1.1(a)(2) of the *SCM Agreement* provides relevant context to the interpretation of "export subsidy" in Article 10.1 of the *Agreement on Agriculture*.⁴⁴⁸ They allege that the CEM system is one providing "income or price support ... which operates directly or indirectly to increase exports" because the government has created a system which makes milk available to processors for export at below both its domestic price and its average total cost of production.⁴⁴⁹

5.148 Recalling our statement in paragraph 5.142 above, the Panel *finds* that the Complainants' case, as described in paragraphs 5.144-5.147 above, provides a *prima facie* showing that export subsidies within the meaning of Article 10.1 exist, such that Canada can reasonably attempt to discharge its burden, under Article 10.3 of the *Agreement on Agriculture*, of establishing that no export subsidies exist.

(b) Canada's case on whether "export subsidies" exist

5.149 Canada argues that because there is an issue as to the meaning of "indirectly through government-mandated schemes", as set forth in paragraph (d) of Annex I of the *SCM Agreement*, it is necessary to have recourse to the general definition of "subsidy" set out in Article 1.1 of the *SCM Agreement*.⁴⁵⁰ In this context, Canada specifically references the definition provided in Article 1.1(a)(1)(iv), according to which a government "entrusts or directs a private body" to provide goods through delegation or an authoritative instruction or command.⁴⁵¹ Canada maintains that the government has not instructed individual producers to provide CEM to processors but rather that they enter into commercial transactions on their own volition.⁴⁵²

⁴⁴³ Para. 3.146 above.

⁴⁴⁴ Para. 3.132 above.

⁴⁴⁵ Para. 3.133 above.

⁴⁴⁶ Paras. 3.134 - 3.135 above.

⁴⁴⁷ Para. 3.144 above.

⁴⁴⁸ Para 3.153 above.

⁴⁴⁹ *Ibid.*

⁴⁵⁰ Para. 3.147 above.

⁴⁵¹ Para. 3.148 above.

⁴⁵² *Ibid.*

5.150 Moreover, Canada contends that Canada's regulation of its dairy industry does not meet the definitional requirements of paragraph (d) of the *Illustrative List*.⁴⁵³ In this connection, Canada asserts that the meaning of "indirect" in paragraph (d) should be interpreted consistently with the meaning of that term as it appears in Article 1.1 of the *SCM Agreement*.⁴⁵⁴ Specifically, Canada maintains that there is no provision of products through a government mandated scheme because the government does not command or direct producers to produce CEM.⁴⁵⁵ Canada also disputes that the prices under IREP are less favourable than prices for CEM because, in its view, the Appellate Body has already rejected that the existence of administrative formalities mean that imports are available on terms and conditions that are less favourable.⁴⁵⁶ Tariffs, in Canada's view, fall into the same category as administrative formalities.⁴⁵⁷ Finally, Canada submits that there is no independent requirement that a subsidy illustrated in paragraph (d) be shown to be contingent on export performance because "every subsidy illustrated in Annex I of the *SCM Agreement* is by definition an Article 1.1 'subsidy' that is contingent on export performance".⁴⁵⁸

5.151 In reference to Article 1.1(a)(2), Canada asserts that to conclude that because Canada does not prevent sales of CEM from occurring at prices mutually agreed to between buyer and seller Canada is thereby "supporting" the income generated by these sales is inconsistent with the concept of "support".⁴⁵⁹

(c) Panel's examination of whether "export subsidies" exist

5.152 On the issue of how to give definition to the term "export subsidies" in Article 10.1, the Panel recalls that the Parties disagree as to whether reference to the *Illustrative List* found in Annex I of the *SCM Agreement* should be made in this case for contextual guidance.⁴⁶⁰

5.153 We note that Article 1(e) of the *Agreement on Agriculture* defines "export subsidies" as "subsidies contingent upon export performance", which is essentially identical to the definition of prohibited export subsidies found in Article 3.1(a) of the *SCM Agreement*. Moreover, Article 3.1(a) includes within the concept of "subsidies contingent upon export performance", those subsidies illustrated in Annex I. Accordingly, and in line with the approach adopted by the original panel on *Canada – Dairy*, we consider it appropriate to turn first to Article 3.1(a) of the *SCM Agreement* and the *Illustrative List* in Annex I to that Agreement as contextual guidance for the term "export subsidies" as contained in Article 10.1 of the *Agreement on Agriculture*.

5.154 WTO jurisprudence confirms that all of the practices identified in the *Illustrative List* of the *SCM Agreement* are subsidies contingent upon export performance, within the meaning of Article 3.1(a).⁴⁶¹ We note that the panel in *Brazil – Aircraft (Article 21.5 (I))* analogized the *Illustrative List* to a list of *per se* violations.⁴⁶² This reasoning was implicitly endorsed by the Appellate Body in reviewing that panel's decision.⁴⁶³ We therefore consider that we need not first turn to Article 1.1(a)(1), and particularly not Article 1.1(a)(1)(iv). In this connection, we note that in the first Article 21.5 compliance case in *Brazil – Aircraft*, Canada actually argued to the panel that the *Illustrative List*

⁴⁵³ Para. 3.139 above.

⁴⁵⁴ Para. 3.137 above.

⁴⁵⁵ Paras. 3.139 and 3.142 above.

⁴⁵⁶ Canada's Executive Summary, para. 41.

⁴⁵⁷ Canada's Executive Summary, para. 42.

⁴⁵⁸ Para. 3.137 above.

⁴⁵⁹ Para. 3.162 above.

⁴⁶⁰ See paras. 5.144 and 5.149 above.

⁴⁶¹ Panel Report, *Canada – Autos*, para. 10.197; Panel Report, *Brazil – Aircraft (Article 21.5 (I))*, para. 6.42.

⁴⁶² Panel Report, *Brazil – Aircraft (Article 21.5 (I))*, para. 6.42.

⁴⁶³ Appellate Body Report, *Brazil – Aircraft (Article 21.5 (I))*, para. 61.

should be considered a *per se* list of prohibited export subsidies.⁴⁶⁴ Neither do we think it necessary to have recourse to Article 1.1(a)(2), which the Complainants suggest also provides interpretative guidance for the meaning of "export subsidies" within the meaning of Article 10.1 of the *Agreement on Agriculture*.

5.155 We shall accordingly examine the Parties' claims in relation to paragraph (d) of the *Illustrative List*, as interpretative guidance, to determine whether Canada provides a valid defence to the claim that export subsidies, within the meaning of Article 10.1 of the *Agreement on Agriculture*, exist.

5.156 Paragraph (d) of the *Illustrative List* provides in relevant part as follows:

"The provision by governments or their agencies either directly or indirectly through government-mandated schemes, 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, if ... such terms or conditions are more favourable than those commercially available⁵⁷ on world markets to their exporters.

⁵⁷ (*footnote original*) The term 'commercially available' means that the choice between domestic and imported products is unrestricted and depends only on commercial considerations".

5.157 We understand that, as stated by the original panel in *Canada - Dairy*⁴⁶⁵, paragraph (d) requires the presence of three elements: (1) the provision of products for use in export production on terms more favourable than for provision of like products for use in domestic production; (2) by governments either directly or indirectly through government mandated schemes; and (3) on terms more favourable than those commercially available on world markets.

5.158 As for the first element, the Panel notes it is uncontested that CEM prices are lower than the in-quota price of milk on the domestic market. As Canada considers it unnecessary to contest this first element⁴⁶⁶, the Panel need not examine this issue further.

5.159 With respect to the second element, the Panel recalls Canada's contention that the regulation of its dairy industry does not meet some of the definitional requirements of paragraph (d) of the *Illustrative List*.⁴⁶⁷ First, we note that Canada asks us to interpret the meaning of "indirect" in paragraph (d) in accordance with the meaning of that term as it appears in Article 1.1 of the *SCM Agreement* and, accordingly, to find that there is no provision of products through a government mandated scheme because the government does not command or direct producers to produce CEM.⁴⁶⁸ We also note the Complainants' response to the effect that the provision of goods is made or mandated by government for export as a result of the governmentally created and enforced prohibition on diversion of CEM into the domestic regulated market and because the lower prices for CEM are available only for export.⁴⁶⁹

5.160 On the interpretation of the term "indirect", we do not consider Canada's proposed reference to the terms "entrust[ing] or direct[ing] a private body ...", as contained in Article 1.1(a)(1)(iv), to be relevant to the type of governmental involvement at issue in this case. Moreover, we recall our analysis under Article 9.1(c) of the *Agreement on Agriculture*, in which we found a demonstrable link between payments and the financing by virtue of governmental action without such a degree of directness as that

⁴⁶⁴ Panel Report, *Brazil – Aircraft (Article 21.5 (I))*, Annex 1-2: Canada's Rebuttal Submission, para. 26.

⁴⁶⁵ Panel Report, *Canada – Dairy*, DSR 1999:VI, 2097, para. 7.128.

⁴⁶⁶ Canada's First Submission, para. 102.

⁴⁶⁷ See para. 5.150 above.

⁴⁶⁸ *Ibid.*

⁴⁶⁹ See para. 5.145 above.

being called for by Canada under Article 10.1.⁴⁷⁰ We observe that given the residual character of Article 10.1, which comes into operation only if one of the elements of an Article 9.1 export subsidy is not present, for us to rely on Canada's proposed interpretation would unduly narrow Article 10.1, thus depriving it of meaning. Rather, as the Complainants argue, we consider that the provision of goods is made or mandated by government for export as a result of the prohibition on diversion of CEM back into the domestic regulated market and the exemption which gives processors for export access to the lower CEM prices.

5.161 As for the third element, we recall our earlier observation that IREP prices are on average higher than CEM prices.⁴⁷¹ Based on the arguments and evidence before this Panel, we consider that the combination of the discretionary nature of the IREP permit, the permit fee itself, the in-quota tariff on IREP milk, the formalities associated with obtaining duty drawback, the limited substitutability of IREP imports and the costs of rehydration of IREP dried milk, not only make IREP milk products more expensive than CEM but generally make it a less favourable option.⁴⁷²

5.162 Finally, since Canada considers that there is no independent requirement that a subsidy illustrated in paragraph (d) be shown to be contingent on export performance because "every subsidy illustrated in Annex I of the *SCM Agreement* is by definition an Article 1.1 'subsidy' that is contingent on export performance", we decline to independently examine whether Canada's CEM system is contingent on export performance, within the meaning of paragraph (d) of the *Illustrative List*.

(d) Conclusion as to whether "export subsidies" exist

5.163 The Panel recalls its finding in paragraph 5.148 above that the Complainants make a *prima facie* case that export subsidies within the meaning of Article 10.1 exist.

5.164 In light of our analysis in paragraphs 5.152-5.162 above the Panel *finds* that Canada has failed to establish that any of the three required elements of an export subsidy illustrated in paragraph (d) of the *Illustrative List* is not present and that it has therefore also failed to establish that no export subsidies within the meaning of Article 10.1 exist.

5.165 Accordingly, we *find* that Canada provides export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*.

3. Whether there is circumvention of export subsidy commitments or a threat thereof

5.166 Recalling our considerations set out in paragraphs 5.18-5.19 and in paragraph 5.142 above, the Panel will first examine whether the Complainants make out a *prima facie* case that export subsidies are applied in a manner leading to or threatening to lead to circumvention of export subsidy reduction commitment levels.

(a) Whether the Complainants make a *prima facie* case on circumvention

5.167 The Complainants contend that exporting or adopting measures enabling the export of subsidized products in excess of reduction commitment levels raises a presumption of circumvention or threat thereof.⁴⁷³ The Complainants both argue that because of this presumption, to the extent that dairy products have been exported in excess of Canada's reduction commitment levels, there has been actual

⁴⁷⁰ See paras. 5.134-5.135 above.

⁴⁷¹ See para. 5.116 and footnote 411 above.

⁴⁷² See paras. 5.145-5.146 above.

⁴⁷³ The Panel notes that while only New Zealand explicitly makes this argument, the United States also implicitly makes the same point. See para. 3.165 above.

circumvention.⁴⁷⁴ Because there is no government imposed limit on the amounts of dairy products that may be exported, and because Canada enables subsidization of exports, the Complainants argue, there is a threat of circumvention.⁴⁷⁵

5.168 The Panel, in recalling its finding in paragraph 5.148 and its statement in paragraph 5.166 above, *finds* that the exposition of the Complainants' case in paragraph 5.167 constitutes a *prima facie* case of circumvention or threat thereof such that Canada can reasonably attempt to discharge its burden under Article 10.3 of establishing that the manner of application of export subsidies does not result in or threaten to lead to circumvention of export subsidy reduction commitment levels.

(b) Canada's case on circumvention

5.169 Canada claims that because it does not provide an export subsidy, it is not circumventing its export subsidy commitments.⁴⁷⁶ For this reason, Canada argues that the issue of circumvention is moot.⁴⁷⁷

(c) Panel's examination of the issue of circumvention

5.170 The Panel recalls that it is for Canada, pursuant to Article 10.3, to establish that export subsidies are not being applied so as to circumvent or threaten to circumvent Canada's export subsidy commitments. We take note of Canada's argument that the issue of circumvention becomes moot because it is not providing either a subsidy or an export subsidy.⁴⁷⁸ However, as we have found at paragraph 5.165 above that Canada is providing export subsidies of a type other than those listed in Article 9.1, we do not consider that the issue of circumvention is moot.

(d) Conclusion on the issue of circumvention

5.171 The Panel recalls its finding in paragraph 5.168 above that the Complainants make a *prima facie* showing of circumvention or threat of circumvention of export subsidy reduction commitment levels.

5.172 In light of our consideration in paragraph 5.170 above and because Canada does not make any further arguments on this issue, the Panel *finds* that Canada has failed to establish that export subsidies are not being applied so as to circumvent or threaten to circumvent Canada's export subsidy commitments.

5.173 We therefore also *find* that the manner of application of export subsidies circumvents or threatens to circumvent Canada's export subsidy commitments, within the meaning of Article 10.1.

4. Conclusion on Article 10.1

5.174 Recalling our findings at paragraphs 5.165 and 5.173 above, we *find* that Canada is applying export subsidies of a type not listed in Article 9.1 in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments, inconsistently with Article 10.1 of the *Agreement on Agriculture*. We emphasize that this finding is made in the alternative, in the event that our finding in paragraph 5.136 above with respect to Article 9.1(c) would be overturned on appeal.

⁴⁷⁴ Paras. 3.165 and 3.168 above.

⁴⁷⁵ Paras. 3.165 and 3.167 – 3.168 above.

⁴⁷⁶ Para. 3.169 above.

⁴⁷⁷ *Ibid.*

⁴⁷⁸ See para. 5.169 above.

5.175 Because we have already found in the previous paragraph that Canada has acted inconsistently with its obligations under Article 10.1, we consider it appropriate to exercise judicial economy with respect to the Parties' additional claims on whether "non-commercial transactions" are used to circumvent export subsidy commitments.

G. WHETHER OR NOT EXPORT SUBSIDIES NOT IN CONFORMITY WITH THE AGREEMENT ON AGRICULTURE AND THE COMMITMENTS SPECIFIED IN CANADA'S SCHEDULE ARE PROVIDED, WITHIN THE MEANING OF ARTICLE 8 OF THE AGREEMENT ON AGRICULTURE

5.176 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(c)) or Article 10.1, Canada has acted inconsistently with its obligations under Article 8.

H. WHETHER OR NOT CANADA PROVIDES PROHIBITED EXPORT SUBSIDIES WITHIN THE MEANING OF ARTICLE 3.1 OF THE SCM AGREEMENT

5.177 The United States claims, in addition, that Canada's measure is an export subsidy within the meaning of Article 3.1 of the *SCM Agreement*. Canada, in contrast, disputes this claim.

5.178 Because the Panel has found that export subsidies exist, within the meaning of Article 9.1(c) or, in the alternative, Article 10.1 of the *Agreement on Agriculture*, we consider we have made findings sufficient to resolve the matter in dispute. Should the Appellate Body, however, not uphold our finding under Article 9.1(c) and our alternate finding under Article 10.1, we deem the factual record to be complete with respect to making a finding under Article 3.1 of the *SCM Agreement*.

VI. CONCLUSIONS AND RECOMMENDATIONS

6.1 In light of the findings contained in Section V above, the Panel *concludes* that Canada, through the CEM scheme and the continued operation of Special Milk Class 5(d), has acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*, by providing export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture* in excess of its quantity commitment levels specified in its Schedule for exports of cheese and "other dairy products". In light of our alternative finding in Section V that Canada has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture*, we conclude that Canada has acted inconsistently with its obligations under Article 8 of the *Agreement on Agriculture*.

6.2 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, the action is considered *prima facie* to constitute a case of nullification or impairment", the Panel *concludes* that – to the extent Canada has acted inconsistently with its obligations under the *Agreement on Agriculture* – it has nullified or impaired benefits accruing to New Zealand and the United States under this Agreement.

6.3 The Panel *recommends* that the Dispute Settlement Body request Canada to bring its dairy products marketing regime into conformity with its obligations in respect of export subsidies under the *Agreement on Agriculture*.

VII. ANNEX

1. Abbreviations used for dispute settlement cases referred to in the report

Short title	Full Title
<i>Brazil – Desiccated Coconut</i>	Report of the panel <i>Brazil – Measures Affecting Desiccated Coconut</i> , WT/DS22/R, adopted 20 March 1997
<i>Brazil – Aircraft</i>	Report of the Appellate Body <i>Brazil – Export Financing Programme for Aircraft</i> , WT/DS46/AB/R, adopted 20 August 1999
<i>Brazil – Aircraft Article 21.5 (I)</i>	Report of the panel <i>Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU</i> , WT/DS46/RW, 9 May 2000
<i>Canada – Aircraft</i>	Report of the Appellate Body <i>Canada – Measures Affecting the Export of Civilian Aircraft</i> , WT/DS70/AB/R, adopted 20 August 1999
<i>Canada – Autos</i>	<i>Canada – Certain Measures Affecting the Automotive Industry</i> , WT/DS139-WT/DS142
<i>Canada – Dairy</i>	Report of the panel <i>Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products</i> , WT/DS103/R, WT/DS113/R, adopted 27 October 1999
<i>Canada – Dairy</i>	Report of the Appellate Body <i>Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products</i> , WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999
<i>Canada – Dairy (Article 21.5 - New Zealand and US)</i>	Report of the panel <i>Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products</i> , recourse to Article 21.5 of the DSU by New Zealand and the United States, WT/DS103/RW, WT/DS113/RW, adopted 18 December 2001
<i>Canada – Dairy (Article 21.5 - New Zealand and US)</i>	Report of the Appellate Body <i>Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products</i> , recourse to Article 21.5 of the DSU by New Zealand and the United States, WT/DS103/AB/RW, WT/DS113/AB/RW, adopted 18 December 2001
<i>Canada – Export Credits</i>	Report of the panel <i>Canada – Export Credits and Loan Guarantees for Regional Aircraft</i> , WT/DS222/R, adopted 19 February 2002
<i>India – Patents</i>	Report of the Appellate Body <i>India – Patent Protection for Pharmaceutical and Agricultural Chemical Products</i> , WT/DS50/AB/R, adopted 16 January 1998
<i>US – Export Restraints</i>	Report of the panel <i>United States – Measures Treating Export Restraints as Subsidies</i> , WT/DS194/R, adopted 23 August 2001
<i>US – FSC</i>	Report of the Appellate Body <i>United States - Tax Treatment of Foreign Sales Corporations</i> , WT/DS108/AB/R, adopted 20 March 2000
<i>United States – FSC Article 21.5</i>	Report of the Appellate Body <i>United States - Tax Treatment for Foreign Sales Corporations recourse to Article 21.5 of the DSU</i> , WT/DS108/AB/RW, adopted 29 January 2002