

**CANADA – MEASURES AFFECTING THE IMPORTATION OF MILK
AND THE EXPORTATION OF DAIRY PRODUCTS**

**SECOND RECOURSE TO ARTICLE 21.5 OF THE DSU
BY NEW ZEALAND AND THE UNITED STATES**

AB-2002-6

Report of the Appellate Body

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<i>Canada – Dairy (Article 21.5 – New Zealand and US)</i>	Appellate Body Report, <i>Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Recourse to Article 21.5 of the DSU by New Zealand and the United States</i> , WT/DS103/AB/RW, WT/DS113/AB/RW, adopted 18 December 2001 Panel Report, <i>Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Recourse to Article 21.5 of the DSU by New Zealand and the United States</i> , WT/DS103/RW, WT/DS113/RW, adopted 18 December 2001, as reversed by the Appellate Body Report, WT/DS103/AB/RW, WT/DS113/AB/RW
<i>Canada – Dairy (Article 21.5 – New Zealand and US II)</i>	Panel Report, <i>Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Second Recourse to Article 21.5 of the DSU by New Zealand and the United States</i> , WT/DS103/RW2, WT/DS113/RW2, 26 July 2002
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<i>US – Wheat Gluten</i>	Appellate Body Report, <i>United States – Definitive Safeguard Measures on Imports of Wheat Gluten from the European Communities</i> , WT/DS166/AB/R, adopted 19 January 2001

WORLD TRADE ORGANIZATION
APPELLATE BODY**Canada – Measures Affecting the Importation of
Milk and the Exportation of Dairy Products**Second Recourse to Article 21.5 of the DSU
by New Zealand and the United States

Canada, *Appellant*
New Zealand, *Appellee*
United States, *Appellee*
Argentina, *Third Participant*
Australia, *Third Participant*
European Communities, *Third Participant*

AB-2002-6

Present:

Baptista, Presiding Member
Sacerdoti, Member
Taniguchi, Member

I. Introduction

1. Canada appeals certain issues of law and legal interpretations in the Panel Report, *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Second Recourse to Article 21.5 of the DSU by New Zealand and the United States* (the "Panel Report").¹ The Panel was established to consider a complaint by New Zealand and the United States that certain measures taken by Canada to comply with the recommendations and rulings of the Dispute Settlement Body (the "DSB") in *Canada – Dairy*² are not consistent with Canada's obligations under the *Agreement on Agriculture* and the *Agreement on Subsidies and Countervailing Measures* (the "SCM Agreement").

2. In *Canada – Dairy*, the original panel and the Appellate Body found, *inter alia*, that Canada provided, through Special Milk Classes 5(d) and 5(e), "export subsidies" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. The original panel and the Appellate Body also found that Canada provided these export subsidies in excess of the quantity commitment levels specified in its Schedule to the *General Agreement on Tariffs and Trade 1994* (the "Schedule") and that, therefore,

¹WT/DS103/RW2, WT/DS113/RW2, 26 July 2002. In this Report, we refer to the panel that considered the second recourse to Article 21.5 of the DSU by New Zealand and the United States—and whose findings are the subject of this appeal—as the "Panel".

²The recommendations and rulings of the DSB resulted from the adoption, by the DSB, of the panel report in *Canada – Dairy*. In this Report, we refer to the panel that considered the original complaint brought by New Zealand and the United States as the "original panel".

Canada had acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*. On 27 October 1999, the DSB adopted the original panel and Appellate Body reports.

3. On 23 December 1999, pursuant to Article 21.3(b) of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), Canada, New Zealand, and the United States agreed that the reasonable period of time for Canada to implement the recommendations and rulings of the DSB would expire on 31 December 2000.³ On 11 December 2000, the parties agreed to extend this period of time until 31 January 2001.⁴

4. Canada subsequently adopted certain measures with a view to implementing the recommendations and rulings of the DSB. These measures are described in Section II of this Report. Taking the view that certain of these measures were not consistent with Canada's obligations under the *Agreement on Agriculture* and the *SCM Agreement*, New Zealand and the United States requested, on 16 February 2001, that the matter be referred to a panel pursuant to Article 21.5 of the DSU.⁵

5. On the same day, New Zealand and the United States also requested authorization from the DSB to suspend concessions and other obligations, as provided for in Article 22.2 of the DSU.⁶ Canada objected to the level of suspension proposed and the matter was referred to arbitration, pursuant to Article 22.6 of the DSU.⁷ However, the parties agreed to request the arbitrator to suspend its work pending the outcome of the Article 21.5 proceedings.⁸

6. The panel in *Canada – Dairy (Article 21.5 – New Zealand and US)*⁹ found that Canada provided, through its "commercial export milk" ("CEM") mechanism, "export subsidies" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. The panel also found that Canada provided these export subsidies in excess of the quantity commitment levels specified in its Schedule and that, therefore, Canada had acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*. The Appellate Body reversed the panel's findings on the grounds that the panel had erred in its interpretation of Article 9.1(c). The Appellate Body held that the appropriate standard, in those proceedings, for determining whether "payments" are made under Article 9.1(c), is

³WT/DS103/10, WT/DS113/10, 7 January 2000.

⁴WT/DS103/13, WT/DS113/13, 13 December 2000.

⁵WT/DS103/16, 19 February 2001; WT/DS113/16, 19 February 2001.

⁶WT/DS103/17, 19 February 2001; WT/DS113/17, 19 February 2001.

⁷WT/DS103/18, 28 February 2001; WT/DS113/18, 28 February 2001.

⁸WT/DS103/14, 5 January 2001, para. 9; WT/DS113/14, 5 January 2001, para. 9.

⁹In this Report, we refer to this panel as the "first Article 21.5 panel".

not, as held by the first Article 21.5 panel, the domestic price, but rather the producer's costs of production. However, in the light of the factual findings made by the first Article 21.5 panel, the Appellate Body was unable to determine whether the implementation measures involved such "payments" and, hence, export subsidies within the meaning of Article 9.1(c). Consequently, the Appellate Body was also unable to determine whether these measures were consistent with Articles 3.3 and 8 of the *Agreement on Agriculture*.¹⁰

7. On 6 December 2001, before adoption of the panel and Appellate Body reports in the first Article 21.5 proceedings¹¹, New Zealand and the United States requested the establishment of a second Article 21.5 panel. They maintained that the measures taken by Canada to comply with the recommendations and rulings of the DSB of 27 October 1999, that is, the same measures at issue in the first Article 21.5 proceedings, were inconsistent with Canada's obligations under the *Agreement on Agriculture*.¹²

8. On 18 December 2001, Canada, New Zealand, and the United States agreed that the arbitration previously requested by Canada under Article 22.6 of the DSU would remain suspended pending the outcome of the second Article 21.5 proceedings.¹³ The parties also agreed that New Zealand and the United States would request that the work of the Panel be suspended pursuant to Article 12.12 of the DSU until 18 February 2002.¹⁴

9. In the Panel Report, circulated to Members of the World Trade Organization (the "WTO") on 26 July 2002, the Panel concluded that:

... Canada, through the CEM scheme and the continued operation of Special Milk Class 5(d), has acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*, by providing export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture* in excess of its quantity commitment levels specified in its Schedule for exports of cheese and "other dairy products". In light of our alternative finding ... that Canada has acted inconsistently with its obligations under Article 10.1 of the *Agreement on Agriculture*, we conclude that Canada has acted inconsistently with its obligations under Article 8 of the *Agreement on Agriculture*.¹⁵

¹⁰Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 126-127.

¹¹The DSB adopted the panel report and the Appellate Body Report in *Canada – Dairy (Article 21.5 – New Zealand and US)* on 18 December 2001.

¹²WT/DS103/23, 6 December 2001; WT/DS113/23, 6 December 2001.

¹³WT/DS103/24, 2 January 2002; WT/DS113/24, 2 January 2002.

¹⁴*Ibid.* This request, however, did not extend to matters relating to panel composition.

¹⁵Panel Report, para. 6.1.

The Panel recommended that the DSB request Canada "to bring its dairy products marketing regime into conformity with its obligations in respect of export subsidies under the *Agreement on Agriculture*."¹⁶

10. On 23 September 2002, Canada notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to Article 16.4 of the DSU, and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*").¹⁷ On 3 October 2002, Canada filed its appellant's submission.¹⁸ On 18 October 2002, New Zealand and the United States each filed an appellee's submission.¹⁹ On the same day, Argentina and the European Communities each filed a third participant's submission.²⁰ On the same day, Australia notified the Appellate Body Secretariat that, although it would not file a written submission, it intended to participate at the oral hearing.²¹

11. The oral hearing in the appeal was held on 31 October 2002. The participants and Argentina, Australia, and the European Communities presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

II. Background

12. The original panel found, *inter alia*, and the Appellate Body upheld, that Canada provided, through Special Milk Classes 5(d) and 5(e), "export subsidies" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. It was also found that these subsidies were being provided for quantities of exports that exceeded the quantity commitment level specified in Canada's Schedule. The original panel concluded, and the Appellate Body upheld, that Canada, therefore, had acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*.²²

¹⁶Panel Report, para. 6.3.

¹⁷Canada appeals the Panel's findings under Articles 3.3, 8, 9.1(c), 10.1, and 10.3 of the *Agreement on Agriculture*.

¹⁸Pursuant to Rule 21 of the *Working Procedures*.

¹⁹Pursuant to Rules 22 and 23(3) of the *Working Procedures*.

²⁰Pursuant to Rule 24(1) of the *Working Procedures*.

²¹Pursuant to Rule 24(2) of the *Working Procedures*.

²²Panel Report, *Canada – Dairy*, para. 8.1(a); Appellate Body Report, *Canada – Dairy*, para. 144(b).

13. By way of implementation, Canada abolished Special Milk Class 5(e) and restricted export subsidies under Special Milk Class 5(d) to its commitment levels.²³ At the same time, Canada established a new class of milk, Class 4(m), under which over-quota milk can be sold as domestic animal feed. Canada otherwise left unchanged its domestic milk supply management system, under which domestic milk supply is controlled through the allocation of quota to individual milk producers by government agencies.²⁴ Generally, a producer can sell milk domestically only within the limits of its quota. The only exception is that a producer can sell over-quota milk in the new Class 4(m) as domestic animal feed, but for a much lower price.²⁵ Moreover, the price of domestic milk is fixed by government agencies. Government agencies also market domestic milk, collect the sales proceeds and distribute these proceeds among producers.²⁶

14. Canada also introduced a new category of milk for export processing, known as "commercial export milk" ("CEM"). Sales of CEM are made by Canadian producers to Canadian processors, for processing of that milk into various dairy products for export. These sales are made pursuant to "pre-commitment" contracts, that is, contracts concluded in advance of milk production.²⁷ Canadian producers may sell any quantity of CEM to processors on terms and conditions freely negotiated between the producer and the processor. Sales of CEM do not require a quota or any other form of permit from the Canadian government or its agencies. Revenues derived from sales of CEM are collected directly by producers, without government involvement. However, if a dairy product derived from CEM is sold on the domestic market, the processor is liable to financial penalties for diverting the dairy product into the domestic market. The factual aspects of the new scheme are set out in greater detail in the Panel Report.²⁸

²³Canada's quantity commitment levels, as contained in Part IV, Section II, of its Schedule, are: 3,500 tonnes for butter; 44,953 tonnes for skim milk powder; 9,076 tonnes for cheese; and 30,282 tonnes for other milk products.

²⁴In response to questioning at the oral hearing, Canada stated that, when the milk supply management system was created, quota was allocated among existing farmers. Canada also indicated that quota is a transferable right and that an active market for quota has developed. The price of quota on this market is currently in the range of C\$15,000-C\$30,000/kg of butterfat per day.

²⁵The administered price for Class 4(m) milk is C\$10 per hectolitre ("hl"), as opposed to C\$49.48/hl and C\$56.06/hl, which is the price range for domestic industrial milk. Canada does not dispute these figures. (Panel Report, footnote 410 to para. 5.116)

²⁶For a more detailed description of the pre-existing milk supply management system see Appellate Body Report, *Canada – Dairy*, paras. 6-16; and Panel Report, *Canada – Dairy*, paras. 2.1-2.66.

²⁷At the oral hearing, Canada informed the Appellate Body that, generally, producers pre-commit to sell CEM at least 30 days in advance of the sale.

²⁸Panel Report, paras. 2.2-2.4. See also Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 3.1-3.9. The average CEM price is approximately C\$29/hl. (Panel Report, para. 5.60)

III. Written Arguments of the Participants and the Third Participants

A. *Claims of Error by Canada – Appellant*

1. Article 10.3 of the *Agreement on Agriculture*—Rules of Evidence

15. Canada argues that the Panel's interpretation of Article 10.3 is "plainly erroneous", as this provision sets out a "reverse" burden of proof that requires the responding Member to establish a rebuttable presumption that its measures are not inconsistent with its obligations. It then falls upon the complaining Members to present evidence and argument to rebut this presumption.

16. Canada contends that the Panel erroneously imposed a minimal burden on the complaining Members in examining whether they had made out a *prima facie* case. Canada also submits that it had presented sufficient evidence to raise a rebuttable presumption showing that there is no export subsidy and that the United States and New Zealand did not succeed in rebutting this presumption. Had it properly applied Article 10.3, the Panel would have ruled in favour of Canada.

2. Article 9.1(c) of the *Agreement on Agriculture*—"Payments Financed by Virtue of Governmental Action"

17. Canada claims that the Panel erred in finding that Canada's measures provide export subsidies within the meaning of Article 9.1(c) of the *Agreement on Agriculture* and disagrees with the Panel's findings both with respect to "payments" and to "financed by virtue of governmental action".

(a) "Payments"

18. With respect to "payments", Canada argues, first, that the Appellate Body intended the cost of production standard to be based on the costs of individual dairy farmers and not on a single, industry-wide average cost of production figure. Canada points to statements of the Appellate Body such as "each producer decid[ing] for *itself*", "value of the milk to *the* producer", and "cost incurred by *the* producer" as demonstrating that the Appellate Body focused on the costs of production of the individual milk producer. An industry-wide average, in Canada's view, does not have "any relevance" to the decisions of individual producers participating in CEM transactions.

19. Second, Canada argues that the Panel erred by including imputed returns for family labour, return to management, and return to equity in a cost of production determination. Imputed returns constitute government intervention in the marketplace and are included in the Canadian Dairy Commission (the "CDC") annual cost of production survey to ensure that dairy farmers obtain "a fair

return for their labour and investment".²⁹ Further, returns to family labour, management, and owner's equity are derived from the profits of the dairy enterprise. Canada asserts that profits are distinct from costs and are, therefore, excluded from the cost of production determination.

20. Third, Canada maintains that marketing, transport, and administrative costs are not production costs and, therefore, should not be included in the cost of production determination. Canada also disagrees with the Panel's finding that the costs of acquiring quota should be included in the cost of production determination. Quota costs should be treated as marketing costs confined to the domestic market and not as relevant in examining export sales. Moreover, Canada considers that quota is an intangible asset with an indefinite useful life and therefore disagrees with the Panel's conclusion that Generally Accepted Accounting Principles ("GAAP") permit amortization of quota costs.

21. Finally, Canada disputes the nature of evidence which the Panel, in Canada's view, required in order to show that "payments" are not being made. According to Canada, the Panel held that there would be no "payments" if Canada could establish that the individual producer's costs of production allow the producer to participate in the CEM market without incurring losses. Canada argues that the Panel, in so holding, required Canada to match the costs of individual producers participating in CEM transactions with the returns obtained by those same producers. This would place on Canada a burden that it "cannot possibly be expected to meet".³⁰ Canada alleges that Article 9.1(c) cannot contemplate the existence of "payments" where a Member demonstrates that a significant proportion of producers have costs of production allowing them to participate in CEM transactions, while recouping their total cost of production.

(b) "Financed by Virtue of Governmental Action"

22. Canada submits that the Panel erred by finding a "demonstrable link" between the financing of "payments" on the sale of CEM and Canadian "governmental action". Canada believes that for a demonstrable link to exist between these two elements, there must be affirmative governmental action over the decisions of producers, for instance, where the government provides, raises, furnishes, or manages funds. Canada alleges that, where, as in the present case, government does no more than establish a framework merely *enabling* producers and processors, if they so choose, to freely negotiate the purchase and sale of milk for export, payments are not "financed by virtue of

²⁹See Section 8 of the Canadian Dairy Commission Act (R.S.C. 1985, c. C-15), Exhibit CDA-3 submitted by Canada to the Panel; Exhibit NZ-8 submitted by New Zealand to the Panel.

³⁰Canada's appellant's submission, para. 47.

governmental action". Canada argues that, as the Appellate Body said, the Canadian government does not *oblige* or *drive* producers to produce and sell CEM.³¹

23. In Canada's view, exempting processors of CEM from any requirement to pay the domestic administered price and the prohibition of diversion of CEM into the domestic market are not demonstrably linked to the financing of any payments and are in no way inconsistent with Canada's obligations under the covered agreements. Similarly, Canada contends that the practice of pre-committing sales of CEM does not "finance" payments, but rather ensures that CEM is not surplus milk.

24. Next, according to Canada, the Panel's reliance upon the notion of "cross-subsidization" introduces a "foreign" and "open-ended notion" into Article 9.1(c) without this discipline having been negotiated and accepted by WTO Members.³² The domestic regulated price does not finance "payments" within the meaning of Article 9.1(c) because it is linked only to the domestic market. Canada further alleges that it makes no sense that a producer would willingly produce additional milk and sell it at a loss. Canada also contends that a finding of "cross-subsidization" cannot, in any case, extend to the approximately 100 CEM producers in Canada that do not sell milk in the domestic market.

3. Article 10.1 of the *Agreement on Agriculture*—"Export Subsidies"

25. Canada submits that, if the Panel had correctly interpreted item (d) of the Illustrative List of Export Subsidies (the "Illustrative List") in Annex I of the *SCM Agreement* in the light of the context provided by Article 1.1(a)(1)(iv) of that Agreement, it could only have concluded that CEM is not provided "indirectly through government-mandated schemes". The Panel also erred in rejecting the evidence presented by Canada, showing that CEM is available on terms as favourable as those applicable to milk components under Canada's Import for Re-Export Program ("IREP"). Therefore, in Canada's view, CEM sales do not constitute export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*.

³¹Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 117.

³²Canada's appellant's submission, para. 91.

B. *Written Arguments of New Zealand – Appellee*

1. Article 10.3 of the *Agreement on Agriculture—Rules of Evidence*

26. New Zealand argues that, if the Panel did not apply the burden of proof rules as set forth in Article 10.3, this was to Canada's advantage, because Canada was relieved from a burden it would otherwise have borne. Furthermore, the Panel's analysis "makes clear" that the Panel *did* require Canada to establish that no export subsidy existed and that Canada failed to discharge that burden. New Zealand submits that, in any event, any error made by the Panel in interpreting Article 10.3 had no impact on the outcome of the case.

2. Article 9.1(c) of the *Agreement on Agriculture—"Payments Financed by Virtue of Governmental Action"*

(a) "Payments"

27. New Zealand contends that Canada's objections to the Panel's application of the average total cost of production standard are founded on a rejection of this standard's inherent logic. Canada's approach would make the standard "fundamentally unworkable" and would "void it of any content".³³

28. New Zealand submits, first, that a determination whether producers make sales of CEM at prices below the average total cost of production can be made only by looking at an average industry-wide determination of the total cost of production. According to New Zealand, a determination of the average total cost of production on the basis of individual producer costs of production, as proposed by Canada, is "simply unworkable"³⁴ and implies that the average total cost of production of each and every Canadian producer would have to be considered in order to determine whether any "payments" have been made.

29. Second, New Zealand argues that imputed costs of family labour, return to management, and return to equity must be included in the cost of production determination, because these costs represent costs incurred by the producer. New Zealand considers that these imputed costs are distinct from profits, as profits are "something over and above" all fixed and variable costs.³⁵ New Zealand also believes that the Panel was correct to rely on CDC cost of production data, as these are based on an objective study and are subject to audit.

³³New Zealand's appellee's submission, paras. 3.08 and 3.17.

³⁴*Ibid.*, para. 3.35.

³⁵*Ibid.*, para. 3.23.

30. Third, New Zealand submits that Canada's complaint about the Panel's treatment of transport and marketing costs, as well as of quota costs, is also without merit. All these costs, according to New Zealand, are costs incurred by the producers that must be recouped in the sales price. Describing costs as "marketing" costs, rather than "production" costs, does not alter this fact. New Zealand also argues that the cost of quota cannot be eliminated by assigning it to the domestic market, because the Appellate Body has said that costs related to both the domestic and the export markets have to be taken into consideration.

(b) "Financed by Virtue of Governmental Action"

31. New Zealand opines that the essence of Canada's objections to the Panel's conclusions on the phrase "financed by virtue of governmental action" is that the relevant governmental action does not "oblige" or "drive" producers to "produce and sell" CEM. However, in New Zealand's view, the Appellate Body did not find that "payments" can only be "financed by virtue of governmental action" where producers are "obliged" or "driven" to produce and sell CEM. Rather, the Panel correctly examined whether there was a demonstrable link between the governmental action and the financing of "payments".

32. In New Zealand's view, exempting the processor from the requirement to pay the higher domestic price is clearly linked to the financing of "payments". The sole purpose of the exemption is to make milk available for export processing. This would not be possible if processors had to purchase milk at the domestic price.

33. With respect to the Canadian argument that the notion of "cross-subsidization" is "foreign" to the *Agreement on Agriculture* and any other covered agreement, New Zealand claims that cross-subsidization is relevant under the *Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994* (the "Anti-Dumping Agreement"). Also, the possibility of cross-subsidization under Article 9.1(c) was identified, as a relevant consideration, by the Appellate Body in the first Article 21.5 proceedings.

3. Article 10.1 of the *Agreement on Agriculture*—"Export Subsidies"

34. In New Zealand's view, Canada's arguments that the Panel should have derived guidance from Article 1 of the *SCM Agreement* in its interpretation of item (d) of the Illustrative List of the *SCM Agreement* would artificially narrow the scope of item (d). The Panel, in New Zealand's view, applied item (d) in accordance with its terms, and it was unnecessary to look elsewhere to restrict or

expand the scope of that provision. New Zealand also agrees with the Panel that IREP imports are available to export processors on commercially less favourable terms than CEM.

C. *Written Arguments of the United States – Appellee*

1. Article 10.3 of the *Agreement on Agriculture*—Rules of Evidence

35. The United States argues that Canada's objection to the Panel's interpretation of Article 10.3 overlooks the fact that the Panel's approach could only serve to benefit Canada, since the Panel unnecessarily examined initially whether the complainants had made out a *prima facie* case. However, the United States is of the view that this additional step did not change the outcome of the dispute.

2. Article 9.1(c) of the *Agreement on Agriculture*—"Payments Financed by Virtue of Governmental Action"

(a) "Payments"

36. The United States opines that the Panel properly concluded that Canadian milk producers are making "payments" to Canadian milk processors. First, the United States submits that the Panel correctly found that the Appellate Body, in the first Article 21.5 proceedings, did not intend an individual cost of production standard and that a cost of production benchmark based on individual producers was "unworkable".³⁶

37. Second, the United States agrees with the Panel that all economic costs should be included in the cost of production benchmark. With respect to imputed costs, the Panel correctly recognized that investment of family labour, management, and capital in the dairy enterprise involves economic opportunity costs. The fact that the CDC calculates these costs annually and includes them in its survey of costs of production contradicts Canada's argument that a determination of a proper amount for imputed returns to family labour, management, and owner's equity is inherently speculative as well as subjective. The United States asserts that the use of this data to establish the domestic regulated price does not detract from the validity of this data.

38. Third, the United States also agrees with the Panel that marketing, transportation, and administrative costs are to be included in the cost of production standard, as they represent real costs that a producer must recoup in order to remain in business over time. Similarly, the cost of obtaining

³⁶United States' appellee's submission, para. 29.

a production quota represents a real cost that a producer will incur in the production of milk, regardless of its treatment under accounting principles.

39. Finally, the United States submits that the Panel correctly found that Canada's individual producer data does not establish that producers are not making "payments" to processors. Canada was unable to provide evidence correlating individual producer's costs of production with sales by each producer in the CEM market, and the Panel correctly declined to assume that only those producers with costs of production below the CEM price participate in the CEM market.

(b) "Financed by Virtue of Governmental Action"

40. The United States argues that Canada's objections to the Panel's findings with respect to the phrase "financed by virtue of governmental action" are without merit. The United States disagrees with Canada's apparent contention that the Appellate Body has already ruled on the governmental action element of Article 9.1(c). The Appellate Body did not find that Article 9.1(c) requires that producers be "obliged" or "driven" to produce additional milk for export.

41. In the United States' view, the Appellate Body explained, in the first Article 21.5 proceedings, that relevant governmental action could include the regulation of the supply and price of milk in the domestic market. The Panel then rightly concluded that a profit-maximizing milk producer will consider the extent to which the cost-covering, regulated price of domestic milk allows it to make additional sales in the CEM market while still covering its marginal costs. Canada is incorrect in its assertion that the Panel found that Canadian governmental action merely makes it possible for producers to make "payments".

42. The United States agrees that Canada's policies of exempting the processor from paying the higher domestic price, and of prohibiting diversion of CEM into the domestic market support the Panel's finding that payments are "financed by virtue of governmental action". Through these policies, Canadian governmental action ensures that the bulk of non-quota milk will be channelled into the CEM market.

43. The United States also agrees with the Panel that the requirement to pre-commit CEM sales creates an additional incentive to dedicate a larger quantity of milk to the CEM market than would otherwise be the case. As a result, the pre-commitment policy supports the Panel's finding of a "demonstrable link" between governmental action and the financing of "payments".

44. Finally, the United States believes that Canada mischaracterizes the Panel's analysis of Canada's regulation of the domestic supply and price of milk. The Panel did not create any new form of subsidization or new WTO obligation; rather, the Panel "carefully" followed the Appellate Body's guidance in this regard and used the term "cross-subsidization" as a convenient shorthand expression in its analysis of the governmental action in the form of the regulation of the domestic price and supply of milk.³⁷ The United States asserts that the Panel carefully considered whether the domestic regulated price allowed producers to engage in less remunerative CEM sales, while at least covering their marginal costs of production.

3. Article 10.1 of the *Agreement on Agriculture*—"Export Subsidies"

45. According to the United States, the Panel correctly found that Canada's CEM scheme is inconsistent with Article 10.1 of the *Agreement on Agriculture*. Contrary to Canada's allegations, the Panel did not overlook relevant context in applying item (d) of the Illustrative List of the *SCM Agreement*. Furthermore, the United States agrees with the Panel that Canadian milk processors obtain CEM at more favourable terms than whole milk powder through IREP.

D. *Written Arguments of the Third Participants*

1. Argentina

46. Argentina agrees broadly with the Panel's reasoning under Article 9.1(c) and considers that, given the characteristics of the Canadian milk supply system—as discussed by the Panel—,Canadian producers will channel their surplus production into the CEM market. Argentina also submits that the use of the phrase "by virtue of", rather than of the word "by", indicates that Article 9.1(c) covers circumstances where "payments" are not financed directly by government, and where government does not intervene directly in the provision of "payments", but nevertheless creates "a whole set of circumstances" that ultimately lead to "payments" on exports.³⁸

47. As regards Article 10.1 of the *Agreement on Agriculture*, Argentina concurs with the Panel that Canada failed to establish the absence of the three elements of export subsidies contemplated by item (d) of the Illustrative List of the *SCM Agreement*. A governmental measure that falls under item (d) of the Illustrative List of the *SCM Agreement* is, at the same time, an "export subsidy" within the meaning of Article 10.1, even if no charge on the public account is involved.

³⁷United States' appellee's submission, para. 61.

³⁸Argentina's third participant's submission, para. 26.

2. European Communities

48. The European Communities agrees with Canada that the Panel incorrectly interpreted Article 10.3 of the *Agreement on Agriculture*. The correct standard of proof to be applied in this case is that Canada should make out a *prima facie* case to establish that its measure does not constitute an "export subsidy".

49. With respect to the issue of "payments" under Article 9.1(c) of the *Agreement on Agriculture*, the European Communities considers that the average total cost of production is not the appropriate benchmark for assessing whether there are "payments" within the meaning of Article 9.1(c). The Panel's standard makes it possible to find a subsidy where no "benefit" is provided and, in any event, the standard is "unworkable".³⁹ The Panel also erred in including in the cost of production standard an amount for profit as well as cost items such as family labour, return on management, and return on equity. Finally, in examining the evidence of "payments", the Panel imposed an insurmountable burden of proof on Canada.

50. With respect to the phrase "financed by virtue of governmental action", the European Communities "fully supports" Canada's appeal.⁴⁰ The Panel applied a standard that contradicts the Appellate Body's guidance in that the Panel found that it was sufficient to show that governmental action makes sales possible. None of the four governmental actions identified by the Panel—that is, prohibition on diversion of CEM into the domestic market; the exemption of export processors from paying the fixed domestic price; cross-subsidization; and the pre-commitment requirement—is sufficient to establish that producers are obliged or driven to provide CEM.

51. The European Communities opines that the Panel added to the obligations under Article 9.1(c) of the *Agreement on Agriculture*. An interpretation of the term "financed" as also covering payments-in-kind goes beyond the ordinary meaning of the term. Article 9.1(c) includes private party payments only to the extent that "payments" are financed from the proceeds of a levy imposed on the agricultural product concerned. Accordingly, the European Communities submits that, for a measure to fall under Article 9.1(c), the government must "impose" or "mandate" payments.⁴¹

³⁹European Communities' third participant's submission, title of section IV.A.1 (b), p. 12.

⁴⁰*Ibid.*, para. 67.

⁴¹*Ibid.*, title of section IV.B.4 (b), p. 25.

52. The European Communities further contends that the Panel's findings are based on the assumption that WTO Members intended to prevent cross-subsidization, that is, that WTO Members intended to target the *omission* of governments to prevent the "natural economic behaviour" of cross-subsidization.⁴² However, Article 9.1(c), like all WTO law, is concerned only with governmental *actions*, not also with governmental *omissions*.

53. The European Communities disagrees with the Panel's findings on Article 10.1 of the *Agreement on Agriculture*. The notion of an export subsidy under this provision must be read "co-extensively"⁴³ with the basic definition of subsidies under the *SCM Agreement*, unless the *Agreement on Agriculture* contains an explicit derogation. In the European Communities' view, the measure at issue does not meet the basic definitional elements for a "financial contribution", under Article 1.1(a)(1)(iv) of the *SCM Agreement*, because it does not "entrust or direct a private body to carry out" a function otherwise carried out by governments. Nor is the measure a "government-mandated scheme" within the meaning of item (d) of the Illustrative List of the *SCM Agreement*.

IV. Issues Raised in this Appeal

54. This appeal raises the following issues:

- (a) whether the Panel erred, in paragraph 5.18 of the Panel Report, in its finding under Article 10.3 of the *Agreement on Agriculture*, with respect to the allocation of the burden of proof under that provision;
- (b) whether the Panel erred, in paragraphs 5.89 and 5.135 of the Panel Report, in its finding under Article 9.1(c) of the *Agreement on Agriculture*, in particular, in finding that "commercial export milk" ("CEM") involves "payments" and that these "payments" are "financed by virtue of governmental action"; and
- (c) whether the Panel erred, in paragraph 5.165 of the Panel Report, in reaching its alternative finding under Article 10.1 of the *Agreement on Agriculture*, that CEM involves export subsidies applied in a manner that is inconsistent with that provision.

⁴²European Communities' third participant's submission, para. 115.

⁴³*Ibid.*, para. 125.

V. Article 10.3 of the *Agreement on Agriculture*—Rules of Evidence

55. At the outset of its findings, the Panel considered the significance of Article 10.3 of the *Agreement on Agriculture* for these proceedings. The Panel noted that the parties were in agreement that, under Article 10.3, Canada—the responding Member—bears the burden of proof.⁴⁴ Accordingly, the Panel opined that, if the complaining Members demonstrated "that Canada has exceeded its export subsidy reduction commitment levels on certain dairy products", it would be for Canada to establish that it is not providing export subsidies in relation to the exports exceeding its commitment levels.⁴⁵ In that respect, the Panel stated that:

... an operational interpretation of Article 10.3 requires that the Complainants make a *prima facie* showing that the elements of the claimed export subsidies are present.

... [P]rovided that the Complainants make out a *prima facie* case that certain elements of the Canadian regulation of its dairy industry constitute export subsidies under either Article 9.1(c) or Article 10.1, it will then be for Canada, pursuant to Article 10.3 of the *Agreement on Agriculture* ... to establish that [these products] do not benefit from these particular types of export subsidies.⁴⁶ (underlining added)

56. Thus, the Panel envisaged a three-step process under Article 10.3:

- (i) The *complaining* Member(s) must demonstrate that the responding Member has exported an agricultural product in quantities that exceed the quantity commitment level specified in its Schedule to the *General Agreement on Tariffs and Trade 1994* (the "Schedule");
- (ii) the *complaining* Member(s) must next "make out" a *prima facie* case that "the elements of the claimed export subsidies" are present; and
- (iii) the *responding* Member(s) must establish that no export subsidy has been granted for exports of the product in excess of the quantity commitment level.

⁴⁴Panel Report, para. 5.13. See also Panel Report, paras. 3.4-3.5.

⁴⁵*Ibid.*, para. 5.15.

⁴⁶*Ibid.*, paras. 5.18-5.19.

57. Canada considers that the Panel erred by requiring the complaining Members to make out a *prima facie* case of their claims. In consequence, Canada argues that the Panel failed properly to apply the burden of proof. Canada asserts that Article 10.3:

... sets out a reverse burden of proof, which ... requires the respondent to establish a rebuttable presumption that its measures are not inconsistent. It is then up to the complainant to present evidence and argument that rebuts this presumption.⁴⁷

58. In its appeal, Canada submits that the original panel in *Canada – Dairy*⁴⁸ correctly interpreted Article 10.3.

59. In the original panel proceedings, the panel made the following remarks on Article 10.3:

This provision *shifts the burden of proof* from the complainant to the defendant. A defending party (i.e., the exporting country) alleging that exports in excess of its reduction commitment level are not subsidized must demonstrate that no export subsidy in respect of this excess has been granted. All parties in dispute agree that the wording of Article 10.3 has this effect of reversing the usual burden of proof.⁴⁹ (emphasis added; footnote omitted)

60. The original panel did not require the complaining Member to make out a *prima facie* case; that is, the second step above was not included in the reasoning. Instead, the original panel read Article 10.3 as allocating the burden of proof to the responding Member to demonstrate that no subsidies were provided for exports exceeding the commitment levels (that is, the third step above).⁵⁰

61. In the first Article 21.5 proceedings, the panel expressed a very similar view, opining that "when reduction commitments have been exceeded, Article 10.3 has the effect of reversing the usual burden of proof".⁵¹ That panel did not require the complaining Members to make out a *prima facie* case of the elements of the claimed export subsidy.

⁴⁷Canada's appellant's submission, para. 31.

⁴⁸In this Report, we refer to the panel that considered the original complaint brought by New Zealand and the United States as the "original panel".

⁴⁹Panel Report, *Canada – Dairy*, para. 7.33.

⁵⁰The original panel also established that Canada had exported dairy products in quantities exceeding the quantity commitment level (that is, the first step above). (*Ibid.*, para. 7.34)

⁵¹Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.3.

62. The meaning of Article 10.3 of the *Agreement on Agriculture* was also addressed in the original proceedings in *US – FSC*. In that dispute, the panel considered it "evident" that Article 10.3 "shifts" or, as it also said, "reverses", the usual rule that the burden of proof is on the complaining Member to establish its claims.⁵² That panel also made no mention of any requirement for the complaining Member to make out a *prima facie* case of the elements of the claimed export subsidy.

63. Although Article 10.3 of the *Agreement on Agriculture* has been examined by several panels, this is the first time that we examine the interpretation of this provision.

64. Before addressing Article 10.3, it is useful to recall our view of the burden of proof as a general matter. This issue was first examined in *US – Wool Shirts and Blouses*, where we stated that:

... various international tribunals, including the International Court of Justice, have generally and consistently accepted and applied the rule that the party who asserts a fact, whether the claimant or the respondent, is responsible for providing proof thereof. Also, it is a generally-accepted canon of evidence in civil law, common law and, in fact, most jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence. If that party adduces evidence sufficient to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption.⁵³ (footnotes omitted)

65. In *EC – Hormones*, we said:

The initial burden lies on the complaining party, which must establish a *prima facie* case of inconsistency with a particular provision of the *SPS Agreement* on the part of the defending party, or more precisely, of its SPS measure or measures complained about. When that *prima facie* case is made, the burden of proof moves to the defending party, which must in turn counter or refute the claimed inconsistency.⁵⁴

66. Thus, we have consistently held that, as a general matter, the burden of proof rests upon the complaining Member. That Member must make out a *prima facie* case by presenting sufficient evidence to raise a presumption in favour of its claim. If the complaining Member succeeds, the responding Member may then seek to rebut this presumption. Therefore, under the usual allocation of the burden of proof, a responding Member's measure will be treated as *WTO-consistent*, until

⁵²Panel Report, *US – FSC*, paras. 7.136 and 7.161.

⁵³Appellate Body Report, *US – Wool Shirts and Blouses*, at 335.

⁵⁴Appellate Body Report, *EC – Hormones*, para. 98.

sufficient evidence is presented to prove the contrary. We will not readily find that the usual rules on burden of proof do not apply, as they reflect a "canon of evidence" accepted and applied in international proceedings.

67. Article 10.3 of the *Agreement on Agriculture* reads:

Prevention of Circumvention of Export Subsidy Commitments

...

3. Any Member which claims that any quantity exported in excess of a reduction commitment level is *not* subsidized *must establish that no export subsidy*, whether listed in Article 9 or not, *has been granted* in respect of the quantity of exports in question. (emphasis added)

68. This provision requires that a specific Member, in defined circumstances, "establish that no export subsidy ... has been granted". We begin by identifying the specific Member and circumstances to which Article 10.3 applies. The provision refers to a Member making a "claim" that certain exports are "*not* [being] subsidized". Although the word "claim" usually refers to an assertion by a complaining Member that a measure is *WTO-inconsistent*, in this provision the word "claim" refers to an assertion by a responding Member that a measure is *WTO-consistent*. The "claim" to which Article 10.3 refers is, therefore, a defensive argument made by the responding Member.

69. Article 10.3 does not impose any substantive obligations regulating the grant of export subsidies under the *Agreement on Agriculture*. Rather, Article 10.3 provides a special rule for proof of export subsidies that applies in certain disputes under Articles 3, 8, 9, and 10 of the *Agreement on Agriculture*.

70. In identifying the nature of the special rule, it is useful to analyze the character of claims brought under these provisions. Pursuant to Article 3 of the *Agreement on Agriculture*, a Member is *entitled* to grant export subsidies within the limits of the reduction commitment specified in its Schedule.⁵⁵ Where a Member claims that another Member has acted inconsistently with Article 3.3 by granting export subsidies in excess of a quantity commitment level, there are *two* separate parts to the claim. First, the responding Member must have exported an agricultural product in quantities exceeding its quantity commitment level. If the quantities exported do not reach the quantity commitment level, there can be no violation of that commitment, under Article 3.3. However, merely exporting a product in quantities that exceed the quantity commitment level is not inconsistent with

⁵⁵Under Articles 3.1 and 3.3 of the *Agreement on Agriculture*, "commitments limiting subsidization" of exports are specified in the Schedule in terms of "budgetary outlay and quantity commitment levels".

the commitment. The commitment is an undertaking to limit the quantity of exports that may be *subsidized* and not a commitment to restrict the volume or quantity of exports *as such*. The second part of the claim is, therefore, that the responding Member must have granted export subsidies with respect to quantities exceeding the quantity commitment level. There is, in other words, a *quantitative* aspect and an *export subsidization* aspect to the claim.

71. Under the usual rules on burden of proof, the complaining Member would bear the burden of proving both parts of the claim. However, Article 10.3 of the *Agreement on Agriculture* partially alters the usual rules. The provision cleaves the complaining Member's claim in two, allocating to different parties the burden of proof with respect to the two parts of the claim we have described.

72. Consistent with the usual rules on burden of proof, it is for the complaining Member to prove the first part of the claim, namely that the responding Member has exported an agricultural product in quantities that exceed the responding Member's quantity commitment level.

73. If the complaining Member succeeds in proving the quantitative part of the claim, and the responding Member contests the export subsidization aspect of the claim, then, under Article 10.3, the responding Member "*must establish* that no export subsidy ... has been granted" in respect of the excess quantity exported. (emphasis added) The language of Article 10.3 is clearly intended to alter the generally-accepted rules on burden of proof. The verb "establish" is synonymous with the verbs "demonstrate" and "prove".⁵⁶ Moreover, the auxiliary verb "must" conveys that the responding Member has an obligation—or legal burden—to "establish" or "prove" that "no export subsidy ... has been granted".

74. The plain meaning of the text is borne out by the immediate context of Article 10.3 of the *Agreement on Agriculture*. Article 10 is entitled "*Prevention of Circumvention of Export Subsidy Commitments*". As a subparagraph of this provision, Article 10.3 pursues this aim. The significance of Article 10.3 is that, where a Member exports an agricultural product in quantities that exceed its quantity commitment level, that Member will be treated as if it has granted WTO-*inconsistent* export subsidies, for the excess quantities, unless the Member presents adequate evidence to "establish" the contrary. This reversal of the usual rules obliges the responding Member to bear the consequences of any doubts concerning the evidence of export subsidization. Article 10.3 thus acts as an incentive to Members to ensure that they are in a position to demonstrate compliance with their quantity commitments under Article 3.3.

⁵⁶*The Shorter Oxford English Dictionary*, C.T. Onions (ed.) (Guild Publishing, 1983), Vol. I, p. 682; *Roget's Thesaurus of English words and phrases* (Longman Group Limited, 1982), p. 809.

75. With respect to the export subsidization part of the claim, the complaining Member, therefore, is relieved of its burden, under the usual rules, to establish a *prima facie* case of export subsidization of the excess quantity, provided that this Member has established the quantitative part of the claim. We, therefore, do not agree with the Panel that the complaining Member must make out a *prima facie* case in support of this part of its claim. In practice, the complaining Member may wish to present evidence to rebut any evidence presented by the responding Member. However, the complaining Member is not required to lead in the presentation of evidence to panels, and it might well succeed in its claim even if it presents no evidence—should the responding Member fail to meet its legal burden to establish that no export subsidy has been granted with respect to the excess quantity.

76. We, therefore, find that the Panel erred, in paragraph 5.18 of the Panel Report, in its interpretation of Article 10.3 of the *Agreement on Agriculture*, by imposing upon the complaining Members the duty to make out a *prima facie* case in support of all aspects of their claims under Articles 3.3, 8, 9.1(c), and 10.1.⁵⁷ When the Panel had determined that the complainants had established that Canada had exported dairy products in quantities exceeding its quantity commitment levels, it should have proceeded directly to require Canada to establish that the exports of dairy products did not benefit from export subsidies. Instead, the Panel's next step was to require the complaining Members to "make a *prima facie* showing that the elements of the claimed export subsidies are present."⁵⁸ However, as the Panel found that the complaining Members had made out such a *prima facie* case, the Panel went on correctly to hold that it is for Canada "to establish that Canadian exports of cheese and 'other milk products' do not benefit from these particular types of export subsidies."⁵⁹

77. Thus, although the Panel's interpretation was in error, this error does not vitiate any of the Panel's findings under Articles 3.3, 8, 9.1(c), and 10.1 of the *Agreement on Agriculture*. The Panel found that the complaining Members *had* made out a *prima facie* case that CEM involved export subsidies. Although the Panel should not have engaged in this inquiry, the inquiry led the Panel to find, correctly, that Canada was obliged to prove that it had not granted export subsidies for the dairy products exported in excess of the quantity commitment level. The Panel, therefore, arrived at the legal situation envisaged by Article 10.3 and, thereafter, properly applied the rules on burden of proof in that provision with respect to proof of the export subsidization aspect of the claim. The Panel

⁵⁷The Panel reiterated this error in paragraph 5.19 of the Panel Report.

⁵⁸Panel Report, para. 5.18.

⁵⁹*Ibid.*, para. 5.19.

concluded that Canada "failed to establish" that CEM did not involve export subsidies.⁶⁰ We will examine, below, the appeals that Canada makes against this finding under Articles 9.1(c) and 10.1 of the *Agreement on Agriculture*. However, we see no reason to disturb these findings on the grounds that the Panel misinterpreted Article 10.3.

VI. Article 9.1(c) of the *Agreement on Agriculture*—"Payments Financed by Virtue of Governmental Action"

78. The second issue appealed by Canada is whether the Panel erred in its interpretation and application of Article 9.1(c) of the *Agreement on Agriculture*. This issue raises two separate questions: (a) whether the Panel erred in finding that CEM involves "payments" under Article 9.1(c); and (b) having found that CEM involves "payments", whether the Panel erred in finding that these "payments" are "*financed by virtue of governmental action*". We will examine these questions in turn.

79. Before turning to the question of "payments", we note that Canada does not appeal, and we will not address, the Panel's finding that the alleged CEM payments are made "*on the export*" of agricultural products, as required by Article 9.1(c) of the *Agreement on Agriculture*.⁶¹

A. "*Payments*"

80. The Panel began its reasoning by recalling that "payments" under Article 9.1(c) of the *Agreement on Agriculture* include "payments-in-kind" made through the supply of goods or services.⁶² The Panel noted that we held, in the first Article 21.5 proceedings, that the existence of payments-in-kind, for purposes of CEM, should be determined by comparing CEM prices with "some objective standard ... reflect[ing] the proper value" of milk to the producer.⁶³ The Panel also observed that we held that "the *average total cost of production* represents the appropriate standard" in these proceedings.⁶⁴

⁶⁰Panel Report, paras. 5.136 and 5.164.

⁶¹See *ibid.*, para. 5.23.

⁶²*Ibid.*, para. 5.26, referring to Appellate Body Report, *Canada – Dairy*, para. 112; and to Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 71 and 76.

⁶³*Ibid.*, para. 5.27, referring to Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 74-75, 96, and 104.

⁶⁴*Ibid.*, para. 5.28, referring to Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 87. (emphasis added) See also Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 96.

81. Before the Panel, the parties disagreed as to how the average total cost of production standard (the "COP standard") should be determined. The Panel "doubted" that Canada was correct to argue that the standard should be each *individual* producer's costs of production, rather than a single *industry-wide* average figure, as proposed by the complaining Members.⁶⁵ The Panel also found that Canada did not demonstrate why imputed costs for family labour and management, and for owner's equity, as well as quota, transport, marketing, and administrative costs, should not be included in calculating the COP standard, as suggested by the complaining Members.⁶⁶

82. Despite these doubts regarding Canada's position, the Panel made two distinct findings on the existence of "payments"; one based on Canada's interpretation of the COP standard and the other based on the complaining Members' interpretation. The Panel ruled that, *even assuming Canada's interpretation of the standard were correct*, the evidence submitted by Canada did *not* support Canada's position that payments were not made.⁶⁷ The Panel also considered that the complaining Members' evidence was sufficient to establish a *prima facie* case that payments were made, on the basis of their interpretation of the COP standard.⁶⁸

83. As the Panel came to an identical conclusion under both interpretations of the COP standard, it concluded that it was "unnecessary [for it] to decide in this case which of these two interpretations is the correct one."⁶⁹ Therefore, the Panel did *not* express any definitive views on the proper application of the COP standard.

84. In its appeal, Canada makes four primary arguments on the question of "payments". Canada contends: first, that the Panel erred in considering that the COP standard should be applied on an industry-wide basis; second, that the Panel erred in finding that the COP standard includes "non-monetary costs", such as the costs of family labour and management, and of owner's equity, that do not represent actual cash costs incurred by the producer; third, that the Panel erred in finding that the COP standard extends to costs associated with selling milk, such as quota, transport, marketing, and administrative costs, whereas Canada submits that it covers only the on-farm costs of producing milk; and fourth, that the Panel erred in its assessment of the evidence by placing a burden on Canada that it

⁶⁵Panel Report, paras. 5.50-5.51.

⁶⁶*Ibid.*, para. 5.85.

⁶⁷*Ibid.*, paras. 5.65 and 5.87.

⁶⁸*Ibid.*, paras. 5.34 and 5.86.

⁶⁹*Ibid.*, para. 5.90. (original italics; underlining added) We note, however, that the Panel also stated, in paragraph 5.126 of the Panel Report, that "imputed costs of family labour, return to management, return to equity, and production quota, as well as transport, marketing and administrative costs ... are properly to be included in a calculation of the average total cost of production."

"cannot possibly be expected to meet".⁷⁰ Before examining these four arguments, we provide general observations relating to Article 9.1(c).

1. General Remarks on Article 9.1(c) of the *Agreement on Agriculture*

85. The word "payment", in Article 9.1(c) of the *Agreement on Agriculture*, denotes a "transfer of economic resources".⁷¹ Although a monetary payment certainly involves such a transfer, the same is equally true where goods or services are transferred for less than full value. Recognizing this, we upheld the original panel's finding that the ordinary meaning of the word "payment", in Article 9.1(c) of the *Agreement on Agriculture*, "encompasses 'payments' made in forms other than money".⁷²

86. In these second Article 21.5 proceedings, New Zealand and the United States assert that non-monetary "payments" are effected through the supply of goods—CEM. The issue is, therefore, whether supplies of CEM, by Canadian producers, involve a transfer of economic resources to processors.

87. In examining this question in the first Article 21.5 proceedings, we took into account that Article 9.1(c) of the *Agreement on Agriculture* describes an unusual form of subsidy in that "payments" can be made by private parties, and need not be made by government.⁷³ Moreover, "payments" need not be funded from government resources, provided they are "financed by virtue of governmental action".⁷⁴ Article 9.1(c), therefore, contemplates that "payments" may be made and funded by private parties, without the type of governmental involvement ordinarily associated with a subsidy. Furthermore, the notion of payments encompasses a diverse range of practices involving monetary transfers, or transfers-in-kind. We, therefore, determined that, in identifying whether "payments" are made, it is necessary to consider the particular features of the alleged "payments", by whom they are made, and in what circumstances. Thus, we found that the standard for determining the existence of "payments" under Article 9.1(c) must be identified after careful scrutiny of the factual and regulatory setting of the measure.⁷⁵

⁷⁰Canada's appellant's submission, para. 47.

⁷¹Appellate Body Report, *Canada – Dairy*, para. 107.

⁷²*Ibid.*, para. 112.

⁷³Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 113 and 115.

⁷⁴*Ibid.*, para. 114.

⁷⁵*Ibid.*, para. 76.

88. In the case of CEM, we took into account the fact that the alleged "payments" are made by private parties through the supply of milk. Moreover, subject to the requirement to pre-commit sales of CEM, the private parties are entirely free to produce milk for sale as CEM, and it is for them to agree the price, volume, and timing of the sale with the buyers.⁷⁶ In these particular circumstances, we considered that the determination of whether "payments" are made depends on a comparison between the price of CEM and an "objective standard or benchmark which reflects the proper value of the [milk] to [its] provider".⁷⁷ We found that, in the circumstances of this dispute, the standard for determining the proper value of CEM is the average total cost of production of the milk (the COP standard), as this standard represents the economic resources the producer invests in the milk. If CEM is sold at less than its proper value, "payments" are made, because there is a transfer of the portion of economic resources not reflected in the selling price.

89. We also provided certain guidance on the determination of the COP standard:

The average total cost of production would be determined by dividing the fixed and variable costs of producing *all* milk, whether destined for domestic or export markets, by the total number of units of milk produced for both these markets.⁷⁸ (original italics)

90. With these general observations in mind, we turn to Canada's four primary arguments on "payments".

2. Individual Producer's Costs of Production or Industry-wide Average

91. Canada argues that the Panel erred in considering that the COP standard is a single, *industry-wide* average cost of production figure, rather than each *individual* producer's costs of production.⁷⁹

92. Although the Panel expressed "doubts" that the COP standard should be each individual producer's costs, rather than an industry-wide figure, we note that it did not reach a definitive view on

⁷⁶In response to questioning at the oral hearing, Canada affirmed us that pre-commitment of CEM sales must be made at least 30 days in advance of the sale date.

⁷⁷Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 74.

⁷⁸*Ibid.*, para. 96.

⁷⁹We note that, although Canada argues that the COP standard should be each individual producer's costs of production, Canada presented evidence based on ten industry-wide groupings, giving an average cost of production figure for each of these groups. For each group or "decile", Canada gave the lowest and highest individual cost of production figure. The Panel also makes this point: "While speaking of the costs to individual producers, not industry-wide average costs, Canada has only provided the Panel with average costs, albeit averages within ten groupings of producers." (Panel Report, para. 5.64)

this question.⁸⁰ Instead, as we said, the Panel examined the evidence from the perspective of the alternative positions, and found against Canada under each of them.⁸¹

93. Canada asserts that we found, in the first Article 21.5 proceedings, that the COP standard is based on individual producer's costs of production. However, this question was not specifically examined, nor resolved, in the first Article 21.5 proceedings.

94. For purposes of resolving this question, it is relevant to consider the *nature* of the obligations imposed under the *Agreement on Agriculture*. That Agreement, which is annexed to the *Marrakesh Agreement Establishing the World Trade Organization*, is an international agreement to which Canada is a party, as a sovereign State. Pursuant to this Agreement, Canada has undertaken a number of different obligations. Among these are the obligations in Articles 3.3 and 8 of the *Agreement on Agriculture* not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule. Accordingly, under Article 3.3, Canada has undertaken not to provide the export subsidies listed in Article 9.1 "in excess of ... [its] quantity commitment levels".

95. However, under Article 9.1(c) of the *Agreement on Agriculture*, it is not solely the conduct of WTO Members that is relevant. We have noted that Article 9.1(c) describes an unusual form of export subsidy in that "payments" can be made and funded by private parties, and not just by government.⁸² The conduct of private parties, therefore, may play an important role in applying Article 9.1(c). Yet, irrespective of the role of private parties under Article 9.1(c), the obligations imposed in relation to Article 9.1(c) remain obligations imposed on Canada. It is Canada, and not private parties, which is responsible for ensuring that it respects its export subsidy commitments under the covered agreements. Thus, under the *Agreement on Agriculture*, any "export subsidies" provided through private party action in Canada are deemed to be provided by Canada, and count towards Canada's export subsidy commitment levels.

96. We believe that the standard for determining the existence of "payments", under Article 9.1(c), should reflect the fact that the obligation at issue is an international obligation imposed on Canada. The question is not whether one or more individual milk producers, efficient or not, are selling CEM at a price above or below their individual costs of production. The issue is whether Canada, on a national basis, has respected its WTO obligations and, in particular, its commitment

⁸⁰Panel Report, paras. 5.50 and 5.90.

⁸¹*Ibid.*, paras. 5.86-5.87.

⁸²*Supra*, para. 87.

levels. It, therefore, seems to us that the benchmark should be a single, industry-wide cost of production figure, rather than an indefinite number of cost of production figures for each individual producer. The industry-wide figure enables cost of production data for producers, as a whole, to be aggregated into a single, national standard that can be used to assess Canada's compliance with its international obligations.

97. By contrast, if the benchmark were to operate at the level of each individual producer, there would be a proliferation of standards, requiring individual-level inquiry and application of Article 9.1(c), as if the obligations under the *Agreement on Agriculture* involved rights and obligations of individual producers, rather than WTO Members.

98. We, therefore, find that the COP standard for determining whether the sale of CEM involves "payments", under Article 9.1(c) of the *Agreement on Agriculture*, is an industry-wide average figure that aggregates the costs of production of all producers of milk.⁸³ Although the Panel did not express any firm view on this issue, we see no error in the Panel's treatment of this question.

3. Imputed Costs

99. Canada objects to the inclusion, in the COP standard, of an imputed amount for the costs of the producer's family labour and management, and for the costs of owner's equity. Canada contends that, as the producer does not incur a cash cost for these items, they are not relevant because the COP standard does not include "non-monetary" costs.⁸⁴ Rather, Canada says, these items are rewarded by any profits earned if revenues from milk sales exceed costs.

100. The Panel did not find that these imputed costs are to be included in the COP standard nor that they are to be excluded from it. Instead, the Panel examined the evidence from the perspective of these two positions, and found against Canada under each of them.⁸⁵

⁸³We consider that it may be appropriate for the industry-wide cost of production figure to be determined using a statistically valid sample of all producers.

⁸⁴Canada's appellant's submission, para. 59.

⁸⁵Panel Report, para. 5.90. We note, however, that the Panel also "recalled", in paragraph 5.126 of the Panel Report, that these imputed costs "are properly to be included in a calculation of the average total cost of production."

101. In examining this issue, we recall that the notion of "payment", in Article 9.1(c), covers transfers of economic resources, irrespective of the means by which the resources are transferred. Thus, the transfer may be effected in monetary form or equally by a transfer of goods or services for less than full value.⁸⁶

102. In these proceedings, the purpose of the COP standard is precisely to determine whether supplies of CEM involve payments-in-kind that are made in a form other than money. If the COP standard were confined solely to cash costs, as Canada argues, this would overlook the possibility of "payments" being made in the form of non-cash resources invested in the production of milk. Thus, the COP standard must cover *all* of the economic resources invested in the production of milk and which may be transferred, irrespective of whether the resources involve an actual cash cost.

103. We are satisfied that any labour or management services provided by the farmer's family to the dairy enterprise are relevant economic resources invested in the production of milk and must be included in the COP standard. For the dairy farmer, and his or her family, the investment of services in the dairy enterprise has an economic cost, as those services cannot be put to an alternative remunerative use. We observe that both the United States and New Zealand submitted evidence to the Panel in support of the view that, from the perspective of economic theory, any labour and management services provided to an enterprise involve such an economic "opportunity" cost.⁸⁷ Moreover, we believe that remuneration of family labour and management services is not part of the profits of the dairy farm. Rather, profits are the proceeds remaining after all costs, including such salary costs, have been accounted for.

104. The same is also true of any equity the owner invests in the dairy enterprise. The allocation of such capital is, clearly, an investment of economic resources and carries an economic opportunity cost to the owner because the capital cannot simultaneously be invested elsewhere.⁸⁸ Again, the profits of the dairy enterprise are the proceeds after all costs, including the cost of equity, have been accounted for.

⁸⁶Appellate Body Report, *Canada – Dairy*, paras. 107-112.

⁸⁷Exhibit NZ-23 submitted by New Zealand to the Panel; Exhibit US-35 submitted by the United States to the Panel.

⁸⁸The documentary evidence submitted by New Zealand and the United States is equally supportive of the view that, in economic theory, investment of equity involves an economic opportunity cost. (*Ibid.*)

105. Moreover, it would be incongruous if the costs of family labour and management were excluded from the COP standard when provided by family, but included when provided by others.⁸⁹ Likewise, it would be curious if the cost of capital, of which equity is one type, were excluded from the COP standard when capital is provided through the owner's equity, but included when it is provided through, for instance, debt, merely because the cost of debt is expressed in recurring cash outlays for interest payments. In each case, the dairy enterprise is incurring an economic cost and that cost should be appropriately reflected in the costs of production.

106. Accordingly, we find that any failure to include in the COP standard the costs of family labour and management, or of owner's equity, would understate the costs of milk production, and may lead to a non-monetary "payment" going undetected.

107. Although it is clear that the COP standard includes all economic costs, even if they are non-cash costs, we acknowledge that a specific value cannot be as readily ascribed to non-cash costs as it can to cash costs. However, we do not believe, as suggested by Canada, that this practical difficulty precludes the application of an objective COP standard.

108. In some situations, it may be appropriate for a panel to value non-monetary costs using a methodology set forth in a Member's Generally Accepted Accounting Principles ("GAAP"). In that respect, we observe that Canada did not contest the amounts the Canadian Dairy Commission (the "CDC") ascribed to depreciation using the rules in Canadian GAAP.⁹⁰ However, although GAAP provide an objective valuation methodology for some non-monetary costs, they may not address all such costs.⁹¹ If GAAP rules do not provide an appropriate basis for valuing a particular cost, a panel should attempt to determine a value for relevant non-monetary costs using an objective methodology that is reasonable in the circumstances. Clearly, a panel must base itself on the evidence before it, applying the applicable rules on burden of proof.

⁸⁹We note that, according to the Canadian Dairy Commission Handbook ("*CDC Handbook*"), family labour and management is treated as an imputed, non-cash cost, "regardless of whether or not the family member is paid for his/her labour". (*CDC Handbook*, p. 26, Exhibit NZ-4 submitted by New Zealand to the Panel; Exhibit US-22 submitted by the United States to the Panel) Thus, in some cases there may be an actual cost for family labour and management which is excluded by the CDC and replaced by an imputed cost using the CDC's methodology. Canada's argument would, in fact, exclude both an actual cost incurred by the dairy enterprise and an imputed cost. We note also that the *CDC Handbook* defines a family member in broad terms to include: "the producer, the producer's spouse, children, brothers, sisters, sons-in-law, daughters-in-law and parents." (*CDC Handbook*, p. 25, principle 8, Exhibit NZ-4 submitted by New Zealand to the Panel)

⁹⁰*CDC Handbook*, pp. 23-24, Exhibit NZ-4 submitted by New Zealand to the Panel; Exhibit US-22 submitted by the United States to the Panel.

⁹¹We note that GAAP typically provide accounting rules for corporations, often publicly listed, and not for smaller family-run enterprises. As such, many countries' GAAP may not provide rules on imputed costs for family labour, management, or owner's equity.

109. We note that New Zealand and the United States submitted evidence to the Panel in the form of CDC data that includes an imputed amount for the costs of family labour and management, and of owner's equity. The methodologies the CDC used to arrive at the costs for these items are set forth in the *CDC Handbook* and seem, to us, to be perfectly reasonable.⁹² In our view, the Panel did not err in placing reliance upon these data and the methodologies underlying them. Although we acknowledge that other equally reasonable valuation methods may exist, we note that Canada did not submit, pursuant to Article 10.3 of the *Agreement on Agriculture*, evidence of any alternative method for valuing these inputs.

110. We, therefore, find that the COP standard for determining whether "payments" exist, under Article 9.1(c) of the *Agreement on Agriculture*, includes all monetary and non-monetary economic costs of production, such as the costs of family labour and management, and of owner's equity. We see no error in the Panel's approach to this issue.

4. Selling Costs

111. Canada suggests that, for purposes of Article 9.1(c) of the *Agreement on Agriculture*, only the farm-based costs of producing milk should be taken into account in the COP standard, so that the costs of selling milk—such as quota, transport, marketing, and administrative costs—would be excluded.⁹³

112. The Panel did not find that these selling costs are to be included in the COP standard, nor that they are to be excluded from it. Instead, the Panel examined the evidence from the perspective of both positions and found against Canada under each of them.⁹⁴

113. We recall that the COP standard represents the producer's investment of economic resources in milk and, hence, in these proceedings, the proper value of the milk to the producer.⁹⁵ In our view, costs incurred by the producer in selling milk are as much a part of the economic resources the

⁹²*CDC Handbook*, pp. 26-31, Exhibit NZ-4 submitted by New Zealand to the Panel; Exhibit US-22 submitted by the United States to the Panel.

⁹³Although Canada considers that these costs should be excluded from the COP standard, Canada also considers that sales proceeds referable to transport, marketing, and administration inputs should be deducted from the sales price in comparing the COP standard to CEM prices. (Canada's appellant's submission, para. 64) As Canada stated at the oral hearing, the *result* is, therefore, the *same* as if these costs were *included* in the COP standard and *included* in the price. However, leaving aside the practical implications of Canada's position, the legal issue remains whether it is appropriate for selling costs to be included in the COP standard.

⁹⁴Panel Report, para. 5.90. We note, however, that the Panel also "recalled", in paragraph 5.126 of the Panel Report, that the cost of quota, and transport, marketing and administrative costs "are properly to be included in a calculation of the average total cost of production."

⁹⁵Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 96.

producer invests in the milk as are farm-based production costs. Indeed, the costs incurred to make sales are a vital part of the process by which the producer earns revenues through producing milk. If the producer sells milk at a price sufficient to cover only the farm-based production costs, it transfers to the processor any resources invested in selling the milk, such as the value of transport, marketing, and administration. There would, in such circumstances, be a "payment" of the value of these additional selling costs. Accordingly, these costs must be included in the COP standard in the comparison with the sales price of CEM.

114. In addition, we can see no reason to exclude the cost of quota from the COP standard. On the contrary, to the extent that the acquisition or retention of quota involves economic costs for the dairy producer, these costs should be reflected in the COP standard. In that respect, we are not persuaded by Canada that the cost of quota should be excluded from the COP standard because it relates solely to the domestic market. In the first Article 21.5 proceedings, we held that the COP standard must be determined for "all milk, whether destined for domestic or export markets".⁹⁶ Thus, in principle, the costs of quota form part of the COP standard. It remains, however, to decide how quota costs are to be incorporated into the standard.

115. In these second Article 21.5 proceedings, there is very little evidence on record relating to the cost of acquiring or retaining quota, and the Panel did not make any specific findings relating to the cost of quota. Instead, in the absence of evidence, the Panel made a general statement that, "[i]f anything, additions reflecting the cost of quota" should be made to the CDC data on costs of production.⁹⁷ In other words, the Panel believed that the CDC data understated the real costs of production because they did not include an amount for the cost of quota. But the Panel was unable to quantify the addition it believed should be made. As the Panel had found that the evidence before it supported a finding that CEM sales are, on average, made at a price below the COP standard, this general remark did not have any bearing on the Panel's conclusion.⁹⁸ In the light of this fact, and in the absence of evidence relating to quota, we make no determination as to how, precisely, the cost of quota should be reflected in the COP standard.

116. Accordingly, we find that any transport, marketing, and administrative costs are to be included in the COP standard applied under Article 9.1(c), as are any costs of acquiring and retaining quota. The Panel committed no error of law in its assessment of these costs.

⁹⁶Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 96. (original italics; underlining added)

⁹⁷Panel Report, para. 5.85.

⁹⁸*Ibid.*, para. 5.89.

5. Assessment of Evidence

117. We recall that the Panel examined the evidence from two different perspectives—that is, using both the complaining Members' and Canada's proposed COP standards. The Panel found that, under both of these standards, "payments" were being made through the supply of CEM.⁹⁹

118. Canada submits that the Panel erred in its assessment of the evidence by placing a burden on Canada that it "cannot possibly be expected to meet."¹⁰⁰ Canada's argument relates to the Panel's assessment of the evidence *using Canada's proposed COP standard*, that is, a COP standard applied on an "individual", as opposed to an "industry-wide" basis, and *excluding* from the COP standard, the costs of family labour and management, and of owner's equity, and also quota, transport, marketing, and administrative costs.

119. We have held that the COP standard is to be determined on an industry-wide basis and that it *includes* all the costs that Canada proposed be excluded, as they involve economic resources invested in the production of milk.¹⁰¹ As such, the Panel's examination of the evidence from Canada's perspective is rendered moot, because it is based on a legal standard that we have found to be the incorrect one. Any review of the Panel's treatment of the evidence must, instead, focus on its examination of the evidence which *included* the various costs Canada proposed to exclude. That is, we must review the Panel's comparison of the price of CEM with the COP standard *including* the costs of family labour and management, and of owner's equity, and also quota, transport, marketing, and administrative costs.

120. The evidence submitted to the Panel by the complaining Members, in the form of CDC data, included amounts for all these costs, other than quota. According to this evidence, the industry-wide cost of production figure for the year 2000 was C\$57.27 per hectolitre ("hl"), and for 2001, it was C\$58.12/hl. The average prices for CEM for these periods were C\$29/hl and C\$31.72/hl, respectively.¹⁰² Thus, as the Panel found, on an industry-wide basis, CEM prices are significantly below the COP standard. On the basis of this evidence, the Panel found that there was a *prima facie* case that "payments" are being made.¹⁰³ Moreover, under Article 10.3 of the *Agreement on Agriculture*, the burden of proof was on Canada to establish the contrary. The Panel found that

⁹⁹Panel Report, para. 5.89.

¹⁰⁰Canada's appellant's submission, para. 47.

¹⁰¹*Supra*, paras. 110 and 116.

¹⁰²Panel Report, para. 5.33; Canada's response to Question 61 posed by the Panel during the Panel proceedings.

¹⁰³Panel Report, para. 5.89.

Canada had not satisfied that burden.¹⁰⁴ We can see no error in the Panel's assessment of the evidence.¹⁰⁵

6. Conclusion on "Payments" under Article 9.1(c)

121. For all these reasons, we uphold the Panel's finding, in paragraph 5.89 of the Panel Report, that the supply of CEM, by producers to processors, involves "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

B. *"Financed by Virtue of Governmental Action"*

122. We turn now to the second element of Canada's appeal of the Panel's findings under Article 9.1(c) of the *Agreement on Agriculture*—whether the Panel erred in finding that "payments", made on the sale of CEM, are "financed by virtue of governmental action".

123. The Panel recalled that there must be a "demonstrable link" between governmental action and the financing of "payments".¹⁰⁶ The Panel proceeded to examine several actions of the Canadian government in regulating the supply of domestic milk and CEM. It concluded that New Zealand and the United States had made out a *prima facie* case that a demonstrable link exists between these Canadian governmental actions and the financing of CEM payments. Further, the Panel found that Canada had failed to establish, pursuant to Article 10.3 of the *Agreement on Agriculture*, that these governmental actions were not demonstrably linked to the financing of the payments.¹⁰⁷

124. On appeal, Canada argues that the Panel erred under Article 9.1(c) of the *Agreement on Agriculture*, in particular by finding that a "demonstrable link" exists between Canadian governmental action and the financing of CEM payments. Canada claims that it has removed government action from "every stage of the export transaction" and that producers and processors "freely choose to enter into export transactions".¹⁰⁸ Therefore, Canada argues that no demonstrable link exists between governmental action and financing of CEM payments.

¹⁰⁴Panel Report, para. 5.89.

¹⁰⁵Pursuant to Article 11 of the DSU, a panel must make an objective assessment of the facts. As such, a panel is the trier of facts, responsible for evaluating the credibility and weight of the evidence. As we have stated, we will interfere with a panel's assessment of the evidence only if the panel has exceeded the bounds of its discretion as trier of facts. (Appellate Body Report, *US – Wheat Gluten*, para. 151)

¹⁰⁶Panel Report, para 5.106, referring to Appellate Body Report, *Canada – Dairy*, para. 113.

¹⁰⁷*Ibid.*, paras. 5.133-5.135.

¹⁰⁸Canada's appellant's submission, paras. 74 and 101.

125. Article 9.1(c) of the *Agreement on Agriculture* provides:

Export Subsidy Commitments

1. The following export subsidies are subject to reduction commitments under this Agreement:

...

(c) 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; (emphasis added)

126. The phrase "financed by virtue of governmental action" has three distinct elements—"governmental action"; "by virtue of"; and "financed"—which we will address in turn.

127. As regards "governmental action", we held in the first Article 21.5 proceedings that "the text of Article 9.1(c) does not place any qualifications on the types of 'governmental action' which may be relevant under Article 9.1(c)."¹⁰⁹ Instead, the provision gives but one example of governmental action that is "included" in Article 9.1(c)—however, this example is merely illustrative.¹¹⁰ Accordingly, we stated that Article 9.1(c) "embraces the full-range" of activities by which governments "regulate", "control" or "supervise" individuals.¹¹¹ In particular, we said that governmental action "regulating the supply and price of milk in the domestic market" might be relevant "action" under Article 9.1(c).¹¹² Moreover, the governmental action may be a single act or omission, or a series of acts or omissions.

128. We observe that Article 9.1(c) does not require that payments be financed by virtue of government "mandate", or other "direction". Although the word "action" certainly covers situations where government mandates or directs that payments be made, it also covers other situations where no such compulsion is involved.¹¹³

¹⁰⁹Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 112.

¹¹⁰The example given is "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".

¹¹¹Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 112.

¹¹²*Ibid.*

¹¹³Article 9.1(c) of the *Agreement on Agriculture* may be contrasted with Article 9.1(e) of the *Agreement on Agriculture*, as well as with Article 1.1(a)(1)(iv) of the *SCM Agreement*, and items (c), (d), (j), and (k) of the Illustrative List of Export Subsidies (the "Illustrative List") of the *SCM Agreement*. In these provisions, some kind of government mandate, direction, or control is an element of a subsidy provided through a third party.

129. Although the term "governmental action", when read in isolation, is somewhat open-ended, perhaps even abstract, the words "by virtue of" clarify further the meaning of this term. In the first Article 21.5 proceedings, we opined:

The 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, in some way, financed as a result of, or as a consequence of, the governmental action.¹¹⁴ (original italics)

130. The words "by virtue of", therefore, express the relationship between "governmental action" and the "financing" of payments for the purpose of Article 9.1(c). The essence of that relationship is the "nexus" or "link" between "action" and "financing".

131. Thus, although Article 9.1(c) extends, in principle, to *any* "governmental action", not every governmental action will have the requisite nexus to the financing of payments. In the first Article 21.5 proceedings, we observed that "[g]overnments are constantly engaged in regulation of different kinds in pursuit of a variety of objectives."¹¹⁵ Yet, we went on to say that regulation that merely *enables* payments to occur will not suffice for those payments to be regarded as "financed by virtue of governmental action". We stated:

[Where regulation merely enables payments to occur], the link between the governmental action and the financing of the payments is too tenuous for the "payments" to be regarded as "*financed* by virtue of governmental action" ... within the meaning of Article 9.1(c). Rather, there must be a tighter nexus between the mechanism or process by which the payments are *financed* ...¹¹⁶ (original italics)

132. This brings us to the meaning of the word "financing". The word refers generally to the mechanism or process by which financial resources are provided to enable "payments" to be made. The word could, therefore, be read to mean that government itself must provide the resources for producers to make payments. However, Article 9.1(c) expressly precludes such a reading, as it states that "payments" need *not* involve "a charge on the public account". This is borne out by the fact that the text indicates that "financing" need only be "by virtue of governmental action", rather than "by government" itself. Article 9.1(c), therefore, contemplates that "payments may be financed by virtue

¹¹⁴Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 113.

¹¹⁵*Ibid.*, para. 115.

¹¹⁶*Ibid.*

of governmental action even though significant aspects of the financing might not involve government."¹¹⁷ Indeed, as we have said, payments may be made, and funded, by private parties.¹¹⁸

133. The word "financing" must, nonetheless, be given meaning. Accordingly, even if government does not fund the payments itself, it must play a sufficiently important part in the process by which a private party funds "payments", such that the requisite nexus exists between "governmental action" and "financing".

134. These general remarks illustrate well that "[i]t is extremely difficult ... to define in the abstract the precise character of the required link between the governmental action and the financing of the payments, particularly where payments-in-kind are at issue."¹¹⁹ In each case, the alleged link must be examined taking account of the particular character of the governmental action at issue and its relationship to the payments made.¹²⁰

135. With this mind, we turn to the facts of this dispute. We recall that we have described the key features of the Canadian regulatory system in paragraphs 12-14 of this Report.¹²¹

136. We have also upheld the Panel's finding that producers make "payments", under Article 9.1(c) of the *Agreement on Agriculture*, to processors through sales of CEM at prices that are below the COP standard. As a result, producers' sales revenues do not recoup all of the costs associated with producing and selling CEM. As this short-fall in revenues must be "financed" from some other source, sales of CEM necessarily involve the "financing" of "payments". The crucial question is the *source* of that financing and, in particular, whether the financing occurs "by virtue of governmental action".

137. The Panel considered that "a significant percentage" of Canadian milk producers are able to cover the entirety of fixed and variable costs of production through in-quota sales of domestic milk. As a result, the Panel opined, these producers can afford to make export sales at marginal cost.¹²² The Panel found that governmental action regulating the domestic milk market "cross-subsidizes many sales that otherwise would not be made or would at least constitute sales at a loss."¹²³

¹¹⁷Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 114.

¹¹⁸*Supra*, para. 87.

¹¹⁹Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 115.

¹²⁰*Ibid.*, para. 115.

¹²¹See also Panel Report, paras. 2.1-2.4.

¹²²*Ibid.*, para. 5.128.

¹²³*Ibid.*, para. 5.127.

138. We note that CEM is produced almost exclusively by the same producers who supply milk to the domestic market.¹²⁴ It is not contested that these producers use the same production facilities to produce domestic and export milk—that is, the same land, cattle, buildings, machinery, milking facilities, and so on. Indeed, in some provinces, even after production, both regulatory classes of milk have common storage and transportation facilities.¹²⁵ There is, in other words, a single line of production for all milk, whatever its destination market.

139. Where fungible goods, such as milk, are produced using a single line of production, but sold in two different markets, the fixed costs of production are, in principle, shared between sales revenues from both markets. However, in the event that one of the two markets offers much higher revenues, a disproportionately large part, possibly even all, of the shared fixed costs may be borne by sales made in the more remunerative market.

140. Where sales in the more remunerative market bear more than their relative proportion of shared fixed costs, sales in the other market do not need to cover their relative proportion of the shared fixed costs in order to be profitable.¹²⁶ Rather, these sales can be made profitably *below* the average total cost of production. If the more remunerative sales cover *all* fixed costs, sales in the other market can be made profitably at any price above marginal cost. In these situations, the higher revenue sales effectively "*finance*" a part of the lower revenue sales by funding the portion of the shared fixed costs attributable to the lower priced products.

141. In Canada, the domestic price of milk is fixed by a government agency—the CDC—on the basis of an annual survey of producers' costs of production. The CDC has a statutory mandate to ensure that, through the administered price, a "fair return" is secured for "efficient producers". The CDC sets this administered price on the basis of data covering 70 percent of producers, such that these 70 percent of producers can, on average, cover *all* of their costs of production, including *all fixed*

¹²⁴According to Canada, approximately 100 milk producers produce CEM without, at the same time, holding a domestic quota. (Canada's response to Question 2(c) posed by the Panel during the Panel proceedings, confirmed by Canada's response to questioning at the oral hearing) These 100 producers represent approximately 0.5% of all 19,000 Canadian milk producers and 1.25% of all 8000 CEM producers. (Panel Report, paras. 3.70 and 5.55) Moreover, the export market represents only 3.62 percent, by volume, of the total Canadian milk production. (Canada's response to questioning at the oral hearing)

¹²⁵See, for instance, the Agreement on Commercial Milk Export between the British Columbia Milk Producers Association, the Mainland Dairymen's Association, and the British Columbia Dairy Council, p. 2, Exhibit US-21 submitted by the United States to the Panel.

¹²⁶Even if sales in the more remunerative market do not cover *all* of the shared fixed costs, they may bear a higher relative proportion of those costs, such that sales in the less remunerative market can be made at a price below the average total cost of production, because these sales do not need to cover their entire relative proportion of shared fixed costs.

costs, through domestic sales of milk.¹²⁷ Moreover, for other producers, domestic sales will cover a significant part, if not all, of the fixed costs. This suggests, to us, that a large proportion of producers can finance the sale of CEM at a price that is below the COP standard *as a result of participation in the domestic market*.¹²⁸ In that respect, we note also that the domestic milk market represents 96.4 percent, by volume, of total Canadian milk production, with export production representing only 3.6 percent, by volume.¹²⁹

142. We observe that, although there is a large proportion of producers that could sell CEM below the COP standard, the proportion of producers who have actually made at least one CEM sale is around 40 percent of all producers.

143. In these circumstances, we agree with the Panel that the evidence indicates that a "significant percentage" of producers are "likely" to make sales of CEM at below the costs of production as a result of highly remunerative in-quota sales in the domestic market. For these producers, domestic sales are likely to "finance" payments made on the sale of CEM. Although the Panel's finding is based on "likelihood", this likelihood seems, to us, to be rather high. Any producer whose fixed costs have been, in large part, covered by domestic sales, and who has sufficient capacity to produce for the export market, has a powerful profit incentive to sell CEM at a competitive export price, even if that price is below the average total cost of production, as long as the price is above marginal costs of production. In any event, we recall that, pursuant to Article 10.3 of the *Agreement on Agriculture*, Canada bears the burden of proving that sales of CEM do not involve the granting of export subsidies.

144. It falls now to consider the role of the Canadian government in financing payments made on the sale of CEM. We have agreed with the Panel that a significant percentage of producers are likely to finance sales of CEM at below the costs of production as a result of participation in the domestic market. Canadian "governmental action" controls virtually every aspect of domestic milk supply and management.¹³⁰ In particular, government agencies fix the price of domestic milk that renders it

¹²⁷Panel Report, para. 5.128.

¹²⁸In addition to the *CDC Handbook*, the Panel also referred to newspaper articles submitted by New Zealand to support its view that a significant proportion of producers covers their fixed costs through domestic sales. (Panel Report, para. 5.128; Exhibit NZ-7 submitted by New Zealand to the Panel) In the two newspaper articles, the President of Dairy Farmers Canada and the Chairman of Dairy Farmers Ontario asserted, respectively, that only 25 percent and 39 percent of producers would cover all their costs at the price fixed by the CDC. At the oral hearing, Canada cautioned that such newspaper opinions should be treated "carefully". In any event, we note that even these figures tend to indicate that a large proportion of producers covers most, if not all, of their fixed costs through in-quota domestic sales.

¹²⁹Canada's response to questioning at the oral hearing.

¹³⁰We recall that certain aspects of the supply and management of milk in Canada were examined in the original proceedings in this dispute. In those proceedings, we found that the agencies managing the supply of milk were "government" agencies. (Appellate Body Report, *Canada – Dairy*, para. 118)

highly remunerative to producers. Government action also controls the supply of domestic milk through quota, thereby protecting the administered price. The imposition by government of financial penalties on processors that divert CEM into the domestic market is another element of governmental control over the supply of milk. Further, the degree of government control over the domestic market is emphasized by the fact that government pools, allocates, and distributes revenues to producers from all domestic sales. Finally, governmental action also protects the domestic market from import competition through tariffs.¹³¹

145. In our view, the effect of these different governmental actions is to secure a highly remunerative price for sales of domestic milk by producers. In turn, it is due to this price that a significant proportion of producers covers their fixed costs in the domestic market and, as a result, has the resources profitably to sell export milk at prices that are below the costs of production.

146. Accordingly, we agree with the Panel that "governmental action" in the domestic market plays a critical part in the "financing" of payments made by a significant percentage of producers on the sale of CEM. As such, we agree with the Panel that payments made through the supply of CEM at below the COP standard are financed by virtue of this governmental action.¹³² We also agree with the Panel that Canada failed to establish the contrary, pursuant to Article 10.3 of the *Agreement on Agriculture*.

147. We do not agree with Canada that the circumstances indicate that the Canadian government has merely created a regulatory framework whereby it has enabled producers to sell CEM at prices that are below the costs of production. Certainly, producers decide for themselves whether and when to sell CEM. However, governmental action in the domestic market goes further than simply creating a regulatory environment in which producers choose to make export payments using their own resources. Rather, as we have said, Canadian governmental action is instrumental in providing a significant percentage of producers with the *resources* that enable them to sell CEM at below the costs of production.

¹³¹For instance, in its Schedule, Canada has established a tariff quota of 64,500 tonnes for fluid milk (tariff headings 0401.10.10 and 0401.20.10) for cross-border purchases imported by Canadian consumers, with an in-quota tariff rate of 7.5 percent since 2001; outside this tariff quota, since 2001, Canada's bound tariff is 241.3 percent, but not less than C\$34.5/hl. For yogurt (tariff heading 0403.10), the tariff quota is 332 tonnes and is limited to yogurt in retail-sized containers only; outside this quota, since 2001, the applicable bound tariff rate is 237.5 percent, but not less than 46.6¢/kg. "Fresh (unripened or uncured) cheese" (tariff heading 0406.10) falls under a tariff quota of 20,411,866 tonnes; outside this quota, since 2001, the applicable bound tariff rate is 245.6 percent, but not less than 451.1¢/kg.

¹³²Panel Report, paras. 5.133-5.135.

148. Canada also objects that this reasoning brings "cross-subsidization" under Article 9.1(c) of the *Agreement on Agriculture*.¹³³ We have explained that the text of Article 9.1(c) applies to any "governmental action" which "finances" export "payments". The text does not exclude from the scope of the provision any particular governmental action, such as regulation of domestic markets, to the extent that this action may become an instrument for granting export subsidies. Nor does the text exclude any particular form of financing, such as "cross-subsidization". Moreover, the text focuses on the consequences of governmental action ("by virtue of which") and not the intent of government. Thus, the provision applies to governmental action that finances export payments, even if this result is not intended. As stated in our Report in the first Article 21.5 proceedings, this reading of Article 9.1(c) serves to preserve the legal "distinction between the domestic support and export subsidies disciplines of the *Agreement on Agriculture*".¹³⁴ Subsidies may be granted in both the domestic and export markets, provided that the disciplines imposed by the Agreement on the levels of subsidization are respected. If governmental action in support of the domestic market could be applied to subsidize export sales, without respecting the commitments Members made to limit the level of export subsidies, the value of these commitments would be undermined. Article 9.1(c) addresses this possibility by bringing, in some circumstances, governmental action in the domestic market within the scope of the "export subsidies" disciplines of Article 3.3.

149. In our view, the nexus between the Canadian governmental actions in regulating the domestic market and the financing of payments made on the sale of CEM is sufficient, on its own, for us to uphold the Panel's finding that these payments are financed "by virtue of" governmental action. However, we note that, besides these actions, the Panel also relied on other forms of governmental action in support of its conclusion on this issue.¹³⁵ The first of these was that *processors* are exempt from paying the higher domestic price for milk when they purchase CEM.¹³⁶ We do not believe that this action influences the "financing" of payments by the producer. Certainly, this action explains why the *processor* of CEM is not *required* to pay the higher domestic price for CEM. However, the mere fact that the processor is not obliged to buy CEM at the domestic price does not demonstrate a link between this exemption and the financing of payments by the *producer* on the sale of CEM. The exemption is, in short, not linked to the mechanism by which the producer funds the payments.

¹³³The Panel used this term to describe the fact that sales revenues from one market—the domestic market—finance a portion of the costs associated with sales made in another market—the CEM market. (Panel Report, paras. 5.127, 5.130, and 5.134)

¹³⁴Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 90.

¹³⁵Panel Report, para. 5.134.

¹³⁶*Ibid.*, paras. 5.115-5.116.

150. The second other form of governmental action relied on by the Panel was "the prohibition on the diversion of CEM back into the domestic regulated market".¹³⁷ We have already mentioned this factor in our analysis of governmental action.¹³⁸

151. The final governmental action relied on by the Panel was the requirement for producers to pre-commit to sell CEM. The Panel found that this requirement creates "an additional incentive" to sell a larger quantity of CEM than would be the case if producers could decide to sell to that market "ex post".¹³⁹ Although this may be the case, we also consider it possible that producers are able to make a reasonably accurate prediction of production levels, particularly as pre-commitment occurs on a 30-day basis.¹⁴⁰ Further, we think producers are just as likely to err on the side of caution to ensure that CEM sales do not prejudice their ability to exhaust their quota entitlement to sell milk at the higher domestic price. In the light of these doubts, we attach no weight to the pre-commitment requirement.

152. Before concluding, we wish to comment on Canada's arguments concerning the approximately 100 producers out of the 8,000 who sell CEM, and out of the total of 19,000 producers that do *not* participate in the domestic market at all and sell solely CEM.¹⁴¹ Canada argues that the Panel erred in finding that, for these producers, sales of CEM involve payments "financed by virtue of governmental action". We do not believe that it is necessary for us to make any findings regarding these 100 producers. The complaint made by New Zealand and the United States is that Canada has acted inconsistently with its export subsidy commitments under the *Agreement on Agriculture*. Canada may act inconsistently with these commitments, as we have found, even if some producers never make payments financed by virtue of governmental action.

153. We also wish to emphasize that we do not suggest that Canada's domestic supply management system is inconsistent with Canada's obligations under the covered agreements and, specifically, the *Agreement on Agriculture*. The consistency of Canada's domestic milk supply management system is *not* at issue in these proceedings. However, pursuant to Articles 3.3, 8, and 9.1(c) of the *Agreement on Agriculture*, Canada must ensure that it confines, to its export subsidy reduction commitment levels, any export "payments" which are "financed by virtue of" the governmental action Canada takes to regulate the domestic milk market.

¹³⁷Panel Report, paras. 5.117 and 5.134.

¹³⁸*Supra*, para. 144.

¹³⁹Panel Report, para. 5.130.

¹⁴⁰Canada's response to questioning at the oral hearing.

¹⁴¹See *supra*, footnote 124.

154. In conclusion, therefore, we uphold the Panel's finding, in paragraph 5.135 of the Panel Report, that the supply of CEM, by producers to processors, involves payments which are "financed by virtue of governmental action", within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

C. *Conclusion on Article 9.1(c) of the Agreement on Agriculture*

155. We have upheld the Panel's finding that the supply of CEM involves "payments" on the export of dairy products and also its finding that these payments are "financed by virtue of governmental action". Accordingly, we uphold the Panel's finding, in paragraph 5.136 of the Panel Report, that the supply of CEM involves export subsidies under Article 9.1(c) of the *Agreement on Agriculture*.

156. In consequence, we also uphold the Panel's conclusion, in paragraph 6.1 of the Panel Report, that, through the combination of the supply of CEM and the operation of Special Milk Class 5(d), Canada has acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*.

VII. Article 10.1 of the *Agreement on Agriculture*—"Export Subsidies"

157. Canada also appeals the Panel's alternative finding, in paragraph 5.165 of the Panel Report, that, if the CEM scheme does not involve export subsidies under Article 9.1(c) of the *Agreement on Agriculture*, it nevertheless constitutes export subsidies under Article 10.1 of that Agreement.¹⁴² In making this alternative finding, the Panel recalled that Article 10.1 of the *Agreement on Agriculture* is residual in character to Article 9.1 of the *Agreement on Agriculture* and that a measure cannot simultaneously be an export subsidy under both Article 9.1 and Article 10.1.¹⁴³ The Panel stated that its alternative finding under Article 10.1 of the *Agreement on Agriculture* would be relevant only if we were to reverse its finding that the CEM scheme falls within Article 9.1(c) of that Agreement.¹⁴⁴

158. As we have concluded that the CEM scheme involves export subsidies under Article 9.1(c) of the *Agreement on Agriculture*, those subsidies cannot, by definition, simultaneously be export subsidies under Article 10.1. Therefore, the condition on which the Panel premised its alternative finding under Article 10.1 of the *Agreement on Agriculture* does not arise. In these circumstances,

¹⁴²See also Panel Report, paras. 5.174 and 6.1.

¹⁴³See *ibid.*, para. 5.140, referring to Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 121.

¹⁴⁴See *ibid.*, paras. 5.141 and 5.174.

both the Panel's reasoning and its finding under Article 10.1 of the *Agreement on Agriculture* are moot and of no legal effect. There is, therefore, no reason for us to rule upon Canada's appeal of the Panel's finding under Article 10.1, nor to make any finding under this provision.

VIII. Findings and Conclusions

159. For the reasons set out in this Report, the Appellate Body:

- (a) reverses the Panel's interpretation of Article 10.3 of the *Agreement on Agriculture* in paragraph 5.19 of the Panel Report, according to which a complaining Member would be required to make out a *prima facie* case in support of all aspects of its claims under Articles 3.3, 8, 9.1(c), and 10.1 of the *Agreement on Agriculture*, but holds that this error did not vitiate the Panel's findings under Articles 3.3, 8, 9.1(c), and 10.1 of that Agreement;
- (b) upholds the Panel's finding, in paragraphs 5.89 and 5.135 of the Panel Report, that Canada, through the combination of the supply of CEM and the operation of Special Milk Class 5(d), has acted inconsistently with its obligations under Article 3.3 and Article 8 of the *Agreement on Agriculture* by providing export subsidies listed in Article 9.1(c) of that Agreement in excess of the quantity commitment levels specified in Canada's Schedule; and
- (c) declines to rule on the Panel's alternative finding under Article 10.1 of the *Agreement on Agriculture* in paragraph 5.165 of the Panel Report, as, in the light of the Appellate Body's finding in subparagraph (b) above, that alternative finding is moot and of no legal effect.

160. The Appellate Body recommends that the DSB request that Canada bring its measures found in this Report, and in the Panel Report as modified by this Report, to be inconsistent with its obligations under the *Agreement on Agriculture*, into conformity with that Agreement.

Signed in the original at Geneva this 5th day of December 2002 by:

Luiz Olavo Baptista
Presiding Member

Giorgio Sacerdoti
Member

Yasuhei Taniguchi
Member