

*Canada - Measures Affecting the Importation of Milk
and the Exportation of Dairy Products -
Second Recourse by the United States to Article 21.5 of the DSU
(WT/DS103)*

April 30, 2002

ANSWERS OF THE UNITED STATES TO THE QUESTIONS FROM THE PANEL

Q. 21 With reference to ¶ 43 of Canada's Submission and its Exhibits CDA-6 and CDA-7, please explain how the cost of quota should be accounted for over its life.

Answer:

1. As an economic matter, quota is a cost to the producer. If the quota is financed by the owner's equity, the cost is measured by the opportunity cost of holding the quota, similar to land which is also a non-depreciable asset. If the quota is financed by debt, the cost of quota is the interest expense paid on the debt. The manner in which quota is treated under accounting principles is irrelevant as it does not address the economic cost of quota.

Q. 22 The Appellate Body has held that "the determination of whether 'payments' are involved requires a comparison between the price actually charged by the provider of the goods or services.....and some objective standard or benchmark....." (Appellate Body Report *Canada - Dairy Article 21.5* ¶ 7). The Appellate Body goes on to note and Canada in its First Submission reaffirms that "[t]he existence of 'payments' is determined by reference to a standard that focuses on the motivations of the independent economic operator who is making the alleged 'payments' - here the producer - and not upon any government intervention in the marketplace." (Appellate Body Report *Canada - Dairy Article 21.5* ¶ 92). Please explain your suggestion to include quota in the calculation of the average cost of production with reference to the holding of the Appellate Body.

Answer:

2. In paragraph 92, the Appellate Body's reference to government intervention is in the context of explaining its rejection of the domestic administered price as the benchmark and its adoption of the producers' cost of production. In explaining the cost of production standard, the Appellate Body explicitly stated that the costs of *all* milk, whether destined for the domestic or export market, should be included. As explained in response to question 21, quota is a cost incurred by producers that sell in the domestic market. The fact that the government requires a producer to hold quota to sell in the domestic market does not change the fact that it is a cost to the producer.

Q. 23 Please respond to ¶¶ 64-69 of Canada's First Submission that the government is not involved in the decision to produce CEM milk in light of the Appellate Body's statement disagreeing with the Panel's conclusion that producers are obliged or driven to produce CEM

(Appellate Body Report *Canada - Dairy Article 21.5 ¶¶ 117*). Please also explain how the pre-commitment policy relates to financing "by virtue of governmental action."

Answer:

3. There is a difference between the decision to produce additional milk and the decision as to where to sell that milk. In Canada, there is only one real choice for the disposal of milk produced without quota - the CEM market. This situation is no different than the situation that existed under the Special Milk Class system. Under the SMC system, producers were not driven to produce non-quota milk - they could produce as much or as little milk as they liked. But, like under the CEM scheme, once they produced milk without quota, the milk had to be sold in the export market. Nothing has changed. Under the CEM system, governmental action guarantees that milk produced without quota will be sold for export or to feed animals in the domestic market at lower prices. It does this through the ban on selling export milk at the higher domestic price and requiring that the milk be exported, which is enforced with financial penalties.

4. The government requirements that producers pre-commit to export contracts and that export milk is delivered "first out of the tank" are further evidence of the government's hand in transferring economic resources to the processor. Both of these governmental actions further ensure that the transfer of economic resources occurs. The pre-commitment requirement benefits the processor by permitting him or her to plan their exports. If the government did not require pre-commitment, the processor would have to bid higher on export contracts in order to induce a producer to pre-commit to contracts. Thus, the processor is receiving a payment-in-kind through the government's requirement that producers pre-commit. The "first out of the tank" rule ensures that the export contracts are fulfilled and thus provides a payment-in-kind to processors through the reduction in risk to the processor that an export contract will not be fulfilled.

Q. 24 Please respond to the Canadian argument in ¶¶ 58, 63 and 72 of Canada's First Submission that New Zealand's and the United States' reliance on the exemption from the higher domestic price and the prohibition on diversion of CEM milk into the domestic as the relevant elements of "financing by virtue of governmental action" are a) too abstract a link and b) seek to rely on the effects of the measure.

Answer:

5. Re subpart a): The United States considers that the link between the governmental action and the financing of the payments is demonstrable. There is no reason to exempt export milk from the higher domestic price other than to transfer economic resources to the processor. Without this governmental action, there would be no low-priced milk for export as processors would have to pay the higher domestic price.

6. Re subpart b): Canada errs in characterizing the U.S. argument as relying on the "effects"

of the measure. (Furthermore, Canada's use of the term "effects" is meaningless as every act has an effect and the question is the proximity of that effect to its cause.) Here, the governmental measures guarantee the transfer of resources to the processor whenever a processor enters into a contract for export. This result is not incidental or by chance. Indeed, as explained in our written submissions, there is no other reason for the measures, especially the price exemption for export milk, than to transfer economic resources to the processor. The situation here is analogous to that addressed in the Appellate Body's report in *Japan - Taxes on Alcoholic Beverages*.¹ There, the Appellate Body found that an analysis of the design, architecture and revealing structure of a measure can be dispositive.² And here, the design, architecture and revealing structure of Canada's measures demonstrate that the payments are financed by virtue of the actions of Canada.

Q. 25 Please explain and corroborate your statement that only 28% of CEM milk has been sold for prices higher than \$ 29.90/hl and that 60% of producers have costs higher than this (New Zealand Rebuttal Submission ¶¶ 2.51-2.52 and United States Rebuttal Submission ¶ 34).

Answer:

7. The 28 percent figure is calculated from Exhibit CDA-9, 10, and 13. In those exhibits, the volume of CEM sales represented in the last two deciles account for approximately 28 percent of total CEM sales. According to the exhibit CDA-13, the CEM returns for those two deciles have been at or above \$29.90/hl.

8. That 60 percent of producers have a cost of production higher than \$29.90, even according to Canada's definition of cost of production, can be seen in exhibit CDA-14. In that exhibit the cost of production line intersects a \$30/hl CEM return at approximately 40 percent, which means that 60 percent of producers' have a cost of production exceeding \$30/hl. Again, this is accepting Canada's exclusion of the cost of family labor, management services and capital. Once those costs are properly included, the percentage of producers failing to cover their cost of production would be even greater

Q. 26 Please respond to the allegation in Canada's First Submission, ¶¶ 92-95, that Complainants fail to demonstrate any element of support within the meaning of Article 1.1(a)(2) of the SCM Agreement and Article XVI GATT since the government does not establish a support or target price or any manner of government-set income target measures for the benefit of dairy processors and that Complainants focus on the effects of a measure.

¹ WT/DS11/AB/R.

² See page 29 of the Appellate Body report.

Answer:

9. A simple review of the text of those provisions shows that there is no requirement that the government set a support or target price or income target in order to demonstrate income or price support. It is undeniable that the governmental exemption for export milk from the higher domestic price increases the processor's income and allows the processor to sell more by charging a lower price for the exported dairy product.

10. Again, it is not the incidental or unintended "effect" of "commercial transactions" as Canada argues. The governmental measures at issue here guarantee that economic resources will be transferred to processors whenever they enter into export contracts. There is no reason for the price exemption except to transfer economic resources to the processors. It has nothing to do with protecting the domestic supply management system as Canada has argued.

Q. 27 Canada alleges that the words "indirectly through a government-mandated scheme" in Paragraph (d) must have a meaning consistent with Article 1.1(a)(1)(iv) SCM. (Canada First Submission ¶ 101). Please provide a further elaboration of your response to this suggestion with reference also to Canada's argument that the Canadian Government neither directly provides nor entrusts or directs producers to provide milk for export (Canada First Submission ¶ 102).

Answer:

11. As explained in our written submissions, the interpretation of the Illustrative List does not require an interpretation of the particulars of Article 1 of the *SCM Agreement*. As Canada argued in *Brazil-Aircraft*³ dispute, if the requirements of the Illustrative List are satisfied, the measure is *ipso facto* an export subsidy. Furthermore, in any event, the terms "directs and entrusts," which appear in Article 1.1(a)(1)(iv), do not appear in paragraph (d). Thus, an interpretation of those terms provides no context or guidance as to the proper interpretation of paragraph (d). In addition, as explained in the U.S. written submissions, the CEM scheme falls within the terms of Article 1.1(a)(2) of the SCM Agreement, and Canada's argument is not relevant to this provision.

Q. 28 Please explain how the CEM operates directly or indirectly to increase exports (New Zealand First Submission ¶ 5.76 and United States First Submission ¶¶ 60-61). Please also respond to the Canadian argument in ¶ 90 of its First Submission that the government has no hand in setting time, amount or price of export sales.

Answer:

12. Canada does not dispute that, without the CEM scheme, its dairy processors could not

³Brazil- Export Financing Programme for Aircraft, WT/DS46/R (14 April 1999), para. 4.58

compete on world markets. Thus, the CEM scheme operates directly to increase exports. Just because the government does not micro-manage the specific terms of the contracts does not mean that it is not the government's hand that is transferring economic resources to the processors. Just like under the Special Milk Class system, processors are guaranteed by governmental action that they will have lower-priced milk available so that they can compete on world markets.

Questions to All Parties

Q. 31 Please provide your interpretation of the holding of the Appellate Body that the benchmark for the determination of whether payments exist is the average cost of producing all milk (Appellate Body Report *Canada - Dairy Article 21.5 ¶ 96*). Please clarify whether you interpret the holding as referring to an industry-wide average or to the average cost within groups of similar producers. Specifically, please address whether you interpret "all milk" to refer to the total volume of milk produced or the total number of milk producers.

Answer:

13. In the view of the United States, the Appellate Body report refers to an industry-wide average. This conclusion is supported by the Appellate Body's reference in paragraph 96 to "all milk" and by its reference to the standard adopted in paragraph 104 as "*the average total cost of production of the milk producers.*" In other words, one average for all producers. In particular, the reference to "all milk" is a reference to the total volume of milk produced and not the total number of milk producers. This is supported by the fact that the Appellate Body specifically states in paragraph 96 that the total cost of production should be divided by the total number of units of milk produced.

14. In addition to being consistent with the Appellate Body's report, an industry-wide average is the only workable standard. Otherwise, an individual analysis would have to be carried out for each and every producer to determine whether any one producer had sold milk for export at less than its cost of production. This would render the export subsidy disciplines dependent upon the efficiency of a particular dairy farmer. Since the burden of proof is on Canada to demonstrate that any particular export is not subsidized, such an approach would require Canada to prove that each and every export sale was made at a price above the cost of production of the particular dairy producer(s) involved. Such an approach would be unworkable for responding parties. In light of this, the United States is confused as to why Canada is advocating an individual analysis approach. Furthermore, even if at a particular point in time the sales price was at or above the cost of production, there is no guarantee under Canada's scheme that in the future the price will not be below the cost of production. As a result, there would still be a threat of circumvention of Canada's reduction commitments within the meaning of Article 10 of the *Agreement on Agriculture*.

Q. 32 New Zealand and the United States submit that the calculation of the cost of production

should include measurements of imputed cost (return to capital, family labour, quota and market valuation of assets) as well as marketing, transportation and certain administrative costs (New Zealand First Submission ¶ 5.25 and United States First Submission ¶ 32 and New Zealand Rebuttal Submission ¶ 2.17 and United States Rebuttal Submission ¶ 18) while Canada argues that imputed costs should not be included in a cost of production determination (Canada First Submission ¶ 45). Can the Parties explain to the Panel how these items are to be treated in cost-calculations under the Anti-dumping Agreement?

Answer:

15. Under Article 2.2 of the Anti-dumping Agreement a "normal value" can be constructed on a cost of production basis. In general, the calculation would include imputed costs such as return on capital, quota and family labor. In addition, marketing, transportation and administrative costs would be included. With respect to Article 2.2.1.1 which was mentioned by the Panel at the meeting with the parties, the reference to "generally accepted accounting principles" ("GAAP") is in the context of ensuring that the records kept are reliable and is not a limitation on the method for calculating the cost.

Q. 33 Please provide figures on what percentage of all the Canadian producers cover their cost of production in the range of \$ 49.48 and \$ 56.06 per hectolitre.

Answer:

16. Because the United States does not have access to information regarding cost of production for individual producers, the United States cannot answer this question precisely. In the first Article 21.5 proceeding, however, the United States submitted Exhibit US-22 which was based upon information presented in a Dairy Farmers of Canada policy paper. According to the Dairy Farmers of Canada, based on data for the dairy year 2000, only 29 percent of Canadian dairy farmers cover their costs of production at \$57.41/hl.

Q. 34 Please explain the holding of the Appellate that "in the ordinary course of business, an economic operator chooses to invest, produce and sell, not only to recover the total cost of production, but also in the hope of making profits" with reference to the inclusion or exclusion of: a) quota, b) return to capital and c) return family labour and management from the calculation of the cost of production (Appellate Body Report *Canada - Dairy Article 21.5* ¶ 95).

Answer:

17. The costs of capital, family labor, management and quota are actual costs that the farmer must recoup in order to avoid incurring losses in the long-run. The "profits" referenced by the Appellate Body include any revenue received which exceeds the total cost of production, including these imputed costs. A basic economic principle holds that an enterprise wants to

maximize its economic profits. Economic profits are defined as total revenue minus total economic costs. These costs would include both actual cash outlays and opportunity costs, therefore including quota, costs of capital and family labor. To the extent that total revenues exceed total economic costs, the enterprise makes positive economic profits. In the long term, economic profits are expected to be zero for a competitive market that has no barriers to enter or exit. This is the case because positive economic profits provide the incentive for others to enter the market, thereby increasing supply and reducing prices. This would continue until economic profits were zero. Although barriers exist for entry to the domestic Canadian milk market, (*i.e.* the need for quota) in the long term economic profits should still be zero since economic agents would bid up the price to acquire quota to the point that the cost of quota offsets any expected positive economic profits. Unusual weather conditions, market imperfections and the inclusion or exclusion of government program payments may explain why economic profits may not equal zero in any given production period or year.

18. We note that the Canadian Dairy Commission Handbook (exhibit US-22) refers to the return on capital, family labor and management as costs and, more importantly, calculates these items as costs. For example, it refers to the return on equity as a capital cost on pages 14 and 15. Likewise, it refers to the "cost/return for family labour" on page 25 and "costing family labor" which includes management labor on page 29. The CDC requires that individuals working on a farm record their labor hours on timesheets. The CDC then uses the published Agricultural Professional salary for federal Public Service for costing management services and the industrial salary/wage rate published by Statistics Canada for other family labor. CDC Handbook, page 30, exhibit US-22. For the cost of capital, the CDC uses a rate for a Farm Credit Corporation five-year term loan. CDC Handbook, page 8, exhibit US-22.

Q. 35 The Appellate Body has noted that producers that do not recoup their total cost of production over time sustain losses which may be financed by virtue of governmental action. (Appellate Body Report *Canada - Dairy 21.5* ¶ 87). New Zealand asserts that Canada's argument that the CEM is too new is unpersuasive, that whether transactions are economic is not a matter of trial and error and that a wait-and-see approach would make a mockery of the WTO obligation to implement (New Zealand Rebuttal Submission ¶ 2.38). Please respond to the these two statements.

Answer:

19. The United States agrees with New Zealand's statements. The Appellate Body's reference to the long-term was a reference to the types of costs that should be considered by the Panel (*i.e.* costs that must be recouped to avoid losses over the long-term) and not a suggestion that the CEM scheme cannot be reviewed for consistency with Article 9.1(c) because it is "too new."

Q.36 The Appellate Body held that "[t]he words 'by virtue of' indicate that there must be a

demonstrable link between the *governmental action* at issue and the *financing* of the payments, whereby the payments are.....financed as a result of, or as a consequence of, the governmental action.....although the words "by virtue of" render governmental action essential, Article 9(1)(c) contemplates that payments may be financed by virtue of governmental action even though significant aspects of the financing might not involve government.....there must be a tighter nexus between the mechanism or process by which the payments are *financed*, even if by a third person, and governmental action [than a regulatory framework merely enabling persons to freely make and finance payments]." (Appellate Body Report *Canada - Dairy Article 21.5* ¶¶ 113-115). Please discuss this statement in relation to the holding of the Panel in *Japan - Film* that ".....it is clear that non-binding actions, which include sufficient incentives or disincentives for private parties to act in a particular manner, can potentially have adverse effects on competitive conditions of market access" (Panel Report *Japan - Film* ¶ 10.49).

Answer:

20. In the view of the United States, the statement in *Japan-Film* noted above offers little guidance in this case as that statement was made in the context of a non-violation claim under GATT Article XXIII:1(b) and the effect that non-binding governmental actions may have on market conditions.

21. Here, there is no question that the measures are binding. Likewise, there is no question regarding the impact of the measures: the governmental action at issue - the price exemption for export milk and the artificial segregation of the market - guarantee a transfer of economic resources to the processor whenever he or she purchases milk for export. By governmental action, the producer has no choice but to finance payments whenever he or she sells milk for export. Thus, this is not an example of a regulatory framework where the producer freely chooses to finance payments.

Q. 37 Please provide the Panel with your interpretation of Article XVI:1 of the GATT 1994 which reads in relevant part: "If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the CONTRACTING PARTIES in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary....." In this context, please also comment on the statements by Canada that Complainants focus on the effects of commercial export transactions and fail to demonstrate that the Canadian Government establishes either a support or target price or any manner of government-set income target measures for the benefit of dairy processors (Canada First Submission ¶¶ 92 and 95).

Answer:

22. Please see our response to Question 26.

Q. 38 Please provide the Panel with evidence on the prices of IREP, taking into account the costs arising from application for a permit, the in-quota tariff duties and the costs for re-hydration. Please also provide the Panel with evidence on the uses of dry milk powder in the production of dairy products. Please confirm whether duty-drawback is limited to NAFTA Members.

Answer:

23. Because the United States does not have access to specific IREP prices, we cannot provide a fuller response than the information presented during the first Article 21.5 panel proceeding in the U.S. comments on Canada's response to question 10 from the Panel. Those comments are reproduced below. With regard to the use of whole milk powder, because IREP data is not publicly available in Canada, the U.S. contention that most of the whole milk powder imported under IREP is not used for production of cheese and other milk products is based on the analogous situation in the United States. In the United States, the confectionary industry is the main user of whole milk powder. In 1999 and 2000, in the United States, the confectionary industry accounted for 80 percent of total whole milk powder domestic use. Use of whole milk powder in other dairy products such as cheese averaged less than 7 percent during the same period. Since many of the same confectionary companies operate on both sides of the U.S.-Canada border, it seems likely they use similar manufacturing techniques on the Canadian side. [Source: American Dairy Products Institute. 2000 Dry Milk Products Utilization and Production Trends]

**COMMENTS OF THE UNITED STATES ON CANADA'S ANSWER TO
QUESTION 10**

22 JUNE 2001

1. In response to question 10 from the Panel, Canada implies, but never directly argues, that imports of fluid milk under the IREP are made on terms that are as favorable as milk obtained through domestic sources for export contract. Canada states that the average weighted price for fluid milk for the period examined is CDN \$0.44 per kilogram, which equals approximately CDN \$45 per hectoliter. Canada states, without any support, that this price is "significantly inflated" due to imports of pasteurized milk for ships' stores use.
2. In addition, Canada argues, as it did in the original proceeding, that whole milk powder is competitive with fluid milk and is available on equally favorable terms.
3. First, with regard to imports of fluid milk, the information provided by Canada itself shows that imports of fluid milk under the IREP are not on equally favorable terms. According to Canada, the price of fluid milk imported under the IREP equals approximately CDN \$45 per hectoliter. In comparison, it is recalled (see US Exhibit 2) the price paid for domestic milk destined for the export market is between CDN \$ 29 to \$33 per hectoliter. Although Canada claims that the IREP price is "inflated," it has not provided any support for this allegation. Without such data, the best information available, as presented by Canada itself, shows that the IREP price for fluid milk is higher (and therefore not as favorable) as the price for milk purchased domestically for export dairy products.
4. Likewise, imports of whole milk powder under the IREP does not constitute a source of milk that is available on equally favorable terms as domestically purchased milk. First, the data presented by Canada does not accurately reflect the price of whole milk

powder under the IREP. Statistics Canada (US Exhibit 25) shows imports of 15,010 tons of whole milk powder with a value of CDN \$38.2 million for the same period, giving a unit value of CDN \$2.55 per kilogram, approximately 37 percent higher than the CDN \$1.86 per kilogram suggested by Canada. (Even Canada's response suggests a problem with its data - footnote 1 states that international whole milk powder prices averaged CDN \$2.93 per kilogram during the same period but gives no explanation as to why FOB Canada could be so much less). Further, rather than a conversion factor of 11 for whole milk powder to fluid milk, the Dairy Farmers of Canada (US Exhibit 26) indicates that the correct yield factor is 7.78 liters of milk from one kilogram of whole milk powder. Use of the correct yield factor would add another 41 percent to the price of equivalent milk. If both corrections are applied, the CDN \$20.46 per hectoliter price that Canada asserts is the equivalent price of whole milk powder is nearly doubled. As such, the price is not as equally favorable.

5. Second, even if the price of whole milk powder were equally favorable, the United States disagrees that whole milk powder is directly competitive with fluid milk, as asserted by Canada. The finding by the panel in the original proceeding still holds true. Whole milk powder must be re-hydrated before it can be used for most end-uses. Thus, "additional time and cost are involved when using milk powder as an input rather than fluid milk." Para. 7.55. Canada's argument that the technology for drying milk has improved is irrelevant to this point. Even if true, Canada does not dispute that milk powder must be re-hydrated for most end-uses and that there is additional time and expense involved in doing so.

6. Finally, Canada's citation of *Korea- Definitive Safeguard Measure on Imports of Certain Dairy Products* is inapposite. First, Canada relies upon the parties' agreement in that case regarding the composition of the domestic industry as support for its argument that milk powder is directly competitive with fluid milk. The question in this case,

however, is whether the inherent differences between the inputs affect the terms and conditions upon which the inputs are commercially available. In this regard, nothing has changed since the original proceeding. There are still inherent differences between whole milk powder and fluid milk which have an unfavorable effect on the terms and conditions on which whole milk powder is available. Second, even if the parties' agreement regarding the composition of the domestic industry were relevant, the United States was a third party in that case, not a party. It is absurd to suggest that a third party adopts all arguments or positions of the parties to which it does not explicitly object.