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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

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,

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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 licensing[9], quota[10] and levy requirements[11] 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 5July 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

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[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)

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* proceeding[21], 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). 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"

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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 Tj 30 5.ts for b

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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" milk[37], 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 3 Tw3o the requireme ent35Tj T* -0.153 Tc 0.590n0w3o t 3.20government's inte1vention i cose

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

(iv) Imputed costs

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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.

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[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 cost[53] 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

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 above[59], 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

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)

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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 decile[73] 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

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[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

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 ex3/RW2

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

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

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 linkages[97]

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.

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[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).

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[118] Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, para. 115.
[119]

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

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

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

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 sycmylms) FAretguateoryfreameworkthat tmre ly enble anthaird prs n foee ly o aakesan dfinanci

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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 above[132], 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*,

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 established Tc 0 listed 5 TD -0.18pb2525 Tgreement"5-iIo Tj -2ercumvc 0.915 Tw (, an25 TD /F1T

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

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

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

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

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".

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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

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.

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*

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

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 s e e t e

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

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 a; anmene 1.1(a)(iv) of302 TD A g r e 7

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 Boj -5re

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

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,

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[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

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]

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[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]

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

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

4.39

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 9.1(c) of the

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]

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[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 operation2

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

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[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 producer[242], 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 resources[244] 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 , in ting ma44es The Complpaym10. , aof 4 s". rel notes tlls the Appellatee total cost of pranel, in

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(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] total 56uon ofand8

agreement that this is the benchmark the Panel should apply[276], none of them having endorsed the criticisms set forth in the European Communities' Third-Party Submission[277], 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

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 try-wce involve 'payments' 366 may ver24te Body Tf -0.10r -0.18dj -292.laer of units of milk ppr

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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

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 farm -0.138fent farm -nts to thda ph Tj 0 -12.75 TD -0.1615 Tce,

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 $66.80[322], 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 output[326], 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 producers[332], 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

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[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.

5.73 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 $31.50[340] 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

indefinite useful life[353], 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 included[356], 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 in time

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

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

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,

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[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*

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

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 c 1.3407 Tw (tW IWe-0. 0.7051s551 r5w ("nem Tjgher0 Twd, Canada has admitted th8it02rota nTc (407as ad

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 providek for the cq1.T

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

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 law[428], 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

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.

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 milk[444]; (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 export[445]; (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.,

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 available[57] 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 element[466], 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

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[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

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.

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[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

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
Brazil – Desiccated Coconut	Report of the panel *Brazil – Measures Affecting Desiccated Coconut*, WT/DS22/R, adopted 20 March 1997
Brazil – Aircraft	Report of the Appellate Body *Brazil – Export Financing Programme for Aircraft*, WT/DS46/AB/R, adopted 20 August 1999
Brazil – Aircraft Article 21.5 (I)	Report of the panel *Brazil - Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, 9 May 2000
Canada – Aircraft	Report of the Appellate Body *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, adopted 20 August 1999
Canada – Autos	*Canada – Certain Measures Affecting the Automotive Industry*, WT/DS139-WT/DS142
Canada – Dairy	Report of the panel *Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/R, WT/DS113/R, adopted 27 October 1999
Canada – Dairy	Report of the Appellate Body *Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999
Canada – Dairy (Article 21.5 - New Zealand and US)	Report of the panel *Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, 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
Canada – Dairy (Article 21.5 - New Zealand and US)	Report of the Appellate Body *Canada Dairy – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, 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
Canada – Export Credits	Report of the panel *Canada – Export Credits and Loan Guarantees for Regional Aircraft*, WT/DS222/R, adopted 19 February 2002
India – Patents	Report of the Appellate Body *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WT/DS50/AB/R, adopted 16 January 1998