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

Second Submission of the United States

May 25, 2001

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I. Introduction

1. In our first written submission, the United States showed that, while Canada did indeed eliminate Special Milk Class 5(e) in response to the recommendations and rulings of the Dispute Settlement Body ("DSB"), 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 *Subsidies and Countervailing Measures Agreement* ("SCM Agreement"). Canada bears the burden of proof under the *Agreement on Agriculture* and has failed to demonstrate that its new export programs are consistent with its WTO obligations.

2. Instead, Canada devotes the vast 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, which it is not, 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 by virtue of government action.

3. The answer to that question is a categorical "yes." Contrary to Canada's suggestion, the United States is not arguing that the mere existence of parallel markets for domestic use and for export with different prices constitutes an export subsidy. As noted by the Panel in the original case, "whether or not the 'payments in kind' to processors in this dispute constitute an export subsidy depends on the government's involvement in providing it."[1] The United States demonstrated in its first submission that it is only through action of the Canadian government

[1]Panel Report, para. 7.62.

(both at the federal and provincial levels) that processors have access to lower-priced milk for export. The United States does not dispute that Canada has made some regulatory changes to its export dairy regime. However, it is still the hand of the government that is essential to the transfer of resources from the producers to the processors for the subsidized export of dairy products.

4. That the level of government involvement remains substantial is clear from a review of the details of the new provincial export requirements. For example, as explained more fully below, it is mandated by law in all provinces that milk contracted for export cannot be redirected into the domestic market, and that contracts for export milk must be "pre-committed" and that the export milk must be delivered "first out of the tank." In addition, in Ontario and Quebec, which are by far the dominant milk-producing provinces in Canada, it is mandated by law that any producer wishing to sell milk for export must contract for the sale of such milk through a single electronic bulletin board mechanism. These legal requirements are monitored and enforced by Canadian officials at both the federal and provincial levels through an array of mechanisms.

5. Thus, even though the Canadian government no longer micro manages the export milk market by setting the price and volume of specific export contracts, that does not translate into producers' decisions being market-driven. This is because the nominally distinct markets in which the producers operate, the domestic and export markets, are contrived by the Canadian government. The lower-priced milk destined for the export market exists solely by virtue of the Canadian government's carefully policed exclusion of such milk from the domestic market. In addition, the export market is directly affected in Ontario and Quebec by the requirements of the exclusive bulletin board mechanisms in those provinces.

6. Likewise, the processors' "decisions" to export dairy products are made possible only by the government sponsored supply of discount milk for export.

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. The Market For Export Milk Is Created and Controlled By the Canadian Government

8. As described in our opening submission, although the new provincial export programs differ in some regards from the Special Milk Class 5(e) that they replace, the objective is the exactly the same: the provision of low priced milk to processors/exporters to make dairy exports commercially viable and thus to limit dairy surpluses that would otherwise depress domestic prices for these products. The provincial programs vary to some extent but possess several common elements that enable the new programs to accomplish this goal. First, any milk produced above the level of the domestic quota must be sold for export-only processing (or relegated to marginal uses like animal feed that carry a low price mandated by the government). The milk that is committed to export may not be introduced into the domestic market; such milk and all components of it (or the resulting dairy products) must be exported by law. Second, exporters of dairy products are provided access to milk at significantly lower prices; they are not required to pay the much higher, regulated price for milk produced within the domestic quota, for which prices are specifically established by provincial authorities. Third, producers must benefit processors by "pre-committing" to sell in the export market and export milk must be delivered "first out of the tank." This benefits processors by providing them with a predictable supply of

milk. Fourth, the federal and provincial governments monitor and enforce the requirement that milk contracted for export may not be redirected into the domestic market.[2]

9. Thus, a separate market for discounted export milk exists in all provinces solely by virtue of the government controls on milk produced above or outside of domestic quota. The United States focused on the provinces of Quebec and Ontario in its first written submission because those two provinces account for the vast majority of Canadian milk production as well as some 80 percent of dairy exports from Canada. However, the requirement that milk produced and sold without or above quota be kept out of the domestic market is applicable in all provinces. By mandating the separation of the two markets, the Canadian government ensures that reduced price milk will be offered to processors for export. The producers have no real choice if they produce over-quota or without quota. They can either: 1) sell their milk into the export market for a reduced price; 2) sell their milk into the animal feed market under Class 4(m) at a very low government-set price; or 3) destroy the extra milk at a total loss. The only real commercial option is to sell any over-quota or non-quota milk into the export market.[3] Thus, by restricting the choice of the producer, the government ensures that reduced priced milk will be transferred to processors for export. Absent these restrictions, the processor would have to pay the higher price applicable to milk for dairy products sold into the domestic market.

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[2]Canada argues that the Canadian Dairy Commission's ("CDC") audit authority has been severely curtailed. Canada First Submission, para. 24. This assertion is spurious. As noted in our first submission, the Dairy Products Marketing Regulations, as amended, plainly state in section 10(1) that the CDC retains the authority to request information from producers or processors that it deems "is necessary to determine whether [commercial export milk or cream] has been marketed for final consumption *in* Canada." U.S. First Submission, para. 43 (emphasis added)

[3]As noted in our first submission, it is understanding of the United States that very little milk has been allocated under Class 4(m) and that the price for Class 4(m) milk is substantially lower than the average export price for milk.

10. The government further secures the supply of discounted milk for the export market by requiring that producers "pre-commit" their milk destined for the export market and that export milk must be delivered "first out of the tank." This ensures that, by law, producers cannot abandon their obligations to supply milk for export at a discount from the domestic price. If the export market is truly a commercial market, as so vigorously argued by Canada, why does the Canadian government require by law that producers pre-commit their milk for export? Likewise, if the enforcement of export contracts is purely a private matter, as repeatedly asserted by Canada, why does the Canadian government require by law that milk contracted for export be delivered "first out of the tank?"

11. These requirements further demonstrate that the export market is not a true commercial market but rather a contrived market created and controlled by the Canadian government. While creating the impression that producers are making a commercial decision to produce for the export market, these two requirements help ensure that export milk is not redirected into the domestic market. In reality, the system is doing exactly what it did under the Special Milk Class program - arranging for the disposition of any milk not permitted to be sold in the domestic market. Under the new scheme, the difference is that the government is forcing the producer to estimate up-front the amount of milk, if any, that cannot be sold into the domestic market

(because it is beyond its quota and the class 4(m) market provides an unattractive return).[4] This benefits the processor by providing it with a more predictable supply of milk for export.

12. Canada's argument that milk producers precisely control their production levels thereby enabling them to deliberately allocate their production between the domestic and export markets in order to maximize revenue misrepresents the reality of dairy farming. As explained in the original proceedings, there are a variety of factors, mostly beyond the control of the dairy farmer, that determine the level of production. These include the weather, the quality of feed, and the biological condition of the herd. The United States cited the statements of several Canadian authorities as confirmation that production level is not within the complete control of the producer.[5] This reality has not changed under the new provincial export programs. Despite their best efforts, dairy farmers cannot regulate their production with precision.

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[4]Canada points to the fact that there are 74 producers that produce only for the export market as evidence that it is a "commercial" decision to produce for the export market (presumably based upon maximizing revenue.) First, the United States notes that 74 producers is less than one-half of one percent of all producers in Canada. Such a minuscule number does not provide a basis for summarily concluding that the majority or even an appreciable number of producers are voluntarily producing for the export market in order to maximize their revenue. Furthermore, these producers would presumably choose to receive the much higher price for selling into the domestic market if they had access to that market. They do not by virtue of the government's action in limiting access to the domestic market. Second, as explained more fully in the legal analysis of Article 9.1(c) below, Canada misses the point by focusing only on the basis of the producer's decision. Even though these particular producers are not producing within the domestic quota system, the processors buying from these producers are still accessing lower-price milk by virtue of the government's exclusion of export milk from the domestic market.

[5]Panel Report, para. 4.99-4.100. (citing the Director of Government Affairs for the Dairy Farmers of Canada stating that the level of over-quota production is dependent upon the biological conditions on the farm and citing the President of the Canadian Dairy Commission referring to the level of over-quota production as being affected by feed and climate as a matter of chance).

13. Cost of production data used to set prices in the domestic system also contradict the claim in Canada's first submission that farmers freely supply this milk based on normal commercial factors. According to data from the official cost of production survey, less than 30 percent of Canadian farmers cover their cost of production at an average price of C$57.41/hl and less than 1 percent could cover costs at export market prices of around C$30/hl.[6] Why would the average farmer choose to produce for this market?

14. Thus, to suggest that the producers decide on their own to produce for the export market instead of the domestic market ignores the fact that they cannot control their production with that degree of precision, that they have an incentive to produce to the full amount of their domestic quota, that export milk prices do not come close to covering production costs, and that the government *forces* them to "pre-commit" to export contracts if they export.[7] These facts make it clear that the producers's decision to produce for the export market is not a real decision at all, let alone a purely commercial decision. Just like under the Special Milk Class system, the producer exports in order to dispose of milk produced outside of its domestic quota because it is prohibited from selling milk into the domestic market (except at the even lower price for animal feed).[8] The government facilitates the disposal of this surplus by giving processors/exporters access to the milk at a lower price.

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[6]U.S. Exhibit 24.

[7]Producers have an strong incentive to produce to the full amount of their domestic quota because that is the best opportunity to recover as much of the applicable fixed costs of production and make a profit since quota production is entitled to receive the higher domestic prices.

[8]Canada's argument that a producer can buy additional quota is illusory. This argument overlooks the fact that trading quota is a zero-sum game, whereby quota purchased from one producer means that another producer's milk would now have to be disposed of on the export market. In other words, trading quota does not increase the total level of quota.

15. The description of the objective of Special Milk Class scheme in the panel report is also applicable to Canada's now-modified export regime.

> The entire ... procedure was aimed at assuring a price to the processor/exporter that allowed the export to take place at world market prices. While presumably the interests of the dairy producers were considered, the over-riding objective was to ensure that surplus dairy products were exported. The major benefit derived by milk producers from such exports was that they assisted in administering the supply management of dairy products and producers got some return for this surplus production. Without such exports, the surplus would be destroyed with obvious political ramifications.[9]

16. This is exactly the objective of the new export regime. The Canadian government must ensure the export of any milk that is produced outside of domestic quota in order to maintain the high domestic price. The government does this by excluding export milk and all components thereof from the domestic market (and ensuring its export through monitoring and enforcement mechanisms) and by permitting processors to purchase such milk at lower prices in order to make Canadian dairy products commercially viable on the export market. Although the Canadian government no longer directly performs the negotiating activities on behalf of the producers, the result is the same because the price on the export market is driven by world market prices just as it was under the Special Milk Class 5(e) scheme.

17. The export market is further controlled in Ontario and Quebec, the primary dairy-producing provinces in Canada, through the mandatory and exclusive bulletin board mechanism

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[9]Panel Report, para. 4.82.

established by the milk marketing boards in those provinces. As explained in our first submission, the milk marketing boards, which both the panel and the Appellate Body found to be government agencies, in both Ontario and Quebec retain authority to ensure that any milk sold for export is funneled through the exclusive, mandatory electronic bulletin board mechanism and to take action in the event that milk committed to export enters the Canadian domestic market.[10]

18. Canada argues that the exclusive bulletin board mechanisms are not indicative of government involvement but are provided by the government to supply "transparency, efficiency and the competitiveness of free markets."[11] Canada further maintains that the bulletin boards are not controlled by the provincial milk marketing boards because they operate on a cost recovery basis and are administered by a private third party.

19. Despite Canada's effort to minimize the implications, the fact remains that, through the creation of a single, exclusive bulletin board which is administered by a delegate of the government, the milk marketing boards in Ontario and Quebec effectively manage the manner in which milk is sold to exporters. That the bulletin boards are indeed a creature of the provincial milk marketing boards is perhaps best demonstrated by the recent dispute between the Ontario bulletin board administered by Deloitte and Touche and a milk broker called Milk Trade. There

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[10]In the description of the Ontario Dairy Export Mechanism provided by Canada, it states in paragraph B.7 that "Any buyer who markets domestically any dairy product or any of the milk volume and/or components originally committed to export, will be subject to sanction for operating in contravention of domestic regulation." See U.S Exhibit 6. In Quebec, the milk marketing agreement provides specifically that monetary penalties will apply if export milk is marketed domestically. See U.S. Exhibit 12.

[11]Canada First Submission, para. 66.

the broker was forced to cease operations due to the high fees charged by Deloitte and Touche. In its press release announcing its decision, Milk Trade states that

> When Milk Trade embarked on the export milk project it understood from the WTO ruling that export milk would be handled on a commercial basis, free of all government control. The reality is that the Export Contract Exchange mechanism, which has been granted a statutory monopoly power over confirmation of export milk contracts, is taking full advantage of its monopoly power and refusing to adapt to commercial realities.[12]

20. This should remove any doubt that, despite Canada's self-serving protests, the bulletin boards are indeed an extension of the provincial governments that have significant influence on the circumstances in which export contracts are made.

III. Legal Analysis

A. Burden of Proof

21. New Zealand is correct in asserting 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 acknowledges the burden of proof imposed on it by

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[12]Milk Trade, press release dated April 23, 2001. U.S. Exhibit 23.

Article 10.3, but then suggests that that burden is somehow reversed or lessened in the particular context of Article 21.5 of the DSU.[13] This is simply not the case.

22. The DSU does not specify any specialized burden of proof that applies in Article 21.5 proceedings. Accordingly, Article 21.5 panels and the Appellate Body apply the same rules regarding the burden of proof that apply in the initial panel and Appellate Body proceedings under DSU Articles 1 through 20.

23. This approach is consistent with, and indeed virtually dictated by, the panel's mandate under DSU Article 21.5. An Article 21.5 proceeding is concerned with evaluating the consistency of a Member's new measures (*i.e.* those taken to comply with DSB recommendations) with its obligations under covered agreements. Because it is evaluating the WTO-consistency of the new measures as such (rather than, for example, simply contrasting the new measures with the old), the Article 21.5 panel approaches its legal task in much the same way as would a panel evaluating the new measures *ab initio*. It would be incongruous for that Article 21.5 panel to apply a different burden of proof than would an Article 7 panel examining the same measures.

24. In most cases, "the burden of proof rests upon the party . . . who asserts the affirmative of a particular claim or defense"[14] — and it is applied in an Article 21.5 proceeding just as in any

[13] First Submission of Canada, para. 76.

[14] *United States—Measures Affecting Imports of Woven Wool Shirts and Blouses from India*, WT/DS33/AB/R (23 May 1997) at page 14, quoted in *European Communities—Regime for the Importation, Sale and Distribution of Bananas—Recourse to Article 21.5 by Ecuador*, WT/DS27/RW/ECU (12 April 1999) at n. 255 to para. 6.133).

other WTO dispute settlement proceeding addressing that claim.[15] This is not the case, however, with respect to a claim under the *Agreement on Agriculture* regarding agricultural export subsidies. Such claims are governed by the *lex specialis* of Article 10.3 of the *Agreement on Agriculture*. With respect to those claims, the burden falls on the defending party – in this case, Canada. Canada has failed to point to any element of the WTO Agreement nor any decision of a WTO panel or the Appellate Body that would justify altering the application of Article 10.3 by virtue of the fact that Canada's measures are now being reviewed under DSU Article 21.5.

25. The cases cited by Canada are not to the contrary. None of the cases involves an Article 21.5 proceeding reviewing agricultural export subsidies subject to the particularized burden of proof rule of Article 10.3 of the *Agreement on Agriculture*. As such, they all involve claims and defenses subject to the regular rule on the burden of proof—namely that the Member claiming that another Member's measure is non-compliant bears the initial burden of proof—and they simply confirm that that rule from the original proceedings is equally applicable to later Article 21.5 proceedings involving those same claims.

26. Accordingly, as specified by Article 10.3 of the *Agreement on Agriculture*, Canada continues to bear the burden of establishing that its dairy management measures, including those putatively taken to comply with the DSB's recommendations, have not subsidized dairy exports in excess of its commitment levels under that *Agreement*. Canada has demonstrably failed to meet this burden, for the reasons set forth below.

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[15] *See, e.g., Canada—Measures Affecting the Export of Civilian Aircraft—Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW (9 May 2000) at para. 5.26.

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

27. Canada asserts that, "as a result of the measures taken by Canada to comply with the DSB recommendations and ruling, none of the factors relied upon by the Panel and Appellate Body in *Canada-Dairy* to establish the existence of export subsidies remains in place." This assertion is simply not sustained by the facts of this case. Although the United States does not dispute that Canada undertook statutory and regulatory changes in response to the DSB ruling, as demonstrated in our first submission, the Canadian government has retained sufficient authority with regard to dairy exports, and the milk provided to exporters, that its role in dairy product exports still can only be viewed as indispensable. 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 agriculture 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)

28. Canada agrees that, in accordance with the Appellate Body report in this case, a "payment" exists within the meaning of Article 9.1(c) if "goods or services are supplied to an enterprise, or a group of enterprises, at reduced rates (that is, at below market-rates)..." Canada nonetheless contends that there is no "payment" to processors because the processors are purchasing export milk at "market" rates, and not at reduced rates. In other words, Canada contends that the price negotiated between the producers and processors for export milk, which is driven by world market prices, is the "market" rate for milk.

29. The flaw in Canada's reasoning is that it has confused the appropriate benchmark for assessing whether export milk is made available to processors at below market rates. Canada's approach to analyzing whether a "payment" is conferred assumes that the appropriate benchmark is the export market price. However, this approach is inconsistent with the legal standard that the Appellate Body and the Panel in this case applied in determining the existence of a subsidy under Article 9.[16] The Appellate Body in this case, in discussing the issue of "benefit" under Article 9.1(a), noted that: "a 'subsidy' within the meaning of Article 1.1 of the SCM Agreement arises where the grantor makes a 'financial contribution' which confers a 'benefit' to the recipient, *as compared to what would have been otherwise available to the recipient in the marketplace."*[17] Canada agrees that this reasoning applies to Article 9.1(c) as well.[18] Thus, in determining whether a "payment" is made within Article 9.1(c), this Panel must assess what would have been *otherwise available* to processors/exporters in the marketplace.

30. This is consistent with the reasoning applied by the Panel in the original case in analyzing the appropriate benchmark in the context of determining whether a "payment-in-kind" within the meaning of Article 9.1(a) was made to processors.[19] The Panel concluded that "if the price of [export milk] is lower than the price at which processor/exporters can obtain milk from any other source, a bounty or benefit – i.e., something they would otherwise not have obtained – would,

[16] This approach is also defective as a logical matter because the only reason that the processor has access to a lower price is that the milk is being purchased for export.

[17]AB Report, para. 87, 107.

[18]Canada First Submission, fn 86.

[19]Although the Appellate Body reversed the Panel due to its flawed interpretative approach of the relationship between the terms "payment-in-kind" and "direct subsidy," the Panel's analysis of the appropriate benchmark was not criticized and remains sound.

indeed, be conferred."[20] The Panel found that the price of export milk was significantly lower than the price for domestic milk. The Panel also concluded that the terms and conditions were more favorable for export milk than those available for milk purchased from any other source, including the Import for Re-export Program.

31. Nothing has changed under the new measures. It is simple logic that the only potential sources of milk for Canadian processors are milk produced in Canada and milk imported into Canada. The United States established in its first written submission, and Canada did not dispute, that the export prices for milk are significantly lower than the domestic price for milk. Thus, using the domestic price as the relevant benchmark, the processor is receiving a benefit and therefore a "payment" when the processor obtains milk at a discount for the export market.

32. This conclusion holds even if the price available from any other source (i.e., imports) is used as the relevant benchmark. In this instance, the only other potential source of milk for export products is the Import for Re-Export Program because a highly restrictive tariff rate quota otherwise keeps milk imports out of the country. Canada has not met its burden of showing that processors may source milk from the Import for Re-Export Program on terms and conditions that are as favorable as those available for Canadian-produced milk destined for export. In fact, Canada does not even contend that the Import for Re-Export program offers another source of milk for processors on equal or more favorable terms than the price available if the milk is going to be exported. Canada does mention that imports under this program have increased since the original panel proceeding. Yet, it offers no documentation or even source in support of this allegation.

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[20]Panel Report, para. 7.48.

33. In any event, even if processors could theoretically purchase milk under the Import for Re-Export Program at an equally favorable price, the terms and conditions upon which that milk is available are not as favorable. This is because Canada has not changed the requirement that a permit must be obtained from the Minister of the Canadian Department of Foreign Affairs and International Trade before imports under the program are allowed. Moreover, the Minister has considerable discretion in deciding whether to issue a permit. Thus, as the Panel found, "whether or not processors for export access fluid milk or milk derivatives under this Program depends, in the first place, not on commercial considerations (i.e., price), but on the discretion of the Canadian authorities."[21]

34. For all practical purposes, the only source of milk otherwise available to Canadian processors/exporters is milk produced in Canada. And that milk is sold at a high price pursuant to regulation (unless, of course, the milk is destined for export). Just as in the case of the Special Milk Class 5(e) scheme, the processor is accessing milk for export at a price that is lower than would be paid by the same processor purchasing the same milk for use in manufacturing dairy products destined for the domestic market. Likewise, producers are providing milk for export at a substantial discount to the market price for milk delivered for domestic consumption. Thus, under the replacement provincial measures, producers are foregoing revenue and processors are receiving a benefit in the same manner that the Panel and Appellate Body found to constitute a "payment" within the meaning of Article 9.1(c).

35. Further, Canada cannot dispute that the payment (i.e., the provision of lower priced milk) is only available in the case of milk purchased for the manufacture of dairy products destined for

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[21]Panel Report, para. 7.53.

the export market. Consequently, the payment constitutes a payment "on the export of an agricultural product" under Article 9.1(c).

2. The Payment to Processors/Exporters Is Provided By Virtue of Government Action

36. Contrary to the Canada's assertion, the United States does not contend that the mere existence of parallel markets with different prices constitutes an export subsidy. It is the indispensable government involvement in the new provincial export programs that satisfies the requirement under Article 9.1(c) that payments must be made "by virtue of government action."

37. In our first submission, the United States explained that the Appellate Body and Panel relied upon two key factors in their assessment of whether processors received a payment under the Special Milk Class scheme by "virtue of government action." First, the Appellate Body found that "since all of the bodies involved in the supply of milk under Special Classes 5(d) and 5(e) are 'government agencies' under Article 9.1(a), a strong presumption arises that their conduct in managing those Special Classes may appropriately be regarded as 'governmental action."[22] Second, the Appellate Body found it necessary to consider the "'governmental' involvement as a whole" and the "'action' of all these bodies together" to assess whether the "payment" from milk producers was "financed by virtue of governmental action."[23]

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[22]Appellate Body Report, para. 118.

[23]Appellate Body Report, para. 119.

38. The United States established, and Canada has not refuted, that all the relevant bodies involved in the provincial milk schemes are governmental. As in the case of the Special Milk Class scheme, the CDC, the Canadian Milk Supply Management Committee (CMSMC), the provincial governments, and the milk marketing boards, which are all governmental bodies, are integral -- and indeed indispensable -- to the operation of the current export schemes. Their respective functions are explained in detail in paragraphs 63 to 72 of our first written submission and will not be repeated here. Because these entities are governmental, in accordance with the Appellate Body's findings regarding the Special Milk Class system, a presumption exists that the provision of discounted milk is by "virtue of government action."

39. Even without a presumption, however, it is clear from a review of the government's involvement that the payments to the processors under the provincial export programs are made by "virtue of government action."[24] As explained in our first submission, there are three primary indicia of the government's involvement in the new provincial export programs. These include: 1) the fact that Canada artificially segregates and enforces the separation of the market for milk that is exported and milk that is consumed domestically; 2) that provincial regulations compel the export of any milk committed under export contracts through the new export schemes, and that the provincial governments have sanction authority to enforce this requirement; and 3) that in the

[24]Canada argues that there must be a "direct connection" between the "government action" and the "payment." Canada First Submission para. 94. However, there is no support for such an interpretation in the plain language of Article 9.1(c). The more reasonable interpretation is that by qualifying "government action" with the phrase "by virtue of," the negotiators intended to capture actions taken through indirect connections. Indeed, even the definition of "by virtue of" quoted by Canada supports this conclusion. As noted by Canada, Black's Law Dictionary defines "by virtue of" as "by force of, by authority of, by reason of." See Canada First Submission, fn 96. The phrase "by reason of," for example, suggests that a payment need only be caused by government action, not arise directly from it. In any event, the United States considers that there is a direct connection between the payments under the new provincial export programs and the government action.

provinces in which the vast majority of milk is produced (Ontario and Quebec) all milk destined for export must be sold through an exclusive mandatory bulletin board system.[25]

40. The United States explained in its first written submission that it is the enforced segregation of the market that permits exporters to purchase milk for exports at discounted prices. By excluding milk for export from the domestic market, 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 exclusion of export contract milk from the domestic market which enables processors that export dairy products to avoid paying the higher domestic price for milk.

41. Canada argues that the government's segregation of the market should not be taken into account because the segregation does not force sales into the commercial export market. According to Canada, it is the producers that are making a "commercial" decision to produce for the export market, and that decision has nothing to do with the domestic quota system and the resulting segregation of the market.

42. As explained earlier, this argument ignores the reality of dairy farming. To suggest that the producers decide on their own to produce for the export market instead of the domestic market ignores the fact that they cannot control their production with a degree of precision that would exactly match their quota, that the government *forces* them to "pre-commit"to export contracts if they export, and that they have an incentive to produce to the full amount of their

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[25]Canada makes much of the lack of such a government-mandated bulletin board system in other provinces. In the view of the United States, however, it is in fact telling that it is precisely in the largest dairy provinces that Canada deemed this additional layer of government intervention to be necessary.

domestic quota. Just like under the Special Milk Class system, the producer thus exports in order to dispose of milk produced outside of its domestic quota because that is the only commercially viable market available for non-quota milk.[26] The government facilitates the disposal of this surplus by giving processors/exporters access to the milk at a discount from domestic prices.

43. The Panel recognized the role of Canada's domestic quota system in the transfer of resources from the producer to the processor under the Special Milk Class system. Its analysis of this issue is directly applicable to the role of the domestic quota system and hence the government action under the new provincial export programs. In rejecting Canada's argument (the exact argument Canada is making now) that dairy producers made a "commercial" decision to export under the Special Milk Class scheme, the Panel explained:

> Canada is, therefore, correct that producers do not have a choice to make with respect to the allocation of Classes 5(d) and 5(e) milk. However, this is so (i.e., the producers' choice is predetermined) *not* -- as Canada implies -- because of commercial reasons (e.g., because of a lower domestic demand the producer -- depending on its profitability -- decides, in order to maximize its total revenue, to allocate a certain share of its production to lower priced export markets), **but because of governmental actions**. Under the Canadian system, selling milk for use in the domestic market is no longer an option (i.e., the choice for a higher return is taken away) **mainly because the quotas - set by Canadian governments or their agencies - are met**; *not* because there is no more domestic

[26]As noted previously, the only other permitted avenue for disposal of over-quota milk (other than destruction) is for use in animal feed under Class 4(m) – a use which obtains substantially lower prices than the export market.

> demand for milk. As noted earlier, producers would likely be able to sell more milk domestically if they were allowed to do so, albeit probably at a somewhat lower price. In conclusion, we consider that producers do forego a choice or revenue - **albeit through governmental action** - and, therefore, make a payment in kind to processors/exporters in the sense of Article 9.1(c). [27]

44. In other words, the producers are selling in the export market, not because there is no demand in the higher-priced domestic market and the producer is therefore making a commercial choice to sell in the lower-priced export market, but because the domestic quota, which is set by the government, has been met. As a result, the producer is foregoing revenue not based upon "commercial" reasons but as a direct consequence of governmental action. This situation described and relied upon by the Panel has not changed under the new provincial export programs.

45. Canada argues that the "pre-commitment" requirement shows that producers are making a commercial decision. Canada ignores the fact that producers do not choose to pre-commit to export contracts; they are *required* by law to pre-commit if they are going to export at all. The fact that the government is requiring the producers to estimate up-front their portion of production that cannot be sold into the domestic market does not change the economic reality that a producer will only sell milk for the export market if it cannot be sold at the higher domestic price. This is a function of the domestic quota system's enforcement mechanism and the segregation of the market. The segregation of the market by the government and the exemption of export milk from the higher domestic price is the "government action" that is indispensable to the transfer of resources from the producers to the processors. More

[27]Panel Report, para. 7.100 (emphasis in bold added).

importantly, the requirement that producers "pre-commit" to export contracts is a government action further benefitting the processors by making the supply of export milk more predictable.

46. The federal and provincial governments' audit and enforcement authority (including provincial penalties) also forms part of the "government action" that is indispensable to the transfer of resources. Canada argues that these types of authority should not be considered "government action" because they could not affect a producer's decision regarding whether to commit milk for export. Again, Canada's argument misses the point. The relevance of the audit and enforcement authority is that it is essential to maintaining separate markets for domestic and export milk, and is therefore essential to the transfer of resources that the segregation of markets makes possible. Accordingly, they are properly considered as "government action" relating to this transfer of resources.

47. Canada's criticisms of the explanation by the United States of the particular audit and enforcement powers at both the federal and provincial levels are unfounded. Canada asserts that the power of the Ontario milk marketing board (the DFO) to revoke or suspend a producer's license is unrelated to export milk transactions because the DFO "cannot use licensing as a means to enforce private commercial export transactions."[28] Canada is mistaken; the United States is not contending that the DFO could use its licensing authority to enforce a private contract. In its first submission, the United States points out that the DFO has the authority to revoke or suspend a license for violation of the Ontario regulations. Delivery of milk contracted for export into the domestic market would clearly constitute such a regulatory violation. The

[28]Canada First Submission, para. 109.

DFO's authority is not a matter of enforcing a private contract; it is a matter of securing compliance with the regulation.

48. Canada also argues that the CDC's audit authority cannot be considered "government action" because it has been "severely" curtailed in relation to export milk. Whether or not the CDC's authority has been reduced in relative terms, it remains the case that the regulation clearly states that the CDC may request "information that is necessary to determine whether [commercial export milk or cream] has been marketed for final consumption in Canada."[29] On its face, the grant of authority is actually quite broad as it gives the CDC the power to request <u>any</u> information that it believes is necessary to determining whether export milk has been redirected to the domestic market.

49. Finally, despite Canada's contrary assertion, a review of the Dairy Product Marketing Regulations shows that, although there is no explicit prohibition on redirecting milk contracted for export into the domestic market, to do so would still constitute a violation of the Regulations. This is because only milk that precisely meets the definition of "commercial export milk" is exempt from the regulations. Part of the definition of "commercial export milk" under section 2(1)(b) is that the milk must be "marketed in a province set out in the schedule and *in a manner that is consistent with exclusions from the dairy product marketing laws in that province*."[30] Thus, if export milk is redirected into the domestic market in violation of provincial regulations, it would no longer fall within the exclusion for "commercial export milk" and therefore would be subject to domestic regulation and the seizure power of the federal inspectors.

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[29]Regulations Amending Dairy Product Marketing Regulations, Sec. 10 (p.58) U.S. Exhibit 4.

[30]Canada Gazette, 3 January 2001, pg. 57. U.S. Exhibit 4.

50. In sum, Canada has failed to establish that the overall action of Canadian governments in excluding over-quota and non-quota milk from the domestic market, in exempting export contract milk from domestic pricing requirements, in instituting mandatory and exclusive export contracting mechanisms, and in enforcing the various obligations arising from these regulatory requirements, does not constitute pervasive government intervention. On the contrary, it is clear that it is only through the exercise of these governmental powers that processors are provided milk at discounted prices, contingent on export. Accordingly, the requirement under Article 9.1(c) that payments are financed "by virtue of government action" is satisfied in this case.

C. In The Alternative, Canada's Export Schemes Are Inconsistent With Article 10.1 of the Agreement on Agriculture

51. 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 its new provincial export programs do not fall within Article 10.1 because they are not subsidies within the meaning of Article 1 of the *SCM Agreement*. In essence, Canada argues that the standard for finding a subsidy under Article 1 of the *SCM Agreement* is necessarily the same as that which applies to Article 10.1 of the *Agricultural Agreement*.

52. Canada's argument is without legal support and should be rejected by the Panel.[31] Both the Panel in this case and the Appellate Body in this case and in *United States - Foreign Sales Corporations* relied upon the definition of subsidy in the SCM Agreement as *context* for analyzing Article 10.1 of the *Agricultural Agreement*.[32] They did not equate the standards. Indeed, in *United States - FSC*, the Appellate Body noted that, although the requirement relating to export contingency was the same, "there are differences between the export subsidy disciplines established under the two Agreements."[33]

53. In any event, as the Panel in the original proceeding found, because the question is one of export subsidies in this case, 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."[34] 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.

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[31]In any event, the standard Canada is advocating that must be met to fall within Article 1 of the *SCM Agreement* is inconsistent with paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I to the *SCM Agreement*. Canada argues that there must be a "direct provision of goods" by the government in order to fall within the *SCM Agreement*. However, under paragraph (d), the provision of the subsidy may be either "directly or indirectly through government-mandated schemes."

[32]Panel Report, para. 7.126; Appellate Body Report, para. 87. *United States - Foreign Sales Corporations (FSC)*, WT/DS108/AB/R, 19 January 1999, para. 136.

[33]*United States - FSC*, Appellate Body Report, para. 141.

[34]Panel Report, para. 7.126. Notwithstanding the Panel's statement in this regard, the United States demonstrated in its first written submission at paragraphs 95 to 99 that the measures at issue here satisfy the general requirements of an export subsidy under Article 1 of the SCM Agreement.

54. The United States demonstrated in its first written submission that Canada's new provincial measures satisfy the requirements of paragraph (d) of the Illustrative List. As noted in our 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 on world markets to those exporters.[35]

55. For the reasons discussed above, Canada's new provincial export schemes satisfy each of these elements. First, as explained above, dairy processors continue to have access to milk that is priced on more favorable terms than would otherwise be available to such processors for milk in the domestic market. Second, it is undisputed that the lower prices are only available for milk used in the production of export products. 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 government-mandated exclusion of such milk from the domestic market. And, finally, 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.[36]

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[35] Panel Report, para. 7.128

[36] Canada asserts, without offering any proof or even supporting cites, that exporters are sourcing milk through the Import for Re–Export Program at terms which are at least as favorable as those on the export market. As noted above, without more, Canada does not satisfy its burden of proof on this point. Canada has not even quoted price data for this program, let alone supply the documentation. Further, as explained above, importing under this program is still subject to a discretionary permit requirement. Thus, even if the prices were the same, the terms and conditions are not as favorable.

56. Thus, because the new provincial export schemes satisfy each of the criteria identified in Paragraph (d) of the Illustrative List, the new provincial schemes are 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 provincial schemes constitute a subsidy under the Illustrative List supports a finding that the provincial export schemes are export subsidies under Article 10.1 of the *Agreement on Agriculture.*

57. Additionally, Canada did dispute the point made by the United States that there are no restraints on the availability of the export subsidies created by the new export schemes. 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.

D. Canada's Export Schemes Constitute Prohibited Export Subsidies Under The Article 3 of the SCM Agreement

58. As demonstrated above and in our 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 *Agricultural Agreement* Article 13(c)(ii)).

59. Canada, in its first submission, appears to take the United States to task for the brevity of the arguments provided in our first submission in support of the claim that Canada's export schemes violate the *SCM Agreement* as well as the *Agreement on Agriculture.* As demonstrated above with respect to the claims under the Agreement on Agriculture, Canada has changed the

form, but not the substance, of its export schemes. As in the earlier stage of the proceedings, the United States' analysis under the *Agreement on Agriculture* incorporated and referred to elements of the *SCM Agreement*, including the Illustrative List. Thus, in presenting arguments in support of the claim under Article 3 of the *SCM Agreement*, the United States was able to avoid repetition.

60. The analysis under the *SCM Agreement* is quite straightforward. With respect to the federal level of Canada's system, the 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 its 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*. With respect to measures at the provincial level, the United States has demonstrated at paragraphs 106 through 112 of its first submission that Canada's new measures at issue in this proceeding constitute an export subsidy, again relying on paragraph (d) of the Illustrative List. Finally, the United States reviewed at paragraphs 115 through 122 the arguments under the *SCM Agreement* with respect to the export schemes as a whole.

61. Although the arguments presented by the United States may have the benefit of brevity, the approach -- and in particular, the reliance on the Illustrative List to abbreviate the arguments in support of claims under *SCM Agreement* Article 3 -- is hardly novel. Indeed, Canada championed this same approach successfully in another recent 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 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.[37]

The panel in the Article 21.5 proceedings in the same dispute reached the same conclusion:

> [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.[38]

62. 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. Thus, contrary to Canada's apparent criticisms, no elaborate exegesis on the application of SCM Article 3 is called for.

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

[38] *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.

IV. Conclusion

63. 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*.

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