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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*

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(AB-2002-6)

STATEMENT OF THE UNITED STATES AT THE ORAL HEARING

October 31, 2002

1. Mr. Chairman and members of the Division, I am pleased to appear before you today to present the views of the United States.
2. In this second Article 21.5 proceeding, the Panel carefully followed the guidance set forth in the Appellate Body's second report in this dispute, which I will refer to as *Canada – Dairy II*, in 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 or 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. In the alternative, the Panel found that through the CEM program Canada is applying export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*.
3. Canada has appealed several aspects of the Panel's report, but in doing so, mischaracterizes the report and greatly exaggerates the implications of the Panel's findings. As the United States has explained in its submission, in reality, the Panel's report is a reasonable and measured analysis that carefully applies the Appellate Body's guidance to the facts of this case.

### **Article 10.3**

4. Canada first challenges the Panel's application of Article 10.3 of the *Agreement on Agriculture*, claiming that the Panel erroneously decided to examine whether Complainants had made a *prima facie* showing that the elements of the alleged export subsidies were present before it examined whether Canada had met its burden. Canada overlooks 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. Moreover,

this additional step did not change the outcome of the Panel's analysis.

5. Canada also claims that it had presented sufficient evidence to raise a rebuttable presumption that it did not subsidize its excess exports of cheese and other milk products. The Panel obviously disagreed with Canada's self-evaluation of the merits of its case. 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) correctly concluded that Canada had failed to meet its burden.

#### **"Payments"**

6. Canada also challenges the Panel's finding that Canadian dairy producers are making payments to Canadian dairy processors within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

7. The Panel agreed with the Complainants that the cost of production data that the Canadian Dairy Commission collects each year provides a reasonable, albeit understated, measure of the average total cost of production of the Canadian dairy industry.

8. In particular, the Panel found that the CDC cost of production data showed that the average cost of production per hectoliter of the Canadian dairy industry was over \$57 in 2000 and was estimated to be over \$58 in 2001. In contrast, the Panel found that the average CEM price per hectoliter was approximately \$29 in 2000 and approximately \$31.50 in 2001. The Panel concluded that these facts provide a "strong indication that, on average, payments are being made."

9. Canada contends that there is no support in the Appellate Body's report for an industry-wide analysis of the average total cost of production and that the Panel failed to consider relevant statements of the Appellate Body that Canada claims support a producer-specific approach. Yet, even a cursory review of the Panel report shows that the Panel carefully considered the Appellate Body's guidance and the parties' opposing views on it, as well as the basis for the Panel's conclusion that the Appellate Body did not intend "a calculation for each *individual* producer."

10. Moreover, the Panel correctly recognized the unworkability of a producer-specific cost of production benchmark, since governments rarely have the sort of detailed, producer-specific information about individual farmers' costs of production that such a test would require.

11. The Panel also properly found that Canada's individual producer data is insufficient to support Canada's claim that payments are not being made. 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."

12. Moreover, Canada's claim that 77 percent of the producers have costs of production within the "range" of CEM returns 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.

13. In addition, 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. These costs include (i) imputed costs for family labor, management services and return on equity; (ii) marketing, transportation, and administrative costs; and (iii) the costs of production quota. The Panel correctly recognized that these are "real costs" that a producer must recoup in order to stay in business over time. Canada's argument elevates form over substance and is inconsistent with the purpose of the Appellate Body's test, which is to include all costs an economic operator must recoup in order to avoid incurring losses in the long run.

**Financed by Virtue of Governmental Action**

14. With respect to the second prong of Article 9.1(c), the Panel carefully reconsidered whether the payments-in-kind that Canadian dairy producers make to dairy processors are financed by virtue of governmental action in light of the Appellate Body's extensive guidance. The Panel concluded that four factors supported its conclusion that the payments are financed by virtue of governmental action. These factors are: (i) the exemption of export processors from having to pay the domestic, regulated price, (ii) the prohibition on the diversion of CEM milk into the domestic market, (iii) the pre-commitment requirements (including the "first-out-of-the-tank" requirement), and (iv) the government's regulation of the domestic price and supply of

milk.

15. Canada claims that the Panel did not properly interpret and apply the Appellate Body's guidance. Yet, 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" to produce and sell commercial export milk as if such a finding were required to satisfy the governmental action prong. The Appellate Body made no such finding, however. In any event, the question is not whether producers are obliged or driven to produce milk for the export market. The relevant question is whether, after the milk is produced, the processor is receiving a subsidy upon export that is financed by virtue of governmental action.

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

17. Canada also misconstrues the Panel report when it argues that the Panel merely required a showing that payments are "made or made possible." 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 light of the Appellate Body's guidance that relevant governmental action could include the regulation of the price and supply of milk in the domestic market, 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 may 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.”

18. The Panel correctly concluded that the federal and provincial governmental actions that (i) exempt export processors from the requirement to purchase milk at the domestic, regulated price, and (ii) prohibit the diversion of any dairy products made with CEM milk into the domestic market support the conclusion that there is a demonstrable link between the governmental action and the financing of the payments. 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. Conversely, these policies put the dairy processor in a strong position to negotiate low prices for CEM milk, especially given the low, regulated price for milk sold as animal feed, which is the only other category of non-quota milk.

19. The Panel also correctly found that provincial pre-commitment policies provide additional support for its conclusion. These policies require producers, if they want to be able to sell into the CEM market, to “pre-commit” to sell a quantity of CEM milk and, once pre-committed, that milk must be “first-out-of-the-tank.” The fact that the government requires these conditions demonstrates that they are not normal commercial terms; the government is imposing these conditions to the benefit of the processor. 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 animal feed 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.

20. Lastly, the Panel correctly found that governmental regulation of the domestic price and supply of milk is another aspect of governmental action that establishes a “demonstrable link” to the financing of payments from the producers to the processors. Canada mis-characterizes the Panel’s analysis and, in particular, the Panel’s use of the term “cross-subsidization.”

21. The Panel did not create some new form of subsidization or new WTO obligation, as Canada suggests. Rather, the Panel used that 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. Once again, 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.” It noted that it is appropriate to consider what effects the governmental action had “on payments made by a third person.” 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.

22. 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, while at least covering their marginal costs of production. The Panel concluded that when all economic costs are taken into account, the Canadian producers on average are unable to cover their fixed and variable costs in the CEM market. 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.



**The SCM Agreement**

23. 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. Canada's argument overlooks the fact that in *Canada – Dairy II* the Appellate Body provided detailed guidance on the meaning of the term “payment” and the phrase “financed by virtue of governmental action” as used in Article 9.1(c) without itself resorting to the SCM Agreement. There was simply no need for the Panel to go beyond the Appellate Body's extensive guidance.

**Article 10.1 of the Agreement on Agriculture**

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

25. 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 as contextual guidance in evaluating whether Canada is providing export subsidies within the meaning of Article 10.1.

26. With respect to the first element of paragraph (d), the Panel noted that Canada does not dispute that fluid milk is sold for processing into exported dairy products at more favorable prices than for processing into domestic dairy products.

27. With respect to the second element of paragraph (d), 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” in paragraph (d). Consistent with prior WTO jurisprudence, the Panel concluded that the practices identified in the Illustrative List should be considered a *per se* list of prohibited export subsidies.

Therefore, 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 and the enforced prohibition on the diversion of CEM milk ensure that milk for processing into exported dairy products is sold on more favorable terms than milk sold for processing into domestic dairy products.

28. With respect to the third element of paragraph (d), 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. Canada attempts to undercut the Panel's finding by arguing that the price of whole milk powder under the IREP program falls within the eighteen month range of CEM prices. 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 below the price of whole milk powder.

29. 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, including the 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. The Panel's conclusion is borne out by the fact that most whole milk powder imported under the IREP program is used in confectionary products.

30. Thus, the Panel correctly concluded that all three elements of paragraph (d) are met and, on this basis, correctly found that Canada is providing export subsidies within the meaning of Article 10.1.

31. That concludes our oral statement. We would welcome the opportunity to address your questions. Thank you.