BEFORE THE
WORLD TRADE ORGANIZATION
APPELLATE BODY

Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products

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

(AB-2002-6)

APPELLEE'S SUBMISSION OF THE UNITED STATES OF AMERICA

October 18, 2002

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I. INTRODUCTION AND EXECUTIVE SUMMARY

1. In *Canada – Dairy II*,[1] the Appellate Body found that the appropriate benchmark for determining whether a "payment" is made under Article 9.1(c) of the *Agreement on Agriculture* is the "average total cost of production of the milk producers," rather than the domestic, regulated price that the first Article 21.5 panel had relied on. Although the Appellate Body discussed the "financed by virtue of governmental action" prong of Article 9.1(c), it made no finding on that issue.[2]

2. As discussed in detail below, the Panel in the second Article 21.5 proceeding carefully followed the Appellate Body's guidance regarding the analysis for determining whether "payments" are being made under Article 9.1(c) of the *Agreement on Agriculture* and whether such payments are "financed by virtue of governmental action." The Panel found that under Canada's "commercial export milk" ("CEM") program, Canadian milk producers are making "payments" to Canadian dairy processors in the form of milk that is sold for less than the average total cost of production, and that such payments are "financed by virtue of governmental action."[3] In the alternative, the Panel found that through the CEM program Canada is applying export subsidies of a type not listed in Article 9.1 of the *Agreement on Agriculture*, which circumvent or threaten to circumvent Canada's export subsidy commitments, inconsistently with Article 10.1 of the *Agreement on Agriculture*.[4]

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[1] Appellate Body Report on *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* ("*Canada – Dairy II*"), WT/DS103/AB/R and WT/DS113/AB/R, adopted December 18, 2001, para. 104.

[2] *Id.*, paras. 111 - 118.

[3] Panel Report on *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* ("*Second Article 21.5 Panel Report*"), WT/DS103/RW2 and WT/DS113/RW2, July 26, 2002, paras. 5.89 and 5.135. In this submission, references to the "Panel" mean the panel acting under the second recourse to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes*.

[4] *Id.*, para. 5.174.

3. Canada appeals several aspects of the Panel's report. First, Canada contends that the Panel misapplied Article 10.3 of the *Agreement on Agriculture*. Second, Canada claims that the Panel erroneously concluded that Canadian dairy producers are making "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture* to Canadian dairy processors. Third, Canada asserts that the Panel erroneously concluded that such "payments" are "financed by virtue of governmental action" within the meaning of Article 9.1(c). Fourth, Canada claims that the Panel erred in finding, in the alternative, that Canada is providing export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*.

4. The Panel's findings should be upheld. The Panel's application of Article 10.3 of the *Agreement on Agriculture* did not result in any reversible error. Consistent with prior Appellate Body and panel reports in this dispute, the Panel correctly required Canada to establish that it has not granted export subsidies on cheese and other milk products in excess of its export subsidy reduction commitments. The Panel carefully examined Canada's evidence and arguments on the issues and properly found that Canada had failed to meet its burden.

5. The Panel correctly found that Canadian dairy producers are making "payments" to Canadian dairy processors within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. Consistent with the Appellate Body's report in *Canada – Dairy II*, the Panel properly rejected Canada's narrow, cash-basis accounting approach to the average total cost of production benchmark and, instead, properly concluded that *all* economic costs should be included. Such costs include (i) imputed costs for family labor and management services and return on equity; (ii) marketing, transportation, and administrative costs; and (iii) the costs of production quota. The Panel correctly concluded that an industry-wide, average total cost of production benchmark,

based on Canada's own annual cost of production survey, is a reasonable, although understated, benchmark.

6. The Panel was correct in rejecting Canada's claim that its individual producer cost of production data established that payments are not being made. Canada provided no evidence showing that the surveyed producers actually participated in the CEM market, let alone any evidence matching the costs of production of such producers and the prices they obtained in the CEM market. In effect, Canada asked the Panel to *assume* that only those Canadian producers with costs of production less than CEM prices participated in the CEM market and that each of those producers' sales of CEM milk was at a price above that individual producer's average total cost of production. The Panel properly refused simply to make such an assumption.

7. The Panel properly concluded that the Canadian dairy producers' payments to Canadian dairy processors are "financed by virtue of governmental action" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. The Panel correctly rejected Canada's attempt to restate the "financed by virtue of governmental action" requirement in terms of whether Canadian producers are "obliged or driven" to produce milk for the CEM market. Such an inquiry is not based on the text of Article 9.1(c) and, in any event, is not relevant, since the appropriate question under Article 9.1(c) is whether, once the milk is produced, the dairy processor/exporter is receiving a subsidy upon export of the resulting dairy product that is financed by virtue of governmental action.

8. The Panel correctly found that several factors – the exemption of export processors from having to pay the domestic, regulated price, the prohibition on the diversion of CEM into the domestic market, the government's regulation of the domestic price and supply of milk, and the

pre-commitment requirements – supported its conclusion that the payments are financed by virtue of governmental action. The Panel did not need to conduct an examination of Article 1.1 of the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement") before reaching its conclusion.

9. The Panel correctly concluded, in the alternative, that Canada is providing export subsidies under Article 10.1 of the *Agreement on Agriculture*. The Panel properly found that it was appropriate to examine Article 3.1(a) of the SCM Agreement and paragraph (d) of the Illustrative List of Export Subsidies in Annex I to the SCM Agreement as contextual guidance in evaluating whether Canada is providing export subsidies within the meaning of Article 10.1. Consistent with prior WTO jurisprudence, the Panel correctly found that it did not need to examine the general definition of the term "subsidy" in Article 1.1 of the SCM Agreement in applying the phrase "indirectly through government-mandated schemes" contained in paragraph (d) of the Illustrative List.

10. The Panel correctly found that the government-mandated exemption of export processors from paying the domestic, regulated price, as well as the enforced prohibition on the diversion of CEM milk into the domestic market, ensure that milk for processing into exported dairy products is sold at more favorable terms than milk sold for processing into domestic products. The Panel also correctly found – in light of the lower price of fluid milk under the CEM program, tariffs on imported whole milk powder, and other relevant factors – that dairy processors obtain fluid milk under the CEM program on more favorable terms than whole milk powder under Canada's re-export program. Thus, the Panel correctly concluded that the CEM program provides an export subsidy within the meaning of paragraph (d) of the Illustrative List.

11. Thus, as the United States will demonstrate in greater detail below, Canada's appeal is not well founded and the Panel's findings should be affirmed.

II. ARGUMENT

A. The Panel's Application of Article 10.3 of the *Agreement on Agriculture* Did Not Result in Reversible Error

12. Article 10.3 of the *Agreement on Agriculture* provides that a Member claiming that it has not subsidized any quantity of an agricultural product exported in excess of its reduction commitments "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."

13. In prior phases of this dispute, the panel and the Appellate Body have concluded that as a consequence of this provision, "the burden of proof is on Canada."[5]

14. This Panel found that Canada's exports of cheese and other milk products exceeded Canada's commitment levels in marketing year 2000-01 and were likely to exceed its commitment levels in marketing year 2001-02.[6] Having made this finding, the Panel appropriately placed the burden on Canada to establish that it did not subsidize these exports.

15. In addition, however, the Panel stated that before it would examine whether Canada had met its burden, it would examine whether Complainants had made a *prima facie* showing that the elements of the alleged export subsidies were present.[7] Canada makes much of the Panel's decision to scrutinize the Complainants' claims in this manner, arguing that the Panel revised the burden of proof from what it had applied in the prior Article 21.5 proceeding.[8] Canada overlooks

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[5] *Canada – Dairy II*, para. 98.
[6] *Second Article 21.5 Panel Report*, para. 5.17.
[7] *Id.*, para. 5.18.
[8] Canada's Appellant Submission (Oct. 3, 2002), paras. 30 - 31.

the obvious fact that the Panel's approach could only serve to benefit Canada, since the Panel engaged in an initial scrutiny of the Complainants' claims that is not strictly required under Article 10.3. The United States cannot help but note the irony. If anyone would be in a position to appeal this additional step by the Panel, it would be one of the complaining parties, not Canada. And this additional step did not change the outcome of the Panel's analysis and did not result in reversible error in the Panel's conclusions that Canada's measures are inconsistent with the *Agreement on Agriculture*.

16. Canada also claims that under Article 10.3 its obligation was to establish a rebuttable presumption that it did not subsidize its excess cheese and dairy product exports, and that it had presented more than sufficient evidence to raise such a rebuttable presumption.[9] However, Canada's self-evaluation of the merits of its case is obviously at odds with the Panel's conclusions. The reality is that the Panel (i) correctly required Canada to establish that no export subsidies have been granted on its excess cheese and other milk products exports; (ii) carefully examined Canada's evidence and arguments on each issue; and (iii) concluded that Canada had failed to meet its burden. While Canada obviously takes issue with this ultimate conclusion, there is no basis to find fault with the Panel's application of Article 10.3.

B. The Panel Properly Concluded that Canada Is Providing Export Subsidies Within the Meaning of Article 9.1(c) of the *Agreement on Agriculture*

17. Article 9.1(c) of the *Agreement on Agriculture* provides, in relevant part:

> 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 ....

[9] *Id.*, para. 33.

Thus, to prevail under Article 9.1(c), Canada must show either that (i) there are no "payments" on the export of the agricultural products in question, or (ii) that any such payments are not "financed by virtue of governmental action." The Panel concluded that Canada failed to establish either prong of Article 9.1(c) and, therefore, Canada is providing export subsidies within the meaning of that Article. Canada's challenges to the Panel's conclusions are groundless.

1. The Panel Properly Concluded That Canadian Milk Producers Are Making "Payments" To Canadian Dairy Processors

18. In *Canada – Dairy II*, the Appellate Body concluded that "the determination of whether 'payments' are involved requires a comparison between the price actually charged by the provider of the goods or services – the prices of CEM in this case – and some objective standard or benchmark which reflects the proper value of the goods or services to their provider – the milk producer in this case."[10] For purposes of this dispute, the Appellate Body concluded 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*."[11] The Appellate Body instructed that the 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."[12]

19. Before the Panel, the parties disagreed over whether the average total cost of production standard should be determined on an industry-wide basis, as the Complainants argued, or on the

[10] *Canada – Dairy II*, para. 74.
[11] *Id.*, para. 96.
[12] *Id.*

basis of individual producer data, as Canada argued.

20. The Complainants argued that existing Canadian government data provided a reasonable, albeit understated, benchmark for the average total cost of production for the Canadian milk producers. Specifically, the Canadian Dairy Commission ("CDC") each year collects data from provincial surveys on the costs of production. The CDC uses this data to set the domestic price. The CDC annually estimates the costs of milk production based on a sample of dairy producers that are intended to represent the performance of an efficient segment of the Canadian industry. The CDC includes in its cost of production analysis cash costs (*e.g.*, feed, labor), capital costs (*e.g.*, debt, asset depreciation), as well as certain "imputed" costs and marketing, transportation, and administrative costs at issue in this appeal.

21. The Complainants pointed out that the CDC data is in fact understated, since the CDC excludes (i) the 30 percent of farms with the highest costs of production; (ii) small farms (those with production that is less than 60 percent of the average provincial production); and (iii) the cost of production quota.[13]

22. The Panel carefully considered both viewpoints. It concluded that it need not make a definitive finding as between an industry-wide and an individual producer approach, since it found that under either approach Canada had failed to establish that payments are not being made.[14]

23. Nevertheless, the Panel did conclude that the Appellate Body's test "seems to be consistent with an industry-wide approach"[15] and that the CDC data provided a "reasonably

[13] *Second Article 21.5 Panel Report*, para. 5.31.
[14] *Id.*, para. 5.90.
[15] *Id.*, para. 5.47.

accurate and objective measure of costs of production of Canadian dairy producers."[16]

24. In particular, the Panel found that the CDC cost of production data (which the United States would again note is itself a conservative sampling) showed that the average cost of production of the Canadian dairy industry was $57.27 in 2000 and was estimated to be $58.12 in 2001.[17] In contrast, the Panel found that the average CEM price was approximately $29 in 2000 and approximately $31.50 in 2001.[18] The Panel found that these facts provide a "strong indication that, on average, payments are being made."[19]

25. Canada challenges (i) the Panel's conclusion that an industry-wide analysis is consistent with the Appellate Body's average total cost of production test; (ii) the nature of the evidence that the Panel concluded that Canada must show to support its individual producer analysis, if such an approach were used; and (iii) the Panel's conclusion that all economic costs, including imputed costs should be included in the average total cost of production.[20] Canada's appeal on these issues should be rejected.

a. The Panel Correctly Found that an Industry-Wide Average Cost of Production is Consistent with the Appellate Body's Benchmark

26. Canada claims that the Panel erred in its conclusion that an industry-wide cost of production analysis was consistent with the Appellate Body's benchmark.[21]

27. Specifically, Canada argues that there is no support in the Appellate Body's report for an

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[16] *Id.*, para. 5.71.
[17] *Id.*, para. 5.73.
[18] *Id.*, para. 5.74.
[19] *Id.*
[20] Canada's Appellant Submission, para. 36.
[21] *Id.*, para. 38.

industry-wide approach.[22] There is no basis for this argument. The Panel carefully considered the Appellate Body's guidance on the nature of the benchmark.[23] In particular, the Panel correctly concluded that the Appellate Body's direction that the "cost of producing *all* milk should be divided by the *total number of units* of milk,"[24] in the absence of any explicit instruction to make this calculation on the basis of individual producers, supported the conclusion that the Appellate Body did not intend "a calculation for each *individual* producer."[25]

28. Nor is there any basis for Canada's claim that the Panel failed to take into account relevant statements of the Appellate Body.[26] The Panel carefully considered the parties' opposing views of the Appellate Body report and the statements on which those views were based.[27] Notwithstanding Canada's selective quotations from the Appellate Body report, the Panel properly concluded that it was "not persuaded by Canada's suggestion that we should imply that the Appellate Body intended a calculation for each *individual* producer."[28]

29. Moreover, the Panel correctly recognized that an individual producer cost of production benchmark was unworkable. The Panel noted that governments rarely have the sort of detailed, producer-specific information that such a test would require.[29] Indeed, as discussed below, Canada itself was unable to supply the necessary data regarding individual producer participation in the CEM market to support its claim that no payments were being made.[30] The Panel also

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[22] *Id.*
[23] *Second Article 21.5 Panel Report*, paras. 5.41 - 5.51.
[24] *Id.*, para. 5.48.
[25] *Id.*, para. 5.49.
[26] Canada's Appellant Submission, para. 40.
[27] *Second Article 21.5 Panel Report*, para. 5.47.
[28] *Id.*, para. 5.49.
[29] *Id.*, para. 5.67.
[30] *Id.*, para. 5.64.

correctly pointed out that the extensive amount of information that an individual producer approach would require would make it very difficult for WTO Members to know whether they are meeting their export subsidy commitments.[31]

30. While Canada claimed that an industry-wide measure of the average cost of production would make it difficult for Members to monitor and notify their export subsidies, the Panel rightly concluded that Canada's interpretation of the average total cost of production benchmark would make that task even more difficult.[32] Again, since Canada bears the burden of proof, it is ironic that Canada is arguing for a standard (individual producer cost of production) that Canada admits it cannot meet, while the complaining parties have argued for a standard that would not be as difficult for Canada to meet.

31. In sum, the Panel's reliance on the CDC's average total cost of production data as a "sufficient, albeit conservative, approximation of the average total cost of production of the Canadian dairy industry"[33] is consistent with the Appellate Body's instruction to use an average total cost of production benchmark in this case.

b. The Panel Correctly Found that Canada's Individual Producer Data Does Not Establish the Absence of Payments from Canadian Dairy Producers to Processors

32. Canada presented to the Panel cost of production data for 274 producers. The data was derived from CDC sampling data. However, Canada deducted certain imputed costs, including those relating to family labor and management and owner's equity, and marketing, transportation, and administrative costs from the CDC data. On the basis of this (in the Complainants' and the

[31] *Id.*, para. 5.68.
[32] *Id.*, para. 5.69.
[33] *Id.*, para. 5.85.

Panel's view, understated) cost data, Canada claimed that 77 percent of Canadian dairy producers had costs of production within the range of CEM returns.[34]

33. The Panel carefully considered, but rejected, Canada's claim that this data established that payments were not being made. On appeal, Canada claims that the Panel placed an impossible burden on it.[35] Canada's claim should be dismissed.

34. The Panel recognized that the logical extension of Canada's proposed individual producer cost of production test is that Canada must provide evidence correlating individual producer costs of production with sales by those producers in the CEM market. However, Canada failed to provide any such evidence. Consequently, in effect, Canada asked the Panel to *assume* that only those producers with costs of production below the CEM price participated in the CEM market and that each of those producers' sales of CEM milk was at a price above that individual producer's average total cost of production. As the Panel stated, such an assumption would "obviate any examination pursuant to the Appellate Body's benchmark of whether sales below the average total cost of production are being made."[36]

35. Likewise, the Panel correctly concluded that while Canada admitted that 23 percent of the producers had costs of production in excess of the highest CEM price, Canada provided no data on which the Panel could conclude that none of those producers participated in the CEM market.[37]

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[34] *Id.*, paras. 5.55 - 5.57.

[35] Canada's Appellant Submission, para. 47.

[36] *Second Article 21.5 Panel Report*, para. 5.63.

[37] *Id.*, paras. 5.63 - 5.64. *See also* Canada's Response to Questions 53 and 59 from the Panel (May 1, 2002), paras. 11 and 20, in which Canada admitted it has no information on whether any of the 274 producers in its survey participated in the CEM market.

36. Moreover, Canada's 77 percent figure is highly misleading. Apart from the fact that it is based on Canada's understated cost of production data, this figure is derived from comparing the individual company cost of production data to the *single highest* CEM return ($37.02) among the 785 CEM contracts included in Canada's data, rather than to the average CEM price of approximately $29 - $31 at which most CEM sales were made. The same exhibit on which Canada bases its 77 percent figure shows that, even using Canada's understated cost of production data, only 40 percent of the producers had costs of production under $30.[38] Moreover, Canada's data indicates that approximately 70 percent of the milk sold on the CEM market obtained a return of $30 or less.[39]

37. Thus, there is no basis for Canada's claim that the Panel imposed an excessive burden. Canada cannot claim that an individual producer cost of production analysis is the appropriate way to apply the average total cost of production test, but at the same time fail to provide any evidence on whether the individual producers have participated in the CEM market and evidence that each of those producers' sales of CEM milk was at a price above that individual producer's average total cost of production.

c. The Panel Properly Concluded That All Economic Costs Should Be Included in the Cost of Production Benchmark

38. As it did before the Panel, Canada seeks to rely on narrow accounting concepts in support of its argument that (i) imputed costs relating to family labor, family management, and owner's equity, (ii) marketing, transportation, and certain administrative costs, and (iii) costs of

[38] *See* Exhibit CDA-14.
[39] *See* Exhibit CDA-13; Second Submission of the United States to the Panel (April 8, 2002), para. 34.

production quota should not be included in the calculation of the average total cost of production.[40]

39. The Panel properly rejected Canada's position on the ground that the Appellate Body had endorsed a "broad interpretation" of the cost of production test.[41] Specifically, the Panel noted that the Appellate Body had indicated that all fixed and variable costs should be included in the average total cost of production, "thus suggesting that there is no reason *a priori* to use only cash-based accounting methods."[42]

i. Imputed Costs

40. With respect to imputed costs, the Panel correctly recognized that these are "real costs" that a producer must recoup in order to stay in business over time.[43] 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. The producers' resources include family labor, its managerial services, and its capital. There is a cost associated with using all of these resources. For example, if a farmer foregoes the opportunity to earn cash wages off the farm in order to contribute his labor to the farm's production, the value of his labor is properly counted as an economic cost to the farm even though the farmer does not pay cash wages to himself. Likewise, it makes no sense 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.

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[40] Canada's Appellant Submission, paras. 53 - 66.
[41] *Second Article 21.5 Panel Report*, para. 5.84.
[42] *Id.*, para. 5.80.
[43] *Id.*, para. 5.85.

41. Canada's argument that any determination of the proper amount for imputed returns to family labor, management, and owner's equity is "inherently speculative and subjective"[44] is surprising in light of the fact that the CDC calculates these costs annually and includes them in its cost of production survey. Nor is there any merit in Canada's complaint that using the CDC figure is another way to introduce the benchmark that the Appellate Body rejected.[45] According to Canada, the fact that the CDC uses the cost information in setting the domestic, regulated 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 Panel correctly observed that the fact that Canada uses this data to establish the domestic, regulated price "does not detract from the validity of the data."[46] 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.[47]

ii. Marketing, Transportation, and Administrative Costs

42. Likewise, the Panel correctly concluded that there is no basis to exclude the marketing, transportation, and administrative costs included in the CDC cost of production data. While not strictly speaking "production" costs, the Panel properly concluded that these are also "real costs" that producers must recoup if they are to remain in business over time. Canada's argument elevates form over substance and is inconsistent with the purpose of the Appellate Body's benchmark. The Appellate Body set a benchmark that included all costs an economic operator

[44]Canada's Appellant Submission, para. 56.
[45]*Id.*, para. 58.
[46]*Second Article 21.5 Panel Report*, para. 5.71.
[47]*Canada – Dairy II*, para. 81.

must recoup in order to avoid incurring losses in the long run. The costs incurred by the farmer that must be recouped to avoid going out of business do not stop at the "farm gate."[48]

iii. Cost of Quota

43. Regarding quota, the Panel correctly concluded that the cost of obtaining a production quota represents a real cost that a producer will incur in the production of milk, regardless of its treatment under accounting principles.[49] Indeed, the record reflects that there is an active commercial market in the trading of quota, making it readily possible to establish the price, or cost, of holding quota.[50] The Appellate Body explained 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.

44. Moreover, Canada mis-characterizes the Appellate Body's test when it argues that because a minuscule number of Canadian producers do not hold quota, the costs associated with the acquisition of quota are "not a cost of production of *all* milk."[51] There is nothing in the Appellate Body's report that supports such a tortured reading of the Appellate Body's test.

45. In sum, the Panel properly rejected Canada's extremely narrow reading of the Appellate Body's average total cost of production test and correctly concluded that all relevant economic costs should be included in the average total cost of production.

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[48]The Panel also correctly noted the inconsistency in Canada's argument that imputed costs and marketing, transportation, and administrative costs should not be included in the average total cost of production, given the fact that the CDC includes these costs when determining the average cost of production for purposes of establishing the domestic price for milk. *Second Article 21.5 Panel Report*, para. 5.83.

[49]*Second Article 21.5 Panel Report*., para. 5.84.

[50]*See* Second Submission of the United States to the Panel, para. 25.

[51]Canada's Appellant Submission, para. 65.

2. The Panel Properly Concluded that the Canadian Dairy Producers' Payments to Dairy Processors Are Financed by Virtue of Governmental Action

46. As discussed below, the Panel carefully reconsidered whether the payments that Canadian dairy producers are making to dairy processors are "financed by virtue of governmental action" in light of the extensive guidance that the Appellate Body provided on the meaning of this phrase in *Canada – Dairy II*. The Panel concluded that several factors – the exemption of export processors from having to pay the domestic, regulated price, the prohibition on the diversion of CEM milk into the domestic market, the government's regulation of the domestic price and supply of milk, and the pre-commitment requirements (including the "first-out-of-the-tank" requirement) – supported its conclusion that the payments are financed by virtue of governmental action.[52]

47. Canada claims that the Panel (i) did not properly interpret and apply the Appellate Body's guidance on this issue; (ii) did not examine contextual guidance provided by the SCM Agreement; and (iii) adopted a test for governmental action that is inconsistent with the object and purpose of the *Agreement on Agriculture*.[53] These objections are without merit.

a. The Panel Properly Considered and Applied the Appellate Body's Guidance

48. Canada's first point appears to be that the Appellate Body has "already ruled" on the governmental action prong of Article 9.1(c), such that there was no room for additional analysis from the Panel.[54] This contention is groundless. The Appellate Body specifically did not make a

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[52] *Second Article 21.5 Panel Report*, para. 5.134.
[53] Canada's Appellant Submission, para. 71.
[54] *Id.*, para. 73.

finding on the governmental action prong in light of its finding regarding "payments"[55] under the first prong of Article 9.1(c), although it did observe approvingly 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."[56]

49. Moreover, it is Canada that misconstrues the Appellate Body's guidance, not the Panel. Canada repeatedly refers to the Appellate Body's prior statement that Canadian producers are not "obliged or driven"[57] to produce and sell commercial export milk and argues that the Appellate Body (and Article 9.1(c)) require such a finding to satisfy the governmental action prong.[58] Elsewhere, Canada claims that there must be a "clear and evident" showing of a linkage between the government action and the financing of the payments.[59] Both are Canada's invention; neither is an actual requirement for a finding under Article 9.1(c).

50. While it is true that the Appellate Body disagreed with the first Article 21.5 panel's characterization that Canadian governmental measures oblige or drive Canadian producers to produce additional milk for export sale, the Appellate Body did not conclude (as Canada appears to believe) that Article 9.1(c) requires a showing that producers are "obliged or driven" to produce additional milk for export.[60] Indeed, if a conclusion that producers are not obliged to sell into the export market were determinative of the governmental action prong of Article 9.1(c), the Appellate Body could have simply found that this prong was not satisfied as it would have

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[55] *Canada – Dairy II*, para. 118.
[56] *Id.*, para. 116.
[57] *Id.*, para. 117.
[58] Canada's Appellant Submission, paras. 73, 83, 93, 95, and 100.
[59] *Id.*, paras. 98 - 99.
[60] *Id.*, para. 117.

needed no additional facts to complete that analysis. And, whether or not it is true that producers are not obliged or driven to produce milk for the export market, that argument misses the point. The question is not whether the milk is required to be produced – this dispute is not about production subsidies but about export subsidies. The question is what happens to the milk *after* it is produced. Specifically, the relevant issue 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.

51. The Appellate Body has explained that the phrase "financed by virtue of governmental action" in Article 9.1(c) requires a "demonstrable link"[61] between the governmental action and the financing of the payments. That is the analysis that the Panel carefully engaged in. Canada should not complain because the Panel applied Article 9.1(c) in a manner consistent with the Appellate Body's guidance, rather than on the basis of some other test that Canada would prefer.

52. Canada also misconstrues the Panel report when it argues that the Panel merely required a showing that payments are "'made' or 'made possible.'"[62] When considered in their context, it is clear that the Panel's statements were intended to explain the connection between governmental action and the "financing" of the payments. In particular, the Panel's comments were in response to Canada's argument that the governmental action must "oblige or drive" producers to produce milk for the CEM market to satisfy the Appellate Body's test.[63]

53. The Appellate Body explained that relevant governmental action could include the regulation of the supply and price of milk in the domestic market and that an appropriate analysis

[61]The phrase "demonstrable link" is not part of the text of Article 9.1(c).
[62]Canada's Appellant Submission, para. 78.
[63]*Second Article 21.5 Panel Report*, para. 5.119.

under the government action prong must take into account the effect of governmental action on payments made by a third person.[64] In light of this guidance, the Panel correctly concluded that it was not necessary to find that producers are "obliged or driven" to produce CEM milk. Rather, the Panel concluded that the "financing" aspect of the governmental action prong would be satisfied "if governmental action makes possible sales into the CEM market which would otherwise be made at a loss, i.e., not allowing for recovery of fixed and variable costs."[65]

54. Accordingly, the Panel observed that a profit-maximizing milk producer will consider the extent to which the high, regulated price of domestic milk allows it to make additional sales in the CEM market while still covering its marginal costs. The Panel found that a "strong nexus" between the governmental action and the financing of the payments would exist "[t]o 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."[66] Contrary to Canada's argument, the Panel's conclusions are fully consistent with the Appellate Body's analysis. Indeed, the Appellate Body stated that a producer may use "highly profitable sales of the product in another market" to finance sales made at prices that only cover marginal costs of production.[67]

b. Canada's Policies of Exemption and Prohibition on Diversion Support the Panel's Finding

55. The Panel recalled that in its first Article 21.5 report, it had focused on the federal and provincial governmental actions that (i) exempted export processors from the requirement to

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[64] *Id.*, para. 5.121 (citing *Canada – Dairy II*, paras. 112 and 115).
[65] *Id.*, para. 5.121.
[66] *Id.*, para. 5.125.
[67] *Canada – Dairy II*, para. 94.

purchase milk at the domestic, regulated price, and (ii) prohibited the diversion of dairy products made with CEM into the domestic market.[68] In light of the Appellate Body's support[69] for its earlier reasoning, the Panel concluded that it would begin its analysis with a discussion of these same elements of governmental action, while taking into account the Appellate Body's guidance on this aspect of Article 9.1(c).[70] The Panel noted that as a result of these governmental actions, the CEM market is the "only viable option to transact outside the regulatory framework of price floors and quota ceilings."[71]

56. The Panel explained that these policies have the effect of taking away from the producer its first-best option, *i.e.*, selling milk at the high, domestic price.[72] Conversely, these policies put the dairy processor in a strong position to negotiate low prices for CEM milk, especially given the very low, regulated price for the only other category of non-quota milk (Class 4(m) animal feed).[73] The Panel correctly reasoned that as a result of these policies, and the regulation of the Class 4(m) price, Canadian governmental action "ensures that the bulk of non-quota milk will be channelled into the CEM market."[74]

57. Canada again attempts to dismiss the Panel's analysis on the ground that the Appellate Body already considered these factors and concluded that they did not oblige or drive producers to produce and sell CEM milk.[75] As discussed above, whether governmental action "obliges or

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[68] *Second Article 21.5 Panel Report*, para. 5.110.
[69] *Canada – Dairy II*, para. 116.
[70] *Second Article 21.5 Panel Report*, para. 5.111.
[71] *Id.*, para. 5.110.
[72] *Id.*, para. 5.123.
[73] *Id.*, para. 5.116.
[74] *Id.*, para. 5.124.
[75] Canada's Appellant Submission, para. 83.

drives" producers to produce and sell CEM milk is not the test set forth in the Appellate Body's report. Moreover, the Appellate Body agreed that the Panel's prior analysis of these factors properly "was directed towards establishing the demonstrable link between governmental action and the financing of the payments."[76] Nothing in Canada's argument undermines the fact that these governmental actions support the Panel's conclusion on the governmental action prong of Article 9.1(c).

c. Canada's Pre-Commitment Policies Support the Panel's Finding

58. Canada's complaints regarding the Panel's analysis of the provincial pre-commitment requirements are equally groundless.[77]

59. Provincial pre-commitment policies require producers, if they want to be able to sell into the CEM market, to "pre-commit" to sell a quantity of CEM and, once pre-committed, that milk must be "first-out-of-the-tank."[78] The Panel correctly recognized that because of the high domestic price, producers will want to fill the entire amount of their quota and, therefore, are likely to plan to overproduce to ensure full utilization of the quota. Moreover, given the low, government-regulated price for Class 4(m) animal feed milk (the only other option for selling non-quota milk), the pre-commitment policies create an additional incentive to dedicate a larger quantity of milk to the CEM market than would otherwise be the case.[79] Thus, contrary to Canada's claim, the pre-commitment policies support the Panel's finding of a "demonstrable link" between the government action and the financing of the in-kind payments from producers

[76] *Canada – Dairy II*, para. 116.
[77] Canada's Appellant Submission, paras. 88 - 89.
[78] *Second Article 21.5 Panel Report*, para. 5.112.
[79] *Id.*, para. 5.130.

to processors.

d. Canada's Regulation of the Domestic Supply and Price of Milk Supports the Panel's Finding

60. Canada mis-characterizes the Panel's analysis of Canada's regulation of the domestic supply and price of milk. Canada makes much of the Panel's use of the term "cross-subsidization" as if the Panel were attempting to describe some new form of subsidization in a technical sense or to impose a new WTO obligation. Canada claims, for example, that "cross-subsidization" is an "open-ended notion" that is "foreign" to the WTO, and one that the Members would have negotiated if they had intended such disciplines.[80]

61. The Panel did not create some new form of subsidization or new WTO obligation, as Canada suggests. Rather, the Panel used the term as a convenient shorthand expression for its analysis of governmental action in the form of the regulation of the domestic price and supply of milk. In this regard, the Panel carefully followed the Appellate Body's guidance. The Appellate Body stated that relevant governmental action may include "regulating the supply and price of milk in the domestic market."[81] It noted that it was appropriate to consider what "effects" the governmental action had "on payments made by a third person."[82] Furthermore, the Appellate Body recognized that a producer may use "highly profitable sales of the product in another market" to "finance[]" sales made at prices that only cover marginal costs.[83]

62. This is exactly the analysis that the Panel engaged in. The Panel carefully considered the extent to which the domestic, regulated price allowed producers to participate in CEM sales,

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[80] Canada's Appellant Submission, paras. 91 - 92.
[81] *Canada – Dairy II*, para. 112.
[82] *Id.*, para. 115.
[83] *Id.*, para. 94.

while at least covering their marginal costs of production.[84] The Panel concluded that when all economic costs are taken into account, the Canadian producers are unable to cover their fixed and variable costs in the CEM market.[85] Thus, the Panel concluded that the governmental regulation of the price and supply of domestic milk, through which producers are able to cover their fixed and variable costs of production, caused "significant effects on payments made by third persons," in that it allowed domestic producers to make sales in the CEM market that they otherwise would not make or that would constitute sales at a loss.[86]

63. Canada goes too far when it asserts that the Panel's analysis of the regulation of the domestic price and supply of milk contradicts the Panel's analysis of the payments issue.[87] The Panel never said, as Canada suggests, that no producer can cover its fixed and variable costs through sales at the domestic, regulated price. Rather, the Panel merely observed that for those producers who are barely able to cover their total costs of production through domestic, in-quota sales, the level of the domestic, regulated price "creates a strong inducement" to produce additional milk for the CEM market, provided that such producers can cover their marginal costs of production.[88]

64. Similarly, Canada misses the point when it argues that "it does not make sense that a producer would willingly produce additional milk and sell it at a loss."[89] The Panel did not conclude that producers would sell in the CEM market at a loss. Rather, consistent with the

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[84] *Second Article 21.5 Panel Report*, para. 5.125.
[85] *Id.*, para. 5.127.
[86] *Id.*, para. 5.127.
[87] Canada's Appellant Submission, para. 94.
[88] *Second Article 21.5 Panel Report*, para. 5.128.
[89] Canada's Appellant Submission, para. 95.

Appellate Body's analysis[90] and fundamental economic theory, the Panel concluded that Canada's regulation of the domestic market has significant effects on payments in that sales at the high, regulated price allow producers to make additional sales in the CEM market so long as they cover their marginal costs.[91]

65. The Panel correctly considered governmental regulation of the domestic price and supply of milk as one of several aspects of governmental action that establishes a "demonstrable link" to the financing of payments from the producers to the processors.

e. The Panel Did Not Need to Consider the SCM Agreement in Analyzing Article 9.1(c)

66. Canada wrongly asserts that the Panel misconstrued Article 9.1(c) because it did not examine Article 9.1(c) in light of Article 1.1 of the SCM Agreement and the panel report in *United States – Export Restraints*.[92]

67. Canada's argument overlooks the fact that in *Canada – Dairy II* the Appellate Body provided detailed guidance on the meaning of the term "payment"[93] and the phrase "financed by virtue of governmental action"[94] as used in Article 9.1(c). There was simply no basis for the Panel to go beyond the Appellate Body's extensive guidance. It is noteworthy, in this regard,

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[90] *Canada – Dairy II*, para. 94.

[91] *Second Article 21.5 Panel Report*, paras. 5.125 - 5.129. Canada argues that the Panel's conclusion regarding the governmental regulation of the supply and price of milk cannot be extended to those producers that do not hold domestic quota. Canada's Appellant Submission, para. 97. This assertion is of no consequence. Such producers represent less than one percent of total Canadian production. *See* Panel Report on *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103RW and WT/DS113/RW, adopted Dec. 18, 2001 (as modified by the Appellate Body), para. 6.45, note 137 and para. 6.46, note 139.

[92] Canada's Appellant Submission, paras. 104 - 106 (citing Panel Report on *United States – Measures Treating Export Restraints as Subsidies* ("*United States – Export Restraints*"), WT/DS194/R, adopted August 23, 2001).

[93] *Canada – Dairy II*, paras. 86 - 96.

[94] *Canada – Dairy II*, paras. 111 - 117.

that the Appellate Body did not look to Article 1.1 of the SCM Agreement in interpreting the term "payments" or the phrase "financed by virtue of governmental action" in Article 9.1(c).[95]

68. Moreover, the terms "entrust" and "direct," which Canada argues the Panel should have applied,[96] are terms that are not used in Article 9.1(c) of the *Agreement on Agriculture*. The negotiators of the *Agreement on Agriculture* could have used the terms "entrust" or "direct," but instead chose to use the phrase "financed *by virtue of* governmental action." Thus, under Article 9.1(c), it is the phrase "financed by virtue of governmental action" that must be interpreted and applied, not "entrust" or "direct." These terms offer no contextual guidance to the interpretation of Article 9.1(c).

f. The Panel's Interpretation of Article 9.1(c) Is Not Inconsistent With the Object and Purpose of the *Agreement on Agriculture*

69. There is no basis for Canada's claim that the Panel's interpretation of Article 9.1(c) is inconsistent with the object and purpose of the *Agreement on Agriculture*. Canada claims that its "deregulation" of its export market is consistent with the long-term objective of the *Agreement on Agriculture* and asserts that the Panel created export subsidy disciplines on agricultural products that are broader than the disciplines applicable to industrial products.[97]

70. Of course, Canada has not actually deregulated its market. It has replaced one form of regulation with another. Through government action, Canada exempts processors of exported

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[95]The dispute in *United States – Export Restraints* involved Article 1.1(a)(1)(iv) of the SCM Agreement, not the *Agreement on Agriculture*, and, consequently, the report in that dispute does not apply to Article 9.1(c). The United States notes that the Appellate Body did not cite *United States – Export Restraints* in analyzing Article 9.1(c) even though the panel report in that dispute was issued approximately six months before the Appellate Body's report in *Canada – Dairy II*. Moreover, the discussion of the phrase "entrusts or directs" in *United States – Export Restraints* is *dicta*, since the panel found that the U.S. measures in question were discretionary and, hence, not inconsistent with U.S. WTO obligations.

[96]Canada's Appellant Submission, paras. 107 - 108.

[97]*Id.*, paras. 111 - 115.

dairy products from having to pay Canada's domestic, regulated price and prohibits the diversion of export milk back into the domestic market. Canada also dictates key terms of CEM sales with its pre-commitment and "first-out-of-the-tank" requirements. Thus, Canada's milk market remains highly regulated.

71. Furthermore, the Panel did not create new disciplines under the *Agreement on Agriculture*. As already discussed, the Panel scrupulously followed the Appellate Body's guidance in analyzing whether Canadian milk producers are making "payments" to Canadian dairy processors and whether such payments are "financed by virtue of governmental action." It bears repeating that the Appellate Body itself indicated that a producer may use "highly profitable sales" in one market to finance sales in another market that only cover the producer's marginal costs.[98]

72. The Panel properly applied the export subsidy disciplines of Article 9.1(c) of the *Agreement on Agriculture*, as clarified by the Appellate Body. Thus, there is no basis to conclude that the Panel's decision is inconsistent with the object and purpose of that Agreement.

C. The Panel Correctly Found that Canada's Measures Are Inconsistent with Article 10.1 of the *Agreement on Agriculture*

73. The Panel also correctly found, in the alternative, that Canada is providing export subsidies under Article 10.1 of the *Agreement on Agriculture*. Article 10.1 provides:

> Export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments.

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[98] *Canada – Dairy II*, para. 94.

74. The Appellate Body found that Article 10.1 is "residual in character to Article 9.1" such that a measure cannot simultaneously be an export subsidy under Article 9.1 and Article 10.1.[99] Accordingly, the Panel made its findings under Article 10.1 in the alternative.[100]

75. The Panel began its analysis by noting that Article 1(e) of the *Agreement on Agriculture* defines "export subsidies" in essentially identical terms with the description of prohibited export subsidies in Article 3.1(a) of the SCM Agreement.[101] Therefore, consistent with the original panel report in this dispute, the Panel concluded that it was appropriate to examine Article 3.1(a) of the SCM Agreement and paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I to the SCM Agreement as contextual guidance in evaluating whether Canada is providing export subsidies within the meaning of Article 10.1.[102]

76. The Panel noted that the original panel in this dispute had concluded that the following three elements must be shown to establish a violation of paragraph (d) of the Illustrative List:

- The provision of products for use in export production on terms more favorable than the provision of like products for use in domestic production;
- By governments either directly or indirectly through government-mandated schemes; and
- On terms more favorable than those commercially available on world markets.[103]

77. Canada does not dispute that fluid milk is sold for processing into exported products at more favorable prices than for processing into domestic dairy products.[104]

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[99] *Id.*, para. 121.
[100] *Second Article 21.5 Panel Report*, para. 5.174.
[101] *Id.*, para. 5.153.
[102] *Id.*, paras. 5.153 and 5.155.
[103] *Id.*, para. 5.157.
[104] *Id.*, para. 5.158.

78. Canada takes issue with the Panel's conclusions regarding the second and third elements of paragraph (d).[105] Canada's claims, however, are without merit.

1. The Panel Did Not Ignore Relevant Context in Applying Paragraph (d) of the Illustrative List

79. Canada argues that the meaning of the phrase "indirectly through government-mandated schemes" in paragraph (d) is unclear. Therefore, it claims that the Panel should have considered the general definition of the term "subsidy" in Article 1.1 of the SCM Agreement and, in particular, Article 1.1(a)(1)(iv) in interpreting the phrase "indirectly through government-mandated schemes."[106] Further, Canada argues that the panel in *United States – Export Restraints* interpreted the phrase "entrusts or directs" in Article 1.1(a)(1)(iv) of the SCM Agreement to require an "explicit and affirmative" act of "delegation or command."[107]

80. The Panel rightly rejected Canada's arguments noting that: "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)."[108] The Panel noted that in the *Brazil – Aircraft* dispute, Canada itself successfully argued that the Illustrative List should be considered a *per se* list of prohibited export subsidies and that the Appellate Body implicitly endorsed this reasoning.[109] The *Brazil – Aircraft* panel concluded that:

> [I]t would be possible to demonstrate that a measure falls within the scope of an item of

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[105] Canada's Appellant Submission, paras. 120 - 121.

[106] *Id.*, para. 123.

[107] *Id.*, para. 129.

[108] *Second Article 21.5 Panel Report*, para. 5.154 (citing Panel Report on *Canada – Certain Measures Affecting the Automotive Industry*, WT/DS139-WT/DS142, adopted June 19, 2000 (as modified by the Appellate Body), para. 10.197 and Panel Report on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU*, WT/DS46RW, adopted August 4, 2000 (as modified by the Appellate Body), para. 6.42).

[109] *Id.*, para. 5.154 (citing Appellate Body Report on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/AB/R, adopted August 4, 2000, para. 61).

> 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.[110]

81. Canada's reliance on the Appellate Body's decision in *United States – FSC* is misplaced.[111] There, the Appellate Body had to determine whether certain tax measures constituted a "subsidy" in a general sense; not whether the measures came within the scope of one of the export subsidies included in the Illustrative List.[112]

82. Moreover, the Panel obviously did not share Canada's belief that the meaning of the phrase "indirectly through government-mandated schemes" is so unclear that it must resort to Article 1.1 of the SCM Agreement for guidance. Rather, the Panel applied the text of paragraph (d) and correctly found that the government-mandated exemption of export processors from paying the regulated domestic price as well as the enforced prohibition on the diversion of CEM ensure that milk for processing into exported dairy products is sold at more favorable terms than milk sold for processing into domestic dairy products.[113] Accordingly, the Panel correctly found that the second element of paragraph (d) of the Illustrative List is met.

2. The Panel Correctly Found that Canadian Dairy Processors Obtain Fluid Milk Through the CEM Program at More Favorable Terms Than Whole Milk Powder Through the IREP Program

83. With respect to the third element of paragraph (d) of the Illustrative List, Canada

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[110]Panel Report on *Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, adopted August 4, 2000 (as modified by the Appellate Body), para. 6.42.

[111]Canada's Appellant Submission, para. 124.

[112]Appellate Body Report on *United States – Tax Treatment for "Foreign Sales Corporations"*, WT/DS108/AB/R, adopted March 20, 2000, paras. 136 - 139. Moreover, as noted above, the discussion in *United States – Export Restraints* of the phrase "entrusts or directs" is *dicta*, since the panel in that dispute concluded that the U.S. measures in question were discretionary and, therefore, were not inconsistent with U.S. obligations.

[113]*Second Article 21.5 Panel Report*, para. 5.160.

erroneously contends that the Panel failed to consider the relevant factors in evaluating whether processors obtain fluid milk under the CEM program on more favorable terms than whole milk powder under Canada's Import for Re-Export Program (IREP).[114]

84. The Appellate Body stated in *Canada – Dairy II* that in assessing the relative availability of inputs in the world market, the "primary consideration must be price."[115]

85. The Panel found that the price of whole milk powder under the IREP program is higher, on average, than the price of fluid milk under the CEM program.[116] Specifically, the Panel found that the price of whole milk powder under the IREP program is $32.45 per hectoliter, compared to the average fluid milk price under CEM of $29 per hectoliter.[117]

86. Canada complains that the Panel's conclusion that CEM prices are below IREP prices was based only on data for 2000.[118] However, the Panel's report shows that the average CEM price in 2001 was only $31.50, still below the IREP price of $32.42 per hectoliter for that year.[119]

87. Canada then asserts that, at $32.42 per hectoliter, the price of whole milk powder under the IREP program "falls within the eighteen month range of commercial export milk prices of $23.69 to $40.12 per hectolitre."[120] Canada's reference to the "range" of CEM prices is misleading, since it ignores the fact that the majority of CEM sales were made at prices under $32.42 per hectoliter.[121]

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[114]Canada's Appellant Submission, para. 118.
[115]*Canada – Dairy II*, para. 83, note 55.
[116]*Second Article 21.5 Panel Report*, paras. 5.116, note 411 and 5.161.
[117]*Id.*, para. 5.116, note 411.
[118]Canada's Appellant Submission, para. 141.
[119]*Second Article 21.5 Panel Report*, para. 5.74. Canada states that the IREP price for 2001 was $32.42 per hectoliter. Canada's Appellant Submission, para. 141.
[120]Canada's Appellant Submission, para. 141.
[121]*See* Second Submission of the United States to the Panel (April 8, 2002), para. 34; Exhibit CDA-13.

88. This clear price differential alone is sufficient to support the Panel's conclusion that processors obtain fluid milk under the CEM program on more favorable terms than whole milk powder under the IREP program. However, the Panel cited a number of other factors that also support its conclusion. These include:

- Tariffs on imported whole milk powder;
- The formalities of obtaining duty drawback for such tariffs;
- The limited substitutability of whole milk powder for fluid milk and the costs of re-hydration of whole milk powder; and
- The discretionary nature of the IREP permit and the permit fee itself.[122]

The Panel's conclusion that fluid milk under the CEM program is a more favorable option is further borne out by the fact that two-thirds of the imports under the IREP program are used in the production of confectionary products, rather than dairy products.[123]

89. In sum, the Panel correctly concluded, based on ample evidence in the record, that processors obtain fluid milk under the CEM program on more favorable terms than whole milk powder under the IREP program and, consequently, that the third element of paragraph (d) of the Illustrative List is met.

3. The Panel Correctly Concluded that Canada Is Applying Export Subsidies Under Article 10.1 in a Manner that Circumvents or Threatens to Circumvent its Export Subsidy Commitments

90. Canada asserted before the Panel, as it has on appeal, that since it is not providing export subsidies under Article 10.1 of the *Agreement on Agriculture*, the issue of "circumvention" is

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[122] *Second Article 21.5 Panel Report*, para. 5.161.

[123] *See* Canada's Response to Question 38 from the Panel (April 30, 2002), para. 144 and Tables 3, 4, and 5; Comments of the United States on Canada's Responses to Questions from the Panel (May 6, 2002), para. 15.

moot.[124]

91. As the Panel correctly concluded (in the alternative) that Canada is providing export subsidies within the meaning of Article 10.1, it also correctly concluded that the issue of circumvention is not moot.[125] The fact that Canada has exported dairy products in excess of its reduction commitment levels and that there is no limit on the amounts of dairy products that may be exported pursuant to the CEM program supports the Panel's conclusion that Canada is applying its export subsidies in a manner that circumvents or threatens to circumvent Canada's export subsidy commitments.[126]

III. CONCLUSION

92. For the foregoing reasons, the United States respectfully requests that the Appellate Body affirm the Panel's findings in this matter.[127]

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[124]Canada's Appellant Submission, para. 144.
[125]*Second Article 21.5 Panel Report*, para. 5.170.
[126]*Id.*, para. 5.167.
[127]Canada refers the Appellate Body to Canada's submissions to the Panel in the event that the Appellate Body decides to address the consistency of Canada's CEM program with Article 3.1 of the SCM Agreement. Canada's Appellant Submission, para. 27, note 29. In that event, the United States also refers the Appellate Body to its submissions to the Panel on this issue. *See* First Submission of the United States to the Panel (March 11, 2002), paras. 72 - 79; Second Submission of the United States to the Panel (April 8, 2002), paras. 72 - 76.