United States – Subsidies on Upland Cotton: 
Arbitration Under Article 22.6 of the DSU 
and Article 4.11 of the SCM Agreement 
(WT/DS267)

United States – Subsidies on Upland Cotton: 
Arbitration Under Article 22.6 of the DSU 
and Article 7.10 of the SCM Agreement 
(WT/DS267)

Answers of the United States 
to the Additional Questions from the Arbitrators

March 20, 2009
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A. LEVEL OF COUNTERMEASURES IN RELATION TO THE PROHIBITED SUBSIDIES

Notion of "appropriate countermeasures"

To both parties:

69. Brazil has requested countermeasures based on particular principles. Does the Arbitrator have to agree that the request is justifiable in terms of the principles used, or is within a range of principles which could be justified, before a “burden of proof” is imposed on the US? Would the Arbitrator have to accept any proposal put to it, by Brazil, unless the US disproves it?

1. The burden of proof to show that a request for suspension of concessions or countermeasures does not meet the applicable legal standard is on the party challenging the request – in this dispute, the United States.\(^1\) The United States has met this burden. As the Arbitrator’s question suggests, if the request for countermeasures is based on principles, or a methodology, which the Arbitrator recognizes as bearing no or little relation to the notion of countermeasures in WTO dispute settlement, or no or little relation to the DSB recommendations and rulings in the dispute, or indeed have been abandoned by the Member seeking authorization, then the burden is easily met by the objecting Member.

2. In this proceeding, for example, Brazil abandoned the approach to countermeasures in its original request. Brazil requested countermeasures for GSM 102 guarantees based on “an amount that corresponds . . . to the total of exporter applications received . . . for the most recent concluded fiscal year.” The United States objected to this request, thereby referring the matter to arbitration. Brazil’s methodology paper presented an entirely different basis for countermeasures (a methodology purportedly calculating the amount of the subsidy through the interest rate subsidy plus “additionality” effects for U.S. producers), effectively rejecting the principles relied upon in its request. In other words, even Brazil concedes that its request did not conform to the applicable legal criteria. Accordingly, because of Brazil’s response to the U.S. objection, it is evident that Brazil’s original request was not “appropriate.” The United States has carried its initial burden in this proceeding.\(^2\) At this point, it falls to the Arbitrator to determine what are the “appropriate countermeasures,”\(^3\) and Brazil’s new approach should not be given any special weight by the Arbitrator.\(^4\)

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\(^1\)U.S. Response to Arbitrator’s Question 41.

\(^2\)In fact, as Brazil’s methodology paper concedes, the amount of exporter applications for GSM 102 guarantees bears no relation to either the “amount of the subsidy” or to “trade effects.” That is, the face value of guarantees has never been asserted to represent entirely a subsidy, nor has it ever been asserted that each dollar in registered guarantee value causes a dollar of trade effects.

\(^3\)Brazil-Aircraft (22.6), paras. 2.8-2.9; CDSOA, paras. 2.36-2.38.

\(^4\)Brazil has taken a new approach for both GSM 102 and Step 2. As the United States has explained (U.S. Submission, paras. 226-228), Step 2 has been repealed, and there is no basis for any countermeasures with respect to Step 2. It is worth noting, however, that the original request for countermeasures for Step 2 was not a one-time payment, but was to be based on the most recently completed marketing year. That might be the most recent year prior to the 2005 request,
70. **What is the role of the Arbitrator in these proceedings? Is it limited to agreeing or disagreeing with either or both of you, or would it extend to proposing an alternative figure, whether based on the principles presented to the Arbitrator or on principles substituted, by the Arbitrator, for those presented to the Arbitrator?**

3. In these proceedings, once the burden of proof has been met (and as explained in the reply to question 69, here the United States has met its burden of proof), the Arbitrator is not limited to agreeing or disagreeing with the parties. The Arbitrator’s task is to determine “appropriate” countermeasures for prohibited subsidies or, for actionable subsidies, countermeasures “commensurate with the nature and degree of the adverse effects determined to exist.”

4. For the reasons already detailed by the United States in its written materials and during the meeting with the Arbitrators, the Arbitrator should reject Brazil’s current approach as not appropriate. The United States has presented an alternative approach that would be “appropriate,” and the Arbitrator may, but is not required to, use the U.S. approach in making its award.

71. **Are the amount of subsidy and trade effects on the complaining Member the only parameters that define "appropriate countermeasures", or could the appropriateness of countermeasures differ depending the circumstances of each specific case? Would it be possible to use calculation principles other than the “amount of the subsidy” and “trade effects” in working out the quantum of the “appropriate countermeasure” under Article 4.10 of the SCM Agreement?**

5. Trade effects should be used for countermeasures, following the same principle as for the suspension of concessions under the DSU. While prior arbitrators considering requests for countermeasures for prohibited subsidies have used an “amount of the subsidy” approach, they have also acknowledged the “trade effects” approach.\(^5\)

6. In this arbitration, Brazil has presented its revised arguments for countermeasures solely on the basis of an alleged “amount of the subsidy” approach. The United States has explained that, with respect to GSM 102, Brazil’s approach actually consists of a flawed “amount of the

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or it might be 2007-2008, if a formula were intended. Both would be retrospective, as Step 2 has been repealed; but if a formula approach were intended then even under Brazil’s own request, the amount would be zero, consistent with the fact that the program has been repealed. In addition, although this request is presented with respect to prohibited subsidies, the United States would observe that Brazil has also substantially changed its request for actionable subsidies. Such revisions call into question the reliability of Brazil’s requests.

\(^5\)Brazili-Aircraft (22.6), paras. 3.57-3.60; US-FSC (22.6), paras. 6.33-6.34.
subsidy” calculation and an estimate (based purely on assumptions) of additional U.S. sales generated by GSM 102. The United States has further explained that Brazil’s “additionality” calculation cannot serve as a basis for determining “appropriate” countermeasures, and Brazil at the hearing conceded that its “additionality” approach was not a calculation of trade effects on Brazil (that is, lost export opportunities to Brazilian producers). What is important is that, regardless of the particular approach used, the countermeasure not be disproportionate and flow from the particular DSB recommendations and rulings.

72. Reference has been made to the ILC's Articles on State Responsibility.

(a) What exactly is the legal relevance of the notion of “countermeasures” as reflected in the ILC’s Articles on State Responsibility in the context of this Arbitrator’s assessment?

(b) Do these Articles reflect or embody, in your view, rules of public international law?

(c) Please comment on the following passage of the commentaries to the Draft Articles: in every case a countermeasure must be commensurate with the injury suffered, including the importance of the issue of principle involved and this has a function partly independent of the question whether the countermeasure was necessary to achieve the result of ensuring compliance.

7. The ILC Articles themselves establish that the notion of “countermeasures” reflected in those Articles are not relevant in this arbitration. These arbitrations are governed by the specifically applicable treaty provisions of the WTO, in particular the DSU and the SCM Agreement. Thus, a lex specialis regime is in place. Article 55 on lex specialis provides:

> These articles do not apply where and to the extent that the conditions for the existence of an internationally wrongful act or the content or implementation of the international responsibility of a State are governed by special rules of international law.

8. Accordingly, the term “countermeasure” should be interpreted as it appears in the relevant WTO Agreement – the SCM Agreement – and not based on its usage in the ILC Draft Articles, and the commentaries would not apply either since they are commentaries to a provision that does not apply in these proceedings.

9. Furthermore, the ILC Draft Articles do not constitute rules of public international law, although some of their provisions may reflect customary international law. In terms of the status of the Draft Articles themselves, they do not constitute law in their own right. Rather, they include some provisions that reflect customary international law, others that explicitly do not, and still others the status of which is unclear. What is important for these proceedings is that they are not “covered agreements” set forth in Appendix 1 to the DSU, the lex specialis for this
10. The particular passage highlighted by the Arbitrator in part (c) of this question points to the importance of the injury suffered when considering countermeasures with respect to the cause of that injury. As noted, the ILC Draft Articles, including this passage, are not relevant for the Arbitrator in this proceeding.

11. However, consideration of the injury to a party, described in terms of nullification or impairment of benefits to a Member, is important under the terms of the WTO Agreement itself. Indeed, the general provisions of the DSU, including the affirmation in Article 3.1 of the DSU of the principles of Article XXIII of the GATT on nullification and impairment, make this explicit. Brazil has not shown any such nullification or impairment, or indeed any injury to it, as part of its arguments for proposed countermeasures, and as such its proposed countermeasures do not meet the applicable legal standards of the DSU or the SCM Agreement, regardless of the scope of the Draft ILC Articles.

73. In the event that the Member concerned fails to bring the relevant measure into compliance, Article 22.2 of the DSU envisages that Member entering into negotiations with the complaining Member[s] with a view to developing mutually acceptable "compensation". A similar compensation mechanism is not provided for in the dispute settlement provisions of the SCM Agreement. Might this suggest that the SCM Agreement is not necessarily concerned with "compensating" the complaining Member for the nullification or impairment of benefits accruing directly to it? Please explain.

12. Article 22.2 provides a mechanism for negotiations on mutually acceptable compensation, if such negotiations are requested. The effect of this mechanism is both to compel the responding party to enter into negotiations, perhaps averting a request for authorization to suspend concessions, and to compel the complaining party to wait at least 20 days after the end of the reasonable period of time before having a request for authorization considered by the DSB, which may serve as encouragement to explore the possibility of compensation. In this way, the aims of the dispute settlement system set out in DSU Article 3.7 are furthered, for example, by ensuring that the suspension of concessions remains a “last resort.”

13. DSU Article 3.7, setting out the “aim” and “objective[s]” of the dispute settlement mechanism apply to disputes under the SCM Agreement as well. As the Appellate Body has recognized, the “special or additional” rules referred to in the DSU (in this case Articles 4 and 7 of the SCM Agreement) apply “in conjunction with” the rules of the DSU.\(^6\) Nothing in Articles 4 and 7 “conflict” with Article 3.7 of the DSU. Neither article provides an express mechanism under which a request for countermeasures is to be delayed to allow an opportunity to negotiate

\(^6\) Guatemala Cement I (AB), para. 65; US-FSC (22.6), para. 5.5.
compensation. However, the absence of an express mechanism goes to the question of timing and whether to mandate a window of opportunity for negotiation. The absence does not mean that the Article 3.7 of the DSU is inapplicable.

14. In this connection it is useful to recall that both Article 4 and Article 7 of the SCM Agreement sets up an expedited process for resolving disputes related to prohibited and actionable subsidies, respectively.\(^7\) It is not surprising, therefore, that negotiators did not provide for the same 20 day window in which to negotiate compensation as under the DSU. However, Article 7.9 of the SCM Agreement affirms that compensation is still relevant – it provides that the DSB’s authorization of countermeasures would only be provided in “the absence of agreement on compensation.” That is, DSU Article 3.7 applies in conjunction with Articles 4 and 7, with the result that countermeasures remain the “last resort” after withdrawal or compensation do not occur.

74. Article 3.8 of the DSU provides that an infringement of obligations assumed under a covered agreement, including the SCM Agreement, "is considered prima facie to constitute a case of nullification or impairment". Indeed, the original panel made such a finding of nullification or impairment at para. 8.2 of its Report. What is the relevance, if any, of Article 3.8 of the DSU to the issue of whether or not the scope of countermeasures under the SCM Agreement should necessarily be restricted to nullification or impairment of benefits accruing directly to the complaining Member? In particular, why would Article 3.8 provide for nullification or impairment in the event of a violation of the SCM Agreement if that concept were not to play a role in determining the scope of countermeasures authorized under that agreement? Is there anything about Article 3.8 which tells us that the nullification or impairment is limited to the effect of the non-compliance on the complaining party?

15. Article 3.8 of the DSU is useful context in understanding that the standard of “appropriate countermeasures” in Article 4 of the SCM Agreement relates back to the nullification and impairment of benefits to the complaining party. Article 3.8 establishes that a breach of a WTO obligation “is considered prima facie to constitute a case of nullification or impairment,” regardless of the specific WTO obligation that has been infringed. Thus, breach of the obligation not to grant or maintain prohibited subsidies under Article 3.1 of the SCM Agreement would also prima facie be a case of nullification or impairment. Further context supporting the notion that nullification or impairment relates to benefits to the complaining party can be found in the SCM Agreement and the GATT 1994. Article 30 of the SCM Agreement provides that “[t]he provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute

\(^7\) In the underlying dispute, neither of these expedited timeframes applied. This aspect of the dispute only supports the fact that there is no reason to exclude compensation in SCM Agreement disputes.
Settlement Understanding shall apply to consultations and the settlement of disputes under this Agreement, except as otherwise specifically provided herein.” GATT 1994 Article XXIII, in turn, provides that “if any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired . . . as the result of: (a) the failure of another contracting party to carry out its obligations under this Agreement.” Thus, these provisions confirm what is suggested by Article 3.8 of the DSU: a breach of a WTO obligation, including an obligation under the SCM Agreement, constitutes a case of nullification or impairment of benefits accruing to that Member. This provision applies equally to disputes where suspension of concessions is exclusively governed by the “equivalent to the level of nullification and impairment” standard of Article 22.4 of the DSU as well as disputes where special and additional rules of the SCM Agreement apply. Between the two situations, there is no basis in the text of 3.8 to apply the normal reading of nullification and impairment (that is, nullification and impairment of benefits to the Member concerned) in one situation but a different reading of nullification and impairment in another.

75. Imagine the DS267 proceedings had been initiated by a Member who produces none of the products covered by the subsidy programmes at issue. Imagine also that that Member requested authorization to adopt the exact same countermeasures as those requested by Brazil, on the basis of the findings of WTO-inconsistency already obtained by Brazil in the earlier proceedings. Should the fact that that Member does not suffer any economic disadvantage as a result of the relevant subsidy programmes affect the Arbitrator's determination of whether the proposed countermeasures are "appropriate" and "commensurate with the degree and nature of the adverse effects determined to exist"? Please explain.

16. In a situation where a Member does not suffer any economic disadvantage as a result of the subsidies at issue in a dispute, this fact should definitely affect the Arbitrator’s determination: the Arbitrator should not find that countermeasures are appropriate for that Member to impose. However, that the Member suffers no economic disadvantage would only apply to the question of countermeasures. It would not affect the ability of the Member to bring a dispute and obtain DSB recommendations and rulings since demonstrating a WTO breach prima facie constitutes a case of nullification or impairment. Neither would it affect the responsibility of the responding party to bring its measure into conformity with its WTO obligations. It simply would reflect that suspension of concessions is the “last resort” under the dispute settlement system, and the DSU

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8Brazil invoked GATT 1994 Article XXIII and SCM Agreement Article 30 as part of its request for establishment of a panel: “The Government of Brazil therefore hereby requests that a panel be established pursuant to Articles 6 of the DSU, Article XXIII:2 of GATT 1994, Article 19 of the Agreement on Agriculture, and Articles 4.4, 7.4 and 30 of the SCM Agreement (to the extent that Article 30 incorporates by reference Article XXIII of GATT 1994).” WT/DS267/7, p. 1.
and SCM Agreement set limits on the application of this least-favored option.

17. In terms of “appropriate” countermeasures under Article 4 of the SCM Agreement, if a Member were authorized to suspend concessions in response to a measure that did not cause it any economic disadvantage, such countermeasures would be disproportionate to the trade effects caused by the measure. In this circumstance, the trade distortion resulting from suspending concessions would by definition be out of proportion to the impact of the inconsistent measure that is meant to be addressed by the countermeasure.

18. Similarly, in terms of countermeasures commensurate with the adverse effects on a Member, under the premise of the question, no countermeasures could be imposed. Nor should they. The negotiators specifically provided that the findings with respect to actionable subsidies are based on the effect of a subsidy on the complaining Member. This is equally true for each type of “adverse effects” described in Article 5 of the SCM Agreement. Article 5(a) provides that “adverse effects” may be assessed based on injury to the complaining Member’s domestic industry; Article 5(b) provides for “adverse effects” based on “nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994”; and Article 5(c), which was applied in this dispute, provides for assessing “adverse effects” on the basis of “serious prejudice to the interests of another Member” (emphasis added). It is also useful to note the standard for awards of countermeasures under Articles 7.9 and 7.10 of the SCM Agreement, which confirms that it must be commensurate with the “adverse effects determined to exist.” This reference back to “adverse effects” – which are defined in Article 5 of the SCM Agreement – reinforces that it is the effects on the complaining Member that are central for any award of countermeasures for actionable subsidies.9

To the US:

81. You are asking us to confine ourselves to a very narrow standard of “amount of subsidy”, based on the nature of the findings. Yet you recognize that there is some flexibility embodied in Article 4.10. So on what basis do you say that there is no other option?

19. The flexibility in Article 4.10 relates to the fact that, unlike Article 22 of the DSU, it does not require a precise numerical equivalence with the level of nullification and impairment caused by the subsidy, and also the fact that the amount of the subsidy may be used in assessing appropriate countermeasures.

20. The reason that the “amount of the subsidy” is to be measured by net cost to government

9Note Indonesia-Autos (panel), para. 14.202, confirming that a member may not bring a claim that another member has suffered serious prejudice.
is that this was the basis for the DSB findings in this dispute.

21. Both Brazil and the United States have presented methods to assess possible countermeasures on the basis of “amount of the subsidy.”\(^{10}\) Given the need for the Arbitrator to fulfil its mandate through an award based on the relevant facts, and given the facts available to it, the U.S. description of the “amount of the subsidy” provides the correct standard.

22. As the United States has explained, Brazil’s calculation is disproportionate with any reasonable measure of the amount of the subsidy, or interest rate discount, provided by GSM 102. Even the most basic adjustments to Brazil’s calculations, such as using default probabilities for individual obligors rather than relying on the arbitrary “uncreditworthiness” characterizations by Brazil, lower the interest rate subsidy more than 57%.\(^{11}\) Other basic adjustments bring the estimated interest rate subsidy down even more. In Exhibit US-116a, the US has described two such changes, 1) using more realistic bank ratings that do not use Brazil’s arbitrary one-notch and four-notch method and 2) removing permitted subsidy amounts and subsidies for products not before the panel.\(^{12}\) Brazil has also added in “additionality” to its calculations, but the additionality is the effect of the subsidy, and not the subsidy itself.

23. By contrast, the approach to measuring the “amount of the subsidy” presented by the United States uses the same data, not prepared for litigation, that was reviewed by both the original and compliance panels in this dispute and which is based on actual information on the performance of the GSM 102 guarantees.\(^{13}\) In fact, it is the only approach to measure of the subsidy that parallels the findings of the DSB in this dispute.

82. Please clarify how you define “punitive” countermeasures.

- Do you consider that countermeasures would be punitive whenever they exceed the level of adverse trade effects suffered by the complainant?

\(^{10}\)As a separate component, Brazil has included effects of the subsidy as “additionality.” However, Brazil cannot claim countermeasures on two separate bases, “amount of the subsidy” and “trade effects.” They are alternative approaches. Canada-Aircraft (Article 22.6), para. 3.30. They cannot be added together as Brazil has requested in this arbitration.

\(^{11}\)U.S. Response to Arbitrator Question 51, para. 109.

\(^{12}\)Brazil’s estimate of the interest rate subsidy is also far in excess – more than double – what has been included in related academic literature. Exhibit US-92.

24. If countermeasures exceed the level of adverse trade effects suffered by the complainant, that means that the complainant is imposing an additional amount above what would be needed to restore the balance of concessions between the complainant and the other Member. Punitive countermeasures are a concern in that circumstance. However, given the margin of flexibility provided by the special and additional rules (e.g., “appropriate” instead of “equivalent”) and given the possibility for different principles (e.g., amount of the subsidy) for assessing countermeasures, the United States does not argue that a countermeasure is punitive every time it is even slightly greater than the adverse trade effects suffered by the complainant.

- If so, then what is, in your view, the difference between the standards embodied in Articles 22.4 of the DSU, Article 4.10 of the SCM Agreement and Article 7.8 of the SCM Agreement?

25. The concern that countermeasures are punitive arises when the countermeasure exceeds the applicable standard, including where a special or additional rule applies. The extent of a countermeasure that is permitted for the purposes of the DSU is defined by such standards, and additional amounts of countermeasures would be serving some other purpose not authorized by the DSB – such as punishment.

26. For Article 4.10 of the SCM Agreement, the term “appropriate” introduces more flexibility into the determination of the level of countermeasures. However, as explained above, the clarification that the term “appropriate” is not meant to allow countermeasure that are “disproportionate” links this provision to trade effects because the nullification or impairment caused by the measure (the metric used under Article 22 of the DSU) provides the basis against which to judge whether the proposed countermeasure is disproportionate. Accordingly, where a countermeasure is disproportionate with, or in excess of, the amount of the subsidy in an award where countermeasures are based on “amount of the subsidy,” there is a concern that the countermeasure is punitive.

27. For Article 7 of the SCM Agreement, three types of adverse effects may underlie the findings of the DSB and the amount of countermeasures. Specifically, these types are injury to the Member’s domestic industry, nullification or impairment of benefits to a Member, or serious prejudice to the interests of a Member. Where countermeasures exceed the “adverse effects” of the type used in the DSB findings in a particular dispute, there is a concern that they would be punitive, as they would no longer be related to the adverse effects that the countermeasure is intended to address.

- The arbitrator in Brazil – Aircraft stated the following:

“A countermeasure becomes punitive when it is not only intended to ensure that the State in breach of its obligations bring its conduct into conformity with its international obligations, but
contains an additional dimension meant to sanction the action of that state” (para. 3.55).

Do you agree with this characterization?

28. Where a countermeasure includes an additional dimension of sanctions, it would certainly be punitive for purposes of WTO dispute settlement. However, countermeasures may be punitive even without an explicit sanctioning element. If the intent of a countermeasure is “ensuring” that a member changes its conduct in a particular way, such an intention could potentially overwhelm the specific standards of the DSU and the special and additional rules of the SCM Agreement, as it would be potentially without limit. The countermeasures will be punitive, and not in accordance with the DSU and SCM Agreement, in the case that they are either (1) out of proportion to the trade effects of a prohibited subsidy, in light of the fact the subsidy is prohibited, or (2) not commensurate with the adverse effects of an actionable subsidy.

83. What is the legal basis for the concept of “rebalancing of rights and obligations” that you refer to? Does it relate only to the rebalancing of the rights and obligations of the parties in the dispute? If so, why? Could it relate to the rights and obligations of WTO Members at large?

29. The concept of “rebalancing” is grounded first of all in Article 22 of the DSU, which provides the general rule (or baseline) for suspension of concessions. The authorization of suspension of concessions or other obligations by the DSB must be equivalent to the nullification and impairment of benefits, so that suspension of concessions would serve to reset or “rebalance” such nullification or impairment.

30. Recall that the Preamble to the WTO Agreement includes the goal of liberalization through “reciprocal and mutually advantageous arrangements,” and that under the DSU suspension of concessions is considered a last resort. Accordingly, the Arbitrator should bear in mind that the WTO consists of a series of these arrangements among Members. Allowing a Member to retaliate for the impact on another Member’s trade when that other Member has not brought the dispute would improperly read the SCM Agreement. It would disregard the context provided by both Article 3.7 of the DSU and the Preamble. It essentially would amount to allowing the complaining Member to suspend trade concessions on behalf of another Member, when that other Member has not chosen the “last resort” option in its trade relations with the responding Member. If Brazil did so, it would effectively be usurping the decisions between the United States and those other Members about their “reciprocal and mutually advantageous” trading relationship. This “rebalancing” speaks fundamentally to adjustment of the balance between those particular individual Members who are engaged in a dispute, and not the balance among Members who have not chosen to resort to dispute settlement (let alone the “last resort”

14DSU Article 3.7.
of suspension of concessions) in their trading relationship.

31. Because of the fact that “rebalancing” is grounded in the idea of response to nullification and impairment, it relates to the findings in dispute settlement with respect to the particular parties concerned, and does not concern rights of other Members not parties to a dispute. If an individual complaining Member could suspend concessions for the rights of all Members, the suspension would not “rebalance” rights and obligations, but would create a new imbalance. The complaining Member would take on suspension of concessions and affect the responding Member’s rights (with possible detrimental effects) far out of proportion with the subsidy and not commensurate with the effects on the Member. Accordingly, rebalancing in a dispute refers to “balancing” of the two sides of the scale: the DSB finding with respect to the measure of the subsidizing Member, and the rights of the complaining Member.

84. Is there any textual support for the view that a countermeasure in relation to a prohibited subsidy can only relate to the trade effect on the complaining Member itself? If it is the case that only that proportion of the effects relating to a complaining Member can be the subject of a countermeasure, how can past rulings of Arbitrators, which have based the quantum of a countermeasure on the entire amount of a subsidy, and not only on that part of the subsidy which generated the effects on the complaining Member itself, be explained?

32. A countermeasure for a prohibited subsidy must relate to the trade effect on the complaining Member because of the provisions of the DSU and the SCM Agreement. First, DSU Article 22.4 provides the baseline for authorization to suspend concessions as the level of nullification and impairment to the complaining party. Article 22.4 reflects the fact that under GATT Article XXIII, a Member can bring an action when it considers that benefits accruing to it directly or indirectly are being nullified or impaired by a measure that breaches the agreement, and Article 30 of the SCM Agreement confirms that GATT Article XXIII applies to actions under the SCM Agreement unless otherwise specified therein.

33. Article 4.11 of the SCM Agreement provides that countermeasures for prohibited subsidies must be appropriate, which is not meant to allow “disproportionate” countermeasures. The nullification and impairment caused by the measure, as the otherwise applicable standard under the DSU to limit countermeasures, is the basis for comparison to determine whether the proposed countermeasure is “disproportionate.” Flexibility is provided by the following phrase “in light of the fact that the subsidies dealt with under these provisions are prohibited.” Article 3.8 of the DSU confirms the link of the “nullification and impairment” concept to the SCM Agreement. By providing that an infringement of the obligations of a covered agreement (including the SCM Agreement) constitutes a prima facie case of nullification and impairment, it confirms that SCM Agreement breaches, too, create nullification and impairment. Thus, the relevant provisions of the DSU and the SCM Agreement provide the textual link between the
special and additional rules under 4.11 and nullification and impairment to the complaining party under the DSU.

34. With respect to prior findings on prohibited subsidies, the United States has serious concerns with those awards that would enable a Member to impose countermeasures in excess of the effect of a subsidy on that Member. Such awards ignore the text of the SCM Agreement. In particular, they failed to rely on the ordinary meaning of “disproportionate” in context and in light of the agreement’s object and purpose. “Disproportionate” can only be understood by comparing the countermeasure to something else, and that something is nullification and impairment of benefits to a Member, even where that level of nullification and impairment is approximated by the “amount of the subsidy” in a particular dispute. Furthermore, the approach taken in those awards raises the possibility that any amount might be deemed “appropriate” as long as it is judged to promote or induce compliance, and presumably for any level specific, an higher level would always be more likely to induce compliance. Nor are the approaches taken in different awards consistent.

"Benefits" (Brazil's approach)
To both parties:

91. Is there, in your view, any correlation between the "benefits" having accrued to operators in the form of "additional" sales, and any "adverse effects" suffered by other WTO Members in the form of "lost sales" as a result of the measure?

35. Depending on how “additional” sales are measured, there may be a correlation between such “additional” sales resulting from a subsidy and “lost sales” that may be felt by another WTO Member. Fundamentally, however, both of these impacts on sales are effects of a subsidy. The economic concepts of additional sales and lost sales are not the type of “benefit” of a subsidy that is applicable for subsidies, as defined under the SCM Agreement. Any “benefit” should be measured consistently with the SCM Agreement and how it provides for measurement of subsidies for export guarantee programs.

36. The “benefit” of a subsidy for the purposes of the SCM Agreement is explicitly the “benefit” conferred by the governmental financial contribution. Thus, there is a certain correlation between the financial contribution (which can be measured, as in the circumstances of GSM 102, on the basis of cost to government) and the “benefits” of the subsidy. The SCM Agreement also provides guidance in Article 14(c), which defines the benefit of a loan guarantee as the interest rate differential – the “difference between the amount that the firm receiving the guarantee pays on a loan guaranteed by the government and the amount that the firm would pay on a comparable commercial loan absent the government guarantee.”

37. Where there are other “benefits” or “advantages” resulting from a financial contribution,
these are consequences or results of the subsidy, not “benefits” for the purposes of the SCM Agreement and not measurement of the subsidy provided by a Member.

38. With respect to the other possible effects that Brazil has characterized as “benefits” of loan guarantees under GSM 102, we note the distinction between “additional sales” and “lost sales” concepts. Additional sales may be generated by additional demand and would simply be extra sales that would not have happened without GSM 102; they are not necessarily related to sales that would exist without GSM 102 that any country “lost” or any other effect on another Member. With respect to the idea of “lost sales,” this could relate to sales that U.S. exporters made that would have been made by other exporters in the absence of GSM 102 guarantees. Lost sales may thus result from trade diversion, and not necessarily any additionality. In this proceeding, Brazil has not shown – nor attempted to show – whether Brazilian producers would have enjoyed more sales if there were no GSM 102 guarantees.

39. Finally, the ramifications of Brazil’s approach to “benefits” should be considered. Brazil is effectively asking the Arbitrator to include not only the subsidy benefit conferred by the governmental financial contribution, but also separate, additional effects of the guarantees. Brazil has expressly asked the Arbitrator to follow the general approach of previous arbitrations and set the appropriate countermeasures as the “amount of the subsidy.” If the Arbitrator’s award reflected Brazil’s specific methodology and approach, however, the Arbitrator would effectively adopt a different definition of subsidy than that provided for in the SCM Agreement. Such an award would also require a more thorough examination of all possible benefits – and costs – related to the economic activity related to export of products under GSM 102. The benefits that Brazilian banks receive from participating in GSM 102 financing would be important, as would benefits to Brazil’s importers from purchases of U.S. products. For producers, costs would have to be taken into account, including costs related to production that would not otherwise occur and the relative costs of other ways of financing exports. Yet, none of these questions need be before the Arbitrator. The subsidy is the benefit conferred by the governmental financial contribution, and any “appropriate” award need go no further.

To the United States:

96. Please refer to paragraph 35 of your oral statement. In light of Brazil’s suggestion that there may be some flexibility in determining credit-worthiness, where might one draw the line?

40. The United States understands Brazil’s current proposed “line” for uncreditworthiness now to be a numerical rating of 14 and below.15 Such a line is as arbitrary and unjustified as the

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15Statement by R. Sundaram, Exhibit Bra-793, para. 54. Brazil appears to have drawn its new line based on its conclusion that “it is implausible that [an entity with a ‘B’ rating from
previous proposed line of 11 and below.

41. Brazil is as wrong to treat an entity rated at 14 or inferior as automatically equivalent to an 18 as it was so to treat an entity rated at 11 or inferior. As the United States pointed out in paragraph 35 of its oral statement, Brazil makes no allowance for creditworthiness below its own arbitrarily drawn line. Brazil’s own written submission recognizes that “non-investment grade” or “speculative grade” is not synonymous with “uncreditworthy”: “The term ‘investment grade’ historically referred to bonds and other debt securities that bank regulators and market participants viewed as suitable investments for financial institutions. Now the term is broadly used to describe issuers and issues with relatively high levels of creditworthiness and credit quality. In contrast, the term ‘non-investment grade,’ or ‘speculative grade,’ generally refers to debt securities where the issuer currently has the ability to repay but faces significant uncertainties, such as adverse business or financial circumstances that could affect credit risk.”

42. Brazil’s argument about where to draw the “line” for uncreditworthiness has shifted throughout these proceedings as Brazil has sought a principle to support its line-drawing. Originally, all obligors rated 11 or inferior “would not have been able to secure credit at market at all, [and therefore] utilizing a common default probability of ‘18’ for all non-creditworthy borrowers is conservative.” Now, however, Brazil says that “reasonable minds can differ on where the threshold between creditworthy and uncreditworthy obligors should fall” and similarly, “reasonable minds can differ on the point at which the credit risk posed by a foreign obligor is high enough to make it uncreditworthy.”

43. In that light, even setting aside for the moment that the appropriate starting point of analysis should not be credit ratings at all, the Arbitrator is entitled to know: why doesn’t Brazil’s
methodology simply apply the default probabilities associated with each rating? One possible answer may relate to this fact: as the United States has demonstrated, if one calculates an interest rate subsidy by applying all parameters of Brazil’s methodology, but replacing Brazil’s attribution of uncreditworthy default probabilities with the default probability corresponding to the relevant actual or otherwise imputed risk rating, the interest rate subsidy calculation falls by more than 57 percent.

44. As noted, however, the United States does not believe that determinations of creditworthiness should hinge, in the first instance, on credit ratings, nor is it appropriate to draw a bright line for such determinations based on credit ratings.

45. Brazil asserts that it is using a U.S. Department of Commerce methodology “to calculate a counterfactual market interest rate associated with a single probability of default common to the entire class of uncreditworthy obligors.” Brazil asserts that its methodology for assigning “a default probability corresponding to rating category 18” (i.e., “uncreditworthy”) “to all borrowers with a credit rating at or inferior to 11 on the 1-18 numerical scale . . . is justified as consistent with the DoC’s own approach.” Elsewhere, however, Brazil acknowledges that the Department of Commerce does not apply such an approach in its analysis and determinations regarding creditworthiness.

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20Exhibit Bra-696, Worksheet 2. “Worksheet 2 of Exhibit Bra-696 reproduces Moody’s 2006 list of cumulative default probabilities for all 18 credit risk groups over different time horizons.” Brazil Methodology Paper, para. 33. Curiously, Brazil’s argument against the use of IMF national average interest rates is that they are inferior to “rates calculated using the specific probability of default for each creditworthy foreign obligor.” Exhibit Bra-793, para. 51. Brazil fails to explain why a specific probability of default is valid for an entity with a credit rating of 10, but not 11. Or now, why valid for 13, but not 14?

21U.S. Oral Statement, para. 34; U.S. Responses to Arbitrator’s Questions, para. 109; Exhibit US-79. In fact, the interest rate subsidy calculation would fall even further under Brazil’s most recent proposal. The calculations in Exhibit US-79 adopt Brazil’s prior approach of ascribing to “unrated” banks a rating one notch below the lowest rating in the particular country. Brazil now proposes that such rating could be on par with the lowest rating. Exhibit Bra-793, para. 55.

22Written Submission of Brazil, para. 196. See also, Written Submission of Brazil, para. 200.

23Exhibit Bra-793, para. 52. See also, Brazil’s Oral Statement, paras. 78, 85

24The United States has suggested that the DoC itself uses the methodology only in cases where the borrower is non-creditworthy in the sense that it is not able to access borrowed funds at all. The fact that the method is not applied to borrowers in general does not mean that it is not applicable to them.” Exhibit Bra-793, paras. 38, 39
46. Brazil *assumes* that all obligors with a credit rating inferior to 10 (or now, 13) are uncreditworthy. The Department of Commerce makes no such assumption. As the United States has previously explained, the Department of Commerce first makes a determination, based on independent criteria, whether or not a company is creditworthy, and only upon a specific determination of uncreditworthiness does it employ a corresponding default probability. Consistent with the description of “non-investment grade” noted above, the Department of Commerce recognizes that companies that are not investment grade may indeed be creditworthy and should not have the default probability for uncreditworthy borrowers automatically ascribed to them.

47. Under the Department’s regulations and methodology, an uncreditworthy borrower is a borrower that the Department determines, after a detailed analysis of the borrower’s financial health and ability to service debt obligations, *cannot* secure financing from conventional commercial sources. The Department’s creditworthiness determination is based on a number of factors, including the receipt of any commercial long-term loans, the present and past financial health of the firm, the firm’s ability to meet its costs and fixed financial obligations, and evidence of the firm’s future financial position. The set of borrowers who *cannot* secure financing from conventional commercial sources is clearly different (fundamentally so) from the set of borrowers who *can* secure financing from conventional commercial sources, but just not at investment-grade rates (which is most borrowers). The borrowers in the latter set are clearly creditworthy (by definition); they are just not investment-grade creditworthy.

48. Brazil’s oral statement and the statement of Mr. Sundaram (Exhibit 793) further confirm

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25 Brazil mischaracterizes the U.S. Written Submission when it states: “As a first alternative to the USDOC methodology, the United States appears to suggest that for uncreditworthy obligors, the USDOC might consider using ‘national average interest rates’. This is simply false.” Written Submission of Brazil, para. 198. The United States suggested no such thing, and Brazil puts the cart before the horse. The United States observed that in determining, in the first instance, *whether* an obligor is or is not creditworthy, the Department of Commerce, unlike Brazil’s methodology, first looks at objective criteria, such as the ability of the firm to meet its costs and fixed financial obligations out of cash flow, its ability, in general, to secure long-term lending from conventional commercial sources, and, in particular, “the actual experience of the firm in question in obtaining comparable commercial loans.” If, after the borrower is determined to be creditworthy, and the borrower happens to have taken out no comparable loans in the relevant period, “a national average interest” may be used. U.S. Written Submission, paras. 157-160. Only *after* a determination of uncreditworthiness, does the Department of Commerce utilize a corresponding default probability for the uncreditworthy company in the benchmark rate formula.

26 19 CFR 351.505(a)(4).
that Brazil’s approach to assigning a determination of “uncreditworthy” to 85.7 percent\(^{27}\) of CCC-approved obligors is inappropriate.

49. First, in effect, Brazil inappropriately asserts that the absence of loans identical to a (1) foreign currency, (2) uncollateralized, (3) 24-36 month term loan is dispositive of a determination of uncreditworthiness. Although such loan characteristics may be appropriately considered for purposes of identifying and appropriate benchmark interest rate, Brazil inappropriately applies them instead to determinations of creditworthiness.

50. The evaluation and determination of creditworthiness is a fundamental question that should precede, and be wholly distinct from, the identification of appropriate benchmark interest rates for an obligor, whether creditworthy or uncreditworthy.

51. Brazil, however, conflates these. Brazil asks “in the absence of a GSM 102 guarantee, what interest rate would a particular foreign obligor have paid to secure credit comparable to that secured with the guarantee?”\(^{28}\) Brazil defines “comparable” as “long-term, non-collateralized loans in foreign currency.”\(^{29}\) Brazil’s use of the term “comparable” makes clear that it means identical to loans guaranteed under GSM 102.\(^{30}\)

52. Although the question Brazil poses concerning “comparable” credit goes to the question

\(^{27}\) See, U.S. Oral Statement, para. 31; Exhibit Bra-722; Brazil Methodology Paper, para. 40.

\(^{28}\) Brazil’s Oral Statement, paras. 70, 76.

\(^{29}\) Brazil’s Oral Statement, para. 77.

\(^{30}\) Brazil’s implied definition of “long-term” is 24-36 months. See, e.g., Brazil’s Responses to Arbitrator’s Questions, para. 318. “GSM 102 loan guarantees have several important and defining characteristics. They are dollar-denominated; they are unsecured; and they are often long-dated, with maturities of 3 years.” Exhibit Bra-793, para. 42. The United States notes, however, that tenor of GSM-102 guarantees is not necessarily limited to such tenor (up to 3 years) (See, Upland Cotton (21.5), para. 14.5), and in fact, during FY 2006 nearly $148 million of transactions of shorter tenor occurred. U.S. Submission, para. 163, fn. 248; Exhibit US-78.

In addition, GSM 102 guarantees leave unguaranteed at least 2 percent of principal and most, if not nearly all, of the interest. Applicable federal regulations provide that the maximum interest rate guaranteed will be stated on the face of the guarantee itself. However, “the maximum interest rate stated in the payment guarantee, when determined or adjusted by CCC, will not exceed the average investment rate of the more recent Treasury 52-week bill auction in effect at that time.” 7 CFR §1493.20(g). Nothing in the program regulations precludes collateralization of the underlying loans, and such collateralization may indeed exist in some transactions.
of an appropriate benchmark interest rate, Brazil makes it clear that it uses the same definition of ‘comparable’ in its approach to creditworthiness determinations: the “counterfactual question presumes . . . that without GSM 102 guarantees, every foreign obligor would be able to secure comparable credit (that is, long-term, non-collateralized loans in foreign currency). . . .”31 “[T]he counterfactual must also assess at what point the credit risk posed by a foreign obligor is simply too high to enable the obligor to secure comparable credit.”32

53. In contrast, the United States has proposed that for purposes of determining creditworthiness, obligor access to real-world loans and debt servicing during the relevant period of time are the appropriate basis for analysis and has provided extensive evidence of such loans, including interest rates and other specific information from financial statements of banks on loans obtained.33 Furthermore, Brazil’s approach ignores the fact that CCC conducts its own bank analysis and establishes bank limits before issuance of any guarantees with respect to approved obligors34 and that CCC must consider, in its programming decisions, the “financial status of participating banks.”35

54. In response, with respect to creditworthiness determinations, Brazil argues that balance-sheets, specifically including the “examples raised by the United States from its own balance-sheet hunt . . . [do] not provide the necessary information.”36 The alleged insufficiency of information is that “a balance sheet will not reveal whether a firm has secured a long-term (3-year), unsecured, dollar-denominated borrowing.”37 As a result, Brazil treats as irrelevant any balance sheet that does not specifically affirmatively identify and contain each such loan characteristic, failing which it “does not show the ability of the obligor to secure a loan comparable to that secured with a GSM 102 guarantee” both for purposes of creditworthiness and for purposes of a determination at what rate the obligor would have been able to access unsecured dollar-denominated long-term funds in the market.38 The absence of such loan has no necessary bearing on the creditworthiness of the firm. It only shows that the bank had not obtained a loan on identical terms, not the inability to obtain such a loan. The balance sheets show, however, the loans that the bank opted to obtain during the particular time frame and thereby directly demonstrate creditworthiness.

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31Brazil’s Oral Statement, para. 77.
32Brazil’s Oral Statement, para. 78.
357 CFR §1493.4(c).
36Exhibit Bra-793, para. 41.
37Exhibit Bra-793, para. 43.
38Exhibit Bra-793, para. 43.
55. Notwithstanding Brazil’s erroneous assertions that its methodology adheres to that of the Department of Commerce in respect of creditworthiness determinations, as already noted, the Department does not automatically assign an uncreditworthy default probability to an entity that merely possess a credit rating below investment grade. Indeed, it does not use credit ratings at all. Second, its examinations of creditworthiness are not limited to foreign currency loans. Third, its examinations of creditworthiness are not limited to uncollateralized obligations. Fourth, it certainly would not consider, with respect to any given entity, the absence of evidence of long-term, foreign currency, uncollateralized loans as dispositive of uncreditworthiness. To the contrary, the Department of Commerce says “in the case of firms not owned by the government, the receipt by the firm of comparable, long-term commercial loans unaccompanied by a government-provided guarantee will normally constitute dispositive evidence that the firm is not uncreditworthy.”

56. The Department of Commerce approach to creditworthiness determinations is set forth in the United States Code of Federal Regulations:

“The Secretary [of Commerce] will consider a firm to be uncreditworthy if the Secretary determines that, based on information available at the time of the government-provided loan, the firm could not have obtained long-term loans from conventional commercial sources. The Secretary will determine uncreditworthiness on a case-by-case basis, and may, in appropriate circumstances, focus its creditworthiness analysis on the project being financed rather than the company as a whole. In making the creditworthiness determination, the Secretary may examine, among other factors, the following:

(A) The receipt by the firm of comparable commercial long-term loans;
(B) The present and past financial health of the firm, as reflected in various financial indicators calculated from the firm's financial statements and accounts;
(C) The firm's recent past and present ability to meet its costs and fixed financial obligations with its cash flow; and
(D) Evidence of the firm's future financial position, such as market studies, country and industry economic forecasts, and project and loan appraisals prepared prior to the agreement between the lender and the firm on the terms of the loan.”

57. Although the affirmative receipt of commercial long-term loans is ordinarily dispositive of creditworthiness, its absence (particularly of comparable loans) does not preclude such a determination and certainly does not require a determination of uncreditworthiness, as Brazil’s approach would.

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39Brazil’s Oral Statement, paras. 78, 85, 88.
41 19 CFR 351.505(a)(4)(i).
58. Furthermore, in contrast to Brazil’s requirement of a 24-36 month tenor, the applicable
definition of a long-term loan is not “24-36 months” but “a loan the terms of repayment for
which are greater than one year.” 42 Indeed, in its submissions, Brazil has acknowledged that “in
ratings agency parlance, long-term refers to obligations with a maturity of more than one year (13
months in the case of Fitch).” 43

59. Even in the absence of long-term (i.e., 12 month) loans, the regulation describes
numerous other indicia that can suffice for an affirmative creditworthiness determination.
Brazil’s methodology allows for none of these.

60. Brazil’s appendix to Exhibit Bra-793 purports to visually depict the characteristics of 24
balance sheet examples the United States has supplied. It makes clear that, from Brazil’s
perspective, none of these balance sheets indicates any loan experience or debt servicing that is
relevant at all for creditworthiness determination purposes, because they do not identically reflect
each of the three elements Brazil identifies as the relevant characteristics of GSM 102-guaranteed
loans. According to Brazil, therefore, these balance sheets and the loan experience and debt
servicing information they contain should be utterly excluded from any examination of
creditworthiness of the particular banks.

61. First, Brazil curiously dismisses 6 of these as “not relevant.” However, 5 are deemed
“not relevant” because such banks “had no GSM 102-backed transactions in FY 2006.” 44 This
fact has no bearing on Brazil’s proposed methodology, as Brazil has treated them as
uncreditworthy in its own calculations. 45 Two of the five undeniably obtained loans of one-year
or longer during the relevant period of time. 46

62. Of the remaining 18, Brazil acknowledges that 8 of the banks received loans of
“comparable maturity.” Brazil denies that the balance of 10 banks received loans of “comparable
maturity.” However, if one examines whether those banks received long-term loans (i.e., one
year or longer), 6 undeniably did. 47 As a result, fully 17 of the 24 listed incontrovertibly obtained

42 19 CFR 351.102(b).
43 Written Submission of Brazil, para. 165, fn. 128.
44 Appendix to Exhibit Bra-793.
45 Exhibit Bra-722.
46 Banco Nacional de Costa Rica: 10-year loan from Barclays (Exhibit US-85, p. 56);
Bank Positif Kredi: one-year syndicated loan (Exhibit US-87; U.S. Responses to Arbitrators’
Questions, para. 115)
47 (1) Turkland Bank: $40 million, one-year syndicated loan (U.S. Submission, para. 151;
Exhibit US-41); (2) Bank Caspian: as of 31 December 2006, syndicated loan tranche due in
September, 2008 (Exhibit US-43); (3) Bank Center Credit: see newly issued “long term loans due
to other banks and financial institutions” (Exhibit US-45); (4) Finansbank: multi-million euro-
long-term loans during the relevant period, which under the Department of Commerce approach would alone ordinarily render them dispositively creditworthy. Brazil, however, treats all of them as uncreditworthy. With respect to the remaining 7, the balance sheets reflect other indicia of creditworthiness, as contemplated by the Department of Commerce regulations.

63. Brazil implies that the United States argues that “every foreign obligor could secure comparable credit to effect purchases of U.S. exports made with a GSM 102 guarantee.” The United States has not so argued, nor does it have the burden to so. However, the United States has provided evidence that scores of banks that Brazil asserts are wholly uncreditworthy are indeed creditworthy. The proper treatment is not to consign them to the dustbin of a default probability of 18, but to examine the rates at which they did receive loans, and from that starting point construct an interest rate at which each such bank would have been able to secure a loan on terms comparable to those guaranteed under the GSM 102 program.

64. Conversely, contrary to its own acknowledgment of the creditworthiness of numerous obligors participating in the GSM-102 program, Brazil makes the outlandish assertion that the “evidence justifies an assumption that without a GSM 102 guarantee, no CCC-approved foreign obligor could have secured credit comparable to that secured with the guarantee.” Such acknowledgment of the breadth of its assumption and the voluminous evidence supplied by the United States, including the balance sheets, which Brazil wrongly dismisses as irrelevant, exposes the stark overreaching of Brazil’s argument.

65. Brazil’s line drawing exercise is not grounded in proper factual determinations of creditworthiness and serves only to inappropriately inflate the interest rate subsidy calculations. Although even an obligor with a credit rating of 18 could be creditworthy, if the question in this case is where should one draw the line for uncreditworthy obligors for the limited purposes of estimating the appropriate value of countermeasures for GSM 102 guarantees, the question

denominated loans with one and two-year maturities (U.S. Submission, para. 153; Exhibit US-50); (5) RosEvroBank: Brazil’s own submission acknowledges loans with maturities of 2, 5, and 7 years (Appendix to Exhibit Bra-793, fn. 34); (6) Far Eastern Bank: $28 million one-year loan (Exhibit US-82).

48Brazil’s Oral Statement, para. 79. See also, Brazil’s Oral Statement, para. 87
49 See, Oral Statement of the United States, paras. 55-56; Exhibit Bra-722.
50Brazil’s Oral Statement, para. 85.
51Brazil’s is argument is also disingenuous. It criticizes the United States’ use of academic studies on the subject of interest rate subsidy because the studies examined data “over a different time-period from Brazil’s analysis.” Exhibit Bra-793, para. 46. However, Brazil attempts to assert the validity of its interest rate study calculations based on a study from 1994, which obviously has no data on the performance of the GSM-102 program for the last fifteen years. Exhibit Bra-793, para. 48, fn. 14.
answers itself: 18.

97. The United States has criticized the use of a cap in Brazil’s model to calculate marginal additionality suggesting that this should raise doubts about the internal consistency of the model. In its response to question # 29 from the Arbitrator, Brazil has modified one of its original equations and explains the need for a cap as arising from the very small shares of GSM 102-backed exports in the relevant markets. This means that the elasticity of those U.S. exports that had previously been backed by GSM 102 subsidies would decline dramatically, if GSM 102 were to be withdrawn. Does this explanation and modification of one of the equations in Brazil’s model address the United State’s concern about the marginal additionality analysis? Please provide an explanation.

66. No, Brazil’s change to equation E does not address the U.S. concerns. The adjusted equation E is still used to arbitrarily cap the change in U.S. exports resulting from the elimination of GSM 102 at 100 percent of the value of GSM 102 transactions. The structure of the model was not changed, with the result being that the weighting system used in the model produces extraordinarily large elasticities and equally extraordinary results. The capping procedure, whether expressed as a percentage or as an absolute, is still in place to make the model results conform to something closer to reality without the extraordinarily large elasticities. This capping procedure should not be necessary. An internally consistent model should produce reasonable estimates without reliance on the capping procedure.

67. The same defects the United States pointed out before remain. Brazil has incorrectly modeled the removal of GSM 102 from the supply side, rather than from the demand side. Brazil’s concept of marginal additionality in fact assumes complete additionality because the capping factor is simply set at -1. The change in Equation E in no way addresses these flaws.

98. The United States has criticized Brazil’s marginal additionality calculations, noting among other things, its use of elasticities that are "inconsistent" with the calculation for actionable subsidies. Would the United States be able to propose alternative parameter values for these elasticities for the marginal additionality analysis? Please cite relevant studies or literature that offer support for the use of these parameter values?

68. The United States has offered extensive criticism of Brazil’s choice of elasticities in the model used for actionable subsidies. The United States did not criticize per se the elasticities Brazil used in the marginal additionality model, which came from FAPRI, but rather on the inconsistent approaches used by Brazil. The U.S. criticism focused on Brazil’s arbitrariness in

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choosing elasticities which appear to be based on a presumed outcome. That is, FAPRI elasticities were apparently appropriate for the marginal additionality model because the changes were expected and presumed to be small. On the other hand, the changes from removing two U.S. cotton support payments were expected and presumed to have large price effects so Brazil chose elasticities to reflect its expectations. The U.S. criticism is not so much with the elasticity choices for the marginal additionality model as with the choices for the actionable subsidies model. (As previously noted in Question 97, the United States has serious concerns about the structure of the marginal additionality model.)

69. As the United States noted before the Arbitrator during the meeting, if an institution such as FAPRI were to examine the effects of removal of cotton marketing loan benefits and countercyclical payments to cotton base acres, one would not expect FAPRI to change the existing elasticities in its model because of some expectation of a particular outcome. Rather, FAPRI would run its model using the existing parameters and see what the model produced.

To both parties:

99. Could you provide the following data for products supported by GSM-102 export credit guarantees in MY2005.
   The value of domestic US production (US$ dollars)
   The value of domestic US consumption (US$ dollars)
   The value of the exports of the product supported by GSM 102 export credit guarantees (US$ dollars)

70. Much of the data requested by the Arbitrator is not available from official government sources. For example, USDA’s National Agricultural Statistics Service (NASS) publishes data on the value of production for basic crops and meat animals, but not on the processed products such as corn products, soybean products, and fats and greases. Data from private trade groups has been used where possible. The data and sources are noted in the attached spreadsheet (Exhibit US-118).

71. In accordance with the Arbitrator’s clarification, a quantity of domestic use or consumption was valued at the same price used for production.

72. For two products – corn gluten feed and corn gluten meal – no official government data are available. Data on shipments were obtained for 2005 from the Corn Refiners Association and prices were obtained from USDA’s Economic Research Service.

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54 Written Submission of Brazil, 13 January 2009, paras. 226 and 227.
73. Trade data are the most easily obtainable data, although here one must use the tariff codes that correspond to the GSM 102 commodity category. A best effort was made to do so, but there could be discrepancies between the product exported under GSM 102 and the tariff codes used to represent that product. For example, four tariff codes were selected for beef offals.

74. Finally, the Arbitrator asked for data by marketing year 2005. The marketing year varies by product. NASS reports the value of production by marketing year, and the export data were generated to match that marketing year. For example, the corn marketing year is September 1 - August 31 for the United States as a whole, although NASS lists different periods for different States. Therefore, data on the value of production, consumption, and exports are given for 2005 and 2006. These years may be split years (that is, marketing years that overlap a calendar year) or they may be calendar years. The period of the marketing year is noted in the spreadsheet.

75. The Arbitrator will recall the findings of the compliance panel limiting the scope of scheduled and unscheduled products at issue.\(^{55}\) For the period October 2005 - September 2006, roughly the period that conforms to a 2005 marketing year, the unscheduled products are distillers dried grains, corn oil, pork offals, breeding swine, white corn, and yellow corn, in addition to the non-agricultural products that are also not subject to this dispute. These products equal 18 percent of the $1.36 billion in GSM 102 guarantees for 2005/06.\(^{56}\)

<table>
<thead>
<tr>
<th>Product</th>
<th>Shipments (lbs)</th>
<th>Price (ton)</th>
<th>Value ($1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corn gluten feed</td>
<td>10046508500</td>
<td>56.18</td>
<td>282206</td>
</tr>
<tr>
<td>Corn gluten meal</td>
<td>2468292000</td>
<td>268.73</td>
<td>331652</td>
</tr>
</tbody>
</table>

To the United States:

102. How would the United States respond to the critique by Brazil (Exhibit Bra-793) of the United States’ approach to the calculation of the net cost to government of the GSM 102 programme that, even on the basis of cash accounting, only the two earliest cohorts (1992, 1993) are able to break even.

76. Brazil’s criticism fails to take into account (1) fees received and (2) performance of reschedulings that will continue to provide revenue.

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\(^{55}\) US Submission, December 9, 2008, paras. 21 and 96.

\(^{56}\) This adjustment does not account for pork offals, which are combined with pork meat in the GSM 102 data base and cannot be accounted for separately.
77. The United States understands Brazil’s criticism to be directly linked to paragraph 94 and Table 4 of the United States response to the Arbitrator’s Question 48.\(^{57}\) Brazil attempts to characterize such response and table as reflecting the total cash inflows of the program.\(^{58}\) This characterization is incorrect.

78. The United States viewed question 48 to contain an implicit invitation to explain the principal reason for the magnitude of the long-term profitability of the GSM 102 program and the consequent insignificance of the potential for borrowing from the U.S. Treasury. The United States offered data related solely to performance of reschedulings. Certainly, fees collected are a direct contributor to profitability,\(^{59}\) but the response of the United States did not attempt either to portray all revenue received or a cash-basis accounting of the program.

79. Table 4 already shows cash inflows exceeding cash outflows for cohorts 1992-2008 by over $805 million. Exhibit Bra-793, however, arbitrarily and selectively excludes cohorts 1992, 1993, and 2003-2008 to make its therefore meaningless assertion that for cohorts 1994-2002 “cash outflows exceeded the cash inflows by around $240 million.”\(^{60}\) However, the United States would note that in addition to the already demonstrated positive cash flow of $805 million, fees for 1992-2008 total $320.6 million.\(^{61}\)

80. Furthermore, Table 4 reflects only cash already received from reschedulings. It makes no attempt to reflect net present value calculations of payments on performing reschedulings yet to

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\(^{57}\) Exhibit Bra-793, paras. 26-29.

\(^{58}\) Exhibit Bra-793, paras. 27, 29.

\(^{59}\) See, e.g., Upland Cotton (21.5), para. 14.84

\(^{60}\) Exhibit Bra-793, para. 29.

\(^{61}\) Of this, for fiscal years 1993-2005, fees totalled $249.5 million. See, Upland Cotton (21.5), para. 14.84. For 2005, the amount of $508 million is an obvious printing error. As the United States noted to the compliance panel, the correct number for 2005 is $21 million. See, U.S. Rebuttal Submission, para. 98, fn. 149.

Fees for fiscal year 1992 were $36.1 million.


Fees for 2006 and 2007 total $20 million.


Fees for 2008 are estimated at $15 million.

be received. Obviously, upon receipt of such payments the numbers in Table 4 would increase commensurately.

81. Lastly, Brazil’s criticism conveniently and arbitrarily excludes cash allocable to the 1992, 1993 and 2003-2008 cohorts. Such selectivity lacks justification. The test under item (j) of the Illustrative List of Export Subsidies is adequacy of premia to cover long-term operating costs and losses. Brazil is arbitrarily selecting only a middle slice of cohorts for its misplaced critique. Even looking simplistically at the historical performance of reschedulings plus fees collected the program has been profitable over the entire 1992-2002 period, the longer 1992-2008 period, and so far in 13 out of 17 cohorts for which we have data. Future performance of reschedulings can only improve that picture.

103. The US argues that both the original panel and the compliance panel examined the GSM 102 measures under item (j) of the Illustrative List of Export Subsidies and found that it was inconsistent with this item because there is net cost to the government, and that the amount of subsidy should therefore be appropriate only if the amount is linked to the net cost of the subsidy to the government as determined by the panels. In your view, is there anything in the SCM Agreement indicating that the appropriateness has to be quantified in such a manner?

82. The SCM Agreement provides the standard for countermeasures for prohibited subsidies in Article 4.10/4.11 and the footnotes to these articles. In the first instance, Article 4.10 applies only “if the recommendation of the DSB is not followed within the time-period specified by the panel.” Pursuant to Article 4.7, in the case of a prohibited subsidy, “the panel shall recommend that the subsidizing Member withdraw the subsidy.” The finding that GSM 102 export credit guarantees confer a prohibited export subsidy was made solely “by applying the standard set out in item (j)” of the Illustrative List of Export Subsidies. Consequently, the right to take “appropriate countermeasures” under Article 4.10 is conditional on failure of the subsidizing Member to adhere to the recommendation of the DSB, which in this case means failure to provide GSM 102 export credit guarantees at premium rates adequate to cover the long-term operating costs and losses of the GSM 102 program. As a result, “appropriate countermeasures” must be examined in that context.

83. Countermeasures must be “appropriate” and “not disproportionate.” The caveat that the countermeasures cannot be disproportionate – set out plainly in the footnote – shows that there is a limitation on possible countermeasures. As footnotes 9 and 10 explain, “appropriate countermeasures” cannot be “disproportionate” in light of the fact that the subsidies dealt with are prohibited – in other words, it is not just the adverse effects caused by the subsidies that are of concern, as it is under Article 7. Rather, the subsidies themselves are of concern. In this

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dispute, the “subsidy” is defined in relation to the cost to the government of the GSM 102 guarantees. 63

84. “Appropriate” connotes the close relationship between countermeasures and the particular circumstances of a given case. In its context in the SCM Agreement, the term “countermeasure” means that the countermeasure is compared or assessed with respect to the inconsistency with the WTO Agreement, since it is that inconsistency that the “measure” is to “counter.” The determination that the GSM 102 program confers an export subsidy was made solely “by applying the standard set out in item (j) of the Illustrative List.” 64 The United States robustly contested, and, more importantly, the compliance panel specifically did not address Brazil’s request for findings on the alternative theory “that the export credit guarantees meet the definition of an export subsidy under the terms of Articles 1.1 and 3.1(a) of the SCM Agreement.” 65 The original panel similarly declined to make findings on such claims of Brazil. 66 As a result, the only basis for the finding that the GSM 102 guarantees confer an export subsidy is that the program was provided at premium rates which were inadequate to meet the long-term operating costs and losses of the GSM 102 guarantees. In light of the compliance recommendations and rulings, the correct approach for GSM 102 guarantees is to start from the amount of the subsidy (as measured by net cost to government) and make certain adjustments to reflect the impact of the subsidy on Brazil.

85. Consequently, the compliance recommendations and rulings are critical for determining what is “appropriate” in the circumstances of this dispute, whether described as the “findings made” or the “prohibited subsidy finding of the panel.” (With respect to Article 4.10, which only applies to prohibited subsidies, any findings would be “prohibited subsidy findings.”) In this particular dispute, where the DSB found that GSM 102 export credit guarantees constitute an “export subsidy” because they are provided against premia which are inadequate to cover the U.S. government’s operating costs and losses under the terms of item(j) of the illustrative list, a calculation of the amount of the subsidy based on net cost to government is the correct measure of the subsidy. 67

63 U.S. Responses to Arbitrator’s Questions, para. 55
67 Past arbitrations on prohibited subsidies have also used an approach based on the amount of the subsidy, but in each case the Arbitrators explored different ways to calculate the “amount of the subsidy.” Brazil-Aircraft (Article 22.6); Canada-Aircraft II (Article 22.6), US-FSC (Article 22.6).
US adjustment for the "impact on Brazil"

To the US:

104. If what is ultimately relevant is the "impact on Brazil" of the measures, why would the amount of the subsidy be an adequate starting point to the analysis?

86. As noted above, trade effects on Brazil (nullification or impairment) would be an “appropriate” way to value the countermeasures which Brazil is entitled to take. The amount of the subsidy may be used as a proxy for trade effects of the subsidy, in the context of applying the special and additional rule of Article 4.11. However, both methods to the amount of the subsidy put forward in this proceeding – the cost to government approach previously used by the DSB and detailed by the United States and the erroneous benefits-plus-additionality approach by Brazil – estimate the total subsidy amount for the guarantees at issue for the entire program for the particular products at issue. Thus, both approaches result in an amount that serve as proxy for the program’s effects on the entire world, without regard for whether Brazil is affected by the subsidy.

87. Accordingly, and consistent with the notion that a breach of WTO rules results in nullification or impairment of benefits accruing to a Member, a method of reducing the total subsidy amount to only the portion affecting Brazil is necessary. It is true that the method for tailoring the total subsidy amount to this dispute by Brazil is different from the way the total subsidy amount is calculated, but neither Brazil’s nor the U.S. approach to the amount of the subsidy provides a clear way to show the effect of GSM 102 on Brazil under its own terms. This is not surprising, due to the number of different parties and different issues concerned with each guarantee. Not only is it necessary to do so to avoid an *erga omnes* award, but it is reasonable to do so in the absence of any showing that GSM 102 has a negative impact on Brazil. In other words, where there is no evidence of any impact on Brazil, it would be even more disproportionate to provide an award to Brazil that is based on world-wide impacts.

105. In proposing to apportion a share of the amount of the subsidy to Brazil in order to reflect the impact of the measure on Brazil, are you effectively proposing to use the total amount of the subsidy as a proxy for the global trade effects of the subsidy? If so, what is the rationale for this assumption? Please comment on this determination of the arbitrator in the US – FSC case: the proxy approach proposed by the United States is based on no particular economic rationale. It simply assumes a one to one correspondence of dollar of subsidy to dollar of trade impact. This is manifestly arbitrary. (decision of the arbitrator, US – FSC, para. 6.39).

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68 *Canada-Aircraft* (22.6), para. 3.30.
69 See, e.g. DSU Article 3.8; GATT 1994 Article XXIII:1(a); SCM Agreement Article 30.
88. The special and differential rule of Article 4.10 of the SCM Agreement, provides additional flexibility. Under the “appropriate” standard, arbitrators have accepted “amount of the subsidy” to determine an award for countermeasures. But as a legal matter, the “amount of the subsidy” approach, as an alternative principle on which to base a countermeasure, is best understood as a proxy for the “trade effects” analysis under DSU Article 22.

89. To use such a proxy, it is not necessary to assume something arbitrary like a one-to-one correspondence between spending and trade impact. Rather, the type of correlation between the expenses of the subsidizing Member and the benefits of the subsidy – like that identified in US-FSC – is sufficient. The important point is that Article 4.10 allows for such a proxy, however imperfect, in determining amount of countermeasures. Still, a countermeasure cannot be “disproportionate” and, viewed in the context of the relevant provisions of the SCM Agreement, DSU and GATT 1994, the comparison should be to the trade effects on the complaining party.

90. It is also useful to note that, with the lack of showing of any impact on Brazil, if a proxy for trade effects were not possible, Brazil would not be entitled to any countermeasures whatsoever.

LEVEL OF COUNTERMEASURES IN RELATION TO THE ACTIONABLE SUBSIDIES
To both parties:

112. You have referred, in your written submissions, to the ILC's Articles on State Responsibility.

What exactly is the legal relevance of the notion of “countermeasures” as reflected in the ILC’s Articles on State Responsibility in the context of this Arbitrator’s assessment?
Do these Articles reflect or embody, in your view, rules of public international law?
Please comment on the following passage of the commentaries to the Draft Articles:
"in every case a countermeasure must be commensurate with the injury suffered, including the importance of the issue of principle involved and this has a function partly independent of the question whether the countermeasure was necessary to achieve the result of ensuring compliance" (last sentence of the Commentaries to Article 51)

91. See the response to question 72, which also applies for this response.

To the US:

113. You have presented in your written submission and in your oral statement some facts and

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70 US-FSC (22.6), para. 6.21.
92. In the first place, the data on the U.S. cotton sector challenges the assumptions that drive Brazil’s arguments and model. Brazil’s arguments with regard to marketing loan and countercyclical payments are premised on the assumption that these payments continue to have significant production effects: that is, U.S. production is significantly larger than it would be in the absence of the payments, resulting in significantly lower prices that adversely affect Brazilian producers. The facts, however, do not support the assumption of strong production effects that Brazil embeds in its analysis and model. Contrary to what would follow from Brazil’s assumption, over the past several years, U.S. cotton production and exports have shrunk dramatically.

- Planted acreage for U.S. cotton for 2009 is projected to be 41% below 2005 levels.\(^{71}\) Planted acreage fell 29% in 2007 and another 13% in 2008; USDA projects cotton planted acreage to decline another 14% in 2009.\(^{72}\)

- The ratio of planted acres to base acres has fallen sharply. In 2002, planted acres equaled 72% of base acres (13,714,000 to 18,961,000). In 2007, the most recent year data are available, the ratio had slipped to 59% (10,830,000 compared to 18,265,000 acres). This is strong evidence that countercyclical payments are neither encouraging cotton planting nor having a strong production effect. In fact, the 8.4 million planted acres expected for 2009 would equal only about 46% of base acres.\(^{73}\)

- The U.S. share of world exports has declined for five years, from a high of 41 percent in 2003/2004, to a projection of only 35 percent in 2007/2008.\(^{74}\)

93. Over the same period, world prices have showed no particular trend, contrary to Brazil’s premise. The A-Index increased in 2006 and 2007 but fell sharply in 2008. Prices remained lower in 2009. The sharp decline in U.S. production and exports has simply been filled in by other suppliers, as the United States has argued all along. (This development is consistent with the U.S. approach that the only way to assess the impact of the removal of marketing loans and countercyclical payments is a longer run assessment, to allow for full adjustment.) In fact, the United States is only one player among many in world cotton markets. Changes in U.S. production, for whatever reason – weather, competing crops, changes in policy – are important in

\(^{71}\) U.S. Oral Statement, para. 2.
\(^{72}\) U.S. Oral Statement, para. 2.
\(^{73}\) U.S. Oral Statement, para. 2. Projection; data for 2009 not yet available.
\(^{74}\) U.S. Written Submission, para. 232.
the world context but clearly is not the only driver in world markets. The current situation indicates that adverse effects of marketing loan and countercyclical payments are no more than modest, and Brazil has clearly overestimated such effects.

94. More specifically, the lack of a strong increase in cotton prices over a period of time in which there have been such significant declines in U.S. acreage and production suggests that the extent to which these payments suppress world prices can only be small.

**Interpretation of Article 7.9 of the SCM Agreement**

*To both parties:*

114. *In Article 6.3(c) of the SCM Agreement, who is the “another Member” that is referred to? Is it necessarily the complaining party in a dispute?*

95. The “another Member” referred to in Article 6.3(c) is the complaining party in the dispute. It parallels the term “another Member” in Article 5 of the SCM Agreement, where it appears specifically in both (a) and (c) of that Article. With respect to (b), the link to the Member bringing a dispute is clear by virtue of the use of the general rule of nullification and impairment of trade benefits. In each instance, the Member bringing the dispute (who would impose countermeasures to enforce its rights) is the Member concerned.

*To the US:*

115. *Could you please comment on Brazil’s arguments in its oral statement that “the particular subsidy effects that constitute serious prejudice are defined in the various sub paras of Article 6.3” (para 51 ff). Some of these do refer to the specific effect on a Member, the others don’t seem to.*

96. Article 6.3 of the SCM Agreement defines four types of subsidy effects that may constitute serious prejudice to the interests of a complaining Member. Brazil’s interpretation of these provisions would read each in isolation from the governing provisions of Article 5 and from other elements of Article 6. But when 6.3 is interpreted in context, it is evident that the effect on the complaining Member is the concern for all four types of subsidy effect described therein.

97. Most importantly, all the subparagraphs of Article 6.3 of the SCM Agreement must each be read in the context of Article 5(c) because the introductory phrase to Article 6.3 specifically states that serious prejudice in the sense of Article 5(c) may arise in the circumstances described in Article 6.3. Article 5 refers to “adverse effects to the interests of other Members,” and Article 5(c) explicitly refers to “serious prejudice to the interests of another Member.” It is not necessary for the requirement of adverse effects on another Member be repeated under 6.3 (c) for it to
apply. Nonetheless, a review of the individual provisions of 6.3(c) reinforces, rather than contradicts, the emphasis that 5(c) places on the complaining Member.

98. Each of the provisions of Article 6.3(c) take a different approach, reflecting the particular type of serious prejudice to which it pertains. Article 6.3(a), on displaced imports into the market of the subsidizing Member, focuses on the complaining Member’s exports. Article 6.3(b) also focuses on the complaining Member’s exports, but in this case it looks at the effect of the subsidies on imports into a third country market. In both cases, the decision about “serious prejudice” relates to the effect of the subsidizing Member’s measure on the complaining Member’s exports.

99. Similarly, Article 6.3(c) guides the fact-finder to the trade relationship between the complaining Member and the subsidizing Member, so that any decision will be based on the effects of the subsidies on the complaining Member. Those effects can be of price undercutting of the non-subsidized product “in the same market” or of price suppression, price depression, or lost sales “in the same market”, that is, the market in which the products of the subsidizing Member and the complaining Member compete.\textsuperscript{75}

100. With respect to 6.3(d), world market share, this provision does not include the same type of explicit confirmation that the lost market share of concern is that of the complaining Member. However, along with the other sub-paragraphs of 6.3, it is covered by the same “serious prejudice to the interests of another Member” language in 5(c). All four are also equally covered by the different provisions of Article 6.7, which highlight different circumstances with respect to the complaining Member to limit the circumstances in which serious prejudice may be found.

101. Moreover, Article 6.6 corroborates the fact that the market share concerned in Article 6.3(d) is that of the complaining Member, where it refers to “relevant information that can be obtained as to the changes in market share of the parties to the dispute” (emphasis added).

102. Thus, while the four provisions of 6.3 take different approaches to measuring “serious prejudice,” each of them relates to the interests of the complaining Member.

\textit{Calculation of the “adverse effects determined to exist”}

\textit{To both parties:}

118. Do you accept that the time period for calculating the trade effects is necessarily post-implementation period, or that it can straddle the end of the implementation period to some degree? If the “adverse effects determined to exist” were determined by the

\textsuperscript{75}Upland Cotton (Panel), para 7.1248, 7.1251.
original panel, what basis is there for calculating those effects at a much later time (apart from the fact that this is how previous Arbitrators have approached the issue)?

103. Brazil’s approach to calculating the effects of marketing loan and countercyclical payments depends on a very rigid approach to the significance of the period immediately after the implementation period. Brazil argues that the counterfactual for the Arbitrator must be the immediate reaction to the end of marketing loan and countercyclical payments at the end of the implementation period. But, the issue of the time period for measuring effects does not require such rigid view.

104. In determining the time period for calculating trade effects, the legal issue of the WTO inconsistency that would be removed in a counterfactual – is critical, as is the fact-oriented issue of what data are available for modeling that counterfactual.

105. With regard to the legal issue of findings of WTO inconsistency, the recommendations and rulings of the DSB that resulted from the original panel proceedings were followed by changes to the measures that were found WTO-inconsistent and an Article 21.5 compliance proceeding to assess the consistency of the U.S. subsidies. The recommendations and rulings of the DSB, and the findings in the compliance proceeding brought by Brazil with respect to U.S. compliance with the DSB recommendations and rulings, form the underlying findings for arbitration under Article 22.6 of the DSU. Were the findings of the original panel the sole basis for an arbitration award, without regard to the findings of the compliance panel, the award would not have any basis in the current findings of the DSB. Indeed, the award would be based on findings regarding measures that no longer exist (e.g., Step 2). Therefore, for the purposes of the counterfactual – regardless of the exact time period used – the measure at issue is the marketing loan and countercyclical payments where there are current findings of inconsistency. These findings are the ones from the compliance panel.

106. Furthermore, the Arbitrator is tasked with determining what level of countermeasures should be authorized that would be commensurate with the adverse effects - this is a forward looking exercise in the sense that to be “commensurate” with, and to “counter,” the adverse effects, the countermeasures would need to be calibrated to the adverse effects around the time that the countermeasures are being applied. The countermeasures are not to “counter” adverse effects from well before the time they are authorized.

107. This leaves the question, “What are the adverse effects determined to exist?” The first answer is that the “adverse effects determined to exist” are the category of adverse effects that provide the basis for the finding of the DSB under Article 5 of the SCM Agreement. In this dispute, the “adverse effects determined to exist” are serious prejudice to the interests of another Member under the terms of Article 5(c).
108. Also, the “adverse effects” finding is based on the particular measure that provides the basis for the current DSB findings (marketing loan and countercyclical payments) and the correct counterfactual models removal of these adverse effects. In terms of the correct time period to examine, the Arbitrator should consider issues of data availability, and what type of data must be used to correctly model a counterfactual that will allow the Arbitrator to make an award of countermeasures consistent with the legal standard. For marketing loan and countercyclical payments, we note that one of the characteristics of this measure is that the payments – and their effects – vary considerably from year to year. In order for an arbitration award to be commensurate with the adverse effects of the measure with respect to which the DSB has made findings, the award would be better if not limited to the particular effects in an isolated time period, but corresponded to the nature and degree of payments under the measure. By modeling the effects of the marketing loan and countercyclical payments at a later, more current time, the Arbitrator can more accurately estimate the effects of these payments.

119. Brazil asserts (in paragraph 286 of its Written Submission) that a short run counterfactual is appropriate “in light of the requirement in Article 7.9 that the defending Member withdraw the subsidy or remove its adverse effects within 6 months.” Would not the adverse effects existing in the reference period be the result of the cumulated impact of the existence of the policy over a number of years, and thus justify a long-term approach?

109. Brazil’s approach, which isolates the immediate response to withdrawal of a subsidy, proposes the wrong counterfactual. The proper question is what the price of upland cotton would be in the absence of marketing loan and countercyclical payments, not how producers and purchasers react before they have time to adjust to the lack of these payments.

110. It is because of the need for the modeling to show this adjustment that a short term, reactive approach is not appropriate. The number of months permitted for adjustment, per se, is not the relevant factor, nor is whether that number of months is “long-term” or “short-term.” What is critical is that the counterfactual modeling show full adjustment so that the situation with marketing loan and countercyclical payments can be compared to the situation without. Long-run elasticities are suitable for modeling adjustment by U.S. and ROW producers, and U.S. and ROW purchasers.

120. The compliance panel noted that Brazil’s model had been submitted to it for the first time in that dispute, and had to earn the confidence of the Panel. Can the parties point to any literature since then in which the model and its parameters has been discussed or reviewed?

111. As Dr. Sumner noted during the meeting with the Arbitrator in March 4, he has not submitted his model to a peer-reviewed journal because the model was specifically designed for
this WTO proceeding. As a result, the United States has not been able to locate formal reviews or comments on the model.

112. The United States notes the model does have some history before Dr. Sumner presented it to the compliance panel. Similar models were developed for corn, wheat, and soybeans for an article published by Dr. Sumner for the Cato organization. At least one economist did not think Dr. Sumner’s approach of isolating individual commodities to determine price effects of removing subsidies was appropriate.

113. Dr. Sumner has published another article using this model, which looked at the effects on West African cotton producers of removing all U.S. cotton programs (direct payments, countercyclical payments and marketing loan payments). Several results from the study are worth noting. The impact of removing all U.S. subsidies in that study resulted in a price effect that is quite similar to that produced by Brazil’s model in the arbitration solely for removal of marketing loan and countercyclical payments – 11.5 percent versus 10.75 percent. Also, the reported range of price effects was relatively large. It is also interesting to note that the results are characterized as “medium term,” which allows some time for policy changes.

> “Across the range of these parameters, the estimated effect of removal of US cotton policy on the world price ranges from 5.9 percent to 17.0 percent. More likely parameter combinations would imply an estimate close to the midpoint of the range, 11.5 percent. We interpret these impacts as intermediate-term impacts that persist for several years after there is time for the policy change to have an impact on reducing US production. They are not immediate year-one impacts, nor are they very long-run effects that would allow for new technology on the production side or new cotton mills on the demand side.”

114. This article also used two values for the coupling factor for counter-cyclical payments – 0.3 and 0.6. “They used two sets of relative incentive factors, corresponding to values for $\gamma$

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79 “Impacts of Reductions in US Cotton Subsidies on West African Cotton Producers.” Julian M. Alston, Daniel A. Sumner, and Henrich Brunke. Oxfam of America. Page 5. Exhibit US-.120. Note that the values used for the U.S. supply elasticity in this paper to represent the medium term were 0.5 to 1.0, in contrast to Dr. Sumner’s high choice of 0.8 for the short run modeling he conducted for this dispute.
applying to different elements of $g$. One set includes values of 0.20 for direct payments, 0.30 for counter-cyclical payments, and 1.00 for marketing loans. To assess robustness of the results they also employed a set of values of 0.40 payments, 0.60 for counter-cyclical payments, and 1.00 for marketing loans.\textsuperscript{80}

121. The parties have suggested different values as appropriate for the demand elasticity parameters in the model. Do the parties wish to submit any additional evidence in support of the values which they proposed?

115. As the United States explained in its Written Submission,\textsuperscript{81} Brazil underestimates demand elasticity. Brazil’s choices for these parameters, when combined with the large U.S. supply elasticity Brazil uses, exaggerate the effects of marketing loan and countercyclical payments on price.

116. The United States would like to offer some addition comments on one aspect of demand elasticity, relating to demand for cotton by textile producers. Brazil has argued that cotton’s share of the total cost of the final textile or apparel product is small and therefore, any price change in cotton will have minimal effect on demand for cotton to justify its low demand elasticity.\textsuperscript{82} But as the United States has pointed out, FAO analysts have questioned this rationale for determining an appropriate demand elasticity. In fact, as FAO analysts have shown, the important determining factor for demand elasticity is not cotton’s share of total cost for final goods, but the substitutability between cotton and other fibers at the mill. In fact, even Brazil’s economic consultant has recognized this. In an article written for a World Bank publication, he wrote that “[t]he significant issue for the elasticity of demand for cotton is the substitution between cotton and other fibers, especially synthetics, by textile manufacturers.”\textsuperscript{83}

117. Many have commented on the significance of substitution between cotton and synthetic fibers, especially polyester. For an example, in an ICAC presentation at the WTO, ICAC commented on competition between cotton and polyester:

“For cotton, competition with polyester is a challenge that is accelerating as chemical fiber production technology results in lower costs of polyester


\textsuperscript{81}U.S. Written Submission, para. 264-265.

\textsuperscript{82}Brazil Methodology Paper, para. 108.

production and an increased range of uses for chemical fibers. Production of all fibers other than cotton rose from 5 million tons in 1960 to 10 million in 1970, 16 million in 1980, 19 million in 1990, and then leaped to 30 million in 2000. Non-cotton fiber production is estimated at 37 million tons in 2006....

The decline in cotton’s share of world fiber use from 50% in the 1980s to 40% at present represents a loss in demand in apparel and household furnishing markets of approximately 3 million tons, or about one-eighth of current world cotton consumption. This lost demand for cotton caused by competition with polyester can easily explain much of the decline in average cotton prices since the 1980s and 1990s.84

118. The President and CEO of Cotton Inc, J.Berrye Worsham, III, stated that small changes in the relative prices between cotton and manmade fibers can result in switching:

“Historically, if demand rises and inventories fall, cotton prices show strength. We are seeing some reductions in this ratio which bodes well for future cotton prices. The rise in energy prices will serve to put upward pressure on petroleum-based fiber prices, which should prevent switching to other fibers if cotton prices do rise.” 85

119. And Brazil’s economic consultant has opined on the appropriate demand elasticities in light of the issue of substitutability between cotton and other fibers:

“Focusing on long-run effects of the cotton initiative, a demand elasticity nearing -1.0 might be expected. Such a demand elasticity may be appropriate for questions about the long-term price gains to be expected from removal of subsidies. For shorter-term effects, such as the immediate price impacts of subsidy reductions, a demand elasticity below -0.5 is more consistent with the econometric evidence as well as with evidence of large short-term price swings.” 86

120. These citations show the importance of the issue of substitutability between cotton and other fibers for demand elasticity, as opposed to Brazil’s emphasis on cotton’s percentage of the total cost of a good. Accordingly, a larger demand elasticity like that proposed by the United

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86 Exhibit US-121, p. 281.
States is appropriate. 87

122. Both parties have adverted to the significance of the price suppression in the world market for cotton as something to which the Arbitrator needs to give weight. Would you agree that even small price discounts offered by an exporter/seller in the market can lead to a significant gain in sales for that seller at the expense of others? Would the parties be able to provide studies or market intelligence reports that document how large such price differences need to be in order to achieve a competitive advantage for an exporter?

121. The United States is not aware of studies or market intelligence reports that document how large price differences would need to be in order to achieve a competitive advantage for an exporter. The difficulty in determining this is related to the different factors involved, and that factors other than price may be important to purchaser decisions and competitiveness of exports.

122. First, price reflects not only the commodity characteristics, but also the unknown risks associated with the transaction. Several examples of the unknowns are the contract delivery period, contract sanctity, contract quality assurance, opening of banking documents in a timely manner, and settlement of contract differences.

123. Secondly, the direction and perceived long-term outlook of the world market determines actions of the buyers. If cotton is experiencing a steadily declining market, buyers want to see large discounts as they presume the market will keep falling. However, in a bullish or rising market, mills will only chase the market to a certain point before they completely stop buying until it is vital to continue their operations. They can not afford to tie up lines of credits as they sell low priced yarn, because the yarn market traditionally moves up at a slower pace than cotton prices.

124. Third, quality is of paramount importance as mills will be less concerned with price if the cotton does not meet the specifications necessary for their desired yarn production.

125. We also recall that competing offers (with respect to which the above considerations may be relevant) need not come from merchants in two different countries; they may come from competing merchants in the same country.

87 A study by an ERS economist looked at U.S. mill demand from 1962 through 1997. In this study, a 10 percent increase in the cotton to polyester fiber price ratio resulted in a 5 percent decline in mill cotton demand. This would support Dr. Sumner’s opinion from the study cited above that a short run elasticity of around -0.5 is appropriate. Meyer, Leslie A. “An Economic Analysis of U.S. Total Fiber Demand and Cotton Mill Demand.” Cotton and Wool Situation and Outlook/CWS, ERS, November 1999, pp 23-28. Exhibit US-124.
126. Also, the United States notes that this issue of price differences offered in particular transactions does not go to the question of price suppression and whether it is significant. As the original panel noted, “significance” relates to the degree of price suppression and not the issues discussed above. In addition, because of the use of the world market and world price for analysis in this dispute, discussion of individual sales in actual markets was avoided.

123. In its Oral Statement on the actionable subsidies dispute, the United States criticized the inclusion of non-WTO Members in Brazil's calculation of the adverse effects of marketing loans and countercyclical payments. Would the parties be able to identify who these non-WTO members are? Would the parties be able to provide the volume of production of these non-WTO members for MY 1999-2007?

127. The following countries are cotton producers who are not currently members of the WTO:

Afghanistan, Azerbaijan, Ethiopia, Iran, Iraq, Kazakhstan, North Korea, Somalia, Sudan, Syria, Tajikistan, Turkmenistan and Uzbekistan.

128. The share of ROW production (that is, world production excluding the United States) that these countries accounted for ranged from a low of 9.89% to a high of 13.77% over the period MY1999-MY2007. ROW exports for these countries ranged from about 25% to 28% during same period. Production and export volumes for all countries are provided in Exhibit US-125.

To the US:

127. Please comment on the approach used by Brazil in its response to the Arbitrator’s questions to measure the long term effects in MY 2005 of the policies in place prior to that date. Is Brazil’s approach equivalent to your preferred approach to use long-term elasticities to simulate a long-run approach?

129. The United States believes that the correct analytical approach for marketing loan and countercyclical payments is to look at the difference between the factual situation with the marketing loan and countercyclical payments in place and the formally estimated, or counterfactual situation, with those payments removed, where producers and other market participants have fully adjusted to the different situation. The difference between the two situations is the estimated effects of the payments. In order to capture the full effects of the payments, the United States has focused on, and believes that long-run, full adjustment parameters should be used to model the counterfactual.
130. Not only is Brazil’s general approach incorrect, but efforts to model are flawed. Consider Brazil’s approach to measuring long term, lingering effects of past payments on future years. To represent the lingering effects of a payment in subsequent years, Brazil repeatedly removes the same payment against the same base conditions but with increasing elasticities, thereby ensuring positive effects in each subsequent year. Also, the lingering effects determined by Brazil are directly influenced by the arbitrary proportional adjustments applied to the supply and demand elasticities. Additionally, the lingering effects in Brazil’s analysis are counterintuitive with, in some cases, payments made 3 to 5 years earlier having larger lingering effects than payments made just in the past year. Clearly, this analysis is nothing more than a sensitivity analysis of alternative elasticities and does not describe “lingering effects” in the way Brazil asserts.

131. Conceptually, it may be possible to look at the dynamics of the policy change to arrive at the long-run effects of removing the programs in question. Imposing a dynamic structure, while complicating the modeling exercise, should provide the same total result as simply applying the long-run elasticities in the comparative static framework. Brazil’s approach to measuring lingering effects by taking “snapshots” year by year may attempt to do this, but the results show that it is flawed. The standard comparative static model with long-run elasticities gives the maximum and appropriate effect for a permanent change in prices. As the dynamic structure results in a different total effect, one must strongly suspect misspecification in the dynamic modeling by Brazil.

132. The United States believes that trying to force a dynamic approach onto a comparative static model needlessly complicates the task at hand, and is unnecessary. Using the correct approach to modeling the counterfactual, one can simply using the comparative static model without the attempt to show the dynamic changes.

128. Does the evidence on recent trends in cotton production introduced by the US provide support to the Brazilian argument that the short-run supply elasticity of US cotton producers is relatively high?

133. No, the acreage changes in recent years do not support Brazil’s assertion of a short-run elasticity of 0.8. First, the United States believes that insufficient data points exist to confidently estimate supply elasticities based on the acreage changes of 2007 and 2008. A longer time frame is necessary to provide statistically reliable results.

134. Second, a number of other factors beyond relative market prices affect acreage decisions, including input costs and weather events. Weather can be particularly influential in certain years, as was the case in 2007.

135. USDA data indicate that final upland plantings in 2007 fell by 29.5% from the 2006 level. However, a closer examination of the data indicates that more than economic signals
played a role in the sharp reduction. At the end of March each year, USDA releases their first survey-based estimate of planting intentions in the Prospective Plantings report. In 2007, the Prospective Plantings indicated that cotton farmers intended to reduce acreage by 20.7% from the 2006 level. In many ways, the Prospective Plantings are a better measure of farmers’ intentions based on economic factors, anticipated rotational constraints, and agronomic conditions. Changes between intentions and the final number will reflect changing economic conditions, but often are highly influenced by weather events during the planting season. This was the case in Texas, where initial intentions for 2007 put state acreage at 5.7 million acres, well above the final number of 4.9 million acres. According to the USDA’s Texas Crop Weather report, excessively wet conditions prevented some acres from being planted.

136. With adjustments for the weather influences of 2007, US upland cotton area fell by 20.7%, and then declined by another 11.8% in 2008. USDA projects cotton planted acreage for 2009 at 8.4 million acres, 14% lower than 2008.

137. During those years, expected prices, as measured by the January-March average of the harvest-time futures contracts, also experienced large changes. For example, the expected corn price increased by 56.0%, while the cotton price fell by 0.9%. In 2008, all prices moved higher, with soybeans showing the largest gain of 61.7%. In terms of a short-run analysis, when evaluated against the backdrop of the price changes that occurred in those years, short-run FAPRI elasticities adopted by the United States are reasonable measures of the response of US cotton farmers. Also, the FAPRI elasticities are based on a well-respected, independent modeling system and not simply imposed based on a priori expectations like those imposed by Brazil with its counterfactual of a large, short term shock effect.

129. Brazil argues that value of ROW supply elasticities must be lower than the US supply elasticity for a variety of reasons. The US proposes elasticity estimates which show the reverse for both the short and long run cases. Could the US provide any arguments to suggest why it might be reasonable to expect a higher supply response in other countries to changes in world cotton prices than in the US?

138. It is important to remind the Arbitrator that Brazil’s relative supply response of the US and ROW is a result of their arbitrary and unsubstantiated elasticity choices. By contrast, the United States relies on independent models developed by FAPRI and the U.N.’s Food and Agriculture Organization (FAO) for the elasticities of the U.S. and ROW supply. With that in mind, the United States would like to respond to the Arbitrators’ specific questions regarding reasons supporting the FAPRI and FAO elasticities.

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89 Exhibit US-126
90 Exhibit US-127.
139. Agricultural economists tend to use acreage elasticities and supply elasticities interchangeably. This convention is reasonable since farmers have greater control over their acreage decisions than their supply decisions given the inordinate influence of weather on yield and production. Thus, a supply elasticity largely reflects the ability or willingness of farmers to change their planting decisions based on changes in price. Their responsiveness to the price signals is influenced by a number of factors, which include but are not limited to, availability of additional land, ability to plant alternative crops, investment in infrastructure, rotational constraints, lease arrangements, and ability to obtain production financing.

140. Farmers in the United States have only limited ability to bring new land into the production of row crops. For example, in the cotton-producing regions of the United States, total land devoted to major row-crop production has been steadily declining. This is in sharp contrast to Brazil, which can and has brought significant amounts of new land into production. As a result, it is not surprising that FAO has larger supply elasticities for Brazil than the United States. Brazil is not alone in its ability to increase acreage to cotton production. As discussed in the FAO study, in major producing countries, such as China, India and Pakistan, cotton only accounts for 2 to 4 percent of agricultural land so that a small price change can result in a significant expansion of cotton acreage. Additionally, the FAO study states the domination of small farms in cotton production in these countries allows them to respond to any price movement in a massive way.  

141. The ability to plant alternative crops also affects the supply elasticity, and this ability may vary from region to region. In the eastern parts of the U.S. cotton-producing regions, it is the case that farmers have the ability to plant alternative crops such as corn and soybeans. However, in Texas, alternatives to cotton are more limited and a acreage response generally less than observed in other regions of the United States. This further limits the overall supply elasticity of U.S. cotton acres. By contrast, most cotton-producing regions of China can and do readily shift to alternative crops such as wheat and corn.

142. In the United States, downstream investment or vertical integration bears a substantial influence on acreage change. The prevalence of vertical integration through producer ownership of gins and warehouses is likely only second to Australia, and is certainly greater than vertical integration in China, India, West African and Central Asia.

143. In fact, the U.S. cotton sector has undergone rapid and significant structural change over the past decade, as evidenced by the just-released 2007 Census of Agriculture. The total number of cotton farms has declined 46% between 1997 and 2007. Smaller farms have exited at a higher rate than larger farms and larger farms now account for a much larger share of acreage.

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93 Exhibit US-115.
The United States submitted cost of production data during the compliance proceedings that showed smaller cotton farms have higher production costs. It is not surprising that these are the farms that are exiting cotton production. The U.S. data showed that larger farms more than covered their variable and fixed costs, and were able to weather periods of low prices. The larger, more efficient farms are able to continue operation even in the face of lower prices and greater market uncertainty.

144. According to USDA’s Commodity Credit Corporation (CCC) Cotton Online Processing System (COPS) database, 8.3 million bales of warehouse storage space in 2006 were designated as being cooperatively owned by cotton producers. In addition, another 6.4 million bales of warehouse capacity were owned by gins, which are predominantly owned by producers. For example, an industry survey in 1999 indicated that 82% of gins were under some form of ownership by cotton growers.

145. In addition to the investments in cotton gins and warehouses, U.S. farmers are highly mechanized with specialized equipment for the production, harvesting and transportation of cotton. This is not the case in many other cotton-producing developing countries that rely on hand-picking and lack the complement of specialized equipment. This lack of investments will allow other countries to be more responsive to price changes than U.S. farmers.

146. As a final point, 65 percent of U.S. cotton production occurs on land where the operator is not the owner of the land. It is not uncommon for lease arrangements to stipulate cropping choices by the tenant, particularly when the landlord may also have an investment in cotton infrastructure.

147. For these reasons, the United States believes that relative elasticities found in the FAPRI and FAO research accurately represent cotton acreage response.

130. *Brazil has argued that the recent literature which it cites in its Oral Statement to the Arbitrator justifies the value of 0.4 which it proposes as the coupling factor for CCP payments. Does the US have any views to offer on these arguments?*

148. In his oral statement, Dr. Sumner asserts that it is “universally accepted that the CCP subsidy causes production effects through several mechanisms.” Dr. Sumner may accept that characterization, but it is far from universal, which is why there continues to be a wide range of research results on this issue. Research in this area, because of the complexities of separating out

94 Exhibit US-128
95 Exhibit US-129.
97 Exhibit Bra-803, para. 25.
effects of CCPs alone, has been difficult. The mechanisms cited by Dr. Sumner have been hypothesized to have potential production effects. But a consensus on those effects, much less the specific magnitude of the effects, does not exist. The United States has found no empirical studies that validate a coupling factor of 0.4. The common theme of the studies is to simply offer the theoretical arguments about how decoupled payments can affect planting decisions. However, attempts to statistically estimate the impacts of decoupled payments have generally shown little or no impact.

149. Dr. Sumner correctly notes that the Beckman, Wailes article contains a second model. But this second model has very unusual results. It shows very large production effects of CCPs, even greater than the “gross margin,” which also includes marketing loan benefits. These results are clearly an outlier, and perhaps reflect the use of only a very few years of data (2002 - 2004), as well as the use of the previous Market Loss Assistance payment as a proxy for the CCP for one year.

150. Dr. Sumner states that the results of the Beckman, Wailes article are relevant for cotton because rice has consistently received countercyclical payments, similarly to cotton. But in fact, rice countercyclical payments have been erratic and variable, and in some years zero. Dr. Sumner dismisses some studies that use data for commodities such as corn and wheat (Anton and Le Mouel), stating that they studies are not relevant because these products have not regularly received countercyclical payments. Yet, corn countercyclical payments were very large in several years. Overall, the difficulty of drawing firm conclusions from the literature is that the studies have been done for different crops, using different data sources, and different methods and assumptions are clear.

151. Finally, Dr. Sumner continues to insist that farmers expected there to be a base updating in the 2008 Farm Bill and acted accordingly by increasing plantings, based on the fact that base updating was allowed in the 2002 Farm Bill, the only time in recent U.S. history that such an updating occurred. Brazil has never offered any evidence that farmers had such expectations, nor that such thinking actually affected plantings. Dr. Sumner cites the Coble, Miller and Hudson study as offering evidence that 16 percent of cotton farmers were induced to plant more area because of the possibility of base updating. But even these results would suggest that 84 percent of farmers were not so induced. This small percentage does not suggest a strong production incentive; it suggests the opposite.

152. These sorts of anomalies highlight the difficulties of sorting out just exactly what the economic literature concludes with respect to the production effect of CCPs. The United States

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98 Exhibit Bra-803, para. 27. The United States pointed out problems with the first model.
99 Exhibit Bra-803, para. 31.
offered these studies, as inconclusive as they are, to point out to the Arbitrator that the literature on this subject is far from conclusive. The United States does not deny that countercyclical payments may have some production effect as any transfer payment may. But, the consensus of the economic literature is that the countercyclical payments, as they are decoupled from the producer’s actual production decision, have a smaller production effect than programs that are fully coupled to production decisions. Accordingly, the U.S. took the assumption that there could be a production effect from countercyclical payments, and selected a parameter from the research literature, namely the well-known FAPRI parameter of 0.25, rather than arbitrarily picking a coupling factor.

131. Please respond to Brazil’s critique of the way in which you have used futures prices to predict the value of ML and CCP payments in the model simulation that you have provided.

153. The United States has opted to use basis subtractions to arrive at estimated payments for countercyclical and marketing loan payments instead of using Dr. Sumner’s regressions. As the United States discussed at the meeting with the Arbitrator, these regressions had low explanatory value in explaining the dependent variable of marketing loan and countercyclical payments.

154. Within the marketing structure of U.S. cotton, the use of futures as adjusted by the basis is widely accepted. Marketing strategies using a basis off the new York futures are commonly available to farmers. In addition, USDA regularly publishes the basis of spot market information relative to futures. Data are also available through the Cotton Outlook publication. As previously discussed, to arrive at an estimated farm gate price, the United States took the average of the January-March futures price for December delivery minus a five cent basis. Why the 5 cent basis? When growers make planting decisions, they will base their price expectations on the futures contract – typically the contract most closely corresponding to the time of new crop marketing. For cotton, that is the December contract. However, a grower understands that while the futures market is the best barometer of the value of the cotton, that price corresponds to a particular quality and location. The futures price must be adjusted based on the grower’s quality and location. In other words, the grower must also have an expectation of the basis relative to the futures contract. If the grower is forward contracting with a merchant, the basis will be quoted by the merchant. While the futures market gives a projection for prices, there is no corresponding projection for a basis. Thus, if a grower is not forward contracting, but instead intends to sell at harvest, a reasonable expectation of the harvest-time basis would be to look at past experience.

155. Data from 2001 through 2007 show that the basis, defined as NY Dec futures minus
average farm price, for the months of Oct-Dec average between 4 and 5 cents consistently regardless of the period to generate the average.\textsuperscript{103}

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<thead>
<tr>
<th>Years</th>
<th>Cents</th>
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<tr>
<td>01-05 avg</td>
<td>4.32</td>
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<tr>
<td>01-06 avg</td>
<td>4.11</td>
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<tr>
<td>01-07 avg</td>
<td>4.33</td>
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<tr>
<td>02-05 avg</td>
<td>4.44</td>
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<tr>
<td>02-06 avg</td>
<td>4.16</td>
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<tr>
<td>02-07 avg</td>
<td>4.41</td>
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156. Once the expected farm price is determined, it is straightforward to calculate the expected countercyclical payment. The United States took the expected farm price and inserted it into the countercyclical payment formula to determine the expected payment:

\[
\text{Max}(0, 72.4-6.67-\text{max}(52, \text{expected farm price})
\]

157. Brazil, on the other hand, used a flawed regression equation to derive the expected countercyclical payment. The regression equation used by Brazil had a relatively low explanatory value for the variance in the dependent variable (an \(R^2\) of 0.57). But more importantly, the regression tended to overestimate the countercyclical payment when compared to the actual countercyclical payment formula that is generally known. As reported in the spreadsheet ‘2006 – Compliance Panel– Brazil’s Annex I (Electronic Version of Simulation Model) 17 Nov.xls,’ the regression equation linking the futures price to the farm price generates an expected farm price of $0.591 for 2004. However, a separate regression equation for the expected countercyclical payment generates a value of $0.081. The two values are inherently inconsistent. U.S. producers know the formula used to generate a countercyclical payment for a given farm price, and thus would equate a farm price of $0.591 with a countercyclical payment of $0.066 (derived as $0.724-$0.0667-$0.591).

158. As with the expected countercyclical payment, the United States did not use the expected marketing loan payment regression equation. Not only did the regression equation have an even lower explanatory power of the variance in the dependent variable (\(R^2 = 0.179\)), the coefficient was not statistically significant. Instead, the United States created an expected AWP that could be used to determine the expected marketing loan payment. Admittedly, the AWP tends to be lower than the farm price and the United States made the assumption that producers are aware of this difference. The United States compared the farm price and the AWP for the 2002 through 2007 marketing years. During this period, the AWP averaged 2.74 cents lower than the farm price.\textsuperscript{104} Thus, to be conservative, the United States subtracted 3 cents from the expected farm price.

\textsuperscript{103}Exhibit US-134.
\textsuperscript{104}Exhibit US-134.
price to arrive at the expected AWP. Then the expected marketing loan payment could be determined by the following formula:
Max (0, 52-(expected farm price - 3 cents))

132. The United States believes that an adjustment should be applied to the amount of countermeasures that is requested by Brazil to reflect that it is "significant" price suppression rather than simply price suppression that causes adverse effects on Brazil. But the United States has provided no quantum for determining at what threshold price suppression leads to "significant" price suppression. If the United States is unable to propose an exact threshold, are there perhaps economic characteristics of the world market or the product at issue that would assist in determining such a threshold?

159. The United States cannot propose an exact threshold as to what distinguishes "significant" price suppression from price suppression in this particular dispute. Also, the United States reaffirms that given the declining production of U.S. cotton in recent years, the effect of such production in "significantly" suppressing prices is likely to be small.

160. The United States will note that one way the Arbitrator may examine the issue of significance is in light of the price of the product itself. That is, price suppression might be more or less significant given the prevailing price of the product whose price is suppressed. Another analytical tool that suggests itself is to look at the nature of the product’s price. Strong or frequent fluctuations in price would themselves tend to cut against a finding that any alleged suppression is “significant,” especially if the variability frequently brings the price of the product to a level at which the alleged suppression (judged in light of that price). The United States notes that the price of upland cotton is highly variable, with frequent swings of substantial degree. An analysis of cotton price variability over 1980 to 2003 shows that annual cotton price variability for the entire period is in range of 18 to 20 percent. The United States believes that the regular variability of cotton prices should be taken into consideration in any analysis of the “significance” of any price suppression.

CROSS-RETRALIATION (IN RELATION TO BOTH REQUESTS)
To both parties:

133. If the Arbitrator determines that the provisions of the SCM Agreement only are applicable to the form of countermeasures, and that the principles of Article 22.3 of the DSU do not apply, as Brazil suggests, how exactly would the Arbitrator make a single assessment encompassing the level of countermeasures under both proceedings, as suggested by Brazil, given that the applicable standards would be different in relation to each of the amounts? how might the Arbitrator take into account the amount in the other
proceedings, if it made separate assessments? would an assessment of "appropriateness" of the form of the countermeasures under Article 4.10 or 7.9 of the SCM Agreement involve an analysis very different from that under Article 22.3 of the DSU, or would the "practicability and effectiveness" of the countermeasures be of some relevance to the Arbitrator’s determination?

161. Article 22.3 of the DSU applies to proposed cross-agreement or cross-sectoral countermeasures under the SCM Agreement, and Brazil requested countermeasures under the TRIPS and GATS under Article 22.3. Therefore, it is not necessary to consider what principles might apply other than those under Article 22.3.

162. However, suspension of concessions outside of the Agreement where there have been findings of WTO inconsistency should be exceptional in any event, and where it would be practicable and effective for a Member to suspend concessions in the same sector and Agreement the Member should do so.

134. In your view, if the Arbitrator determined that the rules and principles of Article 22.3 of the DSU apply to its determinations in relation to one or both of Brazil’s requests for cross-retaliation, should the amount of countermeasure determined by the Arbitrator in relation to the prohibited subsidies and the amount of countermeasure determined in relation to the actionable subsidies be cumulated or aggregated in considering whether it is "practicable or effective" to take countermeasures within the goods sector?

163. The amount of countermeasures is the main factor in the analysis of whether a Member has met the requirements of Article 22.3 of the DSU. Past arbitrators have accordingly first determined the amount of suspension of concessions, and only then turned to the hierarchical test in Article 22.3.\(^\text{106}\)

164. Because of the importance of the amount itself, the United States anticipates that, if the Arbitrators award Brazil some level of countermeasures for both the prohibited and actionable subsidies, the Arbitrator in one proceeding would take cognizance of the award in the other proceeding in considering whether Brazil has met the requirements of Article 22.3. However, even if the Arbitrator does so, the United States requests that the Arbitrator also consider whether cross-agreement suspension of concessions would be permitted for actionable subsidies and for prohibited subsidies, if the individual arbitrations were considered in isolation. This could help resolve the dispute as any additional developments occur.

165. If the Arbitrator’s awards include cross-agreement suspension of concessions, separate analysis is crucial in order to know whether the Arbitrator intends for Brazil to be permitted to

\(^{106}\)US-Gambling (Article 22.6), para. 4.24.
impose cross-agreement suspension of concessions for every dollar of retaliation, even if Brazil chooses to suspend concessions for less than the entire amount permitted. Members, including Brazil, have often chosen not to suspend concessions for the entire amount of an arbitration award and have even declined to suspend concessions. Similarly, for transparency, it is also important to know whether the Arbitrators intend Brazil to be permitted to suspend concessions in other agreements even if the United States fully complies with the recommendations and rulings of the DSB with respect to GSM 102 or marketing loan and countercyclical payments, but not both.

To the US:

135. Brazil argues that of the USD 1.27 billion of imports of consumer goods, almost USD 1.1 billion correspond to medical and educational supplies, food and automotive goods and arms, and that medical supplies alone account for USD 0.9 billion of the total imports of consumer goods from the US. Please comment on these arguments. In your view, is it practicable and effective to take countermeasures in the goods sector in light of these facts?

166. The scope of the goods sector is “all goods,” but Brazil would take entire broad categories of goods entirely off the table for countermeasures. This approach is too sweeping, and Article 22.3 does not exclude entire categories of goods from a Member’s obligation to consider whether suspension in the relevant sector is practicable or effective. While it may be appropriate to examine the potential negative impact that may occur for a Member if it suspends concessions on particular types of goods that may be necessities, where the goods are not necessities or where alternative sources of supply are available, there is no basis on which to assert that suspension of concessions for those goods is not practicable or effective.

167. Before looking more closely at the categories of goods Brazil would exclude, the United States recalls the fact that Brazil is one of the world’s largest economies. Measured GDP (PPP based) was $1.8 trillion in 2007, ranking as the world’s 9th largest economy. Even if one used GDP (current prices), Brazil is the 10th largest economy with a GDP of $1.3 trillion.

168. More specifically to the Arbitrator’s question, a closer look at the categories of goods Brazil claims are off limits for suspension of concessions reveals that many of the goods in these categories are not “necessities.” US $1.8 million for sugarless chewing gum is part of the broad “food” category. More than US$24 million is included for other printed books in the “books” category, without any indication of the type of materials, and whether they are used for education, entertainment or some other purpose. The medical category even includes more than

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107DSU Article 22.3(f)(i).
108Bra-754, lines 2106.90.60, 4901.99.00 and 9603.21.00.
US$4 million for toothbrushes, which, while essential to health, are of an entirely different order than more specialized products such as complex surgical instruments. In the arms category, Brazil has not indicated the extent to which these imported goods are to be used by the police, military, or others in the public service.

169. Next, while the United States exports substantial quantities of goods in these categories to Brazil – enough for practicable and effective suspension of concessions – Brazil imports goods in these categories from other sources, and also produces them domestically. Brazil has not explained why the U.S. imports cannot be replaced from other sources.

170. In its oral statement, the United States referred to several types of exports to Brazil where Brazil has other available sources of supply. On further inspection, even more examples emerge. Brazil does have room to maneuver. Pears and quinces are an example in the food area, where 2007 imports from the United States to Brazil were $10.071 million, a substantial amount. But Argentina’s exports jumped by more than $10 million in a single year, from $73 million in 2007 to over $98 million in 2008. An example in the medical area is medical sterilizers, where the exports by Brazil exceeded the imports of this product category from the United States in 2007 ($4.6 million in exports, $1.5 million in imports). Clearly, Brazil has domestic capacity in this area. Similarly, Brazil’s own exports for autos\(^{109}\) were more than $3.2 billion in 2007\(^{110}\).

Certainly, the specifics of the products involved will be important. But the main point is clear: Brazil has the economic size and diversity to suspend concessions without resort to the exceptional step of cross-agreement countermeasures.

171. In short, Brazil’s presentation has failed to do what it must. Rather than explaining why, notwithstanding the availability of alternatives, suspension of concessions in the goods sector is not practicable or effective, Brazil would simply take broad categories of goods out of consideration based on mere assertion.

136. *Please clarify what conditions you would consider to constitute “circumstances … serious enough” to justify seeking cross-agreement suspension of concessions or other obligations within the meaning of Article 22.3 (c) of the DSU and whether these conditions are met in this instance.*

172. The requirement that the “circumstances” be “serious enough” in Article 22.3 of the DSU is an additional consideration that is added to the requirement that suspension of concessions under the same sector and agreement would not be practicable or effective for a Member to impose cross-sectoral suspension of concessions. If the “practical or effective” requirements of

\(^{109}\) Cars and other motor vehicles between 1500CCs and 3000CCs

\(^{110}\) Data from World Trade Atlas.
22.3(b) and (c) are not met, the request for cross-sectoral or cross-agreement suspension of concessions fails and there is no basis to examine the seriousness of the circumstances.

173. At the same time, the requirement that the “circumstances are serious enough” does not stand in place of or modify the standard for determining amount of countermeasures, whether under the “equivalent” standard of Article 22 of the DSU or the “appropriate” or “commensurate” standards of the special or additional rules in the SCM Agreement.

174. “Circumstances are serious enough” may refer to the potential consequences for the Member of suspending concessions in the same sector and agreement, or the potential consequences of foregoing the right to suspend concessions. In the circumstances of this dispute, where Brazil’s proposal for countermeasures does not substantiate any adverse effect on Brazil from the measures at issue, it is not clear what consequences these would be or whether they would be serious at all.

175. In fact, Brazil’s agriculture sector, and its cotton producers in particular, have been effective competitors world-wide even with the existence of GSM 102, marketing loan payments and countercyclical payments and without any countermeasures whatsoever. Brazilian cotton exports have reached record levels in recent years.\footnote{111}{U.S. Written Submission, para. 233.}

176. The circumstances surrounding potential countermeasures in services and intellectual property are also a factor. Brazil has not detailed how it might impose such countermeasures; and in fact it is not obligated to do so at this time. Effectively, if Brazil is authorized to impose countermeasures under these other Agreements it would cause an additional layer of uncertainty for these sectors, with potentially devastating consequences.

137. \textit{In your view, what does the term "effective " mean in Article 22.3 of the DSU?}

177. In Article 22.3, the term “effective” means that a Member should not be prevented from imposing countermeasures of the intended weight as a result of the limitation of those countermeasures to the same sector/agreement. The intended “weight” is what is authorized based on the applicable standard, including where special or additional rules apply. Thus, a Member should be able to take the “appropriate” amount of countermeasures with respect to prohibited subsidies, and for subsidies causing adverse effects, a Member should be able to take countermeasures commensurate with those adverse effects.

178. For example, a Member may have multiple, readily-available sources of supply for a particular imported product, and there may be no issue of practicability with regard to countermeasures on that product. But, if the amount of proposed countermeasures is greater than
the trade volume of the product imported from the Member against whose measure there has been a finding of WTO inconsistency, it would not be effective to take countermeasure with respect to that product.