Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products - Second Recourse by the United States to Article 21.5 of the DSU

(WT/DS103)

SECOND SUBMISSION OF THE UNITED STATES OF AMERICA

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. LEGAL ANALYSIS 3

A. Burden of Proof 3

B. Canada Continues to Provide Export Subsidies Within the Meaning of Article 9.1(c) of the *Agreement on Agriculture* 3

1. The Processors/Exporters Receive A Payment Within the Meaning of Article 9.1(c) 3

a. The Appellate Body's Standard 4

b. The Costs of Family Labor, Management Services and Capital Are Properly Included in the Cost of Production 5

c. The CDC Methodology Understates the Average Total Cost of Production . 8

d. Canada's Calculation Is Inaccurate and Its Exhibits Are Misleading 9

2. CEM Payments Are "Financed by Virtue of Government Action" 12

C. In the Alternative, the CEM Scheme Contravenes Article 10.1 of the *Agreement on Agriculture* 17

D. The CEM Scheme and Special Milk Class 5(d) Constitute Prohibited Export Subsidies Under Article 3 of the SCM Agreement 22

III. CONCLUSION 24

I. INTRODUCTION

1. In the U.S. first written submission, the United States demonstrated that Canada continues to provide an export subsidy in the form of discounted milk in violation of its obligations under the *Agreement on Agriculture* and the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement"). Canada bears the burden of proof under the *Agreement on Agriculture* and has failed to demonstrate that its CEM scheme is consistent with its WTO obligations. As explained below, Canada either mis-characterizes or ignores the legal standards applicable in this proceeding.

2. According to the Appellate Body, the benchmark for determining the existence of a "payment" under Article 9.1(c) should be determined by comparing the CEM price to the average total cost of production for all of Canada's milk producers. The United States demonstrated in its first submission that the average total cost of production for Canadian milk producers exceeds the average price of CEM milk by a substantial margin. As a result, a "payment" exists under Article 9.1(c).

3. In response, Canada ignores the Appellate Body's instruction to consider the total costs of production for an economic operator. Instead, Canada seeks to apply a cash-basis accounting method by excluding costs that do not require an actual cash outlay, such as family labor, management services and capital. As explained more fully below, the Panel should reject Canada's approach for several reasons including that it fails to measure the true cost of production and is inconsistent with the Appellate Body's standard. The Appellate Body clearly contemplated that all economic costs would be taken into account.

4. Likewise, Canada misinterprets the Appellate Body's statements regarding the second prong of Article 9.1(c). Canada argues that a "payment" is "financed by virtue of governmental

action" only if the producer is obliged or driven to sell milk in the CEM market. Canada continues by arguing that, because the Appellate Body found that producers are not obliged to sell into the export market, the second prong is not satisfied. Yet, despite the opportunity, the Appellate Body drew no such conclusion regarding the fulfillment of the governmental action prong. To the contrary, the Appellate Body stated that the determination must be made on a "case-by-case basis."

5. Here, this is not a case where there are "spill-over benefits" from the domestic supply management system. Canada has made the deliberate choice to exempt export milk from the higher domestic price so that its processors can compete in the world market. Without this government exemption from the high domestic price and exclusion from the domestic market, there would be no low-priced milk for export. This governmental action is indispensable to the transfer of resources from the producers to the processors and satisfies the second prong of Article 9.1(c).

6. Finally, for the reasons explained more fully below, Canada fails to rebut the U.S. alternative argument that its CEM scheme falls within the terms of Article 10.1 of the *Agreement on Agriculture* and in addition provides prohibited export subsidies under Article 3 of the SCM Agreement.

7. Because Canada continues to subsidize exports of dairy products in excess of its reduction commitments under the *Agreement on Agriculture*, the United States respectfully requests that the Panel find that Canada has not implemented the recommendations and rulings of the DSB.

II. LEGAL ANALYSIS

A. Burden of Proof

8. The United States explained in its first submission that, under Article 10.3 of the *Agreement on Agriculture*, Canada bears the burden of proving that it has not subsidized any exports in excess of its reduction commitments. Canada does not contest that it bears this burden. Canada has demonstrably failed to meet this burden, for the reasons set forth below.

B. Canada Continues to Provide Export Subsidies Within the Meaning of Article 9.1(c) of the *Agreement on Agriculture*

9. As noted above, Canada bears the burden of establishing that it is not subsidizing exports of dairy products in excess of its reduction commitment. To do so under Article 9.1(c) of the *Agreement on Agriculture*, Canada must show that 1) there are no "payments" on the export of an agricultural product; or 2) that the payments are not financed by "virtue of governmental action." Canada has failed to establish this.

1. The Processors/Exporters Receive A Payment Within the Meaning of Article 9.1(c)

10. In its recent report in this case, the Appellate Body adopted a new standard for determining whether a "payment" has been made under Article 9.1(c). The Appellate Body concluded that the "average total cost of production" of dairy farmers in Canada is the appropriate benchmark.[1]

[1] *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products, Recourse by the United States and New Zealand to Article 21.5 of the DSU*, WT/DS113/AB/RW, WT/DS103/AB/RW, adopted 18 December 2001(hereinafter Article 21.5 AB Report).

11. Canada agrees that this is the appropriate benchmark but then advocates a calculation of this benchmark which radically departs from the Appellate Body standard. Canada argues that only actual cash outlays are properly taken into account under the new standard. Thus, according to Canada, the cost of family labor, management services and capital should be excluded. Canada also argues that costs associated with the selling of milk (*i.e.* marketing costs) should not be included in the benchmark since they are not directly related to the *production* of milk. Finally, Canada disputes that the CDC's calculation underestimates the cost of production by excluding quota costs and valuing capital at book value rather than market value.

12. As will be discussed below, Canada's cash-basis accounting approach should be rejected because it is neither consistent with the Appellate Body's standard nor founded in economic theory.

a. The Appellate Body's Standard

13. As noted by Canada, the Appellate Body stated that the analysis under Article 9.1(c) must be based on a "standard that focuses upon the motivations of the independent *economic* operator."[2] 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." [3] 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 explained that

> [t]hese fixed and variable costs are the total amount which the producer must spend in order to produce the milk and the total amount it must recoup in the

[2]Article 21.5 AB Report, para. 92.

[3]Id. at para. 87.

long-term to avoid making losses.[4]

14. It is clear from the Appellate Body's statements and reasoning that all economic costs should be taken into account, and not just actual cash outlays as argued by Canada. If an economic operator recoups 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. It is plain from the Appellate Body's explanation that the production of milk involves an "investment of economic resources," and it contemplated that all economic costs would be taken into account.

15. Furthermore, Canada's statement that the Appellate Body "focus[ed] on the cost of production of individual producers and not an industry-wide average" is quite remarkable as it is squarely contradicted by the Appellate Body's explanation of the calculation of the new standard. The Appellate Body explicitly stated that "[t]he 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."[5] Thus, it is clear 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 based upon only the cash outlays of individual producers (broken down into "deciles") and therefore are inconsistent with the Appellate Body's standard.

b. The Costs of Family Labor, Management Services and Capital Are Properly Included in the Cost of Production

16. As the United States explained in its first written submission, every year the Canadian

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[4]Id.

[5]Id. at para. 96.

Dairy Commission ("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. As also previously explained, the methodology used by the CDC corresponds to the standard set forth by the Appellate Body in this case.

17. Canada argues that the CDC's calculation is inappropriate because it is prepared for a different purpose. According to Canada, the fact that the CDC uses the cost information in setting the administered price of milk in Canada somehow renders the costs unsuitable for use under the Appellate Body's standard. However, it is the actual economic cost of production that is being measured in both instances. The fact that the ultimate price set by the Canadian government reflects "government economic and social policy objectives" does not affect the accuracy or relevance of the underlying cost data. Indeed, the Appellate Body recognized that it is the administered *price* that is based "not only on economic considerations but also on other social objectives," not the underlying cost data.[6] Even Canada admonished in its first written submission that "the validity of using the [CDC] data in making cost computations for purposes of these proceedings is not in dispute."[7] Canada simply seeks to exclude certain cost items for the purposes of these proceedings because the cost did not involve a cash outlay. However, fundamental economic theory holds (as well as just basic common sense) that the absence of a cash outlay does not mean that a cost was not actually incurred.

18. Thus, the inclusion of costs for family labor, management services and capital is consistent with the Appellate Body standard and grounded in economic theory. These are costs that are incurred by the producer and if not recouped will result in losses over the long run. This is precisely what the Appellate Body's standard seeks to measure.

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[6]Article 21.5 AB Report, para. 81.

[7]Canada First Submission, para. 46.

19. In economic terms, these costs represent opportunity costs or the costs associated with opportunities that are foregone by not putting the producers' resources to their best use.[8] The producers' resources include family labor, its managerial services and its capital. There is a cost associated with using all of these resources. It is absurd to suggest, as Canada does, that the farm which hires labor and management services is incurring a cost, while the farm that uses family labor and management is making a profit. 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 over the long run.

20. It is important to note that Canada does not dispute the accuracy of the CDC's calculation of the cost of family labor, management and capital, which is relied upon by the United States. Rather, Canada argues that, as a conceptual matter, those costs should not be included. As explained above, the exclusion of these costs would result in a cost of production calculation based upon a cash accounting standard. Canada's proposed standard does not represent the true economic cost of producing milk (which is why the CDC takes such costs into account in setting the administered price of milk) and is not consistent with the Appellate Body report in this case.

21. Canada also makes the argument that, although the CDC includes marketing costs in its calculation of the cost of producing milk, marketing costs should not be included in these proceedings because the Appellate Body used the term cost of *production,* and because marketing costs are identified separately from production costs on financial statements under certain accounting principles.

22. Canada's argument elevates form over substance, and is inconsistent with the purpose of

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

the Appellate Body's inquiry. The Appellate Body set a standard that included all costs an economic operator must recoup in order to avoid incurring losses in the long run. Obviously, the costs incurred by the farmer that must be recouped to avoid going out of business do not stop at the "farm gate." Again, it is simple common sense that marketing costs must be recouped to avoid incurring losses in the long run and therefore must be included in the cost of production calculation in these proceedings. Indeed, Canada even acknowledges that the producer will attempt to recover marketing costs from the sale of milk.[9] In fact, there is no other revenue stream from which to recover these costs or to which these costs should be allocated.

c. The CDC Methodology Understates the Average Total Cost of Production

23. In the U.S. first submission, the United States explained that the CDC methodology understated the total costs of production because it does not include the cost of quota and relies upon the book value of capital instead of the market value in calculating the cost of capital.

24. Canada responds that the costs of quota should not be included because, under certain accounting standards, quota, as an intangible asset, is not required to be amortized. In addition, Canada argues that quota is not related to the cost of production because it is an entitlement to sell.

25. This argument misses the point. Regardless of how quota is treated under accounting principles, it represents an economic cost to farmers that produce for the domestic market - a cost that is usually quite high. Indeed, Canada itself has emphasized that "there is an active commercial market in the trading of quota at privately negotiated rates."[10] For example, for

[9]Canada First Submission, para. 41.

[10] *See* paragraph 54 of the second submission of Canada in the proceedings in the first recourse to Article 21.5 of the DSU.

butter fat, quota can cost as much as CDN $25,000 per kilogram in Quebec and CDN $20,000 per kilogram in Ontario. The Appellate Body determined that the cost of production should be based on all milk production, regardless of the milk's ultimate destination. Accordingly, any and all costs associated with the domestic market, such as quota, should be included in the benchmark. Even Canada admits that this is a cost that producers will seek to recoup from the returns of milk sold in the domestic market.[11]

26. Likewise, Canada's argument regarding the market value of capital misses the point. Regardless of how capital is recorded according to accounting principles, its economic cost is measured by its market value. Thus, the fact that the CDC uses book value to estimate the cost of capital results in an understatement of the cost of production.

27. The fact that the CDC methodology understates the cost of milk production does not mean that the CDC methodology cannot be used in this proceeding. As explained in the U.S. first written submission, even with this understated cost estimate, the average CEM price is below the average total cost of production for dairy farmers in Canada.

d. Canada's Calculation Is Inaccurate and Its Exhibits Are Misleading

28. As explained above, in calculating the cost of production, Canada fails to follow the Appellate Body's mandate. Instead of focusing on the actual economic cost of producing milk, Canada uses a cash-basis accounting approach.

29. Canada also ignores the Appellate Body's instruction that the "payment" is to be measured by the average total cost of production for all milk. Instead, Canada uses a distortive and misleading "decile" method. Canada states that "it is more relevant for the purposes of these

[11] Canada First Written Submission, para. 42.

proceedings to examine a range of total costs of production and not a single average total cost" because the cost of production will vary among individual producers.[12]

30. Yet, the Appellate Body specifically stated that the benchmark in this proceeding should be calculated by "dividing the fixed and variable costs of producing *all* milk, whether destined for the domestic or export markets, by the *total* number of units of milk produced for *both* of these markets."[13] The Appellate Body did not find that the existence of a "payment" under Article 9.1(c) does depends upon whether any given individual producer may or may not happen to recoup its total cost of production.

31. In order to compare its deciles, Canada calculates a "range" of CEM returns from August 2000 to January 2002 based on prices obtained in Quebec, Ontario and Manitoba (Exhibit CDA-13).[14] In exhibit CDA-14, Canada then purports to show that, if the deciles of production costs are compared to the deciles of CEM returns, approximately 75 percent of producers "fall within the range of commercial export returns."

32. However, exhibit 14 is misleading and distortive. This is because the exhibit suggests that the producers with the higher cost of production are obtaining the higher CEM return. Yet, there is no evidence to suggest that the farms in decile 10 of production costs on CDA-9 are obtaining the CEM returns in decile 10 on CDA-13. Canada implicitly recognizes this when it states in footnote 70 that "[t]he production of producers who can cover their cost of production by commercial export milk sales is more than enough to account for total export milk production." In other words, even though CDA-14 insinuates that the high cost producers are matched with the high CEM returns, Canada acknowledges that its conclusion is really based on

[12]Canada First Submission, para. 48.

[13]*Canada - Dairy*, AB Report, para. 96.

[14]The United States notes that Canada further distorts its results by comparing CEM returns for a different time period (August 2000 to January 2002) than that used for the costs of production (August 2000 to July 2001).

the fact that there must be individual producers represented within the range somewhere that are recouping their total cost of production in the CEM "market."

33. As explained above, however, the Appellate Body's standard requires a comparison of the "average total cost of production." Obviously, in crafting this standard, the Appellate Body realized that some producers would recoup their cost of production and some would not.

34. Even using Canada's cost of production calculation (which excludes the several actual costs described above),[15] Canada's exhibit 14 shows that roughly 60 percent of Canadian producers could not cover their costs of production at CDN $30. Furthermore, a review of the information presented on CDA-13 shows that approximately 70 percent of milk sold on the CEM "market" obtains a return of CDN $30 or less.

35. In the end, it seems that Canada would prefer to avoid this whole exercise by arguing that it is too soon to determine whether producers will be able to recoup their costs in the long run because the CEM scheme has been in place for only a short period of time. This argument is illogical and mis-characterizes the Appellate Body report. The Appellate Body did not state that the cost of production must be examined over a long period of time. Rather, in referring to the long run, it was describing the types of costs that must be recouped in order to avoid losses. The point is that if the average total cost of production exceeds the average CEM price, the producer will incur losses over the long run. There is no need to wait and see. The comparison is accomplished now, not at some point in the indefinite future.

36. In order to remain faithful to the Appellate Body's standard and avoid comparing apples

[15]Canada also claims that it has resolved the downward bias in the CDC calculation complained of by the United States and New Zealand by including in its calculations the 30 percent of high-cost producers excluded by the CDC. However, in footnote 61 Canada admits that it has not included the producers whose milk production is less than 60 percent of the annual average in their province, which accounts for 18 percent or almost one-fifth of Canada's total milk production. Because small farms tend to have higher costs of production, the exclusion of these producers further understates the true average total cost of production.

to oranges, the average total cost of production must be compared to the average CEM price. As explained in the U.S. first written submission, the average CEM price for Quebec and Ontario for the dairy year 2000 was approximately CDN $29.[16] For the same time period, the CDC calculated the average total cost of production as CDN $57.27.[17] Even with this understated cost, the average total cost of production exceeded the CEM price by a substantial margin. Hence, applying the test set forth by the Appellate Body, "payments" from producers to processors have occurred under the CEM scheme.

2. CEM Payments Are "Financed by Virtue of Government Action"

37. Canada's response to the U.S. position regarding the second prong of Article 9.1(c) is to mis-characterize or ignore the arguments raised in the U.S. first submission and otherwise misinterpret the Appellate Body's findings.

38. First, contrary to Canada's suggestion, the Unites States is not arguing that payments made by an independent party are financed by virtue of government action "by the mere fact that the government, somehow, regulates some aspects of the industry within which that private party operates."[18]

39. Similarly, Canada mis-characterizes the Appellate Body's findings. The Appellate Body could not have "contemplated and rejected" the position of the United States because the Appellate Body made no findings with regard to whether a payment was "financed by virtue of government action." Furthermore, although the Appellate Body disagreed with the Panel's factual finding that the CEM scheme "oblig[es] producers, at least *de facto*, to sell outside-quota

[16]Exhibit US-3.

[17]Exhibit US-4.

[18] Canada First Submission, para 58.

milk for export," it also acknowledged that "the Panel's reasoning, taken as a whole, was directed towards establishing the demonstrable link between governmental action and the financing of the payments".[19]

40. Like in the first Article 21.5 proceeding, Canada devotes the majority of its first written submission to arguing that producers decide whether to sell milk for the export market and that that decision is based solely upon commercial grounds. Even if that were true, the argument misses the point. The focus in this case must be on the *dairy processor* as it is the processor that is the recipient of the payment. Thus, the relevant question in this case under Article 9.1(c) of the *Agreement on Agriculture* is whether the processor/exporter is receiving a subsidy upon export that is financed by virtue of governmental action.

41. The answer to that question is a categorical "yes." The United States demonstrated in its first submission that it is only through action of the Canadian government (both at the federal and provincial levels) that processors have access to lower-priced milk for export. The primary indicia of this action are the prohibition on producers selling non-quota milk into the domestic market, with appropriate sanctions to support this prohibition, and the exemption of processors for export from the requirement to purchase milk at the high domestic price.[20]

42. It is the enforced segregation of the market that permits exporters to purchase milk for export at discounted prices. By exempting milk for export from the high domestic administered price, Canada has created a separate pool of milk that would not otherwise exist which is available exclusively for dairy processors for export. It is the government exemption of export milk from the high domestic price which finances the payment to processors.

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[19] Article 21.5 AB Report, para 116. In footnote 90, the Appellate Body describes in detail the approach taken by the Panel.

[20] United States First Submission, paras. 35-50.

43. This is not a case where there are "spill-over benefits" from the domestic supply management system. Canada has made the deliberate choice to exempt export milk from the higher domestic price so that its processors can compete in the world market. This exemption is not necessary to maintain the Canadian domestic supply system. Rather, the government has chosen to subsidize its processors in this way in order to help them increase their exports. Without this government exemption, there would be no low-priced milk for export. It constitutes government action which is indispensable to the transfer of resources from the producers to the processors.

44. Whether or not producers are freely choosing to produce milk for export,[21] producers are not freely choosing to finance the payment. The government has made this choice by ensuring that the sale of that milk from the producer to the processor includes a transfer of economic resources to the processors. The transfer is guaranteed by the exemption from the higher administered price for domestic milk. Contrary to Canada's assertion, the United States does not rely upon the "alleged effects" of domestic measures. As explained above, the exemption from the high administered price has nothing to do with maintaining the domestic supply system. In Canada's terms, it is governmental action "focused and directed" to the financing of payments to processors. The "demonstrable link" between the government action and the financing of the payment is crystal clear.

45. The response offered by Canada is that "[t]he measures identified by the Complainants as the governmental action that finances protect a producer's entitlement to the higher domestic price" and that "[t]hey have no relation or any link to any alleged sale by a producer of milk to a

[21] *See* paragraph 117 of the Article 21.5 AB Report and for example paragraph 12 of the U.S. second submission to the panel in the proceedings on the first recourse by the United States to Article 21.5 of the DSU.

processor at below his or her cost of production."[22]

46. However, Canada fails to explains how exempting export milk from the high domestic price protects a producer's entitlement to that high price. The reality is that Canada could manage and control its domestic supply of milk without exempting export milk from the high price. It may mean that Canada's dairy processors are no longer able to export because they cannot compete without subsidization, but the right to maintain and subsidize domestic production does not also provide a right to subsidize export production beyond the applicable reduction commitments. As explained in the U.S. first submission, for example, other Members maintain a domestic supply management system without distinguishing between the price of milk sold domestically and the price of milk sold for export production. Canada could also do this. It has made a choice not to.

47. Canada misinterprets the Appellate Body report when it argues that producers are not obliged or driven to sell into the export market and therefore there is no demonstrable link between the financing of the payment and governmental action. 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 have not needed additional facts to complete that analysis. But it did not so find. In fact, despite its statement regarding the obligation to sell into the export market, the Appellate Body cited with approval the Panel's consideration of the second prong: "we consider that the Panel's reasoning, taken as a whole, was directed towards establishing the demonstrable link between governmental action and the financing of the payments."

48. The fact that producers are not obliged to sell into the export market is irrelevant. There is no basis in the text of Article 9.1(c) for the conclusion that the governmental action prong

[22]Canada First Submission, para. 66.

requires that the government force producers to participate in the subsidy program, or even that the governmental action be "focused or directed towards the financing of the alleged payments," as claimed by Canada. The point is that once farmers do produce over quota milk, they are compelled by government action to transfer economic resources to the processors.

49. Canada's attempt to bolster its position by reference to the context of the SCM Agreement and the object and purpose of the *Agreement on Agriculture* are unpersuasive.

50. With regard to the SCM Agreement, Canada relies upon the term "financial contribution" and the concepts of "entrustment" and "direction" which all appear in Article 1. Yet, none of these terms appear in Article 9.1(c) of the *Agreement on Agriculture*, and therefore offer no contextual guidance to its interpretation. Likewise, the dispute in *United States - Export Restraints* case, cited by Canada, was brought under Article 1.1(a)(1)(iv) of the SCM Agreement, not the Agriculture Agreement, and therefore the report in that dispute provides no support for Canada's position.

51. With regard to the object and purpose of the *Agreement on Agriculture*, in the view of the United States, it is Canada's position that undermines the object and purpose to reduce agricultural support and protection over time. Despite its claims of deregulation, rather than reducing its subsidization of dairy products for export, it continues to increase subsidized exports through its CEM scheme.

52. In sum, Canada's arguments mis-characterize the U.S. position and misstate the Appellate Body report. The United States has demonstrated that Canada has failed to meet its burden of showing that the "payments' are not financed by virtue of governmental action. The evidence is quite clear that only through the exercise of governmental powers do processors receive "payments" when they purchase milk for export production. There is unquestionably a

demonstrable link between governmental action and the financing of the payment.

C. In the Alternative, the CEM Scheme Contravenes Article 10.1 of the *Agreement on Agriculture*

53. In response to the United States' argument that, if the new Canadian export programs are not considered to be export subsidies within the meaning of Article 9.1(c), those schemes should then be found to be export subsidies under Article 10.1, Canada contends that the CEM scheme does not fall within Article 10.1 because it is not a subsidy within the scope of paragraph (d) of the Illustrative List. Specifically, Canada argues that paragraph (d) does not apply because, first, the CEM scheme does not fall within the terms of Article 1.1(a)(1)(iv) and, second, because milk is allegedly available to processors on equally favorable terms and conditions through the Import for Re-Export Program.

54. Canada's arguments are without legal support and should be rejected by the Panel. Because the question in this case is one of export subsidies, as this Panel stated in its original report, it is more appropriate "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." 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.

55. The United States demonstrated in its first written submission that Canada's export measures satisfy the requirements of paragraph (d) of the Illustrative List. As noted in the U.S. first submission, there are several conditions that must be fulfilled to satisfy paragraph (d): (1) the goods must be provided on terms or conditions more favorable than for provision of like or competitive products in the production of goods for domestic consumption; (2) the goods must be used in the production; (3) the provision of goods must be by governments or mandated by

them, either directly or indirectly; and (4) the goods provided to export processors must be available on terms or conditions more favorable than those commercially available to those exporters on world markets.[23]

56. For the reasons discussed above and in the U.S. first written submission, Canada's CEM scheme satisfies each of these elements. First, as explained above, it is undisputed that dairy processors continue to have access to milk for export that is priced on more favorable terms than would otherwise be available to such processors in the domestic market. Second, it is also undisputed that the lower prices are only available for milk used in the production of export products.

57. Third, the lower-priced milk is provided by Canada's "governments or agencies directly or indirectly through government-mandated schemes." Again, as explained above, the provision of lower-priced milk for use in production of export dairy products is made possible only through the processor's government-mandated exemption from paying the higher domestic price for milk if used in the production of export products. Exempting milk for export from the higher price is not necessary to the maintenance of Canada's domestic supply management system. Rather, the Canadian government has made a deliberate choice to enact and enforce this exemption, thereby funneling milk into the CEM "market" in order to subsidize its dairy processors for the purposes of export.

58. Contrary to Canada's suggestion, 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 fulfill the requirements of paragraph (d). In fact, Canada itself agrees with this approach. As noted below, 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

[23] Original Panel Report, para. 7.128

"subsidy" in Article 1 of the SCM Agreement.[24]

59. And, finally, the United States 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 favorable than those available to them from other sources. In response, Canada argues that its export processors can source whole milk powder through the Import for Re–Export Program at terms which are at least as favorable as those obtained for industrial fluid milk through the CEM scheme.

60. First, the United States does not agree that a discretionary permit requirement, no matter how routine its issuance, and an administrative fee constitute "formalities" that do not affect the commercial attractiveness of the IREP option. Such "formalities" are at a minimum an administrative burden that will make IREP purchases less attractive then CEM purchases that require no such steps. Indeed, as mentioned in the U.S. first submission, the fact that the IREP is so infrequently accessed constitutes persuasive evidence that its terms and conditions are less favorable then those available under Canada's export schemes.

61. Second, Canada does not claim that imports of fluid milk constitute a commercially viable alternative to CEM milk. Instead, Canada relies upon imports of whole milk powder. It is simply a fact, however, that there are inherent differences between whole milk powder and fluid milk that processors can obtain in the CEM "market" which have an unfavorable effect on the terms and conditions on which whole milk powder is available. For example, whole milk powder must be re-hydrated for most end-uses which requires additional time and expense.

62. Third, Canada admits but tries to belittle the fact that a tariff rate of 7.5 percent applies to

[24] *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW (9 May 2000), para. 6.42. This is consistent with the text of Article 3.1(a) of the SCM Agreement which provides that subsidies illustrated in Annex I shall be prohibited.

many imports under the IREP.[25] An additional cost in the form of a tariff assessment obviously renders the terms of IREP imports less favorable than CEM milk which does not incur that cost. Further, the IREP would require obtaining duty drawback, an additional factor that renders the conditions of IREP less favorable.

63. Fourth, and perhaps most important, the prices of IREP whole milk powder are less favorable than the prices of CEM fluid milk. As explained in the U.S. comments on Canada's answer to question 10 from the Panel in the first Article 21.5 proceeding, using the conversion factor that the Dairy Farmers of Canada recommends (7.78 liters of milk from one kilogram of whole milk powder) provides a milk equivalent price of $C37.70/hl at the port, which is more than the average price of CEM milk.[26] Moreover, to be properly compared with CEM milk prices, transportation and rehydration charges must be added to the already non-competitive IREP price.

64. Finally, it is the U.S. understanding that whole milk powder is not used in the production of cheese or "other milk products," the two categories of exports at issue here. Rather, whole milk powder is predominately used in the production of confectionary products (*i.e.* candy) in Canada. Thus, the evidence does not support Canada's assertion that Canadian manufacturers of cheese and "other milk products" are accessing whole milk powder imports under the IREP or, even if they were, that the terms are as favorable as under the CEM scheme.

65. Thus, because the CEM scheme satisfies each of the criteria identified in Paragraph (d) of the Illustrative List, the CEM scheme provides export subsidies for purposes of the SCM *Agreement*. As the SCM Agreement is part of the context of the *Agreement on Agriculture*, the fact that the CEM scheme provides subsidies identified in the Illustrative List supports a finding

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

[26] See Exhibit US-34.

that the CEM scheme constitutes an export subsidy under Article 10.1 of the *Agreement on Agriculture*.

66. As explained in the U.S. first submission, an analysis of Article 1.1(a)(2) of the SCM *Agreement* also supports a finding under Article 10.1 of the Agriculture Agreement. Canada's response is that Article 1.1(a)(2) does not apply because it has not been shown that the government has set "target" income or price levels. However, there is no support in the language of that provision for requiring that the government set a "target" price or income level. Article 1.1(a)(2) points instead to "*any form* of income or price support in the sense of Article XVI of GATT 1994." Nor is there any requirement in Article XVI that the government set a "target" price or income level.

67. As explained in the U.S. first submission, Canada provides income and price support to its exporters by exempting milk used in the production of export products from the high domestic price. It is undisputed that Canadian processors could not compete in the export market without the low-price inputs (CEM milk) available to them as a result of this exemption. Thus, although the individual prices of the export contracts are negotiated by the producers and processors themselves, this government exemption from the high domestic price necessarily operates to increase the exports of dairy products from Canada. Without it, the processor would have to purchase its milk for export at the higher domestic price. This is not the "perceived effects of commercial export transactions" as argued by Canada.[27] This is the guaranteed result of the government-mandated price exemption.

68. Second, Canada cannot deny that dairy products produced for export using CEM are priced lower than the same dairy products produced for domestic consumption.

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

69. Finally, Canada does not dispute that there are no restraints on the availability of the export subsidies created by the CEM scheme. Consequently, the export schemes have already resulted in or threaten to lead to the circumvention of Canada's reduction commitment within the meaning of Article 10.1.

70. In response to the U.S. argument regarding "non-commercial transactions" under Article 10.1, Canada argues that CEM transactions are commercial because producers and processors negotiate the specific terms of the contracts themselves and because producers are free to choose not to produce for the export market. This reasoning ignores the fact 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.[28] The only difference is the price of milk, which is a result of government intervention.

71. The United State has demonstrated that the average price of CEM milk does not allow producers to recoup their total average cost of production over the long run. As previously explained, producers engage in these uneconomic CEM transactions because the only other alternatives legally available to them—disposal, or Class 4(m) sales for animal feed—offer even less of a return on their investment. If they produce milk without quota, the Canadian government leaves them no choice but to engage in "non-commercial" sales of this milk in the CEM market. Those sales to export processors, in turn, have resulted in the circumvention (and threaten further, unlimited circumvention) of Canada's export subsidy reduction commitments.

D. The CEM Scheme and Special Milk Class 5(d) Constitute Prohibited Export Subsidies Under Article 3 of the SCM Agreement

72. The United States demonstrated in its first written submission that Canada's CEM

[28] *Canada-Dairy* - Article 21.5 Panel Report, Para. 6.16

scheme as well as the maintenance of Special Milk Class 5(d) constitute prohibited export subsidies under Article 3 of the SCM Agreement.[29] Canada has failed to rebut this showing.

73. In addition to satisfying the particular terms of Article 1.1 of the SCM Agreement, the CEM scheme also satisfies Paragraph (d) of the Illustrative List, as explained in the U.S. first written submission and as further discussed above.

74. With respect to the federal level of Canada's system, the original Panel and the Appellate Body's findings are more than sufficient to demonstrate that the maintenance of Special Class 5(d) is a prohibited export subsidy inconsistent with SCM Agreement Article 3. At paragraph 7.132 of the original panel report, the Panel found that Special Class 5(d) constituted "an export subsidy as listed in Paragraph (d) of the Illustrative List of Export Subsidies annexed to the SCM Agreement." It went on, in the next sentence, to note the "fact" that the scheme involves an export subsidy under the SCM Agreement.

75. Indeed, this Panel need not analyze the particular requirements of Article 1.1 because the CEM scheme falls withing the scope of the Illustrative List of Export Subsidies. Canada itself championed this same approach successfully in another case involving export subsidies. The panel in the original proceedings in the *Brazil - Aircraft* dispute, citing Canada's arguments, noted that:

> Canada submits that a measure that meets the criteria of item (k) [of the Illustrative List] is *ipso facto* an export subsidy and therefore prohibited. In respect of such a measure, it is not necessary for a complainant to establish that the export credit in question is a "subsidy" within the meaning of Article 1, or that it is "contingent on export performance." Rather, a complainant may simply

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

> demonstrate that a government export credit is granted below its cost of funds so as to "secure a material advantage in the field of export credits"; such an export credit would be prohibited.[30]

The panel in the Article 21.5 proceedings in that dispute agreed:

> [I]t would be possible to demonstrate that a measure falls within the scope of an item of the Illustrative List and was thus prohibited without being required to demonstrate that Article 3, and thus Article 1, was satisfied. To borrow a concept from the field of competition law, the Illustrative List could be seen as analogous to a list of *per se* violations.[31]

76. Just as in the *Brazil - Aircraft* dispute, this Panel is confronted with a *per se* violation of SCM Agreement Article 3, 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 favorable 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.

III. CONCLUSION

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

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[30] *Brazil - Export Financing Programme for Aircraft*, WT/DS46/R (14 April 1999), para. 4.58.

[31] *Brazil - Export Financing Programme for Aircraft - Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW (9 May 2000), para. 6.42.

export subsidy within the meaning of the *Agreement on Agriculture.*

78. Accordingly, in light of subsidized exports by Canada that exceed the applicable reduction commitment quantities for cheese and other dairy products, the United States respectfully requests that this 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.

79. The United States requests that the Panel direct Canada to bring its measures for dairy products into conformity with its WTO obligations.

EXHIBIT LIST

Exhibit No.	Exhibit
US-34	Dairy Facts and Figures 1999, 1999/2000, Dairy Farmers of Canada
US-35	Mansfield, Edwin, Microeconomics: Theory and Applications (Fourth Edition, New York: W.W. Norton and Company, 1982), p.178.