

**Before The  
World Trade Organization  
Appellate Body**

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

Article 21.5 Proceeding

**SUBMISSION OF  
THE UNITED STATES**

**4 May 2001**

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## I. INTRODUCTION

1. On 27 October 1999, the Dispute Settlement Body (“DSB”) adopted the Appellate Body Report, and the modified Panel Report in *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*.<sup>1</sup> The DSB found that Canada’s Special Milk Class (“SMC”) system, which provides milk at reduced prices to processors for the manufacture of dairy products for export, constitutes an export subsidy for purposes of the *Agreement on Agriculture*. The DSB also concluded that Canada exported a greater quantity of subsidized dairy products than is permitted by its reduction commitments on export subsidies and, therefore, breached its obligations under the *Agreement*. Accordingly, the DSB recommended that Canada bring its export subsidy regime into compliance with its export subsidy reduction commitments under Articles 3.3 and 8 of the *Agreement on Agriculture*.

2. Although the reasonable period of time for Canada to comply with its export subsidy obligations expired on 31 January 2001, Canada’s export subsidies have not been brought into conformity with the DSB’s rulings and recommendations as Canada persists in subsidizing dairy exports at a level that is inconsistent with its reduction commitments. To address Canada’s continuing breach of its export subsidy obligations, the United States requested that this Panel be convened pursuant to Article 21.5 of the *Understanding on Rules and Procedures Governing Settlement of Disputes* (“DSU”).

3. The question of whether Canada’s new measures constitute export subsidies has implications that go far beyond trade in dairy products. With discussions already underway on

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<sup>1</sup> Panel Report on *Canada - Measures Affecting the Exportation of Dairy Products and the Importation of Milk*, WT/DS103; WT/DS113, 17 May 1999 (hereinafter “Panel Report”); Appellate Body Report on *Canada - Measures Affecting the Exportation of Dairy Products and the Importation of Milk*, AB-1999-4, 13 October 1999 (hereinafter “AB Report”).

further reform in agriculture, WTO Members do not have the luxury of allowing disciplines already in place to go unheeded. Canada's new measures leave unchanged the most fundamental aspects of the programs found by the DSB to constitute export subsidies. Yet Canada has indicated that it does not consider such exports to be subject to its export subsidy reduction commitments.

4. All of the substantive elements of the WTO-inconsistent SMC export subsidies are encompassed in the new measures. Under both the SMC system and the new measures, milk at discounted prices is still provided only to exporters. Indeed, prohibitive penalties exist to deter diversion into the Canadian market of any discounted milk or products made from such milk. Most importantly, the provision of discounted milk to exporters is accomplished through the indispensable intervention of the federal and provincial governments. Thus, only the form, not the substance, of Canada's export subsidies has changed.

5. Canada's disregard of its obligations threatens one of the most critical objectives of the Agreement on Agriculture, the reduction of export subsidies. The severity of Canada's breach is evident in the fact that Canada has breached its export subsidy commitments for the dairy sector for every year of the implementation period, now in its final year.<sup>2</sup> In fact, during the 1999-2000 marketing year, Canada subsidized exports of cheese that were more than twice the amount permitted by its export subsidy commitments.<sup>3</sup> Canada's export of "other milk products" during the same period were 175 percent higher than is allowed by its reduction commitments.<sup>4</sup>

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<sup>2</sup> See U.S. Exhibit 1.

<sup>3</sup> See U.S. Exhibit 1.

<sup>4</sup> See U.S. Exhibit 1

## II. PROCEDURAL HISTORY

6. On 25 March 1998, the DSB established a Panel to consider both the New Zealand and U.S. complaints relating to Canada's SMC system.<sup>5</sup> Almost two years ago, in May 1999, that Panel circulated its report finding that the SMC system constitutes an export subsidy for purposes of the *Agreement on Agriculture* and concluding that Canada was exporting subsidized dairy products at a rate that exceeds the level permitted by Canada's reduction commitments under the *Agreement*.<sup>6</sup>

7. Canada disputed the conclusions reached by the Panel and sought Appellate Body review of those findings on 15 July 1999. The Appellate Body, however, sustained the Panel's determination that Special Milk Classes 5(d) and 5(e) conferred an export subsidy under Article 9.1(c) of the *Agreement on Agriculture*, and that Canada's operation of such export subsidies was inconsistent with Canada's obligations under Articles 3.3 and 8 of the *Agreement*.<sup>7</sup> The DSB adopted the Appellate Body and modified Panel Reports on 27 October 1999. At a meeting of the DSB on 19 November 1999, Canada stated its intentions to implement the DSB rulings and recommendations.

8. The parties to the dispute mutually agreed on the reasonable period available to Canada to bring its export subsidy regime into conformity with its obligations.<sup>8</sup> That period, originally

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<sup>5</sup> WT/DSB/M/44.

<sup>6</sup> Panel Report at para.8.1.

<sup>7</sup> AB Report at para. 144.

<sup>8</sup>On 23 December 1999, Canada and the United States concluded an agreement pursuant to Article 21.3 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU") (WT/DS103/10) on the reasonable period of time available to Canada to implement the DSB's recommendations.

scheduled to expire on 31 December 2000,<sup>9</sup> was later extended to 31 January 2001, again by agreement of the parties.<sup>10</sup>

9. On 22 December 2000, the United States and Canada entered into a procedural agreement applicable to the Article 21 and Article 22 process under the DSU.<sup>11</sup> That Agreement provides for panel and Appellate Body review of the WTO-consistency of Canada's export regime before any consideration of the appropriate amount, if any, of countermeasures or suspension of concessions under Article 22.6 of the DSU.

10. Upon the expiration of the reasonable period of time under Article 21.3 of the DSU, the United States on 2 February 2001 requested additional consultations with Canada due to a disagreement as to the consistency of the measures taken by Canada to comply with the DSB rulings and recommendations in *Canada - Dairy*.<sup>12</sup> Those consultations, conducted on 9 February, failed to resolve the disagreement between the parties and the United States subsequently requested the establishment of a Panel pursuant to Article 21.5 of the DSU on February 16.<sup>13</sup> Simultaneously, the United States requested authorization from the DSB pursuant to Article 22.2 of the DSU to take appropriate countermeasures and suspend concessions. On 28 February 2001, pursuant to Article 22.6 of the DSU, Canada objected to the level of suspension of concessions proposed by the United States, thereby resulting in a referral of the matter to arbitration.<sup>14</sup>

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<sup>9</sup> WT/DS103/10.

<sup>10</sup> WT/DS103/13.

<sup>11</sup> WT/DS103/14

<sup>12</sup> WT/DS103/15

<sup>13</sup> WT/DS103/16

<sup>14</sup> WT/DS103/18

11. This Panel was established by the DSB at a meeting held on 1 March 2001, with standard terms of reference pursuant to Article 7 of the DSU.<sup>15</sup>

### III. CANADA CONTINUES TO PROVIDE A SUBSIDY IN THE FORM OF DISCOUNTED MILK ONLY TO EXPORTERS

12. The United States considers that Canada has failed to comply with the DSB recommendations and rulings by not bringing its export regime for dairy products into compliance with its export subsidy commitments under the *Agreement on Agriculture*. While Canada eliminated the Special Milk Class 5(e) export subsidies that the DSB found in violation of Canada's export subsidy commitments under Articles 3 and 8 of the *Agreement*, Canada substituted new provincial export subsidy programs in their place.<sup>16</sup> In addition, Canada has retained and continues to subsidize exports through Special Class 5(d), which the DSB found and Canada acknowledges to be an export subsidy.

13. During the course of 2000, Canada apparently evaluated a number of alternatives for addressing the DSB ruling and recommendations and bringing its export subsidy regime into compliance with its export subsidy obligations. Little consideration appears to have been given to simply confining the quantity of subsidized exports to the level of Canada's reduction commitments, although that approach would have permitted immediate compliance with the DSB's recommendations. Instead, Canada chose to maximize export opportunities for its dairy industry at the risk of again breaching its *Agreement on Agriculture* obligations.

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<sup>15</sup> WT/DS103/19

<sup>16</sup> Effective 1 August 2000, Canada eliminated Special Class 5(e), which had been one of the two main means by which Canada subsidized dairy exports since 1995. Under Special Class 5(e) milk that was produced outside of the domestic quota could be supplied to produce products for export once a declaration had been made that such milk was surplus to the needs of Canada's domestic market.



14. As has long been evident, Canada cannot export most dairy products without providing its exporters with milk components at discounted prices. This is precisely the market situation that originally caused Canada to employ export subsidies in the form of producer-financed export rebates, and later to introduce the SMC system where export rebates took the form of reduced-price inputs.<sup>17</sup> Canada now has resorted to yet another producer-financed subsidy scheme for dairy exports.

15. While the programs introduced in August 2000 are in some regards different from the SMC system which they replace, their objective, the provision of low priced milk to exporters to make dairy exports commercially viable, is precisely the same. This is plainly indicated in the 3 January 2001 Canada Gazette where Government of Canada published revisions to the Dairy Products Marketing Regulations. In discussing the benefits of the new provincial programs, Canada stated that: “. . . Canadian exports of dairy products would be severely curtailed if WTO-compliant, de-regulated exports were not in effect, especially for cheese and other milk products.”<sup>18</sup> Notably, this comment was made in explaining a chart contained in the notice. The chart compared the high level of recent dairy exports with Canada’s reduction commitment levels.

16. Having built subsidized cheese exports to levels equal to three times the permitted levels and other subsidized dairy product exports to levels almost double those provided for under Canada’s WTO reduction commitments, Canada had three options. It could reduce dairy exports by rationalizing production. It could encourage more domestic milk consumption by reducing

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<sup>17</sup> Canada implemented the Special Classes in August 1995, immediately prior to the effective date of the *Agreement on Agriculture* for Canada’s dairy sector. Canada instituted the Special Classes to replace export rebates financed by producer levies.

<sup>18</sup> Canada Gazette, 3 January 2001, p. 62; U.S. Exhibit 4.

domestic prices. Or it could continue to provide discounted milk to its exporters and try to convince its trading partners that the new export schemes were no longer export subsidies. The last alternative, of course, is complicated by the many common features shared by the new scheme and earlier Canadian export regimes that were found to be export subsidies. Unfortunately, Canada chose the third option.

17. By 1 August 2000, new export schemes had been adopted in nine of Canada's ten provinces. The only exception is Newfoundland, which plays only a minor role in Canada's dairy supply management system and does not export dairy products.<sup>19</sup>

**A. The New Programs Fulfill the Same Function As  
The Special Milk Class System**

18. The new programs introduced by Canada as part of its avowed implementation vary from province to province, but possess several common elements. The provincial programs allow exporters to purchase milk at prices that are below prevailing market levels for milk used in dairy products sold into Canada's domestic market. The low-priced milk made available to dairy processors and exporters can only be used to manufacture dairy products for export. Thus, the availability of such discounted milk is contingent on export. Furthermore, any person that diverts the low-priced milk, products made from it, or components of the milk, into Canada's domestic market faces severe sanctions.

19. The provision of low-priced milk through these substitute programs does not differ in any meaningful respect from Special Class 5(e) of the SMC system that was found by the DSB to constitute an export subsidy. Thus, Canada continues to provide export subsidies on dairy

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<sup>19</sup> Canada Gazette, 3 January 2001, pg. 59, U.S. Exhibit 4.

products. The exports made with the benefit of such subsidies, when combined with exports made with Special Class 5(d) milk, exceed the level of subsidized exports permitted by Canada's reduction commitments. For example, available data show that the quantity of Canada's subsidized exports of cheese and other dairy products (other than butter and skim milk powder) were substantially higher than the applicable reduction commitment levels for marketing year 1999/2000.<sup>20</sup> Moreover, cheese exports during the 2000/2001 marketing year have already exceeded Canada's reduction commitments and export of other milk products appear to be occurring at monthly levels that, if continued for the remainder of the year, would result in yet an additional year of subsidized export shipments inconsistent with Canada's obligations.<sup>21</sup> These export subsidies distort markets for dairy products and adversely affect the United States.

20. Because Ontario and Quebec account for the vast majority (approximately 80 percent) of dairy product exports from Canada, the following discussion focuses on the fundamental aspects of the provincial regimes that have been established there.<sup>22</sup> There are four core elements to the provincial regimes. First, any milk produced above the level of the domestic quota must be sold for export-only processing (or relegated to use in the production of animal feed).<sup>23</sup> The milk that is committed to export may not be introduced into the domestic market; such milk (or the resulting dairy products) must be exported. Second, the price paid by exporters for milk produced outside of the domestic quota is not regulated; this is in contrast to milk produced

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<sup>20</sup> See U.S. Exhibit 1.

<sup>21</sup> See U.S. Exhibit 1.

<sup>22</sup> A compilation of the descriptions provided by Canada and the relevant regulatory amendments and orders for the export regimes in each of the other provinces (excluding Newfoundland) is contained in U.S. Exhibits 16 to 21.

<sup>23</sup> Canada advised at the December 7, 2000, implementation consultations that there had been no use of Special Class 4(m) involving the diversion of over-quota milk production into the manufacture of animal feed. Although there has been one press report indicating the use of Special Class 4(m) by dairy farmers in Manitoba, this apparently was the result of a declaration by the federal authorities in Canada that the Manitoba export scheme was potentially inconsistent with WTO obligations.

within the domestic quota, for which prices are specifically established by the provincial authorities. Third, any milk producer desiring to contract to provide milk for export must do so through a single, mandatory offer-and- acceptance process established by the provincial milk marketing board in conjunction with dairy processors in each province. Fourth, the export contracts are policed and enforced by the federal and provincial governments through a comprehensive array of mechanisms. While the contracts can be enforced by the private parties themselves, they are also subject to audit and enforcement by both provincial and federal authorities. For example, in Quebec a substantial monetary penalty is imposed on any entity diverting into Canada's domestic market any milk or milk products committed to an export contract.<sup>24</sup>

**B. Ontario's New Export Scheme, Established and Policed by Government Action, Provides Discounted Milk Only To Exporters**

21. Ontario introduced an export contract scheme for milk in June 2000, with an effective date of 1 August 2000. This scheme was created by the Dairy Farmers of Ontario (the DFO), which is the Ontario milk marketing board, and the Ontario Dairy Council, representing dairy processors. The Ontario export scheme closely parallels the export regime established in Quebec.

22. Perhaps the most significant aspect of the Ontario scheme, like that of Quebec, is that it is both exclusive and obligatory.<sup>25</sup> Any milk producer wishing to sell milk to a processor engaged

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<sup>24</sup> See U.S. Exhibit 12, Regie Decision 7111, p. 9

<sup>25</sup> Canada's description of the Ontario system states that "All contract offers and contract bids will be tendered through a single market mechanism (the Export Contract Exchange, or ECE)." Outline of Ontario Export Contract Exchange Mechanism provided by the Canadian Department of Foreign Affairs and International Trade on June 15, 2000, para. A.2; U.S. Exhibit 6. ("Canada MFAT June 15, 2000 description"). In the same description, Canada describes the expected introduction of the Ontario export scheme as follows: "Ontario will request an

in export trade must contract for the sale of such milk through the single bulletin board contracting mechanism created by the DFO. Likewise any processor intending to export dairy products must contract for milk purchases through this exclusive export mechanism. No alternative contracting procedures are permitted.<sup>26</sup> We note that in December 2000, the Ontario bulletin board started posting Manitoba contracts also as that province's original mechanism proved unworkable.

23. The export scheme introduced in Ontario virtually eliminates any commercial flexibility for milk producers and dairy processors. Indeed, the so-called Export Contract Exchange ("ECE") Agreement, and DFO Milk General Regulation 09/00 implementing it, specify everything from the manner in which milk will be collected<sup>27</sup> and transported<sup>28</sup> to the period of time within which payment will be made<sup>29</sup> and exports shipped.<sup>30</sup>

24. Relying on powers delegated from the provincial and federal governments, the DFO possesses the authority and the means to enforce the mandatory elements of the export mechanism. The DFO, as the milk marketing board in Ontario, is granted the sole authority to license milk producers in the province. Section 5(1) of DFO Milk General Regulation 09/00 provides that "no person shall commence or continue to engage in the producing or marketing of milk except under the authority of a license to produce and market milk in Form 1." Paragraph 4 of that section directs that:

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amended federal regulatory regime that contemplates provincial establishment of an exclusive export contract mechanism administered by an independent third party appointed by industry." para. F.2.

<sup>26</sup> Id. at para. A.2.

<sup>27</sup> DFO Milk General Regulation 09/00, section 40. U.S. Exhibit 7.

<sup>28</sup> Id., section 9, 23, 33, 41-44.

<sup>29</sup> Canada MFAT June 15, 2000 description, para. B.4. U.S. Exhibit 6.

<sup>30</sup> Id., para. B.6.

DFO may refuse to grant or renew or may suspend or revoke a license to engage in the producing or marketing of milk where the applicant or licensee has failed to comply with or has contravened the Act, the Regulations, the Plan or any Order or Direction of the DFO.

25. The powers conferred by the Government in this Regulation are far-reaching.<sup>31</sup> By virtue of its statutory authority to suspend or revoke a necessary license, the DFO effectively has the power to force any entity producing or marketing milk to cease operations. Furthermore, the DFO's authority in this respect is cast in very broad terms; the DFO may suspend or revoke a license for failure to comply with any of a multitude of legal obligations contained in the relevant Act, Regulations, Plan or DFO Order. In addition, the DFO continues to enjoy specified powers with respect to export contract milk sold through the ECE.<sup>32</sup> Thus, the DFO possesses ample authority to punish any breach of the export mechanism with the suspension or revocation of a producer's or processor's license.

26. Consequently, the milk marketing board in Ontario retains authority both to ensure that any milk sold for export is funneled through the exclusive Export Contract Exchange and to take action to prevent milk committed to export contracts from entering the Canadian domestic market. Although the provincial milk marketing orders were amended generally to eliminate the milk board's authority over "export milk," the power to prevent milk subject to export contract from diversion into the domestic market was specifically reserved. Indeed, the province (as well

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<sup>31</sup> The United States notes that whereas certain specified provisions of the DFO Order 09/00 are not applicable to export contract milk as defined therein, Section 5 is not an exempted provision and, thus, applies with equal force to export contract milk. Export contract milk is defined in Section 1(b) of the regulation as follows: "export contract milk means pre-committed first milk out of a producer's bulk tank that is the subject of a commercial export contract made through the export contract exchange operated by the Third Party Administrator and is deemed to be the first milk supplied to a processor." U.S. Exhibit 7.

<sup>32</sup> See, e.g., Sections 5, 7, 9, 11, 12, 18, 23-26, 29-56 of DFO Milk General Regulation 09/00. U.S. Exhibit 7.

as the Canadian Dairy Commission) retains full power to audit the records of milk producers and dairy processors to ensure that milk committed to export contracts does not seep into the domestic market.<sup>33</sup>

27. Not willing to rely on private parties to oversee the fulfillment of the export contracts, Canadian federal and provincial authorities crafted statutory and regulatory authorities so as to maintain continued governmental control over the milk export regime. Canada's own description of the export scheme notes that "[a] fundamental feature of the Ontario approach is that there be a strict audit of all milk components to ensure that there is no redirection of any milk contracted to export market back into the domestic market. All components or equivalents of milk committed to export contracts must be exported from Canada."<sup>34</sup> To accomplish this objective, DFO Regulation 09/00 provides the milk marketing board with the authority to cease deliveries of milk to any processor that does not provide information to the DFO necessary to permit it to determine the utilization of all milk received by a processor.<sup>35</sup>

28. The Ontario milk marketing board also influences the administration of the ECE through its appointment of the Third Party Administrator, which operates the ECE mechanism. By the establishment of a single-desk mechanism over which the DFO exercises indirect, if not direct, control, the DFO effectively manages the manner in which milk is sold to exporters. The fact that the DFO does not directly determine the price and volume of the individual milk export contracts is relatively unimportant in light of the overall influence of the milk marketing board on the circumstances in which such contracts are made. Moreover, we should not under-estimate

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<sup>33</sup> See August 18, 2000 letter from Minister Vanclief to the Honorable Ernie Hardemann, Minister of Agriculture, Food and Rural Affairs, Government of Ontario; U.S. Exhibit 9.

<sup>34</sup> Canada MFAT June 15, 2000, description, para. A.4, U.S. Exhibit 6.

<sup>35</sup> See DFO Regulation 09/00, section 22.2(c) & (d), U.S. Exhibit 7.

the ability of the DFO, which controls the delivery and sale of all milk sold for ultimate consumption in Canada to influence the conduct of the same producers and processors in relation to their export activity.

29. While the provincial milk marketing boards do not control the price and volume of individual export contracts, the practical significance of this is rather limited. A comparison of recent milk prices under the new provincial schemes reveals that they are virtually the same, on average, as those which prevailed under Special Class 5(e).<sup>36</sup> Likewise, the volume of milk exported remains linked to total production levels in each of the provinces and the relative requirements of the domestic market. Most export milk is milk not needed to meet domestic demand. With such a wide margin between export milk and domestic milk, few milk producers will voluntarily sell for export milk that could be sold on the domestic market for twice the export price. Thus, milk that is exported is predominantly milk produced in excess of the domestic quota held by a producer, just as was the case under the Special Milk Class system.

**C. Quebec's New Export Scheme, Established and Policed by Government Action, Provides Discounted Milk Only to Exporters**

30. Like most Canadian provinces, Quebec introduced its new export regime last summer, intending for the regime to be operational in time for the commencement of the new dairy marketing year on 1 August 2000. This goal was largely achieved when the *Regie des marches agricoles et alimentaires du Quebec* (hereinafter "the Regie"), an agency of the provincial government in Quebec, confirmed the essential elements of the regime on 28 July 2000. It did so through the issuance of an arbitration decision, Regie Decision 7111, and through the amendment

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<sup>36</sup> See U.S. Exhibit 2.



of provincial regulations governing dairy products.<sup>37</sup> As will be detailed below, the central role played by the Quebec government in the establishment of the new export regime and its modification of the regulations governing the dairy sector dispels any notion that Canada has eliminated substantial government involvement in its export programs for dairy products.

31. Quebec's new export regime was implemented by the Regie under Decision 7111, a ruling resulting from an arbitration proceeding over whether the export regime proposed by the provincial milk producers' association, La Federation des producteurs de lait du Quebec (hereinafter, the "Federation") which also serves as the provincial milk marketing board, would be the exclusive means of providing milk to processors for export markets.<sup>38</sup> This issue was joined because milk producer cooperatives in Quebec sought an exemption from the proposed export contract regime that would allow them to process their members' export milk, or to provide that milk directly to other processors, without participating in the exclusive bulletin board system advocated by the Federation.

32. The exclusive export regime proposed by the Federation was based on the establishment of a bulletin board administered by a third party.<sup>39</sup> Under the mechanism, processors' purchase

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<sup>37</sup> See Regie Decision 7111 (28 July 2000), U.S. Exhibit 12.

<sup>38</sup> The Regie possesses broad powers over the dairy sector and its decisions are binding on the producers and processors comprising the dairy industry in Quebec. The Act respecting the marketing of agricultural, food, and fish products in Quebec, for example, provides that: "[t]he functions of the Regie are to foster the efficient and orderly marketing of agricultural and food products, the development of harmonious relations between the various interveners, the settlement of problems arising in connection with the production and marketing of such products, taking into account the interests of consumers and the protection of the public interest." In fulfilling these responsibilities, the Regie may "amend, replace or revoke any provision of a plan, by-law, the constituting instrument of a chamber or a decision of a board of producers or fishermen or of a chamber." In addition, the Regie may "exempt any person or category of persons or any society engaged in the production or marketing of an agricultural product or the marketing of a fish product of any class or variety of such products from all or some of the effects of the constituting instrument of a chamber, a joint plan, a regulation, a by-law or an agreement." Regie Decision 7111, para. 3.1.1. U.S. Exhibit 12.

<sup>39</sup> Regie Decision 7111, p. 13. U.S. Exhibit 12.

offers would be sent to the third party, which would inform all milk producers of these offers. The producers in turn would openly announce their production commitments based on the proposed offers, and a purchase contract, confirmed by the third party, would result. Processors could only make offers on the bulletin board, and producers' export-committed milk would be accessible only through that mechanism. All components of the milk subject to such contracts would have to be exported.<sup>40</sup>

33. To provide for the establishment of the proposed exclusive mechanism, the Federation filed with the Regie proposed amendments to: (1) the Quebec Milk Producers' Joint Plan,<sup>41</sup> (2) the Reglement sur les quotas des producteurs de lait (Regulation respecting milk producers' quotas)<sup>42</sup>; (3) the Reglement sur le paiement du lait aux producteurs (Regulation respecting the payment for milk),<sup>43</sup> and (4) the milk producers' marketing agreements with the cooperatives.<sup>44</sup>

34. The basis for these amendments was a consensus reached in December 1999 by the members of the Standing Committee on Harmonization of Canadian and Quebec Marketing Rules<sup>45</sup> regarding the necessary elements of the provincial export regimes that were to replace the WTO-inconsistent SMC system.<sup>46</sup>

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<sup>40</sup> Id. at p.14.

<sup>41</sup> According to the Regie's decision, the Quebec Milk Producers' Joint Plan (1980) applies to all milk and cream sold and delivered to any producer who manages a dairy herd from which he derives an income. The Federation remains responsible for carrying out the plan and for enforcing the regulations arising from it for all milk and cream sold or delivered. Regie Decision 711, p.23, section 6.6.1., U.S. Exhibit 12.

<sup>42</sup> Id. at p.24.

<sup>43</sup> Id.

<sup>44</sup> Id. at p.24.

<sup>45</sup> This committee comprises all of the signatories to the milk marketing agreements.

<sup>46</sup> Regie decision 7111, p.20.

35. The Standing Committee had agreed that the following principles must be embodied in the new export regimes: "Milk intended for export markets cannot, under any circumstances, be redirected to the domestic market. Verification of the separateness of the two systems is important. Records and statements of enterprises will be used in the audit process."<sup>47</sup> Indeed, the cooperatives appearing before the Regie in the arbitration proceeding testified that verification of the use of milk intended for export needed to be co-ordinated at the national level through the Canadian Dairy Commission (CDC).<sup>48</sup> As will be discussed below, not only has this monitoring role since been assigned to the CDC, but the CDC has been given broad enforcement powers to seize any milk that it discovers has been diverted to the domestic market after having been committed to an export contract under the new provincial export mechanisms.

36. Because the Federation and the cooperatives could not agree on whether all milk producers would be required to sell milk destined for export through a single, mandatory bulletin board system, the question was taken to the Regie for arbitration.<sup>49</sup> This arbitration proceeding culminated in Regie Decision 7111, which made amendments to the text of the Joint Plan, the quota and payment regulations, and the marketing agreements between the producers and cooperatives. The most relevant changes for purposes of this proceeding are:

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<sup>47</sup> Id, at p. 20.

<sup>48</sup> Id. at p. 21.

<sup>49</sup> The Regie summarized the position of two of the cooperatives, Agropur and Lactel, as follows:

The proposed approach allows producers and processors to buy and sell freely and voluntarily the milk committed individually for export. Thus, in the case of members of dairy cooperatives who are already bound by contract to a cooperative, the milk of members committed for export continues to be entrusted to the cooperative for marketing. Producers who do not belong to a cooperative can sell the milk they commit for export directly to milk processors including cooperatives, with perhaps multiple marketing mechanisms for milk committed for export. Id. at p. 12.

- the binding nature of the agreement between producers and processors;<sup>50</sup>
- the obligation that all milk components received by a milk dealer under the export scheme must be exported, under threat of penalties;<sup>51</sup>
- the requirement that all producers who wish to supply volumes of milk for export must go through the bulletin board if they have no specific commitment to this effect with the cooperative to which they belong;<sup>52</sup>
- the requirement that milk dealers that are not cooperatives must deal with producers exclusively through the single bulletin board;<sup>53</sup> and
- the specification of procedures and rules governing the operation of the bulletin board.<sup>54</sup>

37. Each of the Agreements between the Federation and the three principal cooperatives were also modified by the Regie decision to provide that: “All components of milk intended for export markets and covered by a specific commitment between an individual producer and a milk dealer must be exported. Any milk dealer who breaches this obligation is subject to the penalties stipulated in this chapter.”<sup>55</sup> The penalty provided is severe. When a milk dealer is unable to show that all the quantities of components<sup>56</sup> of the volume of milk received have been exported or are stored subject to export at a later date, it must pay to the Federation an amount, per

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<sup>50</sup> Id, para. 6.5.

<sup>51</sup> Id.

<sup>52</sup> Regie decision 7111, para. 6.6.4., U.S. Exhibit 12.

<sup>53</sup> Id., para. 6.6.4.

<sup>54</sup> Id., para. 6.6.4. Significantly, a six member committee was established to oversee the operation of the bulletin board mechanism. While the committee is to make all decisions by consensus, three of the six members of the committee are from the Federation, the provincial milk marketing board, giving the provincial authorities substantial additional influence over the administrative rules for the export mechanism.

<sup>55</sup> Id. at Annex 4, para. 2.25 (p.2).

<sup>56</sup> There are three broad categories of milk components: butter fat, milk proteins, and other milk solids.

kilogram of milk component, equal to twice the component price payable in Class 3b.<sup>57</sup> Because the Class 3b price pertaining to milk sold in the domestic market will generally be approximately twice the export price, the penalty will equal an amount that is approximately four times the price that the processor would have paid for milk destined for export.

38. That aspect of the Regie's decision which permitted the milk producer cooperatives to operate outside of the otherwise obligatory export mechanism was subsequently the subject of a request for reconsideration by the Federation, which challenged the differential treatment accorded by the Regie to milk producers who were members of a cooperative. The Regie rejected the Federation's petition for reconsideration,<sup>58</sup> including the Federation's claim that the exemption of cooperatives from the bulletin board requirement would quickly lead to a proliferation of marketing systems and the demise of the new export scheme.

39. The matter did not end there, however. The Regie ruling permitting non-bulletin board sales by cooperatives was overturned by a decision of the cabinet of the Government of Quebec on 6 December 2000.<sup>59</sup> Based on the recommendation of the provincial Minister of Agriculture,

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<sup>57</sup> Paragraph 2.43 of the amended marketing agreement between the Federation and Agropur. Identical provisions are contained in the marketing agreements with the other cooperatives. See Regie Decision 7111, Annex 4, para. 2.43, U.S. Exhibit 12.

<sup>58</sup> The Regie's decision clearly delineated the broad scope of its authority:

Pursuant to sections 28, 36, and 64 of the Act, the Regie therefore has jurisdiction to restrict the powers of the marketing board with respect to milk for export. And this is precisely what it did in its arbitration award 7111, by restricting the exercise of the powers of the plan relating to the price and volume of this milk, setting of quotas and the pooling of revenues for milk for export subject to a specific agreement between a producers and a milk dealer. Section 116 allows the Regie to render an arbitration award should the parties be unable to reach an agreement.

Regie Decision 7140, 27 October 2000, p.12. U.S. Exhibit 13.

<sup>59</sup> Order in Council, 1408-2000, December 6, 2000 (emphasis added). U.S. Exhibit 14.

Fisheries and Food, the Quebec Executive Council mandated that the bulletin board prescribed in Decision 7111 must be the “*sole mechanism for the marketing of milk intended for export.*” This decision by the highest levels of the Quebec provincial government placed members of cooperatives on the same footing as other milk producers in the province. As a consequence, there are no exceptions to the export mechanism in Quebec. All milk producers, members of cooperatives as well as independent producers, must contract to sell any milk destined for export through the single export mechanism established by the provincial authorities.<sup>60</sup>

**D. The Canadian Dairy Commission Ensures That Discounted Milk Is Used Only In Exports**

40. The Canadian Dairy Commission (CDC) also continues to play a central role in the export of dairy products. Last year Canada eliminated Special Milk Class 5(e), the main mechanism for surplus removal, but the CDC is still involved in the issuance of permits and the negotiation of milk prices for Class 5 (d) and 5(a), 5(b) and 5(c). Also, the CDC remains heavily engaged both in the operation of Canada’s supply management system, as well as in the enforcement of the export mechanisms recently created by the provinces.

41. The CDC is, of course, still very much involved in the determination of the annual domestic production quota or MSQ. The CDC also controls the licensing of milk producers for purposes of the federal dairy quota. This power is significant since Section 7(3) of the Dairy Products Marketing Regulations prohibits anyone from marketing for export any dairy product not made from milk produced by a person holding a federal license. In addition, the CDC is still

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<sup>60</sup> The Cabinet Council in Quebec left no doubt that it viewed the new export mechanism as being established through the authority of the provincial authorities. Thus, the Council’s December 6 decision states that “. . . the Regie des marches agricoles et alimentaires du Quebec has established an individual export mechanism that consists of a bulletin board to which all milk producers and marketers have access . . .” U.S. Exhibit 14.

responsible for the operation of the Special Class 5(d) export subsidy and the negotiation of contracts relating to “planned exports” under that provision.

42. More importantly for this proceeding, the CDC fulfills important new responsibilities in connection with the provincial export schemes. In particular, the CDC, which possesses the authority to audit the books and records of both producers and processors, exercises the control necessary to ensure that milk committed to export contracts is used exclusively for that purpose, as required by Section 7 of the Dairy Products Marketing Regulations.<sup>61</sup>

43. Section 10 of the Regulations specifies the nature of the information that must be made available to the CDC for audit purposes:

Every person who is engaged in the production or processing of a dairy product for marketing in interprovincial or *export* trade shall maintain complete and accurate books and records of all matters relating to that production or processing and shall make those books and records available to the Commission on its request. (emphasis added)

Although Section 10 was recently amended to ostensibly remove pricing and quantity information from the scope of the records that must be provided to the CDC, the phrasing of the amended provision makes clear that the CDC will continue to have access to such information where necessary. The pertinent part of the amended regulation is paragraph 1 of Section 10, which reads as follows:

Any information made available to the Commission under Section 10 does not have to contain pricing or other information on commercial export milk or cream,

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<sup>61</sup> Section 7(4) of the Regulations provides that : “No person contravenes section (3) in respect of a dairy product that was commercial export milk or cream that is marketed for final consumption in Canada if the person believed on reasonable grounds, when they marketed the product, that the product would be exported.” The language of this provision indicates that any person who knowingly diverts commercial export milk or cream for final consumption in Canada violates the Regulations. See U.S. Exhibit 4.

except information that is necessary to determine whether it has been marketed for final consumption in Canada.<sup>62</sup>

44. The Canada Gazette notice setting forth the amendment to the Regulations reinforces the conclusion that the CDC's audit authority applies to milk committed for export under the new export schemes. The scope of the CDC's audit authority was explained as follows:

In order to protect the integrity of the domestic milk supply management system through audit authority, section 10 of the regulations (regarding books and records) applies to CEM<sup>63</sup> (commercial export milk); however, any information available to the Commission under section 10 does not have to contain any information on CEM except that which is necessary to determine whether the product has been marketed for final consumption in Canada.<sup>64</sup>

45. In discussing enforcement of the new provincial schemes, the notice in the Canada Gazette states that additional audit resources are likely to be necessary "to determine whether or when commercial export milk or cream is consumed in Canada. It is expected that the Commission will appoint provincial dairy auditors as inspectors for this purpose."<sup>65</sup> Thus, the CDC will not only oversee the functioning of the provincial export schemes to ensure that no commercial export milk leaks into the domestic market, but the CDC intends to delegate some of

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<sup>62</sup> Regulations Amending Dairy Products Market Regulations, Sec. 10 (p.58) U.S. Exhibit 4.

<sup>63</sup> CEM is an acronym for commercial export milk and is the term used in the amendments to the Dairy Product Marketing Regulations for milk exported under the new provincial schemes. Section 2 of the amended regulations specifies that commercial export milk or cream is milk or cream that is "(a) produced and marketed under a sales contract between the producer of the milk or cream and a buyer in which any dairy product that is, or is manufactured from, the milk or cream is destined for export; (b) marketed in a province set out in the schedule and in a manner that is consistent with exclusions from the dairy product marketing laws in that province, (c) marketed in export trade or is manufactured into a dairy product that is marketed in export trade; and (d) not subject to a program established by the Commission [CDC] under paragraph 9(1)(i) of the Act."

<sup>64</sup> Regulatory Impact Analysis Statement, Canada Gazette, 3 January 2001, p. 60. U.S Exhibit 4.

<sup>65</sup> Directions to the Canadian Dairy Commission (Export Dairy Products), Canada Gazette, 3 January 2001, p. 62. U.S. Exhibit 4.



its powers to the provincial dairy boards to perform this oversight function on behalf of the Canadian federal government.

46. Perhaps the most important modification of the Regulations as they apply to the CDC's authority respecting the new provincial schemes is new Section 11(1). That provision empowers inspectors appointed under the Canadian Dairy Commission Act to seize any dairy product that the inspector believes on reasonable grounds was marketed in interprovincial or export trade in contravention of the Regulations.<sup>66</sup> Since the Regulations prohibit the diversion into Canada's domestic market of any milk committed to export, the CDC inspectors (and their provincial counterparts) have been given authority to seize any commercial export milk or cream that based "on reasonable grounds" is believed to have been sold into the domestic market for final consumption, rather than exported as required by the Regulations. There can be no question that this power will prove to be an effective enforcement measure to ensure that milk committed to export contracts is in fact delivered to the exporting processors and ultimately exported. The federal enforcement efforts are designed to complement the provincial powers discussed above, which include the imposition of prohibitive penalties and the revocation of licenses necessary to produce and ship milk.

#### **E. Canada Continues To Use Special Class 5(d) Export Subsidies**

47. It is also important to recognize that Canada did not replace the SMC system in its entirety. Provision for so-called "planned exports" under Special Milk Class 5(d) remains part of Canada's export regime. Indeed, Canada has done nothing at all to alter Special Class 5(d)

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<sup>66</sup> Regulations Amending the Dairy Products Marketing Regulations, para. 8(i) amending Section 11(1), Canada Gazette, 3 January 2001, p.58. U.S. Exhibit 4.

exports or the role of the Canadian Dairy Commission and the provincial marketing boards in implementing them. Moreover, as reflected in Canada's recent amendment of the Dairy Products Marketing Regulations, Canada does not dispute the status of Special Milk Class 5(d) as an export subsidy pursuant to the provisions of the *Agreement on Agriculture*. There Canada stated that "[n]ew section 7.1 [of the regulations] provides that export subsidies for Canadian dairy products will be provided only by a program established under paragraph 9(1)(i) of the CDC Act (Class 5(d))".

48. Canada continues to utilize the Special Class 5(d) subsidies to enable dairy product exports to traditional markets such as the United Kingdom and North Africa. During the 1999/2000 dairy marketing year, subsidized exports under Special Class 5(d), 5(e) and the Optional Export Program equaled 85,560 metric tons, or 200 percent of Canada's permitted subsidized exports of cheese and other dairy products.<sup>67</sup>

49. In sum, the reforms undertaken by Canada last year fall short of achieving the change necessary to convert export subsidies resulting from governmental action into simple commercial transactions between milk producers and processors. Canada's modification of its dairy export regime has neither eliminated the export subsidies nor brought the level of subsidized exports within the bounds accepted by Canada as part of its obligations under the *Agreement on Agriculture*. Instead, Canada has introduced new provincial measures that have the identical purpose and same subsidizing effect as the Special Milk Class export subsidies found by the DSB to be inconsistent with Canada's export subsidy obligations.

### LEGAL ARGUMENT

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<sup>67</sup> See U.S. Exhibit 1.

**IV. The Agreement on Agriculture Requires That the Quantity of Subsidized Exports Be No Greater Than the Level Specified In a Member's Reduction Commitments**

50. Although Canada would no doubt prefer to emphasize the statutory and regulatory changes reducing the scope of the government's powers relating to export contract milk, the Canadian government has retained sufficient authority with regard to dairy exports, and milk provided to exporters, that its role in dairy product exports still can only be viewed as indispensable. Furthermore, both the essential manner in which discounted milk is provided to dairy processors and the benefit to those processors is largely unchanged. The provincial programs each still reflect systematic government intervention and constitute export subsidies for purposes of the *Agreement on Agriculture*.

51. Under the *Agreement on Agriculture*, a Member is permitted to use export subsidies to the extent of the quantity and budgetary commitment levels, if any, contained in that Member's WTO Schedule. There are two distinct product-specific obligations: (1) a restriction on the volume of subsidized exports that may be made in any year and (2) a ceiling on the annual budgetary expenditures for export subsidies. Agricultural export subsidies or subsidized exports that exceed the specified limits are prohibited by Article 3.3 and Article 8 of the *Agreement*. The DSB found on 27 October 1999 that Canada breached these obligations because its SMC system constituted an export subsidy within the meaning of Article 9.1(c) of the *Agreement*, and Canada used that system to subsidize exports of butter, cheese, and other dairy products in greater quantities than are permitted by Canada's export subsidy reduction commitments.

52. Now, an almost identical legal issue is again presented. Canada introduced new export measures last year with the objective of establishing provincial schemes to replace the SMC system while continuing to provide discount priced milk to exporters. Without access to such

low-priced milk, Canadian dairy processors simply cannot compete on export markets given prevailing world prices for dairy products.

53. The fundamental obligation of the *Agreement on Agriculture* concerning export subsidies is contained in Article 8, which provides that: “Each Member undertakes not to provide export subsidies other than in conformity with this *Agreement* and with the commitments as specified in that Member’s Schedule.” Article 3.3 of the *Agreement*, in turn, provides that a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in excess of the budgetary outlay and quantity commitment levels specified in Section II of Part IV of that Member’s Schedule. To ensure, moreover, that the disciplines on export subsidies contained in Article 3.3 are not circumvented, Article 10.1 of the *Agreement* directs that any export subsidy not identified in Article 9.1 may “not be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments . . .” Thus, a Member may use export subsidies not listed in Article 9.1 only within the limits of its scheduled reduction commitments.

54. Given this framework, any export subsidy that falls either within the scope of the export subsidy descriptions contained in Article 9.1 or within the broader reach of Article 10.1 of the *Agreement* is subject to the limitations, both budgetary and quantitative, included in each Member’s Schedule. For the reasons that follow, Canada’s provincial export measures are export subsidies within the meaning of Article 1(e) of the *Agreement* and, therefore, must be confined within the quantitative limits prescribed in Canada’s Schedule. Canada’s failure to respect its Schedule limitations on export subsidies is, in turn, a failure to comply with the DSB’s recommendations to bring its milk export subsidies into conformity with the *Agreement*.

**A. Canada's New Export Schemes Are Article 9.1(c) Export Subsidies**

55. Article 9.1 of the *Agreement on Agriculture* contains six paragraphs, each setting forth a different category of export subsidies, all of which are subject to the *Agreement's* reduction commitments. Canada's provincial export mechanisms are export subsidies because they satisfy the criteria contained in Article 9.1(c) of the *Agreement*. Article 9.1(c) identifies the following practice as an export subsidy:

payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived.

56. The foregoing text establishes two conditions for finding an export subsidy to exist under paragraph (c). There must be: (1) payments on the export of an agricultural product and (2) those "payments" must be "financed by virtue of governmental action."<sup>68</sup> The new provincial export schemes fulfill both of these conditions as demonstrated below and, thus, constitute an Article 9.1(c) export subsidy.

**1. The Provision of Discounted Milk to Dairy Processors Is a "Payment"**

57. The Appellate Body has already determined in this case that "the provision of milk at discounted prices to processors for export under Special Milk Classes 5(d) and 5(e) constitutes

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<sup>68</sup> Canada does not dispute that these are the appropriate factors for consideration under Article 9.1(c) of the *Agreement on Agriculture*. Canada Appellant Submission, para. 118.

‘payments’, . . . within the meaning of Article 9.1(c).<sup>69</sup> The Appellate Body articulated its conclusion in pragmatic terms:

If goods or services are supplied to an enterprise, or a group of enterprises, at reduced rates (that is, at below market-rates), “payments” are, in effect, made to the recipient of the portion of the price that is not charged. Instead of receiving a monetary payment equal to the revenue foregone, the recipient is paid in the form of goods or services. But as far as the recipient is concerned, the economic value of the transfer is precisely the same.<sup>70</sup>

58. Canadian governmental authorities continue to provide milk for export products at a discount from domestic prices. Prices for milk consumed in Canada remain highly regulated through the authority conferred on the milk marketing boards by the federal and provincial governments. Such prices are determined by the marketing boards and must be paid by processors; there is no choice in the matter. If they seek to purchase milk for their domestic operations they must pay the high price fixed by the provincial milk board. In contrast, those same dairy processors set the price they are willing to pay for milk for specific export contracts under the new provincial export schemes. Significantly, prices offered by dairy processors to milk producers for export contracts have been uniformly lower than those that prevail in Canada for milk for the domestic market.<sup>71</sup> Dairy processors can offer such reduced prices for milk for export because the provincial milk marketing boards now exempt prices for export milk from the

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<sup>69</sup> AB Report, para. 113.

<sup>70</sup> Id.

<sup>71</sup> See U.S. Exhibit 2. Export contracts appearing on the Ontario and Quebec electronic bulletin boards reveal prices averaging approximately C\$29 to C\$31 per hectoliter.

highly regulated price regime administered by the boards with respect to milk consumed domestically.

59. The benefit derived by exporters from the reduced prices charged for milk delivered through the replacement provincial export schemes is no less a payment for purposes of Article 9.1(c) than the discounted milk previously made available to exporters under the SMC system. Indeed, the milk provided through the new provincial export schemes is sold to processors for export within the same general price range that was applicable under the SMC system. The similarity of prices is demonstrated by a comparison of the SMC 5(e) prices with prices recently posted on the bulletin board export schemes now operating in Ontario and Quebec. Under the export contract schemes in Ontario and Quebec, the prices range between C\$29 to C\$31 per hectoliter, which is only slightly higher than prices for Class 5(e) milk under the SMC system in 2000.<sup>72</sup>

60. More importantly, the contract prices offered under the replacement provincial measures are significantly below the market prices paid for milk entering Canada's domestic market for final consumption. For example, the average price for Class 3 milk sold into the Canadian market for ultimate consumption within Canada was about C\$56 per hectoliter for the period August to December 2000, about 85 percent above the much lower price offered in export contracts reported for the same month.<sup>73</sup> Thus, just as in the case of the earlier SMC system, the replacement provincial export measures result in milk producers providing milk for export at a substantial discount to the prevailing market price for milk delivered for ultimate consumption in Canada. Milk producers are now foregoing revenue in the same manner that the Panel and

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<sup>72</sup>See U.S. Exhibit 2.

<sup>73</sup> See U.S. Exhibit 2.

Appellate Body found to constitute a “payment” for purposes of Article 9.1(c) under the SMC system.

61. The result under the provincial programs and the SMC system is also the same for dairy processors, which continue to receive milk for export at a price that is lower than would be paid by the same processor purchasing milk for use in manufacturing products for Canada’s domestic market. The provincial measures introduced to replace the SMC system, therefore, fulfill the first element, *i.e.*, the existence of a payment, necessary to establish the existence of an export subsidy under Article 9.1(c). If the provision of such economic value is, in addition, the result of governmental action, the provincial measures then constitute export subsidies for purposes of the *Agreement on Agriculture*. In such circumstances, any exports made with such subsidies must be counted against Canada’s export subsidy reduction commitments.

## **2. The “Payments” to Processors Are Financed By Virtue of Governmental Action**

62. The factors considered by the Panel and Appellate Body in their application of the second part of Article 9.1(c) to the circumstances of the SMC system are also relevant here. Two considerations were given paramount consideration in that analysis. First, the Appellate Body found that “since all of the bodies involved in the supply of milk under Special Classes 5(d) and 5(e) are ‘government agencies’ under Article 9.1(a), a strong presumption arises that their conduct in managing those Special Classes may appropriately be regarded as ‘governmental action’”.<sup>74</sup> Second, the Appellate Body found it necessary to consider the “‘governmental’ involvement as a whole” and the “‘action’ of all these bodies together” to assess whether the

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<sup>74</sup> Appellate Body Report, para. 118.



“payment” from milk producers was “financed by virtue of governmental action.”<sup>75</sup> Central to the Appellate Body’s analysis, moreover, was the ordinary meaning of the word “government” as used in Article 9.1:

According to *Black’s Law Dictionary*, “government” means, *inter alia*, “[t]he regulation, restraint, supervision, or control which is exercised upon the individual members of an organized jural society by those invested with authority”. (emphasis added) This is similar to meanings given in other dictionaries. The essence of “government” is, therefore, that it enjoys the effective power to “regulate,” “control” or “supervise” individuals, or otherwise “restrain” their conduct, through the exercise of lawful authority. This meaning is derived, in part, from the *functions* performed by a government and, in part, from the government having the *powers* and *authority* to perform those functions. A “government agency” is, in our view, an entity which exercises powers vested in it by a “government” for the purpose of performing functions of a “governmental” character, that is, to “regulate”, “restrain”, “supervise” or “control” the conduct of private citizens (emphasis in the original, footnote omitted).<sup>76</sup>

**a. All the relevant bodies involved in the provincial  
milk schemes are governmental**

63. As in the case of the SMC system, the bodies involved in the new provincial milk schemes are either explicitly government agencies or governmental in terms of the delegated authority that they exercise and the functions they perform. Indeed, to a large extent, the same entities are associated with the new export schemes as were involved in the SMC system.

64. Because the CDC is a Crown corporation, there is no question about its governmental character.<sup>77</sup> Likewise, the provincial governments, nine of which are signatories to the National

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<sup>75</sup> Appellate Body Report, para. 119.

<sup>76</sup> AB Report, para. 97.

<sup>77</sup> Panel Report, para. 7.75.

Milk Marketing Plan, are by definition government entities, as the Panel found in its original report.<sup>78</sup> Significantly, the Panel also determined that the provincial governments both regulate the milk marketing boards<sup>79</sup> and are a source of the boards' delegated powers relating to intra-provincial activities.<sup>80</sup> In doing so, the Panel observed that governmental commissions in the provinces act as the ultimate arbiters in resolving intra-provincial disputes concerning the milk marketing boards.<sup>81</sup> The Panel also found that all of the Members of the Canadian Milk Supply Management Committee (CMSMC) were government entities, making the Committee itself governmental in character.<sup>82</sup>

65. Finally, the Panel also viewed the provincial milk marketing boards as government agencies. The Panel noted that the marketing boards act with authority delegated to them by the federal and provincial governments.<sup>83</sup> The Panel then discussed how the status, powers, and functions of the marketing boards affected its consideration of whether those entities are government agencies for purposes of Article 9.1(a). The Panel emphasized four factors: (1) the marketing boards' authority is delegated from the federal and provincial governments;<sup>84</sup> (2) the marketing boards may enforce their orders in the Canadian courts;<sup>85</sup> (3) individual decisions by the boards are subject to appeal to a provincial (and undisputedly governmental) supervisory

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<sup>78</sup> Panel Report, para. 7.73.

<sup>79</sup> Panel Report, para. 7.76, 7.78.

<sup>80</sup> Panel Report, para. 7.76.

<sup>81</sup> Panel Report, para. 7.76.

<sup>82</sup> Each of the provincial governments is represented on the Committee. Panel Report, para. 7.79. This characterization appears particularly appropriate given that CDC employees, that is, employees of the federal government in Canada, provide the research and administrative functions necessary for the CMSMC's operation. Panel Report, para. 2.29.

<sup>83</sup> Panel Report, para. 7.76.

<sup>84</sup> Panel Report, para. 7.76.

<sup>85</sup> Panel Report, para. 7.76.

board or commission;<sup>86</sup> and (4) the marketing boards performing these functions are explicitly government entities in Alberta, Nova Scotia, and Saskatchewan. In sum, the Panel found that:

. . . Canadian governments maintain the ultimate control and supervision of most, if not all, of the boards' activities. These governments define, and approve changes to, the boards' mandates and functions. (footnotes omitted)<sup>87</sup>

66. The bodies that were central to the administration of the SMC system are similarly integral to the operation of the current export schemes. The CMSMC's responsibilities are essentially unchanged. The Committee continues to annually set the amount of "traditional" export sales made through Special Class 5(d),<sup>88</sup> to establish the annual production quota (which determines the relative amount of in-quota and over-quota milk production),<sup>89</sup> and to oversee the implementation of the Comprehensive Agreement on Special Class Pooling,<sup>90</sup> which remains relevant for exports under Special Milk Class 5(d).

67. The CDC continues to perform various functions associated with the domestic production quota, the licensing of the federal quota shares, the negotiation of prices and sales of Special Milk Class 5(d) milk for export, and, critically, the comprehensive audit functions necessary to ensure that milk directed to export does not enter the Canadian domestic market. Similarly, the significance of the provincial governments remains undiminished. Those governments still are the source of much of the authority delegated to the milk marketing boards

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<sup>86</sup> Panel Report, para. 7.76 (The Panel observed that Canada recognizes the governmental nature of the supervisory boards and commissions.)

<sup>87</sup> Panel Report, para. 7.78.

<sup>88</sup> Panel Report, para. 7.68.

<sup>89</sup> Panel Report, para. 7.84.

<sup>90</sup> Panel Report, para. 7.79.

and the provincial governments also maintain the same ultimate powers to resolve and determine issues relating to the sale and distribution of milk and dairy products.

68. It is only the role of the milk marketing boards that has changed in the last year. The adjustment here, however, is far more modest than has been portrayed by Canada in its various representations to the DSB. Indeed, the powers of the marketing boards have been modified in only one narrow sense: their *direct* authority relating to the *price* and *volume* of export contracts for milk was eliminated through revision of the milk marketing orders in each province. Whereas following the *Bari* litigation<sup>91</sup> the marketing orders had been revised to expressly provide the boards with authority over milk intended for export, those same orders now have been carefully amended to circumscribe such authority. However, close attention must be paid to the limited extent to which those powers have actually been confined, because the authority that has been retained is more than necessary to ensure that processors continue to receive milk at discounted prices for export.

69. The pertinent analysis here is the same as the Panel adopted in its consideration of the role of the milk marketing boards in the SMC system. The Panel did not limit its focus to simply the delegation of powers to the marketing boards. Instead, the Panel additionally considered their actual functions of the boards in respect of the operations of the Special Classes,<sup>92</sup> as well as the extent to which the provincial and federal governments retained supervisory oversight regarding the boards' exercise of delegated powers.

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<sup>91</sup> As described in the Panel Report, in the *Bari* litigation, it was found that the provincial marketing boards could not act at the inter-provincial or international level since they did not have the necessary federal authority. That shortcoming was rectified by amending the CDC Act. Panel Report, para. 7.77.

<sup>92</sup> Panel Report, para. 7.76-7.78.

70. The Panel's findings regarding the SMC system are equally applicable to the new export schemes. Specifically, the "Canadian federal and provincial governments maintain the ultimate control and supervision of most, if not all, of the boards' activities. These governments define, and approve changes to, the boards' mandates and functions."<sup>93</sup> The ultimate and decisive role of the provincial governments could not be evidenced more clearly than by the role, described earlier, played by the Regie and the Executive Council in Quebec in the establishment of the export scheme in that province.

71. The powers retained by the milk marketing boards enable them to regulate and control the use and manner of sale of all milk, including export milk, and the boards do so based on governmental powers that have been delegated to them. Thus, the boards possess all of the hallmarks of government agencies as identified by the Appellate Body: they exercise powers vested by government "for the purpose of performing functions of a "governmental" character; that is, to "regulate", "restrain", "supervise" or "control" the conduct of private citizens."<sup>94</sup>

72. Since, the CDC, CMSMC, the provincial governments and the milk marketing boards are all governmental, a presumption should exist, consistent with the Appellate Body findings relating to the SMC system, that the provision of discounted milk for export through the new export schemes is "financed by virtue of governmental action" for purposes of Article 9.1(c) of the *Agreement on Agriculture*.

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<sup>93</sup> Panel Report, para. 7.78 (footnotes omitted).

<sup>94</sup> AB Report, para. 97.

**b. Government involvement as a “whole” must be examined**

73. Additionally, the Appellate Body declared that in determining whether a payment is “financed by virtue of governmental action,” government’s involvement as a whole must be considered.<sup>95</sup> This conclusion flowed from the Appellate Body’s acknowledgment that the “functioning of the [SMC] system depends on a complex regulatory web involving the CDC and the CMSMC, acting together with the provincial milk marketing boards.”<sup>96</sup>

74. No less is true in the case of Canada’s new export schemes. Today, the CDC, the CMSMC, and the provincial milk marketing boards all remain heavily engaged in not only managing the size of the annual domestic milk quota and its allocation to individual milk producers, but also in establishing the prices for milk sold for consumption in Canada, in ensuring that no milk produced outside of the domestic quota enters the domestic market, and in developing export schemes to provide discounted milk for export. It is essential that this Panel examine the federal and provincial rules governing the current Canadian milk regime and determine the effect of those requirements on the delivery of export contract milk to dairy processors.

75. The Panel’s assessment should give consideration to three related elements of Canada’s government-mandated dairy regime. First, Canada distinguishes between milk destined for consumption in its domestic market and that which is exported. Whereas milk sold into the domestic market is regulated with respect to both quantity ceilings and price floors, milk that is designated for export markets is entirely exempt from such regulation (and hence is supplied at a discount). To enforce this distinction in treatment, government regulations prohibit milk

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<sup>95</sup> AB Report, para. 119.

<sup>96</sup> AB Report, para. 119.

produced outside of milk producers' domestic quotas from being sold into the Canadian market for final consumption there.<sup>97</sup> Over-quota, or even non-quota,<sup>98</sup> milk may only be directed into one of two alternative channels: either into export or for use in the production of animal feed.

76. Second, in Ontario and Quebec which account for approximately 80 percent of production, all milk destined for export must be sold through an exclusive, mandatory bulletin board system where processors invite offers of milk for specific export contracts at prices established by the processors.<sup>99</sup> Processors post invitations for milk producers to commit to contracts for specified quantities of milk at posted prices for the duration of a particular contract. In response, milk producers may designate the quantity of milk that they wish to supply at the price indicated by the processor.

77. The provincial regulations regarding export contract milk are exhaustive. They not only stipulate such matters as how the bulletin boards will operate, but also specify the procedures that will apply in the eventuality of non-fulfillment of obligations by one of the parties to an export contract. For example, in Quebec the provincial regulations specify how the milk committed by a producer will be assigned in the event of failure to produce sufficient milk to meet deliveries owed to processors under export contracts.<sup>100</sup> The milk producer is not given any discretion in the matter; instead, the regulations specifically direct that milk will be provided to processors in the sequence in which the contracts were entered into.<sup>101</sup> In such circumstances, provincial

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<sup>97</sup> Canada Dairy Products Marketing Regulations, U.S. Exhibits 4-5; Ontario DFO Milk General Regulation, 09/00, 08/00, U.S. Exhibits 7-8; Regie Decision 7111 describing Quebec's requirements, U.S. Exhibit 12.

<sup>98</sup> Non-quota milk is milk produced by dairy farmers who hold no domestic production quota.

<sup>99</sup> See Regie Decision 7111, 28 July 2000, U.S. Exhibit 12, Order in Council, 6 December 2000, U.S. Exhibit 14, p.2. ; Canada MFAT June 15, 2000, description of Ontario system, p. A.2., U.S. Exhibit 6.

<sup>100</sup> Regie Decision 7111, 28 July 2000, Annex 4, para. 2.30, U.S. Exhibit 12, pg. 40/75.

<sup>101</sup> Id.

regulatory controls preclude any choice by the producer based on such factors as the contract price or the contract volume.

78. As previously discussed, these bulletin board systems are at the center of the export schemes instituted in both Ontario, Quebec, and Manitoba, and have many common elements with schemes in other provinces. Milk for export that is not contracted through these systems is not exempt from price regulation by the milk marketing boards. For example, in Ontario the board's regulations are drafted so that only milk that is (1) pre-committed, (2) subject to an export contract and (3) made through the third party administered export contract exchange is considered to be "export contract milk."<sup>102</sup> Any milk not satisfying all of the listed conditions remains subject to full regulation as "domestic" milk by the marketing board.

79. Because over-quota and non-quota milk that does not fulfill the criteria for designation as export contract milk can only be used as an ingredient in animal feed, a far less remunerative end-use, milk producers have a significant financial incentive to provide any such milk to exporters and to comply with the board's requirements under the bulletin board system. Because any milk committed to an export contract is exempt from the higher regulated milk prices that apply to milk consumed in the domestic market, processors obtain milk at discounted prices as a result of the existence of the new export schemes. Without such schemes, milk at such discounted prices would not be available through any other channel to processors for export. Dairy processors that export are, therefore, the true beneficiaries of the new export regime in Canada.

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<sup>102</sup> See Ontario DFO Milk General Regulation 09/00, section 1(b). U.S. Exhibit 7



80. Third, the governing provincial regulations require that any milk committed to export contracts through the new export schemes be exported.<sup>103</sup> Failure to export milk so committed results in substantial monetary penalties in Quebec<sup>104</sup> and can lead to a board's refusal to deliver milk to processors and the revocation of the license of a milk producer in Ontario.<sup>105</sup> In all provinces, the diversion of export milk into the domestic market can lead to the seizure of the milk, or products made from it, by CDC inspectors or their provincial counterparts.<sup>106</sup>

81. From the foregoing it should be apparent that through their coordinated action Canada's national and provincial governments continue to regulate the production, distribution, and sale of milk, including export contract milk, in a detailed manner. This Panel should draw its conclusions whether discounted milk is provided to exporters by virtue of governmental action with this complex regulatory web firmly in mind.

**c. The Export Schemes are Indispensable to the Provision  
of Discounted Milk to Exporters**

82. The Appellate Body indicated that one measure of whether "payments" to processors are made "by virtue of governmental action" is to assess whether government action is indispensable. While the Appellate Body did not state that this is the only test, it concluded that if governmental action is shown to be indispensable to the occurrence of the payment, then the requirement contained in Article 9.1(c) that payment be made by "virtue of governmental action" is satisfied.

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<sup>103</sup> Canada MFAT June 15, 2000, description of Ontario, para. A.5, B.7, U.S. Exhibit 6; Regie Decision 7111, Annex 4, para. 2.25 U.S. Exhibit 12, pg. 38/75

<sup>104</sup> Regie Decision 7111, Annex 4, para. 2.43, U.S. Exhibit 12, pg. 45/75.

<sup>105</sup> Ontario DFO Milk General Regulation 09/00, section 5(4), U.S. Exhibit 7; Canada MFAT June 15, 2000, description of Ontario, para. B.7, U.S. Exhibit 6

<sup>106</sup> See Regulations Amending the Dairy Products Marketing Regulations, para. 8 amending section 11(1), Canada Gazette, 3 January 2001, p. 58, U.S. Exhibit 4.

83. To determine whether processors would have access to discounted milk for export absent the new provincial schemes, the Panel must consider the entire regulatory context in which the export schemes operate. Foremost in importance in this regard are the regulatory requirements that over-quota and non-quota milk not enter the domestic market, and that export contract milk be exempted from the regulated pricing that applies to all quota milk. Without the former, farmers who produce more than their quota or, in rare instances, produce outside of the quota system altogether, would be free to sell their milk into the market of their choice. Because the Canadian domestic market commands a price that is approximately twice the price level for milk that is exported, milk producers in such circumstances would opt to maximize revenue and would choose to sell more, not less, milk into Canada's domestic market. Consequently, milk now committed to export would flow into the domestic market *but for* the exclusion of over-quota and non-quota milk from the domestic market.

84. However, Canada's milk regime does not afford milk producers the liberty to choose where to sell the milk that they produce. By excluding over-quota and non-quota milk from the domestic market, Canada's governments make a separate pool of milk, that would not otherwise exist, exclusively available (for all practical purposes) for dairy processors for export. The exemption of "export contract milk" from domestic pricing regulation also means that processors that export dairy products are not required to pay the higher domestic market prices for milk. The exemption from this additional expense results exclusively from the recent *government* action excluding export milk from the scope of the provincial boards' pricing authority over milk. This exclusion was accomplished through the Canadian federal government's amendment of each of the provincial milk marketing orders to delete their power over the pricing of export contract milk. The exemption is of enormous economic benefit to exporters. Indeed, as shown in the original proceeding before the Panel, Canada's dairy processors could not compete in export

markets if the price they paid for milk were set at the level that processors must pay when producing dairy products for the domestic market.

85. Thus, under the new export schemes, the milk producers' choices are confined by government action no less so than was the case under the SMC system. It is this same government action, of course, that provides exporters with discounted milk. Dairy farmers producing more than their domestic quota or without quota altogether possess only two outlets for their excess production: (1) they can sell it for use in animal feed, netting approximately C\$15-20 per hectoliter or (2) they can sell the milk to exporters for approximately C\$29-31 per hectoliter.<sup>107</sup> That dairy farmers have overwhelmingly chosen to sell any production outside the quota to exporters, rather than into use as animal feed, should come as no surprise given the return from sales to exporters is roughly twice that obtained from the animal feed market. Indeed, Canada reported in its quarterly consultations with the United States under the Implementation Agreement that there was no milk consigned to use as feed under SMC 4(m) during the first months of the new provincial export contract mechanisms, evidencing that milk producers shunned that market for the more lucrative export contracts.

86. That Canada deems the prohibition on entry of milk committed to export contracts into Canada's domestic market as necessary to maintain the integrity of its supply management system for milk does not alter or diminish the fact that the exclusion of over-quota and non-quota production from the domestic milk market has the predictable and, of course planned, consequence of making discounted milk available to exporters. Milk is available at such reduced prices *only* because the Canadian government decided that, while dairy product manufacturers producing for the domestic market will have to pay the high prices established by provincial

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<sup>107</sup> See U.S. Exhibit 2.

marketing boards, those manufacturers will be exempt from paying such high prices for milk that they purchase to produce dairy products for export. These discounted prices cannot be viewed as freely negotiated when they are essentially distress prices resulting from the government's decision that milk produced in excess of domestic requirements must be sold into export markets, if it is to be sold at all.<sup>108</sup>

87. This Panel need look no further than a recent article appearing in the *Quebec Farmers' Advocate* for confirmation that without the involvement of the Canadian government, the new provincial export schemes would not exist and exporters would not have access to discounted milk in the manner to which they have grown accustomed. According to the article:

The Bouchard Cabinet, succumbing to months of pressure from Quebec dairy producers, has overturned a ruling by the Regie des marches agricoles and given its support to the creation of a single dairy exchange for exports.<sup>109</sup>

88. In that same article, producer organizations in Quebec are described as giving their endorsement to the Cabinet's decision, in large part, because they feared that unless a single exclusive export mechanism was enforced, the development of multiple contracting channels would have taken them "back to the situation 20 years ago," causing producers to "stop producing milk for export markets" or possibly "kill[ing] the whole system." One Quebec farmer, referring to the decision of the Regie allowing cooperatives to contract for milk outside of the bulletin board system, stated that: "We're really glad we got that hole plugged."<sup>110</sup>

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<sup>108</sup> The ceiling on prices for milk used for export is established by the world prices for the dairy products that Canadian processors seek to export.

<sup>109</sup> Quebec Farmers Advocate, January 2001, U.S. Exhibit 3.

<sup>110</sup> Id.

89. As a result of the foregoing Canadian government actions, there has been no change under the new provincial programs in the prices that processors pay for the milk purchased for use in manufacturing dairy products for export. Those processors still have access to milk at reduced prices, as was the case under Special Classes 5(d) and 5(e). The choices available to the milk producer also have not changed in any material way. Milk not eligible to be sold onto the domestic market either because it was produced outside of the farmer's domestic quota (so-called over-quota milk) or because it was deemed surplus to domestic market requirements<sup>111</sup> is routed into export channels, the only outlet that provides more than a minimal return to the farmer.

90. The overall action of Canadian governments in establishing domestic production quotas, in excluding over-quota and non-quota milk from the domestic market, in exempting export contract milk from domestic pricing requirements, in instituting mandatory and exclusive export contracting mechanisms, and in enforcing the various obligations arising from these regulatory requirements, constitutes pervasive government intervention. The essential fact is that only through the exercise of government powers are exporters provided milk at discounted prices. As

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<sup>111</sup> The MSQ is now modified on a continuing basis to better reflect domestic demand for milk. These constant adjustments are touted as necessary to ensure that production does not exceed domestic requirements now that the surplus management tool represented by Special System Class 5(e) has been eliminated. However, the actual effect of the frequent adjustments to MSQ is to make more milk available to processors for export. If production is likely to exceed domestic requirements, the MSQ will be adjusted downward, thereby proportionally reducing the domestic quotas of all affected milk producers. The effect is to move milk no longer needed for the domestic market into export channels at the lower prices required by processors to manufacture dairy products for export. In all important respects, the frequent adjustments to MSQ serve the same fundamental purpose as did the surplus removal mechanism under the Special Class System, i.e., the identification of circumstances where production exceeds domestic requirements, releasing milk at reduced prices for the export market. Whereas milk was removed from the system previously by declarations that milk was in surplus, now producers are signaled by the frequent revisions to domestic quota that they need to either reduce production or commit over-quota production to export contracts to avoid an over-supply situation on the domestic market. If producers do not heed the changes in domestic quota, they do so at considerable expense to themselves. Any milk that is produced over-quota, that is above the quota amount allocated to each producer, must be funneled into the production of animal feed, at the lowest market return to the dairy farmer, or simply destroyed.

in the case of the SMC system, governmental action is indispensable “to enable the supply of milk to processors for export, and hence the transfer of resources, to take place.”

91. This prohibition on the entry of over-quota and non-quota milk into the domestic market is enforced through government action and based on government authority. Consequently, without the prohibitions on the entry of such milk production into the domestic market, exporters would not have a viable source of milk priced at levels to permit the manufacture of competitively priced dairy products for export. It is in turn the government- enforced exclusion of over-quota and non-quota milk from Canada’s domestic market that leaves milk producers with little choice but to accept the prices offered by exporters.

92. While some of the particulars of involvement by Canada’s governments, both federal and provincial, have changed with the elimination of Special Class 5(e), the essential elements which made the SMC system an export subsidy under Article 9.1(c) of the *Agreement on Agriculture* are equally present in the replacement provincial measures introduced since August 2000, when Special Class 5(e) was eliminated. Moreover, since not a single day passed between the elimination of Special Class 5(e) and the effective date of the new provincial measures, Canadian exporters did not suffer any interruption in their access to discount priced milk.

**IV. ALTERNATIVELY CANADA'S EXPORT SCHEMES ARE INCONSISTENT  
WITH ARTICLE 10.1 OF THE *AGREEMENT ON AGRICULTURE***

93. If the new Canadian export schemes are not considered to be export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, those schemes should then be found to be export subsidies for purposes of Article 10.1 of the Agreement.

94. Article 10.1 provides:

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

95. In *United States - Tax Treatment of Foreign Sales Corporations*, WT/DS108/AB/R, adopted 20 March 2000, the Appellate Body stated that the obligations under Article 10.1 come into play when three factors are present: (1) there is a subsidy not identified in Article 9.1 of the *Agreement*, (2) that subsidy is contingent on export, and (3) the subsidy results in, or threatens to lead to, circumvention of a Member's export subsidy commitments.<sup>112</sup>

96. Therefore, the Panel's initial task here, should it not find export subsidies within the definitions of Article 9.1, is to determine whether the new export schemes in Canada are export subsidies for purposes of Article 10.1. In *Foreign Sales Corporations*, the Appellate Body drew upon the definition of subsidy in Article 1.1 of the *SCM Agreement* as context for construing that same term for purposes of the *Agreement on Agriculture*.<sup>113</sup> The Appellate Body observed that "... a 'subsidy' within the meaning of Article 1.1 of the *SCM Agreement* arises where the grantor

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<sup>112</sup> *United States - FSC*, AB Report, para. 135-154.

<sup>113</sup> *Id.* at para. 136.

makes a 'financial contribution' which confers a 'benefit' on the recipient,<sup>114</sup> as compared with what would have been otherwise available to the recipient in the marketplace."<sup>115</sup> Consistent with the text of Article 1.1, the Appellate Body concluded that there must be a financial contribution as well as a benefit to the recipient for a subsidy to exist. We recall that the Appellate Body in its original report in this dispute found that the provision of discounted milk constituted a transfer of economic resources for less than full consideration.<sup>116</sup>

97. The new Canadian export schemes share almost all of the attributes of the Special Milk Class system as was discussed earlier in this submission. For example, exporters obtain milk through the new bulletin board arrangements on a discounted basis, at a lower price than would otherwise be available to them in their domestic market. The access of exporters to discounted milk relieves them from a cost - higher priced milk - that they would incur absent the mandatory participation in the new export schemes by milk producers wishing to sell non-quota milk. The processors; thus, receive a benefit comprised of the cost savings resulting from the availability of lower priced milk. This benefit is, of course, funded by the revenue foregone by milk producers, who must sell any over-quota or non-quota milk into either the export market or for use in animal feed. Thus, a subsidy exists for purposes of Article 10.1.<sup>117</sup>

98. The next factor in the analytical framework suggested by the Appellate Body is to consider whether the availability of discounted milk pursuant to the export schemes is

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<sup>114</sup> As the Appellant Body noted in *Canada - Measures Affecting The Export of Civilian Aircraft*, AB-1999-2, Report of the Appellate Body, 2 August 1999, para. 154: "The term 'benefit' implies that there must be a recipient. This provides textual support for the view that the focus of the inquiry under Article 1.1(b) of the *SCM Agreement* should be on the recipient and not on the granting authority."

<sup>115</sup> *United States - FSC*, AB Report, para. 136.

<sup>116</sup> AB Report, para. 113.

<sup>117</sup> The United States discusses *infra* why consideration of paragraph (d) of Annex I of the *SCM Agreement* support a finding that Canada's new export schemes are export subsidies for purposes of either the *SCM Agreement* or the *Agreement on Agriculture*.



“contingent on export performance.”<sup>118</sup> The Appellate Body concluded in *Foreign Sales Corporations* that the export contingency requirement in the *SCM Agreement* and the *Agreement on Agriculture* should be read to have the same meaning in light of the identical language used in each agreement to define “export subsidies.”<sup>119</sup> There, both the Panel and the Appellate Body found the subsidy to be contingent on export as “the existence and amount of the subsidy depends upon the existence of income arising from the exportation of U.S. goods or the provision of services relating to the exportation of such goods.”<sup>120</sup>

99. In the Canadian export contract schemes, the availability of discounted milk is similarly dependent on use of the milk in the manufacture of dairy exports. Indeed, as we have seen, for milk to qualify as “export contract milk” under the applicable provincial regulations, milk must be pre-committed for export and sold through the exclusive, compulsory bulletin board networks existing in the provinces. Discounted milk intended for the export market may not be legally diverted into Canada’s domestic market without triggering substantial penalties that would more than negate the reduction in processors’ costs normally associated with their use of export contract milk. The subsidy resulting from the provincial schemes is, thus, contingent on export within the meaning of Article 1.1(e) of the *Agreement on Agriculture* and is an export subsidy for purposes of Article 10.1 of the *Agreement*.

100. The only question that remains in determining whether Article 10.1 applies to the export schemes is whether the export subsidy thereby conferred “results in, or threatens to lead, to circumvention of export subsidy commitments.” The Appellate Body’s construction of this requirement in *Foreign Sales Corporations* is also pertinent in this dispute.

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<sup>118</sup> *United States - FSC*, AB Report, para. 141.

<sup>119</sup> *Id.* at para. 141.

<sup>120</sup> *United States - FSC*, Panel Report, para. 7.108.

101. In *Foreign Sales Corporations*, the Appellate Body began its interpretation of the relevant text with the words “export subsidy commitments,” “because the meaning of those words defines the obligations that are to be protected under Article 10.1.”<sup>121</sup> The Appellate Body found that the words “export subsidy commitments” refer to the obligations assumed by WTO Members under Articles 3, 8 and 9 of the *Agreement on Agriculture*.

102. The Appellate Body found that Article 10.1's prohibition on the circumvention of export subsidy commitments is designed to prevent Members from “evading” their “export subsidy commitments.”<sup>122</sup> Significantly, the Appellate Body concluded that: “. . . under Article 10.1 it is not necessary to demonstrate *actual* ‘circumvention’ of ‘export subsidy commitments’. It suffices that ‘export subsidies’ are applied in a manner . . . which *threatens to lead to circumvention* of export subsidy commitments.”<sup>123</sup> In determining whether circumvention of export subsidy commitments is likely to result, the Appellate Body concluded that the structure and other characteristics of the measure are pertinent.<sup>124</sup>

103. Under the provincial export schemes, milk that qualifies as export contract milk is exempt from regulated pricing by the milk marketing boards. In addition, the Canadian government requires that over-quota or non-quota milk be excluded from ultimate consumption in the domestic market. The direct consequence of that exclusion is that such milk must be used

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<sup>121</sup> *United States - FSC*, AB Report, para. 144.

<sup>122</sup> *Id.* at para. 148. The Panel found it unnecessary to construe the second part of Article 10.1 in the original dairy report as the parties all agreed that in circumstances where the volume of exports exceeded the level indicated in a Member's export subsidy commitments and an export subsidy other than one identified in Article 9.1 was applicable, circumvention of those commitments within the meaning of Article 10.1 had occurred. See *United States - FSC*, Panel Report, para. 7.122-7.123.

<sup>123</sup> *United States - FSC*, AB Report, para. 148.

<sup>124</sup> *Id.* at para. 149.

to produce either products that must be exported or animal feed. Processors who export are free from any limitation on the amount of over-quota or non-quota milk for which they contract. Similarly, milk producers may provide as much such milk to processors for export as those producers are willing to commit. In other words, the availability of discounted milk for export is confined only by the export opportunities available to Canada's dairy product processors. The provincial export schemes lack any internal limit or control on the volume of discounted milk going to processors for export. Indeed, Canadian federal authorities repeatedly emphasized in implementation consultations with the United States and New Zealand that those authorities had no intention to monitor the volume of milk exported pursuant to the new export regime. Consequently, the export schemes, and the resulting subsidized exports, are not subject to any limitation.

104. The absence of any constraints on the use of an export subsidy was an important consideration for the Appellate Body in determining whether an export subsidy was likely to threaten to lead to circumvention of export subsidy commitments in *Foreign Sales Corporations*. In construing the obligations under the *Agreement on Agriculture*, the Appellate Body concluded that the first clause of Article 3.3 "provides a *limited authorization* for Members to provide such subsidies [those listed in Article 9.1] up to the level of the reduction commitments specified in their Schedule."<sup>125</sup> Once the level of those reduction commitments has been reached, however, the limited authorization is effectively converted into a prohibition on the provision of those subsidies.<sup>126</sup> Furthermore, the Appellate Body reasoned that to allow export subsidies other than those specified in Article 9.1 in connection with exports exceeding the level of the reduction

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<sup>125</sup> Id. at para. 151 (emphasis in the original).

<sup>126</sup> Id. at paras. 151-152.

commitments would constitute circumvention of those commitments within the meaning of Article 10.1.<sup>127</sup>

105. It is for this same reason that Canada's new export schemes threaten to lead to circumvention of Canada's export reduction commitments on dairy products. For the reasons stated, Canada's provincial export schemes constitute an export subsidy under Article 10.1 if this Panel does not conclude that such subsidies are encompassed by Article 9.1(c) of the *Agreement on Agriculture*. Additionally, because there is no constraint on the availability of the export subsidy created by the new export schemes, those export subsidies are unlimited in scope as are the exports which they foster. As a result, those export schemes threaten to lead to the circumvention of Canada's reduction commitments in precisely the same manner that caused the Appellate Body to conclude in *Foreign Sales Corporations* that the United States had breached Articles 3.3 and 8 of the *Agreement*.

106. A finding that the new provincial export schemes are export subsidies within Article 10.1 is also supported by consideration of the schemes under Paragraph (d) of Annex 1 of the SCM Agreement - the Illustrative List of Export Subsidies. The Panel in this dispute considered Paragraph (d) germane to a determination of whether Canada's Special Milk Classes constituted an export subsidy under Article 10.1. Paragraph (d) specifically addresses the situation where a government provides inputs to exporters "on terms or conditions more favorable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption."

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<sup>127</sup> Id. at para. 152.

107. The Panel concluded that there are several conditions that must be fulfilled to satisfy paragraph (d): (1) the goods must be provided on terms or conditions more favorable than for provision of like or competitive products in the production of goods for domestic consumption; (2) the goods must be used in the production; (3) the provision of goods must be by governments or mandated by them, either directly or indirectly; and (4) the goods provided to export processors must be available on terms or conditions more favorable than those commercially available on world markets to those exporters.<sup>128</sup>

108. Like the Special Milk Classes, Canada's new provincial export schemes satisfy each of these elements. First, as explained above, dairy processors continue to have access to milk through the electronic export contract bulletin boards boards that is priced on more favorable terms than would otherwise be available to such processors for milk in the domestic market. The price differential continues to be substantial.

109. Second, the lower prices are only available for milk used in the production of export products. As explained above, all milk purchased through the export contracts bulletin boards must be used in products that are exported. There are severe penalties if such products are ultimately sold into the domestic market.

110. Third, the lower-priced milk is provided by Canada's "governments or agencies directly or indirectly through government-mandated schemes." Again, as explained above, the provision of lower-priced milk for use in production of export dairy products is made possible only through the government-mandated exclusion of such milk from the domestic market. In addition, the

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<sup>128</sup> Panel Report, para. 7.128

electronic export contract bulletin boards are mandated by the Canadian governments or agencies as the sole and exclusive means for buying such milk.

111. Finally, the terms and conditions on which milk is made available to processors for export are more favorable than those available to them on world markets. In fact, the facts underlying the Panel's finding on this point have not changed. For all practical purposes, commercial imports of fluid milk for processing cannot enter Canada due to import restrictions.<sup>129</sup> Thus, if processors want to export dairy products, their only choice is to use milk obtained through the export contract bulletin boards. Obviously, this is not a choice which is "unrestricted and depends only on commercial considerations" in the sense of the footnote to Paragraph (d).

112. Thus, because the new provincial export schemes satisfy each of the criteria identified in Paragraph (d) of the Illustrative List, the new provincial schemes are export subsidies for purposes of the *SCM Agreement*. As the *SCM Agreement* is part of the context of the *Agreement on Agriculture*, the fact that the provincial schemes constitute a subsidy under the Illustrative List supports a finding that the provincial export schemes are export subsidies under Article 10.1 of the *Agreement on Agriculture*.

**V. CANADA'S EXPORTS OF SUBSIDIZED DAIRY PRODUCTS EXCEED ITS QUANTITY-BASED REDUCTION COMMITMENTS UNDER THE AGREEMENT ON AGRICULTURE**

113. A review of available export data contained in U.S. Exhibit 1 shows that, when the volume of exports made pursuant to Special Milk Class 5(d) is combined with exports made

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<sup>129</sup> See Panel Report para. 7.53-7.55, 7.131.

under the provincial marketing schemes, the total aggregate volume of exports of cheese already exceed Canada's reduction commitments and exports of other milk products is barely below the quantity of subsidized exports that may be permitted consistent with Canada's reduction commitments.<sup>130</sup>

114. Consequently, because the new provincial export schemes constitute export subsidies, Canada's exports of cheese and other dairy products breach its obligations under Articles 3.3, 8 and 9 of the *Agreement on Agriculture*. The United States also notes that Canada has acknowledged that "where export subsidies, other than those listed in Article 9.1 of the *Agriculture Agreement*, have been applied to a commodity subject to subsidy reduction commitments in excess of the reduction commitment level specified in a Member's schedule for that commodity, a presumption of circumvention pursuant to Article 10 should arise."<sup>131</sup> Accordingly, in the event that the Panel finds that the provincial export mechanisms constitute an export subsidy within the meaning of Article 10, as opposed to Article 9, of the *Agreement on Agriculture*, a finding of circumvention is justified on the basis of the quantity of subsidized exports.

## **VI. THE NEW EXPORT SCHEMES CONSTITUTE PROHIBITED EXPORT SUBSIDIES UNDER ARTICLE 3 OF THE SCM AGREEMENT**

115. In addition to constituting violations of Articles 9.1(c), or in the alternative, Article 10 of the *Agreement on Agriculture*, Canada's measures affecting the exportation of dairy products constitute prohibited export subsidies pursuant to Articles 1.1 and 3.1 of the *Agreement on Subsidies and Countervailing Measures (SCM Agreement)*. These measures -- Canada's new

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<sup>130</sup> U.S. Exhibit 1.

<sup>131</sup> Answer of Canada to the Panel's Question 16, U.S. Exhibit 22.

provincial export subsidy programs as well as the maintenance of Special Class 5(d) -- provide discounted milk to milk dealers on the condition that the milk is exported to foreign markets. They do so by allowing exporters to purchase milk at prices that are below prevailing market-levels as compared to milk used in dairy products sold in Canada's domestic market. Access to this low-priced product is contingent on the product being exported, because should a milk dealer divert the low-priced milk or products made from it to the domestic market, the milk dealer must pay a severe penalty. The result is that milk sold for export is often half the price of milk sold on the domestic market.

116. Therefore, Canada's measures constitute subsidies contingent upon export performance in violation of Article 3.1(a) of the *SCM Agreement*, and the appropriate remedy shall be withdrawal of the subsidy without delay pursuant to Article 4.7 of the *SCM Agreement*.

**A. Canada's New Export Schemes Are Subsidies**

117. In its report on Canada's SMC system, the Appellate Body noted that:

[a] we said in our Report in *Canada - Aircraft*, a "subsidy", within the meaning of Article 1.1. of the *SCM Agreement*, arises where the grantor makes a "financial contribution" which confers a "benefit" on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace.  
[footnote omitted]<sup>131</sup>

Notwithstanding the change that Canada imposed on the form of its programs, Canada's measures continue to meet Appellate Body's definition of a "subsidy" under Article 1.1 of the *SCM Agreement*.

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<sup>131</sup>AB Report, para. 87.



**1. The Provision of Discounted Milk to Dairy Processors Constitutes a  
Financial Contribution**

118. Article 1.1(a)(1) of the *SCM Agreement* provides in part that a government offers a "financial contribution" where a government provides goods or services other than general infrastructure, or purchases goods; [or] a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments[.]

119. As stated above, Canadian governmental authorities continue to provide milk for export products at a discount from domestic prices. Under Canada's new scheme, the CDC, CMSMC, the provincial governments, the milk marketing boards and the new provincial programs -- with their mandated bulletin board systems and penalties for milk that is not properly channeled -- all conspire to ensure that this is the case. The Appellate Body found that, in such circumstances, "the recipient is paid in the form of goods or services."<sup>132</sup> This constitutes a financial contribution under Article 1.1(a)(1)(iii) of the *SCM Agreement*.

120. Alternatively, if the mandated bulletin board systems were deemed to be private bodies and not "agencies" of Canada's governments,<sup>133</sup> their role in the overall export subsidy scheme would constitute a "financial contribution" under paragraph (a)(1)(iv) of Article 1.1 of the *SCM Agreement*. The mandated bulletin board systems are "entrusted" by the governments with the

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<sup>132</sup> AB Report, para. 113.

<sup>133</sup> AB Report, para. 102.

marketplace control function that would otherwise be carried out by the marketing boards or another government agencies. It is a distinction without a difference.

## 2. The Provision of Discounted Milk to Dairy Processors Confers a Benefit

121. The term “benefit” was interpreted in the *Canada – Aircraft* case. The Appellate Body found that:<sup>134</sup>

[T]he word ‘benefit’, as used in Article 1.1(b), implies some kind of comparison. This must be so, for there can be no ‘benefit’ to the recipient unless the ‘financial contribution’ [or ‘income or price support’] makes the recipient ‘better off’ than it would otherwise have been, absent that contribution. In our view, the marketplace provides an appropriate basis for comparison in determining whether a ‘benefit’ has been ‘conferred’, because the trade-distorting potential of a ‘financial contribution’ [or ‘income or price support’] can be identified by determining whether the recipient has received a ‘financial contribution’ [or ‘income or price support’] on terms more favorable than those available to the recipient in the market.

Because of the incentive to sell milk at lower prices for export, dairy processors that export are the true beneficiaries of the new export regime in Canada. Without such schemes, milk at such discounted prices would not be available through any other channel to processors for export. Since those processors have no other source for such low-priced milk and they could not sell their dairy products into world markets if they were compelled to pay the much higher domestic prices in Canada for milk, the processors clearly receive a competitive advantage that they would otherwise lack. Since the milk for export is provided on lower terms than would otherwise be

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<sup>134</sup> *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R (2 August 1999), para. 157.

available on the market absent the provincial pricing systems, the financial contribution provides a benefit within the meaning of Article 1.1(b) of the *SCM Agreement*.

**B. Canada's New Export Schemes are Prohibited Export Subsidies**

122. Canada's new export schemes reduce the price for milk provided the milk is exported. As such, these subsidies are "contingent on export performance" and therefore prohibited under Article 3.1 of the *SCM Agreement*. Article 3.1 provides that:

[T]he following subsidies, within the meaning of Article 1, shall be prohibited:

subsidies contingent, in law or in fact [footnote omitted], whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I; ...

A subsidy is "contingent ... on export performance" when it is conditional on or tied to exports; that is, where it is available only on condition that goods are exported. Under the new export schemes, when a milk dealer is unable to show that all the quantities of components of the volume of milk have been exported, the milk dealer must pay a penalty. Canada's new export schemes are, therefore, "contingent ... upon export performance" and, as such, constitute prohibited subsidies under Article 3.1 of the *SCM Agreement*. As such, the appropriate remedy under Article 4.7 of the *SCM Agreement* is for the panel to recommend that Canada withdraws the subsidy -- that is, Special Milk Class 5(d) and the new provincial programs -- without delay.

## VII. CONCLUSION

123. Canada's introduction of new export schemes to replace Special Milk Class 5(e) cannot conceal the fact that dairy processors continue to receive milk for use in the production of exported goods at prices substantially below those applicable to milk used in the production of the same goods destined for domestic consumption. This price benefit is conferred through export mechanisms authorized, administered, and enforced through governmental action. Thus there can be no doubt that Canada's current export regime for dairy products, consisting of both Special Milk Class 5(d), as well as the provincial export contract mechanisms, constitutes an export subsidy within the meaning of the *Agreement on Agriculture*.

124. Accordingly, in light of subsidized exports by Canada that exceed the applicable reduction commitment quantities for cheese and other dairy products, the United States respectfully requests that this Panel find that Canada has breached Articles 3.3., 8, and 9.1(c), or alternatively, Article 10.1, of the *Agreement on Agriculture*. In addition, the United States requests that the Panel find that Canada has breached Article 3 of the SCM Agreement.

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